IC Brief

Credit Hedge Rebuild After Index Dislocation

Scenario Type: Private Credit – Portfolio Credit Protection
Asset Class: Senior Secured Direct Lending (Mid-Market, APAC)
Risk Focus: Index hedge dislocation, premium drag, ineffective downside protection, governance distortion
Primary Offer: Hedge Rebuild™ (Portfolio Credit Protection Redesign)

1. Decision Context

This scenario addresses a recurring issue in private credit portfolios where credit hedges remain anchored to public indices long after portfolio composition has become specialised and idiosyncratic.

The risk is not absence of protection. It is **misaligned protection** – where hedge behaviour increasingly reflects public market stress rather than the forces that actually drive losses in the loan book.

2. The Structural Problem

- Portfolio credit risk is sector-specific, asset-backed, and recovery-driven
- Index hedges respond to broad market constituents irrelevant to the loan book
- Hedge effectiveness is inferred during crises, **not tested across cycles**

Over time, the hedge shifts from insurance to **macro overlay**, injecting noise into governance rather than absorbing risk.

3. Why This Matters at Portfolio Level

Once index dislocation emerges:

- Premium drag becomes structural rather than tactical
- Hedge P&L distorts performance narratives
- IC discussions focus on hedge optics rather than borrower risk
- Decision-making degrades during stress events

The hedge begins shaping governance outcomes without protecting capital.

4. What Fails if Left Untreated

- Continued payment for irrelevant protection
- Hedge moves driven by unrelated market events
- Increasing difficulty justifying hedge retention or removal
- False comfort masking real concentration risk

Capital is consumed quietly – without improving downside protection.

5. Illustrative Structuring Response

The objective is **not** to optimise hedge mechanics. It is to restore **causal alignment** between portfolio losses and hedge behaviour.

This typically involves:

- Decomposing the portfolio into real economic loss drivers
- Replacing index exposure with correlated proxy baskets
- Targeting protection to senior-secured loss profiles
- Introducing proportional or conditional activation
- Aligning collateral and governance with the hedge design

Structure first. Instruments second.

6. Intended Outcome

- Reduced premium drag without sacrificing protection relevance
- Hedge behaviour explainable in borrower-level terms
- Improved IC confidence under volatility
- Hedge returns to a background risk control

This is a **capital efficiency intervention**, not a trading strategy.

7. Applicability

Most relevant where:

- Portfolios are sector-specific and asset-backed
- Index hedges no longer resemble underlying risk
- Premium drag persists without demonstrable effectiveness

Less relevant where:

- Portfolios closely mirror public credit benchmarks
- Loss severity is binary with minimal recoveries

8. IC Takeaway

This is not an execution problem. It is not a market timing problem.

It is a **hedge relevance problem**.

9. Engagement Path

Primary: Hedge Rebuild™ Portfolio Credit Protection Redesign

Secondary / Bespoke: Proxy basket construction, tranche calibration, contingent activation, collateral and governance frameworks

Disclaimer

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