Trade Finance Loans as an Investable Asset Class

For professional investors only
Introduction

"It is not the strongest of the species that survives, nor the most intelligent, but the one most responsive to change."
- Charles Darwin

An ever increasing number of investors have come to recognize that the low interest environment is not as temporary as some had initially hoped. In response, many are recalibrating their expectations and diagnosing a structural change rather than a situational one. For certain developed economies, the paradigm shift in terms of growth is so well advanced, that a return to the past is unlikely.

The global financial crisis has shaken some of finance’s most robust dogmas, notions such as “correlation”, “risk free rate” and “liquidity” have lost their relevance in an environment that is still subject to uncertainty. The need for investors to preserve wealth and diversification is hardly fulfilled by the conventional sources of yield. A growing viable alternative relates to the real economy.

Subsequently, real assets backed lending strategies, which previously were the realm of institutional investors, are naturally attractive. The financing of the trading, processing and transportation of goods known as trade finance is a clear example of such strategies.

Increasingly, trade finance is becoming a trendy topic explored both by institutional investors and academics but in reality the financing of trade is as old as trade itself. Its strong tie with the world of trade rather than credit makes its assessment by asset allocators a challenge. The understanding of international trade financing involves being accustomed to a wide spectrum of risks some of which are related to trading rather than financing.

This paper offers a succinct review of trade finance loans as an investable asset class, covering the basic fundamentals, means of access, key characteristics and diversification benefits.
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## IV SUMMARY
I. WHAT IS TRADE FINANCE

Definition

Trade finance is a specialised area of financing that is tailored to and supportive of international trade. According to the World Trade Organization, an estimated 90% of world trade is financed, making it likely that many of the everyday goods we rely on have benefited from either domestic or international financing. This has been the case since ancient times and throughout our history. Although in modern times financing structures have reached higher levels of sophistication, their functioning remains essentially unchanged.

Importance of trade

In trading, there is frequently a time lag existing between the shipment of goods by the exporter and their receipt by the importer depending on the length of the ship’s voyage. Normally, exporters require payment upon loading, whilst importers ideally would delay payment until arrival. In its simplest form, trade finance reconciles these timing lags by providing a short-term customised credit facility. These are generally intermediated by specialised third party financial institutions and collateralized by the underlying goods as well as by additional guarantees.

In learning about trade finance, it is essential to understand the underlying mechanisms associated with trading. Unlike traditional credit that is built on a bilateral agreement between the lender and borrower, trade finance involves three parties: the exporter (seller), the importer (buyer) and the financier. This triangulation is one of the main factors explaining the extremely low default rates in comparison to other forms of credit. In fact, neither exporters nor importers are incentivised to interrupt the transaction as doing so would have irreversible consequences on their businesses.

Market dynamics and sizing

Since 2002, world trade has been growing at a compounded annual rate of 11% reaching US$18.3 trillion in 2012 (Figure 1). According to the ICC Banking Commission, the current US$14-16 trillion global trade finance industry is estimated to double by 2020 fuelled by the increase in global trade flows.
Evidence of the importance of trade finance came during the 2008 global financial crisis when the severe credit crunch experienced by banks constricted their financing ability. In 2009, the value of world merchandise trade declined by 22% marking the first serious downturn in a decade of strong growth.

**Emerging markets**

Since then, emerging markets have driven trade recovery as their growth in imports contributed to half of world trade growth in 2010. In contrast, developed economies have experienced stagnant trade growth due to high unemployment and fiscal consolidation. Global trade flows are increasingly dominated by bilateral trade between developing countries, with South-South trade accounting for over half of developing economies’ exports since 2010.²

**Commodities**

The portion of trade finance focusing on commodities (aka commodity trade finance) represents US$6.5 trillion, close to 40% of global trade value.³ Some commodities (metals, energy and agriculture) are a crucial part of the industrial process and economic development in many countries and can be considered as being of strategic importance. Any disruption in their supply or consumption can have a severe impact to a nation’s economy. With historically high commodity prices, financing strategic commodity flows requires substantial capital highlighting why commodity trade finance has principally been arranged by leading trade finance banks with a global reach and experience. According to Galena estimates, the flow of commodity trade financing arranged by commercial banks is circa US$2-3 trillion per annum, with around US$1 trillion outstanding at any one time. The size of the bank-intermediated commodity trade finance loans market is therefore as big if not bigger than the size of the US bank (leveraged) loans market, estimated at US$731 billion ⁴.

**Market participants**

The activity of financing trade can be undertaken either by providing direct credit extended bilaterally between different entities or through bank-intermediation. As of 2008, trade credit between companies
accounted for an estimated 60% of market share while the remaining 40% consisted of bank-intermediated trade finance (Figure 2). The shift towards direct trade credit is driven by reduced costs (i.e. the bank’s fees), increased efficiency (i.e. less paperwork), increased competition and the more familiarity between buyer and supplier over the continuous flow of goods. It is estimated that 80% of the number of trade transactions are now being settled on an open account basis. Conversely, the majority of open account arrangements are intra-firm trades between subsidiaries of the parent company where there is limited default risk.

Intermediated trade finance involves commercial banks which, for a fee, may agree to take on part of the inherent trade risks that companies are exposed to while being secured against defaults or non-performance through the assignment of sales receivables and the collateralization of the underlying assets associated to the trade. In both categories of trade finance, international trade credit can be guaranteed by trade credit insurance. This is especially the case for direct trade finance credit, of which a large portion is insured. Export credit agencies (ECAs) and trade credit insurers are an integral and important part of the trade finance industry.

Types of trade finance arrangements

A wide range of trade finance arrangements are available throughout the value added chain. Short-term trade loans are revolving in nature, whereas long-term trade finance involves larger multi-year contracts with complex services including trade credit insurance, therefore requiring higher fees. Trade finance arrangements have an average tenor of 115 days with 80% being on a transaction basis between 90 to 120 days. This encompasses vastly different situations such as receivables financing on a 30-day basis up to the much longer tenor of, say, pre-export finance facilities which may vary from 1 to 5 years.
For illustration purposes, we will discuss some of the most common types of trade finance arrangements falling under transactional financing (namely purchase financing and receivable financing) and specialised financing (namely pre-export financing).

The most basic form of transactional financing is purchase financing, making heavy use of letters of credit (LCs), the most common and standardised bank-intermediated trade finance instruments. An LC is a legal undertaking by an issuing bank to make payment on behalf of the importer to the exporter upon delivery of the goods. When the exporter presents reliable proof of delivery by submitting the necessary trade documents, the bank will make payment on behalf of the importer. The bank retains a security interest in the goods and sales proceeds until repayment and charges the importer a service fee.

Trade receivables financing is another form of transactional financing, namely a form of secured lending giving a company short-term financing by selling its trade receivables or pledging them as collateral for a loan. Typically, once a producer has shipped its goods, the payment is not processed until proof of delivery is presented, tying up valuable cash. Factoring and forfaiting, both performed by banks or specialty finance firms, are commonly used and involve the sale of receivables and the transfer of the associated risks.

In the space of specialised financing, pre-export finance (PXF) is an established structure used to provide finance to producers of goods and commodities. In a standard PXF facility, funds will be advanced by a lender or syndicate of lenders to producers to assist in meeting either working capital needs or capital investment needs. PXF facilities are typically secured by an assignment of rights by the producer under an offtake contract (i.e. a sale and purchase contract between the producer and a buyer of goods or commodities), and a pledge against the collection account (a bank account into which proceeds due to the producer from the buyer of commodities under the offtake contract are credited). Such facility will have a tenor of between 1 and 5 years, although evidence suggests that it is not uncommon for facilities to be repaid early.

**Low historical default rates and loss rates**

The diversity of the trade finance universe is such that it remains challenging to find supportive evidence of its relatively low defaults rates compared to other forms of credit. However, good proxy for the bank-intermediated trade finance is available through the publications of the International Chamber of Commerce (ICC).

A preliminary 2010 ICC survey has analysed portfolio level data of 9 banks, covering over 5.2 million transactions with a total exposure of US$2.5 trillion during the period from 2005 to 2009. Its key findings conclude there had been 1140 defaults across the key trade finance products, with an average default rate of 0.022% with a recovery rate close to 60%. The resilience of trade finance transactions has been highlighted through the global economic downturn of 2008 and 2009 with only 445 defaults out of 2.8 million transactions.

The most recent ICC survey published in 2013 provides a comprehensive analysis of trade finance based on fully disclosed trade finance data from 21 banks on over 8.1 million transactions during the period from 2008 to 2011. According to the study, there have been 1,746 defaults across the key trade finance products, with an average default rate of 0.021% (0.039% on an exposure-weighted
basis) with a loss rate of 0.012%. The overall recovery rate of 52% across all product types increases to 71% if the collateralized transactions (stripping out bank guarantees) alone are taken into account.

Private trade credit insurers also report relatively low loss rates, albeit larger and more volatile than indicated by the ICC trade register. The loss rate as calculated by the ratio of claims over exposures was 0.17% on average between 2005 and 2012, but then almost doubled to 0.30% in 2009. Figure 5 below puts into perspective the default rates of trade finance with those of other traditional fixed income instruments, bearing in mind that such default rates have been calculated by different institutions using different methodologies and time periods. Default rates of trade finance reported below for the 2008-2011 period, one of the worst period on record for default rates of any lending strategy, are faring well compared to default rates of other lending strategies measured over longer and less eventful time periods.

![Figure 5 - Default rates](image)

<table>
<thead>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Tenor</td>
<td>90-120 days 10-12yr 1yr 5yr 10yr 1yr 5yr 10yr 5yr</td>
<td>0.039% 0.59% 0.106% 1.146% 2.744% 0.000% 0.658% 1.364% 2.794%</td>
<td>0.039% 0.59% 0.106% 1.146% 2.744% 0.000% 0.658% 1.364% 2.794%</td>
<td>0.039% 0.59% 0.106% 1.146% 2.744% 0.000% 0.658% 1.364% 2.794%</td>
</tr>
<tr>
<td>Default Rate</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>


Such desirable characteristics - low default rates and relatively high recovery rates - will be further discussed and accounted for in section 3.

**Historical yields**

The pricing of trade finance facilities, consisting of a premium on short term Libor, can vary significantly according to a wide array of factors. However, yield expectations invariably depend on the cost of local funding, availability of credit, transaction dollar amount, and counterparty risk. Whilst the direct-lending trade finance market remains opaque, the bank-intermediated one, although private, does produce some numbers.

Bank data suggest that mainstream bank-financed transactions are priced at 50 bps to 450bps over US Libor. Figure 4 overleaf illustrates our understanding of the relationship between the volume of transactions (in dollar terms) and the interest rates in the trade finance space, based on our research. This bank-intermediated segment, core market, represents the vast majority of transaction volumes in dollar terms, and where arguably better credit quality, liquidity, transparency and larger transaction sizes can be found. The direct-lending segment is where boutique non-bank financial institutions (NBFIs) typically extend credit to small and medium-sized enterprises in emerging markets that face
constraints in accessing bank-intermediated trade finance. In this fringe segment, smaller transactions are priced anywhere from 400 bps for bankable counterparties in Asia up to 1500 bps over US Libor for smaller local producers of less strategic or perishable goods in frontier markets.

As an illustration, a syndicated pre-export finance loan of US$3 billion arranged by a leading European bank for a leading oil producer in sub-Saharan Africa may be priced at 300bps over US Libor and include 20 banks and NBFIs in the bank syndicate. Further up the yield spectrum, a directly originated trade finance loan of US$1 million to a low-tier exporter of fertilizer in Argentina arranged by a boutique NBFI may be priced at 1000bps over US Libor. As a rule of thumb, the further up the yield axis, the lower the size and the quality of the borrower, and the smaller the transaction dollar value.
II. HOW TO ACCESS THE TRADE FINANCE LOANS ASSET CLASS

Historically the preserve of commercial banks

Trade finance loans may not have been considered by institutional investors as an opportunity set as it has historically been the preserve of commercial banks. The largest commercial banks appear to account for a third of the global supply of bank-intermediated trade finance, with local and regional banks providing the remainder. For instance, the 21 banks participating in the latest ICC survey provided US$2 trillion of the estimated US$ 5.5-6.4 trillion of bank-intermediated trade finance, thus supporting about 11% of global trade through short-term trade finance products in 2011.9

In commodity trade finance, European banks (primarily French, Swiss and Dutch banks), historically providing up to 80% of the financing for the trading of commodities worldwide, still capture about 50% of the deal flow10. This concentration is a direct consequence of the required level of investments and the relatively long payback. It is necessary for banks to invest significantly in global infrastructure, operations, and support services over a period of 5 to 7 years in order to build a sizable portfolio, develop long term client relationships and nurture the relevant skill sets. Fundamentally, with trade finance being a scale-dependent business, profit margins improve with volume which leads to a large disparity in profitability between well-established market leaders and smaller regional players. New entrants may be deterred by the high barriers to entry.

The commodities super-cycle and the financial crisis have offered new opportunities

During the bullish commodities cycle (2001 to 2011), the price of most commodities and their associated transportation costs increased fivefold. The volumes transacted also grew substantially. Simultaneously, the financial crisis has forced banks, under pressure to deleverage, to curtail lending activities by giving up certain trade finance business or to seek greater syndication of risk. This has created a substantial gap in new capital requirements and new opportunities for alternative sources of funding. According to Galena estimates, the funded exposure of leading European banks to the commodity trade finance sector has shrunk by 20-25% from 2010 to 2012 and has yet to recover to 2010 levels.

In the deleveraging process, leading trade finance banks have been keen to safeguard the low-risk segment of trade finance at the expense of longer term financing activities such as infrastructure & project finance, and shipping finance, which are deemed more capital intensive. Nevertheless, under the new Basel III liquidity standard, the same banks have been urged to implement “originate-to-distribute” (OTD) models, thus providing other banks and specialist fund managers with some degree of access, albeit exclusive.
Investable trade finance opportunities

Institutional investors looking to build a sizable trade finance portfolio may look at three possible avenues.

Direct investments or co-investments would appeal to the more expert investors with substantial capital to invest, a much longer investment horizon and risk management experience. For example, an investor could participate in a large lending transaction arranged by a sourcing party (typically a bank, finance or trading company) for a single name obligor usually involving the flow of a specific commodity. Another illustration would be for an institutional investor to access a portfolio of bank trade finance assets through securitisation vehicles.

Separate accounts or managed accounts can be arranged by a sourcing party (specialist asset managers or merchant boutiques) for larger institutional mandates, where the institutional investor may participate in the customisation of the portfolios, namely defining the eligible assets and geographies, duration, risk budgeting, asset-liability management, and in the investment decisions.

Finally, trade finance loan funds have flourished over the past 15 years filling the gap left by retracting banks or complementing bank financing. Such funds, open or closed-ended commingled vehicles run by specialist managers, allow access to a portfolio of trade finance debt assets not readily available to institutional investors. These funds are involved in the financing of goods/commodities trade flows along the value chain by extending loans to producers, transformers, importers, and trading companies and usually provide diversification across geographical areas, types of goods/commodities, transaction structures and types of borrowers. Liquidity terms may vary, from monthly to a few years for the closed-end vehicles.

Trade finance loan funds

According to Galena estimates, there are approximately 20 investable funds worldwide which focus wholly or in part on trade finance transactions, with combined assets not exceeding US$5 billion. Whilst these investable funds have become a more significant source of credit capital over recent years, the scale remains modest compared to the overall size of the market.

Trade finance loan funds have, in general, been established by specialist fund managers who have held senior trade finance positions at commercial banks, within commodity trading firms, or have spent time with export insurance companies. While these fund managers share the same broad original skillsets, they operate vastly different strategies, depending on respective areas of concentration, expertise, and geographic reach. Investment returns are often dependent on different positioning in sourcing methods (direct lending or bank intermediated), commodity focus (specialised vs. agnostic), quality of borrowers (high-tier, low-tier) and geographic footprint (domestic, regional, continental or global). In addition to the overall fund positioning, the returns are reliant on the availability and price of alternative sources of credit, as seen in the earlier section “Historical yields”.

The future success of trade finance loan funds depends on the ability of fund managers to source and process sufficient transactions, find scale, implement robust investment processes and risk management (key man and operational risks). Success will also be influenced by market parameters such as the absolute level of yields that can be achieved, relative value compared to other asset classes (and to other loan asset classes), the price of bank capital and liquidity.
III. CHARACTERISTICS OF TRADE FINANCE LOANS AS AN ASSET CLASS

This section outlines the key characteristics of trade finance loans—an asset class which may be of interest to institutional investors and their advisors in the current low-yield environment—and the potential diversification benefits.

Key characteristics of trade finance loans

Libor floating, self-liquidating and amortizing nature accounts for low duration
Trade finance loans, largely dollar-denominated, are usually extended on a floating rate basis at a spread over 1m-US Libor (or 3m-US Libor) thus resetting the coupon payments on a monthly (or quarterly) basis respectively. Trade finance loans are self-liquidating, i.e. they are used to finance transactions whose proceeds (from the sale of the goods) are in turn used to pay off and extinguish the loans. For longer term trade finance facilities, the loans are typically self-amortizing as payments from each delivery throughout the loan’s tenor are used to pay interest and amortize the principal. This explains why the average life of trade finance loans is lower than that of bullet maturity bonds or bank loans of similar tenor. Trade finance loans, with a typical average life from 1-month to 3 years, have an effective duration close to zero.

Structurally secured, explaining low default rates and high recovery rates
Trade finance loans mitigate the risk of default, even upon occurrence lenders are made whole through a security package that includes pledged accounts receivable and the collateralisation of real assets. The lender’s ability - by virtue of having a security interest - to take delivery of the physical real assets without approval from the borrower significantly reduces the risk of a borrower’s deliberate default and ensures a high degree of recovery. Furthermore, the structured nature of trade finance transactions aims to disconnect the asset from the corporate balance sheet to the extent permitted by law thereby in effect mitigating the insolvency risk of the borrower in case of serious and prolonged recession.

Interest and repayment tied to an identifiable cash flow
A trade finance loan is tied to a specific transaction. Each loan, granted to a real economy company for the use in a particular identifiable transaction flow, generates a payment of interest for the tenor of its utilization. Once the transaction is completed, the generated cash flow from the sale of goods is used to pay off the loan. By contrast, other types of borrowings such as bank (leveraged) loans, unsecured corporate debt or high yield debt are typically raised for “general corporate purposes”. The cash flow for interest servicing or principal repayment, not linked to any specific transaction, may come from operating, financing or investing cash flows. The lack of cash flow traceability and ring-fencing mechanism would expose the holders of such borrowings to the corporate balance sheet of the borrower in case of bankruptcy.
Do not involve speculation on commodity prices

A properly structured and performing trade finance loan should not involve commodity price risk. If a trade finance loan is extended to participants in the commodity supply chain, the commodity price risk component is systematically neutralized thanks to binding sale & purchase (back-to-back) contracts between counterparties for short-term transactions or thanks to overcollateralization and hedging for medium-term transactions. In short, trade finance loans do not involve speculation on commodity prices.

Transaction analysis focuses on performance risk

Spreads on trade finance loans remunerate the performance risk in a transaction. Performance risk is essentially the risk that the parties do not perform their contractual obligations - i.e. the production, processing and delivery of goods under the appropriate specifications by the exporter and the payment by the importer or the offtaker. A great deal of attention will be spent on analyzing such risk in a particular trade finance transaction, especially if it involves borrowers in emerging markets where corporate financing may be too costly or simply unavailable. Figure 6 highlights the difference in risk analysis performed by a lender before arranging a traditional bank loan/bond issue or a trade finance loan for the same borrower.

<table>
<thead>
<tr>
<th>Risk factors</th>
<th>Corporate debt &amp; leveraged loans</th>
<th>Trade finance loans</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit</td>
<td>- Company credit worthiness&lt;br&gt;- Cash flows and liquidity</td>
<td>- Liquidity position and overall credit worthiness&lt;br&gt;- Capacity of company to perform under the transaction and deliver the goods&lt;br&gt;- Security package (may include collateralisation by underlying goods, assignment of export contracts, recourse to fixed assets...)</td>
</tr>
<tr>
<td>Country</td>
<td>- Political stability (sovereign risk)&lt;br&gt;- Macroeconomic environment</td>
<td>- Ability of transaction to survive stressed political environment&lt;br&gt;- Import and export regulations, exchange controls</td>
</tr>
<tr>
<td>Performance</td>
<td>- Profit and Loss&lt;br&gt;- Operating Cash Flows</td>
<td>- Transaction risk or risk threatening the completion of the transaction: operational issues (damage or loss of goods) or specifications (quality and quantity)</td>
</tr>
<tr>
<td>Market</td>
<td>- Interest Rates fluctuations&lt;br&gt;- Volatility of spreads / Stress Periods</td>
<td>- Commodity price risk: mitigated as back-to-back contracts, hedging or overcollateralisation&lt;br&gt;- FX risk: mitigated as trade is usually back to back in $US</td>
</tr>
</tbody>
</table>

Source: Galena Asset Management

When analyzing the credit risk inherent in a trade finance loan, the focus is not solely on company creditworthiness, cash flows and liquidity but equally on the capacity of the company to perform under the transaction and deliver the goods. With regards to country risk, the focus will not be on the political stability or the sovereign risk per se but on the ability of the transaction to survive a stressed political environment. The strategic nature of the goods or the commodities for the country, the existence of an offshore collection/repayment account, and the potential availability of political risk insurance will typically mitigate country risk. The analysis of performance risk will include a thorough analysis of contractual terms, of the track record of the borrower, and a capacity and cost analysis. Recourse to insurance (against loss or damage of goods) and to first class inspection companies (for specification issues) will alleviate operational risk. In terms of market risk, the concern is to ascertain that appropriate mitigants (overcollateralisation, hedging) to an adverse move in the commodity price are in place in the financing facility.
Follow a loans and receivables accounting method

Trade finance assets, typically bought with a buy-and-hold view, follow a loans and receivables accounting method. Loans and receivables, by definition financial assets with fixed or determinable payments that are not quoted in an active market, are carried at amortized cost using the effective interest rate method less any allowance for impairment. Since revenues are generated at regular and frequent intervals from the interest payments on loans, it is easy to monitor and swiftly detect any impairment.

Considerations within portfolio asset allocation

Floating rate income with no correlation to fixed income markets

One key benefit of trade finance loans being long floating rates in the current rate environment is the potential protection they provide from rising interest rates. Any changes in market interest rates have an entirely different effect on trade finance loans than they do on bonds. All other factors being equal, the price of a trade finance loan is generally unaffected by changes in market interest rates. Like floaters, trade finance loans within a broader fixed income portfolio have the potential to protect investors against a rise in interest rates and to offset changes in short-term interest rates.

Consistency of spreads account for the consistency of investment returns

Given the afore-mentioned characteristics of trade finance loans, a lender should expect consistent investment returns with low volatility, provided the proper due diligence and risk management are implemented. The consistent and range bound nature of investment returns can also be accounted for by the relative stability of spreads of trade finance loans. Empirical evidence suggest that such spreads tend to be less volatile than corporate credit spreads used to price other types of borrowings such as corporate bonds, high-yield debt and leveraged loans. The latter corporate spreads are largely influenced by market factors and can widen/tighten after immediate market news. Spreads of trade finance loans, although somewhat influenced by the economic cycle and the availability of bank credit, are more influenced by the parameters that affect an individual transaction. The consistency of such spreads is in direct keeping with the consistency of (low) default rates observed across economic cycles by banks. As a yardstick, trade finance loans spreads can vary by a few basis points (from one transaction to the next involving the same obligor) while corporate credit spreads (implied by trading prices or CDS markets) can often vary by a few percentage points.
Resilience of investment returns in stress periods

Trade flows may vary in terms of size (a combination of the volume and the price of underlying goods) but there is no risk of total interruption. Although global trade volumes may suffer during economic downturn (see Figure 1), strategic commodities such as metals, energy and agriculture will still be produced, processed and consumed. The action of financing these flows, therefore, allows returns to be produced even during periods of recession. If anything, difficult market cycles or tighter credit environment would actually be beneficial to lenders as they would be able to enforce tighter covenants and security package and/or marginally higher spreads on the loans. Consequently, sampled investment returns of trade finance loans, represented in Figure 7 by a sample of trade finance loan funds with 3 or more years of track record\textsuperscript{11}, have exhibited resilience in stress periods when compared to more market sensitive asset classes such as bonds, leveraged loans or hedge funds.

Figure 7 - Resilience of trade finance loans returns (Index 100 as of 1/1/2007)

Source: Bloomberg, Galena Asset Management
**Relative insensitivity to market timing**

Whilst some temporary dislocations in frontier markets may exist, trade finance loans returns are consistent, resilient and relatively insensitive to market timing. To highlight this advantage, we have compared the behavior of returns for holding periods of one year by looking at the rolling 12 month returns for various asset classes between October 2007 (holding period to October 2008) and October 2012 (holding period to October 2013), thus using 6 years' worth of data and 72 consecutive periods of 12 months. Asset classes include trade finance loans (same sample as before), leveraged loans (S&P/LSTA Leveraged Loan Index) and bonds (Barclays U.S. 1-3 Year Treasury Bond Index). The comparative analysis can be found in Figure 8.

![Figure 8 – Rolling 12 month returns](image)

*Source: Bloomberg, Galena Asset Management*

Key findings are as follows:

- Rolling 12 month returns for the sample trade finance loan funds have been consistently positive, unlike bonds and leveraged loans, which have incurred drawdowns on such holding periods (despite some degree of survivorship bias for hedge funds and trade finance loan funds).

- Rolling 12 month returns for the sample trade finance loan funds have been consistent and range bound, with no outsized returns for any given period.

These are key advantages for investors looking at capital preservation and appreciation over a fixed investment horizon. Regardless of the entry and exit points in the market cycle, a trade finance loan investor would have experienced consistently positive returns over any given 12-month period. Leveraged loan investors have experienced an even bumpier ride with a return of -29.1% in 2008 followed by a return of 51.6% in 2009. Even global bond investors may have experienced negative returns (-5.9%) on some holding periods based on the prevailing interests upon exit before maturity.

Trade finance loans will be of interest to investors looking for preservation of capital and accrual of interest over a given holding period, and namely to liability-driven investors sensitive to drawdowns and path-dependency of returns. It will also alleviate the concerns linked to market timing.
Trade Finance Loans as an Investable Asset Class

Diversification benefits in overall portfolio allocation

Investors will enjoy diversification benefits by including trade finance loans in their overall portfolio due to high risk-adjusted returns and negative correlation to other asset classes. To highlight the diversification benefits, we have computed the correlation coefficients between asset classes using monthly returns data observed between October 2007 and October 2013. Asset classes include trade finance (same sample as before), equities (S&P500 & MSCI Emerging Markets), bonds (Barclays U.S. Aggregate Bond Index & Barclays U.S. 1-3 Year Treasury Bond), high yield bonds (JPM Global HY), leveraged loans (S&P/LSTA Leveraged Loan Index), hedge funds (HFRX Global), and commodities (DJ-UBSCI). The resulting correlation matrix can be found in Figure 9.

For investors seeking greater diversification in their portfolios, trade finance loans have a low or negative correlation with the different major asset classes, including leveraged loans.

While bank-syndicated trade finance loans may share some of the characteristics of the better-known leveraged loans - namely bank origination, floating rate, collateral security - they provide better diversification benefits (no correlation to high yield, hedge funds or equity markets) with much lower risk as measured by default rates (Fig. 5). Fixed income investors in general and loan investors in particular should consider supplementing their allocation with trade finance loans, given their risk-adjusted returns and uncorrelated nature.

Figure 9 - Correlation matrix between trade finance loans and other assets

<table>
<thead>
<tr>
<th></th>
<th>Trade Finance Loan Funds</th>
<th>Barclays U.S. 1-3 yr Treasury Index</th>
<th>Barclays U.S. Aggregate Bond Index</th>
<th>S&amp;P/LSTA Leveraged Loan Index</th>
<th>JPM Global HY Bond</th>
<th>DJ-UBSCI</th>
<th>MSCI EM</th>
<th>HFRX</th>
<th>S&amp;P 500</th>
<th>Average Monthly Return</th>
<th>Std. Dev</th>
</tr>
</thead>
<tbody>
<tr>
<td>Trade Finance Loan Funds</td>
<td>1.00</td>
<td>-0.06</td>
<td>0.02</td>
<td>-0.10</td>
<td>-0.20</td>
<td>-0.03</td>
<td>-0.08</td>
<td>-0.10</td>
<td>-0.06</td>
<td>0.69%</td>
<td>0.002</td>
</tr>
<tr>
<td>Barclays U.S. 1-3 yr Treasury Index</td>
<td>-0.06</td>
<td>1.00</td>
<td>-0.07</td>
<td>-0.50</td>
<td>-0.40</td>
<td>-0.15</td>
<td>-0.33</td>
<td>-0.37</td>
<td>-0.32</td>
<td>0.05%</td>
<td>0.004</td>
</tr>
<tr>
<td>Barclays U.S. Aggregate Bond Index</td>
<td>0.02</td>
<td>-0.07</td>
<td>1.00</td>
<td>0.34</td>
<td>0.39</td>
<td>0.28</td>
<td>0.21</td>
<td>0.35</td>
<td>0.28</td>
<td>1.46%</td>
<td>0.028</td>
</tr>
<tr>
<td>S&amp;P/LSTA Leveraged Loan Index</td>
<td>-0.10</td>
<td>-0.50</td>
<td>0.34</td>
<td>1.00</td>
<td>0.89</td>
<td>0.47</td>
<td>0.59</td>
<td>0.78</td>
<td>0.62</td>
<td>0.47%</td>
<td>0.030</td>
</tr>
<tr>
<td>JPM Global HY Bond</td>
<td>-0.20</td>
<td>-0.40</td>
<td>0.39</td>
<td>0.89</td>
<td>1.00</td>
<td>0.57</td>
<td>0.71</td>
<td>0.79</td>
<td>0.73</td>
<td>0.47%</td>
<td>0.044</td>
</tr>
<tr>
<td>DJ-UBS Commodities</td>
<td>-0.03</td>
<td>-0.15</td>
<td>0.28</td>
<td>0.47</td>
<td>0.57</td>
<td>1.00</td>
<td>0.68</td>
<td>0.73</td>
<td>0.58</td>
<td>-0.29%</td>
<td>0.059</td>
</tr>
<tr>
<td>MSCI Emerging Markets</td>
<td>-0.08</td>
<td>-0.33</td>
<td>0.21</td>
<td>0.59</td>
<td>0.71</td>
<td>0.68</td>
<td>1.00</td>
<td>0.74</td>
<td>0.83</td>
<td>0.33%</td>
<td>0.081</td>
</tr>
<tr>
<td>HFRX Global Hedge Fund Index</td>
<td>-0.10</td>
<td>-0.37</td>
<td>0.35</td>
<td>0.78</td>
<td>0.79</td>
<td>0.73</td>
<td>0.74</td>
<td>1.00</td>
<td>0.74</td>
<td>-0.12%</td>
<td>0.020</td>
</tr>
<tr>
<td>S&amp;P 500 (US Equity)</td>
<td>-0.06</td>
<td>-0.32</td>
<td>0.28</td>
<td>0.62</td>
<td>0.73</td>
<td>0.58</td>
<td>0.83</td>
<td>0.74</td>
<td>1.00</td>
<td>0.27%</td>
<td>0.052</td>
</tr>
</tbody>
</table>

Source: Bloomberg, Galena Asset Management
IV. SUMMARY

Trade finance loans are a low duration asset class that produces a low-risk, consistent, non-directional return with traceable cash flows linked to an identifiable trade flow. They are structured to limit downside risk while producing uncorrelated returns over base rates.

Trade finance loans represent a unique asset category with the potential to provide investors with current income as well as significant portfolio diversification. The combination of floating rate income, collateral security and low duration means that trade finance loans can act as a shield against the possibility of rising interest rates in the current rate environment while at the same time offering the security of assets that are backed by collateral.

While they have been the preserve of commercial banks for many years, trade finance loans are now more easily accessible thanks to the deleveraging and greater syndication efforts from banks. Greater access to this sizable market – US$1 trillion alone for bank-arranged commodity trade finance loans - and the growing standardisation and transparency promoted by banks and industry groups are gaining momentum with institutional investors. The growing interest also stems from the recognition that financing real economy businesses, even if returns are on the conservative side, can make a tangible and sustainable contribution to the development of trade and economic growth.

Although the asset class is becoming increasingly accessible, the biggest challenge remains the effort required from mainstream investors to climb an initially steep learning curve. To this end, specialised asset managers are putting considerable efforts to further engage with a broader range of institutional investors and are thankful to those that are increasingly selecting them to access this compelling asset class.

Notes

1 Reaching back in ancient times, sections of the Code of Hammurabi (1792 BC) defines the rules governing trade finance, establishing certain standards and limits for loan agreements to control an abuse of usury and addressing the idea of a secured loan backed by valuable collateral.
2 See ICC “Rethinking Trade & Finance 2013”
3 UNCTAD Handbook of Statistics, 2012
4 Sources: J.P. Morgan; Markit, September 2013
5 See ICC estimates, “ICC Global Survey on Trade Finance” 2012
6 See ICC “Report on findings of ICC-ADB Register on Trade & Finance” September 2010
7 See ICC “Global Risks Trade Finance Report” 2013 for full breakdown of default statistics on trade finance
8 See International Credit Insurance & Surety Association (ICISA). 2013
9 See BIS – CFS Papers – Trade Finance: developments and issues, January 2014
10 See BIS – Central bankers’ speeches – “Financing commodities markets” Timothy Lane, September 2012
11 Disclaimer: the sample, which initially includes a limited amount of funds, may include vastly different lending strategies, may be incomplete and subject to survivorship bias, and therefore should not be construed as being a representative index.
About Galena Asset Management

Galena Asset Management is the wholly-owned subsidiary of the Trafigura Group set up in 2003 to offer investment opportunities through an array of specialised absolute return solutions to institutional investors. Trafigura is the second largest trader of refined metals and the third largest independent trader of energy products globally, with an annual turnover in excess of US$133 billion.

With US$2 billion under discretionary management as of December 2013, Galena acts as investment manager to several funds, managed accounts and bespoke mandates. The range of investment solutions encompasses hedge funds, long-only benchmarked funds, commodity credit and private equity. Our asset management teams are based in Geneva, London, and Singapore. For additional information, please visit the Company's website at www.galena-invest.com.

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