

## **HSBC Global Private Banking & Wealth** **Using Stress Scenarios to build healthy investment portfolios**

### **Wei Mei:**

Welcome to today's discussion where I am pleased to be joined by Willem Sels, our Global CIO. My name is Wei Mei Tan, Global and Asia Head of Advisory. In this session we will address our clients' top queries around our Stress Scenarios, which are available to our Prism Advisory clients in HSBC. We currently have over 50 stress scenarios that cover historical, market driven and specific market shocks.

Let's start the conversation looking at the past, as our clients like using historical scenarios. Willem, it is often mentioned that history tends to repeat itself, is that true?

### **Willem:**

History doesn't repeat itself exactly, but it offers valuable lessons. On average a correction, where markets fall by greater than 10%, happens every 2 years. A bear market, where markets fall by greater than 20% every 7 years and a market crash, where markets fall greater than 30%, every 12 years. So every investor will encounter volatility and we can analyse these past episodes to learn from them.

### **Wei Mei:**

Very good point Willem. Given these valuable lessons in history, it is important to remember when building a portfolio to ensure that risk remains tightly monitored. You cannot just look at historical scenarios in isolation. We should expect that no crisis will be exactly the same but increasing awareness of the downside risks in portfolios will be paramount. Therefore, it will be helpful to combine the assessment with more forward-looking scenarios to have a balanced view of both the upside and downside.

So Willem do you think our forward-looking scenarios are preferred because they tend to act like a crystal ball to gaze into the future?

### **Willem:**

While investors desire having predictive power to determine the direction of the markets, forward looking scenarios are not meant to be a crystal ball. It is always important to understand the assumptions used and be aware how the unfolding of an event may lead to different asset classes reacting in various ways.

### **Wei Mei:**

That makes a lot of sense but let's say there was a military escalation, what would happen in this scenario?

### **Willem:**

There are a plethora of variables that could affect markets and as events unfold these variables change. But our hypothesis would be a risk-off environment with a falling equity market and rising government bond prices. Credit spreads would widen across the spectrum and there would be a flight to safety to Japanese Yen, US Dollar and the Swiss Franc. Safe-haven assets such as Gold would rally as would oil due to speculation of further military tensions unfolding.

### **Wei Mei:**

Some clients also like to understand how are stress scenarios different from doing a simple back of the

envelope exposure calculation. For example, if S&P is up 20%, and my portfolio holds 80% in US equities then my portfolio should go up by 16%.

**Willem:**

It is important to remember that markets are always in a flux and dynamics are constantly changing. It would be inconceivable that if the US market went up by 20% tomorrow – there would be no other consequences to other markets or asset classes. One must remember that correlations exist in financial markets – when one asset class moves, it affects another.

It is also important to remember that it is very rare that a portfolio would only hold one index, portfolios are made up of many asset classes, types of products and allocations to different regions or sectors. At HSBC we use quantitative methods to develop robust stress scenarios and consider aspects such as correlation risks.

Using your risk framework approach, you mentioned what would US equities +20% mean to a typical client portfolio?

**Wei Mei:**

Let's assume the client has a multi-asset portfolio. Using our risk framework that has a 10-year time horizon, the associated market movement to UK equities would be 10.5% and for Gold just 2%. Given a risk-on environment, credit spreads would also tighten across the spectrum, impacting high yield more than investment grade bonds. All the market movements across assets are reflected in the individual clients' portfolio based on current holdings when running the stress tests.

Hence it's not as simple as a multiplication of the magnitude of change you see in a broad market index.

**Willem:**

The biggest market crash in the last 20 years was the Global Financial Crisis. It is still very useful for clients as a stress scenario even though it is unlikely to happen again in the same form. It's a bit like when you see a doctor and want to really understand your health, they will run a health screening. This is where you are pushed on a treadmill or an exercise bike to understand how your body reacts under cardiovascular stress – in a controlled setting. It is something that no one enjoys but is important. This helps the doctor to understand how your body responds and any signs of health issues. The same can be thought of when it comes to your portfolio, we use many scenarios including past events even when improbable, to see how healthy your portfolio might be and where the vulnerabilities are.

What is your view on this Wei Mei?

**Wei Mei:**

I agree. Since 1871, there have been 24 bear markets (defined as when there has been a drop in a broad market index of more than -20%). It is very important to understand how some bear markets would impact your portfolio as a client's number one goal is to achieve their financial objectives – pro-longed drawdowns and lack of a risk framework can be detrimental to the portfolio, resulting in financial goals

not being met.

The Global Financial Crisis had the largest US equity market drawdown in the last 20 years of -57%. For many investors, this event might still play on their minds. By using this scenario, we are not predicting the next Global Financial Crisis, but rather re-enacting the impact on different asset classes and highlighting the importance of diversification when constructing a portfolio.

Thanks Willem. I have greatly enjoyed our discussion today and hope this has been educational for our clients. I look forward to our next conversation on the markets soon.