RESOURCE REAL ESTATE

White Paper

Interval Fund Investing - Institutional Access

Individual investors have long wished for the same access institutions have to alternative investments. Interval funds have potential to unlock this access for the widest possible audience.

The global financial crisis has caused an important structural shift in investor preferences towards alternative investments and away from more volatile equity markets. In addition, bond yields have plummeted in the aftermath of the crisis, leaving investors without the ability to generate income. In essence, the crisis highlighted a flaw in the way many investors approach portfolio diversification — simply having a range of mutual funds with access to different "sectors" may not be enough to create appropriate diversification. For instance, while the underlying investment of a publicly traded Real Estate Investment Trust (REIT) may include real estate, an investor's allocation can behave very much like the S&P500.

Institutions have implicitly acknowledged the limitations of equity market investments for decades, with most maintaining a large allocation to private investments, including real estate.[1] The benefits of these allocations include a decrease in portfolio volatility, lower correlations with equity markets and the potential for increased returns. Historically, access to alternative private investments has been given exclusively to large institutional investors; but this is rapidly changing. The "mass affluent"[2] are now demanding more sophisticated investment products.

REIT Risk: REIT share prices may decline because of adverse developments affecting the real estate industry and real property values. In general, real estate values can be affected by a variety of factors, including supply and demand for properties, the economic health of the country or of different regions, and the strength of specific industries that rent properties. REITs often invest in highly leveraged properties. Returns from REITs, which typically are small or medium capitalization stocks, may trail returns from the overall stock market. In addition, changes in interest rates may hurt real estate values or make REIT shares less attractive than other income-producing investments. REITs are also subject to heavy cash flow dependency, defaults by borrowers and self-liquidation.

Real Estate Concentration Risk: Concentrating in investment vehicles that invest principally in real estate and real estate related industry securities will be significantly impacted by the performance of the real estate market and may experience more volatility and be exposed to greater risk than a more diversified portfolio. Focusing on specific sectors within the real estate industry would further increase risk compared to a more diversified portfolio.

[1] The Yale Endowment Fund is an example of a private investment platform with $20.8B AuM on June 30, 2013. The Endowment targets up to 90% in alternatives including private equity, absolute return, and real estate, investments.yale.edu/images/documents/Yale_Endowment_12.pdf; investments.yale.edu.

[2] The mass affluent segment generally refers to U.S. individual investors or households with $100,000 to $1M in investable assets, www.wikinvest.com/wiki/Mass_Affluent.

Liquidity Risk of Interval Funds: Closed-end investment companies structured as interval funds are designed for long-term investors. These funds are not listed on any securities exchange and are not publicly traded. Limited liquidity is provided to shareholders through fund-specific repurchase offers. Interval funds investing in securities of companies with smaller market capitalizations, derivatives or securities with substantial market and/or credit risk tend to have the greatest exposure to liquidity risk.

Private Investment Fund Risk: Investments in Private Investment Funds will bear a pro-rated share of the vehicles' expenses, including management and performance fees. Incentive fees charged by certain Private Investment Funds may create an incentive for its manager to make investments that are riskier and/or more speculative than those it might have made in the absence of an incentive fee. These funds are not publicly traded, and therefore, may not be as liquid as other types of investments and may have difficulty pricing their assets. These funds are not required to have independent boards, shareholder approval of advisory contracts, a limit on the fund's leverage, or engage in joint transactions with affiliates.

Public Investment Fund Risk: A fund's performance would depend in part upon the performance of the Public Investment Fund managers and selected strategies, the adherence by such Public Investment Fund managers to such selected strategies, the instruments used by such Public Investment Fund managers and a fund advisor's ability to select Public Investment Fund managers and strategies and effectively allocate Fund assets among them. Fund shareholders will bear two layers of fees and expenses: asset-based fees and expenses at the fund level, and asset based fees, which may include incentive allocations or fees and expenses at the Public Investment Fund level.

Recognizing this trend, investment sponsors have developed ways for individual clients to access alternative investments, including real estate equity and debt through non-traded REITs[3] as well as corporate credit through Business Development Companies (BDCs).[4] The Interval Mutual Fund (iFund), while technically a continuously offered closed-end fund, offers daily purchase for investment, and liquidity for redemptions at specific intervals (usually quarterly).

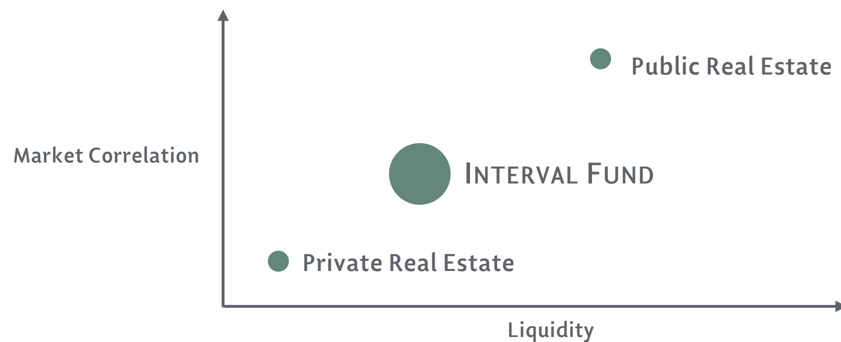
As mutual funds did for equities, iFunds have the potential to unlock alternative investments to the widest possible investor base while simultaneously providing greater price transparency and quarterly liquidity. In addition, iFunds may increase the efficiency and lower the expenses of investments in alternative assets by aggregating capital, thus decreasing costs as a percentage of assets — a significant benefit given the imminent rule changes for commission and fee transparency on client statements for non-traded REITs and BDCs.[5]

Interval Funds: A meeting point for alternative investments and mutual funds

The iFund is simply a vehicle that offers daily investment opportunities and limited redemptions at specific intervals (usually quarterly).[6] This fund structure creates advantages, and it allows the fund to simultaneously invest both in private and public assets — with a structure that has both liquidity and a daily net asset value (NAV). In turn, the sponsor may create a portfolio of investments with high yield and low correlation to equities, but without the usual limitations of private investments (illiquidity and lack of price transparency).

The liquidity feature and price transparency, in conjunction with sufficient portfolio diversification, can make iFunds suitable for a large pool of investors. This also allows interval funds to be held in both fee-based and commission-based accounts — an important benefit given the growth of fee-based assets and the advisors' need to access alternative investments that complement existing traditional mutual fund options.

Graph 1: Interval Funds - an intersection for alternatives and mutual funds



Graph 1: Interval funds offer higher liquidity than private real estate, but reflect market fluctuations. Private investments can offer higher yield and less correlation to the market, but they lack pricing transparency and liquidity. Interval Funds can capture the yield and correlation characteristics of private investments, but also provide liquidity and transparency.

[3] A direct, long-term real estate investment that uses the capital it raises from retail investors to purchase and manage income-producing properties, IPA.com, Investing in Non-traded REITs.

[4] A company that is created to help grow small companies in the initial stages of their development, similar to venture capital funds. Many BDCs are set up much like closed-end investment funds and are actually public companies that are listed on the NYSE, AMEX and NASDAQ, www.investopedia.com/terms/b/bdc.asp.

[5] On February 3, 2014, the Financial Industry Regulatory Authority (FINRA) proposed changes to NASD Rule 2340 which would increase disclosure on the fees and commissions paid to brokers who sell non-traded REITs.

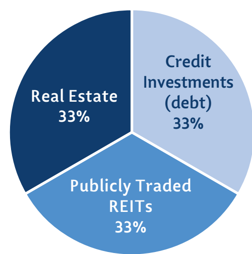
[6] Redemptions are shares bought back from the shareholder/investor by the fund under a program referred to as the Share Redemption Program (SRP) to provide investors with a limited form of liquidity.

Replicating an Institutional Approach to Real Estate Investments

Individual investors' access to real estate has traditionally been limited to publicly traded REITs and non-traded REITs. However, these products represent only a portion of the available access points to real estate investments. Simultaneously accessing different real estate investment types can optimize a real estate allocation by capturing the benefits of listed and non-listed investments, while mitigating their individual disadvantages. For example, investing directly in real estate through institutional private equity can produce moderate yields,[7] growth, and sector diversity, but not liquidity. Publicly traded REITs are liquid and give access to global investment opportunities, non-traditional asset types and growth, but come with a lower yield[8] and higher equity market correlation. Debt can give yield and principal protection, but can fall short on interest rate hedging ability.

In the following example, replicating an institutional real estate allocation by including equal weights of direct real estate, credit investments (debt) and publicly traded REITs would have produced a yield of 5.3 percent and a total return of 8.4 percent, with a volatility of 9.6 percent[9] since December 2000. The Sharpe Ratio would have been 0.88.[10]

Figure 1: An institutional real estate allocation[11]



100% Diversified Real Estate Income	
Annual Income	5.3%
Annual Capital Appreciation	3.2%
Annual Total Return	8.4%
Volatility	9.6%
Sharpe Ratio	0.88

Private Real Estate Equity consists of actively managed real estate equity investments in an unlisted format, typically through a fund or trust. This includes private equity real estate funds and investments in non-traded REITs.

Global Traded REIT Equity is a common stock investment in a publicly traded REIT that owns and operates income-producing real estate. REIT Equity is traded on major stock exchanges and has voting rights.

Real Estate Credit is an investment in a real estate company through a loan obligation, which typically includes instruments such as commercial mortgage backed securities, preferred equity and bonds. This investment may benefit from a higher claim on the assets and earnings of a company than common equity, does not have voting rights, and pays a fixed dividend with a yield usually above that of common equity.

Institutional Real Estate is real estate investments that, due to suitability requirements, are typically available only to institutions and high net-worth investors.

[7] NCREIF Property Index annualized return, 5.16% as of 12/31/14.

[8] NAREIT all equities return for the year was 3.56% for 2014.

[9] The underlying data for equity markets used in this analysis was based on the S&P500 Index that produced a yield of 2.03%, total return of 5.00% and a volatility of 17.72%; the data for publicly traded REIT markets used was the FTSE EPRA NAREIT Global Developed Index (RUGL) which produced a yield of 4.55%, total return of 10.00% and a volatility of 22.23%. The FTSE EPRA NAREIT Global Real Estate Index Series is designed to represent general trends in eligible real estate equities worldwide.

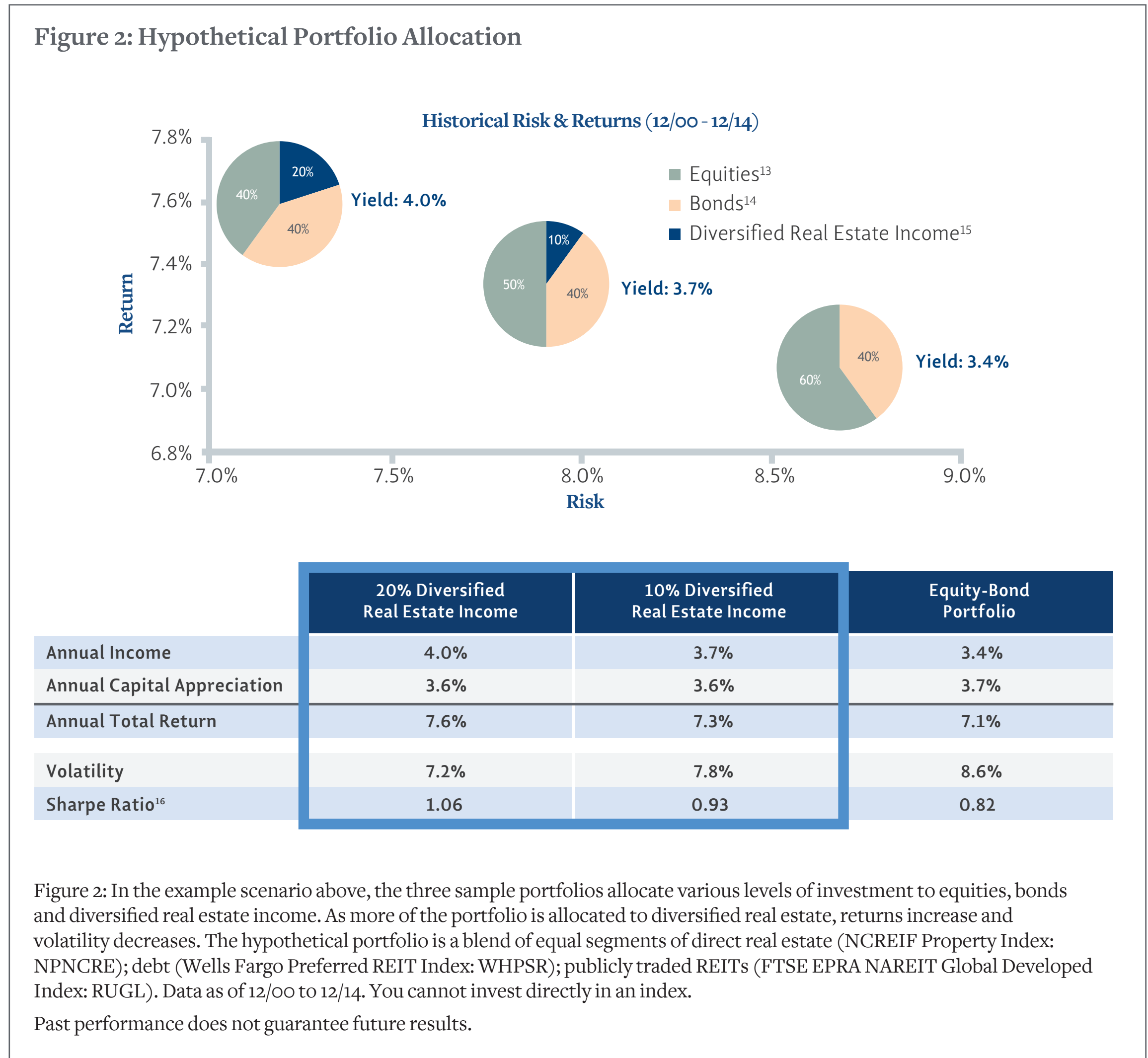
[10] Sharpe Ratio determines an investment's return per unit of risk and is calculated as total return divided by volatility.

[11] To create a hypothetical institutional real estate allocation portfolio, we blended equal segments of direct real estate (NCREIF Property Index: NPNCRE); debt (Wells Fargo Preferred REIT Index: WHPSR); publicly traded REITs (FTSE EPRA NAREIT Global Developed Index: RUGL). Data as of 12/00 to 6/14. Source: Internal Resource Real Estate data. The NCREIF Property Index is a quarterly time series composite total rate of return measure of investment performance of a very large pool of individual commercial real estate properties acquired in the private market for investment purposes only. The Wells Fargo Hybrid and Preferred Securities REIT Index is designed to track the performance of preferred securities issued in the US market by Real Estate Investment Trusts.
Institutional real estate can be classified as high-quality commercial properties — such as office buildings, retail centers, industrial facilities, apartment complexes and hotels — that are usually congregated in large investment portfolios managed professionally on behalf of third-party owners or beneficiaries.

As shown below, an allocation of only equities and bonds (third pie chart below in Figure 2) has potential to bring on more risk and lower returns than allocations that contain equities, bonds and diversified real estate income.[12] When 10 percent of diversified real estate income is added to the allocation (second pie chart in Figure 2), risk decreases, while returns simultaneously increase. When 20 percent of diversified real estate income is added to the portfolio (first pie chart in Figure 2), risk decreases even further, while returns simultaneously climb higher.

An institutional real estate allocation may lower volatility and increase returns

Figure 2: Hypothetical Portfolio Allocation



	20% Diversified Real Estate Income	10% Diversified Real Estate Income	Equity-Bond Portfolio
Annual Income	4.0%	3.7%	3.4%
Annual Capital Appreciation	3.6%	3.6%	3.7%
Annual Total Return	7.6%	7.3%	7.1%
Volatility	7.2%	7.8%	8.6%
Sharpe Ratio[16]	1.06	0.93	0.82

Figure 2: In the example scenario above, the three sample portfolios allocate various levels of investment to equities, bonds and diversified real estate income. As more of the portfolio is allocated to diversified real estate, returns increase and volatility decreases. The hypothetical portfolio is a blend of equal segments of direct real estate (NCREIF Property Index: NPNCRE); debt (Wells Fargo Preferred REIT Index: WHPSR); publicly traded REITs (FTSE EPRA NAREIT Global Developed Index: RUGL). Data as of 12/00 to 12/14. You cannot invest directly in an index.

Past performance does not guarantee future results.

[12] Shown by an increased Sharpe Ratio.

[13] The underlying data for equity markets used in this analysis was based on the S&P500 Index that produced a yield of 2.03%, total return of 5.00% and a volatility of 17.72%; the data for publicly traded REIT markets used was the FTSE EPRA NAREIT Global Developed Index (RUGL) which produced a yield of 4.55%, total return of 10.00% and a volatility of 22.23%.

[14] The data for the bond markets used was based on the EFFAS Bond Index for U.S. 10-year government bonds (Bloomberg: USG5) which produced a yield of 5.35%, total return of 6.98%, and a volatility of 12.26%.

[15] The hypothetical Diversified Real Estate Income portfolio is the same blend as shown in Figure 1. Please note that you cannot invest directly in an index.

[16] Sharpe Ratio determines an investment's return per unit of risk and is calculated as total return divided by volatility. Risk is volatility, and volatility is measured as standard deviation.

A tool for new FINRA client statement rules

The non-traded REIT industry faces a significant change with the expected implementation of new rules for client statement reporting.[17] The changes for fee and commission transparency will have a considerable impact on the non-traded REIT market and, in particular, its fee and commission structures. Coupled with an increase in transparency on the net value of client positions, this change is likely to make interval funds more attractive for both advisors and clients.

Interval funds may be part of the solution for advisors impacted by the potential of lower commissions following the implementation of these new rules. iFunds already enjoy liquidity and transparency in pricing through a daily NAV. Advisors who have been reluctant to make use of more opaque alternative instruments[18] may find iFunds suitable for more clients by virtue of their liquidity and transparency, expanding the use of alternatives by their clients.

The ability to aggregate capital through iFunds provides a further advantage to the industry. Economies of scale and the mutual fund structure can help decrease costs related to due diligence, research and distribution. Just as mutual funds led to the broadening of equity investment over the last two decades (with simultaneous fee compression and expansion of the industry), iFunds may prove a similar catalyst for expanded market penetration by alternatives.

Analyzing Interval Funds

iFunds' attractiveness to investors depends on the content of their portfolios. Strategies will differ; some will include a range of alternative assets in addition to real estate. However, there are a few essential aspects investors should consider when examining an iFund's merits:

- **Investment strategy:** Understand what asset classes the portfolio comprises as well as the largest positions in the fund.
- **Internal investment management versus fund-to-funds approach:** Does the iFund outsource investment management or keep this function "in-house?" It is advantageous for the fund sponsor to perform this important function, as it allows better risk control and more accountability, in addition to potentially lower costs.
- **Level of liquidity and transparency:** The liquidity feature of the iFund structure is an important characteristic as it offers quarterly redemptions of no less than 5% of the shares outstanding. Regardless of how the Fund performs, there is no guarantee that shareholders will be able to sell all of the shares they desire in a quarterly repurchase offer. Further, the allocation to liquid assets improves pricing transparency.
- **Conflicts of interest:** Conflicts can arise if the portfolio manager is allowed to invest in other funds of the sponsor.[19] The most transparent way to ensure no conflicts is to preclude the iFund from investing in other funds of the sponsor.

[17] On February 3, 2014, the Financial Industry Regulatory Authority (FINRA) proposed changes to NASD Rule 2340 which would increase disclosure on the fees and commissions paid to brokers who sell non-traded REITs. Under the new rules, it is proposed that NTR client statements will display the per-share price net of the REIT's expenses, with statements showing the share value after the deduction of fees and any expenses related to organization, offering and property acquisitions. Mutual Funds and Interval Funds tend to have lower fees and expenses and report a price plus commission cost basis on the client statement as opposed to the NTRs current net investment structure. We believe fuller disclosure will benefit both customers and the industry, and may lead to a more mutual fund-like fee structure, with different share classes.

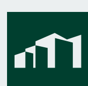
[18] Only one in five of their clients are invested in non-traded REITs, at present. [Stanger Survey of Advisors 2013]

[19] This is the case even if the fund board appoints a third-party sub advisor, if the board is composed of the sponsor's representatives. In such an instance, the sponsor can effectively hire and fire the manager, which does not ensure impartiality when investing in the sponsor's other products.

Conclusion

The demand for uncorrelated income is leading to new ways for advisors and their clients to access alternative investments. iFunds help meet this growing demand through a portfolio of alternative investment securities. This can replicate the benefits of an institutional approach to real estate investment for an expanded set of investors. In addition, the flexibility of the interval mutual fund structure can help advisors adapt to an evolving regulatory landscape. Important aspects to consider when assessing the merits of an interval fund include the investment strategy, internal management, liquidity and lack of conflicts. As the demand for uncorrelated yield continues to increase, iFunds can offer an important tool to gain the widest possible access by the widest possible audience to alternative investments.

An investment in interval funds involves risk, including loss of principal.



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