CAIA’s Filbeck On Interval Funds And Media Criticism Of The Structure

Friday, August 16, 2024

Chuck Jaffe, in this episode of The NAVigator podcast interviewed Aaron Filbeck, Managing Director of the Chartered Alternative Investment Analyst Association (CAIA). Read the Q&A below as Aaron discusses interval funds, their evolution, fee structures, and potential. He also responds to recent media coverage that has been critical of them as investment vehicles, including a recent *Wall Street Journal* article on how interval fund fees "will leave you high and dry."

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

CHUCK JAFFE: Aaron Filbeck, managing director of the CAIA Association is here, we’re discussing recent media criticism of the interval fund business, 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 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 Aaron Filbeck, he is managing director of the Chartered Alternative Investment Analyst Association, CAIA, and we’re considering the recent criticism of the interval structure and fees by Jason Zweig of *The Wall Street Journal*. You can go to CAIA, CAIA.org, for more information on the organization, and we've got a link to Jason Zweig's article in our show description. To learn more generally about interval funds, closed-end funds, and business-development companies check out AICAlliance.org, that's the website for the Active Investment Company Alliance. Aaron Filbeck, welcome back to The NAVigator.

AARON FILBECK: Good to be here, Chuck. Thanks for having me again.

CHUCK JAFFE: Interval funds have gotten popular enough that they're now getting some media attention. Mainstream media when it comes from the form of *The Wall Street Journal* and Jason Zweig, but it's coming in other places as well, and with it, well, interval funds are not many of the things that people say, "Oh, I love about investing in traditional mutual funds." They don't have the liquidity, they don't have some other things, they haven't got to super low fees, they use leverage in ways that can raise their fees and the result is that there's a lot of confusion. It would be easy for someone to say, "Hey, I would never buy these because they're illiquid and their fees are high," and that's kind of what Jason Zweig did, though he was much more nuanced than that. So let's start with the structure and help us understand why folks want to do this, and why they still might want to do this in spite of the fact that, yeah, the structure means that there's fees and liquidity issues that don't exist in your ordinary ETF out there.

AARON FILBECK: Yeah, absolutely, and I think that it's actually been healthy to see some of the continued discussion around interval funds in particular. If you look over the past couple of years we've seen a proliferation of products coming to market and there's been a lot of excitement around this new structure, this new way of accessing what historically has been inaccessible to the individual investor. But it started off with I think a lot of excitement, a lot of interest, particularly from the asset management community as they were creating new products, and now we're moving into a new phase where the excitement is still there but as more products come to market there's more to talk about and more to dig into, whether it's fees or liquidity and so on. I do think that it is healthy to be having this discussion as the products become more popular and more people begin to adopt them, but the real benefit of these structures, and putting aside maybe some of the criticisms for a second, I think the benefit here is that it does open up access to these asset classes that historically were not available to the individual. And if you were thinking about accessing private markets or alternatives more generally, it was very much a binary decision in terms of structure, so on one hand you could go the full-blown liquid alternatives route and go into 40 Act mutual funds and ETFs, or you had to go completely illiquid with traditional LP/GP drawdown fund structures. And there are certainly impediments to both, whether you were rinsing out elements of the strategy on the fully liquid side, or in some cases not being able to perform the strategy at all due to some of the liquidity constraints that were placed on the 40 Act wrapper, on the other hand, on the drawdown fund structure, typically reserved for very, very wealthy individuals or just large ticket sizes that were going to invest. So this creation of a product that sits somewhere in between that still provides access to some of these illiquid asset classes but does it in a way that's more friendly to investors that might be used to the ETF or the mutual fund wrapper with 1099 tax reporting, in many cases a ticker that they can use to invest, more friendly reporting, all of those things I think is a benefit at a very macro level. Now of course we can get into the criticisms, which I'm sure we'll talk about, but I think that's an important backdrop of this landscape.

CHUCK JAFFE: Help people understand why there is the discrepancy in fees, it is one of the things that Jason pointed out. But you've got public versus private assets, interval funds restrict receptions typically, the ability to sell your shares back to about 5% of total assets during a quarter, which shouldn't affect most investors unless there's some sort of a run on the fund, you should be able to get out in total if you wanted to, but help people understand why there is the discrepancy in fees.

AARON FILBECK: Yeah, absolutely. So all else equal, lower fees are better for the client, they're better for the investor when you're comparing apples to apples, but I think that the important thing to think about here is you're not comparing apples to apples, these are not all else equal type of strategies, so if we're comparing high-yield bonds versus private credit, there's a lot of differences. Now there's a lot of similarities underlying that, it's still credit at the end of the day, these are still loans being made to organizations, that is apples to apples in a lot of ways. But when you get into private markets, whether you're talking private credit, private equity, even private real estate in some instances, these managers are taking much more of a hands-on approach to these organizations, they're working with the companies, they're not necessarily buying a loan or a bond off of a ticker or a stock off of a ticker, there's much more of a hands-on approach which requires a little bit more expertise. More than just investing in individual securities, you may be taking active roles in the company's governance, you may be sitting on boards, you may be helping the company actually turn themselves around in some instances, and so alternatives in general, particularly private markets, have historically had higher fees than what you see in the public markets. Now those fees have come down over time, and I think that they will continue to come down over time, but I think saying these things are equivalent and comparing them as apples to apples is not necessarily the right way of thinking about this.

CHUCK JAFFE: Let's also look at one of the big criticisms that Jason Zweig had in his piece, and one that is understandable, which is that some but not all operators of interval funds will charge their fees based on total assets. And what that means is that it's not just, here's the assets that investors put with them, but if they are using leverage and they're borrowing more money, they consider the borrowed money part of their assets as well. And the result of this that, yeah, you're going to be borrowing money on a leveraged basis, you're going to be paying a couple percentage points to get that money, then there's an additional managed fee on top of it, it does mute returns if nothing else. Is it worth it? Does that become a thing where because not everybody does it, if you're really focusing on fees, stay away from the ones who are charging on gross assets, something along those lines?

AARON FILBECK: I think this is where, we're talking about this specific article, I think this is where Jason and I are pretty well aligned in a lot of ways. So one, I think transparency around fees is really important, and that was one of the headlines that he put in this article about you don't necessarily know what fees are being charged and whether that's gross versus net, there's underlying fees, a lot of these interval funds may invest in other funds, and so there's double layers of fees associated with the fund of fund structure or multi-manager structure. There's other things around performance based fees or carried interest, as well as other expenses that may be passed along to investors, so I think at a very, very high level, transparency around how these fees are being charged is critically important. From a due diligence perspective it's important to ask these questions, but on the manager side it's important to disclose these as well so that you can make a more informed decision when comparing different type of fund structures. On the particular issue of gross versus net assets, I think it's really difficult to justify charging fees on gross assets instead of net. There's a lot of reasons for that, but I think even if you just look at numbers, particularly today when leverage is as expensive as it is relative to history, you may be taking on leverage with a cost of five, six, seven percent depending on the type of deal that you're getting on your leverage, and so that's a cost to the investor on top of any of the fees that are being charged as well. I do think the net way is the better approach and the better way to go, but I think at the end of the day the transparency around that I think is the most important thing so that investors can make more informed decisions.

CHUCK JAFFE: I have had audience members for The NAVigator, which includes both industry professionals but also individual investors, and this has been entirely from the individual investors, say to me, "Why bother with an interval fund for private credit? Couldn't I just do this with some sort of a high-yield fund? Couldn't I just do this with an ordinary closed-end fund? I don't have the interval structure, I don't have necessarily the extra fees, et cetera." How do you respond to that?

AARON FILBECK: Well, maybe if I take those in reverse order, I think back to the beginning of this, an interval fund versus a drawdown fund, it's really preference. I mean, at the end of the day these are long-term assets, and so if you're able to, one, access, but two, just functionally stay with a long-term investment that is in a drawdown fund structure, at the end of the day I think that that is usually a better way to go about investing in private markets because there's a true alignment between the underlying assets in the strategy and the structure that's housing that strategy. Now the benefit of the interval fund structure, and I think to be careful about this, is that more friendly performance reporting, more tax-friendly ways of accessing these strategies, 1099 reporting versus K-1s, so there's operational ease that's associated with this, but I would not look at interval funds as trading vehicles. These are not something that you can trade easily in and out of, you shouldn't be trading easily in and out of these structures. I think the liquidity mechanism is there if you need it, if you're rebalancing or if a client situation changes, their goals change, but using this as a trading vehicle I think is ill advised just given the long-term nature of the assets. Now if I compare the interval fund structure versus a mutual fund or an ETF, I think the main difference here is that the assets are very different. High yield, while at the end of the day is still credit, and private credit, again let's use this example, is also credit, these are different companies, these are different parts of the economy, these are different parts of the capital structure, and so I actually think they're more complementary to each other rather than a replacement for one another. So it really comes down to what your overall portfolio looks like and where you're trying to diversify even within your credit allocation, I think that's a better question to ask and more of a decision-making process rather than saying, "Well, I can just buy high yield instead of private credit."

CHUCK JAFFE: Aaron, really interesting. I've got more questions, we don't have more time, but the good news is the more the media covers this, the more we're going to have to discuss, so I'm sure we'll have you back on The NAVigator talking about this and more soon.

AARON FILBECK: Thanks, Chuck.

CHUCK JAFFE: The NAVigator is a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffe. And I am Chuck Jaffe, and I'd love it if you'd check out my podcast by going to MoneyLifeShow.com or by searching for it wherever you find your favorite podcasts. 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 Aaron Filbeck, he's managing director of CAIA, the Chartered Alternative Investment Analyst Association, follow him on X @Filbeck_A and go to CAIA.org for more information on the organization. Plus, we've got a link to that Jason Zweig article we discussed if you look in our show description. The NAVigator podcast is new every Friday, make sure you don't miss an episode by subscribing on your favorite app, and if you like our podcast leave us a review and tell your friends about us. We'll be back next week, and until then, happy investing everybody.

Recorded on August 16th, 2024

To request a particular topic for The NAVigator podcast please send an email to:
TheNAVigator@AICalliance.org

Click the link below to go to the home page of Active Investment Company Alliance to learn more:
https://AICalliance.org/

investors daily liquidity but rather offer liquidity on a monthly, quarterly or semi-annual basis, often on a small percentage of shares. Closed-end funds often use leverage, which can increase the fund's volatility (i.e., risk). Actual distribution amounts may vary with fund performance and other conditions. Past performance is no guarantee of future results. This material is not intended to be a recommendation or investment advice, does not constitute a solicitation to buy, sell or hold a security or an investment strategy, and is not provided in a fiduciary capacity. Shares of closed-end funds are subject to investment risks, including the possible loss of principal invested. Closed-end funds frequently trade at a discount to their net asset value (NAV).