



HOULIHAN LOKEY



Interval Funds: On the Rise Again

Alternative investment managers are continuously looking for new ideas and strategies to meet investors' insatiable appetite for returns. In an era where fashion trends from decades ago are once again in vogue, there has likewise been a resurgence of interest in interval funds as an investment vehicle. The interval fund structure allows fund managers seeking higher returns and diversification to invest in a larger universe of assets with less liquid strategies as compared to open-end mutual funds or traditional exchange-traded, closed-end funds.

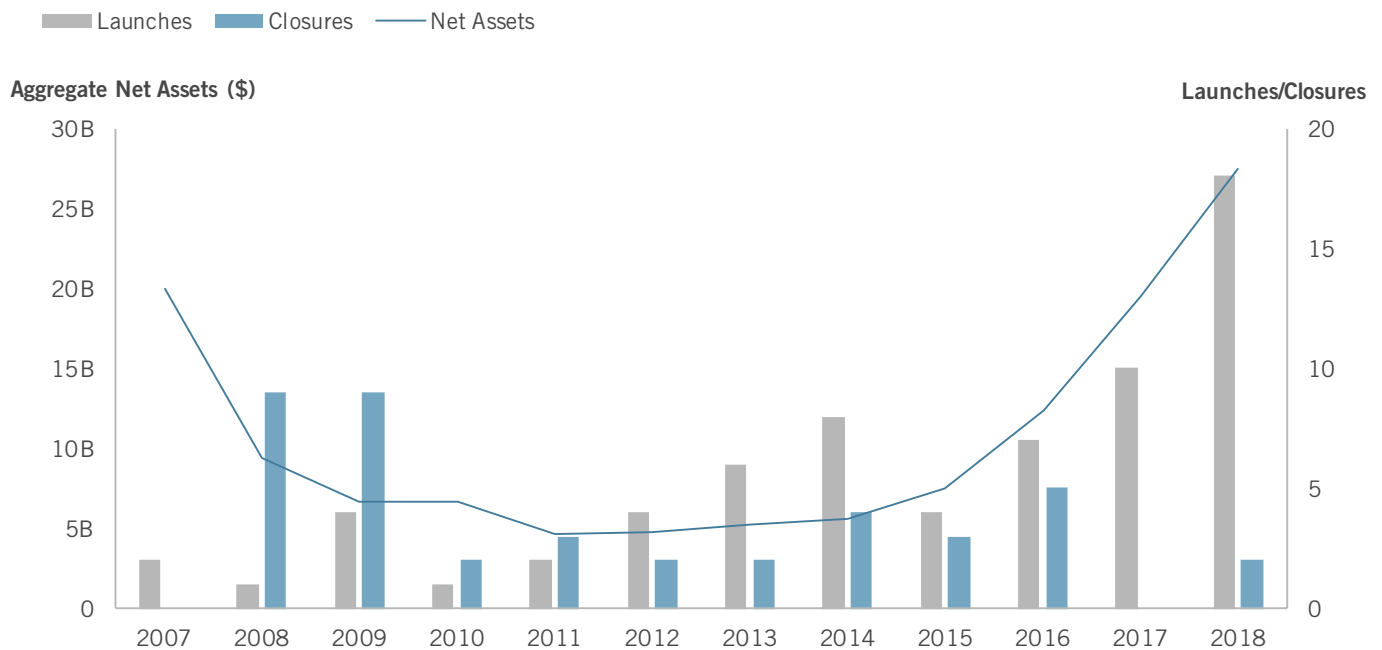
Interval funds were first introduced in 1993. Like mutual funds, they are registered under the Investment Company Act of 1940 and therefore provide certain investor protections. Basic characteristics of interval funds include the following:

- i. Interval funds tend to invest in higher-yielding, income-producing assets and strategies and offer investors periodic distributions in the form of income, capital gains, return of capital, or a combination thereof.
- ii. Interval fund shares are typically not listed on an exchange, and there is generally no secondary market. However, there are periodic repurchases at NAV that differ from closed-end funds, which may trade at premiums or discounts to NAV.
- iii. Interval funds provide liquidity to investors by conducting share repurchase offers every three, six, or 12 months, with some funds conducting monthly repurchase offers.
- iv. Repurchase offers are required to be between 5% and 25% of the fund's outstanding shares.
- v. Interval funds are generally required to compute NAV at least weekly, with daily NAV determination during the five business days preceding a share repurchase request deadline.

Interest in interval funds has increased in recent years as portfolio managers, particularly those seeking income, look for strategies that provide higher yields. According to the Investment Company Institute (ICI), fund managers' interest in offering interval funds increased after the Securities and Exchange Commission (SEC) issued its October 2016 release regarding the liquidity risk management program rule. This rule alleviated some potential regulatory concerns pertaining to the liquidity of these funds. Nearly 40% of active¹ interval funds were launched after the October 2016 SEC release.

As shown in the chart below, the net assets invested in interval funds increased to \$27.5 billion at the end of 2018 (from less than \$7.5 billion at the end of 2015), indicating a compound annual growth rate of over 50%. There were 61 active interval funds as of June 30, 2019, which compares to 23 active funds at the end of the first quarter of 2015.

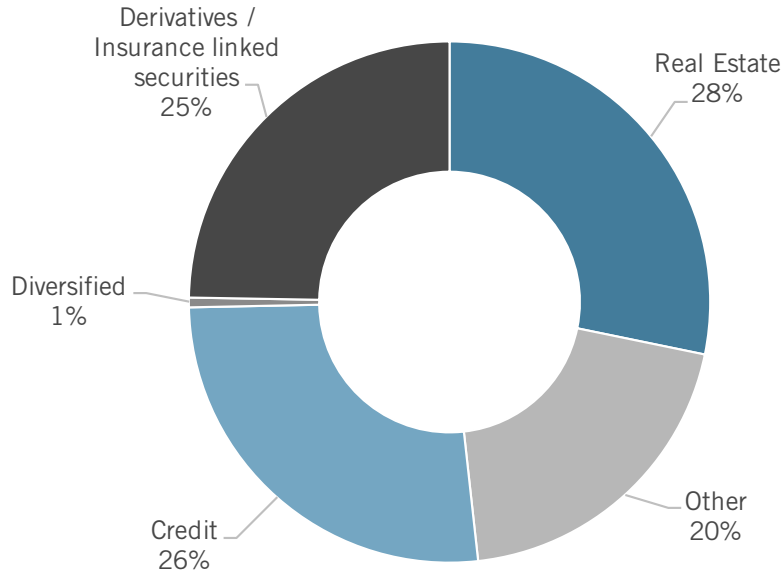
Interval Funds: 2007–2018²



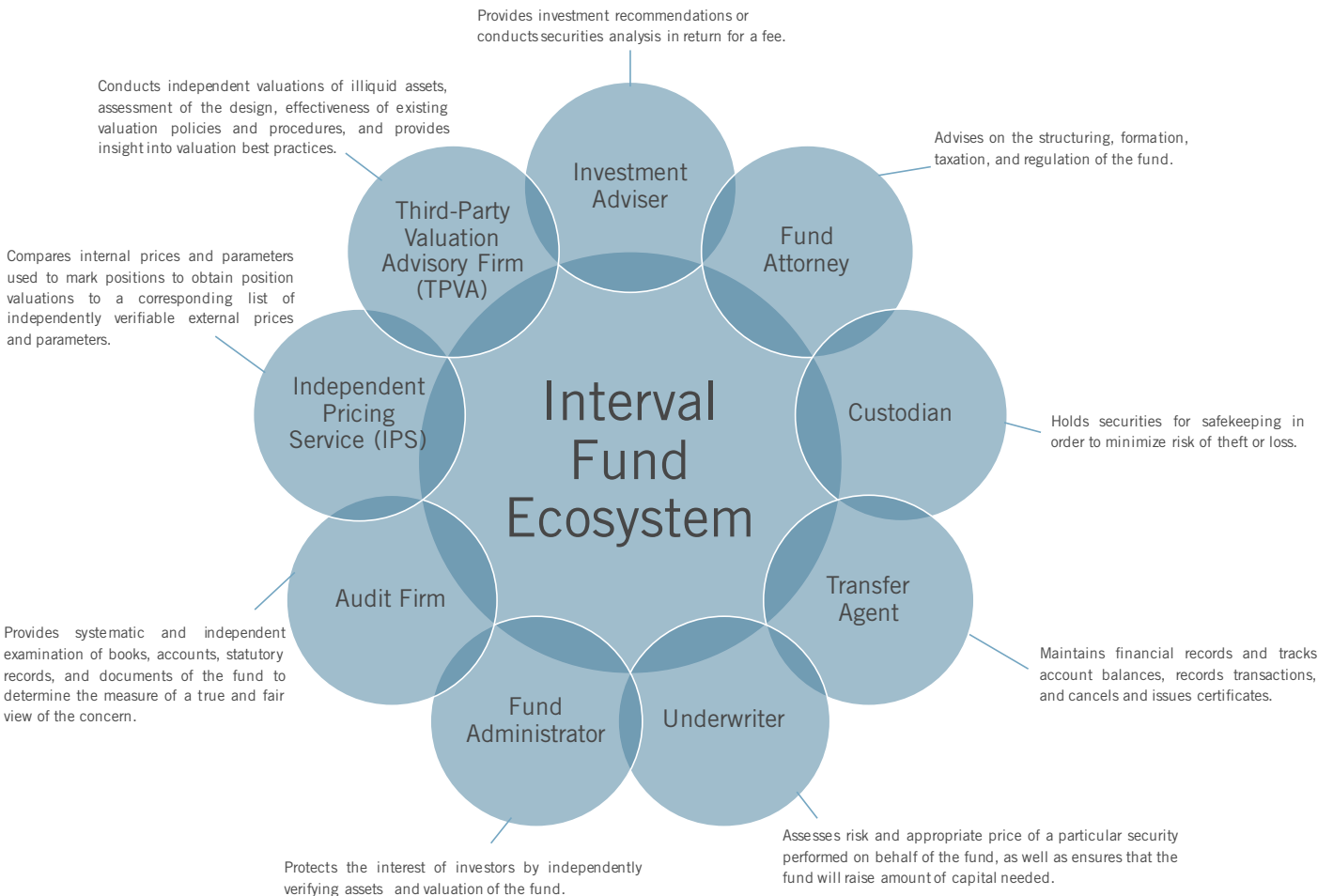
Interval funds can invest in more illiquid assets than mutual funds. This opens up a menu of asset classes that were previously unavailable to certain investors. Typical assets of interval funds tend to be credit-oriented and include directly originated loans, corporate bonds, asset-backed securities, commercial real estate loans, government and municipal obligations, convertible and preferred securities, derivatives, insurance-linked securities, and others. The chart below provides more detail on the variety of assets held by active interval funds.

Source:
 1. Active interval funds are those that have been declared effective by the SEC, launched fundraising, and currently have assets under management.
 2. Interval Fund Tracker

Net Asset Breakdown³



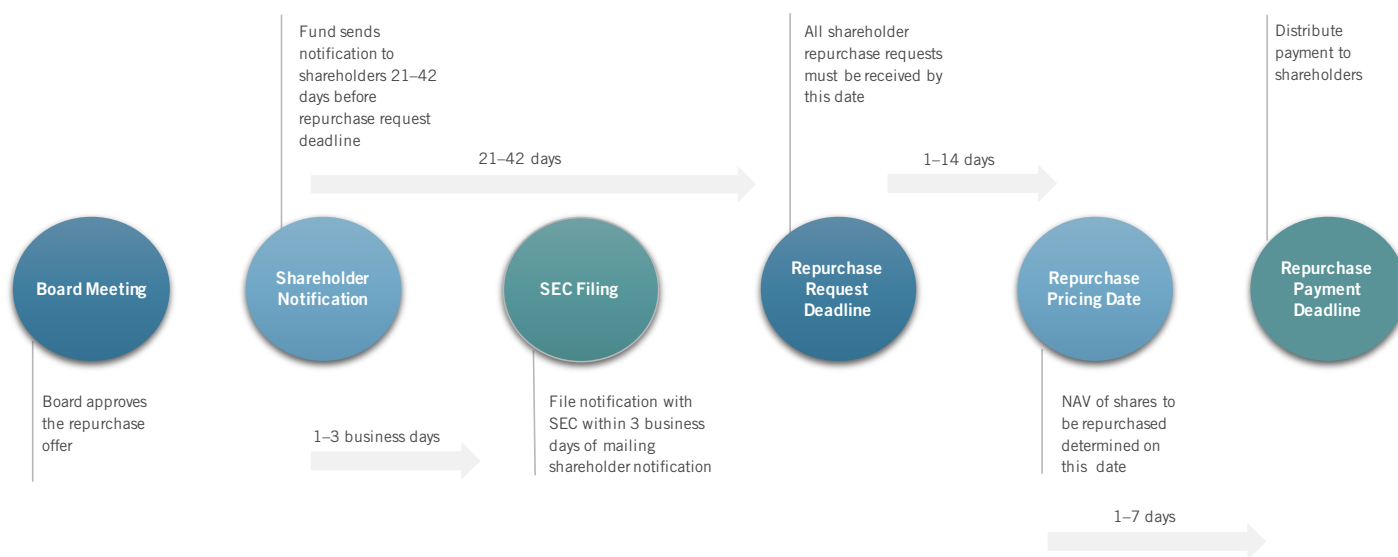
As with a typical alternative asset manager, an ecosystem of third-party service providers is required to support the operations of interval funds. Such service providers include an investment adviser, a distributor/underwriter, fund administrator, transfer agent, custodian, fund attorney, audit firm, independent pricing service (IPS), and a third-party valuation advisory firm (TPVA).



Source:
3. Interval Fund Tracker

Distribution timing issues, and other factors that complicate order processing, impact the continued growth and market acceptance of interval funds since share repurchases are done periodically, not daily. Unlike an open-end mutual fund (when an investor submits a share repurchase request), the transaction is not processed at the end of that day. Instead, the repurchase order is typically held until the designated transaction date for the repurchases, which may be days, weeks, or even months after submission by the investor. We understand that the ICI has established a working group to provide guidance on improving the operational cohesiveness and efficiency of trade processing for interval funds.

Share Repurchase Timeline



Depending on the interval fund's investment objectives, the portfolio is likely to consist of securities across the spectrum of the financial reporting fair value hierarchy (i.e., Levels 1, 2, and 3). Interval funds are required to carry portfolio investments at market value. If no readily available market value exists, investments must be carried at fair value. To determine NAV, an interval fund may use an IPS to obtain market values for publicly traded securities.

For interval funds with credit strategies (broadly defined), real estate investments, asset-backed securities, and investments in private companies, a large percentage of the fund's investments are likely not publicly traded (i.e., Level 2 and Level 3 securities). While an IPS may be able to handle Level 2 securities, they typically are not well equipped to provide reliable indications of fair value for Level 3 securities. In the event of a market disruption or other significant event, the valuations provided by an IPS may be deemed unreliable, and in such situations, a TPVA could be used to determine the fair value of the securities.

Given the complexities surrounding the determination of fair value of Level 3 securities typically held by interval funds, the fund should utilize a TPVA to assist with the portfolio valuation process. The valuation methodology employed depends on the type of asset, but it would likely include the market approach, income approach, and possibly an asset-based approach. An important consideration when selecting a TPVA is whether it has asset-specific experience consistent with the asset classes, in which the interval fund invests, and their ability to meet

rigorous timelines required to report the fund's NAV.

Houlihan Lokey has experience valuing a broad range of complex investments across various industries and asset classes, and has been recognized as a leading TPVA to alternative asset managers, including interval funds. In the Appendix, we summarize certain key considerations for setting up an interval fund. Houlihan Lokey's investment banking platform provides unique attributes and real-world market insights that inform our valuations. As a result, we can be a valuable partner to interval funds with hard-to-value illiquid assets.

Appendix: Key Considerations When Setting Up an Interval Fund

Item	Considerations
Infrastructure	<ul style="list-style-type: none">▪ The fund manager should carefully design infrastructure that can support—among other things—the ability to strike a daily NAV, changes in investor communications and reporting, and issuance of redemption notices, as applicable.
Governance	<ul style="list-style-type: none">▪ The fund must establish a compliance program and form a board of directors, which meets at least quarterly. The chief compliance officer should periodically revisit the manager's policies and procedures.
Liquidity	<ul style="list-style-type: none">▪ The fund manager should determine liquidity levels and intervals as well as limitations on leverage.
Differentiation	<ul style="list-style-type: none">▪ The fund manager needs to decide how to price the interval fund product and/or differentiate the product. If managers plan on using their track record from their private funds to market an interval fund, it may be beneficial to keep pricing consistent across products.
NAV Determination	<ul style="list-style-type: none">▪ The fund needs to determine the frequency of NAV computation (e.g., daily, monthly, or redemption interval focused). This choice potentially impacts whether registered investment advisors (RIAs) can include the interval fund in their client offerings.
Collaboration	<ul style="list-style-type: none">▪ The fund manager may need to invest time and resources in educating the various RIA channels on the benefits of an interval fund in creating a diversified portfolio. It may also be beneficial to obtain RIA commitments for seed funding (via fee breaks or other incentives), to ensure alignment of interests and receive better receptivity from custodial platforms.

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Houlihan Lokey's Portfolio Valuation & Fund Advisory Services practice is a leading advisor to many of the world's largest asset managers who rely on our (i) strong reputation with regulators, auditors, and investors; (ii) private company, structured product, and derivative valuation experience; and (iii) independent voice. We have valued illiquid assets on behalf of hundreds of hedge funds, private equity firms, financial institutions, corporations, and investors. We rapidly mobilize the right team for the job, drawing on our expertise in a wide variety of asset classes and industries along with our real-world transaction experience and market knowledge from our dedicated global Financial Advisory Services business.

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Fund Manager Valuation

Securitization and Regulatory Compliance

Fund Recapitalization and Transaction Opinions

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HOULIHAN LOKEY

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