Q&A:

Federated Hermes

How trade finance plays a key role in multi-asset portfolios

How trade finance serves as an uncorrelated alpha source that can reduce reliance on traditional return drivers.

Why you should consider trade finance as part of an asset allocation:

- **Alpha potential**
  Inefficiencies exist for non-bank investors which can be consistently exploited
- **Diversifier**
  Reduces reliance on traditional return drivers by providing a portfolio of idiosyncratic risks, diversification and potential alpha generation
- **Floating rate returns**
  Coupons fixed over ICE BofA US Dollar 1-Month Deposit Offered Rate Constant Maturity Index resulting in low interest rate risk
- **High income potential**
  Coupons are higher than those of many other short-term debt securities
- **Low volatility**
  Historical annualized volatility has been low
- **Short duration**
  Self-liquidating transactions with a strategy weighted average life of less than 24 months[1]
- **Uncorrelated returns**
  Low to negative correlations with most major market indices and other short duration indices

What is trade finance?

- Trade finance refers to loans that provide short-term financing to support the physical flow of goods while using the goods within the transaction as primary security.
- The loan is collateralised by the goods being financed and is self-amortising from the proceeds of the transaction. Trade finance loans float at a spread over a short duration index, such as the ICE BofA US Dollar 1-Month Deposit Offered Rate Constant Maturity Index.
- The lender uses a number of 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, ring-fenced cash flows and trade credit insurance.

What are some of the characteristics of trade finance?

- Short-term transactions are generally self-liquidating with a strategy weighted average life of less than 24 months[1], exhibiting low interest rate risk and credit duration risk.
- Transactions are secured by specific assets and make use of risk mitigants to reduce risks to an acceptable level.
- The arranger of a trade finance transaction holds a significant part of the deal on its own books to maturity (originate to hold).

How large is the trade finance market?

- Although the demand for trade finance continues to grow, a complex regulatory environment coupled with a lack of understanding of the asset class has contributed to a global shortage of trade financing.
- Global merchandise trade stood at $16tn in 2008 and declined to $12tn at the depths of the financial crisis before resuming its growth to $26tn in 2021.[2]
- World trade declined less during the COVID-19 crisis in 2020 than during the financial crisis in 2009.[2]
- The gap for global trade finance opportunities grew to an all-time high of $2.5tn in 2022, up from $1.7tn two years earlier.[3]

Why is trade finance an alternatives asset class?

- As a short-duration asset class, most banks hold their positions to maturity and thus there is a limited secondary market. Extensive documentation is required; trade settlement occurs in 10-20 days and is considered illiquid. Investment of a fund into trade finance is limited to some extent because of this lack of liquidity.

[1] Average life refers to the underlying securities held by Federated Hermes portfolios which are not available to the public and are used by the multi-sector portfolios to provide more effective diversification than is available through the purchase of individual securities.

[2] Source: WTO, World Trade Report 2022.

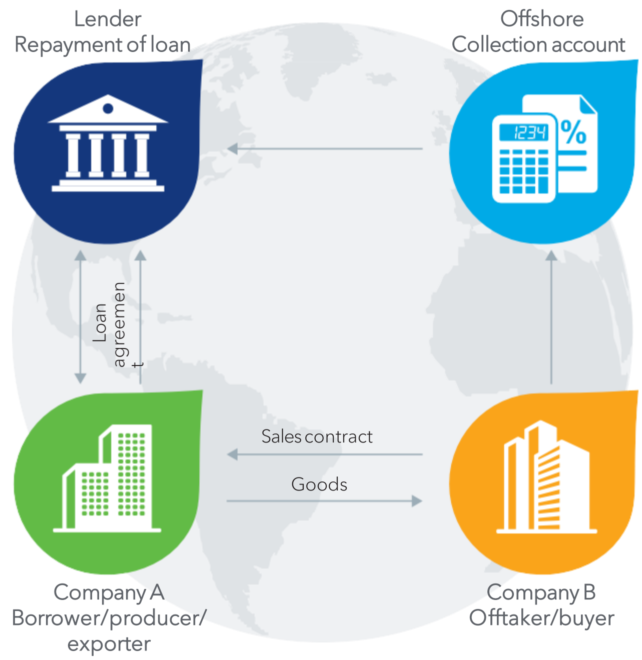
[3] Source: Asian Development Bank, 2022 Trade Finance Gaps, Growth, and Jobs Survey.

Trade finance transaction example

Type of borrowing – Pre-export finance loans

Pre-export finance loans (PXF) allow the exporter of goods to be prepaid for production and sale. This is particularly useful for paying for the costs of production and factor inputs.

- Payments for goods are made to an offshore collection account
- Receipts into this account are used to service debt
- Excess receipts into the collection account are returned to the borrower
- Lenders are generally secured on pledge over the collection account
- Assignments of interest in the commercial contracts
- Acknowledgment from the buyer that payments will be made into the collection account



Definitions

Alpha is a measure of excess return generated, given the risk a portfolio takes. A portfolio with an alpha greater than 0 has earned more than expected given its beta—meaning the portfolio has generated excess return without increasing risk. A portfolio with a negative alpha is producing a lower return than would be expected given its risk.

Beta analyzes the market risk of a security or portfolio by showing how responsive the fund is to the market. The beta of the market is 1.00. Accordingly, a fund with a 1.10 beta is expected to perform 10% better than the market in up markets and 10% worse in down markets. Usually the higher betas represent riskier investments.

Duration is a measure of a security's price sensitivity to changes in interest rates. Securities with longer durations are more sensitive to changes in interest rates than securities of shorter durations.

A word about risk

Bond prices are sensitive to changes in interest rates, and a rise in interest rates can cause a decline in their prices.

Diversification does not assure a profit nor protect against loss.

Trade finance related securities will be located primarily in, or have exposure to, global emerging markets. International investing involves special risks including currency risk, increased volatility, political risks, and differences in auditing and other financial standards. Prices of emerging markets securities can be significantly more volatile than the prices of securities in developed countries and currency risk and political risks are accentuated in emerging markets.

ICE BofA U.S. Dollar 1-Month Deposit Offered Rate Constant Maturity Index is an independent calculation of the 1-month Secured Overnight Financing Rate (SOFR). SOFR is a broad measure of the cost of borrowing cash overnight collateralized by Treasury securities. Prior to October 1, 2022, the index was based on the 1-month London Interbank Offered Rate (LIBOR). LIBOR was a widely used benchmark for short-term interest rates, providing an indication of the average rates at which LIBOR panel banks could obtain wholesale, unsecured funding for set periods in particular currencies.

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