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XA's Flynn Talks Alternative Investments In New, Different Packaging

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Chuck Jaffe, in The NAVigator podcast, interviewed Kimberly Flynn, managing director of alternative investments at XA Investments. Read the Q&A below as Chuck and Kimberly talk about the new and different ways alternatives are being packaged in closed-end funds and how investors and fund companies deal with discounts and new structures in order to invest in assets that otherwise wouldn't be available to individuals. Kimberly also discusses auction funds and hybrid funds, new ways to put alternatives and real estate into portfolios that are just being brought to market now, but which have big potential for the future.

Kimberly Flynn

CHUCK JAFFE: Kimberly Flynn, managing director of alternative investments for XA Investments is here, and we're talking about new and different ways you can put interesting and different assets into your portfolio now on The NAVigator. Welcome to The NAVigator, where we talk about all-weather active investing and plotting a course to financial success with the help of closed-end funds. The NAVigator's brought to you by the Active Investment Company Alliance, a unique industry organization that represents all facets of the closed-end fund industry, from users and investors to fund sponsors and creators. If you're looking for excellence beyond indexing, The NAVigator's going to point you in the right direction. And today the direction we're pointing, it's an alternative direction. My guest is Kimberly Flynn, managing director of alternative investments at XAInvestments. If you are not familiar with the firm, go to XAinvestments.com, and as long as you're doing that, you can find them on Twitter @XAinvestments. If you're looking to learn more about closed-end fund investing, check out AICAlliance.org, the website for the Active Investment Company Alliance. Kimberly Flynn, thank you for joining me again on The NAVigator.

KIMBERLY FLYNN: Thank you, Chuck. Happy to be back.

CHUCK JAFFE: The alternative space is always interesting to me because we're getting alternatives to alternatives at this point. It's how much can the industry develop and how can they use other things? And that's particularly true in the closed-end fund space because we've seen things like non-traded REITs or interval funds, new entries gaining ground. How exciting is this to be able to say, "Hey, I can almost look at anything that couldn't be offered in a consumer friendly package before, and now there's a way to package it"?

KIMBERLY FLYNN: That's right, Chuck. Individual investors have really been limited in the past in terms of getting access to truly institutional alternatives. And part of it has to do with the liquidity of those, and to fit in a mutual fund, which is not terrific. So some of these other structures that you mentioned like the REITs, BDCs, closed-end funds are a much better fit for things like direct real estate, middle market loans, and CLO investments, all sorts of different types of credit that are left liquid and frankly don't fit in a mutual fund and you can't find them in a mutual fund. And so today individual investors have much more choice, many more options, and this is really important for individual investors saving for retirement. They need these alternative investments the way institutions have long used them.

CHUCK JAFFE: They're getting options about them because the SEC has been pretty flexible, pretty liberal in terms of saying, "Hey, try this," or "Check that out". Is that going to continue? And if it continues or as it continues, what is it going to mean in terms of the rollout of new product?

KIMBERLY FLYNN: You're right. The SEC, I think, surprised many members of the asset management business with their openness. The SEC has been lobbied and they understand this really pressing need to make alternatives more accessible, and registered funds, which is the way individual investors save, is the way for them to access them. But today you can't put alternatives into your 401K, so the industry has come together with the encouragement of the SEC to develop some new, innovate product structures that are designed with 1099s and other conveniences that investors have come to expect.

CHUCK JAFFE: You also have folks who may like the idea of alternatives, but when it comes to closed-end funds they're worried about discounts. Discounts are tough enough in the established markets where you can clearly measure them. Do you worry at all given what we're seeing the growth, about how the public's going to react to discounts and the discount structure on new products?

KIMBERLY FLYNN: I do think it's important that advisors and investors understand that listed closed-end funds, which are exchanged traded, they can at discounts, they can trade at premiums. And it really depends on supply and demand, so you need to know that going in. It may be an interesting way to access an asset class that you don't have access to, but there are these trading dynamics that are different. It's more akin to an ETF or a REIT in terms of that exchange mechanism. But closed-end funds, because they have both a price and a NAV, you do have to beware. And so what we encourage investors to think about is not just a bucket for alternatives, but a less liquid bucket. So many investors are using ETFs much more so broadly in their portfolio. So if you have let's say 70%, 80% of your investments in highly liquid exchange traded ETFs, then you can allocate 20 or 30% of your portfolio to less liquid things. So when you do need to sell, you're able to sell something like an ETF that is highly liquid. In March, when we saw a lot of volatility due to COVID, the closed-end fund market on average, if you look at all listed closed-end funds, went to about a 20% discount. And that's the reason why I say this. That discount evaporated in about a week to 10 days, and the discount in the overall closed-end fund market trunks to about 7-8%. And so you still see discounts in certain funds and in certain asset classes. One of the things that smart closed-end fund investors know is that different segments of the market, like munis, equities, or taxable fixed-income, they trade differently. So I think that there's a lot of advisors who've become very smart and very savvy when it comes to investing in exchange traded ETFs, REITs, and BDCs, and so they understand some of those exchange traded dynamics.

CHUCK JAFFE: I would be remise if I had you on the show, somebody who develops new products in the closed-end fund space, and I didn't ask you about some things that maybe the audience is hearing about for the first time. Let's talk a bit about auction funds, explain what they are. We started to see an issue or two that are bringing them forward. Is this something that we're going to hear a lot more about?

KIMBERLY FLYNN: I think so. It's really early with auction funds because they're really not broadly offered to investors. Auction funds, I'll explain, the NASDAQ came up with this innovation. What it does is it takes a standard interval fund, and interval fund is basically a continuously offered closed-end fund, it's a good fit for a lot of these alternative investments. But what the auction fund does, it's an improvement upon the interval fund, it adds an element of exchanged traded liquidity. And so that's why I think even though these are just now coming about, what we were talking about in terms of the savviness of financial advisors and their understanding of the financial markets, this auction mechanism, which is seeking to improve liquidity for interval funds. It's really interesting. So if you have an investor that said, "Hey, I like this interval fund but I want to sell it whenever I want to sell it. I don't want to wait for the quarterly tender to sell my shares." The auction mechanism makes it such that there's an exchange for people who want to buy and sell on any given day. This is, like I said, a NASDAQ innovation, and I think we're going to see more sponsors. Delaware has launched an auction fund, or they filed for one at least with the SEC, and it's a private equity focused fund. As you can imagine, private equity, those investments are long-term investments, they're not liquid. So this auction mechanism will provide this interim liquidity for investors that want to be able to move in and out of that asset class.

CHUCK JAFFE: Quickly, let's go from auction funds to hybrid funds. Closed-end funds that realistically, they're REITs when it comes to tax purposes. What's a hybrid structure look like, and is this something that's going to catch on?

KIMBERLY FLYNN: I think so, because you have large established alternative managers with already big books of real estate assets that they invest in. Real estate most commonly is packed up for investment into the REIT structure, which you all are familiar with. This hybrid is a closed-end fund that is just a REIT for tax purposes. And so what it does is, it opens up the world of fund management for closed-end funds to include things like investing in property or investing in land, it opens up investments in infrastructure. Some of these investments, if they're not deemed to be securities, you can't put them into a regulated investment company. Most mutual funds, most closed-end funds are regulated investment companies. So this new innovation, having a closed-end fund being taxed as a REIT, opens the pathway for investors to be able to invest in this direct land and direct property. And we think that it makes it more approachable because, once again, it's more comfortable investing in something that you understand. It's got all of the protections of a 40 Act fund in that closed-end fund structure, it's got the 1099. And so what I think is interesting is that there's going to be a lot of well-known, big name alternative managers with assets either in real estate or infrastructure or real assets, and we're going to see more and more. The two we've already seen, Legg Mason, their affiliate, Clarion has filed for a closed-end fund REIT hybrid. And KKR just filed most recently, so I think it's really an exciting trend in the closed-end fund marketplace.

CHUCK JAFFE: Kimberly, thanks so much for bringing us up to speed on that. We look forward to hearing from you again and talking about further developments on The NAVigator.

KIMBERLY FLYNN: Great. Thanks so much, Chuck.

CHUCK JAFFE: The NAVigator is a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffe. I'm Chuck Jaffe, your host, and you can check out my show on your favorite podcast app or at MoneyLifeShow.com. To learn more about closed-end funds, and interval funds, and business-development companies go to AICAlliance.org, the website for the Active Investment Company Alliance. On Facebook and LinkedIn @AICAlliance. Thanks to my guest, Kimberly Flynn, managing director for alternative investments at XA Investments. The firm is on Twitter @XAinvestments, and online at XAinvestments.com. The NAVigator podcast is available every Friday, please subscribe on your favorite podcast app and join us again next week to learn more about investing with closed-end funds. Until then, stay safe everybody.

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