

UNDER THE CREDIT MICROSCOPE: METHODS OF SHORTING CORPORATE BONDS

NEUBERGER BERMAN
LONG-SHORT CREDIT TEAM

OCTOBER 2015

Investors typically think about buying a specific security, and profiting from the increase in its value, interest, or dividend payments (or some combination thereof). However, many investors are increasingly seeking opportunistic strategies that can also pursue gains through shorting individual securities. For long-short credit managers, the short element of their process can be crucial in constructing a portfolio with reduced correlation to the broader debt markets and a risk/return profile that is better positioned to deliver consistent returns over time. An investor can either obtain short exposure via shorting the actual security (i.e., cash bonds) or through certain derivative instruments. Here are a few approaches that are commonly employed in shorting a single corporate bond.

SELL SHORT/BORROW CASH BONDS

Shorting cash bonds is very similar, in principal, to shorting stock. The general idea of shorting a bond is to sell one that you have borrowed from another investor. The seller receives the proceeds of the bond (generally its price plus accrued interest) and the seller will close the transaction by buying the bond back in the future (hopefully at a lower price) and returning it to the lender. The short seller realizes the difference between the price at which he sells the bond and the price at which he purchases it back, net of costs. The risk of short selling is that the price appreciates and the short seller is forced to buy the bond back for more than the price at which it was sold.

There are certain costs associated with shorting cash bonds. Specifically, these include the coupon of the bond that accrues over the time the bond is shorted, and other borrowing costs such as the amounts charged by financial institutions to lend the seller the bond. The more difficult the bond is to borrow, typically due to general scarcity or high demand from short investors, the higher the borrowing cost that will be charged to the short seller.

Potential Benefits

Historically strong short correlation exposure to company's credit spreads, based on our observation. Cash bonds provide both short interest and credit spread exposure.

Limitations

Bonds can be difficult or expensive to source. Exposure options are limited to outstanding bonds, and there are different terms across issues and disparate maturities. The ability to use cash shorts may be limited for certain vehicles (e.g., UCITS funds).

Our Approach

We generally prefer cash bond shorts for high correlation to the cash bond market, as well as relative value single-name exposures.

CREDIT DEFAULT SWAPS (CDS)

Single-name credit default swaps are derivative contracts that reference bonds. The buyer of single-name CDS owns derivatives that will rise in value as the underlying capital structure weakens. As a company's credit risk increases, prices of the bonds typically fall and the CDS will generally rise in value to reflect the increased credit risk. Single-name CDS are generally standardized contracts that trade at a discount or premium to the contract spread (e.g., contract spreads in Standard North American Contracts are set at 100 or 500 basis points). Buyers pay the contract spread in return for credit protection (similar to a premium paid on homeowners insurance). The potential loss for a buyer of single-name CDS is limited to the total premium paid (discount received) and the net present value of the spread paid over the duration of the contract.

Potential Benefits

Standardized bond terms and maturities across the credit curve (in durations where cash bond maturities may not exist). Traded CDS are often more liquid than cash bonds.

Limitations

Trading technicals in CDS can create tracking error versus cash bonds. Single-name CDS do not protect an investor from the inherent interest rate exposure of corporate bonds.

Our Approach

Liquid single-name CDS used for directional shorts tied to idiosyncratic credit events.

TOTAL RETURN SWAPS (TRS)

Total return swaps are derivative contracts that allow the seller to gain short credit exposure. TRS essentially involve entering into a contract with a financial institution to trade the cash flows of a cash bond sold short, plus a "service charge." The financial institution that is providing TRS exposure will typically short the bond on behalf of the client and pass along the costs in the terms of the TRS. Why use TRS and not just short cash bonds? Fund regulatory capital requirements (i.e., asset coverage requirements applicable to U.S. mutual funds) and/or regulatory restrictions (i.e., prohibition of shorting cash bonds in UCITS structures) are the most typical rationale; depending on the investment vehicle and regulatory rules, shorting bonds via TRS can be an alternative vehicle to shorting cash bonds and/or a more efficient use of a fund's capital.

Potential Benefits

Preferable regulatory capital benefits.

Limitations

The same as shorting cash bonds (see above), with small additional counterparty costs.

Our Approach

TRS are primarily employed as a capital utilization optimization strategy tool or to facilitate the shorting of cash bonds in particular regulatory structures.

These are three of the most direct ways to express a short bias in the credit structure of an individual company. Short credit market and sector (not individual company) exposure can also be achieved via credit ETFs, closed-end funds, swaps on indices and options on credit vehicles.

ABOUT NEUBERGER BERMAN

Neuberger Berman, founded in 1939, is a private, independent, employee-owned investment manager. The firm manages equities, fixed income, private equity and hedge fund portfolios for institutions and advisors worldwide. With offices in 18 countries, Neuberger Berman has more than 2,100 professionals and the company was named by *Pensions & Investments* as a Best Place to Work in Money Management in 2013 and 2014. Tenured, stable and long-term in focus, the firm fosters an investment culture of fundamental research and independent thinking. Neuberger Berman manages \$251 billion in client assets as of June 30, 2015. For more information, please visit our website at www.nb.com.

This material is provided for informational purposes only and nothing herein constitutes investment, legal, accounting or tax advice, or a recommendation to buy, sell or hold a security. Any views or opinions expressed may not reflect those of the firm as a whole. This material may include estimates, outlooks, projections and other "forward-looking statements." Due to a variety of factors, actual events may differ significantly from those presented. Neuberger Berman products and services may not be available in all jurisdictions or to all client types. Investing entails risks, including possible loss of principal. **Past performance is no guarantee of future results.**

This material is being issued on a limited basis through various global subsidiaries and affiliates of Neuberger Berman Group LLC. Please visit www.nb.com/disclosure-global-communications for the specific entities and jurisdictional limitations and restrictions. Q0378 10/15 ©2015 Neuberger Berman Group LLC. All rights reserved.