

Funds bridge liquidity gap



Trade finance funds are showing new growth momentum, writes Kevin Godier. New bridges are steadily spanning the trade finance and hedge and mutual fund investor communities. In the past few months alone several new trade finance funds have been launched. Are funds just a short-term fad or are they here to stay?

By definition, trade finance is a conservative discipline. While its key frontier and greatest source of deal origination has always been the world's emerging and developing markets, this does not necessarily imply higher risk, due to the intrinsic risk mitigation techniques deployed by practitioners to turn a profit, the importance of trade to emerging market economies, and the potentially serious ramifications attached to any payment defaults.

For nearly a decade, players in the mutual and hedge fund communities have been demonstrating an increasing awareness of the value of trade finance assets – and the increasing level of collaboration between the two universes has been highlighted during recent months by several pieces of news concerning fund inceptions.

Among these, the EuroFin

Asia Group (EFA) is launching a new fund specialising in Asian trade and structured trade finance assets with a focus on commodities and raw materials; Rosemount Capital Management (RCM) has established a hedge fund dedicated to trade finance globally; and Tricon Forfaiting Fund Limited (Bermuda) is re-launching its mainstream forfaiting fund shares with a US\$100mn-US\$200mn investment target.

By inserting such funds in the zone between traditional trade finance and an investor community with little exposure to techniques like forfaiting, structured finance or Islamic finance, the founders are supporting the theory that non-bank money can provide a much-needed alternative source of liquidity for the trade finance market.

According to one market

observer there are now at least six 'pure-play' trade finance funds such as the two new models in existence, as well as a number of 'fund of funds' (FoFs) that invest in trade finance funds as part of their investment activity. These include two funds set up by the London-based alternative asset manager Eden Rock Capital Management in



Hu at IIG

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2004 respectively, to capitalise on the returns available from factoring and other asset-based forms of finance.

"I am also aware of more than six additional trade finance funds being set up – there has been an explosion of hedge fund interest in the market over the last six months, and we expect to see much more hedge fund involvement in commodities finance over the course of the next year," says the observer.

On the demand side, the strategic drivers of change in the market include the Basel II rules, elaborates James Parsons, director at LTP Trade, a London-based consultancy specialising in trade finance analysis. "These will make trade finance assets more expensive for banks to hold and consequently increase the attraction to trade financiers of the availability of risk capital that is not subject to Basel II."

Unfamiliar waters

The roots of the new paradigm lay in the US, where previous overlaps between capital markets and trade finance have seen institutions and individual investors dipping their toes into the relatively unfamiliar trade and



LTP's
Parsons

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project finance environment in return for assets that are proven carriers of low volatility, relative liquidity and solid yield. A key starting point for institutional investors has been forfaiting, where the width of corporate spreads that were formerly available in Latin America, Russia and other emerging markets gradually pulled in a sprinkling of funds and insurance companies as secondary buyers of paper.



Lüschtg-
Emmenegger
at Fimbank

Islamic finance is based very much around trade, so there is a huge opportunity here

Distribution in this direction was a feature of operations in the mid-to-late 1990s by Deutsche Bank and other major banks playing the secondary markets. "In itself, trade finance represents a high quality asset," points out forfaiting guru Margrith Lüschtg-Emmenegger, president of Malta-based Fimbank, and who initiated a partnering between the Tricon Fund and WestLB when at the bank in years previous. "Defaults are rare, because trade is the final currency – if trade isn't paid, countries and banks get into trouble," she continues. "And, even today, the spreads are often more attractive compared with other assets, so people are able to get a good rate for an excellent asset class."

"Subject to the specific strategy adopted, trade finance returns are attractive to investors in their own right," suggests Parsons, who once worked as a forfaiter for Deutsche Bank. Trade finance assets "offer very good reward-to-risk ratios, and due to the lack of correlation with other asset classes are able to add substantial efficiency to investment portfolio diversification," he adds. Fritz vom Scheidt, managing director of Tricon Trade Management, explains the non-correlation angle which allows fund managers to acquire some insulation from adverse movement in US dollar interest rates. "If you take a typical situation where the 7-8% yield on a higher yielding forfaiting asset is structured such that the initial 5% of the asset's yield is Libor rate, and the remaining 2-3% is country and obligor risk, then that 2-3% portion is not influenced by US interest rates but by the evolving credit and political risk in Ukraine, or elsewhere," he says. "When US interest rates move, all US dollar fixed income markets in the world move, including US dollar Libor, because they are all linked to US interest rates. But 28-38% of the forfaiting asset won't move, because it is not correlated to the US interest rate movements.

Conversely, a US dollar bond fund may be doing well, then the Fed raises interest rates by 25bp, and all bonds along the interest rate curve from short to long will drop, as they move inversely to interest rates." One of the first trade finance funds to set up was the International Investment Group's (IIG) main IIG Trade Opportunities Fund (TOF), which invests in global commodity trade finance transactions. This began life in August 1998, "right at the time of the Russian crisis and Long Term Capital Management (LTCM) implosion," recalls David Hu, managing partner at IIG, which is the investment adviser to both the TOF and IIG Trade Finance Partners, which "has slightly different risk parameters than TOF", Hu says. The TOF has shown a 108% return since inception, from a portfolio comprising around 450 transactions with an average duration of 6.3 months. Over 38% of assets comprise receivables financing, with just under 50% originating in Argentina, Brazil and China, as of February 2006, when its two largest sectoral exposures were coffee and frozen beef. Hu describes the fund as "a single strategy, trade finance/hedge fund that consistently provides absolute returns to investors", comprising mostly institutional investors such as pension funds, insurance companies, banks, and FoFs. Currently the net asset value (NAV) of the TOF is "slightly over US\$300mn," he says.

Documentation issues

The fund theme was further amplified in October 2000 by the start up of the Tricon Forfaiting Fund, which has subsequently branched out into the Islamic investment markets via the world's first Islamic trade finance fund. "The force behind the idea was to create more appetite for forfaiting assets among institutions that often wanted to invest but couldn't really

handle some of the complex documentation issues," recalls Lüschtg-Emmenegger. "Creating a vehicle that let investors deal with just one counterparty, this being a well-established company and experienced in dealing with the documentation, made the product acceptable for them."

Traditionally, adds vom Scheidt, "big banks have tried to increase the depth of their secondary distribution by selling trade finance assets to bond funds and insurance companies, but there was always a lack of familiarity with documentation as well as inherent documentation clearing obstacles that hindered marking to market activity and liquidity".

Partially to address these issues, the Tricon team has used first WestLB, and more recently Standard Bank Plc, as its documentation agent, as well as its investment adviser. "Standard Bank provides two important services in which it is a market leader," says vom Scheidt. "In addition to providing us with a constant window on risk assessment in trade finance markets around the world, it also maintains clearing and custody for our trade finance documentation given that trade finance is conducted in a bank-to-bank market without the benefit of third-party clearing such as Euroclear."

A handful of other funds have been established in the US, including the Octave-1 Fund, which invests in inventory finance, trade finance, and asset-backed securities. However the overall dearth of investor participation opportunities has set the stage for new demand which "is now coming in from investors that see the advantages of trade finance as an alternate asset class," notes vom Scheidt. He continues: "Hedge fund managers are now starting to take a serious interest – we're getting a steadily increasing number of calls from people in Germany, Switzerland, London and New York who are interested in our operations."



Klatsky at
RCM

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Yield and stability keys

Although the hedge fund world's highest-profile practitioner, George Soros, has won renown by taking a specific predictive view on the direction of an economy, currency or commodity, a far more typical hedge fund approach is the relative value, or credit arbitrage that identifies and seeks out market inefficiencies, or eliminates the volatility caused by global market fundamentals such as commodity prices and interest rates.

Thus a huge selling point for hedge funds is that trade finance has a minimal correlation with traditional hedge fund strategies, contends Shezad Syed, head of research for the Axiom family of hedge funds that focuses on investing in niche hedge fund strategies. The group has been investing in trade finance since the fund advisory group was created in 2001 by Habibsons Bank, which has a long history in trade finance.

"The ups and downs of a US and European long-short equity fund bears little relation to trade

of leverage – the stability of the returns come from the valuation methodology which is not mark to market as is the case for the majority of hedge fund strategies."

The target for Tricon, net of the costs of running the mutual fund, is "a yield of around 100-200bp over one-month, three-month and six-month Libor," says vom Scheidt. "That's what institutional investors look for, and the fund usually achieves that reasonably well."

An absolutely critical selling point for institutional investors, he adds, "is that we are not taking 100-200bp worth more risk to get that return". On the face of it, the Tricon portfolio would appear to encompass significant risks, with over 50% of its exposure concerning obligors in Romania, Russia and Ukraine, and other major chunks of risk emanating from Iran, Jordan, Kazakhstan and Nigeria. Yet the fund's reward-to-risk ratio – often expressed as a 'Sharpe Ratio' – is "very good", says vom Scheidt. "We prove regularly that the volatility in our price movement is minimal, next to nil."

Purchase and/or participation in well structured, "well put-together" deals is the key to performance, adds vom Scheidt. "To obtain our target returns, we obviously have to invest outside the risk of Fortune 100 banks and corporates in OECD countries. We mitigate our risks by investing in well-documented transactions from sovereign, state, bank and multinational corporate obligors where risk can be assessed by credit profile, payment performance, economic and political environment, best practice and some linear value at risk. We also favour transactions that involve bilateral trade agreements and securitised export contracts carrying a pledge on future receivables."

If a risk profile or country limit changes, then "from time to time we will trade out of the portfolio," says vom Scheidt. For the most part, however, the Tricon fund operates on a buy

and hold strategy akin to that of a bond investor.

"About 98-99% of the portfolio is invested at all times – our book only turns over as a function of maturing transactions, unlike a bank which may turn its forfaying book six-to-eight times a year." IIG also likes to keep its funds' capital as fully invested as possible. "The target is 90-95% – idle cash is not good for investors nor for us," stresses Hu.

RCM sees less volatility

The value of minimum volatility and extra returns is also espoused by James Klatsky, RCM's senior managing director. "Trade finance is less volatile than bonds, and can be more profitable. Equally important, it has the benefit of more stable returns, which are not only based on interest income. The underlying deals cover real trade, and involve less risks than, for example, working capital loans," he argues. Headquartered in New York, RCM was launched with the specific purpose of investing in, trading, and managing a portfolio of trade finance debt instruments stemming from emerging market risks.

It completed the first transactions for its open-ended Rosemount Global Trade Finance Fund in South America and Eastern Europe, and is "meeting our initial objectives", says Klatsky.

In most respects, the RCM fund follows the lines of a conventional trade finance bank, by both originating and buying assets opportunistically as a result of a team-based and formal process that includes a detailed market and credit analysis.

"We originate, buy, hold and sell, utilising the capital in our funds. We currently trade on two fronts – in the banking market, and the non-bank institutional market," Klatsky explains.

He points out that "perhaps 10-15% of our distribution of assets goes into the non-bank

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finance market trends, and diversification is exactly what FoFs are seeking – we don't want the majority of underlying funds within the portfolio to move in the same direction, particularly during a market downdraft," says Syed.

"The returns are not stellar versus what other mainstream hedge fund strategies have been generating over the past 12 months in particular but they are very consistent," he adds. "A decent trade finance asset will typically generate returns of between 80-100bp a month with a minimal amount

market, to other funds, including emerging market fixed-income funds”.

The advantages of using investors' money are mainly structural, notes Klatsky. “We are not encumbered by non-business requirements which are characteristic of large institutions such as banks, and as a result are able to operate in a more efficient manner.

“Whereas banks have to operate their trade finance business within an overall corporate environment that encompasses other business strands such as investment banking and corporate finance, our focus is purely on our trade finance strategy.”

Window for institutions

Another evolving project is Eurofin Asia's (EFA) LH Asian Trade Finance Fund. This is expected to launch during May 2006, offering a window for institutional investors looking to participate in Asian trade finance markets. Making use of the EFA subsidiary EuroFin Investments Pte Ltd, a boutique hedge fund management company based in Singapore, the new fund has a launch target of “between US\$10mn-20mn”, says Craig Dimmick, director and partner of the EFA Group.

The LH Asian Trade Finance Fund (LH-ATFF) will actively structure and invest in asset backed trade and structured trade finance transactions ranging from traditional warehousing and collateral-backed transactions, to working capital financing, through to selected high yield transactions such as transactional equity deals.

In some cases the fund will act as principal and in others, as co-financier, using a pool of small and medium-sized enterprises that are in many cases existing clients.

“Investors looking for a good yield and very low volatility product will probably be enchanted,” forecasts Christian Stauffer, managing director and founder of the EFA group.

Stauffer adds: “We have a lot of respect for the existing players such as IIG Capital or Octagon since they were really pioneers in their time and structuring a real trade finance fund is very different to a forfaiting fund or a fund that will occasionally buy a few trade assets.

“Real trade finance funds require an equal amount of origination, structuring and implementation skills that are not easy to duplicate.”

Asia's growth potential “is really important now, and we think that there is a very good opportunity in this fund,” emphasises Stauffer, underlining that the LH-ATFF will be the first vehicle of its kind in Asia.

FoF structures

One structure highly familiar to the hedge fund community is the FoF concept, epitomised by the Eden Rock Finance Fund and Eden Rock Structured Finance Fund.

The Eden Rock Finance Fund – which invests in over 30 asset-based lending (ABL) and other credit-based funds and contains exposure to over 50,000 individual loans across a broad spectrum of industries and strategies – boasted an annualised net return of 11.45% with a Sharpe Ratio of 10.2 and no down months to mid March 2006.

While being unwilling to specify any of the underlying funds involved, David Moore, a partner at Eden Rock, says these are “hedge funds which operate in the financing business with investors participating in a pool of highly collateralised loans”.

In terms of assets, “well over 50% of the portfolio is collateralised by inventory, work in progress or other assets, and there is a whole different range of financing techniques that the allocated funds will buy into,” Moore notes.

Specifically, inventory financing and factoring assets are a key target of the FoF, which holds over 25% of exposure to this form of ABL.

“Around 20-30% of our fund activities target traditional

trade finance funds within our commodity-focused fund of funds,” says Axiom's Syed, adding that the majority of managers are US-based. “We are increasingly seeing new players from Asia – the reason why Asian funds have yet to really take off versus the US is because the Asian banks like the business so much.” Hu notes that IIG is, “by attrition, gradually reducing the participation of FoFs as they redeem and accepting additional long-term investors, such as pension funds, insurance companies, endowments and foundations, and so on”.

Tapping Islamic sources

Islamic money could represent another highly liquid funding route, given the rising level of oil revenues within the Islamic system, and the need for Islamic banking portfolios to diversify into more non-traditional products.

Launched during 2003, the Class C Shares and Class D Shares for Islamic trade and commodity finance within the Tricon Fund are seen as quite unique investment offerings in both the trade finance and Islamic investment markets. The comparatively small amount of around US\$125mn held under management is “set to reach US\$250mn this year,” says vom Scheidt.

While the boundaries on these assets are inevitably limited by *shariah* law, Tricon has structured the fund to mirror the income streams from maturing trade finance assets with Islamic-compliant metal trades. Investors earn a trading profit, which they are allowed to do, through metals purchases, and the transactions are overseen by Islamic scholars to ensure they remain true to Islamic tenets. “Over time, there will undoubtedly be more funds in the Islamic markets,” says Lütschg-Emmenegger. “Islamic finance is based very much around trade, so there is a

huge opportunity here.”

Growing horizons

So will the trade finance fund trend swell in coming years? Yes, says Hu: “Global trade continues to grow, yet the capital needed to finance it doesn't seem to be growing with it, because banks which traditionally filled this space have gradually moved away from a major part of it, due to factors such as consolidation, Basel II and geographic preferences.” In agreement is Parsons, who expects over the next three years to see an acceleration of the growth of hedge fund involvement in trade finance “because the drivers are sustainable”.

He acknowledges that there are still some infrastructure issues concerning the market that require further expansion and development, the most important of which from the funds side is the issue of independent valuations of trade finance portfolios.

“However several institutions are now pursuing this,” he notes. “I hope the funds grow in number – we'd like to see more liquidity in the market,” moots RCM's Klatsky.

However, while underlining that “people are looking to put more trade finance in various vehicles, vom Scheidt foresees “no wave of similar funds”, given the legal complexities and expense of assembling such structures. One potential stumbling block is the trend in trade finance pricing, which has seen spreads for key markets such as Brazil and Turkey tumble over the past 30 months or so.

“We must hope that the spreads don't get tighter and tighter,” says Lütschg-Emmenegger. Fimbank is nonetheless looking at the possibility of a trade finance fund, given that the back office at its London Forfaiting Company (LFC) unit could handle the fund administration. “But you would need a critical mass,” she insists, stressing that this would also apply to the factoring business that Fimbank is rapidly building up.