Top 3 Stress Testing Scenarios + How to Get the Most Out of Them

One glaring theme remains consistent across the recent economic headlines: uncertainty.

Between record-high inflation, wild swings in the housing market, and geopolitical unrest, dozens of unpredictable levers impact markets. Not only is it difficult for investors to understand how these factors interact, but it's even more challenging to visualize how those myriad factors may impact their portfolios.

That's where advisors do well to lean on stress testing tools. By putting an investor's holdings through their paces in various potential scenarios, you can help clients visualize possible outcomes for their holdings.

A stress testing tool is flexible and responsive, empowering you to walk through any concerns with your investors. No matter what news story they're worried about, there are dozens of scenarios to clarify potential impacts they may see down the road.

While there are many competing macroeconomic stories at present, let's look at three of the scenarios dominating the news cycle and how you can use stress testing to help clients understand what's happening behind the headlines.

1. **Fed Shock Therapy**
   Record-high inflation has put the Fed under the microscope in recent months. As Powell and his team hike rates in an attempt to cool inflation, they run the risk of overshooting and pushing the economy into a recession.

   While we've seen times of high inflation before, the set of circumstances around today's inflation is unique. Forward-looking stress testing considers the particular circumstances of the pandemic-era inflationary environment and continues to adjust to new news — be it the results of a Fed meeting, the latest job numbers or the recent CPI report.

2. **Housing Whiplash**
   Another area that's experienced significant volatility since the start of the pandemic is the housing market. The boom of 2020 has slowed due to various factors, not the least of which is the dramatic rise in interest rates.

   Rental prices are ballooning across the US, and sale inventory is down. As experts continue to watch the housing market as a bellwether for the economy's overall health, this sector remains of high importance to investors.

3. **Cold War 2.0**
   When Russia attacked Ukraine in February 2022, few could have predicted the protracted conflict as we've seen it play out. With Russia's refusal to back down, the macroeconomic impacts of the conflict will continue to reverberate worldwide.

   Russia is a major player in the energy markets, and Ukraine is a key supplier of grains and other crops. But they're only two of the players in this global story. India and China have become the largest single purchasers of Russian oil and gas, while the West shakes its head in disapproval and G7 leaders propose a cap on Russian oil prices to reduce revenue generation.

How To Use Forward-Looking Stress Testing

You've likely fielded many questions about these macro events over the past 18 months. If you're reading the papers daily, you can recite the latest headlines, but that's not the kind of insight clients seek.

What they're really asking for is reassurance. With so much uncertainty in the world, they wonder, *will my portfolio be okay?* While no one can answer that question definitively, stress testing can help ease fears by helping you visualize potential outcomes.

So how do you use stress testing to calm investors and fortify their resolve to stay the course? It's a mix of tech and behavioral finance principles.

1. **Ask Clients About Their Concerns**
   Orion's Chief Behavioral Officer, Dr. Daniel Crosby, has spoken before about engaging with clients in a down market. Productive conversations begin with an emotionally-attuned level set.

   Ask clients how they're feeling, and use your EQ skills of active listening and empathy to hear what they're saying.

   If you hear uncertainty or concern around certain investing strategies you have in place, or specific macroeconomic fears, affirm your client's feelings by acknowledging that you hear them and understand where they're coming from. Then, turn to risk management tools to help them reframe their current thinking about the economic red flags they're seeing.

2. **Walk Them Through the Scenario**
   This is where the stress testing scenarios come into play. You can run a client's portfolio through various scenarios within your risk management tool to illustrate how it may perform in any hypothetical.

   Showing hypothetical performance allows you to illustrate the steps you've taken to protect their holdings. You can show how you've created a portfolio that insulates against downside, leans into any potential upside and provides the sense of security they need to stay the course on strategy and remain invested throughout the volatility.

   A visual representation of the future can be a powerful educational tool in these client conversations. Stress testing scenarios show that you've considered many potential outcomes and have acted proactively to address potential risks. Seeing the stress test results gives investors concrete evidence that they have an advisor who is thinking ahead and considering their best interests.

3. **Follow Up Proactively**

   Once you've built up client trust through these first two steps, you must work to maintain this relationship.

   If your client has expressed fears about the housing market specifically, make a note to contact them if any particularly bad economic news arises around that topic.

   Chances are, your client will be tracking those headlines. If you can reach out proactively to reaffirm your understanding of their concerns and reiterate your work to insulate their portfolio against potential bumps in the housing market, you maintain their trust.

   At the end of the day, all technology works best when paired with thoughtful human interactions. Combining industry-leading stress testing and risk management tools with behavioral finance best practices can win client trust and protect your book of business even in the most turbulent of markets.

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