



Alternative Lending Hedge for Private a Debt Portfolio

Scenario Type: Family Office – Private Credit Allocation

Asset Class: US Middle-Market Direct Lending (Illiquid)

Situation Type: Mature private credit portfolio with no secondary liquidity and no direct hedging instruments

Primary Issue: Unhedgeable-in-form credit exposure creating drawdown risk, governance stress, and forced decision risk during credit deterioration

1. Decision Context

A multi-family office had built a meaningful private credit allocation to solve for income in a low-yield environment.

Returns were stable, distributions reliable, and marks benign.

The issue was not performance. It was **irreversibility under stress**.

Once deployed, the portfolio consisted of dozens of illiquid, untradeable private loans marked quarterly, with no direct exit and no direct hedge. As public credit repriced and spreads widened, the office had **no mechanism to reduce risk, pace losses, or explain downside behaviour**.

The IC decision was not whether private credit was attractive. It was whether the family was comfortable discovering its downside tolerance **in real time**, with no ability to act.

2. What Changed

At entry:

- Private credit viewed as stable income replacement
- Early marks smooth and confidence-building
- No expectation of active risk management
- Governance relaxed due to lack of visible stress

As conditions deteriorated:

- Public credit repriced rapidly
- Private credit marks lagged, then adjusted abruptly
- Illiquidity became binding precisely when risk rose
- No credible hedge or exit pathway existed

The exposure evolved into a **block of credit risk that could not be reduced or transferred**.

3. How the Risk Actually Manifests

The risk was not mark-to-market volatility. It was **clustered drawdown under constraint**.

- Losses appear late and then accelerate
- Public hedges move immediately; private marks lag
- Apparent over-hedging creates political pressure
- Carry bleed erodes confidence before protection pays
- Trustees question the hedge before the portfolio adjusts

The failure mode is not basis risk alone. It is **losing faith in the hedge at the wrong moment**.

4. What Surfaces on Review

When assessed structurally, consistent issues emerged:

- No direct CDS or single-name hedging exists
- Single index hedges misrepresent multi-factor exposure
- Hedge P&L does not align temporally with private marks
- Secondary liquidity clears only at punitive discounts
- Governance is unprepared to tolerate tracking error

This is not negligence. It is a **mismatch between how private credit behaves and how public hedges settle**.

5. Structural Assessment

This was not:

- A pricing issue
- A product selection failure
- A search for precision hedging

It was:

- A survivability problem
- A governance problem under illiquidity
- A need to compress drawdowns, not eliminate losses

Any solution had to preserve:

1. Illiquidity tolerance
2. Governance credibility during stress
3. Hedge durability when it feels wrong

6. Structuring Logic

The exposure was decomposed into behavioural components rather than instruments:

- Systematic loan-market repricing
- Sector-specific credit sensitivity
- Broad spread risk
- Residual idiosyncratic outcomes

The resulting structure:

- Used multiple public proxies rather than a single index
- Accepted imperfection deliberately
- Sized hedges to behaviour, not theory
- Limited rebalancing and intervention
- Embedded governance language and review cadence

The objective was not elegance. It was **a hedge that survives the uncomfortable period.**

7. Intended Outcomes

When implemented correctly:

- Drawdowns are compressed rather than eliminated
- Losses are paced, not clustered
- Forced selling is avoided
- Trustees understand hedge behaviour ex-ante
- Governance remains intact through stress

Carry drag in recovery phases was explicit, accepted, and priced.

The value delivered was **control**, not precision.

8. IC Takeaway

Private credit is not unhedgeable. It is **multi-factor and illiquid** and must be treated accordingly.

The real risk was not basis error. It was being structurally trapped during a credit downturn with no defensible response.

A synthetic hedge designed for behaviour – not optics – restored control.

9. Applicability

Most relevant where:

- Private credit is a core portfolio sleeve
- Secondary liquidity is unavailable in stress
- Investors want drawdown control, not perfect hedging
- Governance must withstand uncomfortable periods

Less relevant where:

- Exposure is small or opportunistic
- Full credit cycle drawdowns are accepted
- Active trading or fund-level risk transfer exists

10. Engagement Path

Primary Offer: Structuring-as-a-Service™ - Synthetic credit hedge architecture and governance framework

Secondary / Bespoke: Hedge ratio calibration, proxy mapping, CDS/TRS execution design, monitoring and review framework

A full structural narrative is available for readers who wish to review the underlying mechanics, trade-offs, and remediation sequencing in greater detail.

Disclaimer

Illustrative scenario for discussion purposes only. Not a transaction summary or client-specific case study.