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Trade Finance: uncorrelated alpha potential

Trade finance – short-term loans to facilitate physical cross-border transactions – plays a vital role in facilitating global trade flows. In this paper, we outline why more investors are turning towards this asset class as a diversifier in their portfolios.

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Due to its ability to provide uncorrelated alpha with limited reliance on traditional return drivers, more investors are turning towards this asset class as a diversifier in their portfolios.

Trade finance refers to loans that provide short-term financing to support the physical flow of goods (such as raw materials) to facilitate international trade flows. These deals are structured to help all parties mitigate the challenges associated with cross-border trade – which can range from foreign currency exchange rates to regulatory compliance and non-payment. Trade finance loans are vital for financing trade with emerging markets to help reduce risk exposure and bridge the liquidity gap for distributors. These loans are collateralised by the goods being financed.

Trade finance loans generally have the following qualities:

- Self-liquidating as goods are delivered.
- Low interest rate and credit duration risk.
- Float at a spread over a short duration index, such as Secured Overnight Financing Rate.

The lender uses several risk mitigation techniques to reduce risks to an acceptable level, such as collateral management of the goods, permanent control of the title over the goods and ring-fenced cash flows. The arranger of a trade finance transaction, often a bank, holds a significant part of the deal on its own books to maturity.

A large, global market that has demonstrated resilience

Over the last decade, world trade has been up against a variety of economic shocks – collectively referred to as the "polycrisis." This includes the COVID-19 pandemic, disruptions to the supply chain and geopolitical concerns.

Through these challenges, trade finance has continued to show resilience due to the ongoing demand to serve a critical need for international economic development. In fact, during the aftermath of the 2008-2009 global financial crisis, it was trade finance that helped keep shipments moving, according to the International Monetary Fund.[1] Accordingly, trade volume has increased by 6.3% since 2019 and 19.1% compared to the average level in 2015.3 South-to-South trade amongst developing countries in the Southern Hemisphere should be the largest driver of future growth in the near term, as it is tracking to grow from 17% in 2010 to an estimated 40% of total global trade by 2030.[2] This surge can be closely linked to the international fragmentation of production in the context of global value chains. World merchandise totals (valued at US$24 trillion) are also expected to grow in the near term, by 2.7% in 2025.[3] This data paints a promising picture of the future for global trade.

Fast reading

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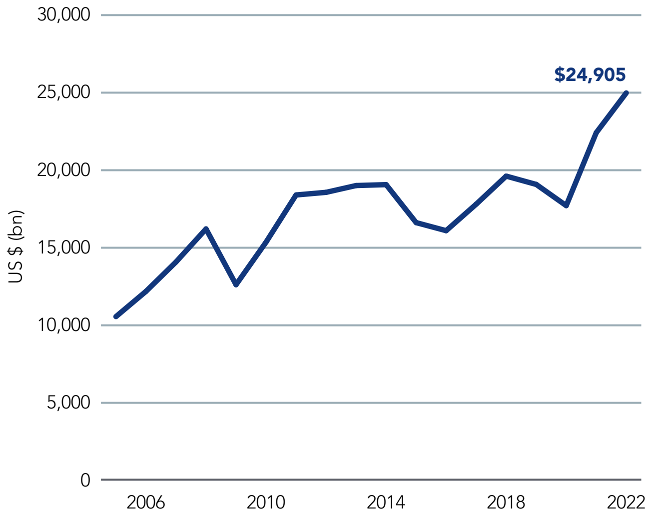
- The lender can use several risk mitigation techniques to reduce risks to an acceptable level, such as collateral management of the goods, permanent control of the title over the goods and ring-fenced cash flows. The arranger of a trade finance transaction, often a bank, holds a significant part of the deal on its own books to maturity.
- The type and characteristics of trade structures can vary depending on the nature of the transaction, countries involved and party creditworthiness.

[1] "Trade and Trade Finance in the 2008-09 Financial Crisis." International Monetary Fund, 2011.
[2] "South-South Trade and its Implications for the World Economy." International Banker, 2015.
[3] "Global Trade Outlook and Statistics." World Trade Organization, April 2024.

Figure 1: Global export value of trade in goods (2005 to 2022)



Source: United Nations Conference on Trade and Development (Unctad).

The trade finance gap

It is estimated that 80% of world trade is dependent on some form of financing.[4] This can be attributed to tighter credit conditions for obtaining alternative sources of capital. But as the demand for trade continues to grow, a complex regulatory environment, coupled with a lack of understanding for the asset class, has contributed to a global shortage of financing.

Common trade finance structures

The type and characteristics of trade structures can vary depending on the nature of the transaction, countries involved and party creditworthiness. Some structures available to investors are listed below.

- Supply chain finance transactions finance payment obligations of large US corporates (buyers, investment grade, multisector) to their suppliers (varying credit quality). This allows suppliers and buyers to optimise working capital cycles as a cost that is reflective of the stronger counterpart's credit risk. Investors can utilise these loans as short-term exposure (30-180 days) to investment-grade publicly listed US corporates, allowing for low payment default probability and limited country risk. The uncommitted nature of the transaction allows investors to quickly reduce or right-size the exposure to an obligor or the program overall.
- Financial institution trade loans are hard currency loans to financial institutions with a typical duration of six months to two years. These are used as senior unsecured bank funding instruments, with on-lending to key trade sectors of the local economy.

- Corporate term loans are hard currency loans to corporate borrowers with a typical duration of three to seven years. These self-liquidating structures are repaid from the top line and include the financing of specific asset expansions programs or cross-border movements of primary goods.
- Sovereign loans are hard currency loans to developing and emerging market foreign governments with a typical duration of five to 30 years. The use of proceeds is linked directly to key infrastructure projects in the central government budget with no general budgetary shortfall funding.
- Project finance loans fund long-term infrastructure, industrial projects and public services using a nonrecourse or limited-recourse financial structure with a typical duration of five to 20 years. The debt and equity used to finance the project are repaid solely from the cash flow generated by the project itself, and investors can benefit from revenues underpinned by long-term contracts.

Portfolio benefits and implementation

Amid an uncertain economic backdrop, a diversified pool of trade transactions has the potential to deliver the kind of "pure alpha" that many investors are searching for.

Characteristics to consider for portfolio implementation include:

- **Uncorrelated returns of private markets without liquidity restraints.** Similar to private markets, this asset class has exhibited uncorrelated returns without liquidity restraints.
- **History of higher return, lower volatility.** Adding trade finance can help achieve higher return and lower volatility for portfolios across investor types. In particular, bonds are fundamental to investment portfolios as they have typically provided a relatively stable stream of cash flows and are generally less volatile than common stocks. They also help manage risk and meet obligations by matching liabilities with reliable cash flow streams.
- **Floating rate nature of leveraged loans with more stringent loan structures and covenants.** Similar to leveraged loans, Trade Finance as an asset class benefits from having little sensitivity to interest rate moves, given all loans are issued based on a spread over a floating rate (such as SOFR or the ICE BofA US Dollar 1-Month Deposit Offered Rate Constant Maturity Index). However, where Trade Finance loans differ from leveraged loans is that each transaction within a trade finance portfolio is originated as part of a structure with specific covenants (loans are typically collateralised by the goods being financed), typically avoiding the risks that leveraged loans are most exposed to in comparison.
- **Low volatility and lower drawdown characteristics compared to public fixed income.** This has been achieved by focusing on two main elements: the structure of the loan and the average life of the loan. Self-liquidating structures include loans that will typically have characteristics preventing their mark-to-market values from being written down as aggressively as corporate bonds might.

[4] "Global Trade Outlook and Statistics." World Trade Organization, April 2024.

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