



PARA BELLUM ADVISORS

ASSET MANAGER · PUBLIC CREDIT (HIGH YIELD)

Credit Hedge Rebuild After Strategy Drift

SCENARIO TYPE	Asset Manager – Public Credit (High Yield)
ASSET CLASS	US High Yield – Cash bonds and CDS
RISK FOCUS	Hedge drift, basis leakage, negative carry drag, false tail protection, governance failure under stress
PRIMARY OFFER	Hedge Rebuild™
RELEVANT SERVICES	Hedge Rebuild™ · Basket CDS design · Index roll policy · LP disclosure pack · Hedge effectiveness dashboard · Documentation / ISDA support

THE SITUATION

The hedge was put on years ago. In 2020, during the COVID dislocation, the fund implemented CDX HY protection across its flagship high yield strategy. At the time, the decision was uncontroversial – markets were disorderly, liquidity was thin, and the portfolio broadly resembled the index composition of that vintage.

The hedge was approved as a standing risk control, not a tactical trade.

Since then, the portfolio did exactly what an active credit portfolio is meant to do. Issuers were rotated, sectors were reweighted, capital was redeployed into improving credits, and new issuance replaced legacy names. The hedge did none of this. By late 2023, the portfolio and the hedge were still described internally as aligned. They were not.

HOW THE DRIFT SETS IN

Not with a decision. With inertia.

The hedge rolls quietly. Premiums are paid. Reports show protection in place. Nobody is incentivised to reopen a structure that has not caused visible damage. The hedge is treated as inert – treasury maintains it, risk reports reference it, portfolio managers assume it provides background protection.

The problem is that active portfolios move by design, while index hedges freeze risk at a moment in time. For a while that mismatch does not matter – markets rally, carry dominates, hedge cost is dismissed as insurance. The divergence accumulates quietly.

The issue does not surface during a crisis. It surfaces during something smaller and more awkward – a sector-specific selloff, a concentrated issuer event. The portfolio loses money. The hedge barely responds. Post-event analysis shows that most of the loss came from names lightly represented or entirely absent from the index.

WHAT TYPICALLY BREAKS

Issuer overlap was low and deteriorating

A large proportion of portfolio holdings are not represented in CDX at all. Many index constituents sold years earlier or never owned. Protection being paid on names irrelevant to the portfolio's current risk – in full, every roll.

Vintage mismatch compounded the problem

The index reflected a fixed 2020 snapshot of the high-yield market. Post-COVID issuers added to the portfolio could never appear in the index hedge. The hedge was protecting an earlier version of the portfolio that no longer existed.

Sector alignment had broken down

The portfolio rotated materially over time. The hedge was over-responsive to moves that barely affected the portfolio and under-responsive to moves that drove actual losses. Paying for the wrong protection is worse than no protection – it creates false confidence.

Ownership became diffuse

No one was explicitly responsible for ensuring the hedge continued to describe the portfolio's risk as it evolved. The hedge existed, was renewed, and was assumed to work. It was never actively governed.

THE STRUCTURAL INSIGHT

The fix was not to resize the index hedge or roll into a newer series. That treats the symptom, not the failure mode.

The portfolio was decomposed into conviction layers and the issuers that genuinely drove downside risk were identified – not in theory, but in dollars. From there, a bespoke single-name CDS basket was built aligned to the largest and most volatile positions, where a default or sharp spread move would materially impact returns.

Rather than paying for diffuse index protection across names the fund did not own, protection was concentrated where losses would occur. Hedge notionals were explicitly sized against live exposures, not benchmark weights. Expensive names were challenged, low-conviction positions excluded, and the basket sized to deliver meaningful protection without recreating the negative carry problem.

Crucially, the solution was designed with governance embedded – a defined rebalancing cadence and explicit tolerance bands so the hedge could not silently drift again as the portfolio evolved.

INTENDED OUTCOMES

- ▶ Protection behaves like protection – when the portfolio loses money in a credit event, the hedge responds rather than absorbing the loss entirely.
- ▶ Hedge economics become explicit – cost assessed against effectiveness, not tradition; the fund can see in advance what it is paying to protect and what it would reasonably recover in stress.
- ▶ PMs can size risk knowing exactly what is hedged and what is not – risk discussions move from generalities to specifics.
- ▶ The hedge ceases to be background insurance and becomes a governed risk tool – from assumed protection to demonstrable protection.
- ▶ Drift cannot silently return – rebalancing cadence and tolerance bands force re-underwriting as the portfolio evolves.

WHERE THIS APPLIES

Most relevant where portfolios are actively managed with meaningful issuer and sector rotation; index hedges were implemented during prior stress periods and left in place; hedge carry is material relative to alpha; concentration risk rather than broad beta drives drawdowns; and governance relies on the existence of a hedge rather than its behaviour.

Less relevant where portfolios closely track benchmark composition; turnover is low and index overlap remains high; credit risk is intentionally macro and beta-driven; or hedging is explicitly temporary and re-underwritten each roll.

TYPICAL ENGAGEMENT PATH

Hedge Rebuild™ – credit hedge diagnostic and redesign: issuer mapping, basis analysis, premium economics, drift governance, and effectiveness monitoring. Secondary: Execution support, documentation alignment, LP disclosure pack, monitoring dashboard.