Trade Finance

The Short Duration Investment Solution to the Yield Drought

THE NEXT PRIVATE CREDIT FRONTIER

Trade Finance Investment Primer

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Executive Summary

Trade finance is the fuel that keeps cross border trade ticking. But regulatory changes forced banks to de-risk. Non-bank entities have stepped in to plug the gap, ushering in a new era of private debt investing.

Private debt offering higher returns and diversification than traditional bond investments has caught the attention of many investors, but the lack of liquidity and duration risk has kept others on the side lines.

Trade finance debt, at the short duration frontier of private debt, boasting attractive risk-adjusted returns that are uncorrelated with traditional investments, is set for a prominent position in investor portfolios.

Introduction

The New Kids on the Block Greasing the Wheels of Global Trade

Moving goods from one country to another is often a costly endeavour. Trade finance plays a vital role in making this cross-border journey financially viable.

But this crucial source of capital isn't as accessible as before.

The regulatory winds of change following the global financial crisis forced banks – the traditional financiers of trade – to adopt a more conservative approach to lending, and set sail away from trade finance.

As banks became even less incentivized to make smaller-sized trade finance loans, small- to-medium enterprises, which make up the bank global trade, fell further behind in the queue for finance.

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The queue for trade finance has continued to grow, resulting in a funding gap currently estimated to be $3.4 trillion.

$3.4 Trillion Funding Gap

Funding global trade has proven a worthwhile investment proposition. Returns are attractive, default rates have been historically low, and performance is uncorrelated with traditional investments.

It wasn't very long until non-bank entities answered the call. Unlike banks, non-banks can take a more tailored approach to financing trade, allowing them to act quickly and provide more flexible terms.

As borrowers are willing to pay a premium for this flexible source of capital, private debt, or non-bank loans that aren't publicly traded, swelled.

Private debt is one of the fastest-growing asset classes, increasing to over $1tn from $42.4bn in 2000.

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Growing Hunt for Yield Lands at the Private Debt Door

It’s no secret that the low-interest-rate environment has lasted for longer than many investors had expected.

Against this “new normal,” investors have struggled to generate the income required from traditional bond investments and are reluctant to move up the risk curve to equities amid concerns about overstretched valuations.

As the hunt for yield intensifies, investors have turned to private debt attractive offering.

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Private Debt **Benefits**

Relatively higher regular income -- through fixed interest payments and principal repayments -- than traditional bond investments.

As private debt isn't publicly traded, and loans are generally held to repayment or maturity, it has limited exposure, investor speculation, minimizing volatility and drawdown during times of market panic.

Increased level of diversification difficult to find in traditional bond investments.

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Lack of Liquidity

But the higher returns come at a price that some investors aren't willing to bear: **a lack of liquidity.**

Private debt is often structured in a closed-end fund. Investors get locked in for long periods, which increases duration risk and hampers portfolio management.

But not all private debt is created equal.

Trade finance, a short-term source of private debt, attracts investors seeking stable returns that are highly uncorrelated with traditional investments, but with limited duration risk.

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The Rise and Rise of Trade Finance as an Asset Class

As the trade finance loan reflects the short-term nature of the underlying asset, with an average maturity of typically between 30-to 180-days, the duration risk is greatly reduced.

The low tenor of the asset class offers investors a clear exit path, and the opportunity to respond to changes in credit or rate conditions.

The portfolio-enhancing characteristics of trade finance don't come at the expense of returns. Trade finance funds provide quarterly or monthly liquidity, and target a floating rate of return at a profit over LIBOR, limiting investor exposure to rising interest rates.

While credit risk, or default risk, always needs to be considered when considering a fixed-income allocation, trade finance products have demonstrated low default rates.

Low Default Rates

Trade finance lenders tend to have a priority claim, or lien, on the goods being financed. This strong asset security ensures recovery rates are high and default rates low.

Default rates for trade finance products from 2008-2018 averaged 0.36% for import letters of credit (L/C), 0.04% for export L/C, 0.73% for loans for import/export, and 0.45% for performance guarantees, according to a 2019 report from International Chamber of Commerce.

Source: ICC Trade Register 2019

Diversification on Several Fronts

As the global flows of trade span across different goods, commodities, geographies, and industries, investors benefit from a wide berth of diversification and low correlation with traditional asset classes.

Trade finance loans offer diversification opportunities not only on a portfolio level as it has limited correlation to traditional investments, but exposure can also be tailored by sector, geography or obligor.

This extensive level of diversification will help steady portfolios in the sea of volatility likely to follow, as central banks are poised to tighten monetary policy.

Trade finance as an asset class offering attractive risk-adjusted returns at low volatility, will have a valuable role to play in the broader private debt frontier and investor portfolios.

Conclusion

As with any emerging asset class, a thorough understanding of the asset, underlying exposure, the return/risk profile and the benefits its brings are crucial steps in making it investable.

For trade finance, an asset class with a complexity premium, investor education will go a long way to ensuring it has a fighting chance to stake its claim for a place in investment portfolios.

Yet, for all its complexities, the trade finance asset class is unlikely to remain in the investment shadows for a prolonged period as attractive risk-adjusted returns at low volatility represent the holy grail of investing.

References

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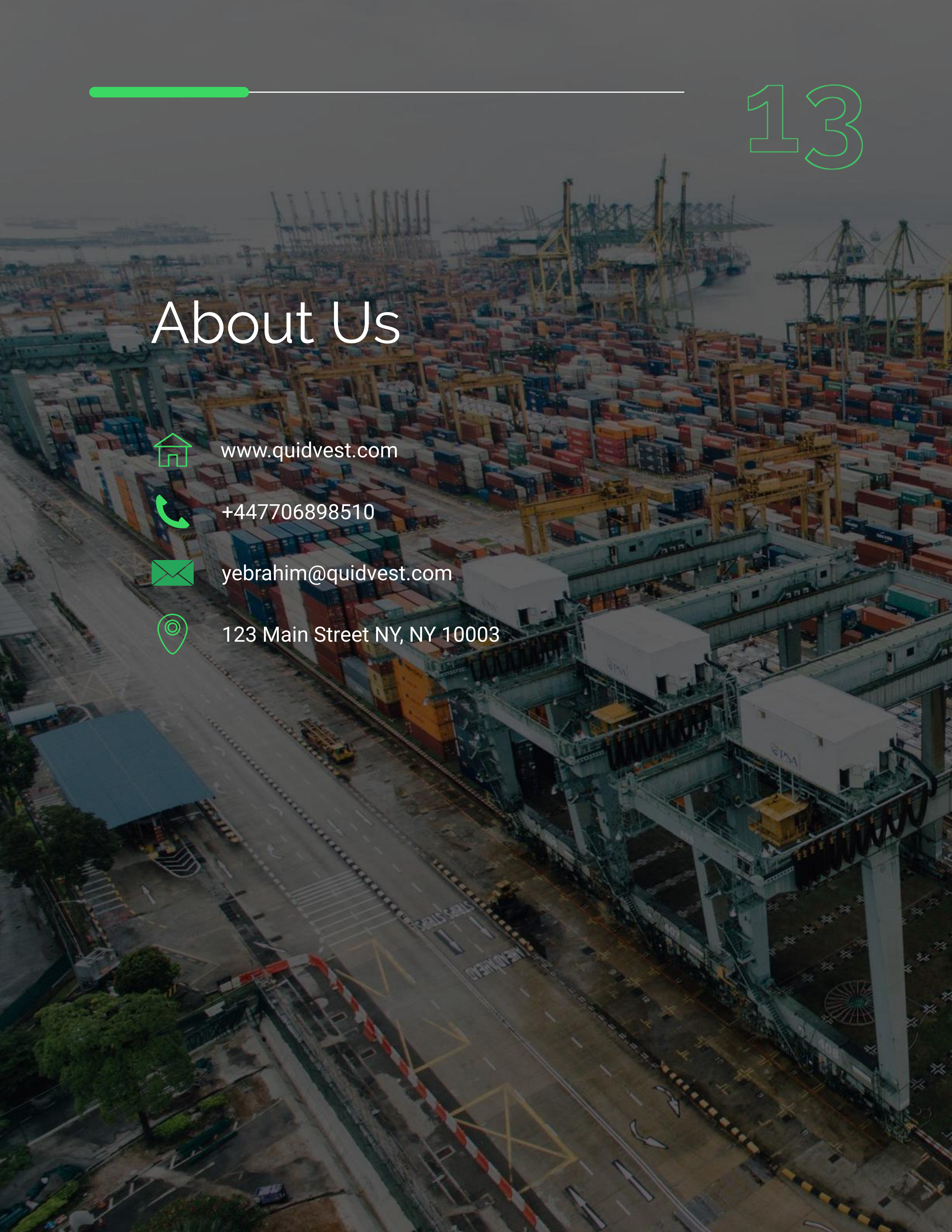

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