Managers Starting to Favor Interval Funds for Structured Credit Finance

By Jennifer Banzaca

As banks have faced greater regulatory scrutiny since the adoption of Dodd-Frank in 2008, interval funds are becoming the new liquidity provider in structured credit finance.

During the Alternative Credit Investing panel during the **Active Investment Company Alliance's (AICA) Interval Fund Boot Camp and Manager** Spotlight on March 31, Christian Aymond, a Principal at A3 Financial Investments, noted that alternative credit assets work best in an interval fund structure, in large part because the funds do not have to offer daily liquidity. "Some alternative strategies may not trade every day, or it might be difficult to get a price for an asset on a day-to-day basis so those types of securities may be best for an interval fund structure," Aymond noted. "We focus on unique credit that's often overlooked such as like CLOs, CMBS, ABS, reverse mortgages, life settlements, and litigation financing."

According to Gary Henson, President of TortoiseEcofin Investments, said assets including reinsurance, real estate, and private credit, which all have various degrees of liquidity, are well-suited for an interval fund structure.

"We wanted to balance being able to have enough liquidity to meet the quarterly redemptions while simultaneously giving the advisor the illiquidity premium that they needed or wanted," Henson said.

Clayton Triick, Senior Portfolio Manager at Angel Oak Capital, said he thinks the interval fund structure works incredibly well for new areas of ABS, and below investment grade CLOs.

"If you're thinking about risk asset allocation, some tranches of CLOs or ABS or RMBS that are just less liquid bonds, those assets are incredibly attractive and can offer double digit total returns in today's environment," Triick noted.

With much uncertainty in the markets in the past year due to the impacts of the COVID-19 pandemic, Aymond said his firm made a conscience effort to become more defensive , and decided to focus on reverse mortgages, which is a niche asset that's not usually utilized by some of the larger players.

Aymond pointed out that reverse mortgages have an extremely attractive income, they have an implied AAA rating, and they're guaranteed by the full faith and credit of the U.S. government that being Ginnie Mae.

"So, we decided to get very defensive and take advantage of that. There was some assurance there when things leveled off or there was a flight to safety that those investments would still perform well," Aymond explained.

With the market uncertainty last year, fund structures such as ETFs and mutual funds were forced sellers. However, with limited liquidity interval funds were able to be opportunistic and take advantage of market dislocations.

Triick said interval funds can retain assets that have the widest bid-ask spreads and essentially "stay the course."

"Given the daily inflows you can have into the fund, when there is a selloff, a new shareholder can come into the fund and effectively buy that entire portfolio at a very opportunistic price and allocate to all those assets immediately. That's what's so powerful in the interval fund structure as opposed to other LP fund structures that need to wait for the next capital call to be added to the fund. On the interval side, they can buy that entire portfolio at that attractive price, at the same time being protected from other shareholder risk by other investors not selling at the wrong time."

A3's Aymond agreed the advantage of the interval fund structure is that it can help shareholder's return over time.

"Because as we all know, investors usually make the wrong investment decisions at the wrong time" Aymond pointed out.

Triick said that Angel Oak tried to be opportunistic during last year's market uncertainty and make modest rotations.

"The interval fund structure is really attractive because our job is to try to predict the future, which is impossible to do. However, if you can predict shareholder flows like we can in an interval fund, that takes a huge variable out of the equation and provide a lot of confidence to our team to make that rotation and buy an asset that we know is cheap today."

Henson noted that forced selling is the "bane of existence" of other fund structures. While TortoiseEcofin assets faced markdowns due to matrix pricing, it was not as bad as those faced by other funds, and the marks did not have to be realized.

"Those marks all came back and then we were able to have a positive return from there. So, I was pleased with the structure of the interval fund and the way that it worked," Henson added.

While interval funds have their advantages in the alternative credit market, Henson said on drawback is that "some folks that don't think strategically tend to look at it tactically, and then that's caused some of the interval funds in the marketplace to be gated, creating a little bit of a taint on the interval fund space together".

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