Interval funds – definition and operations

An investment manager's guide to interval fund operations, market opportunity and best practices

Interval funds explained

Interval funds offer investors a unique opportunity to enter into the alternative investment market through a registered product. A closed-end interval fund is an investment company that is registered with the Securities and Exchange Commission (SEC) under the Investment Company Act of 1940 (1940 Act). Much like a typical mutual fund, investor assets are pooled into an investment portfolio and managed by an investment management firm. What sets interval funds apart from other closed-end funds is that they offer periodic liquidity to investors and are not commonly traded on a secondary market exchange. Interval funds can be offered to the general public or through a private offering to accredited investors.

Common features of closed-end interval funds include:

Subscriptions – Interval funds continuously offer shares to investors at the fund's next determined net asset value (NAV), rather than solely through an initial public offering process. Although an interval fund is a continuous offering of shares similar to open-end funds, interval fund subscription dates are generally periodic, such as monthly, rather than daily.

Redemptions – Unlike open-end or exchange-traded closed-end funds which can be redeemed or sold daily, interval funds offer the option to periodically repurchase shares on specified repurchase dates. These tender offers generally occur quarterly, semi-annually or annually, any time of the year.

Although the interval fund's prospectus and Statement of Additional Information (SAI) will define the specific subscription and redemption terms, interval funds commonly offer monthly subscriptions and quarterly tender offers.

Investor and manager advantages

An interval fund provides certain advantages to both the investor and the investment manager, depending upon their respective objectives. Subsequent to the global financial crisis, investors have sought investment allocations and asset strategies that provide attractive investment returns as well as lower or no correlation to equity markets, thus increasing their investment diversification.

"Interval funds have gained in popularity due to investor appetite for nontraditional assets within the transparency and regulatory structure of an SEC- registered mutual fund. The regular financial reporting, compliance structure, governance, net asset value calculation regimen and portfolio transparency each serves to appeal to the interval fund investor.

Investment managers, including those who manage hedge funds and private equity funds, may want to assess the interval fund structure—either publicly or privately offered—as a means of expanding their asset management business and investor reach."

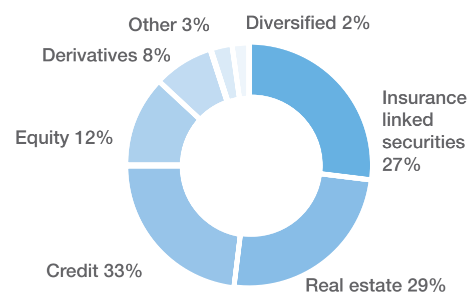
Bob Kern
Executive Vice President
U.S. Bancorp Fund Services

Investor advantages

- Regulatory oversight – interval fund investors benefit from regulatory safeguards, governance and transparency of a SEC-registered fund.
- Portfolio investments – interval fund portfolios can provide investors with exposure to nontraditional portfolio investments and less liquid assets such as high-yield credit, distressed credit, real estate credit, convertibles, etc.
- Valuation – interval fund shares are typically valued at NAV upon redemption, rather than traded on a secondary market where shares may trade at a discount to NAV.
- Periodic liquidity – interval fund investors have the option to periodically redeem shares pursuant to the fund's repurchase guidelines.

Interval Fund Assets by strategy

(December, 2017)



Source - IntervalFundTracker

Investment manager advantages

- Continuous offering – allows the interval fund manager to add investors and assets to a single fund without limiting the number of investors.
- Portfolio investments – the investment manager can allocate interval fund portfolio investments across many different asset classes, some of which may be less liquid than required for other investment funds.
- Private placement – a manager may elect not to file the interval fund under the Securities Act of 1933 (1933 Act) if the shares are intended to be offered exclusively to accredited investors. In this situation, the manager may elect to charge the fund a performance fee.
- Portfolio stability – the infrequent periodic subscription and redemption process eliminates potential volatile daily cash flows that may be common to open-end mutual funds.

Interval fund regulatory requirements

Interval funds are registered under the 1940 Act and the 1933 Act if the fund is intended to be offered to the public. Although an interval fund may include nontraditional portfolio investments, SEC registration requires that the fund regularly adhere to several different compliance requirements, including tests such as portfolio diversification, concentration, liquidity, leverage, etc. The fund administrator will test and report the fund and the investment manager's compliance with each relevant requirement.

- Registration – interval funds are required to register with the SEC and update the registration annually. Interval funds may offer multiple share classes or senior securities pursuant to SEC exemptive relief.
- Fund governance – similar to all mutual funds, interval funds are required to have a board of trustees that oversee all operations of the fund, including fund policies, procedures, compliance and approval of all service providers, including the fund's investment manager, administrator, valuation agent, transfer agent and custodian. The fund's chief compliance officer provides required reporting to the board as to the reasonableness and effectiveness of the fund's compliance program to meet all requirements.
- Portfolio holdings, leverage, compliance – interval funds must maintain compliance with the 1940 Act. Examples include investment and trading requirements, financial reporting, affiliated transactions restrictions, investment company limitations, code of ethics, liquidity guidelines, trust insurance and leverage restriction requiring 300 percent asset coverage, including leverage.
- Valuation – interval funds, similar to other closed-end funds, are required to calculate a share NAV at least weekly, as well as the five business days preceding a repurchase request deadline.
- Financial reporting and regulatory filings – interval funds are required to provide shareholders with annual, semiannual and quarterly financial reporting. Sample SEC interval fund filings include:

Interval Fund – Sample SEC Filings			
Form	Frequency/Purpose	Form	Frequency/Purpose
Form N-SAR	Semiannually – Fund financial data reporting	Form N-2	As needed – Registration statement
Form N-CSR	Semiannually – Certified shareholder report	Form N-PX	Annually – Fund proxy voting record
Form N-Q	1st and 3rd financial quarters – Quarterly holdings report	Tender Offers	Quarterly, or as offered – Tender offer statement

Periodic repurchase offer process

An interval fund is required to offer shareholders the option to periodically tender their fund shares pursuant to Rule 23c-3 under the 1940 Act. This rule requires that the fund offer to repurchase between 5 percent and 25 percent of the fund's outstanding shares at each redemption period, from all investors at a predetermined date for NAV.

- The interval fund repurchase process is a fundamental policy determined and approved by the fund board at the launch of the fund, and may be changed only by shareholder vote.
- The fund's annual report, prospectus and SAI disclose the repurchase offer frequency and terms.
- The fund must send a repurchase offer to shareholders indicating the due date for a repurchase request, the percentage of outstanding shares offered for repurchase, the date at which the fund's NAV will be used for repurchase, procedures by which shareholders may redeem shares, the anticipated payment date and additional repurchase information.
- The fund may impose a repurchase fee of up to 2 percent of investor proceeds to compensate the fund for repurchase expenses.
- If the repurchase is oversubscribed, the fund material will describe the pro rata process by which shares will be repurchased for each shareholder requesting repurchase.
- The investment manager must make available sufficiently liquid portfolio assets in the amount of the repurchase offer from the time of shareholder notice until the repurchase payment deadline.

Conclusion

Interval funds provide unique advantages to investment managers through the opportunity to offer a mutual fund product to meet the needs of their investors. Although interval funds do not offer daily investor liquidity or daily share valuation, interval fund investments can provide investors with access to nontraditional asset classes such as real estate debt, derivatives and insurance-linked securities. Consequently, interval funds are a growing example of the convergence of the alternative investment market with the registered mutual fund industry.

Reference Materials – Investment Company Act of 1940, Securities Act of 1933, SEC Forms N-SAR, N-CSR, N-Q, N-2, N-PX, Tender Offer Statement

"Interval funds provide a pooled investment for both traditional and alternative asset managers to serve their investors."

About the author

Bob Kern serves as managing director and executive vice president of U.S. Bancorp Fund Services LLC. He began his career with U.S. Bancorp Fund Services in 1982 and has served as an operations manager since 1984. In his current role, Bob manages all global business development efforts including mutual fund, exchange-traded fund and alternative investment products in the U.S. and Europe. Bob played a leadership role in building U.S. Bancorp Fund Services into a leading global asset servicing business to support funds of all types—open-end, closed-end, interval, BDC, CIT, hedge funds, private equity, fund of funds, exchange-traded products and UCITS

Education and credentials

Bob received his undergraduate degree from Marquette University in business administration with specializations in finance and marketing. Bob serves as a board member of U.S. Bancorp Fund Services, and interested trustee and chair of Managed Portfolio Series, an open-end mutual fund series trust

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About us

For more than 45 years, U.S. Bancorp Fund Services has leveraged specialized experience across our organization to provide seamless service solutions for our clients regardless of the complexity and depth of their products. With client relationships lasting since our inception, we know the foundation for strong relationships is built on open communication, trust, and accountability. Our managers and professionals will deliver the amount of support, guidance, and insight into the market our clients need to be successful.

Headquartered in Milwaukee since 1969, U.S. Bancorp Fund Services currently provides services to more than 580 alternative, ETF and mutual fund clients with 3,268 portfolios and aggregate assets of $1.125 trillion as of March 31, 2018. Our clients include mutual funds, investment partnerships, hedge funds, separately managed accounts, fund-of-funds, and offshore funds. It is a subsidiary of U.S. Bank, N.A., the fifth largest commercial bank in the United States with assets of $462 billion, noted in the fourth quarter 2017 corporate profile.

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