# The strongest link? Trade finance as an option for pension funds

**With stock markets in turmoil and bond yields depleting, some pension funds are looking at trade finance as an alternative for diversification, writes Christopher Marchant**

**Summary**
• Trade finance is seen as a potential for diversification.
• It is arguably less susceptible to negative impact from global events than some other options.
• It can also fulfil the ESG angle pension funds are looking for.
• The issue of complexity needs to be addressed.

Put simply, trade finance is a line of credit from a third-party financier, which seeks to assist companies in funding the buying and selling of goods. Its access to quick cash can enable buyers to pay their suppliers straight away, while paying back the credit facility over time. From a funder's perspective, a key advantage of trade finance is the short length of contracts, with those offering trade finance rarely locked into contracts longer than 180 days, and therefore allowing a high level of agility and responsiveness.

David Newman manages global high yield and multi-asset credit strategies within the global fixed income team at Allianz Global Investors (AllianzGI), having previously led an equivalent team at another firm for eight years. Of this nimble advantage trade finance poses, he says: "If a major geopolitical event happens such as Covid or the Russian invasion of Ukraine and you want to change your portfolio, at the end of the typical 90 day contract you can stop financing and can change the shape of your portfolio with great speed."

Trade finance does not just bring agility with it, but also increased opportunities for profitability. Investors are in search of yields above comparable benchmarks, and trade finance regularly pays above the risk commensurate yield level.

According to Christoph Gugelmann, chief executive at Tradeteq, a software provider active in turning trade finance into a liquid asset, this area of debt has all the components investors are looking for.

"It is a multi-trillion-dollar asset class based on the flow of physical goods and services, making it less susceptible to financial market volatility," he says. "Default rates for trade finance products are generally lower and the time to recovery in case of default tends to be shorter than for other credit products."

Despite these benefits, there are aspects that may be holding back some pension funds. Most notably is the level of complexity associated with trade finance. However, Gugelmann is keen to stress that trade finance infrastructure now exists to enable end-to-end straight-through-processing of hundreds of thousands of instruments in a low-cost way.

Of the complexity considerations, Newman says: "It's a question of

education. Clearly, trade finance is not as simple as other forms of investment. There are other risks you need to understand within trade finance such as delay risk, dilution risk, and fraud.

"So, you have to do your due diligence and know how you mitigate those risks. The best way to mitigate fraud properly is to do strong due diligence on your supplier, the buyer, and the seller, and to be really diversified."

## The Greensill elephant in the room

There of course can be no discussion of trade finance without acknowledging the collapse of supply chain finance provider Greensill Capital in 2021. The implosion of the firm led to losses and lawsuits across Europe and the US, as well as valid questioning as to whether the risk inherent to trade finance itself was greater than its worth.

Lane Clark & Peacock (LCP) partner, Zuhair Mohammed, sees the whole sorry saga as an important learning opportunity for those pension funds considering utilising trade finance: "The bad news that was associated with Greensill is something that would frighten, and often requires some training to explain exactly what did and didn't happen and therefore what not to look for in a trade finance package."

This sentiment is echoed by Newman who actually regards Greensill as "very good" for the industry, in how the individuals and firms involved worked out what went wrong, and this showcased how to do it right.

For the fund manager, the affair also validated the AllianzGI model that showed that a very broad open architecture diversification model was "the way to go." He also pointed out that the Greensill collapse brought about a change in US accounting standards, carrying the potential to bring more trade finance on the balance sheet for companies. Despite these silver linings though, the shadow cast by Greensill has still created critics.

"At present advisers are not familiar with the product, which will naturally hinder access," is the frank assessment by Ross Trustees trustee director, Pavan Bhardwaj.

"As well as this, most funds will not need the incremental returns offered by trade finance. There have also been some high-profile failures of commodity and trade finance firms, leading to many to ask whether there is questionable oversight over their practices."

Yet with these lessons learned and efforts underway to raise the profile of trade finance, it can still be focused on in terms of its agility, profitability, and perhaps sustainability as well. With international trade acting as an engine for inclusive economic growth and poverty reduction, trade finance can also be seen as a tool in achieving the UN Sustainable Development Goals (UN SDGs) one and eight.

## Fulfilling a growing need

According to the most recent estimate by the Asian Development Bank, the global trade finance gap, which is measured through the difference between requests and approvals for financing to support imports and exports, widened to $1.7 trillion in 2020. SMEs are in particular need of trade finance as some banks, the traditional key suppliers, scaled back availability of their funding in the aftermath of the Covid-19 pandemic. Furthermore, female-led SMEs have found it particularly difficult to get finance, with a reported 70 per cent of their applications totally or partially rejected.

Engagement on trade finance can also provide an opportunity for responsible consumption and production, UN SDG 12. Of this area, Newman says: "AllianzGI is helping businesses finance themselves in a cheaper way using the credit of the buyer. Then of course you can decide who you are financing and what you are financing.

"A lot of this business is going to be throwaway fashion. There are issues here with regard to labour practices, accessibility markets, and you can choose not to finance those companies which don't use child labour for example."

Trade finance can clearly act as a boon to global SMEs, as well as the aforementioned diversification option for pension funds. On the risk aspect of trade finance, Hymans Robertson senior investment research consultant, Penny Cochrane, says: "Default probability is less than that of longer-term credit ratings and previous defaults suggest that companies that are a going concern continue to pay their working capital obligations even when in financial difficulty. This equates to a low expected loss."

Given these benefits, how can pension funds best access trade finance?

AllianzGI is seeing an uptick in approaches from pensions for trade finance. Newman says: "When we have pension funds coming into our main fund, the challenges are getting over the initial complexity and setting the stage for trustees. The good thing is a lot of the pension funds we see are from companies which do trade themselves, so a lot of pension fund trustees will understand what trade finance is in certain ways."

Despite this uptick, Bhardwaj says trade finance is still on the periphery for most DB pension funds, and typically, clients would prefer a complexity premium to come from secured income asset backed securities. However, Newman observes that AllianzGI recently hosted a session for pension providers, in which half of attendees had considered trade finance in their portfolios. Five years ago, Newman believes this would have only been 20-30 per cent.

Despite this progress, the fund manager says there is still more to be done on this front for trade finance to become embraced as an asset for pension fund portfolios. Newman says: "There are those in the investment world that are pushing this asset class quite a lot, and consultants are starting to see this. While trade finance may be moving away from the niche and into the mainstream, it's not quite there yet."

**Written by Christopher Marchant, a freelance journalist**