Managing Risk: The Fundamentals Still Apply

In a letter to ***The Wall Street Journal*** (June 9 2016), John Bogle, founder of the Vanguard Group, challenged Wall Street's role in business capital formation in support of economic growth. Citing 2015 data from the Securities Industry and Financial Markets Association (SIFMA), he pointed out that new equity underwriting totaled $256 billion, while the volume of trading in existing shares by speculators and investors exceeded $48 trillion. That's 99.5% of the total stock market activity last year. A similar criticism can be made of bond issuance by corporates where proceeds largely have been put to work buying back shares to boost stock prices rather than growing their businesses and hiring more people.

With "bets" more common than "investments" these days, second guessing central bank interest rate policies and the implications of BREXIT has triggered extreme volatility in global financial markets. Cautious money has moved into bonds, driving prices higher and yields down to historic lows. About $10 trillion of sovereign debt—mainly Japanese and European—now trades with a negative yield. Corporate investment grade bonds are increasingly entering negative territory as well. Only corporate junk bonds provide the roughly 6% yield that investors were accustomed to earning on much less risky investments.

Investors Seeking Returns and Stability

The hunt is on for stability, low correlation and relatively attractive returns—a combination that is hard to come by. Financial Times contributor Abdallah Nauphal suggests investors try to identify assets that will perform well regardless of monetary policy and its impact on growth and inflation. "Ideally," Nauphal writes, "an asset should possess two key characteristics: good cash flow visibility and stability; and an embedded inflation hedge." (See: "**A new monetary order will only emerge from the next crisis,**" May 31, 2016.) After over a 30-year secular bull market, bonds no longer offer stability. Cash returns on offer do not meet even modest investment objectives. And any future inflation will drive fixed income prices lower.

In contrast, an investment in confirmed, **discounted invoices (factoring)** does offer the potential for attractive, predictable cash flow, from assets maturing in 30-120 days. Returns do not move in lockstep with a benchmark interest rate or headline inflation number. Returns are based on speeding up real economic activity by providing immediate working capital to a business for delivered goods and services, rather than having to wait many months to be paid. This type of financing is particularly beneficial for small and medium-sized enterprises (SMEs), which may not have a long track record, extensive financial reporting or adequate collateral. If the role of investing is capital formation, **SMEs are engines of growth** in economies.

Low SME Credit Risk in Invoice Financing

The risks to be considered in providing invoice finance are fundamentally different from direct lending or purchase of debt securities—starting with the legal structure. And the difference is particularly beneficial for small to medium sized enterprises (SMEs) in need of working capital to grow.

Essentially, the counter-party risk is flipped. With a loan, the counter party would be that small or medium-sized enterprise (SME). But by purchasing that SME's confirmed invoices, the counter-party is an established business—often a corporate buyer—where there is much more information available to underwrite the risk.

Ultimately, non-payment of the invoice by the buyer is the central risk in any invoice purchasing transaction. A recent survey of members by the EU Federation for the Factoring and Commercial Finance Industry found that default rates for factors operating in a range of economic environments were low in absolute terms, and lower than comparable forms of lending in the EU in 2014.

- 0.09% vs 0.32% (low risk countries)
- 0.43% vs 1.6% (high risk countries)

Looking at one proxy for investable alternatives, default rates for broadly traded U.S. high yield bonds are forecast to climb above 5% in the coming months. (Forbes: "**S&P: US High Yield Default Rate Expected to Hit 5.3% by March 2017,**" May 10, 2016)

A Traditional Approach to Contract Risk

Successful financing has to be based on as clear an understanding as possible of the legal and regulatory aspects of every enforceable contract. And all the details matter in evaluating and managing risk:

- The "true sale" nature of the arrangement;
- The assignment of the invoices (assets);
- The operation of the collection bank account;
- Foreign law implications in cross-border factoring;
- Insurance terms, if any;
- Impact of insolvency on recourse.

"We actively monitor both our client and our client's customers," said the chief risk officer of one of Advance Global Capital's key factor partners. "We look at the whole business. We go out and see them. Everything is done electronically, but we are on the phone with them too. We do it old school, with a good relationship with our clients."

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>
> Chief risk officer of one of Advance Global Capital's key factor partners

The factor also provides valuable support to its clients who, as SMEs, often have less negotiating power. "We speak to their customers about every invoice we buy," she said. "If there's an error or a dispute, we are involved in the discussion from the outset. The customer is used to speaking to us and knows who we are. By monitoring both the client and the customer, there are no surprises."

Focus on the Fundamentals

AGC meets with factor partners in Macedonia

Advance Global Capital is demonstrating that financing discounted, confirmed invoices can offer attractive returns on assets intended to be held to maturity— typically 30 to 90 days. There is generally no established secondary exchange to mark these assets to market yet. And given their short maturity, little reason to do so unless a specific event requires revaluation. Clearly, our integrity and disciplined portfolio reporting are critical.

Investing always entails risk-taking. But it doesn't have to involve gambling if investors focus on the fundamentals. By allocating capital to discounted invoice financing, investors also gain the satisfaction of knowing that they are supporting fundamental economic activity. Real job creation. Real increases in income. Real financial inclusion for under-served small and medium-sized enterprises.

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