



STORMFIELD INSIGHTS

Liquidity Management

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In designing a fund to house illiquid assets, whether those assets be private corporate debt, infrastructure, real estate debt or private equity, one of the first questions that managers and investors must ask themselves is how to match assets (the investments the fund plans to make) with the liabilities (investor capital and borrowings) the fund will incur. Sadly, this practice of asset-liability matching (“ALM”), is often discarded in favor of designing funds that will attract the most capital over those that will protect investors’ interests over the long term.

By way of background, until fairly recently, most illiquid assets were generally held in closed-end funds with lifespans of 5 to 7 years (in the example of private credit funds) to 8 to 12 years (in the case of private equity, venture capital and infrastructure). These funds call and invest investor capital over a period of several years and return capital as investments are realized. Absent significant borrowings (leverage), these structures have generally done a good job of managing most ALM considerations.

However, while the illiquidity of such funds was acceptable to institutional investors such as university endowments and pension plans with investment horizons that span decades, the structure was less palatable when private equity, real estate, venture capital and infrastructure managers turned their capital raising sights to individual investors. To solve this capital raising problem, large alternative asset managers turned to older, but heretofore seldom used structures such as tender offer funds, interval funds and private BDCs. These structures were created in the late 1970s through early 1990s but remained a relative backwater until recently. Such structures offer several advantages from a capital raising perspective – including being open to a much wider set of investors, greater ease of trading (a potential Achilles Heel in some cases) and most importantly, much greater liquidity than the closed-end vehicles that alternative asset managers had used for decades to invest in less liquid assets. The table below summarizes some of the most salient features of these structures.

Feature	Tender Offer Fund	Interval Fund	Private BDC
Liquidity Mandate	Discretionary	Mandatory	Discretionary
Minimum Repurchase	None by Rule, commonly 5% per interval	5% per interval	None by Rule, commonly 5% per interval
Redemption Frequency (Interval)	Typically Quarterly	Quarterly to Annual (most commonly quarterly)	None by Rule, commonly quarterly
Redemption Pricing	NAV	NAV	NAV
Initial Lock-up Period	None	None	Very uncommon
Leverage Limits	33%	33%	100%
Investor Eligibility	Accredited Investors/ Qualified Clients (AI/QC)	All	Accredit Investors/ Qualified Clients (AI/QC)

On the positive side, these fund structures have opened up new investments to scores of investors. By doing so, investors can incorporate assets into their portfolio that were previously restricted to the domain of only the largest and most sophisticated institutional investors, thereby improving the diversification and risk/reward profile of their holdings.

Unfortunately, all alternative assets are not equally well suited to these vehicles. To take an extreme example, many tender offer funds and interval funds hold investments in traditionally structured, closed-end private equity, venture capital and infrastructure funds with 8 to 12 year lives.

How such investments can be responsibly housed in a vehicle offering quarterly liquidity is a question that confounds us.

Less egregiously, many tender offer funds, interval funds and BDCs have become home to various forms of debt investments. In many cases, these debt investments are very well suited to the liquidity offered by the vehicle, particularly in the case of shorter-term debt investments that generate regular liquidity via interest collections and debt maturities. However, problems begin to arise when debt investments with longer maturities (commonly 5 years in the case of corporate private credit) are placed within these structures, particularly in the presence of leverage. These problems generally stem from a confluence of the following factors.

- The fundamental characteristic of fund level gates (or repurchase amounts in tender offer/interval fund/BDC parlance) creates a challenge. Fund level gates introduce a hazard known in game theory as the “Prisoner’s Dilemma.” Imagine two suspects (A and B) are arrested for a crime and held in separate cells. The prosecutor offers each the same deal. If both remain silent, each prisoner serves one year in prison for a lesser charge. However, if one prisoner betrays the other, the betrayer will be set free while the silent prisoner gets a three-year prison sentence. If both betray each other, each gets two years. The prisoners are not allowed to communicate. The best collective decision would be for both prisoners to remain silent, however, unless the prisoners happen to be familiar with the Nash Equilibrium or share some common cause, most are likely to rat.¹ This dynamic extends to funds that offer liquidity to investors via fund level repurchase windows. If an investor becomes worried about the holdings of a fund, or simply becomes worried that others may be worried, the Prisoner’s Dilemma kicks in. If one is concerned that others may redeem and eat up the capacity of the redemption window, that investor will be incentivized to enter a redemption of their own, even if they are comfortable with the portfolio, purely out of fear that others will redeem and get first place in line for the redemption window. This can quickly create a scenario where redemptions rapidly accumulate and exceed the allowed amount – a dynamic we are seeing play out in real time with many funds holding longer term corporate debt in tender offer/interval funds and/or BDCs.



- A second structural flaw is the lack of lockups. Registered funds such as interval funds and tender offer funds are not allowed to have investor lockups. An initial lockup serves as important deterrent to “hot money” which may be inclined to view certain private credit strategies as a form of enhanced money market fund. By self-selecting an investor base that is comfortable with a one-year initial lock-up, a fund manager can curate a capital base with an appropriate time horizon.
- A third structural flaw is introduced to those funds that apply leverage to this unstable asset base. Invariably, a wave of redemptions will often collide with a rocky period in financial markets. As redemptions accumulate each quarter, a fund with longer term loans will be forced into a difficult situation – selling assets to reduce leverage as a fund’s equity base erodes. Depending on the state of capital markets, such loans may need to be sold at a loss, eroding the returns of all investors in the fund.
- A fourth structural problem is the very democratization that interval/tender funds and BDCs introduce. Such vehicles can often be bought by anyone just as easily as buying stock on an exchange. The reverse is also true if an investor panics or rapidly changes his or her mind. It is unclear how well many retail investors understand what they are buying and the potential pitfalls of the structures they are buying into.

¹The 2001 movie “A Beautiful Mind” does a great job illustrating the Nash Equilibrium for those interested.

Stormfield's Approach

If these structures introduce structural mismatches, the question becomes how to solve them. We put a great deal of thought into our evergreen fund structures when forming Stormfield, including the consideration of interval and fund structures. Not wanting to risk the ALM risks highlighted above, we settled on the following principles:

- Choosing a private fund structure rather than an interval/tender offer or BDC due to the flexibility of terms allowed in privately offered funds.
- Utilize a one-year initial lock-up to deter any "fast money" investors.
- When raising capital from affluent individuals, Stormfield partners with sophisticated wealth managers, family offices and advisors who provide education and counsel to their clients, ensuring that investors understand the semi-liquid nature of Stormfield's funds and therefore invest with the appropriate time horizon and knowledge of the underlying strategy.
- Utilize investor level gates rather than fund level gates to eliminate the "Prisoner's Dilemma." With our investor level gates, investors who wish to redeem their capital receive 25% of their capital back per quarter regardless of the behavior of other investors. In addition to eliminating the Prisoners Dilemma, this also provides investors with greater certainty over the timing of their liquidity disbursements.
- Avoiding the use of leverage.
- Matching the liquidity of our assets (in this case the loans we originate on behalf of our funds) with the liquidity we have offered investors. In our case, this means investing the overwhelming majority of our funds' capital in loans with 12-month maturities. This ensures that the portfolio will naturally produce liquidity (via loan maturities and interest collections) on the order of 25% per quarter, thus aligning the liquidity of the assets in the fund with the redemption terms offered to investors.
- Avoiding any non-cash pay loans, such as PIK or PIK-toggle structures that reduce the cash generative qualities of the portfolio.

Where to go from here?

Private credit, real estate debt and asset-based lending strategies can all materially improve the risk and return profile of a fixed income allocation. A key consideration is ensuring that the vehicle that houses such assets is appropriate for the liquidity of those assets and the liquidity offered to investors. For investors who value proper asset-liability matching, short term real estate debt presents an asset class that is particularly well suited to a semi-liquid evergreen structure. Furthermore, while corporate private credit has been enjoying a halcyon period of asset raising, real estate debt is just now emerging from a three-year downturn while investors first wrestled with the effect of the pandemic on hospitality and office assets and then real estate more broadly following the Federal Reserve's rate hiking cycle of 2022 to 2023. The residential real estate that comprises the majority of Stormfield's collateral has proven resilient through this period and is well poised for continued stability supported by a structural shortage of housing in many markets across the United States.

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