XAI’s Flynn On Growth And Expansion In Interval Funds

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Chuck Jaffe, in this episode of The NAVigator podcast interviewed Kimberly Flynn, Managing Director of Alternative Investments at XA Investments. Read the Q&A below as Kimberly discusses the state of interval funds, which have been growing rapidly and expanding their asset reach. It's not just the 50-plus funds on file and the entry of big players and new investment ideas, but also the recent rise in media interest. In the interview, Flynn responds to a recent *Wall Street Journal* article critical of interval funds and their fee structure.

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

CHUCK JAFFE: We’re talking interval funds with Kimberly Flynn, managing director of alternative investments at XA Investments, 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, which is a unique industry organization representing the entire closed-end fund business from users and investors to fund sponsors and creators. If you’re looking for excellence beyond indexing, The NAVigator will point you in the right direction. And today we’re looking in the direction of interval funds with Kimberly Flynn, managing director of alternatives at XA Investments, which you can learn about online at XAInvestments.com. To learn more generally about closed-end funds, business-development companies, and yes, interval funds, check out AICAlliance.org, that's the website for the Active Investment Company Alliance. Kimberly Flynn, welcome back to The NAVigator.

KIMBERLY FLYNN: Thanks Chuck, happy to be back.

CHUCK JAFFE: I'm hearing more and more about interval funds, in fact they've gotten big enough that they recently attracted some attention in *The Wall Street Journal*. More on that in just a moment, but let's start by talking about the product's structure, which I think most people don't really understand, and why interval funds are a good fit for less liquid alternative investments.

KIMBERLY FLYNN: Absolutely. So investors have long had access to public market securities, so you're talking stocks and bonds, but what individual investors, and especially retirees, have not had access to is things like private equity, venture capital, real assets, infrastructure. This is the domain of institutional investors like pension funds and endowments, and now with an interval fund, which is a type of non-listed closed-end fund, investors have broader access to the private markets. And I think given frankly some of the poor performance and disappointment in public market strategies in recent years, a lot of advisors and their clients are considering alternative investments for the first time.

CHUCK JAFFE: In terms of what the alternative market is growing into, how big has it become and what types of funds? Because it seems like I'm constantly reading about, "Hey, we can now do this," or there's now this new thing out there, so how is the market itself for interval funds changing?

KIMBERLY FLYNN: Yeah, we've seen a lot of growth in the last three years. There's now over 230 different choices, different funds in the interval and tender fund space. The total aggregate market capitalization of this market is now north of $150 billion. I think what's interesting is that we've got a lot of new entrants to the marketplace, so firms largely that have been alternative investment firms managing private funds are now starting to enter the marketplace, partly because we have proof of concept that these funds can scale and become quite sizeable. So the top 20 funds in terms of total assets are all each above two billion in total assets, and so if you're running private funds, you've probably been watching what's going on in the interval fund space with some curiosity. But now we have really large managers, firms like Wellington, firms like Russell Investments, so it's not just hedge fund managers and private equity managers that are entering this market, you've got large multistrategy, multi-asset managers like Wellington in every market across the globe. And then you have a firm like Russell Investments, which is an institutional consultant, and that's where their expertise lies, but they're now making their capability and their strategy available. Russell is on file with two different interval funds, so it's really exciting, the explosion, not just in terms of asset growth but in terms of fund formation. We anticipate quite a bit more in the coming years as more and more of these new entrants come into the market.

CHUCK JAFFE: For years retirees didn't have access to private market strategies, private equity, venture capital, and a lot of the things now available in interval funds. Pension plans and big institutions could get those things, but the guy with the 401(k), mom and pop investor, they couldn't. Well, now they have access, but should they? What do they gain from it? What are they missing if they don't add it to a portfolio?

KIMBERLY FLYNN: I think if we go back to the fundamentals of what are the benefits of alternative investments for either an institution or a retail investor? And so what you're looking for potentially are higher returns or higher current yields, and some of those strategies offer less risk, less volatility than let's say the S&P 500, if we're going to compare it to public equities. And so if you're looking for different sources of return, potentially higher sources of return, you're talking about asset classes that are not directly correlated to the public market, and so a lack of correlation means that these strategies are going to perform differently in different environments. In a diversified portfolio, that's what you want. You don't want everything going up at the same time or going down at the same time, so correlation benefits the overall portfolio for investors. We see in the US at least that the average investor is over-allocated to large cap US equities, these are daily liquid, you can buy and sell, and the reality is if you're saving for retirement, do you need 100% of your portfolio in daily liquid products or daily liquid securities? Because you're giving up potential return and potential diversifying benefits from lower volatility assets that are available in the private markets, but that trade off involves the time horizon upon which you invest. Endowments and pension funds, they have a much longer investment horizon, but frankly I think individual investors have longer investment horizons than they think, right? You're usually saving for a large purchase, something like a home or a second home, or maybe you're saving for retirement, and that timetable is five years out, 10 years out, 20 years out, so to the extent that you don't need a 100% of your portfolio sitting in stocks and bonds which are daily liquid, for a portion of your portfolio alternatives can make sense because they can help you accomplish your long-term investment goals.

CHUCK JAFFE: I mentioned *The Wall Street Journal*, my friend Jason Zweig recently wrote a piece in which he identified interval funds as one of Wall Street's most popular trends. But as the headline and the article noted, he believes, and I quote, "that the fees on these funds will leave you high and dry." It's an article that has been greeted with a lot of concern by the closed-end fund industry and the interval fund space for obvious reasons.

KIMBERLY FLYNN: Sure.

CHUCK JAFFE: It's something we'll talk about more on The NAVigator down the line, but when you see that kind of coverage, how do you respond to it? How do you help an audience like ours here at The NAVigator, which has been hearing about interval funds in a positive way, take this and go, "Okay, look, yes, you do need to understand how fees and funds work, but don't throw the baby out with the bathwater."

KIMBERLY FLYNN: You know, I think it's a sign that interval funds are coming into their own in terms of mainstream attention. Morningstar after not covering this space for a very long time just picked up coverage in June of interval funds, and so I think that there's always questions and concerns when you have a new product structure. Frankly there's a lack of understanding I think about the benefits of the structure and how it's being used. I think all attention is helpful because it really starts the conversation that we're having, Chuck. My perspective is a little bit different than Jason Zweig's with respect to fees and leverage, partly because I talk with GPs and alternative asset managers who are launching these products, many of these alternative investment strategies are capacity constrained. You know, the type of potential higher return, this is not an unlimited opportunity. And so when you think about an alternative asset manager launching a product for private wealth and allowing retail investors to get access, they're benefiting from what institutions have long had access to. And so I think that capacity constraint is important, because to the extent that a manager takes in too much money, you don't want them to take in too much money such that you would see a negative impact to their return performance. And so there has to be a discipline around putting caps on how much capital can be raised and how much capital can be deployed. And so specifically when we talk about these types of interval funds having leverage as a tool, I like the fact that a portfolio manager can use leverage to enhance returns, and I think that many of the portfolio managers are very judicial in their use of leverage. But once again, if they're investing in additional assets beyond the common proceeds, that comes at the expense of the capacity that they have to deploy their strategy. And so I think that alternative managers need to be rewarded for superior performance. One thing not mentioned in the article that we think is a positive sign is that more alternative managers are charging incentive fees or performance fees. Some of them are calculated differently, but generally speaking it creates an alignment of interest, and so investors benefit when there's better performance, and the portfolio managers benefit too in the form of higher incentive fees. Now this all adds up in terms of higher expense, but if investors are benefiting from that performance, they'll see it so I don't think they'll mind the higher level of expense given that alignment. So we should all be mindful of expenses, absolutely, but some of the strategies, particularly the largest part of this marketplace which is private credit, a lot of the private credit funds are using leverage to enhance return for shareholders. I think that they are being diplomatic in their use of leverage, and while it's important to be thoughtful about fees, it is consistent with the way these managers run money for institutions, and I think that's beneficial for retail investors who have access to these interval funds.

CHUCK JAFFE: In terms of the interval fund market, we talked about who's coming in and how we're seeing the expansion of it, but who's leading the market today? I understand for example that Cliffwater with their direct lending fund is kind of the biggest presence, but directly lending is not always what people think about when it comes to private credit, so who are the market leaders on interval funds today?

KIMBERLY FLYNN: So the market leaders today, you've mentioned Cliffwater, you've also got Bluerock, you have Alkeon, PIMCO, so it's a mix of alternative, boutique, and leading mutual fund managers. You have entrants from all over the money management spectrum, now 80% of fund sponsors are these alternative managers, GPs who typically run private funds, so there's definitely a different ethos, but there's plenty of big name money managers like Nuveen and Blackrock and PIMCO as well. And you know, I like that spectrum because those big money managers can educate advisors and investors in a way that some of these alternative boutiques given the size of their sales teams cannot. So it's terrific, we have a lot of energy, a lot of new market entrants, and you know, Chuck, there's a lot of white space in this market in terms of the types of alternative investment strategies that we're going to see. There's about 50 funds right now in the SEC backlog, they're in the SEC registration process and they're expected to come to market in the next six months or so. So there's a lot of really interesting things beyond private credit, beyond private equity, things like infrastructure, things like secondary private equity, some hedge fund strategies which we haven't seen in the past. There's also some really interesting things like litigation finance, some more niche or specialty type investment strategies, so a wide spectrum of alternatives.

CHUCK JAFFE: We'll be watching for those new funds and those alternatives, and I'm sure we'll be talking with you about them down the line. Kim, thanks so much for joining me on The NAVigator.

KIMBERLY FLYNN: Thank you, Chuck.

CHUCK JAFFE: The NAVigator is a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffe. And yes, I'm Chuck Jaffe and you can check out my show by going to MoneyLifeShow.com or by looking for it on your favorite podcast app. To learn more about interval funds, closed-end funds, and business-development companies go to AICAlliance.org, that's the website for the Active Investment Company Alliance, which is on Facebook and LinkedIn @AICAlliance. Thanks to my guest Kimberly Flynn, she's managing director of alternative investments at XA Investments, which you can learn about online at XAInvestments.com and which you can follow on X or Twitter @XAInvestments. The NAVigator podcast is new every Friday, and next week we'll be back talking more about that Jason Zweig article with Aaron Filbeck from CAIA, but be sure not to miss any episodes by subscribing or following along on your favorite podcast app. We'll be back next week, and until then, happy investing everybody.

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