John Cole Scott provides welcoming remarks to the 2022 Interval Fund Spring Manager Spotlight.

Tuesday, April 26, 2022

John Cole Scott, Founder and Executive Chairman of the Active Investment Company Alliance opens the April 2022 AICA virtual event with opening remarks and with an introductory educational presentation on the topic of the event. Read the transcript below to hear what Mr. Scott had to say.

John Cole Scott

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https://aicalliance.org/aica-event/2022intervalfundspringmanagerspotlight/

John Cole Scott: Good afternoon, John Cole Scott, founder and executive chairman of the Active Investment Company Alliance. Thank you to our second Spring Interval Fund Manager Spotlight, we want to welcome you today. We're going to do a short introductory session in a few minutes, but want to just make sure if you're new to AICA or it's been a while, you have a sense of what we are. We are a nonprofit trade association focused on the closed-end fund, the business-development company, and interval fund, and tender offer ecosystem.

We do that both through membership and partnerships with the fund sponsors that give these funds and tools for advisors and their investors that they serve, as well as with the institutional investors, with the product sponsors, with folks like my firm, Closed-End Fund Advisors that builds customized separate accounts with these funds. And as well as service providers, so from accountants to lawyers to proxy to the IPO, to all of the folks that the business they focus on is the closed-ended management structure of which all these funds exist.

We're really excited, AICA, this quarter is closing out its third fiscal year. Thought of launching this nonprofit in the spring of 2019, and we're very excited about the growth and the success that we've had to date. But as it's still a newer organization, we're always looking to improve, always looking to grow, and always looking to get great and honest feedback from our members, from our speakers, and from our attendees.

One of the more recent things we're very excited about is we've been building a nice relationship with CAIA. CAIA really encompasses a lot of the core focus of AICA, and the types of advisors that seek the CAIA designation are often well versed and actively utilizing our funds. You'll find recently on their blog, and there's a link on the agenda page for this event, an article that Mike Taggart, AICA's executive director, published on interval funds as well as giving perspective broader than beyond even our reach.

That's a great segue into saying we're in the third month of working with Mike Taggart as our executive director for AICA. It's been a great beginning, we are improving features and functions and processes every day. He's really a welcome addition to the AICA team. Would like to let people know you can also follow him with his research on Substack. You can Google Mike Taggart and Substack, I'm sure you'll find it.

In my data business CEFdata.com, we have fully fleshed out the nonlisted closed-end fund, and by June 1st we'll have fully all the nonlisted BDC data available. That means the entire full ecosystem, we'll have broad, granular data available for whoever has reasons to access that data. Whether it's a product management team or a due diligence team or a fund sponsor or their board, it's available in different ways, feel free to reach out to my firm separately for that conversation. There is a note that AICA members get a 35% discount on CEFdata products should that apply to you.

My other firm, Closed-End Fund Advisors had their quarterly replay last quarter. The replay has been posted, slide deck and replay video. Feel free to check it out on our website, and it should also be available on the AICA member content section.

We are always planning ahead, so we are going to have a BDC event focused on listed but at least one panel covering nonlisted, June 7th and 8th, virtually on the same platform today, the Remo platform. We're also looking forward to an in-person event in New York City November 16th, the day before the ICI Closed-End Fund Conference. Please feel free to reach out for interest in speaking and sponsoring or helping to organize that event in New York City like we did three years ago in 2019.

And I'll be on our podcast next week, that's *The NAVigator* with Chuck Jaffe as our wonderful and long-time friend and host. It'll be our 150th episode, and as an update, we will have now crossed over 200,000 downloads to this timely, focused, short podcast covering the entire ecosystem. And with that, I'm going to dig in.

This deck again will be loaded onto the event page ideally tomorrow or soon after, depends on the speed of our web team. This is a nonlisted interval fund focused event, but because they're a newer structure I do like to really bring out the nature and the overview of the listed fund space, 506 listed funds in the ecosystem. And if you look at the asset allocation there's some overlap, there are a lot of taxable credit funds. The largest area of assets is the municipal bond sector, it's a growing part with two funds in the interval fund sector. And I'd say that the real estate exposure in interval funds is a larger piece of the pie than the real estate exposure in real asset in the listed fund space.

I generally will say that there's more crossover interest in interval funds when discounts are narrower for closed-end funds. But as we've seen, that was the tone in our December interval fund event with relatively tight discounts to net asset values for the listed funds, we have now experienced much more dramatic discount widening and some hard NAV performances where many interval funds have been outperforming on a NAV basis their listed funds. And again, there's been no extra widening of prices from a discount. And so I'd say that while I wouldn't expect to say this just a few months later, now that discounts are wider, there's even maybe a better story for the interval fund because they just are experiencing less volatility. Which is really one of the designs of the structure as a whole.

Historically looking at the whole universe of discounts, we are not crazy wide but we're not crazy tight. But I'd say that the discounts we see now of 4.72% at the end of the quarter are about a point or so wider than the median discount for closed-end funds. But definitely we are not in a crisis panic period of markets, definitely a challenging time in markets but we have not seen discounts go down to an average 10%, which is traditionally considered extremely wide. As we look over the history of interval funds, there are only nine funds with a 10-year track record. They do go back to 1989 with an Invesco senior loan fund, and there are 16 funds with a five to 10-year track record.

When we really start to look at the big growth, it's in that one to five-year period. A lot of new funds have come to market and have gained a lot of assets and a lot of ground. Gave themselves available on many custodial platforms, and really getting in front of advisors and the investors that they serve. And on a one-year basis, there are five live interval funds that have at least performance being picked up into our database.

When we really think about the interval fund structure and how it's being utilized, there's lots of ways to think about it, but it seems for many of the funds it's best use and most common use is with an access to illiquid private credit and private equity. They do that with easily going up to 80% illiquid investments, and then maintaining that 20% or so liquid exposure to help maintain that liquidity for the typically 5% a quarter tenders that is part of the liquidity offering in the sector. So if you're new to interval funds and you haven't learned a lot about them, they are able to own much more illiquid private Level 2, Level 3 assets than an open-end fund or ETF because that open-end fund or redemption structure. The SEC basically really dislikes anything over 15% illiquid, seven day liquidity for those two structures.

And we find in the listed closed-end fund universe there's a lot more funds that are tapping into 10-20%, some 25%, I think there might be one above a 35% illiquid or Level 3 assets. But we find that at least to date many of those funds tend to have wider discounts than peers because the listed fund investor seems to just have more concern in how they trade those funds. And so we've found a lot more success in this interval fund for that. And so we find that when you're adding, like we do for our clients, 10-20% to common interval fund allocation for the clients at my firm, that we're really trading intraday liquidity and even daily liquidity for this less volatile experience, seeking to get investments that are different than many of the stocks that are available in the market. And you'll hear a lot more about that on our panel discussions.

I would say that sometimes minimum investments are misleading. It obviously can change on any given day based by the fund sponsors, what they've allowed if reached custodian. But we've found that we're sometimes able to get much smaller initial investments for clients than are stated on the website and in other places. So definitely if you're saying no to an interval fund because you can't quite make the minimum for the fund or the share class you're seeking, reach out to the fund sponsor, check with your custodian, there may be more wiggle room there than seems to be normal in the open-end fund space.

We do find leverage is much less commonly used in this structure, some funds just say no leverage at all. I'd say that's often fund sponsors where their advisor base is more maybe familiar with an open-end fund access point, and so leverage at a fund level doesn't make a lot of sense. I'll say that as leverage costs start to stabilize, eventually probably this year, that extra net invest income could be very beneficial to investors of both listed and nonlisted funds. And again, one other difference is it's not like trading an ETF or a closed-end fund, you actually kind of need to have the fund onboarded and available at the custodian.

One thing that AICA has worked hard to do is to be able to help coordinate the due diligence process at different custodians and show the value of the fund and the firm to the advisors and the investors in the place that they're located. And I say the challenge is a lot of the firms, it's a little bit extra workflow to build the pro rata tender mechanism. So should there be a tender of 5% and more than 5% of shares are offered, you do a pro rata tender to shareholders, which happens from time to time in the sector.

From asset allocation and asset growth, I'm just going to talk about the charts here because you guys can read the words, really bond funds are about half the ecosystem, a little over half if you include some of the other places, and real estate's about 20%. So bigger as I mentioned than in the other market. We saw the assets really rise from 2011 through 2021. We are early year to date, so we don't know the future. I'd like to think that we'll get to $80-85 billion in investments in this structure this calendar year with nine months more to go in the data collection, but that would be kind of on pace with the growth. I would say one thing that we've noticed is every year, except for '17, there's a ceased nonlisted fund in the interval fund space. That happens across all fund structures, whether it's open-end funds, ETFs, even closed-end funds. The percentage of funds that basically they tried, it didn't work, they convert it, or they merge it, or other things happen, really is normal.

And there's no new active fund we've tracked. Though again remember it's very early in the year, it usually takes more than three months to get that data in our system because of the way that those funds update in our system. But want to let you know this is definitely a growing area.

If you're hearing more about these funds it's because there's more of them, more advisors are using them, and they're solving problems and filling holes in ways that haven't been done by other RICs or funds versus private funds are doing well.

We did a study right after Covid, really wanted to understand how there were four, at the time, cousin funds. Again, I won't call them twins, even fraternal twins, but same general asset allocation at a high level, same fund sponsor. We looked at it and we did find that, like I mentioned, less leverage being employed at the interval fund, on average about 39% less leverage. Again, because these funds aren't listed they tend to pass on only the yield they're earning in most cases in our experience so the yield levels were less. Sometimes listed closed-end funds overpay to narrow discounts, that is not an issue or concern for interval funds.

We did even find the expense ratios were lower on average for these funds, sometimes people think expense ratios are higher for these funds. But again, for similar firm interval fund versus listed fund, we've found them to be lower and similar. What I really, really, really liked in this work, and we could probably update now since it's been longer, is that the standard deviation was 22% less and that the NAV total return of the listed fund, so not even market price, not even discount widening was 5-6% better through Covid, and then even 10% better reaching back further in the ramp up in the performance pre-Covid.

So I think that maybe a helpful story. Doesn't mean you shouldn't own the listed funds if you like the liquidity and like the discount. But just remember that we find that these products tend to have less leverage, less volatility. And if that's the type of goal you have for your clients, a way of giving them a product that's not duration bond, that's not a cash overhang, that could serve their needs.

This may be hard to see, I tried to make it as large as I can but this is just some of the recent funds in the space that we've tracked and the assets that we've seen in them. We have all of these funds in our database obviously to run this data we have, but wanted to make that aware. And a lot of what I really like is a lot of continued diverse offerings. It sometimes feels that everyone comes out the same type of fund for a year or so and then they all follow each other, but there's a lot of diverse offerings here. More credit funds recently than equity funds, but I would argue that when you are concerned about the market, credit funds tend to be more durable because they're bond payments to shareholders. Whether it's private or public bonds and credit than the equity ones, but there's some nice equity exposure funds too. And then the largest funds, again this list has been shaken up a bit in a very nice way, some of the newer funds are gaining a lot of traction in the space and really pleased with how that's going.

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Click the link below to go to the home page of Active Investment Company Alliance to learn more:

https://AICalliance.org/

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