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Managers Rush Market with Cheaper Alts Funds for Advisors

By Tom Stabile September 13, 2017

The bustling marketplace for non-traded alts funds – upended with shifting regulations, sales patterns, more entrants, and a product development surge – is tilting its center of gravity toward a new model. Interval funds are all the rage in product building efforts by both traditional and alts managers, especially around investments typically not available to financial advisors, but no one has yet carved out an edge.

As the markets for non-traded real estate investment trust (REIT) and business development company (BDC) strategies have undergone massive changes, mostly due to regulatory pressure on longstanding sales models, managers have been plowing into the market with non-listed closed-end alts funds. But the balance in that segment is moving from costlier "tender offer" strategies, which aim for wealthier investors and often charge performance fees, to interval funds that are designed to be cheaper and target a wider audience, according to a new study from UMB Fund Services and FUSE Research Network.

Tender offer funds got more of the early traction, with some large strategies around for more than a decade, and they hold nearly 62% of the $41.7 billion in closed-end fund market assets, while making up more than two-thirds of the 109 registered products in the segment. But interval funds now dominate products in registration, with 25 filed to launch, compared to 12 tender offer products, the report states.

"It's a clear trend of product development in interval funds," says Tony Fischer, president at UMB Fund Services, whose firm administers such products and has seen a swarm of interest from clients in the past year.

Many factors are driving these changes, but a clear strategic aim appears to be the great pressure on fees that is encouraging managers to develop wider product sets – especially with eclectic strategies that have more return potential and can justify higher charges, Fischer says.

"Everyone is feeling the same price compression, the pressure to reduce fees, from passive management," he says.

That is driving many firms – from institutional alts managers to mutual fund powerhouses – into the interval fund market, says Kimberly Flynn, managing director at XA Investments, which has built a private credit closed-end fund subadvised by Octagon Credit Investors, a $16 billion hedge fund.

“They’re looking for ways to continue raising money in active management where the margins are still attractive,” says Flynn, whose firm instead crafted its product as a tender-offer strategy that will become a traded vehicle.

Interval funds are a big topic in discussions between administrators and their manager clients, in many cases as part of efforts to identify growth opportunities, says Cesar Estrada, head of private equity fund services at State Street.

“This is the beginning of a big trend,” he says. “Clients are trying ways to expand the distribution channel for individual investors.”

Big names are sprinkled across the field, including PIMCO, which recently introduced a multi-sector credit interval fund, its first; Highland Capital Management, which has a real estate interval product and another credit fund in the works; and Ares Management, which launched a credit interval vehicle with **CION Investments**.

PIMCO sees the appetite for this market from investors who are trying to replace today’s low yields from fixed income and crowded traditional asset classes, says Jason Mandinach, executive v.p. and product manager.

For all the activity, however, there are no runaway winners in the interval market, Estrada says. “I don’t think the blueprint for success has been clearly identified yet,” he says. “Some are succeeding and some are not.”

And some managers are just ahead of themselves, Flynn says. “Not many of them have the first clue about product structure or about marketing,” she says.

The closed-end fund market’s leaderboard does have several big interval vehicles that have been around and gained traction, including two from Stone Ridge Asset Management – a $4.3 billion insurance-linked catastrophe bond strategy and a $2 billion marketplace loan fund, according to the UMB-FUSE report. The overall non-traded closed-end leader in assets is SkyBridge Capital’s hedge fund of funds tender offer strategy, which has $5.4 billion, and the five largest funds have 40% of the market’s total assets, according to the report.

But interval funds such as Stone Ridge’s largely aimed at wealthier investors or institutions, while the newer focus is a wider audience, largely avoiding higher fees and investment minimums, the report states. And the newer set goes beyond real estate, hedge fund, or private equity fund of funds models, ranging farther into direct loans, non-traditional securities, risk transfer, catastrophe bonds, and other eclectic areas not typically available to advisors, the report states.

“We’re seeing more of the unique strategies,” Fischer says. “And yes, that’s where the advisor demand is – looking at the return profile of a manager with great expertise in reinsurance, for instance.”

That could shift the balance of closed-end fund assets, which today has a broader flavor, with the largest single pocket of $15.4 billion in multi-alternative strategies, according to FUSE data.

Not everyone sees interval funds becoming the first choice of advisors aiming to bring alts to more of their investors. Interval funds are designed largely to remain as non-traded entities, requiring repurchase policies to allow investors to find liquidity, while tender offer funds can more easily change their registration to become a traded fund and provide investors with an exit, Flynn says.

And other non-traded product sets are not dead yet. Blackstone Group has breathed new life into the REIT market after strong sales from a product it launched last year that recast the classic model with a version more appealing to wirehouse advisors.

There also is new activity on the BDC front as well, with firms such as Flat Rock Global in the market with an unconventional non-commission structure that avoids the high fees long associated with non-traded products. Flat Rock last month announced a partnership with Legg Mason’s Western Asset Management, which is taking a 20% stake in the shop and is expected to help on investment, distribution, and other aspects of the new BDC that is targeting $1.5 billion, says Robert Grunewald, CEO at Flat Rock.

Similarly, Apollo Global Management agreed last month to switch from being a subadvisor for a CION Investments-sponsored BDC to becoming a full joint venture partner. That’s just one sign that big alts managers are making bolder moves to grow in the non-traded market, says CION Co-CEO **Michael Reisner**.

But even Flat Rock is looking at a credit interval fund down the line, maybe early next year, Grunewald says. “There are tremendous opportunities to create quality alternative products,” he says.