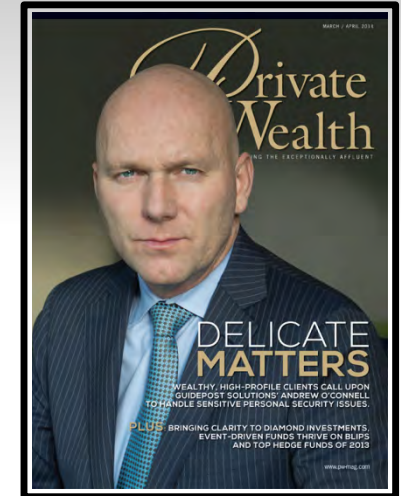RISK MANAGEMENT

Three Steps To Adding Value With Portfolio Crash Testing

www.fa-mag.com   www.pw-mag.com

Presented by

Ben Graham:

"The essence of investment is management of risk, not management of returns"

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Key Uses of Stress Testing for Advisors

- **Verify model portfolio risk profile by examining crash tests**

- **Educate clients about risk/return tradeoffs to achieve goals**

- **Convert prospects by showing them their risk profile without jargon**

- **Manage risk holistically for HNWI with custom scenarios**

Why Stress Testing?

- **Volatility, Sharpe ratio, Beta, VaR are based on past performance of asset classes**

- **Ignores current situation (near zero real rates and trashed balance sheets of sovereigns)**

- **So why would we ignore possibility of fixed income losses?**

- **95% confidence range for risk is like umbrella for when there is no rain**

The Core of the Process

Investment goals:
- **Time Horizon**
- **Objectives**
- **Financial State**
- **Liquidity Needs**

Investment constraints:
- **Risk Tolerance**

You are the Risk Manager. How do you balance?

Choosing a portfolio is similar to choosing a car - we balance tradeoffs: Performance VS. Safety

Performance

Car VS **Portfolio**
- Speed
- Handling
- Durability
- Return
- Liquidity
- Time horizon

Safety

Car VS **Portfolio**
- IIHS Car Crash Test
- Portfolio Crash Test

Key in any crash test is to measure IMPACT

Car   VS   Portfolio
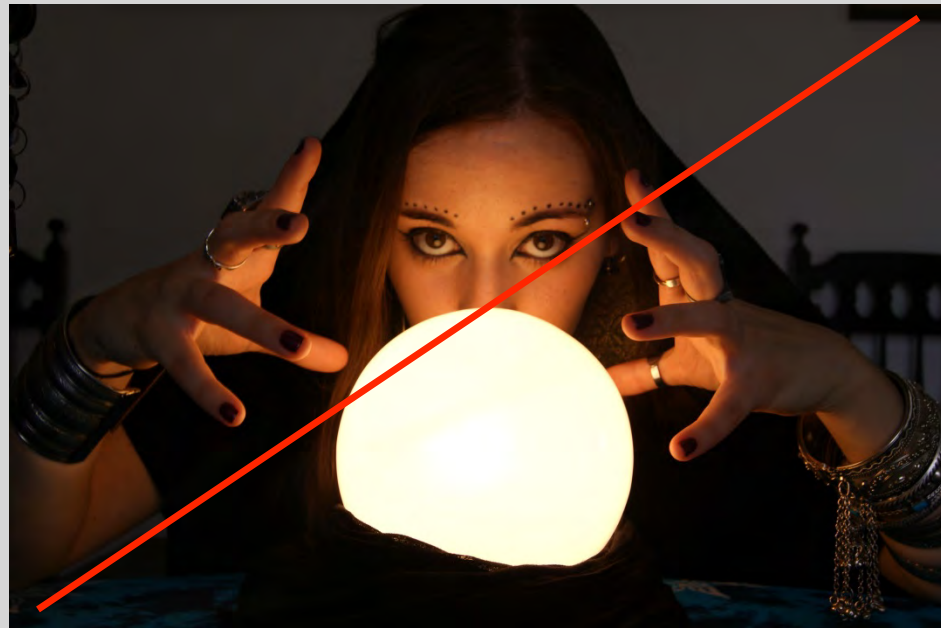
- Front
- Rear
- Side
- Rollover
- Combination

- Inflation
- Emerging Markets Hard Landing
- Fed Tapers QE
- Etc.

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What you are NOT doing

No Crystal Ball
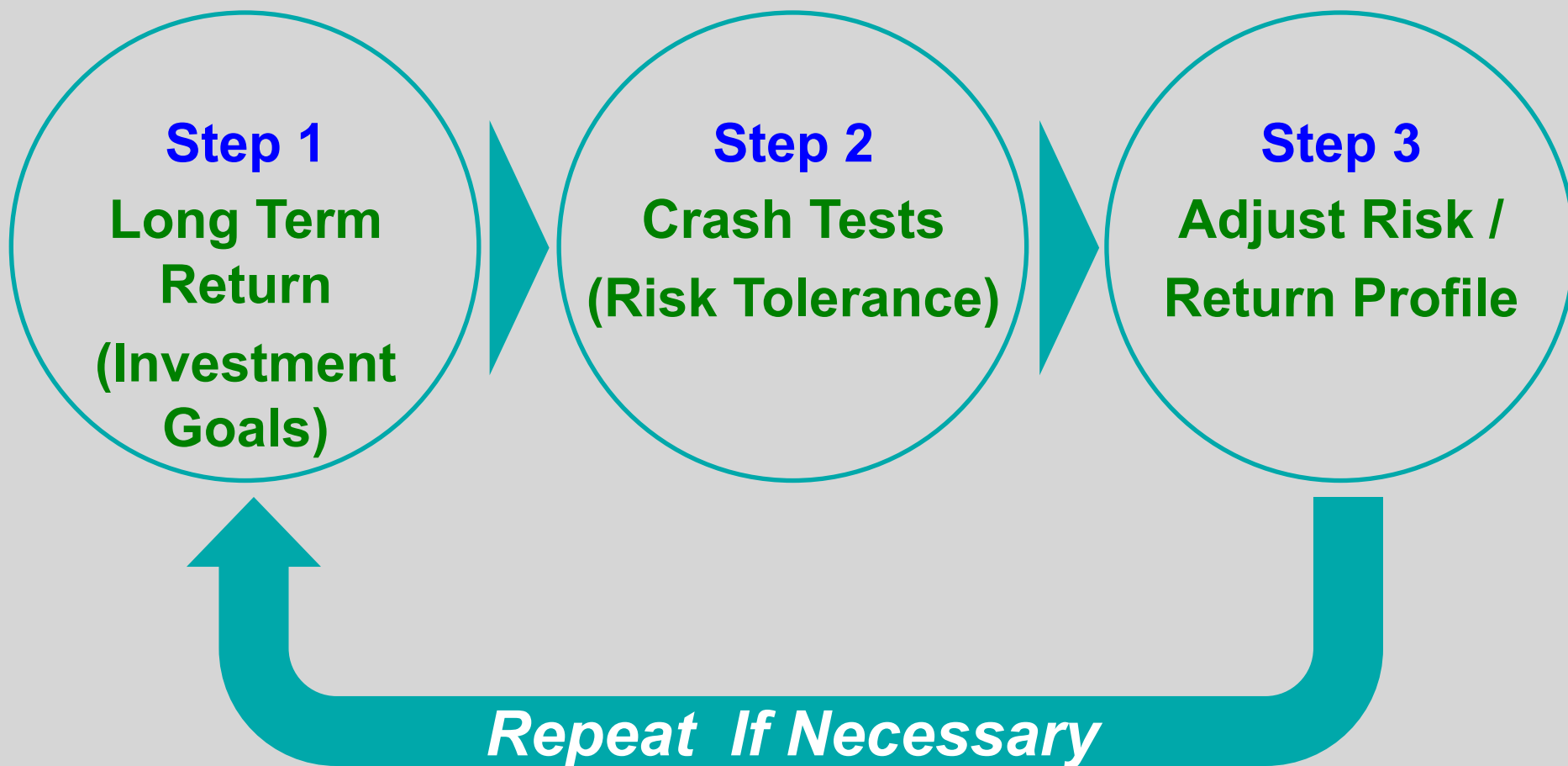
No Timing

Who is your client?

SUV Mom?

Who is your client?

Justin Bieber?

Three Steps to Building the Right Portfolio

Step 1

Long Term Return

(Investment Goals)

Step 2

Crash Tests

(Risk Tolerance)

Step 3

Adjust Risk / Return Profile

Repeat If Necessary

Step 1: Long Term Return (Investment Goals)

Questions

- **What is the long term return required to meet investors' goals?**
- **What proportion is coming from income vs. price appreciation?**

Outcome

- **If the long term return is insufficient or too large, then the goals or portfolio makeup must be revisited**

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Step 2: Crash Tests (Risk Tolerance)

Questions

- Do the biggest losses on the crash test chart make sense?
- Is the client comfortable with the small risk of incurring those losses?
- Are the losses coming from

Outcome

- If client cannot tolerate the magnitude of the losses, even given the long term return and the peak performance of the portfolio, then risk profile needs to be adjusted to match client risk tolerance

Step 3: Adjust Risk / Return Profile

Questions

- **What is the loss level that the investor is willing to bear during the major crises in order to achieve investment goals and peak**

Outcome

- **Adjust the portfolio manually or use Portfolio Crash Testing Optimizer to get the list of suggested trades**