



PARA BELLUM ADVISORS

PRIVATE CREDIT · PORTFOLIO CREDIT PROTECTION

# Credit Hedge Rebuild After Index Dislocation

<b>SCENARIO TYPE</b>	Private Credit – Portfolio Credit Protection, Premium Drag & Governance
<b>ASSET CLASS</b>	Senior Secured Direct Lending (Mid-Market, Asia-Pacific)
<b>RISK FOCUS</b>	Index hedge dislocation, premium drag, ineffective downside protection, governance distortion under market stress
<b>PRIMARY OFFER</b>	Hedge Rebuild™
<b>RELEVANT SERVICES</b>	Hedge Rebuild™ · Capital Drag Audit™ · Bespoke credit proxy baskets · Tranche-aligned protection design · Contingent activation frameworks · CSA optimisation

## THE SITUATION

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A Singapore-based private credit fund managing approximately USD 3.2bn across more than 200 senior secured direct lending positions throughout Asia-Pacific. The portfolio concentrated in healthcare equipment leasing, renewable energy project finance, agricultural infrastructure, logistics, and technology-enabled service businesses – private, regionally concentrated, and typically asset-backed.

From an underwriting perspective, the portfolio behaved as intended: low default frequency, meaningful recoveries, and limited exposure to cyclical corporate leverage. From a hedging perspective, it created a structural problem. Its risk profile bore little resemblance to any standardised CDS index available in the market.

Despite this, the fund maintained a portfolio-level credit hedge using iTraxx Asia IG – implemented several years earlier in response to board-level concerns. The hedge remained anchored to a broad market proxy while the portfolio's risk profile had become increasingly idiosyncratic.

## HOW THE DRIFT SETS IN

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The weakness did not surface as an obvious failure. It surfaced as persistent unease.

Premiums were paid year after year with little scrutiny because the hedge made sense conceptually. Index-driven volatility increasingly dominated hedge P&L discussions, even when the underlying loan book remained stable. Large swings in hedge valuation were driven by stress in sectors the fund did not lend to, while periods of borrower-specific deterioration produced little or no response from the hedge.

The risk began to manifest operationally and politically. Treasury was asked to explain hedge P&L with no obvious link to borrower performance. Board discussions increasingly focused on hedge cost and optics rather than protection quality. The hedge was no longer quietly absorbing risk – it was inserting itself into governance conversations as a source of confusion.

## WHAT TYPICALLY BREAKS

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### **The hedge was anchored to history, not to the current portfolio**

It had been implemented when the book was smaller and more diversified, then left unchanged as the strategy specialised further. Effectiveness was inferred rather than demonstrated – correlation between index movements and portfolio outcomes had never been formally tested outside crisis periods.

### **The index was dominated by irrelevant credit drivers**

Chinese property developers, Korean exporters, banks, and large conglomerates accounted for the majority of index risk yet represented little to no exposure in the loan book. iTraxx Asia IG was not hedging this portfolio – it was hedging something else.

### **Premium drag became structural**

Rising index spreads meant the hedge consumed a material share of gross yield, yet the board could not articulate what specific loss scenarios it was intended to offset. The hedge was defended not on effectiveness, but on familiarity.

### **The structure was misaligned with the fund's position in the capital stack**

As a senior secured lender, losses were shaped by recoveries and collateral realisation, not by full notional defaults. Paying for full-tail index protection overstated the risk being hedged and mispriced the protection required.

## THE STRUCTURAL INSIGHT

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The diagnostic reframed the hedge from a product to a control mechanism and asked one question: does this hedge respond to the same forces that cause this portfolio to lose money?

The response decomposed the loan book into a limited number of economic credit drivers – sectoral, geographic, and structural and mapped how losses would realistically cluster under adverse conditions. From this, a bespoke proxy basket was constructed using publicly traded credits whose spreads were demonstrably sensitive to the same underlying drivers.

The hedge was then structured to reflect the fund's senior secured loss profile – protection targeted at the portion of the loss distribution that mattered economically, rather than blanket coverage that duplicated recoveries already embedded in the lending strategy. Conditional activation features were introduced so that full premium was not paid in benign environments.

Documentation and collateral terms were negotiated alongside the structure, not after the fact – ensuring protection could be carried through stress without introducing new operational constraints.

## INTENDED OUTCOMES

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- ▶ Premium drag reduced by eliminating payment for irrelevant protection while maintaining meaningful coverage in portfolio-relevant stress scenarios.
- ▶ Hedge behaviour became explainable – when protection moved, it did so for reasons the investment team could articulate in terms of borrower performance and recovery risk, not unrelated macro headlines.
- ▶ The board gained a clearer framework for oversight – hedge effectiveness discussable in terms of measured relevance rather than assumed protection.
- ▶ The hedge returned to its intended role as a background control rather than a foreground performance driver dominating portfolio narratives.
- ▶ The fund moved from owning a hedge because everyone does to owning one that reflected its actual risk posture.

## WHERE THIS APPLIES

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Most relevant for private credit portfolios that are highly specialised by sector or geography; predominantly senior secured with meaningful recovery assumptions; structurally misaligned with standard CDS index constituents; and experiencing persistent premium drag without demonstrable effectiveness.

Generally less relevant where portfolios closely resemble public credit benchmarks; loss severity is binary with minimal recoveries; single-name hedging is feasible and liquid; or governance objectives prioritise simplicity over relevance.

### TYPICAL ENGAGEMENT PATH

Hedge Rebuild™ – diagnostic and redesign of portfolio credit protection, including effectiveness testing, premium drag reduction, and collateral alignment. Secondary: Proxy basket construction, tranche and attachment calibration, contingent activation design, hedge accounting support, ongoing rebalance and governance framework.

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