

**FINANCIAL ENGINEERING AND RE-ENGINEERING****Octave Trade Fund: Structured finance, syndication - as applied to Trade, Commodity Finance**

C. Mead Welles
CEO and Senior
Portfolio Manager,
Octave Trade Fund

Perception of risk premiums on offer in the trade/commodity finance space?

Trade finance has historically been the domain of banks due to the commercial nature of the underlying transactions. As such it is a market place which acts for the most part independently from the traditional capital markets. From a credit stand point, trade finance is considered to be relatively low risk because there is an underlying transaction that is the repayment mechanism, a characteristic that places trade finance at the more conservative end of the capital market risk spectrum.

Do you believe the trade/commodity market will continue to be inefficient? Why or why not?

The inefficiencies in trade finance stem from non-standardised, physical documentation, non-standardised settlement procedures, independent pricing and risk methodologies, and varying bank credit and cross-border limits. Furthermore, there is no secondary market trading exchange. We anticipate that these inefficiencies will persist for a number of reasons, but mostly because the fundamental differences such as legal and tax laws that exist in each country make homogenising the industry documentation close to impossible in the near future.

Developments underway with regards the presence of a secondary market for trades' receivable ... implication for a fund such as yours.

While a secondary market exists for trade finance, it will for the foreseeable future be plagued by inefficiencies caused by non-standardised, physical documentation and settlement procedures. In addition, changes in the regulatory landscape such as the Basel II Capital Accord fundamentally alter the marketplace for both trade and warehouse receipt lenders and borrowers globally and have implications for the secondary market in trade receivables. In summary, Basel II aims to modernise outdated risk reserve requirements for commercial banks. As the banking industry adjusts to the new capital adequacy and risk management practices, liquidity to emerging country exporters and importers will decline and disconnects in pricing among institutions will likely develop. The Octave Trade Fund, which operates outside the typical constraints of a bank, will seek out the most inefficient segments of the markets on a global basis to take advantage of arbitrage opportunities.

What does it take to originate deals in the primary market?

Our method of identifying prospects is driven by referrals and by proactive sourcing. However, having been active in international trade for over eight years in our current form, we have developed a reputation as an alternative source of financing which results in a large number of cold calls from potential borrowers around the world. One of the benefits of our company's long operating history and track record in this area is, that we've developed an extensive network of relationships within the international trade space to screen companies, which helps in maintaining a diverse pipeline of viable transactions. Our competitive edge is our experience in financial engineering, structuring, and risk management, as

well as our broad network of global contacts in commodities, finance, emerging markets, banking, and international trade.

Evaluating risk, tranching it and rating it are crucial to be able to structure and syndicate a deal. Elaborate.

In packaging and syndicating transactions, we combine the due diligence procedures of a AAA bank with the experience gained after multiple years of global trade and structured finance to format transactions in creative ways, solving for cross border, counterparty credit, performance, legal, tax, and currency risks. One opportunity we have, is to use our structuring capabilities to package deals in a way that, the inherent risk in the deal is materially reduced. This allows us to sell the exposure at a tighter spread, capturing the differential for the benefit of the Fund.

Comment on the relevance of being insulated to: default risk, fraud, "downgrades", prepayments, spread blow out and the use of special purpose vehicles by funds such as yours.

Historically, human error and fraud have been the two greatest risks inherent in trade finance. While we can never ensure that we will be insulated against those risks, we have taken steps to minimise them. We have and follow standardised policies, procedures and check lists, that reduce the likelihood of human error. Fraud is mitigated in two ways: first by conducting intensive due diligence and careful on-going oversight and second through our structured finance facilities with special purpose vehicles ("SPV's). SPV's have collection accounts and agents that govern the facilities providing another layer of operational risk management. Our facilities not only encumber all the borrower's inventory and receivables, but they test the borrower's financials and the facility performance periodically to pick up negative changes that might indicate fraudulent behaviour.

Prepayment risk is mitigated through prepayment penalties which apply to most transactions. The risk of downgrades and spread expansion will always exist; however, we package our deals to strip out the credit risk of the borrower and as senior secured floaters, our deals are largely immune to interest rate and spread risk. Trade finance benefits from a high priority of payment, due to the essential nature of trade payments versus other forms of debt payments, under the premise - if you don't pay for your inputs, you won't be able to make any outputs.

If this is a "panacea": low volatility, low correlation, reduced concentration risk, increased returns with lower risk, enhanced liquidity to originate new transactions, diversification (geographic, time based) what is holding the others back?

Trade finance is arguably the oldest capital market, yet it has historically been the domain of commercial banks. Money managers have historically come out of investment banks and securities firms and as such they have not had much if any experience in trade finance. What holds others back is the lack of familiarity and experience necessary to identify and capitalise on the inefficiencies in trade finance. That's where the opportunity exists for the Octave Trade Fund.