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Stress Testing in 2026: Designing Scenarios for Correlation and Concentration Risk

Stress testing has become a core component of effective risk management for asset managers. In 2026, this is no longer driven purely by regulatory expectations, but by market reality. Periods of stress increasingly reveal that portfolios which appear diversified under normal conditions can suffer sharp, simultaneous losses when correlations rise and concentration risks materialise.

For asset managers operating from Malta – a small, open financial centre servicing international investors – robust stress testing is particularly important. Funds are exposed to global market dynamics, while investors and regulators expect clear evidence that risks are understood, measured and actively managed.

Why Correlation Risk Matters More Than Ever

One of the most common weaknesses in portfolio risk analysis is the reliance on historical correlations. During periods of market stress, correlations across asset classes, sectors and regions tend to rise sharply, undermining diversification benefits precisely when they are most needed. This phenomenon has been observed repeatedly during past crises and remains a central lesson for risk managers today.

A practical approach is to design scenarios where correlations across major asset classes or sectors converge toward stressed levels observed in past crises or deemed plausible under current conditions.

For example, a fund could apply:

- a 30–40% equity market shock,
- widening credit spreads,
- and an assumption that correlations across growth-oriented assets increase toward 0.8–0.9.

The objective is not to forecast exact outcomes, but to identify non-linear effects. Portfolios with similar exposures may experience disproportionately larger losses once correlation assumptions are stressed, revealing vulnerabilities that standard risk reports do not capture.

Concentration Risk Beyond Position Limits

Concentration risk is often associated with large single-issuer or sector exposures. While position limits remain essential, they do not fully capture economic concentration. Portfolios can be compliant with formal limits while still being heavily exposed to a single risk driver, such as technology growth, liquidity conditions or funding availability.

Stress testing allows asset managers to quantify this risk. A simple concentration stress could involve: applying larger shocks to the top five holdings, or assuming that the most correlated positions experience losses simultaneously.

For instance, if the top 10% of a portfolio by weight contributes 35–40% of stressed losses, this highlights a level of concentration that may not be obvious from headline exposure metrics alone.

Designing Effective Stress Scenarios

Effective stress testing begins with the identification of key risk drivers rather than individual instruments. Scenarios should focus on how these drivers behave under stress and how shocks propagate through the portfolio. This includes exploring situations where correlations increase materially, liquidity deteriorates, or previously defensive assets fail to perform as expected.

Importantly, stress scenarios should be internally consistent and economically plausible. While historical scenarios — such as past financial crises — remain useful reference points, they should be complemented by forward-looking hypothetical scenarios that reflect current market structures. This is particularly relevant in 2026, where market concentration and technology-driven exposures differ significantly from previous cycles.

Conclusion

In 2026, stress testing focused on correlation and concentration risk is essential for understanding true portfolio resilience. For asset managers in Malta, it provides a practical way to look beyond surface-level diversification and assess how portfolios behave when assumptions fail.

Stress testing does not eliminate risk, but it improves transparency, governance and preparedness. In an increasingly volatile and interconnected market environment, that insight is indispensable.

Linking Correlation and Concentration

The real value of stress testing lies in combining correlation and concentration analysis. When correlations rise, concentration effects are amplified. Positions that normally diversify each other may start behaving as a single exposure.

From a quantitative perspective, this can be assessed by:

- decomposing stressed portfolio losses by asset, sector or theme,
- comparing marginal contribution to risk under normal and stressed conditions,
- and identifying which exposures dominate tail outcomes.

This approach shifts the focus from “how much could the portfolio lose?” to “where would losses come from?” — a far more useful question for portfolio construction and risk oversight.

From Quantitative Output to Risk Insight

A common pitfall in stress testing is treating results as purely quantitative outputs. Stress testing should be a diagnostic process, not a box-ticking exercise. The value lies in interpreting results, challenging assumptions and engaging investment teams in informed discussion about vulnerabilities and trade-offs.

Risk managers should focus on explaining why losses occur under stress, which exposures drive outcomes, and whether mitigating actions are realistic under adverse conditions. This approach strengthens the link between risk analysis and decision-making, enhancing the credibility of the risk function.



Reana Micallef
Lead Risk Manager



Our Local Income Funds

	Vilhena Malta Government Bond Fund	Vilhena Malta Bond Fund
Net Asset Value	€123.27 million*	€111.79 million*
Objective	Income & Long-Term Capital Growth	Income Primary Focus
Investment Focus	Maltese Government Stocks	Maltese Corporate Bonds & Maltese Government Stocks
Target Audience	Investors seeking income and conservative growth within the local market	Investors seeking regular income within the local market
Investment Horizon	Medium to long-term	
Risk	Low Risk	
Currency	Euro	
Share Classes	Accumulator & Distributor Share Classes	

*data as at 31st May 2026

The Vilhena Malta Government Bond Fund

The Vilhena Malta Government Bond Fund aims to deliver capital stability and regular income through investments in debt securities issued or guaranteed by the Government of Malta. By focusing on Maltese government bonds, it offers a lower risk fixed income option than equity funds, with an emphasis on preserving and steadily growing capital rather than pursuing aggressive returns. Because it invests in government-backed securities, it is generally suited for investors seeking stability and predictable income rather than high volatility.

The Vilhena Malta Bond Fund

The objective of the Vilhena Malta Bond Fund is to generate income and long term returns by investing principally in Maltese debt securities. The fund focuses on Maltese bonds, including government and local corporate issuers. Its goal is income generation first, with capital growth as a secondary outcome. Compared with the Government Bond Fund, this fund generally involves slightly more risk but offers greater income potential.

A well-diversified portfolio is essential, and our local income funds can help strengthen that diversification. By generating regular income from bond-based investments, they can help smoothen returns during volatile markets and support either reinvestment or ongoing expenses. Their role is to balance growth-oriented holdings by adding stability and predictability. While these funds do not remove risk, they can improve diversification and support long-term financial resilience.

Funds are generally more liquid than direct securities as they are designed to make investing and withdrawing money easier. Our local income funds let you buy or redeem units daily at the fund's net asset value, allowing quick access to cash at a transparent price. Since these funds are made up of a pool multiple assets, investors benefit from built-in liquidity even when some underlying holdings are less liquid. This makes them a practical way to maintain flexibility and manage cash-flow needs within a portfolio.

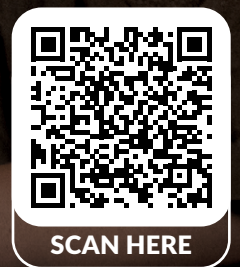


Tara Borg

Manager, BOV Asset Management

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THE BOV BALANCED PORTFOLIO FUND



Contact us | infoassetmanagement@bov.com

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Navigating Geopolitical Shocks

The Case for Active Portfolio Management

The recent conflict in the Middle East has caused volatility to increase among equities, commodities, and fixed-income markets, introducing a new source of uncertainty for investors. Geopolitical shocks, such as the ongoing Iran-US war, create an environment of heightened uncertainty, rapid market swings, and sudden shifts in global risk appetite. During times of geopolitical uncertainty, markets react sharply to such events, causing bouts of volatility before eventually stabilizing and recovering.

However, during a period of decline, active portfolio managers have the agility to adjust portfolios immediately as new information emerges and reduce exposure to vulnerable sectors and reallocate toward assets that

benefit from shifting conditions. Since the conflict began, energy supplies have been disrupted, as about 20% of global oil and liquefied natural gas (LNG) shipments pass through the Strait of Hormuz, making it one of the world's most sensitive geopolitical chokepoints. When tensions escalate, energy markets react immediately, often with significant price spikes. The closure of the Strait of Hormuz has driven Brent crude oil to surge past \$100 per barrel. Markets have also witnessed sharp swings in other commodity prices; for instance, European benchmark gas prices spiked by nearly 40% following disruptions at production sites. Furthermore, the crisis has resulted in regional instability due to significant disruptions to global logistics, causing major ocean carriers to suspend transit and affecting several regional stock exchanges.



During such periods, an active portfolio management strategy becomes essential, as it responds to fast-changing geopolitical and economic events. Active portfolio managers make informed decisions rather than simply tracking an index, offering meaningful advantages during times of crisis. It is a vital tool for protecting capital, managing volatility, and capturing opportunities that result from market movements. Because active portfolio management is flexible, responsive, and has risk-control measures in place, it is well-equipped to navigate ongoing geopolitical crises. Active management relies on flexibility, adjusting positions quickly in response to events and emerging risks, which makes it a strategic asset. When markets are calm, passive strategies often perform well because broad indices tend to rise steadily over time. However, crises disrupt these patterns. Geopolitical shocks can cause correlations between asset classes to break down, sectors to diverge sharply, and risk premiums to widen. In such an environment, the ability to adjust positions quickly becomes a strategic advantage. Conflicts in the Middle East often have immediate implications for global energy markets. Oil prices can spike on fears of supply disruptions, affecting industries ranging from transportation to manufacturing. An active manager can reduce exposure to sectors that are particularly vulnerable to rising energy costs while increasing allocations to those that may benefit, such as energy producers or defense companies. Passive investors, by contrast, remain fully exposed to whatever the index holds, regardless of shifting risk dynamics.

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Active management also enables dynamic asset allocation, a crucial tool during periods of heightened uncertainty. Instead of maintaining a fixed mix of stocks, bonds, and

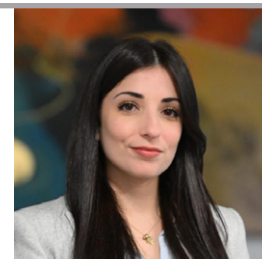


other assets, active managers can adjust allocations based on evolving conditions. For example, they may increase cash holdings to preserve capital, shorten bond durations to reduce interest-rate risk, or add exposure to commodities as an inflation hedge. This adaptability helps cushion portfolios against sharp drawdowns and provides opportunities to re-enter markets at more attractive valuations.

In addition, geopolitical crises often have uneven regional impacts; the Iran conflict, for instance, may affect Middle Eastern markets more directly than those in Europe or North America. Active managers can tilt portfolios away from regions with elevated geopolitical risk and toward those with more resilient economic fundamentals. This targeted approach helps reduce exposure to localized shocks that may not be reflected in global indices.

In uncertain times, investors often seek stability and clarity. While no strategy can eliminate risk entirely,

active portfolio management provides the agility, insight, and discipline needed to navigate turbulent markets. As the Iran conflict continues to shape global economic conditions, the case for active management becomes even more compelling.



Kristina E. Vella
Investment Specialist, BOV Asset Management



BOVAM's London Training Programme: Building Global Investment Knowledge

BOVAM's London training programme has become an annual tradition, giving top-performing Financial Advisers from the Bank's Investment Centres the opportunity to strengthen their expertise. This year, eight employees were chosen to attend a two-day intensive programme hosted by Insight Investment Management (Global) Limited and Fidelity International.

During their visit, the team met with Mr. Ulrich Gerhard, Portfolio Manager, and Ms. Cathy Braganza, Senior Credit Analyst, at Insight Investment Management (Global) Limited, to discuss the Vilhena High Yield Fund, which is well known among local investors for its focus on non-investment-grade bonds. They outlined the Fund's positive view of the high-yield market, supported by attractive yield levels and low default rates, and explained its strategy of investing in companies with stable business models and strong cash flow generation.

The following day a discussion was held with representatives from Fidelity focusing on the macroeconomic and geopolitical landscape and its implications for financial markets. Libby Mcnie, the Investment Director for Fixed Income highlighted how heightened uncertainty and shifting policy dynamics are creating dislocations across asset classes, giving rise to selective and compelling investment opportunities. It was noted that such environments can favour active allocation, with volatility providing attractive entry points into undervalued segments and structurally resilient themes.

The team also met with Ms. Aditja Shivran manager of the Fidelity Global Equity Income Fund, which seeks to provide income alongside long-term capital growth through a globally diversified equity portfolio. The fund invests at least 70% of its assets in income-generating shares of companies worldwide. Investments are selected for their dividend yield, capital growth potential, and sustainable characteristics.

The BOV participants expressed sincere appreciation for the Company's initiative and returned with broader perspectives and valuable insights into the global investment landscape. BOV Asset Management continues to support the Bank's representatives through regular local and international training initiatives, helping them stay current with evolving market conditions and regulatory requirements



Tara Borg

Manager, BOV Asset Management

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VILHENA GLOBAL THEMED FUND

12.5% 5-year
annualised performance



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