Interval Funds

Some closed-end mutual funds, known as interval funds, provide a daily net asset value (NAV) and can be purchased on a daily basis in continuous offerings at a price based on the fund's NAV. However, unlike traditional closed-end funds, interval fund shares do not trade on an exchange or other secondary market. Rather, the funds periodically repurchase shares tendered directly from investors at pre-set intervals, such as quarterly. Most funds limit these periodic repurchase offers from a minimum of 5% to a maximum of 25% of the fund's outstanding shares, and if the total amount of shares tendered exceeds this limit for any particular interval, the fund will typically repurchase shares on a pro rata basis. Typically, repurchase offers of more than 5% are subject to the discretion of the fund's board or investment adviser.

Interval funds are considered to be illiquid because their shares cannot be sold through an exchange or otherwise in a secondary trading market and investors instead must tender their shares of the fund for repurchase at certain intervals. Interval funds are required to offer to repurchase shares at set periods or intervals at the fund's NAV on a specified date. Although investors are not required to tender their shares for repurchase, it is important to note that investors may only sell their shares during these periodic repurchase offers and do not have any other sale or redemption opportunities. Also, investors interested in selling shares back to the fund in response to a repurchase offer must be mindful of the applicable deadline to notify the fund that they wish to sell shares. The actual repurchases are usually made days later at the end of the fund's specified tender period, all on the same day at the same NAV. Interval funds typically post the fund's repurchase schedule on the fund's public website. Investors should refer to the fund's website for the most up-to-date schedule of the fund's upcoming tender offers.

While interval funds are classified as closed-end funds, they possess hybrid characteristics of both closed-end funds and traditional open-end mutual funds (See Mutual Fund Disclosure at https://www.stifel.com/disclosures/mutual-funds/mutual-funds-disclosure). There is no limit to the amount of illiquid investments interval funds can hold, which can also allow them to purchase complex or alternative investments, such as private equity funds, hedge funds, investments in non-public companies, restricted securities, loans, real estate, and other potentially high-yield investments.

Interval funds are intended to allow less sophisticated or lower-net-worth investors access to investment types that are typically limited only to hedge funds and other institutional investors, but these investment types carry special or elevated risks from more traditional investments. It is important to read and understand the investment strategies and underlying investments made by an interval fund.

Interval funds may offer high distribution rates, but such distribution rates are not necessarily the same as total return because some or all of the distributions may be Returns of Capital and not dividends, interest income, or capital appreciation.

Interval funds are usually permitted to deduct a redemption fee from the repurchase amount for any redemption made within a limited period of time after purchasing the fund, generally not to exceed 2% of the redemption amount. An interval fund may also charge other fees such as a management fee, service fee, annual fee, additional front-end sales charges, and broker commissions. Interval funds tend to have higher ongoing annual expenses than other closed-end funds or mutual funds.

Although interval funds can provide greater access to otherwise inaccessible investment options, these funds also carry their own risks, including limited liquidity, and usually have a distinctive fee structure. FINRA has issued an investor alert addressing considerations and risks of interval funds (available at www.finra.org/investors/insights/interval-funds).

More on Interval Funds

What is the potential upside of investing in an interval fund?

The main unique characteristic of the interval fund structure is that, unlike more traditional mutual funds, an interval fund can invest in illiquid assets. Traditional mutual funds generally are not permitted to invest more than 15% of their assets into illiquid investments like private real estate, private equity, hedge funds, or other alternative asset classes. This typical limit does not apply to interval funds; therefore, these more typically inaccessible investment types are made more accessible to a broader range of investors via interval funds. There is the potential for these illiquid investments to perform in a manner uncorrelated to traditional asset classes like stocks or bonds, which may make interval funds useful tools in diversifying an otherwise more traditional portfolio.

What specific risks should I know about investing in an interval fund?

1. Limited Redemptions

Unlike traditional closed-end and open-end mutual funds, interval funds cannot be sold whenever an investor wants out. Instead, the interval fund will make a certain amount of its assets (by regulation, between 5% and 25% – typically 5%) available for redemption on a certain regular schedule (often once per quarter, but monthly, semi-annual, or annual schedules are also possible). The period of time between these withdrawal windows is the “interval” in the name of the fund structure.

It is important to note that the fund will only accept requests for redemptions during a particular window within the quarter, which may be a few weeks long, or it may be shorter. It is possible that investors may have as little as one specific day each quarter to submit a redemption request. If investors do not tender their shares for redemption during the fund’s redemption window, they will have to wait for the next redemption window to have any opportunity to redeem their shares. If redemption requests exceed the limit set by the fund, the fund will honor redemption requests on a pro rata basis, meaning investors may not be able to redeem their full redemption request.

For example, say that there is an interval fund that opens its redemption window once per quarter and makes up to 5% of the fund assets available for redemption. If the fund has $100 million in assets, at the next redemption window up to $5 million in total can be withdrawn from the fund. If an investor has $100,000 in the fund and wants to take 100% of that money out, the investor may receive the entire amount if other investors do not submit redemption requests that exceed the fund’s repurchase limit. But if redemption requests exceed the limit and 25% of the assets in the fund ($25 million) are requested to be withdrawn in that same quarter, then the fund will only allow $5 million to be redeemed. This means that investors who requested withdrawals will only receive back a fraction of the amount tendered for redemption – 20% in this example. So, the investor who tendered their entire $100,000 stake will only receive $20,000 for that redemption period.

2. Complexity

Compared to traditional mutual funds, interval funds are often more complex. Part of the complexity comes from the fund's structure, which only allows for limited redemption windows and limited redemption amounts. But the actual underlying assets that interval funds own can also be complex. A draw of interval funds is to give investors access to illiquid investments like private real estate, private equity, and hedge funds. While these investments might have attractive risk or return features, they tend to be more complex than stocks and bonds that many investors invest in via traditional investments. Instead of having prices set throughout the market day like a stock or a bond might, illiquid assets can be difficult to value properly. Because of their illiquidity, the underlying investments are also inherently hard to turn into cash if the fund manager wishes to sell them. This level of complexity is not appropriate for every investor.

3. High Costs

Because they are actively managed and usually entail complexity in selecting, investing in, and managing underlying illiquid securities, interval funds tend to be much more expensive than other mutual funds and exchange traded funds (ETFs). The largest portion of most funds' expenses is the management fee, which is what the investment adviser that oversees and manages the assets of the fund charges investors in order to pay the expenses of the fund (salaries, office space, software, travel, etc.). Due to the increased expenses involved in properly valuing and investing in illiquid securities, interval funds typically charge investors higher fees than more traditional funds.