

Levered credit: A late cycle ingredient for drawdown pain



As credit spreads normalised through 2025, yield-hungry investors have turned to leverage to maintain 6%+ returns – pushing some parts of the market uncomfortably close to pre-GFC behaviours. But the rising use of repo-based leverage and structured enhancements can turn stable IG portfolios into vehicles for equity-like drawdowns. Investors need to be careful to understand the true risk-return trade-off.

In 2025, with credit spreads normalising, and in some segments moving below long-term averages, a number of yield hungry credit investors responded by adding risk to meet investment objectives. These additional risks to sustain portfolio yields of 6%+ varied from increasing credit risk, interest/spread duration and/or leverage.

While mostly still at manageable levels, increased debt funding of credit securities is nonetheless a throwback to the heady pre-GFC era where synthetic and physical leverage was more commonplace. Indeed, we are now also hearing of less sustainable practices once again creeping into the credit investment lexicon.

From our discussions in the marketplace towards the tail-end of 2025, the use of leverage is principally occurring through the use of repurchase agreements (repo) of eligible collateral up to an eye watering 15-times for AAA rated securities, as well as via placement of senior secured leverage to enhance portfolio yields in both private and public credit portfolios.

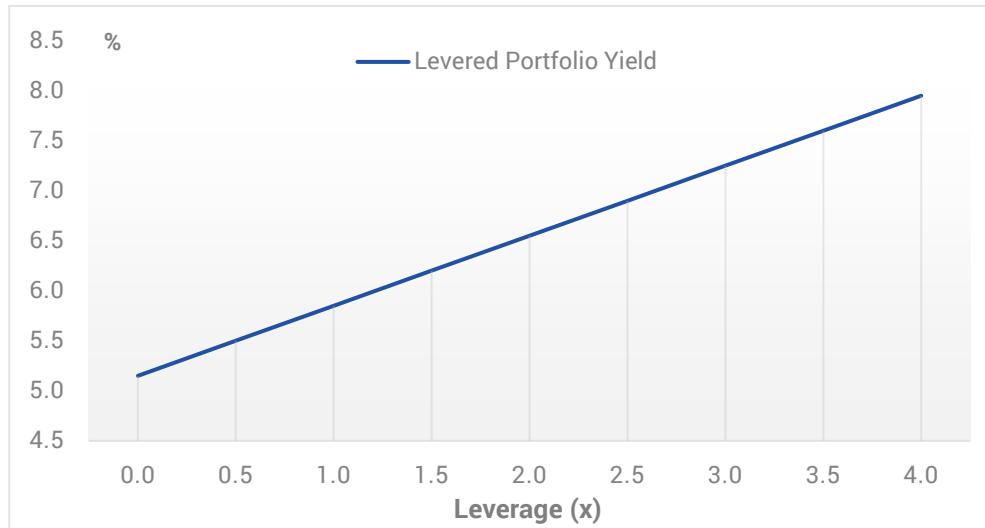
New levered investment products that have recently entered the market offer a floating rate running yield from a portfolio likely comprised of major bank T2 hybrids (T2s) and investment grade (IG) corporate bonds. Products such as these typically seek to enhance yield by deploying 3-3.5-times leverage.

Leverage enhances yields and amplifies performance (both positively and negatively) from changes in spreads and any impairments/defaults. Working off current pricing, an IG portfolio yielding ~5.0-5.5% p.a. with ~3-times leverage moves what is an already enhanced yield into a yield in the 7%+ range (refer Chart 1).



**Phil Strano,
Head of Australian
Credit Research**

Chart 1. YCM estimate: Levered IG portfolio yields

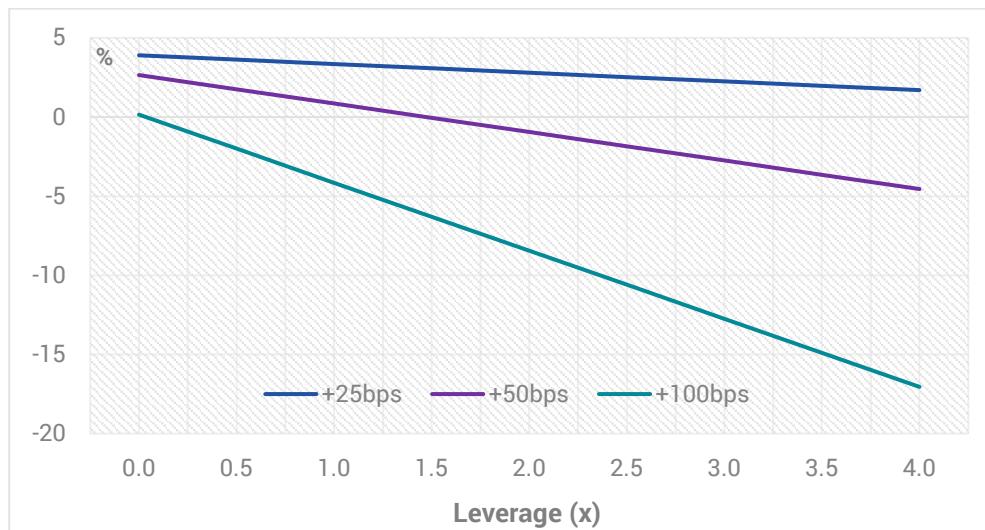


Source: Yarra Capital Management, Feb 2026.

The use of leverage to enhance returns can work very effectively in environments of stable or contracting credit spreads. It is a double-edged sword, however, with the combination of widening credit spreads and leverage usually resulting in significant drawdowns.

For instance, working off an estimated credit spread duration of ~5 years, a widening spread environment would quickly overwhelm underlying yields, with a ~100bp spread expansion on 3-times leverage generating a negative total return in the range of 10-15% from what is an underlying low risk IG credit portfolio (refer Chart 2).

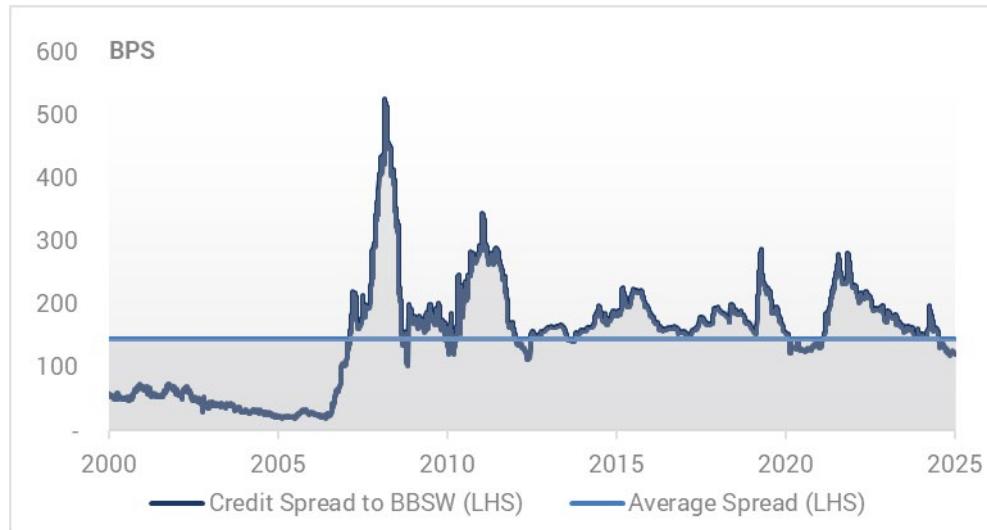
Chart 2. YCM estimate: Levered total returns and widening credit spreads



Source: Yarra Capital Management, Feb 2026.

Given fixed income investors generally have a low tolerance for negative returns over a 12-month period, the use of significant leverage to enhance returns could be somewhat of a dubious exercise, especially when you consider today's starting point. As evidenced by major bank T2s, credit spreads have performed over the last 2-3 years and now sit around their long term averages across most segments of Australian credit and significantly below the previous peak in 2022 (refer Chart 3).

Chart 3. Major bank Tier 2 5yr FRNs (credit spreads and yields)



Source: Yarra Capital Management, Feb 2026.

At current spread levels, the probability of a +/-100bp move is weighted to the positive and in the current macroeconomic environment is entirely possible over the near to medium term. In such an event, which can occur two to three times each decade, the prospect of equity like drawdowns from levered credit funds should give credit investors pause for thought.

Put more simply, credit investors in these levered structures should be thinking hard about whether they are comfortable taking what is effectively equity drawdown risk for a miserly 1-2% in additional yield. We would suggest that this represents incredibly poor compensation for the risk assumed at this point in the cycle.

In contrast to levered credit funds, both the Yarra Enhanced and Higher Income Funds are still providing attractive 6-7% yields with precisely zero leverage. Moreover, while it is true that a 100bps widening in credit spreads would lead to value diminution for both these funds, high unlevered yields combined with active management should protect against negative returns over any 12-month period. We do not believe the same can be said of levered credit funds running a similar mix of underlying credit assets.

About Us

Yarra's fixed income franchise employs an active and research-driven approach, constructing and managing portfolios that represent our best ideas for investors. We target consistent and stable returns over the longer term, employing a rigorous process which follows an established and reliable framework to ensure we are capable of delivering outperformance through market cycles.

[Find out more about our Funds>](#)



Contact us

If you require further information, please contact your relevant [Business Development Manager](#).



Questionable practices are creeping back into credit investing

Yarra Funds Management Limited (ABN 63 005 885 567, AFSL 230 251) ('YFM') is the issuer and responsible entity of a range of registered managed investment schemes, which includes those named in this document ('Funds'). YFM is not licensed to provide personal financial product advice to retail clients. The information provided contains general financial product advice only. The advice has been prepared without taking into account your personal objectives, financial situation or particular needs. Therefore, before acting on any advice, you should consider the appropriateness of the advice in light of your own or your client's objectives, financial situation or needs. Prior to investing in any of the Funds, you should obtain and consider the product disclosure statement ('PDS') and target market determination ('TMD') for the relevant Fund by contacting our Investor Services team on 1800 034 494 or from our website at www.yarracm.com/pdsupdates/. The information set out has been prepared in good faith and while Yarra Funds Management Limited and its related bodies corporate (together, the "Yarra Capital Management Group") reasonably believe the information and opinions to be current, accurate, or reasonably held at the time of publication, to the maximum extent permitted by law, the Yarra Capital Management Group: (a) makes no warranty as to the content's accuracy or reliability; and (b) accepts no liability for any direct or indirect loss or damage arising from any errors, omissions, or information that is not up to date. No part of this material may, without the Yarra Capital Management Group's prior written consent be copied, photocopied, duplicated, adapted, linked to or used to create derivative works in any form by any means.

YFM manages the Fund and will receive fees as set out in the PDS. To the extent that any content set out in this document discusses market activity, macroeconomic views, industry or sector trends, such statements should be construed as general advice only. Any references to specific securities are not intended to be a recommendation to buy, sell, or hold such securities. Past performance is not an indication of, and does not guarantee, future performance. Information about the Fund, including the relevant PDS, should not be construed as an offer to any jurisdiction other than in Australia. With the exception of some Funds that may be offered in New Zealand from time to time (as disclosed in the relevant PDS), we will not accept applications from any person who is not resident in Australia or New Zealand. The Fund is not intended to be sold to any US Persons as defined in Regulation S of the US federal securities laws and has not been registered under the U.S. Securities Act of 1933, as amended.

References to indices, benchmarks or other measures of relative market performance over a specified period of time are provided for your information only and do not imply that the portfolio will achieve similar results. Holdings may change by the time you receive this report. Future portfolio holdings may not be profitable. The information should not be deemed representative of future characteristics for the strategy. There can be no assurance that any targets stated in this document can be achieved. Please be advised that any targets shown are subject to change at any time and are current as of the date of this document only. Targets are objectives and should not be construed as providing any assurance or guarantee as to the results that may be realized in the future from investments in any asset or asset class described herein. If any of the assumptions used do not prove to be true, results may vary substantially. These targets are being shown for informational purposes only.

© Yarra Capital Management, 2026.