Creditflux
August 2020 | Issue 226
Global credit funds & CLOs

Don't be a hero: managers opt to go market-neutral

by Sayed Kadiri

There's yet more volatility in store later this year — that's the consensus according to credit portfolio managers that have spoken to *Creditflux*. What they are unsure about is the scale and direction of this movement, which is leading them to prune their portfolios with an emphasis on market-neutral tactics.

"There is a war brewing between the virus and the Fed," says Paul Horvath, chief executive officer of credit hedge fund manager Orchard Global Asset Management. "The virus is formidable, but the central bank's response has been unprecedented... Although it may be tempting to go short credit, investors will have to tread carefully given the amount of liquidity that has been pumped into the market. It has been like pouring an ocean into a teacup."

The US presidential elections, US-China relations and variations in the way the coronavirus has affected different countries and industries are among other factors shrouding the credit market in uncertainty. Because of this, 'hero trades' are ill-advised, say several portfolio managers.

Instead, fund managers are being drawn towards synthetic credit products. Rather than use these as tools to outright hedge portfolios, fund managers have taken advantage of market dislocations, as reported by *Creditflux* last month.

One example of this approach is San Francisco-based DCI, which has been managing liquid, long-short, market-neutral corporate credit strategies since 2007. Chief executive officer Tim Kasta says that

> **The fund tends to perform best in periods of high volatility**
> Tim Kasta
> *Chief executive officer*
> DCI

DCI limits its CDS investments to the most liquid five-year contracts, ultimately selecting 70-90 longs and a similar number of shorts in risk-matched portfolios.

DCI's investment process focuses on the default probability of reference companies. Kasta says the framework aims to take advantage of individual mispricing in the credit markets, while DCI's risk model targets long and short portfolios that are matched on market risk factors, such as beta, sector, term, rating and region.

"On average it takes two to six months for credit prices to converge to our model spreads; however, this is variable by exposure and is typically accelerated in higher volatility environments," says Kasta.

He adds that investors are showing increased interest in market-neutral strategies, and with the DCI market-neutral credit hedge fund strategy fully utilised in managed accounts, the remaining capacity is in DCI Market Neutral Credit Ucits Fund. This was up 0.86% in March and is among the minority of credit funds to be positive this year, up 2.15% year to date.

Kasta says the fund tends to perform best in periods of high volatility where other liquid alternatives or long-beta products tend to underperform.

Orchard Liquid Credit Fund is not explicitly market neutral, but it has similar all-weather aims. According to Houston-based Horvath, the strategy aims to generate positive carry when markets are functioning normally and to capitalise when they dislocate. This approach has paid off with the Orchard Liquid Credit Fund up 14.4% this year through to the end of May, according to *Creditflux* data.

Horvath says the firm has been boosted by Orchard's exposure to significant risk transfers (SRTs), which take levered exposure to high-quality loans and have shown their resilience since the sell-off in March.

He adds that, like other illiquid credit products, such as CLOs and CSOs, SRTs have greatly improved since the 1990s, and the pipeline is now as deep as he has ever seen it.