Q4 2017

Trade Finance: A Promising New Asset Class for Institutional Investors

GREENWICH ASSOCIATES

EFA GROUP

CONTENTS

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THE RISK/RETURN PROFILE OF TRADE FINANCE INVESTMENTS ALIGNS WITH INSTITUTIONS' CURRENT NEEDS AND INVESTMENT STRATEGIES

COMMODITY TRADE FINANCE PRODUCTS OFFER NET RETURN TARGETS OF 3.5–5% WITH 0.1%–0.3% ANNUALIZED VOLATILITY

Introduction

Commodity trade finance represents a $134 billion[1] annual global industry. Traditionally, this business has been funded by banks. But Basel III capital reserve requirements, other new regulations and associated balance sheet constraints have caused banks from Europe and the United States to reduce their exposures to trade finance. The resulting exit of capital has created a new window of opportunity for institutional investors.

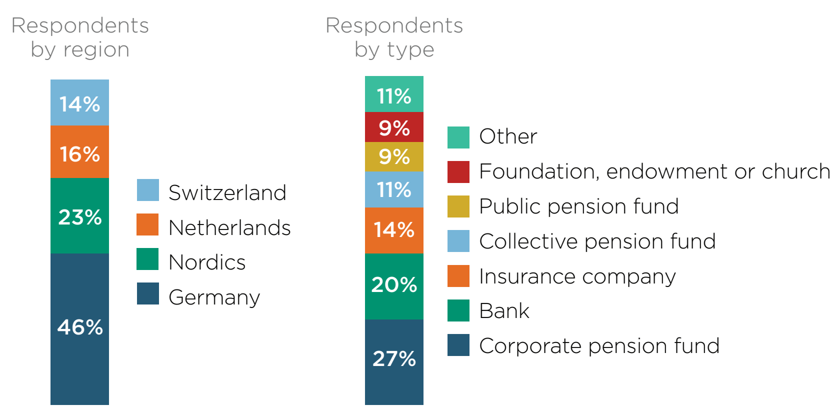
To assess this opportunity and quantify potential demand for this new asset class among institutions in Europe, Greenwich Associates conducted a special study of 56 decision-makers at institutions in Germany, the Nordics, the Netherlands, and Switzerland. These included corporate, public and collective pension funds, banks, insurance companies, endowments, and churches. Interviews were conducted in Q2 2017, and participants were chosen from a universe of institutions with a demonstrated affinity for credit products.

The study was conducted on behalf of EFA Group, an independent asset manager specializing in private debt strategies, with a focus on real-economy business, including trade finance.

1 Burroughs, Callum. "TXF Data Update: Structured Commodity Finance Makes a Comeback." *Txfnews.com*, 31 Mar 2017, www.txfnews.com/News/Article/6036/TXF-data-update-Structured-commodity-finance-makes-a-comeback

METHODOLOGY

During Q2 2017, Greenwich Associates conducted telephone interviews with 56 key decision-makers at European institutional investors to understand their knowledge and interest in commodity trade finance as an investible asset class.



Note: May not total 100% due to rounding.

The results of the study show there is a good fit between the investment needs of these European institutional investors and commodity trade finance. The new asset class possesses several important characteristics that would align with European institutions' investment philosophies and experience. More specifically, the risk-adjusted return profile of trade finance investments would mesh well with institutions' current investment strategies and could help investors achieve important goals within their portfolios.

However, the results also show there is work to be done for trade finance to gain significant traction in institutional portfolios. For starters, familiarity with trade finance and trade finance investments is low among European institutions. Beyond the issue of education, regulations and ESG considerations could serve as impediments to institutional participation.

Greenwich Associates believes some regulatory limitations and other issues will give way as trade finance matures as an asset class among institutions around the world. Regardless, this study finds a sizable institutional market for trade finance investments already in place. Given the alignment between the benefits and characteristics of trade finance investments, and the needs and strategies of institutional investors, we project that allocations will grow at a steady pace in coming years, and that trade finance over time will emerge as an important asset class in the portfolios of many European institutions.

Characteristics of Trade Finance

In quantifying the opportunity set for trade finance, the first question to address is whether the potential benefits of the asset class will be sufficient to generate institutional demand. The answer to that question is an unequivocal "yes."

In today's environment of historically low interest rates, the search for new sources of yield is perhaps the biggest driver of institutional demand for investment products. In this regard, the 3.5%–5.0% net return targets from this credit product would be an attractive addition to most institutional portfolios.

While investors in trade finance funds are exposed to credit risk, the secured and short-term nature of trade-finance transitions have historically kept default rates extremely low. Low default rates contribute to an overall return profile that is remarkably stable and consistent. "Even during the worst of the financial crisis, the asset class did not post a single month of negative returns," says Francois Dotta, CEO of EFA Group.

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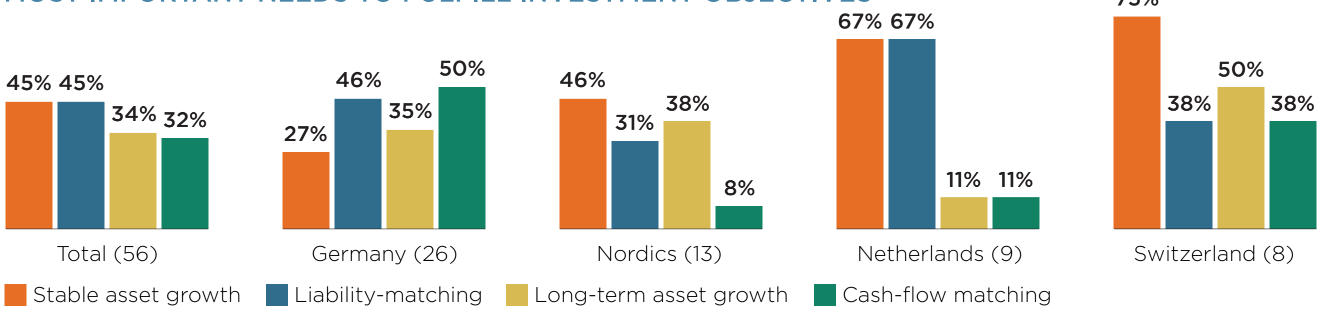
In terms of benchmarking relative returns, a plurality of institutions participating in the Greenwich Associates study would look to benchmark trade finance investments against LIBOR plus 300–400 bps. (A smaller number would benchmark against the Barclays Short-Duration Credit Index.)

Of equal importance to absolute or relative returns, however, are the relatively low volatility levels associated with trade finance investments. Trade finance funds on average generate 12-month annualized volatility of 0.10%–0.30%. These levels are in line with those of three-month LIBOR and far below the 4.44% annual volatility levels of investment-grade bond indexes[1] and the 3.55% of global hedge fund indexes[2]. Just as important, returns on trade finance investments typically have no correlation to other fixed-income strategies.

MOST IMPORTANT NEEDS TO FULFILL INVESTMENT OBJECTIVES



Note: Numbers in parentheses represent respondent counts.
Source: Greenwich Associates 2017 Trade Finance Study.

These are key considerations for institutions considering investment. As shown in the graphic above, the institutions in the study rank stable asset growth and liability-matching as the top investment objectives. Given trade finance's low volatility, stable return profile and lack of correlation to long-term interest rates, investments in this asset class could play a role in helping institutions achieve both goals.

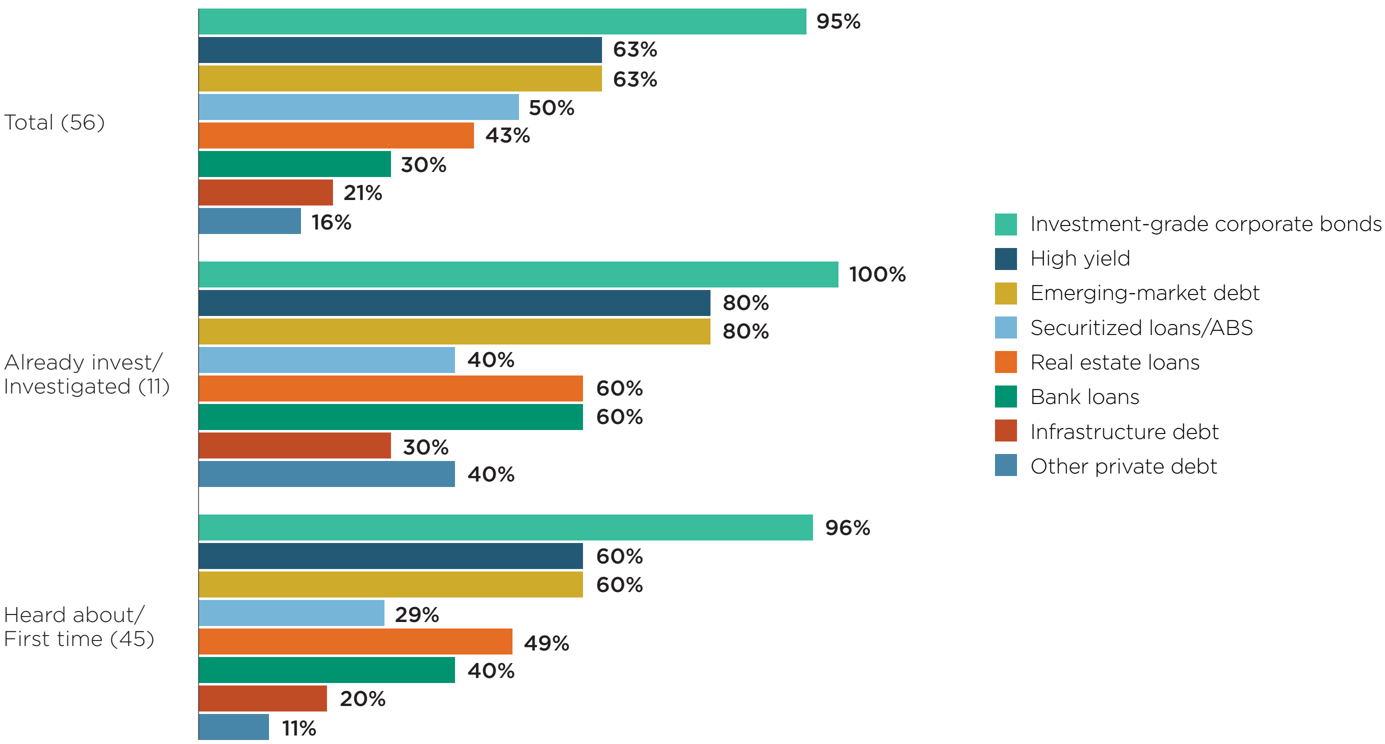
"The fact that the performance of trade finance investments should not be negatively affected by an increase in interest rates could help drive demand for the asset class at a time when the prospects of rising rates represent one of the biggest concerns for European institutions with large exposures to fixed income," says Gerry Afentakis, Head of Strategic Development at EFA Group.

1 IBOXIG Index
2 HFRX Global Hedge Fund Index

European Institutions as Potential Investors

Having established that trade finance would represent an attractive and potentially valuable addition to institutional portfolios, the next question is whether European institutions are well-positioned to take advantage of this opportunity and invest in trade finance.

EXPERIENCE WITH CREDIT-RELATED FIXED-INCOME INVESTING



Note: Numbers in parentheses represent respondent counts.
Source: Greenwich Associates 2017 Trade Finance Study.

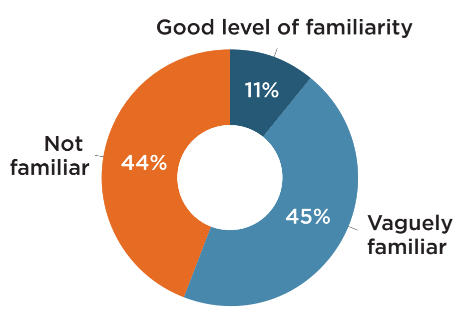
Overall, the study results show that European institutions have the investment capabilities and expertise required to take on this new asset class. Most European institutions have long experience with complex credit investments. About half the institutions in our study invest in securitized loans and real estate loans, indicating a high degree of familiarity with less liquid credit investments—a potentially important factor, given the illiquid nature of trade finance investments. (The typical trade finance fund has a 60-day subscription/redemption period.) At 62%, German investors are the most likely to invest in securitized debt. Nearly two-thirds of the institutions overall invest in high yield.

Among institutions in the study, 63% have experience investing in emerging markets debt, including roughly three-quarters of investors in the Netherlands and Switzerland. Only a relatively small share of institutions—about 16%—are prohibited from investing outside of developed markets—a restriction that would, of course, prohibit investment in trade finance funds targeting specific regions like Asia, or in developing markets globally. Most institutions with these restrictions are in Germany, where a 27% of study participants say they are not permitted to invest in emerging markets.

An Asset Class in Early Stages

It's important to remember that as an institutional asset class, trade finance remains in its infancy in Europe. Only 5% of the institutions in the study have invested in commodity trade finance. Another 14% have investigated trade finance but have not yet invested. Thirty percent of the institutions heard about trade finance for the first time when asked about it by Greenwich Associates interviewers.

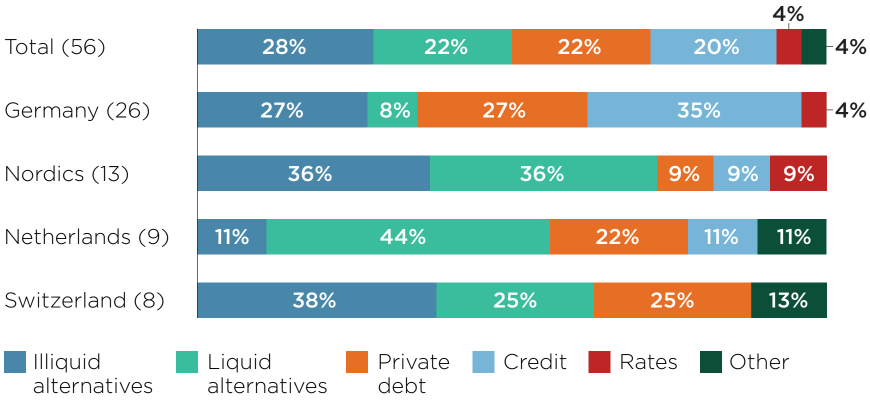
FAMILIARITY WITH THE CONCEPT OF SECURED AND UNSECURED TRADE FINANCE



Note: Based on 56 responses.
Source: Greenwich Associates 2017 Trade Finance Study

Overall, only about 1 in 10 European institutions say they have a solid understanding of how secured and unsecured trade finance investments work. The remainder of institutions say they are either vaguely familiar with the concept or have no real knowledge at all. Among those institutions that have investigated and/or invested in trade finance, only 27% say they have a good level of familiarity with the asset class. Finally, the study shows a lack of any consensus on where trade finance would fit into institutions' overall asset allocation framework, with institutions roughly evenly divided among those who would place it in the credit, private debt, liquid alternatives, and illiquid alternatives buckets.

NO CONSENSUS ON WHERE TO PUT TRADE FINANCE

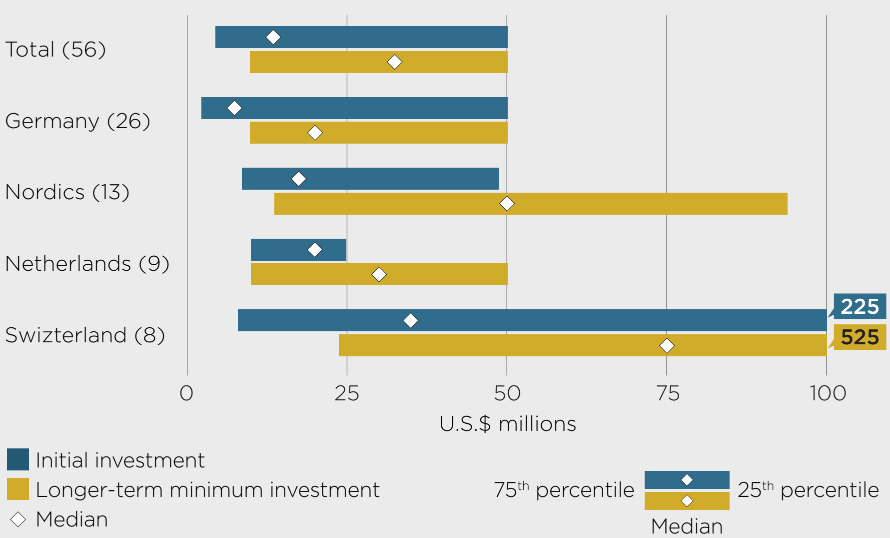


Note: Numbers in parentheses represent respondent counts. May not total 100% due to rounding.
Source: Greenwich Associates 2017 Trade Finance Study.

THINK SMALL

Small and midsize institutions might come to make up the bulk of the institutional investor base for trade finance—at least as the asset class is currently constructed. Institutions expressing interest in trade finance say they would prefer to start with an initial investment of \$10 million–\$50 million and double that amount over time if the asset class meets expectations. However, investments at the higher end of this range might not be a good fit for trade finance funds, given the relatively small size of the transactions in which these funds invest. As a result, initial demand for the asset class could arise among smaller institutions that are comfortable with relatively small allocations.

MINIMUM INVESTMENT AMOUNTS FOR NEW ASSET CLASSES



Note: Numbers in parentheses represent respondent counts. The 25th percentile for Switzerland (initial and longer term investments) extends past the \$100 million mark.
Source: Greenwich Associates 2017 Trade Finance Study.

In light of those findings, it's clear that trade finance asset managers have their work cut out for them. The process of selling trade finance to institutional investors will have to start with providing portfolio managers and investment committees with a thorough education about how the asset class works and the risks and benefits it offers. That effort will take time, and asset managers will have to be effective in presenting trade finance as a fully established asset class that will fit with institutions' investment processes and strategies. Managers will also face some real challenges to institutional uptake.

Asset managers must demonstrate that trade finance is up to institutional standards.

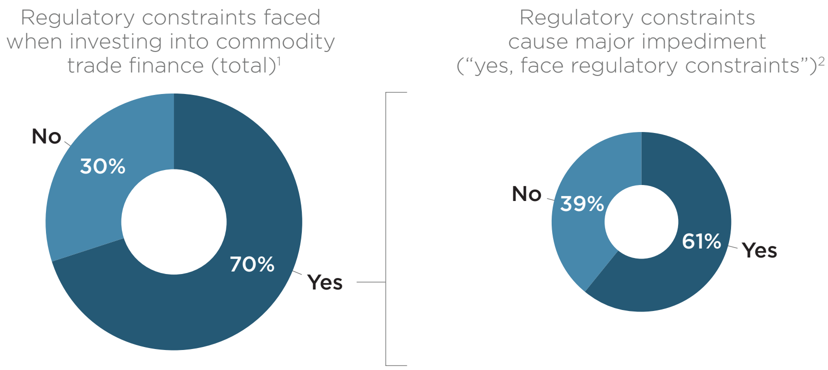
Most institutions take six to 12 months to review and assess a new asset class. During that period, they follow a highly structured process examining the potential asset class' risk/return profile and requirements for regulatory compliance, reporting, IT, and other factors. Asset managers must demonstrate that trade finance is up to institutional standards in all these categories. In many cases, they will have to make this case not only to the institutions themselves, but also to investment consultants. In the Netherlands, the Nordics and Switzerland, consultants will have significant influence on the final outcome.

At a general level, European institutions are increasingly judging asset classes based on how well or how poorly they fit into their existing asset-liability-matching framework. Especially in the Netherlands, the Nordics and Switzerland, asset managers' success in positioning trade finance as a tool that can help in this area will go a long way in determining institutional demand.

Possible Roadblocks: Regulations and ESG Compliance

Seventy percent of the institutions in the study say they would face some regulatory constraints with regard to trade finance investments. Of those, 61% say these rules could represent a major obstacle. German institutions are the most likely to see regulations as a potential hurdle. In terms of specific regulation, issues such as the current lack of credit ratings for most trade finance investments and the relative illiquidity of trade finance funds could complicate the process of review and approval.

REGULATORY CONSTRAINTS AND IMPACT ON INVESTING



Note: [1]Based on 56 responses. [2]Based on 39 responses.
Source: Greenwich Associates 2017 Trade Finance Study.

Approximately half the institutions in the study would have to contend with specific environmental, social and governance (ESG) compliance requirements for any trade finance investments. Trade finance touches on several commodities and markets that have become taboo for institutional investors that have adopted robust ESG standards. "We take a very active approach when it comes to ESG investing—we have no other choice," says a study participant from a Dutch pension fund. "Therefore, anything like coal, GMOs or other products that don't meet our guidelines would be restricted."

Several study participants say their ESG policies prevent them from investing in any agricultural commodities. For example, a representative of a German savings bank says his organization's ESG compliance might allow for investments in coal and oil, but "foods would be a no-go, as well as agricultural products such as soybeans or cocoa and so on."

To overcome this serious limitation to institutional involvement, asset managers will have to make the case that investments in trade finance are not in any way comparable to speculative investments in underlying commodities. Rather, they will have to show that capital invested in trade finance provides a social benefit by helping connect agricultural producers with consumers around the globe, facilitating the flow of food and other commodities to potential customers. As a result, institutions will be contributing to a social good by replacing bank capital in trade finance markets.

Here is how one end user of trade finance services describes the role of institutional capital:

> *As a leading player in trading soft commodities, our mission is to connect agricultural producers with consumers around the globe. While we have a good number of trade finance facilities from international banks, the banks are not always able to finance all our flows or meet the quick response time sometimes necessary to make a trade happen.*
>
> *Institutional capital represents a complementary and agile source of funding to enable us to originate, import, export, and distribute soft commodities worldwide. With the financing provided, we are able to export wheat from Australia, South America and the Black Sea into Asia, for example, or sunflower oil from the Black Sea region into India, where they are further distributed or processed before being sold to local consumers.*

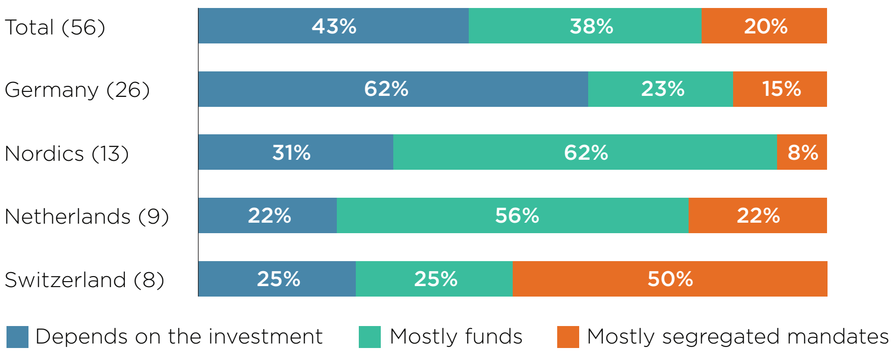
Additional Concerns: Fees and Fund Structure

Institutions point to another factor that could discourage participation in trade finance: the relatively high fees charged by trade finance funds. These funds typically carry management fees of about 1.50% on average, with a performance fee in the 15% range. While about 40% of institutions in the study say their organizations would have no problem with such a fee structure, roughly the same share says fees in that range would represent a problem. (The remaining 20% are not sure.)

Certain types of institutions appear unlikely to participate at these fee levels. For example, German savings banks say their maximum allowable management fee is 75–50 basis points, with one bank reporting a top-end fee of 20 basis points. However, pension funds and insurance companies say they would be open to fees of that level, given the costs and administrative requirements associated with making investments in trade finance.

To attract institutions to this asset class, it will be incumbent upon fund managers to be entirely transparent about fees and to educate potential investors about the expense and burden of legal documentation, credit analysis and other labor-intensive tasks associated with making investments in trade finance.

SEGREGATED MANDATES AND FUND STRUCTURES



Note: Numbers in parentheses represent respondent counts. May not total 100% due to rounding.
Source: Greenwich Associates 2017 Trade Finance Study.

Finally, although most European institutions are more than willing to invest in funds without requiring segregated mandates, fund managers will have to address the issue that most trade finance funds currently available are registered as Cayman Island funds—a structure not in favor among European institutions. Overcoming any preconceived notions about Cayman funds will be a necessity for these managers, since accessing the more popular UCITS structure would require the provision of daily liquidity—now far outside the reach of these funds.

Approximately two-thirds of institutions would consider investing in trade finance funds structured as SIF-SICAV. Individual position-level reporting will be a requirement for the vast bulk of European institutions. German investors in particular will also require Euro-hedged share classes.

Conclusion

Supply and demand forces are aligning to fuel the growth of trade finance as an asset class among European institutions. Although asset managers will have to overcome issues associated with regulations, ESG compliance and an overall lack of familiarity with trade finance among institutional investors, these investments offer several compelling benefits that make them an attractive addition to a portfolio.

European institutions' long experience with credit products make them well-positioned to take advantage. The fact that the risk/return profile of trade finance investments aligns with institutions' current needs and investment strategies suggests that use and allocations will grow in coming months, and that trade finance will gradually emerge as an accepted and established asset class in institutional portfolios.

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