CAPTOR

Whitepaper: Aster Corporate Credit Strategy

Executive Summary

The Aster Corporate Credit Strategy offers investors a unique and innovative way to gain well diversified global credit exposure by using CDS index positions, which are centrally cleared and highly liquid. By utilizing Credit Default Swaps (CDS), rather than physical bonds, the strategy gains several key advantages such as lowered transaction costs and improved risk management. The ability to efficiently roll CDS positions, take advantage of the credit curve, and avoid FX hedging costs typically associated with foreign bond allocations, are essential factors behind the strategy's success.

Captor Fund Management currently offers four UCITs funds that apply the Aster credit strategy. All funds have currency and interest rate exposure in Swedish Krona, while offering different exposure profiles in terms of interest rate duration as well as a different mix of investment grade and/or high yield credit exposure.

Aster Global Credit – a long interest rate duration investment grade fund designed for long-term investments, especially defined benefit pension schemes or defined contribution schemes tailored to late-stage beneficiaries.

Aster Global Credit Short Term – a short interest rate duration investment grade fund for low-risk investors, suitable for investors seeking a liquid enhanced return over bills/deposits.

Aster Global High Yield - efficient allocation to global non-investment grade credit.

Global Fixed Income – an all-weather corporate credit fund with its allocation split 70% investment grade and 30% high yield or non-investment grade, and an interest rate duration of three to five years.

Aster Portfolio Construction

This paper provides an analysis of the Aster Corporate Credit Strategy, discussing its unique value proposition, mechanics, and risk-return profile, while also addressing potential risks and how they are mitigated within the strategy's framework.

Introduction

Credit markets are an essential part of the global financial system, offering opportunities for both yield enhancement and portfolio diversification. Traditional corporate bond allocations, while effective, come with certain drawbacks, including liquidity constraints, transaction costs, and FX hedging requirements, particularly for Swedish investors when investing globally. The Aster Corporate Credit Strategy seeks to address these challenges through the use of liquid 5-year CDS indices, offering investors access to a diversified pool of global credit risk in a highly efficient and cost-effective manner.

Unique Selling Propositions (USPs)

The Aster Corporate Credit Strategy has several key unique selling propositions that differentiate it from other credit investment strategies:

1. **Liquid global credit exposure via cleared 5-Year CDS indices:**
    a. The use of CDS indices, particularly those focusing on 5-year maturities, provides access to broad, diversified credit exposure with a high level of liquidity.
    b. CDS indices are traded on standardized, cleared platforms, reducing counterparty risk and enhancing operational efficiency.
    c. Liquidity is further bolstered by the standardized structure of CDS contracts, making them easier to buy and sell than traditional corporate bonds, especially during periods of market stress.

2. **Diversification and liquidity through CDS indices:**
    a. CDS indices offer exposure to a large basket of corporate issuers, providing inherent diversification across sectors, geographies, and credit qualities.
    b. The indices are rebalanced periodically, and new series ("on the run" series) are introduced, ensuring that the portfolio remains representative of the broader credit market.
    c. This structure allows the Aster strategy to efficiently manage and adjust credit exposure as market conditions evolve, without the liquidity constraints that often accompany trading individual bonds.

3. **Capitalizing on the credit curve and roll effect[1]:**
    a. One of the central advantages of using CDS indices is the ability to "ride the credit curve". As the strategy holds CDS contracts, it benefits from the natural roll-down effect, where the shorter-dated CDS contracts tend to decrease in spread as they approach maturity (all else being equal), providing an additional source of return.
    b. This roll effect is an important driver of performance, as it allows the strategy to monetize the spread compression that occurs as credit risk decreases over time.
    c. Unlike bonds, where liquidity and transaction costs can erode returns when rolling maturities, CDS contracts provide a seamless and cost-efficient way to manage exposure across different maturities.
4. **Avoidance of FX hedging costs:**
    a. Investing in foreign corporate bonds typically requires currency hedging, as FX risk can significantly affect overall returns. Hedging currency risk adds complexity, cost, and operational challenges to global credit investing.
    b. By utilizing global CDS indices, the Aster strategy only involves the need for FX hedging of the value of the contract and not the underlying notional amount. Thus, the strategy does not carry the FX risk inherent in traditional foreign bond allocations, providing a more straightforward and cost-effective means of gaining global credit exposure.

Mechanics of the Aster Corporate Credit Strategy

CDS indices: The core of the strategy

Credit default swaps (CDS) are financial derivatives that allow investors to gain exposure to the credit risk of corporate issuers without owning the underlying bonds. A CDS index is a basket of CDS contracts on multiple corporate issuers, offering exposure to a broad set of credits within a single instrument.

The Aster strategy primarily focuses on **5-year CDS indices**. These indices are widely considered the benchmark for credit risk due to their balance between liquidity, credit risk

[1] A detailed analysis on the value of the roll and how it is structurally valuable over time to use the CDS strategy rather than cash bonds will be published in Q1 2025. Please check https://captor.se/insights for updates.

visibility, and market-standard contract terms. The indices typically cover investment-grade and high-yield issuers, providing a well-diversified credit portfolio.

Roll Strategy: Enhancing Returns by Riding the Curve

The Aster strategy systematically rolls its CDS positions every 6 months to capture the roll-down effect. The roll occurs when the strategy replaces a maturing CDS position with a new one, typically extending to the new on-the-run 5-year series. This roll process is critical to maximizing returns for several reasons:

1. **Roll-down effect:** As a CDS position ages, its spread often compresses as the contract approaches maturity, especially for investment-grade credits. This results in a positive carry, which can be harvested through systematic rolling.
2. **Reducing exposure to market stress:** By maintaining exposure to the most liquid and current series (the on-the-run CDS series), the strategy avoids liquidity traps and market dislocations that can affect older CDS series.
3. **Cost efficiency:** Rolling CDS positions is far more cost-effective compared to the rolling of physical bonds, where transaction costs and liquidity constraints can erode returns. The standardized nature of CDS contracts ensures efficient execution with minimal slippage.

Key Benefits of the Aster Corporate Credit Strategy

1. ALM interest rate matching

The strategy invests the notional in SEK assets and holds long term interest rate duration providing a matching interest rate exposure to the defined benefit scheme of a SEK denominated liability. Aster Global Credit has 10 years duration exposure.

2. Liquidity

The use of CDS indices ensures a high level of liquidity in the strategy. Unlike bonds, which can become illiquid or difficult to price, CDS indices are traded on standardized platforms and cleared centrally, offering deep liquidity even during periods of market stress. This allows the Aster strategy to enter and exit positions with minimal impact on market prices, a crucial advantage during volatile market conditions.

3. Diversification

Each CDS index is comprised of a broad basket of corporate issuers, offering significant diversification benefits. This diversification helps to mitigate the impact of idiosyncratic credit events (e.g., defaults or downgrades of individual issuers), smoothing the return profile of the strategy.

4. Enhanced return potential

By taking advantage of the roll-down effect and the ability to efficiently manage credit exposure across different maturities, the Aster strategy enhances its return potential relative to traditional bond portfolios. The natural roll in CDS indices provides an additional source of yield that is not available in physical bond allocations due to transactions costs and lack of supply.

5. Cost efficiency

The cost of trading and maintaining exposure through CDS indices is significantly lower than that of traditional corporate bond portfolios. CDS contracts do not involve the same transaction costs, bid-ask spreads, or liquidity challenges that are typically associated with bonds, especially in periods of market dislocation.

6. Avoidance of FX hedging costs

Global bond allocations typically require expensive and complex FX hedging strategies to manage currency risk. By using CDS indices, the Aster strategy eliminates the need for FX hedging of cash bonds. This results in lower operational complexity and reduced costs.

Risk Management

While the Aster Corporate Credit Strategy offers several key advantages, it is not without risks. These risks are carefully managed within the framework of the strategy:

1. **Credit risk:** The strategy is inherently exposed to the credit risk of the issuers within the CDS index. However, the broad diversification of the index helps to mitigate the impact of individual credit events. Additionally, the roll of index every 6 months means that only IG rated issuers will be in the index at the beginning of every 6-month period and any de-rated issuer will be screened out as the index rolls.

2. **Liquidity risk:** While CDS indices are highly liquid, market conditions can occasionally impact liquidity. The strategy focuses on the most liquid on-the-run series to ensure access to deep liquidity pools.
3. **Counterparty risk:** CDS contracts introduce counterparty risk. However, all positions are cleared through central counterparties (CCPs), significantly reducing counterparty risk exposure. On the positive side the strategy does not involve the need for FX hedges which involve both costs and counterparty risk.
4. **Market risk:** Changes in credit spreads can affect the value of CDS positions. The strategy employs a systematic approach to managing credit exposure by rolling the index every 6 months.

Conclusion

The Aster Corporate Credit Strategy offers a compelling alternative to traditional corporate bond investments. With its focus on duration, liquidity, diversification, cost efficiency, and the ability to capitalize on the credit curve through the roll effect, the strategy provides an innovative way to access global credit markets without the drawbacks of physical bond allocations. Furthermore, by avoiding the need for FX hedging, the strategy offers a simpler and more cost-effective solution for global credit exposure for SEK based investors.

This approach is ideally suited for institutional investors in Sweden, seeking enhanced yield opportunities, liquidity, and efficient credit exposure.

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