IC Brief

Credit Hedge Rebuild After Strategy Drift

Scenario Type: Asset Manager – Public Credit (High Yield)
Asset Class: US High Yield (Cash Bonds + CDS)
Situation Type: Legacy index-based credit hedge maintained as standing risk control while portfolio composition evolved materially
Primary Issue: Hedge drift driven by issuer, sector, and vintage misalignment, converting intended tail protection into negative carry and false downside insurance

1. Decision Context

The portfolio runs an actively managed high-yield credit strategy.
Issuer selection, sector weights, and concentration evolve continuously by design.

A CDX HY hedge was implemented during a prior stress period and approved as a standing risk control. Since then, the portfolio has rotated materially, while the hedge structure has remained static.

There is no market crisis, no liquidity failure, and no mandate breach.

The IC decision is **not whether credit hedging is appropriate**.
It is whether the **existing hedge still describes the portfolio's actual risk**, or whether structural drift has rendered it expensive, misaligned, and ineffective.

This is a **risk architecture decision**, not a market timing call.

2. What Changed

At inception:

- Portfolio broadly resembled index composition
- Index hedge provided sensible, low-friction protection
- Hedge approved as background risk control

Over time:

- Issuer rotation increased materially
- Sector exposures diverged from index weights
- Concentration shifted toward higher-conviction names
- New issuers entered the portfolio that could never appear in the index

The portfolio evolved as intended. The hedge did not.

3. How the Risk Actually Manifests

The failure does not appear during systemic sell-offs. It appears during **portfolio-specific stress**.

- Concentrated issuer or sector events drive losses
- The index hedge responds weakly or not at all
- Premiums continue to be paid in full
- Protection offsets the wrong risks

The hedge exists. It simply no longer protects what matters.

4. What Surfaces on Review

When assessed against the live portfolio rather than the benchmark narrative:

- Issuer overlap between hedge and portfolio is low and deteriorating
- Sector exposures are misaligned
- Hedge responds to moves in names no longer held
- Large portions of portfolio risk are unhedged
- Carry cost remains material relative to realised protection
- No explicit ownership exists for ongoing hedge alignment

This is not a single error. It is **accumulated misalignment**.

5. Structural Assessment

This is not:

- A hedge execution failure
- A CDS market failure
- A temporary basis issue

It is a **governance failure**: treating a dynamic portfolio as if it were static.

Any response must restore:

1. Alignment between hedge and live exposures
2. Credible downside protection where losses actually occur
3. Explicit ownership and rebalancing discipline

Rolling the index or resizing notional treats symptoms, not the cause.

6. Structuring Logic

Effective remediation focuses on **risk relevance**, not hedge familiarity.

Key principles:

- Map hedge protection to actual loss drivers
- Concentrate protection on issuers and exposures that matter in stress
- Avoid paying for diffuse index protection with low portfolio relevance

- Size hedge notionals against live exposures, not benchmarks
- Embed explicit rebalancing cadence and tolerance bands

The objective is not cleverness. It is **controlled, explainable protection**.

7. Intended Outcomes

When addressed correctly:

- Hedge responds meaningfully to portfolio drawdowns
- Negative carry is aligned to actual protection delivered
- Protection economics become explicit and defensible
- Risk discussions shift from assumptions to evidence
- Hedge drift is prevented from recurring silently

The hedge stops being symbolic. It becomes functional again.

8. IC Takeaway

This was not a failure of markets or execution.

It was the predictable result of leaving a **static hedge attached to a dynamic portfolio**.

Index hedges do not fail suddenly. They fail quietly – by continuing to exist long after they stop describing risk.

9. Applicability

Most relevant where:

- Credit portfolios are actively managed
- Index hedges were implemented during prior stress periods
- Issuer and sector rotation is meaningful
- Hedge carry is material
- Governance relies on the presence of a hedge rather than its behaviour

Less relevant where:

- Portfolios track benchmark composition closely
- Turnover is low
- Credit risk is intentionally macro or beta-driven
- Hedging is explicitly temporary and re-underwritten each roll

10. Engagement Path

Primary Offer: Hedge Rebuild™
Credit hedge diagnostic and redesign – issuer mapping, basis analysis, premium economics, drift governance, and effectiveness monitoring.

Secondary / Bespoke:
Execution support, documentation alignment, LP disclosure materials, and ongoing monitoring frameworks as required.

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.