Stress Testing Your Portfolio: The Key is Transparency | August 2016

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What is the definition of stress? And how does the concept of stress relate to your investment strategy and financial goals?

Stress, as it relates to portfolio construction, refers to the types of outside events that impact a portfolio strategy. Stressors are often unforeseen and sudden. Given the globalization of markets, the instantaneous transmission news making headlines as a result of technology, and the interconnectedness of economies, we believe stress factors will impact portfolios in a significant way on a permanent basis.

In today's volatile and uncertain environment, it is our view that understanding how portfolios react in differing conditions is a critical part of developing an appropriate improvement portfolio strategy. The problem that most investors face is that they really don't know how they are currently invested. Mutual funds and exchange traded funds, combined with a variety of individual assets, make for a confusing mix of positions whose true nature is often mysterious. Throw in a dose of annuities and 401(k)s into the picture and the mix becomes even more murky.

We are not alone in this perspective that stress testing portfolios makes sense on a proactive basis In fact; the Federal Reserve believed stress testing was reasonable exercise for large financial institutions to go through after the 2008 financial crisis as a way to determine if any particular institution was too big to fail. The goal of the Federal Reserve was to examine the asset composition for each financial institution and to stress test the banks solvency and liquidity based on a number of possible negative economic scenarios. The scenarios included a dramatic fall in the real estate market, and unexpectedly large spike in interest rates, a significant equity downturn, an extraordinary move upward in unemployment rates, and a variety of other economic stressors. The goal was to see how these institutions might fare in these types of conditions.

We see no reason why the same exercise cannot be applied to individual portfolio strategies. There is no reason why banks should have the benefit of this assessment and analysis process. Transparency towards developing a clear understanding of how assets are invested can only be a net positive for investors particularly in financial conditions that are so uncertain.

The stress test analysis goal is simple: To understand how you are currently invested and model the impact certain stressors might have on your portfolio strategy and, as a result, the likelihood of you reaching your long-term financial objectives.

Despite the simple goal, the process necessary to gain true transparency is more complex. The only way to truly understand how your portfolio currently is structured is to deconstruct your entire portfolio so you are not merely relying on the names of assets (a comforting title such as a balanced mutual fund might not be how you imagine a balanced fund should be constructed). Every asset needs to be deconstructed and the underlying components examined. This needs to be done for every single asset held within portfolio strategy and the resulting mass of subcomponent positions assessed for risk characteristics as well as return opportunities. Once this deconstruction occurs, the real test begins to assess how your portfolio strategy might be impacted by set of circumstances and conditions.

There are a number of factors that we believe should be assessed when conducting a stress test analysis.

At Destination Wealth Management we have developed a 14 point checklist of items that we review as we deconstruct and assess portfolio strategies. As an illustration of the type of assessment that occurs at DWM, the following are three we believe should be included in any stress test assessment:

Equity market volatility risk: the measurement of the potential fluctuation of portfolio strategies in a variety of economic conditions including replication of the financial crisis in 2008. This assessment is designed to assess how a portfolio strategy will move if fluctuations in the equity market occur up or down. This is important consideration as most investors have an internal threshold of discomfort in terms of potential asset fluctuation.

Categorization risk: an assessment of how assets are invested to determine what weightings are held in each of the three basic categorization types. Determining whether invested assets are cyclical, sensitive, or defensive in nature can assist in predicting volatility as well as the potential for sustainable income streams. Additionally, different types of assets do well in different parts of the economic cycle and understanding how assets are invested can help position portfolios appropriately. In many cases, more aggressive investors seek to have less defensive assets in their portfolio. In many cases, more conservative investors focused on income streams tend to invest in more defensive assets. Deconstructing a portfolio to understand how assets are currently invested relative to the three categories is an important forensic tool.

Credit quality risk: the measurement of credit quality of fixed income assets held and what economic conditions might negatively impact held assets. This assessment focuses on making a determination if fixed income assets held are either too aggressively focused on an excessive amount of low-grade assets or too conservative positioned forfeiting the opportunity of additional yield by utilizing assets with slightly lower credit quality. The important consideration is that investors need to understand how fixed income assets are invested across all asset types including mutual funds and exchange traded funds to determine what credit risk exist.

There are 11 additional key checkpoint items that Destination Wealth analyzes as we review portfolios utilizing our proprietary viewpoint generated from our stress test analysis. Each are key part of constructing an overall viewpoint based on the facts of the underlying components rather than the tiles of each held asset.

Once the measurement occurs of how portfolios are currently constructed, and overlay of potential economic and financial outcomes can help paint a picture of what future return risk characteristics might look like. The overlays might include equity market fluctuations, interest rate increases, recessionary headwinds, global uncertainty, and a variety of other possible future conditions.
It's important to recognize that in an era where the unthinkable is possible, there's no foolproof solution to determining how a portfolio strategy might react in unforeseen circumstances. Still, this exercise is designed to understand likely tendencies and can be significantly helpful in assuring a given strategy meets the comfort level requirements of an investor.

The cold reality is that economic and market volatility will continue as a permanent condition and headlines will no doubt drive fluctuation. Hoping the world and headlines will calm down is, in our viewpoint, wishful thinking. It is our belief that he best response to uncertainty is to have a full picture of how one is invested now and to seek maximum transparency. With the clarity in hand regarding how you are truly positioned on a portfolio basis, you can then make proactively adjustment as needed.

The proprietary Stress Test process utilized by Destination Wealth Management can be an important tool in helping you in understanding the true nature of your currently held assets and how they might respond in future market conditions. We invite you to learn more about DWM at www.destinationwm.com or contact us via email or phone at info@destinationwm.com or 800.947.3864.