ELTIF funds will democratize the access to real assets

The European Long-Term Investment Fund (ELTIF) format allows access to private asset investments without having to invest large sums or be an institutional investor.

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Key messages

1) The current market environment of rising correlation between equities and bonds invites investors to consider other approaches than the traditional 60/40 portfolio.
2) One alternative is to replace part of the bond and equity allocations with less liquid investments invites investors. However, these alternative investments have traditionally been difficult for non-institutional investors to access due to the lack of suitable products.
3) The newly created "ELTIF" (European Long Term Investment Funds) offers individuals the possibility to invest in private assets (private equity, private debt, infrastructure, etc.), thus increasing diversification and risk spreading. All with a low minimum amount and including some specific protections for investors.

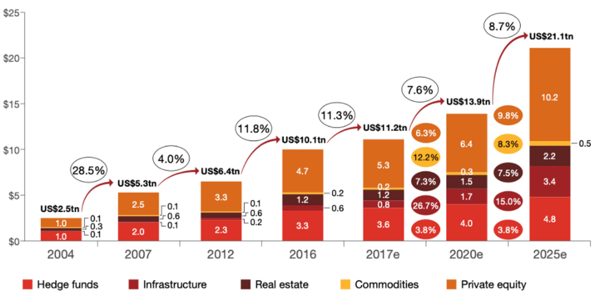
The traditional diversified equity and bond portfolio has enjoyed years of exceptional performance. But the current market environment invites investors to consider new management approaches. Indeed, in a regime of high inflation, the diversification properties of the bond portfolio are much less effective than in the past since the correlation between stocks and bonds tends to be positive.

What new options are investors and savers considering? The first is to accept a higher risk profile (and therefore higher volatility of returns) in order to be able to achieve the performance levels that used to prevail.

Another alternative is to replace part of the bond and equity allocations with less liquid (or even much less liquid) investments such as hedge funds, real estate funds, private debt, or venture capital.

It is worth noting that alternative investments have experienced remarkable growth over the past decade. Just before the great financial crisis of 2008, they represented about $5.3 trillion. By the end of 2020, alternative investment firms were managing some $13.9 trillion in assets. This amount could grow to more than $21 trillion by 2027.

Alternatives by type in US$tn (Base case scenario)



Source: PwC Asset and Wealth Management Research Center analysis.

However, these alternative investments have traditionally been difficult for non-institutional investors to access due to the lack of suitable products, high minimum thresholds, complexity of the underlying investments and low liquidity. But the situation is changing.

The ELTIF structure (European Long Term Investment Funds)

In recent years, European governments have recognized the increasingly important role that private capital plays in economic growth and job creation. In 2015, a new regulatory framework allowed the EU to introduce European Long-Term Investment Funds ("ELTIF").

The objective of this new type of fund was to stimulate the real economy in Europe by helping finance EU companies and projects that need long-term capital but do not have access to public capital markets. The regulation provides for a fund structure that allows sophisticated retail investors to access investments in private assets, such as venture capital (mainly unquoted SMEs) or infrastructure projects. These investment vehicles are eligible for a European passport for the distribution of private asset funds to institutional and retail investors.

The ELTIF format is particularly well suited to retail investors as the funds are structured to make a single capital call and require much lower minimum subscription amounts than institutional venture capital funds. These funds create a way to invest in parts of the economy that retail investors have not had access to before.

On the real economy side, ELTIF funds allow for the financing of SMEs that do not necessarily have easy access to financing. Europe has companies specialized in sectors such as luxury goods, manufacturing, services and technology. They are very attractive because of their know-how and strong growth but are often too small to be listed on the stock exchange. As a result, they are often unable to realize their potential due to insufficient capital funding. ELTIFs help to remedy this.

What are the main characteristics of an ELTIF?

An ELTIF can be considered the equivalent of a UCITS (Undertaking for Collective Investment in Transferable Securities) for illiquid assets. However, the ELTIF has particular risks and complexities associated with its closed-end form and the nature of its underlying investments, which are essentially illiquid.

The biggest disadvantage of the ELTIF (compared to traditional UCITS) is that it is not "liquid": indeed, investors must consider holding it for its full term, typically about 10 years, although this varies from one ELTIF to another. The closed-end structure implies that capital is invested at the outset, and that investors then typically receive distributions, corresponding to the return of capital and performance over the remainder of the fund's life.

In terms of geography, ELTIF version 1.0 stipulates that investments must be tied to the EU economy (which limits diversification for end investors).

The main benefits are the following:

- Access to a diversifying asset class: ELTIF allows retail investors to access asset classes that were previously off limits.

- No double layer of fees: in version 1.0, investment through funds is not allowed.
- A very low minimum investment (usually from 10,000 euros).
- Attractive risk/return trade-off: ELTIFs have a long-time horizon, which often means higher expected returns and lower volatility (no daily or weekly NAVs for the underlying assets).
- Simplified structure and administration: ELTIFs are structured specifically for private investors to reduce administration, e.g., with fewer capital calls, a shorter investment period and tax returns designed for retail investors.
- A pan-European distribution passport that increases the fund's ability to reach critical mass: from the perspective of European asset managers, ELTIFs are virtually the only vehicle capable of distributing private market investments to retail investors throughout Europe. Blackrock believes that ELTIFs could be as successful as the UCITS format. Note that ELTIFs can also be marketed outside the EU in the form of private placements.

Version 2.0 should accelerate the growth of ELTIF funds

ELTIF version 1.0 was not as successful as initially expected. As of January 2023, only 84 ELTIFs were registered in the entire European Economic Area (48 in Luxembourg, 21 in France, 13 in Italy and 2 in Spain) and this for a few billion under management.

In November 2021, the European Commission published its proposal for a revision of the ELTIF Regulation (ELTIF 2.0) to remedy the main shortcomings of the original ELTIF Regulation. The European Council and the European Parliament voted in favor of the new rules, which are expected to come into effect in the first quarter of 2024.

One of the most ambitious and innovative changes in ELTIF 2.0 is to distinguish between ELTIFs that are only for professionals and ELTIFs that are for retail investors. Stricter investment limits, leverage restrictions and concentration limits apply to retail ELTIFs. The assessment of the suitability of investment in an ELTIF for non-institutional investors has been changed - the minimum investment limit and the 10% limit have been removed, which could make the new ELTIF a true savings product for retail investors with no minimum investment amount.

These reforms have been enthusiastically welcomed by the investment and asset management industry, which sees ELTIF 2.0 as the missing piece to truly democratize access to private markets in Europe.

It is worth noting that the conditions to qualify as a "real asset" have been relaxed under ELTIF 2.0. Green bonds, fintech and other real assets are now part of the investable universe.

In addition, the capitalization threshold, portfolio composition requirements, asset diversification limits, and concentration risks have been modified to broaden the scope of eligible assets for an ELTIF. Whereas version 1.0 did not include funds (it was a direct deal fund), version 2.0 can - under certain conditions - invest in funds.

Regarding the redemption modus operandi and liquidity, ELTIF 2.0 remains basically a closed-end fund product. However, it is possible to create semi-liquid structures within ELTIF 2.0.

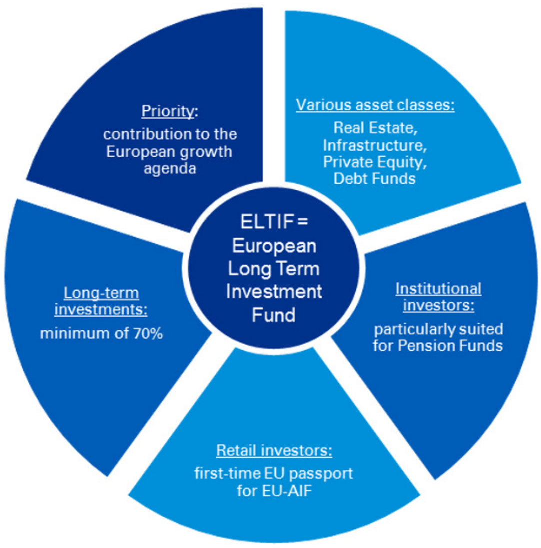
ELTIF 2.0 also includes a new provision for secondary trading of shares/units of an ELTIF. Finally, investors can choose between two ELTIF structures: with calls or fully funded at launch. The advantage of the fully funded vehicle is that it allows clients to avoid receiving a series of calls. The fully funded model comes with potentially shorter investment periods and "J" curves. But there may be a trade-off in the form of lower performance due to holding cash (or other liquid securities) in the fund until the capital can be fully deployed.

In terms of jurisdiction, Luxembourg seems to be well positioned to benefit from ELTIF 2.0, given its worldwide reputation as a location for investment funds and its favorable local legal framework that will allow for the establishment of different ELTIF structures for different types of investors (from retail to high-net-worth individuals, from semi-professional to professional).

Conclusion

ELTIF 2.0 is currently attracting a lot of interest both from companies seeking financing and from individual investors. It is perfectly in line with the political will to direct part of the savings of individuals towards venture capital and the financing of European infrastructure projects. ELTIF 2.0 also offers individuals the possibility to invest in assets other than stock markets or UCITS funds, thus increasing diversification and risk spreading. All with a low minimum amount and including some specific protections for investors.

We have included a first ELTIF fund in our list of open architecture recommendations. It allows many new clients to initiate their first allocation in real assets.



Sources: Blackrock, Société Générale, www.aima.org, GVZH Advocates

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