Revised ELTIF regime can contribute to post-Covid recovery and green transition

By Silke BERNARD, Investment Funds Partner, Linklaters Luxembourg

The European Long-Term Investment Fund regime has been slow to gain traction since its launch in December 2015. But its time may now be arriving with significant changes expected to be proposed by the European Commission this month, at a moment when demand for private investment in long term assets such as physical infrastructure is seen as an important driver of economic recovery from the Covid-19 pandemic.

To date just 57 ELTIFs have been established across Europe, of which 26 are in Luxembourg, with significant numbers also in France and Italy. But up to now many asset managers and fund promoters have complained that the regime was too complex and defeated one of its key goals: to open up alternative strategies hitherto largely restricted to institutional and professional investors to high net worth and mass affluent individuals.

The ELTIF was conceived as a vehicle to broaden access to investments in the 'real economy', including unlisted companies as well as long-term assets such as real estate and infrastructure. It qualifies as an AIF under the alternative investment fund managers directive, and must be managed by an authorised AIFM, but has its own specific product rules. Under the current regime at least 70% of an ELTIF's assets, comprising paid-in capital and commitments, must consist of equity, debt or loans of a qualifying company or project, shares or units in other ELTIFs, EuVECAs or EuSEFs – European venture capital and social entrepreneurship funds, two other investment vehicles in the past decade that have also experienced relatively limited take-up – and direct holdings of real assets including infrastructure, property, ships, aircraft and trains.

Industry members acknowledge that the regime has been hampered by supply-side barriers. The original legislation, which sought to combine the more flexible asset rules of alternative investment funds with access for non-sophisticated investors, ultimately raised a range of technical issues, leading a certain number of fund promoters to conclude that they were unable to fit their strategy and investor profile target within the ELTIF framework.

In addition, it has taken time to understand the regime and to educate both general partners and investors about its potential. There are signs that this is paying off, with momentum gradually developed behind the products, with support especially from distributors that see demand from their investor clients. Government initiatives have helped too - for example, the number of ELTIFs in Italy has grown following the introduction of a tax incentive for retail investors investing in a predetermined investment strategy.

But many industry members hope the proposed revisions to the legislation due to be unveiled by the Commission on or around November 23 will offer the flexibility needed to bring ELTIFs more squarely into the investment mainstream.

Although there are no draft proposals available yet as to how the regime will be amended, on the wish list of industry members are the ability to create as open-ended funds, a broader scope and greater precision on asset eligibility, opening the door to funds of funds and possibly also master-feeder structures, the streamlining of the authorisation process, and more clarity over the role of co- investments.

To judge by consultations held in preparation for revision of the regulation, the Commission has listened closely to and shown willingness to be educated by industry participants and their analysis of the factors that have slowed acceptance of ELTIFs over the past six years. Officials have seemed interested in hearing where problems have arisen and which aspects of the 2015 rulebook worked while others did not. As has been seen with other EU and indeed national legislation, it can often take more than one iteration to adapt a theoretical concept to market reality.

In particular, it appears that the legislative drafters are keen to ensure that this time the structure fulfils its goal of providing accessibility to individual investors – if not always retail consumers, at least those at the lower end of the HNWI market and the higher echelons of the mass affluent, while maintaining appropriate levels of investor protection.

One central element to this will be extending the structuring options beyond closed-ended vehicles, which are not familiar to investors in many countries outside the UK. While ELTIFs by design are conceived as long-term investment structures, there appears to be acceptance of the need for some redemption options and liquidity windows, even if their conditions are inevitably more restrictive than for UCITS and other funds aimed at the retail market.

Arguably the ELTIF review is being conducted at a particularly propitious moment. Investors who have had to cope with years of ultra-low, zero or even negative interest rates are highly receptive to alternative strategies that hold out the prospect of higher returns, even at the cost of reduced liquidity. Individual investors that fail to meet the conditions required to access traditional alternative products can look forward to a wider range of options to diversify their portfolios.

At the same time, governments worldwide are looking to mobilise private capital to help drive an economic rebound from the downturn of the past couple of years, as well as, on a longer time horizon to join the financial effort required for transition to a decarbonised economy and society. If the new ELTIF framework is right, it can help investors make a significant contribution to achieving these twin, closely linked goals.

Once the Commission has published its proposals, how long might implementation of the changes take? In an ideal world, the ELTIF 2.0 framework would be adopted during the first half of 2022, although delays cannot be ruled out. Also, it is not clear at this point whether the proposed revisions to the ELTIF legislation would entail the need for delegated legislative acts, which might push back implementation to the second half of the year or early 2023.

Following intense consultations this year, there is hope that the legislative process may be relatively smooth, and that the ultimate legislation will not differ significantly from the Commission's proposals. In addition, the EU Council presidency in the first half of next year will be held by France, a country that has seen significant creation of ELTIFs and that presumably has an interest in seeing the new rules adopted expeditiously. It's an aim that the investment industry, in Luxembourg and elsewhere, certainly shares.

An analysis of the ESG impact of the largest sustainable focused equity mutual funds

By Gianluca D'ALESSIO, head of portfolio management, FARAD I.M.

ESG and sustainable investing has become a key selling point for most fund promoters. Do funds that claim to be biased towards sustainability really offer investors an exposure to sustainable investments? Can we see this in an analysis of their exposure and biases?

In this article we report the results of an analysis we performed on some of the largest equity mutual funds available in the market. What is specific is that our analysis is focused on the sustainability aspects. This includes the exposure of the fund to the United Nations Sustainable Development Goals (SDGs) and other aspects like carbon emissions or controversies. Our results indicate quite broad differences between the products on the market, confirming the need for investors to go further in their analysis than simply relying on a fund name of a broad statement explaining the aim of a specific investment fund. This is one of the service that FARAD I.M. proposed for its advisory clients, a dedicated sustainable reporting called the GreenEthica Sustainable Scoring System.

The universe reviewed

For this analysis, we selected 10 Large Cap Equity funds from well-known fund houses, with a fund size base currency averaging to EUR 1.8 billion. These funds were selected for their sustainability/ESG attributes, so as to critically assess their sustainable impact against seemingly green funds. This objective is to shed light on the essence of "ESG", "SRI" and "Sustainable" in order to sort the wheat from the chaff. The funds selected are: "*Amundi MSCI Europe SRI*" fund (almost EUR 3 billion in AUM), being, according to its name, a Socially Responsible Investment (SRI) broadly defined; the "*BNPP MSCI Europe SRI S5%*" fund (almost EUR 2 billion in AUM), being also, according to its name, a Socially Responsible Investment fund; the "*Robeco Sustainable Europe Stars*" (Approximately EUR 1.5 billion in AUM), being Sustainable; the "*DWS ESG European Equities*" fund (over EUR 200 million in AUM); the "*HSBC Global Equity Climate Change*" (over EUR 280 million in AUM), entering into the sustainability category thanks to its purpose of climate change fighting; theme also shared with the fund "*Schroder ISF Global Climate Change*" (over EUR 5 billion in AUM); two emerging markets funds, one sustainable and one ESG-focused, respectively, the "*JPM Emerging Markets Sustainable Equity*" (close to EUR 700 million in AUM) and the "*BlackRock Emerging Markets ESG*" (close to EUR 8 billion in AUM); the fund "*BSF Systematic ESG World Equity*" (almost EUR 350 million in AUM) being ESG-focused and finally the fund "*AB SICAV Sustainable Global*" (over EUR 3.5 billion in AUM), sustainability focused. All the mentioned funds are SFDR Article 8.

European Equity Sustainable Funds

Generally speaking, the results of our analysis on the European equity sustainable funds indicate a greater contribution to the Sustainable Development Goals (SDGs) than the funds from the rest of the world. The majority of the European funds have a positive contribution to the goals superior to 20%. Europe does not only advertise for sustainable funds, but actually makes significant and positive impact. For instance, the European funds contribute between three and seven percent of their overall portfolio towards the goals 7 "Affordable and Clean Energy" and 13 "Climate Action". While few other goals are covered between one and three percent, unfortunately the biggest majority of the SDGs are not represented at all, such as "Gender Equality", "Peace, Justice and Strong Institutions" and "Partnerships for the Goals".

From an ESG risk perspective, the European funds have a sustainability score lower than their peers category, meaning that they are better at managing and integrating the risks associated with the three pillars. They also have a weaker carbon intensity than their peers, by emitting 50% less carbon emissions from scope 1 and scope 2. Finally, another advantage of those European Sustainable funds is their complete exclusion of equities with high or severe controversies.

At a fund specific level, within the four European equity funds chosen for the analysis, the most sustainable fund, resulting with the best historical and current sustainability risk score, is "*Amundi MSCI Europe SRI*". The fund with the riskier sustainability score is "*DWS ESG European Equities*" and could therefore be considered as the ESG laggard. However, this fund emits the least carbon emissions – both scope 1 and 2 – among its competitors. The fund "*Robeco Sustainable Europe Stars*" has for instance a carbon intensity three times as high as the DWS fund. But, regarding the contribution to the SDGs, the fund Robeco is the largest contributor, with as much as one fifth of his holdings pursuing the United Nations' sustainable objectives. Each and every metric matters and needs to be studied collectively rather than on a standalone basis. Therefore, the sophisticated investor shall follow an holistic view when conducting a sustainable investing approach.

Emerging Markets Equity Sustainable Funds

On the other hand, Emerging Markets funds tend to less efficiently integrate the risks associated to the different pillars, E, S and G, and to the carbon emissions. Emerging Markets funds also have a greater exposure to high and severe controversies, between three to six percent of their AUM, compared to zero percent for the rest of the world. Regarding the contribution to the SDGs, Emerging Markets funds distinguish themselves by contributing to goals that are usually neglected by developed markets' fund managers, such as "No Poverty", "No Hunger", "Quality Education", "Decent Work and Economic Growth" and "Reduced Inequalities". Their contributions are minimal, generally below one percent, but demonstrate a genuine consideration for these goals. While investing in companies promoting energy transition solutions seems to be an easy option, acting to reduce the poverty in the world is a much more difficult task. Emerging Markets funds, compared to European or US funds, are at least contributing by a slight percentage to solve these goals.

Emerging Markets funds are differentiated from the rest of the world by investing in ideological goals, but striking differences exist among them. While the fund "*JPM Emerging Markets Sustainable*" has a thinner SDG contribution, it addresses two of the most critical challenges faced by developing nations, namely poverty and hunger. On the contrary, the fund "*BlackRock Emerging Markets ESG*", does contribute more than 20% to two other SDGs, "Sustainable Cities and Communities" and "Climate Action", while having no contribution to the SDGs with higher priority from a humanitarian perspective.

Global Equity Sustainable Funds

Finally, global funds are unsurprisingly less vulnerable to ESG risks than Emerging Markets funds, but more vulnerable than European ones. Indeed, Europe positioned itself very well towards sustainability thanks to the SFDR and the EU taxonomy, while other governments did not undertake legal initiatives. Global funds are, generally speaking, contributing positively towards the SDGs, with percentages varying from 5% to 65%.

As already pointed out earlier, the most covered goals are the goals 7 and 13. However, from one fund to another, the contribution to the SDGs differs a lot: from five percent for the fund "*AB SICAV Sustainable Global*", to 65% for "*HSBC GIF Global Equity Climate*". The most sustainable fund is therefore the fund "*HSBC GIF Global Equity Climate*", with more than 20% participation in each goal 7 and 13. In second position the fund "*Schroder ISF Global Climate Change*" reports also high percentages towards these goals. While these contributions pave the way to sustainable action for the planet, none of the global funds are contributing to reduce poverty, gender discrepancies or even inequalities. Global funds still have a great deal of work ahead.

Conclusion

Are self-stated sustainable funds as sustainable as they described themselves? In most cases, yes. Unfortunately, we still observe broad differences between funds branded as ESG or Sustainable, which highlights risk of greenwashing. As a conclusion to our analysis, our results indicate that sustainable Emerging Markets funds are the riskiest in terms of ESG risk exposure, while the least risky are the European ones. We can draw a similar conclusion on the carbon risks. These observations are coherent with the importance Europe gives to sustainability.

Regarding the contribution to the SDGs, the climate change-oriented funds score well, with over 50% of their portfolio participating to the goals. European funds muddle through as well, with more than 20%. No such clear conclusion can be reached for Global and Emerging Markets funds. Their contributions differ widely from five to twenty-five percent. The two take away are: 1. European funds are the best contributors to the SDGs compared to the rest of the world; 2. Purpose-oriented funds, such as climate change solution, are the major contributors over all.

We have been able to achieve such an analysis thanks to our experience in the field and a specific tool we have developed. Without a deeper analysis of these funds, we would not have been able to decipher real sustainability from greenwashing, nor their positive contribution to the Sustainable Development Goals. This is why, at FARAD Investment Management, we provide a dedicated service: the GreenEthica Sustainable Scoring System. This system of scoring allows us to analyze not only the funds' ESG and carbon risks, but more especially their participations to the United Nations' SDGs. It allows investors to have a precise disclosure on how their investments contribute to the greater good. Contact us for more info.

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