Alternatives by
FRANKLIN TEMPLETON

Understanding Interval Funds

Interval funds—a type of closed-end fund not listed on an exchange, in which investors may only sell shares during certain specified periods or intervals. Interval funds make it possible for investors to participate in private investments to a much greater degree than mutual funds, providing access to a wide range of alternative assets (including private credit, private equity and private real estate). They can invest up to 95% of capital in illiquid assets. In contrast, mutual funds are limited to a maximum of 15%.[1]

In addition, mutual funds must maintain a significant cash reserve to cover on-demand redemptions, while interval funds do not. As a result, interval funds can direct more of their capital into productive investments. As such, these strategies may offer opportunities for enhanced risk-adjusted returns, income and portfolio diversification.

How interval funds work

Individual investors who seek the potential gains and diversification available through alternative assets may find interval funds to be a useful vehicle that provides a middle ground between mutual funds and private funds.

Interval funds are legally classified as closed-end mutual funds. But unlike traditional closed-end funds, their shares are not traded on an exchange and therefore do not trade above or below net asset value like closed-end funds. Instead, the fund conducts redemptions at specific times of year, or intervals (e.g., monthly, quarterly, semi-annually, and annually). The total number of shares that can be redeemed in any one interval is limited—typically 5% to 25% of capital—as specified in the fund prospectus. However, if repurchase request received are more than stated amount the shares are redeemed on pro rata basis of net asset value (NAV). Interval funds are permitted to deduct a repurchase fee from the proceeds to compensate the fund for expenses related to repurchases.

1. Investment Company Institute, Interval Funds: Operational Challenges and the Industry's Way Forward, p.7 [PDF], (Accessed January 17, 2022).

Structural considerations: How they differ

	Mutuals Funds Liquid Alternatives	Interval Funds	Closed-End, Private Funds
Eligibility	All	All/accredited investors	Qualified purchasers
Investments	Listed, public investment	Listed, non-listed, public and private investment	Non-listed, private investments
Continuous Offering	Yes	Yes	No
Daily Valuations	Yes	Yes	No
Min Investment	\$1,000–\$5,000	\$2,500–\$25,000	\$1M–\$10M
1099 Tax Treatment	Yes	Yes	K-1
Liquidity Provisions[1]	Daily	**Quarterly** Share repurchase w/ gating provisions	**10+ year lockup** Earlier liquidity not available or at high redemption fees
Capital Calls	No	No	Yes

1. Interval funds, as investment vehicles, offer limited liquidity, as such investors may only be able to redeem a portion of their shares at any time and only on a particular redemption schedule. Additionally, interval funds may be able to invest in securities that are themselves illiquid and thinly traded, which may limit a manager's ability to sell such securities at their fair market value.

Key features of interval funds

For many investors, the potential for enhanced yield, attractive risk-adjusted return profiles and diversification relative to traditional fixed income strategies are reasons to consider investing in interval funds.

Higher income potential

Interval funds generally offer access to higher-yielding private strategies which are not broadly available in daily liquidity vehicles. Because they do not provide daily liquidity, portfolio managers can invest capital in more illiquid assets and do not need to be concerned with the need to hold as much cash on a daily basis (i.e., less 'cash drag') to meet redemption requests.

Investor-friendly structure

Private investment funds or direct investments in private assets typically entail long lock-up periods, high minimum investments, and other liquidity constraints. They may also require investors to provide additional funds on demand to satisfy unanticipated capital calls and in some cases, participation may be limited to a smaller pool of accredited investors and/or qualified purchasers.

However, interval funds are far more investor-friendly, with a greater degree of liquidity through regular redemption periods, lower investment minimums and simplified tax reporting. In addition, share in an interval fund can be purchased at any time.

Portfolio diversification

Alternatives in general tend to behave differently than equities or fixed income, given the broad range of sectors, countries and time scales within the asset class. Interval funds specifically can hold a diversified portfolio of private investments and can invest across the capital structure, the liquidity spectrum, potentially providing investors with muted volatility and attractive yields.

Given the holdings generally have low correlation to the broader market, interval funds can provide a vehicle for diversifying against traditional investment strategies.

DISCLOSURES

Capital calls refer to ad hoc requests for additional investment capital from investors participating in private asset investments.

Cash drag refers to the opportunity cost of holding capital in reserve as cash in order to meet potential redemptions.

Accredited investors are investors that meet specific requirements set by the SEC to invest in unregistered securities. To qualify, individual investors must have annual income over $200,000 (or $300,000 for couples filing jointly) for the last two years with the expectation of the same income in the current year; or have a net worth over $1 million.

Qualified purchasers are investors that meet specific requirements by the SEC to invest in unregistered securities. To qualify, individual investors must have a net worth of more than $5 million.

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