XA Investments' McCulloch Sees More Growth, New Entrants To Interval Funds

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Chuck Jaffe, in this episode of The NAVigator podcast interviewed Ben McCulloch, managing director and general counsel at XA Investments. Read the Q & A below as Ben says that the last five years have seen over $40 billion in growth in interval funds and tender-offer funds, and that interest has attracted more fund sponsors – including companies that have been heretofore more focused on ETFs – and more new ideas. That has brought with it increased regulatory scrutiny, as the Securities and Exchange Commission is evaluating what kinds of alternatives – particularly with private-equity and venture-capital investments – are right for the interval fund structure. But McCulloch sees the growth and the expansion of interval offerings continuing, with more new and different funds on the horizon.

Ben McCulloch

The podcast can be found on AICA's website by clicking here: https://aicalliance.org/alliance-content/pod-cast/

CHUCK JAFFE: Ben McCulloch, managing director of XA Investments is here, and we're talking about what's next for tender offer and interval funds, welcome to The NAVigator. This is 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 is 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, we are looking in the direction of alternative investing and the challenges in expanding interval and tender-offer funds. And we're having that conversation with Ben McCulloch, managing director and general counsel at XA Investments. You can learn about XA online at XAInvestments.com. You can learn more about the basics of interval funds, closed-end funds, and business-development companies at AICAlliance.org, the website for the Active Investment Company Alliance. Ben McCulloch, thanks for joining me on The NAVigator.

BEN McCULLOCH: Hi Chuck, pleased to be here.

CHUCK JAFFE: Ben, one of the things that's been really interesting to me in the time that we've been doing The NAVigator is there's been, I don't want to use the word explosion because that makes it seem much bigger than it is, but there has been a tremendous increase in interest in interval funds and tender-offer funds, and things that are maybe a little less liquid but a little more alternative. And that's good for consumers who are going to get more products, it's tough for guys like you because as general counsel you've got to deal with the regulators who are seemingly always putting the brakes on just about everything. So let's take a look at what you foresee when it comes to growth, expansion, and how much is going to get there. I mean, are we going to be looking at more of the same? Are we going to be looking at more but it's new and different? What's the logical next step in interval and tender offer funds?

BEN McCULLOCH: Yeah Chuck, that's a very good question. Well look, to set the baseline, interval and tender-offer funds have grown in assets over the last five years by about $42 billion. So massive growth, I think you're right in saying that it's been explosive. And we've seen a number of fund sponsors that have taken their time to watch the structure's growth and interest by investors that are now coming into it. Larger fund sponsors that have been traditionally maybe ETF, mutual fund sponsors are now shifting their focus toward interval and tender-offer funds. At the same time, we have probably one of the more aggressive SEC regimes that we've seen in a number of years, and the pace of regulation just over the last 12 months has been impressive if not bewildering for fund counsel, and I'm sure compliance officers as well. So what's it mean for interval and tender offer funds? We've seen some regulations that have come from the SEC regarding ESG. We've seen some regulations that have just gone into effect earlier this year regarding fund of fund investments, Section 12 investments. So I think we'll continue to see some of that, the SEC staff is trying to get their arms around some of the more alternative asset classes that have been put into interval funds more often, and some of the more alternative or ESG type focuses. We'll continue to see them focusing on those. And I don't think that I'm really relaying anything that the market hasn't seen already, but that's not going to stop fund sponsors from looking at the interval and tender-offer structure as a great growth opportunity. And I think the reason why is because you can put some pretty pure and interesting alternative strategies into those structures that you just can't do with really anything except for maybe a listed closed-end fund.

CHUCK JAFFE: When you look at different asset types and what could be in there, the interval fund structure has a significant benefit because fundamentally investors can't be moving out all the time, they're able to get more illiquid assets and go with other things. Are there logical expansions that you expect for the space? I mean, it seems to me like every time I turn around there's somebody new coming in. And while I don't necessarily want you to talk about the competition, obviously if somebody's bringing something new, you guys as competitors are looking at what they're doing. Am I wrong to be looking at this going, "Oh, that's a cool idea," "Oh, that's a cool idea," and that we're going to see more and more?

BEN McCULLOCH: Yes, absolutely, you're right. So we've seen up to this point a lot of interesting structured credit strategies in interval and tender-offer funds. We'll continue to see growth in those. At the same time, over the last two years I think a lot of folks have been trying to solve for private equity investment and venture capital investment. Some of the challenges still remain there, and a lot of that has to do with sourcing those investments. The SEC still has some rules regarding allocations to 3(c)(1) and 3(c)(7) funds. If I'm managing for example a private equity fund of limited partnerships, I struggle to sell that unless I'm focusing on accredited investors and qualified purchasers. So there's some challenges that still remain with the asset classes, and that's just because of some of the inherent challenges to access. But we've seen some new funds in the market come in, and over the last couple of years I think some of them have been very successful. A lot of that has to do with some of the thoughtfulness the managers put into developing the structure and developing the fund, whether that's pre-seeding it, converting a private fund. Shareholders are always going to be fee-sensitive, and that's another piece too where retail investors are just not willing to pay two and 20 generally. And so when a VC manager wants to come in and develop and interval fund, I think we'll have to see some move away from their typical sort of fee structures. So far I've seen some filings with some wild fees out there. Not going to lie, I've seen some that are in high single digit or overall operating expenses for the fund. Just not sure how that's going to be palatable to investor, but when those come down a little more and get a little more competitive, I think venture capital and private equity will be very interesting and a compelling asset class for retail investors for sure when they just have not had traditional access to those asset classes.

CHUCK JAFFE: How much is the SEC standing in the way, how much are they encouraging this? What's the flow, and the rhythm, and the acceptance? Because we know, separate from the closed-end fund, interval fund space, the SEC is not getting along with anybody who's trying to do things like Bitcoin and crypto funds, but the SEC is trying generally to approve a lot of things. How are they feeling in these things where you're talking about things that are illiquid?

BEN McCULLOCH: Yeah, you know, it's interesting, I think the staff at the SEC is traditionally seeing interval and tender offer funds as the better vehicle for these alternative investments. I've had the sense in the past through discussions that they generally have not really received well some of the earlier interval fund strategies that really should have been put into a mutual fund. I think probably if you have an interval fund and the investments in there are mostly liquid if not all liquid, probably not the best vehicle for that investment. You probably should be managing a mutual fund at that point. But it's tougher to manage a mutual fund with basis point fees of 150 or something like that. So there's some funds that the SEC probably, if they're looking at them now would say, "This is a mutual fund, you should not be wrapping this in an interval fund." But I think they have traditionally liked the vehicle for alternative investments because it's a vehicle that is better equipped to handle some of those illiquid assets. I can't speak to the staff now, but they've been granting effectiveness to some funds. They're taking a harder look now at investment strategies. The Names Rule has been an issue for the past year or so, and they did update the Names Rule through their ESG rule proposals. So we'll see that sort of flow into the interval and tender offer fund strategies and the impact there.

CHUCK JAFFE: Yeah, my worry there is that's just going to make it that there are going to be a whole lot of funds, especially in the interval fund space, that will wind up having complicated names that people don't understand. That they're accurate from and SEC standpoint, but they're just going to scare anybody but the actual experts off.

BEN McCULLOCH: Yeah. No, it's funny because I've had this discussion recently, where it seems like many fund names nowadays are just sort of like a parade of buzzwords, right? So either we'll get away from that for many funds, where they'll just instead of having to apply some Names Rule standards, they'll just drop some of their buzzwords out of their fund name. Or we'll have some funds that will migrate more towards that, and so you'll see some more buzzy or odd fund naming conventions. But I actually generally like the update in the Names Rule as giving some clarity to the industry, because there's been a number of questions over the years on should this really apply, should this not? And so I get the staff's intent with it. I think the industry, we'll just adapt.

CHUCK JAFFE: Well, I'm glad you helped us adapt to what we're going to see. Thanks so much for joining me on The NAVigator.

BEN McCULLOCH: Yeah, it's been a pleasure, Chuck. Really appreciate your time.

CHUCK JAFFE: The NAVigator is a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffe. And yes, that's me, and you can check out my hour-long weekday podcast on your favorite podcast app or by going to MoneyLifeShow.com. To learn more about interval funds, tender-offer funds, closed-end funds, business-development companies and more go to AICAlliance.org, the website for the Active Investment Company Alliance. They're on Facebook and LinkedIn @AICAlliance. Thanks to my guest Ben McCulloch, managing director and general counsel at XA Investments, which is trying to bring institutional-level alternative investments to the individual investor community. Learn more at XAInvestments.com. The NAVigator podcast is new every Friday. Ensure you don't miss anything by following us on your favorite podcast app, and if you like us, please leave a review. Until next week, happy investing everybody, and happy 4th of July too.

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