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Navigating uncertainty through trade finance

Trade finance provides an option for institutional investors seeking alternative sources of return, particularly given the recent volatility in fixed income markets. It has the potential to limit downside risk and provide a source of diversification

Fixed income markets have been buffeted by geopolitics, inflation, and recessionary risks during 2022. Together, those factors have contributed to one of the worst drawdowns in fixed income markets in recent memory, sending the Bloomberg Barclays Global Aggregate Index down 18 per cent as of mid-September 2022[1]. For institutional investors seeking alternative sources of return that can limit downside risk and provide a source of diversification, trade finance may offer a solution. In return, they gain access to the so-called complexity premium of trade finance, whereby investors may be rewarded for investing in an asset class that requires particular skill, resources and expertise to access.

Trade finance needs are rising, driven by recent supply chain disruptions and a tightening of bank funding. The scale of disruption caused to global trade over the past two years – by factors including the impact of Covid-19 and geopolitical events such as the war in Ukraine – means significant demand exists for this form of working capital financing, which bridges the gap between the delivery of products and payment. According to the most recent estimate by the Asian Development Bank, the global trade finance gap widened to $1.7 trillion in 2020. Small- and medium-sized businesses are most in need of help as some banks, the traditional key suppliers of trade finance, scaled back availability of funding in the aftermath of the pandemic.

The impact of trade disruption can fall disproportionately on the world's poorest people, given the vital role trade plays in reducing poverty by creating jobs and stimulating economic growth.

How does trade finance work?

Trade finance resembles a line of credit from a third-party financier that helps companies fund the buying and selling of goods. For example, it enables suppliers to receive money straight away, even though their buyers may not need to pay until some point in the future. Trade finance can be divided into four main categories:

1. **Payable finance** supports a buyer by facilitating payments to its suppliers when invoices are raised.
2. **Receivable finance** provides money to a single supplier in advance of its receiving invoice payments from several customers.
3. **Working capital facilities** provide loans to one supplier repaid by receivables from several customers.
4. **Documentary credits** are common instruments used by companies to finance cross-border trade flows and payments under commercial contracts, including letters of credit and bills of exchange.

Why is trade finance a potentially attractive option for institutional investors?

Investors allocating to credit strategies currently face several challenges, most prominently an uncertain geopolitical landscape and a rising yield and spread environment. These investors are therefore looking for assets that may be less impacted by rising bond yields and credit spreads, with the flexibility to navigate macroeconomic uncertainty while still offering the potential for attractive returns.

Trade finance can offer a solution that counters many of these challenges, while harvesting the complexity premium that arises from this asset class. Its short-term maturity profile – typically, transactions have a life cycle of between 30 and 120 days – and low correlation to other asset classes can help investors manage an environment of rising interest rates. Investments in trade finance can also help investors manage downside risks as they tend to exhibit low volatility.

Trade finance also typically exhibits a short spread duration, which can help reduce sensitivity to changes in credit spreads (which usually widen and thus reduce returns in a recessionary environment). While other credit assets might currently offer higher yields – especially after the recent market sell-off – trade finance is defensive in nature. If the credit environment worsens, trade finance could outperform as publicly traded credit spreads might have to widen more since they have not reached recessionary levels yet. Yield does not equal return, and in uncertain markets we prefer the relative certainty of short-dated trade finance.

Investors concerned with the medium-term uncertainty in credit markets may also find the short-term and flexible profile of trade finance appealing. The short maturity profile of the asset class can allow portfolios to minimise capital markets refinancing risk, which will be an increasing source of volatility for public bond markets as financial conditions tighten.

Another feature which could be particularly appealing in the current environment is the "self-liquidating" nature of trade finance assets. If an invoice is bought by an investor at a discount, the investor expects to receive back the par value of the invoice at maturity. This contrasts with public fixed income strategies, where fund redemptions or portfolio repositioning will require the fund to sell at the market price based on market sentiment at the time of sale. This "self-liquidating" feature in trade finance reinforces the potential low-volatility, low correlation profile of trade finance: the obligations of suppliers or buyers to settle trade payments are not linked to the price movements in public fixed income markets.

Lastly, trade finance in general has lower default rates and higher recovery rates than public debt as trade finance is the lifeblood of many companies. Taken together, these attributes lead to low correlation to other asset classes and potential downside mitigation in times of market stress, as again demonstrated during the recent market turbulence.

Beyond the inherent structural advantages, the asset class can also help investors meet long-term sustainability goals. Since international trade is an engine for inclusive economic growth and poverty reduction, trade finance can be an important tool in contributing to the UN Sustainable Development Goals.

At the same time, structural changes are paving the way for institutional investors to enter the market. Banks are looking for partners to fulfil their clients' needs as they struggle to keep up with growing demand due to regulatory capital requirements. Meanwhile, financial technology companies have brought innovation to the field, reducing unit costs and making small financing volumes economical.

What are the risks of the asset class?

The primary risks in trade finance are credit and fraud risk. Credit analysis and diversification mitigates credit risk. Fraud risk can be managed by analysis of the relationship between buyers and suppliers and other parties involved. Careful selection of sourcing partners and due diligence, combined with diversification, should reduce risks. The use of historical data when evaluating the supplier and buyer to determine pricing can lead to the risk of delays and dilution, where the amount that may be payable by the debtor on an agreement will be less than the invoiced amount. But due diligence can again help mitigate risk levels.

How can trade finance fit within a portfolio?

As investors look beyond the main asset classes to diversify return streams in a low-yield environment, trade finance can offer an attractive diversification option. For defined benefit pension schemes, the asset class can act as an alternative to traditional credit assets such as asset-backed securities (ABS) and short-dated investment-grade bonds due to a potentially increased yield helped by a complexity premium. Equally, trade finance may replace government bonds holdings as it offers the possibility of stable returns and low sensitivity to rate changes.

For defined contribution pension schemes and charities, trade finance can provide exposure to private markets, while allowing investors to retain some liquidity. It can also offer a funding source for capital calls. Finally, trade finance can also act as a strategic cash position. Its semi-liquid structure gives investors the ability to shift or reallocate portfolios. This ensures trade finance can provide a potential funding source for private market capital calls.

While this is a relatively new and complex asset class, with the right partner it is possible to take advantage of the potential benefits trade finance offers.

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Written by Allianz Global Investors CIO, Head of Global High Yield, David Newman, and Portfolio Manager, Alternatives, Mike McGill

[1] Source: Bloomberg GlobalAgg Index (USD), a flagship measure of global investment grade debt. Data as of 23rd September 2022.