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Can Your Portfolio, Balance Sheet, and Wealth Plan Pass the Test?

Stress testing is more important than ever as we enter another season of uncertainty

During challenging times

such as we've experienced this year and will likely continue to encounter, it's so important to be sure your portfolio, balance sheet, and wealth plan have been "stress tested" to see how they stack up in case of unplanned, significant events.

As we know, life is not static.

Along with markets and economies, regulatory and tax environments can also be unpredictable. Therefore, we believe your investment, liquidity, and wealth plans should be periodically monitored and tested to gauge how they might withstand the stress of change.

Testing your portfolio

Investing your hard-earned dollars can be frightening and intimidating—particularly when the markets exhibit whipsaw volatility and you see portfolio values plunge. Market downdrafts are never comfortable situations and they will test the resolve of even the savviest investor, tempting one to "cash in" and tuck it all under the mattress. Conversely, when market values soar, it can be very tempting and buy like it's Black Friday. Unless you have flawless psychic powers that can tell you precisely when to hop out of—and back in—the market, your investment plan should be built around manageable prospects in advance of stormy market conditions.

Accounting for investment risk: The lowdown on drawdown

Calculating and anticipating risk is central to a sophisticated investment process that underscores a plan—yet risk arithmetic is challenging to understand if not outright misleading. Traditionally, investment professionals used the default risk metric of standard deviation—a measure that quantifies the amount of variation of a set of returns—to

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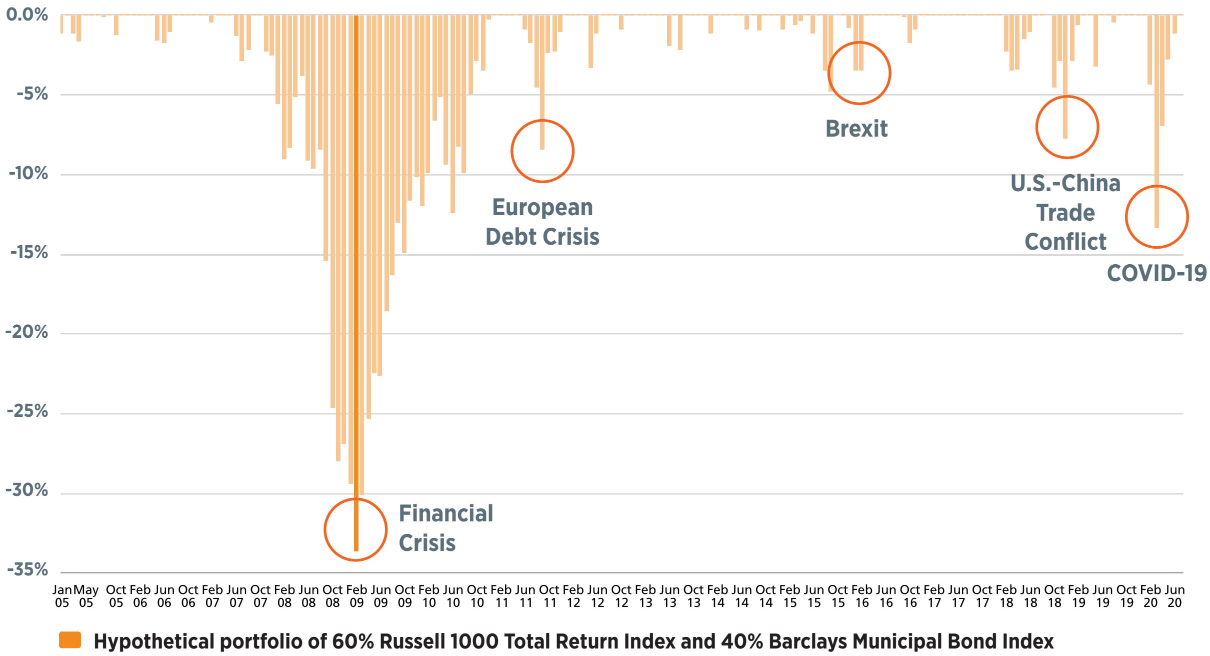
Figure 1

How did a hypothetical portfolio weather the storm?

Historical drawdown exposure



The chart above depicts a hypothetical portfolio of 60% U.S. large-cap stocks and 40% U.S. investment-grade tax exempt bonds. Stocks are represented by the Russell 1000 Total Return Index and bonds are represented by the Barclays Municipal Bond Index. The above chart is for illustration purposes only and does not reflect the actual performance of any specific investment. The hypothetical portfolio is not intended to be indicative of past or future performance of any specific investment option. Indexes are not available for direct investment. Investment in a security or strategy will incur expenses such as management fees and transaction costs, which will reduce returns.

Your investment plan should be built around manageable prospects in advance of a stormy market

determine whether an investment will achieve an expected return in a given period. While standard deviation can be useful, we focus on an additional metric that we find to be more nuanced and intuitive—drawdown.

Drawdown measures the difference in value from the most recent peak to the most recent trough in the market. It can be measured in terms of dollars, which is more meaningful to most investors. Although drawdown does not typically measure how long it will take an investor to recover losses, we believe that structuring portfolios with an eye toward managing drawdowns may help to recover losses more quickly than traditional portfolios focused on managing volatility. Reviewing past drawdowns helps you identify how your portfolio fared, how you felt and reacted during that time, and if you would be willing and/or able to weather the next (Figure 1). While in some areas the pandemic is showing signs of slowing, the future is still unknown in terms of what this virus may do next, and without a vaccine readily available yet, the course of COVID-19 is still unpredictable. Should we face shaky market conditions, or worse, how much would your portfolio be impacted, and for how long? Figure 2 represents future potential returns on a hypothetical portfolio; while your returns could improve, your portfolio could also experience a future drawdown.

By stress testing your current portfolio you can see how it would likely have fared under different market shocks or stress scenarios—such as the tech bubble, financial crisis, or global pandemic—and you can determine whether asset allocation shifts or goal adjustments need to be made.

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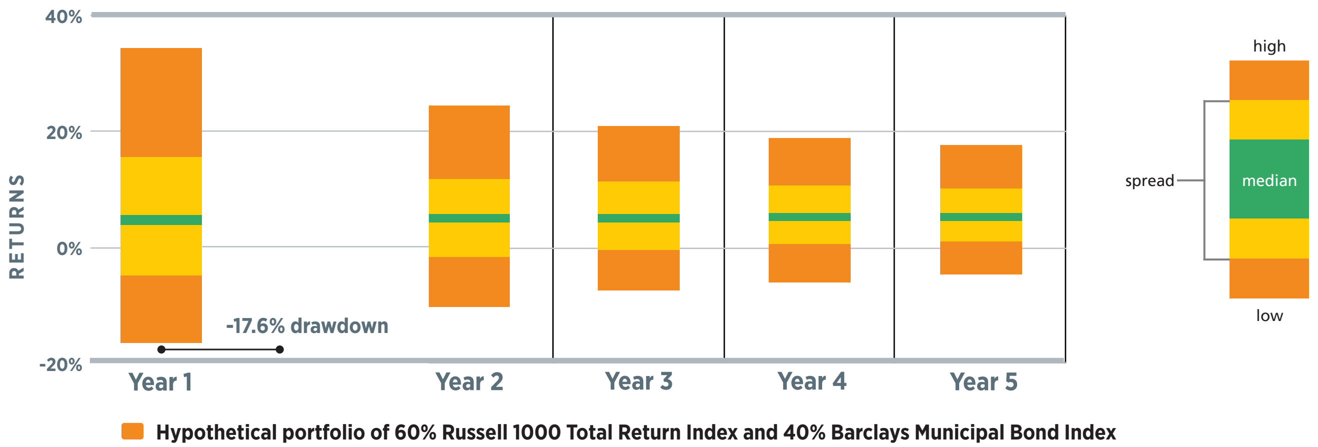
Figure 2

Is this hypothetical portfolio prepared for future volatility?

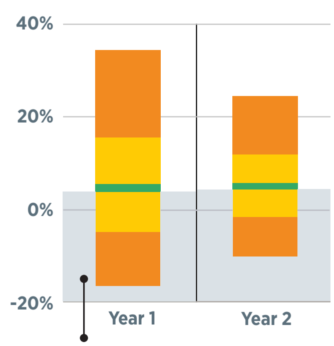
Projected range of returns (after tax)



The chart above represents the range of returns that could be achieved based on Wilmington Trust's Capital Market Assumptions of a hypothetical portfolio consisting of 60% U.S. large-cap stocks and 40% U.S. investment-grade tax exempt bonds. Stocks are represented by the Russell 1000 Total Return Index and bonds are represented by the Barclays Municipal Bond Index. The returns for these asset classes are based on Wilmington Trust's Short Term Capital Assumptions (2020–2021) of 9.78% for U.S. large-cap stocks and 2.72% for U.S. investment-grade tax exempt bonds, respectively. See the disclosures for more information regarding Wilmington Trust's Capital Markets Assumptions. Past performance cannot guarantee future results. Indexes are not available for direct investment. Investment in a security or strategy designed to replicate the performance of an index will incur expenses such as management fees and transaction costs, which will reduce returns.

Assessing your liquidity position

Stress testing balance sheets is equally important and can reveal liquidity gaps and cash flow continuity risks should a significant unexpected event take place. Large medical expenses, tax bills, or other large outflows of cash should not come as a surprise if you have a solid liquidity plan in place. Disrupting your carefully constructed investment portfolio because you need quick access to cash could jeopardize your lifestyle and long-term planning goals. A more viable option may be to establish a line of credit that will be available to meet your immediate cash flow needs when they arise while keeping your investments insulated. A line of credit can also be an excellent resource for positive opportunities, such as purchasing collectibles, cars, marine craft, or other large investments.



During periods of drawdown, a secured line of credit can insulate your portfolio against having to sell securities to cover unexpected expenses.

Evaluating your wealth plan

Your wealth plan should also be stress tested for a variety of factors to be sure you are prepared for life's changes as well as regulatory and tax changes. Is your estate plan up to date? Does it reflect any family considerations that may have occurred due to marriage, divorce, births, and others? Now is also the time to be sure your beneficiary and agent designations are current on all your key legal documents, including your will, trusts, and powers of attorney for financial and health care matters.

With an election looming in November, you may also want to speak with your tax advisor to be sure your plan is positioned to take advantage of today's tax planning opportunities while also preparing for potential changes next year. With the current federal estate tax exemption at an all-time high of $11.58 million per person, there are a variety of techniques that can help you save federal and state estate taxes (if applicable), efficiently transfer wealth for generations, support your charitable giving efforts, and other planning strategies.

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Fall to-do list

September/October:

- ✓ Conduct a stress test on your portfolio to see if you are properly positioned for whatever comes next
- ✓ Work with your investment advisor to make asset allocation adjustments as needed

October/November:

- ✓ Stress test your state of liquidity—if unexpected expenses occur, larger tax bills—do you have the cash to meet those needs?
- ✓ Establish a line of credit with your private banker as part of your cash flow plan and to help protect your portfolio

November/December:

- ✓ Perform a stress test on your wealth plan
- ✓ Speak with your advisor about any year-end tax planning opportunities that may be available in light of potential future changes
- ✓ Read our latest article, Riding the Tax Law Wave: Planning Strategies in a Sea of Change.

Keep in mind that this exemption is scheduled to expire on December 31, 2025; however, if there is a change in the White House there is the possibility that there could be new tax laws on the horizon as well.

A paragon of possibilities to help inform your plan

Our powerful investment modeling software, PARAGON®—Portfolio Analysis, Risk Assessment, and Goals Optimization—examines your portfolio through the lenses of enhanced planning capabilities and goal optimization with a particular focus on drawdown exposure—and a soon-to-be-released differentiating capability of being able to project potential short-term (spot) drawdown scenarios. To ascertain the appropriate investment objective and strategy based on cash flows, goals, risk tolerance levels, and potential wealth outcomes, Paragon:

- Stress tests thousands of hypothetical portfolios to see how they would perform, folding in greater risk than that which is typically used in our industry
- Shows the likelihood of your current portfolio asset allocation to fund your goals
- Fosters a holistic look at wealth by including in the portfolio optimization process a customizable balance sheet, net worth statement, investable and even nonfinancial assets, such as a privately held business

Stress testing is a valuable tool to help you gain clarity on whether or not you are properly prepared for whatever comes next—both opportunities and challenges. We're here to help.

Please contact your advisor or Director of Wealth Sales Engagement and Enablement Jane Kennedy if you would like to review your current plans and be sure they are well positioned for today and the years to come.

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