The Trendiest Investment on Wall Street…That Nobody Knows About

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Among this year's hottest investment ideas is one that even many of the people buying it have never heard of.

This peculiar vehicle is called an interval fund, and asset managers are using it to offer portfolios they might not be able to market otherwise. While such funds come with an admirable focus on holding assets for the long term, they also lock money up in ways many investors aren't accustomed to.

In the first three quarters of this year, asset managers registered to sell $26.7 billion of interval funds, up 24% from the same period in 2015, estimates Robert A. Stanger & Co., a firm in Shrewsbury, N.J., that tracks non-traded securities.

Among them are funds that hold commercial real estate, timberland and farmland, online consumer loans, the debt of distressed or bankrupt companies, "catastrophe bonds" that are tied to risks like hurricanes or earthquakes, and other illiquid positions that seldom trade in the financial markets.

Unlike a conventional mutual fund, an interval fund is ideal for such assets, since purchasers can't sell their shares back at will. Instead, an interval fund will cash you out only a few times a year — most often, quarterly.

Investors as a whole can't get more than 25% of their money back at a time; typically, funds offer to redeem 5% of their total shares at each interval. You could get all your money out at once if other investors don't redeem the maximum, but it could take you as long as several years if they do.

That creates a pool of patient capital: money that won't leave in a panic, because it can't.

The interval structure functions as a counterweight to investors' natural compulsion to buy high and sell low. It can help lengthen their holding periods to match those of a fund manager seeking to take advantage of market dislocations over the longer term.

Patience is a virtue, but it has its price.

On Oct. 25, FS Investments filed with the Securities and Exchange Commission to sell up to $2 billion in shares of an interval fund to be called FS Energy Total Return. Philadelphia-based FS manages more than $18 billion in small-business loans and other so-called alternative assets.

The fund will primarily hold stocks and bonds issued by oil and gas, coal and other natural-resource companies; some may be infrequently traded. It can also borrow up to one-third of total assets — amplifying any gains but also magnifying any losses.

The fund's holdings will be picked in association with Magnetar Asset Management, part of a hedge-fund adviser in Illinois that runs energy portfolios but also helped create mortgage-debt securities that blew up during the financial crisis. A Magnetar spokeswoman declined to comment on the offering.

If you commit $10,000 to the Class A shares, you will pay a 5.75% sales charge, leaving only $9,425 to put to work. As a result, you need a 6.1% return just to break even. Although FS will waive its management fee of up to 2.45% for the first 12 months of the fund's life, a 0.25% servicing fee and up to 0.75% in "ordinary operating expenses" will still apply. In year two and beyond, net annual expenses could total as much as 3.45%.

Add it all up, and the fund has to earn at least 7.1% for you to get out of the hole.

You can avoid that costly sales charge if you buy through some financial advisers, but there's no avoiding all the annual fees. As is customary for companies in the midst of a public offering, FS declined to comment on the specifics of the deal.

Like all funds registered with the Securities and Exchange Commission, interval funds must give your money back as promised — except during an emergency or under a special exemption from the SEC.

Mutual funds usually — although not always – favor securities that are readily tradable. But because interval funds specialize in less-marketable assets, they "could face greater challenges than typical mutual funds in valuing their portfolio holdings," says Barry Barbash, a partner specializing in asset-management law at Willkie Farr & Gallagher in Washington, D.C.

Under SEC rules, as soon as interval funds announce the next scheduled redemption, they must set aside sufficient cash or equivalents to cover the value of the shares they are offering to buy back.

That gives the funds a minimum of 21 days to raise the needed cash, says John Mahon, a partner in securities law at Schulte Roth & Zabel in Washington, D.C.

But a lot can happen in a few weeks when financial markets go wild.

Bear in mind that the word interval derives from the Latin term for the gap between the ramparts atop medieval castles. Before you step out into that space, make sure you are armored with awareness of the risks.

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