Credit Portfolio Trading
The Sea Change in Credit Markets

We believe credit markets are fundamentally changing in an important way.

Growth in bond ETFs is echoing what was seen in the equity markets in the early 2000s. Thanks to the cost benefits and ability to efficiently customize exposures, BlackRock predicts bond ETFs growing from the current $1.8Tn to $5Tn by 2030.

In the wake of bond ETF growth comes Credit **Portfolio Trading (CPT)** – transactions in which dozens or even hundreds of bonds can be offered in a single trade to one or several counterparties. Current GS estimates peg the footprint of Credit Portfolio Trading at 30% of their flows while JPM believes the overall market is roughly 15% CPT[1]. *X Cubed expects this to rise to closer to 50% for the market over the coming years and we believe CPT is the leading edge for how much of the credit market will trade*. The recent entry of Citadel Securities into corporate bond market making underscores the growth of this phenomenon.

We believe the most useful way to think about Credit Portfolio Trading is through the lens of equity-like macroeconomic or style factors. This image from a screen in GS's Marquee system illustrates the breadth of factors available in IG:

GIR Credit IG High Value	GSUCCS05
GIR Credit IG High MOM	GSUCCS13
GIR Credit IG Low Risk	GSUCCS02
GIR Credit IG High Carry	GSUCCS03
GIR Credit IG Low Carry	GSUCCS04
GIR Credit IG High Risk	GSUCCS01
GIR Credit IG Low MOM	GSUCCS14
GIR Credit IG Low Value	GSUCCS06

At X Cubed, we've been using a portfolio approach to credit for some time. Earlier this year for a trade in our Credit RV sleeve we created a basket "by hand" of 10 regional banks that we were long versus broader S&P leverage and volatility. We believe the creation of the basket may have mitigated single name default risk, isolated the factor/theme we had a world view on, and enabled efficient execution.

Understanding and *applying factors across asset classes* has been central to X Cubed (and indeed Andy's multi-decade career) from the very beginning.

What's exciting to us now is that the structure of the credit market is increasingly meeting us in this portfolio and factor-based approach investing in credit. This means that we now can:

[1] Estimates based on conversations with GS and JPM trading desks as of 11/28/23

1) **Monetize systematic credit opportunities through diversification that would have otherwise been prohibitive**: We now execute one systematic credit portfolio trade at the beginning of each week targeting our 15 to 20 best screen ideas, identifying the factors these create and thus the hedge strategy we will deploy. The efficiency of this execution versus the need previously to line up each single name and negotiate with multiple trading desks allows us better to focus on the most optimized investment parameters. *We can tailor the exact exposures we want in ways that would have been hard to do only 6 months ago*.

2) **Use off-the-shelf baskets for very targeted exposures and hedging**: Our systematic capital structure engine analyzes approximately 50 standardized portfolios offered by the street every day to identify opportunities for us as (a) Standalone Trades: We mine for a signal that a basket screens rich or cheap to index equity and volatility, typically and (b) Hedging Opportunities: Can we use a standard basket to hedge exposures created via our screen ideas? If we are delivered a concentration that derives significant short credit risk in a tenor in the curve (for example short front end) and/or an asset class (for example short industrials or financials) we search for an offsetting standard factor mitigant that signals.

3) **Realize price and liquidity improvement over single name trading**: The CPTs we have executed in November created upfront transaction costs of no more than 0.20%. We believe this has reduced our transaction costs over trading single names <u>by at least half</u>.

4) Lower Funding Costs: We typically execute CPTs as total return swaps and not cash trades. This has resulted in lower funding costs for us versus typical prime brokerage funding levels.

Capitalizing on this sea change in credit markets has been the most significant effort inside our firm in the past year. We began this evolution with the advantage of a framework that lends itself to granular expressions of relative value. We've also benefited from having GS as one of our primes (they are one of the dealers shaping CPT). Nevertheless, in the last few months, we've had to optimize our modeling to determine the right number of names to create a portfolio that gives us specific factor exposures while minimizing dilution of identified edge from high conviction single names.

With portfolio trades executed as total return swaps, we've also had to re-configure counter party relationships. In addition to GS, we've initiated coverage with Citadel Securities and expanded relationships with Jane Street and JP Morgan – firms that are also shaping this fundamental shift in credit trading.

We're excited to be in the vanguard of hedge funds in portfolio trading and we believe capitalizing on the benefits will have a profoundly positive impact on our risk/return profile moving forward.

We welcome your questions and discussion on a topic that not only is important to our firm but also may likely have an impact on credit allocations in your wider portfolio.

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