


INVESTMENT DICTIONARY





As is the case in many industries, the ever complex world of investment is full of jargon. Although it is the role of specialists to use clear language rather than technical terms, sometimes these are just unavoidable. To help trustees in their understanding and interpretation of the investment terms that they may encounter in their day-to-day fiduciary responsibilities, Mercer has compiled this *Investment Dictionary*. A number of the terms have other non-investment related meanings, which we have not captured. The dictionary is intended to supplement rather than replace expert investment advice.

We have expanded this year's edition of the *Investment Dictionary* by introducing several terms since our last update in 2012 that cover industry updates, as well as other terms not covered previously. The additions reflect the ever-changing face of investment markets, with the associated phraseology that this introduces. They also represent our efforts to continue to raise the level of knowledge of trustees, thus better equipping them to fulfill their fiduciary duties.

In certain cases we have specified that terms relate to a particular asset class. Readers should be aware that such terms might have a different meaning in general usage or when applied to other asset classes.

401(k) plan

US-defined contribution plan offered by a corporation to its employees, which allows members to set aside tax-deferred income for retirement purposes. (The name 401(k) comes from the IRS section describing the programme.)

A

AAA

Highest rating assigned by a number of credit rating agencies, indicating the relative security of an issuer of debt. Usually accorded to quasi government and large multinational corporate borrowers.

absolute return vehicles/strategies

Investment strategies targeting a positive return in absolute terms rather than relative to an index or other benchmark. These strategies avoid construction limitations imposed by the measurement against a specific benchmark. Often also referred to as cash plus funds. (See also hedge fund.)

accrued benefits

Benefits that an employee has earned to date based on his or her membership of a pension scheme. Accrued benefits are often calculated in relation to the employee's salary and completed service.

accrued interest

Interest that has been earned but not yet received. The purchaser of a bond in the market pays the seller the value of the accrued interest, as the former will receive the full coupon when it is next paid.

ACT

See Advance Corporation Tax.

active management

Approach to investment management which aims to outperform a particular market index or benchmark through asset allocation and/or selection decisions. (See also enhanced indexation, passive management.)

active position

Difference between the actual level of investment made in a particular stock or asset class and the benchmark allocation or weighting of that investment.

active return

Increase in the expected return on a portfolio from active management.

active risk

Risk measured in terms of volatility of a portfolio's return compared with that of the benchmark return, arising from active management. Some level of active risk is necessary to achieve active return. (See also tracking error.)

activism

Intervention by shareholders using their ownership rights to influence the actions of corporate management with a view to enhancing the value of the company.

actuarial assumption

Estimate made for the purposes of an actuarial valuation. Possible variables include life expectancy, return on investments, interest rates and growth in earnings. (See also actuarial valuation.)

actuarial valuation

Professional assessment undertaken by an actuary to determine whether the assets of a plan are likely to be sufficient to meet the accrued benefits; normally carried out at least every three years, in line with legislative requirements.

actuary

Professional who advises on financial issues relating to risks, probabilities and mortality, most frequently in relation to the financing of pension plans and insurance companies.

additional voluntary contributions (AVC)

Contributions over and above a member's contractual contributions to a pension plan, enabling him or her to accrue additional benefits.

adjustable-rate mortgage (ARM)

Mortgage loan whose interest rate is raised or lowered periodically in accordance with a stated reference interest rate. ARM refers both to the original homeowner loan and to a securitised pool of such loans.

ADR

See American Depository Receipt.

Advance Corporation Tax (ACT)

Tax formerly paid by companies on dividends distributed to shareholders.

agency broker

Broker/dealer who acts as agent between market makers and investors.

agency trade

Undertaken on behalf of the client on a best endeavours (and best execution) basis. The client bears the risk (profit or loss) of price movements between giving and completing the order.

AIM

See Alternative Investment Market.

AIMR

Association for Investment Management and Research. See CFA Institute.

All-Share Index

See FTSE All-Share Index.

ALM

See asset/liability modelling.

alpha

Incremental return added by an investment manager through active management.

alpha transfer

Investment strategy combining active management in one asset class (the alpha) with strategic exposure to a different underlying asset class.

Alternative Investment Market (AIM)

Market operated by the London Stock Exchange for smaller companies. The requirements and costs of listing are less onerous than on the main stock exchange.

alternative investments

Investments that do not fit into the mainstream areas of equities, bonds and property, and which would normally only form a small proportion of pension plan portfolios. Examples include private equity/venture capital, hedge funds and commodities. They are typically brought into a portfolio to increase diversification.

AMC

Annual management charge.
See management charges.

American Depository Receipt (ADR)

Security issued by a US bank to represent shares of a foreign (i.e. non-US) company, which can be traded on a US stock exchange as if they were American securities. Similar securities are available on other stock markets.

American Stock Exchange (AMEX)

Stock exchange for certain US stocks not listed on the New York Stock Exchange (NYSE). AMEX stocks tend to be smaller than those listed on the NYSE.

American-style option

Option that can be exercised at any stage during its life, at or before expiration date. The value of an American-style option will always be greater than or equal to the value of a similar European-style option.

amortisation

Repayment by instalments over a period of time.

analyst

See investment analyst.

annual percentage rate (APR)

Cost of debt that is paid by borrowers, expressed as an annualised figure.

annualised return

Periodic rate of return converted into an equivalent one-year rate of return. For example, a return of 75% earned over five years converts to an average annualised return of 11.8% per year.

annuity

Contract designed to provide regular payments to the policyholder in return for an initial lump sum payment. Annuities may have a guaranteed period and/or be payable for life. Payments may be fixed or may vary.

APR

See annual percentage rate.

arbitrage

Risk-free profit derived from differences in price when the same or equivalent investment is traded on two or more markets or in more than one form. By taking advantage of price disparities between markets, arbitrageurs perform the economic function of making these markets trade more efficiently.

Asian option

Option whose price at expiration depends on the average value of the underlying asset over the life of the option.

ask price

Lowest price for which an investor or dealer will sell a given security or commodity. Also called offer price.

asset

Anything that has a monetary value.

asset allocation

Distribution of investments across categories of assets, such as cash, equities and bonds. Asset allocation affects both risk and return and is a central concept in financial planning and investment management.

asset-backed security

Security backed by a pool of notes or receivables against assets of a similar type, such as credit card receivables.

asset carry

Return associated with holding an asset, if positive (e.g. interest earned by the holder of fixed income bond), or the cost of holding an asset, if negative (e.g. warehousing costs of holding commodities).

asset class

Broad category of assets of a similar type — for example, equities, bonds, property and cash.

asset/liability modelling (ALM)

Projection of future movements in assets and liabilities, and especially the relationship between the two. ALM is used to provide an insight into the likely effect of different asset allocation strategies on a pension scheme's future financial position. (See also stochastic modelling.)

asset manager

Firm or individual who manages (i.e. buys and sells) a portfolio of assets.

asset stripping

Process of splitting up and selling parts of a business separately for profit-making purposes.

asset swap

The exchange of a flow of payments from a given security (the asset) in return for a different set of cash flows.

Association for Investment Management and Research (AIMR)

See CFA Institute.

at par

Having a current price equal to face or par value.

at-the-money

Indicates that a traded option has no intrinsic value (positive or negative), i.e. the underlying share price is equal to the strike price.

attribution

See performance attribution.

audit

Unbiased examination and opinion of the financial statements of an organisation. It can be internal (by employees of the organisation) or external (by an outside firm).

authorisation

Required by the Financial Services and Markets Act 2000 for any firm or individual who wants to conduct investment business in the UK, unless the firm is exempt from regulation under the Act.

authorised share capital

Nominal amount of share capital that a company is authorised to issue, in terms of its articles of constitution.

authorised unit trust

Unit trust which has been authorised by the FSA. (See also unit trust.)

Autorité des marchés financiers (AMF)

French regulatory body tasked with improving the efficiency of France's financial regulatory system. Its three main functions are to protect investor interests, to set standards for the provision of investor-related information and to marshal the functioning of financial markets.

AVC

See additional voluntary contributions. (See also FSAVC.)

average daily volume of portfolio

Weighted sum of the quantity of each asset to be traded divided by that asset's average daily traded volume.

B

back office

Administrative activity related to investment management, for example, settlement, pricing and plan accounting. (See also front office.)

backwardation

Situation where the price for future delivery of a commodity in a forward contract is less than spot price of the commodity. (See also contango.)

bad debt

Debt which is viewed as unlikely to be recovered by the creditor and may be written off as worthless.

balanced management

Where an investment manager is given broad discretion in relation to the management of all the main asset classes. (See also specialist management.)

bankruptcy

Legally declared state that is usually triggered by a company's failure or impaired ability to meet its contractual debt obligations. Usually results in restructuring of the company's debt or liquidation of the company. (See also distressed debt.)

barbell strategy

Investment technique, typically related to a bond portfolio, under which a manager holds a combination of both shorter-dated and longer-dated bonds relative to the benchmark, but where overall duration is broadly in line with the benchmark.

bargain

Another word for transaction or deal. It does not imply that a particularly favourable price was obtained.

BARRA

Software programs developed by Barra International and used to evaluate portfolio risk, chiefly in equity investments.

base currency

Currency of the country in which the investor is based.

base rate

Benchmark for other interest rates, including personal loans and mortgages. The high street bank's base rate changes following changes made by the Bank of England to its rates. The Bank of England moves base rates by changing the dealing rates at which it buys bills from the discount houses. The equivalent term in the USA is the "prime rate".

basis point

1/100 of 1%, or 0.01%, thus 100bp = 1%.

basis risk

Risk that arises when an investor attempts to hedge a position in the market using an instrument that has an underlying security which is different from the security whose risk is being hedged. For example, using a FTSE 100 future to hedge a FTSE All-Share UK equity portfolio.

bear

Individual who believes that a security, sector or the overall market is going to fall in price. Opposite of bull.

bear market

Period of sustained stock market decline. Opposite of bull market.

bearer bond

Bond with no central register of bondholders. Entitlement to payments of interest and principal depends on physical possession of the bond. Bondholders submit coupons to the issuer (cut out from the bond) to receive each interest payment.

beauty parade

Competitive review of investment managers, custodians, consultants or other service providers, usually involving written submissions and presentations.

bell curve

See normal distribution.

bellwether

Stock or bond that is widely believed to be an indicator of the condition of the overall market.

below par

Having a current price below face or par value.

benchmark

Measure against which a portfolio's performance, risk and construction is assessed. The benchmark may take the form of a market index for portfolios focusing on a particular market — for example, MSCI World Equity Index — or be a peer group average or median.

benchmark portfolio

Theoretical portfolio of assets against which the performance of an actual portfolio is monitored.

beneficial owner

Person who enjoys the benefits deriving from a security or property. May be different from the legal owner in whose name the title is registered.

best execution

Execution of a securities transaction at the best price available in the market at the time of the transaction.

beta

Statistical measure of risk or volatility. Indicates the sensitivity of a security or portfolio to movements in the market index. Securities/portfolios with a beta greater than one are expected to be more volatile than the market as a whole, outperforming in rising markets and underperforming in falling ones.

bid/offer (bid/ask) spread

Difference between the buying price (offer or ask price) and selling price (bid price) of a pooled fund unit or a security.

bid price

Price at which a security or a unit in a pooled fund can be sold. (See also ask price, offer price, mid price.)

bill, treasury

See treasury bill.

blue chip company

Large, well-known company with a long record of profit growth, strong branding and consistent record of paying dividends.

bond

Certificate of debt issued by a government or company, promising regular payments on a specified date or range of dates, usually with final capital payment at redemption. Most bonds are issued with a nominal face value and a coupon, stated as a percentage of their nominal value, although variations on this structure exist. A bond's price rises as its yield falls, and vice versa. (See also zero coupon bond, index-linked gilt, floating rate bond.)

bond rating

Credit rating on a bond.

bond yield

Income of a bond as a percentage of the capital invested. As bond yields rise, prices fall, and vice versa.

bonus issue

Issuance of free shares by a company to its existing shareholders. No money changes hands and the share price falls pro rata. This is usually used as an exercise to make the shares more marketable (i.e. cheaper per share and therefore more attractive to small investors). Also known as a capitalisation or scrip issue.

book value

Value at which a security is recorded on a balance sheet, usually the cost of buying it. If securities have been acquired at different times and different periods, the book value will reflect the average buying cost.

boom

Period of rapid economic growth.

bootstrapping

Method of interpolating government bonds of differing maturities to gain exposure evenly across the whole yield curve.

bottom quartile

Quartile ranking that is in the bottom 25% of returns. (See also top quartile.)

bottom-up

Approach to active investment management that gives priority to the identification and selection of companies (with less emphasis accorded to sector and geographical region) to build up an investment portfolio. This is the opposite of a top-down approach. (See also country allocation, stock selection, top-down.)

bourse

Another name for a stock exchange; usually applied in a Continental European context.

boutique investment manager

Firm, generally relatively small in scale of operations, which has as its sole purpose the management of investments for third parties for a fee and which does not participate in other activities such as banking or life assurance.

breakeven inflation

The rate of inflation that will equalise the returns between fixed interest and inflation-linked securities of the same maturity. For example, if the yield on a 10-year fixed interest gilt is 5% and the real yield on a 10-year index-linked gilt is 2%, then the breakeven inflation rate is 3%. Also known as implied inflation and can be derived from swaps as well as bonds.

broker/dealer

Individual or firm that acts as an intermediary between buyers and sellers, usually for payment of a commission. It may also buy securities to sell for a profit while fulfilling its role as dealer.

bull

Individual who believes that a security, sector or the overall market is going to rise in price. Opposite of bear.

bull market

Period of sustained stock market growth. Opposite of bear market.

bullet portfolio

Bond portfolio with maturities concentrated over a small cross-section of the yield curve.

business cycle

See economic cycle.

buy and hold analysis

Technique of investment performance measurement which compares a portfolio and its related characteristics (return, income, yield, volatility) at the end of a period with the portfolio as it would have been had no transactions occurred during the period. This separates the effects of market movements and manager decisions.

buy and hold strategy

Investment strategy in which stocks are bought and then held for a long period of time regardless of short-term market movements.

C

CAC 40 index

Paris-based stock market index of the leading 40 French shares.

call

Requirement for an investor to make additional payments on specified dates in order for an investment (e.g. a partly paid stock or an optional ownership) to be fully paid up.

call option

Option which gives the purchaser the right, but not the obligation, to buy an asset at a specified price either on an agreed date (European option) or on or before an agreed date (American option). This date is known as the expiration date. (See *also* put option.)

callable bond

Bond which can be redeemed before maturity at the option of the issuer.

cap

Interest rate contract where the purchaser receives from the seller, at the end of each period prior to expiry of the contract, the difference between current interest rates and a strike interest rate, should interest rates rise above the strike. For example, agreement to receive money for each month during which LIBOR exceeds 5%. (See *also* floor.)

capital adequacy

Firms conducting investment business are required to have sufficient funds of their own. The European Union Capital Adequacy Directive, which sets minimum levels of capital for UK financial service companies, came into effect on 1 January 1996.

capital asset pricing model (CAPM)

Economic model for valuing assets. The simplest version states that the expected excess return of a security over a risk-free asset will be exactly in proportion to its beta.

capital flight

See flight to quality.

capital gains tax (CGT)

Tax levied upon the sale of an asset, based on the increase in its price since purchase. Tax-approved UK pension funds are exempt from CGT.

capital growth

Appreciation in the capital or market value of an investment, as opposed to income (e.g. dividends) which may be received from the investment from time to time.

capital market

Any financial market upon which securities are traded.

capitalisation issue

See bonus issue.

capitalisation-weighted index

Index where the weightings applied to each component security are based on their relative market capitalisations. (See *also* equal-weighted index.)

CAPM

See capital asset pricing model.

CAPS

See Mellon Analytical Services.

carry

See asset carry.

carry trade

Practice of borrowing in currencies with low associated yields and lending in high-yielding currencies. If currency markets are efficient, there should be no gains to the trader, since the yield differential will be offset by changes in the relative exchange rates.

carried interest

Mechanism by which a private equity manager shares in the profits achieved in a private equity fund or investment. Typically, the carried interest will be around 20% of the net gains achieved.

cash flow risk

Risk that an investor scheme is forced to sell assets to meet liabilities. This can occur when the level of cash flow required to meet benefit payments exceeds the contribution and investment income.

CBO

Collateralised bond obligation.
See collateralised debt obligation.

central clearing

Process designed to reduce counterparty risk which is present in bilateral over-the-counter derivative trades by clearing with a single central counterparty.

Central Counterparty Clearing House (CCP)

An organisation that helps facilitate trading done in derivatives and equities markets. There are two main processes that are carried out by CCPs: clearing and settlement of market transactions.

certificate of deposit (CD)

Tradable certificate showing that a particular sum has been deposited with a bank for a certain time at a certain interest rate. CDs are non-interest bearing and are quoted at a discount to their par redemption value.

CDO

See collateralised debt obligation.

CFA[®]

See Chartered Financial Analyst.

CFA Institute

International non-profit organisation composed of more than 90,000 individual voting members and 136 non-voting member societies whose mission is to set a higher standard of professional excellence for the investment profession. Individual members either hold the CFA designation or are active in the investment business and agree to abide by the CFA Institute ethical requirements. The CFA Institute administers the CFA Examination and is responsible for the Global Investment Performance Standards (GIPS™). Previously called the Association for Investment Management and Research (AIMR). (See also GIPS, UKIPS.)

CGT

See capital gains tax.

Chartered Financial Analyst (CFA®)

Qualification awarded by the CFA Institute. Its curriculum develops and reinforces fundamental knowledge of investment principles. Examinations measure a candidate's ability to apply these principles at a professional level. (See also CFA Institute.)

chartism

Form of technical analysis where charts are used to identify trends and study movements in share prices or financial and economic indicators, with the aim of predicting future (often short-term) changes in stock market prices.

Chinese wall

Separation of activities in a financial institution to prevent confidential and/or price-sensitive information from passing from one area to another. For example, it is normal practice for a financial services institution to separate corporate finance, stockbroking and fund management using Chinese walls.

churning

Excessive trading of an investor's portfolio. Sometimes used unethically to generate extra commissions.

CIF

See common investment fund.

circuit breaker

Stock exchange rule or other action designed to maintain orderly trading during periods of market, for example by preventing computer-generated trades from sending the market into a downward spiral.

clean fees

All-inclusive fund management fees, to which no additional charges (e.g. custody, administration) will be added.

cleantech

Products, services and processes geared towards reducing or eliminating the environmental impact of a means of production. May include investments in agriculture, energy, manufacturing, materials, technology, transportation and water.

clearing house

Institution positioned between two respective counterparties and responsible for the trade settlement, thus removing counterparty risk from both parties.

closed-end fund

Collective investment schemes that issue a fixed number of shares which are then usually traded on a stock exchange. The price of each share is determined by supply and demand in the marketplace. The share price may stand at either a discount or premium to the net asset value of the underlying investments. Investment trusts are examples of closed-end funds. (See also open-ended funds.)

closet indexing

Running of an "active" portfolio by an "active" fund manager where the fund's holdings are insufficiently different from the composition of the index for the fund's performance to deviate significantly from the index.

closing price

Price at which the final market transaction in a security took place on a particular business day.

coattail investing

Trading strategy in which investors duplicate the performance of a successful (and usually well-known) investor by copying his or her trades as soon as they are made public. This is a risky strategy, as there is a time delay between when the successful investor's trades occur and when they are made public.

collar hedge

Investment strategy obtained through a combination of put and call options. This option-based strategy results in stabilised portfolio returns by obtaining protection against a major decline in portfolio value in exchange for the sacrifice of part of the portfolio's appreciation in a major rally.

collateral

Assets placed on deposit as security for an open position (e.g. loan, swap, short sale), which may be used to offset the potential loss by a counterparty should the first party default on its obligation.

collateralised debt obligation (CDO)

One of a series of bond-type investments, backed by a pool of assets, such as loans or mortgages, which can be tailored to match one or more investor's requirements in terms of credit rating, risk, duration, timing of payments, etc.

collateralised mortgage obligation (CMO)

Security that pools together mortgages and separates them into tranches paying different rates of interest, depending on their terms to maturity. In most CMOs, coupons are not paid on the final tranche until all other tranches have been redeemed (the coupons are added to the capital outstanding in the interim). Such a tranche is called an accretion bond, an accrual bond or a Z-bond.

Combined Code

Code of good practice in corporate governance in the UK, set out in the Cadbury, Greenbury, and Hampel and Higgs reports. Among other things, the Code refers to institutional shareholders, encouraging them to take responsibility for voting and, where appropriate, to enter into dialogue with the companies in which they invest.

commercial mortgage-backed security (CMBS)

Mortgage-backed security collateralised by commercial rather than residential mortgage loans. Unlike residential MBSs, CMBSs are not usually subject to prepayment risk, as most underlying loans do not permit prepayment without substantial penalties.

commercial paper

Unsecured short-term debt issued by banks, corporations and other borrowers.

commingled fund

See pooled fund.

commission

Fee paid to a stockbroker for buying or selling a security, usually calculated as a percentage of the value of the security. Commissions vary across markets and between brokers. (See also soft commission.)

commission recapture

Facility whereby a network of brokers agrees to rebate a portion of commissions to clients. This is usually managed by a third party that leverages collective clients' buying power.

commodity

Any raw material — examples include oil, gold and cattle.

common investment fund (CIF)

Pool of assets from more than one entity invested under one investment vehicle.

common stock

US name for ordinary shares.

compound interest

Method of accumulating interest, where interest is paid on both the initial investment and the interest accruing during the period.

compound option

Option where the underlying asset is itself an option.

compound rate of return

Total return calculated by multiplying returns for different periods.

compressed valuations

Market conditions in which relative pricing differences between the highest- and lowest-priced segments of a stock market are smaller than the long-term average. Typically favours growth investors, since faster-growing stocks will be trading at a lower-than-normal premium to the market. Value investors, on the other hand, will struggle to find stocks trading at deep discounts to the market.

concentrated portfolio

Portfolio with a small number of securities. This relative lack of diversification aims to achieve higher performance than the benchmark but with a commensurate increase in risk.

consensus fund

Form of passive management that aims to match closely the average return achieved by a specified group of actively managed portfolios. These funds usually operate by continually adjusting their assets to bring them into line with the average asset mix of the specified portfolios and then by investing, within each area, in securities that represent the market index.

consideration

Something of value, such as money or personal services, given by one party to another in exchange for an act or promise.

consolidation

Process where a company increases the nominal value of its shares, and decreases the number of shares in issue by combining multiple denominations. For example, consolidating five shares of 5p each into one share of 25p.

constraints

Limits or restrictions imposed on an investment manager in relation to particular shares, sectors or markets for various reasons, for example, risk reduction or ethical considerations.

Consumer Price Index (CPI)

US measure of price inflation.

Consumer Prices Index (CPI)

Measure of price inflation in the UK. Differs from the RPI in the particular households it represents, the range of goods and services included, and the way the index is constructed. Compiled by the Office for National Statistics and used for the UK government's inflation target. The UK government's name for the Harmonised Index of Consumer Prices (HICP), a standardised European-wide measure of inflation. (See also Retail Prices Index.)

contango

In a forward contract, the situation where the price of a commodity for future delivery exceeds the spot price of the commodity. The difference is considered to indicate the cost of holding the physical asset for future delivery. (See also backwardation.)

contract note

Written record of an agreement to buy or sell securities.

contrarian

Investor who takes a position in the market contrary to that of the majority.

conventional bond

Bond where the coupon and principal payments are fixed.

convertible bond

Bond which, under certain conditions, the owner can opt to convert into another security, normally an ordinary share.

convexity

Measure of the way a bond's duration changes in response to a change in interest rates. Positive convexity is evidenced when the proportional change in a bond's duration is greater than the proportional decrease in interest rates, and vice versa for negative duration.

core holding

Security or asset which is considered to be a long-term holding in a portfolio and, as such, is less likely to be actively traded. They are often high-quality securities with a history of fairly steady performance.

core/satellite

Generally, the partitioning of a plan's assets between a core portfolio of lower risk holdings (which may be managed passively) and one or more actively managed (satellite) portfolios.

corporate bond

Bond issued by a corporation (as opposed to a government) promising regular payments on a specified date or range of dates and a final capital payment at redemption.

corporate governance

Means by which shareholders govern the management of a company through the use of voting powers. Also used more generally with regard to the systems by which boards of directors are composed, and companies are directed and controlled.

corporate social responsibility

Initiative to assess and take responsibility for a company's effects on the environment and impact on social welfare. This goes beyond the environmental measures required by law or by environmental protection groups.

correlation coefficient

Measure of the interdependence of two or more variables, for example, the returns recorded by two stock markets. A correlation coefficient can range from -1 (inverse relationship) to +1 (perfect correlation — change in variables will be identical). A correlation coefficient of 0 indicates the absence of a relationship between the variables.

counterparty risk

Risk that the other party in a financial arrangement defaults on its contractual obligations. For example, in a swap, where interest rates increase, the fixed rate payer in the agreement is at risk that the counterparty (the floating rate payer) fails to deliver the increased interest payment.

country allocation

Integral part of the asset allocation process that selects desired weightings in particular geographic regions.

country risk

Risk attached to investing in a given country that relates to the country, for example, political and economic risks rather than other factors more specific to the investment in question.

coupon

Interest rate payment (usually six-monthly) on a bond.

covenant (bond)

Provisions within a borrowing agreement describing the obligations of a bond issuer to protect the interests of the bondholders. Affirmative covenants require the borrower to take certain actions (e.g. retain a certain debt to equity ratio). Negative covenants prohibit the borrower from certain actions (e.g. pay out too high dividends). The breach of covenant might cause the default of the bond.

covenant (pension fund)

Ability and willingness of the sponsor to make good any shortfall in a scheme's funding. A strong covenant reflects a financially strong sponsoring company, which can be relied upon to rectify funding shortfalls in the pension fund should they emerge. This imparts a degree of investment flexibility and freedom lacking for a pension fund with a weaker covenant from its plan sponsor.

covenant (property)

Commonly used in property investment to refer to the quality of a tenant. A tenant with a good covenant is of high quality and unlikely to break the terms of the agreement, for example, the government or a government agency. The covenant also sets out the obligations of tenant and landlord.

coverage

Proportion of a portfolio's benchmark that is actually held in the portfolio, measured either by market capitalisation or number of stocks. Also refers to the researching of a particular stock by an analyst, who will issue reports and recommendations to fund managers.

covered option

Option where the writer owns the underlying asset (of a call option) or holds cash of equal value to the strike value of the underlying asset (for a call option).

CPI

See Consumer Price Index (US measure of price inflation) or Consumer Prices Index (UK measure).

credit

Debt issued by non-government bodies.

credit crunch

Describes the global financial crisis of 2008/early 2009 which was driven by a chronic lack of liquidity (credit) in financial markets across the world.

credit default swap

Contract between two parties who agree to exchange payments based on a contingency residing with a third party. Typically, the protection buyer will make periodic payments to the protection seller, who in turn agrees to make a contingent payment to the buyer upon the occurrence of a credit event on the third party's asset (e.g. the third party defaulting on a loan repayment).

credit rating

Rating given by a credit-rating agency, based on its view of the financial strength of a borrower and the likelihood of default (i.e. inability to meet debt obligations). The highest rating is usually AAA, and the lowest is D.

credit risk

Risk of suffering loss due to another party defaulting on its financial obligations. Also known as default risk.

credit spread

Difference in the yield available on a corporate bond compared to a government bond. Credit spreads will generally be higher for companies with lower credit ratings. (See also swap spread.)

Credit Support Annex (CSA)

Provides credit protection by setting forth the rules governing the mutual posting of collateral. CSAs are used in documenting collateral arrangements between two parties that trade privately negotiated (over-the-counter) derivative securities. A clean CSA is one that permits only GBP cash and UK gilts to be posted as collateral in GBP-denominated transactions.

Credit Support Deed (CSD)

Annex to an ISDA Master Agreement, drawn up under English law, which allows parties to the agreement to mitigate their credit risk by requiring the out-of-the-money party to post collateral (usually cash, government securities or highly rated bonds) corresponding to the amount which would be payable by that party were all the outstanding transactions under the relevant ISDA Master Agreement terminated. The equivalent agreement under New York law is known as the Credit Support Annex (CSA).

CREST

Real-time settlement system for trading of UK and international shares, UK government and other corporate securities. The system is operated by CRESTCo.

crossing

Transactions undertaken directly with other investors executing the opposite trade, to minimise spread costs and market impact. Internal crossing opportunities are those where the investors are simultaneously trading with a transition management firm. External crossing involves actively seeking out market participants who are executing trades in the opposite direction.

cum dividend

Security where the purchaser is entitled to receive the next coupon or dividend. The opposite of ex-dividend.

currency hedging

Strategy designed to reduce or eliminate exchange rate risk in a portfolio of non-domestic assets through the use of currency futures/forwards or by the purchase, sale or borrowing of the exposed currency.

currency overlay

Investment management technique aimed solely at managing an investor's overseas currency exposure, either actively or passively.

currency risk

Risk of incurring losses in the value of overseas investments as a result of movements in international exchange rates. Can also refer to the additional volatility caused by exposure to assets in foreign currencies. Also known as exchange rate risk.

currency swap

Effectively the exchange of two sets of cash flows in different currencies. Involves the purchase/sale of a currency in the spot market against the simultaneous purchase/sale of the same amount of the currency in the forward market. The agreed payment in each currency changes hands on each swap date (unlike an interest rate swap, where the payments are netted off against each other).

curve risk

Risk that changes the shape and/or slope of the yield curve result in mismatched performance between an actual bond portfolio and its benchmark, or between assets and liabilities where these have different durations.

cushion

In portfolio insurance products, the difference between the cost of buying the zero coupon bond and the principal amount guaranteed. (See also portfolio insurance.)

custodian

Organisation responsible for the safekeeping of assets, income collection and settlement of trades for a portfolio; independent from the asset management function.

cyclical stock

Security which is sensitive to movements in the economic cycle — generally performs well in periods of falling interest rates or growth but poorly during an economic downturn. For example, financial stocks and capital goods. (See also defensive stock.)

cyclical trend

Recurring movements in prices or interest rates, usually linked to stages in the business cycle.

D

DAX index

Stock market index of 30 leading German shares.

DB

See defined benefit.

DC

See defined contribution.

DCF

See discounted cash flow.

debenture

Loan made to a company, secured against its assets.

Debt Capital Markets (DCM)

The environment in which the issuance and trading of debt securities occurs. Debt is often used as an alternative to financing through equity, and can add diversity to funding.

debt/equity ratio

Company's borrowings divided by its issued share capital. It is a measure of the amount of gearing (leverage) of a company and an indicator of financial strength. A company with a higher debt/equity ratio can offer greater returns to shareholders, but these will be more volatile than if the gearing were lower.

decile

Relative ranking (in tenths) of a particular portfolio (or manager) in a league table of returns. For example, a decile ranking of 1 (or "top decile") indicates a performance in the top 10% of portfolios surveyed, a decile ranking of 2 (or "second decile") indicates performance in the next 10%, and so on.

deep discount bond

Bond priced significantly below face value, typically a zero coupon bond or a distressed bond.

default

- a. Failure to pay interest or principal promptly when due.
- b. Failure to make margin payments on a futures contract.
- c. Failure to comply with other conditions of an obligation or agreement.

defensive stock

Stock which is expected to be less volatile than the overall market — for example, utilities stocks. (See also cyclical stock.)

deferred annuity

Annuity whose payments commence from a future date. Deferred annuities can be bought from an insurance company to secure a pension in the future.

defined benefit (DB)

Pension arrangement where the benefits payable to members are clearly specified, usually as a percentage of salary at, or near, retirement. The contributions that are required to ensure that this commitment can be met will vary depending on the plan's investment and demographic experience and the benefits to be provided. The employer bears the investment risk in such an arrangement.

defined contribution (DC)

Pension arrangement where the rate of contribution paid by the employer and/or the employee is defined (usually a percentage of salary). The benefits paid to members will depend on the contributions paid into the plan on behalf of the member, the investment return earned on those contributions, and the terms available at retirement for converting the fund into a pension. The employee/member bears the investment risk in such an arrangement. Also known as money purchase.

deflation

Decline in the prices of goods and services — that is, the opposite of inflation.

delta hedging

Strategy for combining derivatives with holdings in the underlying assets in such a way that the price of the overall portfolio does not change with small instantaneous changes in the price of the underlying asset. Used by investment banks, for example, to control risks in their derivative positions.

derivative

Financial instrument whose value is dependent on the value of an underlying index, currency, commodity or other asset. Examples include options, futures, forwards and swaps.

deterministic modelling

Liability-matching modelling that assumes that the liability payments and the asset cash flows are known with certainty.

devaluation

Formal reduction in the value of a currency relative to other currencies or, historically, to the price of gold. This is different from depreciation, which is the gradual reduction in the value of a currency through market movements.

development capital

Capital investment into companies which are generally profitable but which require further equity finance to expand.

dilution

Reduction in earnings per share and book value per share due to an increase in the number of shares issued. This can occur if convertible securities are converted, if warrants or stock options are exercised, or if a rights issue or scrip issue takes place.

dilution levy

Charge levied on a new investor entering or leaving a pooled fund to ensure that other investors in the fund do not suffer the trading costs of the new investor.

dirty fees

Fund management fees to which extra (often non-explicit) charges are added, for example, for custody, overseas transactions, etc.

discount broker

Stockbroker who charges lower commission rates than a full service stockbroker but usually provides a more limited service.

discount rate

Rate of interest used to convert a cash amount occurring in the future into a present value.

discounted cash flow (DCF)

Process by which future cash flows (for example, dividends or interest payments) are adjusted to allow for the time value of money to arrive at a value in today's terms. Discounted cash flow models are used to determine the fair value of securities, capital projects and corporate entities. (See also net present value.)

discretionary mandate

Instruction given to an investment manager, giving the manager total decision-making authority to manage the assets against a specified benchmark.

distressed debt

Corporate debt where the originator of the debt (the borrowing company) is currently in or approaching financial distress, such that default on the debt has either occurred or is imminent. (See also junk bond.)

diversified growth fund

Actively managed fund designed to generate investment return by investing in a range of growth-seeking asset classes, such as equities, property, commodities, private equity, corporate bonds, etc.

diversification

Risk management technique which involves spreading investments across a range of different investment opportunities, thus helping to reduce overall risk. The risk reduction arises from the different investments not being perfectly correlated. Diversification can apply at various levels, that is, diversification between countries, asset classes, sectors and individual securities. Diversification reduces both the upside and downside potential and allows for more consistent performance under a wide range of economic conditions.

dividend

Discretionary payment out of profits by a company to its shareholders.

dividend cover

Company's post-tax earnings divided by the total amount it has paid in dividends for a particular period. This is an indication of a company's ability to maintain its dividend rate.

dividend discount model

Model used to estimate a security's value by performing a discounted cash flow analysis of future expected dividends.

dividend yield

Return to investors represented by a company's dividend per share divided by its current share price.

DJIA

See Dow Jones index.

double tax agreements

Agreements between countries to offset tax liabilities in one country against those in another, so that the same or similar taxes will not be paid twice.

Dow Jones index (DJIA)

The Dow Jones Industrial Average index. It is the most frequently quoted measure of the performance of industrial stocks on the New York Stock Exchange. It covers a relatively small number of leading shares, but nonetheless its movements can influence other stock markets.

downgrade

When a bond's credit rating is lowered. Usually caused by an event such as a negative trading statement by the issuer, which in turn increases the risk that it might be unable to meet its future payment obligations.

draw down (private equity)

Call on part or all of an investor's outstanding commitment to a private equity fund.

due diligence

Investigation and verification of material facts regarding a proposed transaction. For example, the potential purchaser of a company would undertake due diligence before completing the deal, requesting access from the target company to information that is not publicly available.

duration

Average term (in years) of the payments from a bond, taking into account the present value of each payment. The longer the duration, the more sensitive the price of the stock to changes in interest rates. (See also modified duration, convexity.)

dynamic asset allocation (DAA)

Any portfolio investment strategy where the proportion of the portfolio invested in a given asset class is varied over time.

dynamic portfolio insurance (DPI)

Form of portfolio insurance in which the amount invested in the risky asset is variable. Most DPI approaches involve selling assets where returns have been weak in order to ensure that the targeted level of return is achieved. (See portfolio insurance.)

E

EAFE

Europe, Australasia and Far East. Often used to describe an overseas equity mandate for US investors.

early stage (private equity)

Existing company requiring finance which has developed a prototype product or service but still has limited revenue.

earnings

Net profits of a company available for distribution to shareholders.

earnings per share (EPS)

Company's annual earnings divided by the number of shares in issue. "Fully diluted" earnings per share takes account of the total number of shares allowing for any convertible securities.

earnings yield

Company's earnings per share divided by its current share price. This is the inverse of the price/earnings (P/E) ratio.

EASDAQ

Independent, Brussels-based, pan-European stock market set up in November 1996. It is set up along similar lines to NASDAQ in the US and tends to attract smaller and growth-oriented companies. Companies are allowed to list and trade in euros, sterling or US dollars.

EBITDA

Earnings before deduction of interest, taxes, depreciation and amortisation (an accounting term).

ECB

See European Central Bank.

ECN

See electronic communications network.

economic cycle

Historic analysis of markets and economies demonstrates that they generally move in cycles. A typical cycle would start with a period of low economic activity and low confidence, depressing consumer spending. After some time, in anticipation of an economic and earnings recovery, share prices start to rise. Interest rates fall and stimulate economic activity, and as the economy improves, company earnings rise. This expanding economy eventually puts upward pressure on inflation and interest rates. Bond prices fall and, as interest rates and inflation rise further, company earnings are hit and share prices slump, leading to the start of another cycle.

economic indicators

Statistics that give an indication of the state of an economy. Commonly used indicators in investment analysis include wholesale and retail inflation measures, growth for various sectors of the economy, short- and long-term interest rates, the extent of unused manufacturing capacity and retail sales.

economist

Person who analyses trends in economic indicators and attempts to forecast economic growth, likely trends in interest rates and inflation and the impact of such factors on financial markets.

efficient frontier

Line of risk and reward that graphs all portfolios providing the greatest expected return for a given level of risk or, equivalently, the lowest risk for a given expected return.

efficient market

Investment market where new information is quickly reflected in the price of securities in the market. It is generally more difficult for an investor to outperform in such a market.

efficient portfolio

Portfolio which appears on the efficient frontier. There is no portfolio which has a greater expected return with the same level of risk.

electronic communications network (ECN)

Electronic system that brings buyers and sellers together for the electronic execution of trades. It disseminates information to interested parties about the orders entered into the network and allows these orders to be executed. The ECN thereby networks major brokerages (and individual traders) so that they can trade directly between themselves without having to go through a middleman.

emerging market

Financial market in a developing or newly industrialising country. Such markets can deliver high returns because of the rapid pace of industrialisation, but can be risky owing to low liquidity, lack of reliable information and potential political instability.

emerging market debt

Debt issued by governments and corporations within developing economies. Debt may be issued in the currency of the issuing country or, more commonly, in the currency of a major industrialised economy.

Employee Retirement Income Security Act (1974) (ERISA)

Federal law in the US which governs pension plans in the private sector and specifies minimum levels of pension plan participation, vesting, funding and many other fundamentals. Also introduced stringent new standards of fiduciary responsibility on investment issues.

enhanced indexation

Method of investment which attempts to outperform an index, but to a lesser extent than a traditional active manager. (See active management, passive management.)

enterprise value (EV)

Market value measure of a company from the point of view of the aggregate of all the company's sources of funding, namely: debtholders, preferred shareholders, minority shareholders and common equity holders. Because EV is neutral with respect to capital structure, it is useful when comparing companies with diverse capital structures. (See EV/EBITDA.)

EPS

See earnings per share.

equal-weighted index

Index in which each component security is given an equal value weighting. This results in the need for frequent rebalancing, as the relative weightings are disturbed whenever the value of one security moves relative to another. (See capitalisation-weighted index.)

equalisation

As income from a unit trust accrues between dividend distributions, it is added to the unit price. An investor purchasing units will thus be paying for some of the next dividend payment in the unit price, effectively turning capital into income (which is taxable). Unit trust managers state an equalisation factor with each distribution to indicate the proportion of the total distribution that is not subject to income tax.

equities

Commonly used term for ordinary shares.

equitisation

Using derivatives to create an exposure to equity market price movements, without actually investing in stocks. The derivative positions combined with cash holdings can be arranged so as to give the same returns as having the assets actually invested in stocks. The cash kept in a portfolio for regular settlement of trades can be equitised so that the portfolio is fully exposed to the stock market.

equity risk premium

Extra return expected from investing in equities rather than a riskless asset to compensate for the additional risk/volatility associated with equities.

equivalent yield (real estate)

Time-weighted average of the initial yield and reversionary yield. (See initial yield [real estate], reversionary yield [real estate].)

ERISA

See Employee Retirement Income Security Act (1974).

ETF

See exchange traded fund.

ethical investment

Term given to an investment philosophy focusing on investing in companies according to non-economic criteria such as ethical or religious beliefs. (See socially responsible investment, green investing.)

euro (€)

Single currency unit adopted by member countries of the Economic and Monetary Union (of the European Union; EMU) launched on 1 January 1999, with notes and coins introduced on 1 January 2002.

Eurobond

Bond that is issued by an international syndicate or government and offered to investors in a number of countries at the same time. It is usually issued by a non-European company for sale in Europe, but it does not have to be. Eurobonds are issued outside the jurisdiction of any single country and are traded through banks rather than on stock exchanges.

euroland/eurozone

Group of countries which use the euro as their common currency.

European Central Bank (ECB)

Independent central bank responsible for setting and implementing monetary policy and conducting foreign exchange and reserve operations for the members of the (European) Economic and Monetary Union (EMU). Established in June 1998 as an essential part of the adoption of a single currency.

European-style option

Option which can only be exercised for a short, specified period of time just prior to its expiration, usually a single day.

Eurotop indices

Indices covering the largest companies in Europe and calculated by FTSE International. Variations are Eurotop 100 (top 100 companies) and Eurotop 300 (top 300 companies).

event risk

Risk of a substantial change in the market price of a stock due to a particular event. Often used in bond markets to describe the risk that the rating of a bond will drop due to the taking on of additional debt or a recapitalisation by a company.

EV/EBITDA

Method of valuing companies calculated by dividing a company's enterprise value (market value of equity plus net debt of the company) by its earnings before interest, tax, depreciation and amortisation. This measure relates short term cash flow generation to market valuation.

excess return

Return of a security or portfolio in excess of its benchmark.

exchange rate

Measure of the value of one country's currency in terms of another. Exchange rates may be either floating (determined by the market forces of supply and demand) or fixed (values are artificially held at a certain rate or within a certain narrow band of the value of a specified currency).

exchange traded fund (ETF)

Fund that tracks an index, but can be traded like a stock. The most well-known ETF is the SPDR, which tracks the S&P 500.

exchange traded options

Options traded on a recognised exchange.

ex-ante

Forward-looking measure or estimate. (See tracking error.)

ex-dividend

Security where the purchaser is not entitled to receive the next coupon or dividend payment. A security's cum-or ex-dividend status is dependent on the time it is purchased in the dividend/coupon payment cycle. (See cum dividend.)

exempt approved pension plan

Plan other than a personal pension approved under the Inland Revenue for certain tax advantages in relation to contributions and investment returns.

exercise price

Price at which a call option or put option may be exercised. Also known as the strike price.

exotic options

Generic term for complex financial engineering products created using a combination of basic option contracts.

exit strategy (private equity)

Method by which venture capitalists realise their original investment — usually by sale or flotation.

expected return

Statistical measure of the average future return from an asset or portfolio. Often an asset with a higher expected return will also have a higher standard deviation of return. (See also mean, standard deviation of return.)

expiry date

Last date on which an option can be exercised.

ex-post

Backward-looking measure using actual historical data. (See also tracking error.)

F

factor risk

Common trait that causes many securities to trade together. For example, country risk, sector risk, economic growth rate.

face value

See nominal value.

fair value

Price deemed to accurately reflect the price of a security, based on measurable valuation fundamentals. Considered to be an equitable valuation from the points of view of both buyer and seller. Removes the potential for a market participant making risk-free profits from arbitrage.

fallen angel

Highly rated investment grade bond that falls (or is downgraded/re-rated) below investment grade.

FAS87

See Financial Accounting Standard 87.

Federal funds rate

Interest rate at which the Federal Reserve (the US Central Bank) lends funds from depository banks with excess reserves to depository banks seeking additional reserves overnight. Manipulation of the federal funds rate is the principal instrument for managing monetary policy in the US. Also known as fed funds rate.

fiduciary

Person or entity that acts for the benefit and on behalf of another person or group of persons. A fiduciary holds a legally enforceable position of trust.

Financial Accounting Standard 87 (FAS87)

US accounting standard which sets out the accounting treatment of retirement benefits such as pensions.

Financial Conduct Authority (FCA)

Independent body formed as one of the successors to the Financial Services Authority (FSA), focusing on the regulation of conduct by the financial services industry in the UK.

Financial Reporting Standard 17 (FRS17)

UK accounting standard which sets out the accounting treatment of retirement benefits such as pensions and medical care during retirement. It has replaced SSAP24.

fiscal policy

Collective term for decisions made by a government in relation to tax and spending. It is a tool by which a government influences its economy. Typically, spending will exceed income (taxation) when a government is trying to stimulate the economy, and vice versa when it is trying to temper inflationary growth.

Fitch Ratings

Independent rating agency that assesses the creditworthiness of companies and their debt. The highest rating awarded is AAA, and the lowest is D. Other well-known agencies are Standard & Poor's and Moody's.

fixed interest asset

Asset where the timing and amount of future interest or coupons are specified (and fixed) at the time of issue. (See also real asset.)

flat yield curve

Where short, medium and long maturity bonds in the market all have similar yields.

flight to quality

Passage of funds from riskier to safer investments during periods of market uncertainty — for example, investors seeking government rather than corporate bonds. Can also refer to foreign investors withdrawing capital from a country during times of political or currency instability.

floating rate bond/floating rate note (FRN)

Bond with a variable coupon rate, periodically reset based on some predetermined benchmark interest rate. Floating rate bonds are generally issued by banks or companies whose earnings are closely tied to interest rate fluctuations as a way of more closely matching interest payments to earnings.

floor

Interest rate contract where the purchaser receives from the seller, at the end of each period prior to expiry of the contract, the difference between the strike interest rate and current interest rate, should the interest rate fall below the strike. For example, agreement to receive money for each month during which LIBOR is less than 4%. (See also cap.)

flotation

First issue of shares by a company on a stock exchange. (See also initial public offering.)

forex

Common abbreviation for “foreign exchange”.

forward contract

Contract to buy or sell an asset at an agreed price at a specified date in the future. Forwards are similar to futures but are not exchange traded and need not be standardised.

forward exchange rate

Exchange rate fixed today for the purchase or sale of a currency at a specified future date. It is calculated on the basis of a spot exchange rate and the interest rate differential between the two relevant countries.

forward interest rate

Interest rate fixed now on a loan that will occur at a specified future date.

forward rate agreement (FRA)

Form of a forward contract between two parties to exchange an interest rate differential on a notional principal amount at a given future date. Settlement is through payment of the net differential only. A swap is a combination of FRAs.

forward rate option

Contract giving the buyer the right, but not the obligation, to exchange an interest rate differential on a notional principal amount at a given future date.

FRN

See floating rate bond/floating rate note.

free-standing additional voluntary contributions (FSAVC)

Contributions paid by individuals into investment vehicles administered independently of their occupational pension scheme. Accrue benefits on a money purchase basis. (See also additional voluntary contributions.)

front-end load

Initial payment, in the form of commission, paid to an intermediary or manager upon purchase of a security or unit in a pooled fund. (See also no-load.)

front office

Dealing, research and marketing activity of an investment management company. (See also back office.)

front running

Illegal practice in which a bank, aware of a large order, executes a trade in the market prior to the release of the order to profit from an anticipated favourable price move.

FRS17

See Financial Reporting Standard 17.

FSA

See Financial Services Authority.

FSAVC

See free-standing additional voluntary contributions. (See also additional voluntary contributions.)

FTSE 100 index

FTSE international index of the top 100 companies in the UK by market capitalisation. It is the most frequently quoted measure of the UK market and is also known as the “Footsie”. (The FTSE 250 measures the next 250 largest companies. The FTSE 350 measures the top 350 companies).

FTSE All-Share Index

FTSE index for the main UK stock exchange. The index covers approximately 800 companies.

FTSE indices

Family of indices compiled and promoted by FTSE International, covering most major stock markets and regions worldwide.

FTSE International

Organisation that produces financial market indices with the involvement of the Faculty and Institute of Actuaries. It is co-owned by the Financial Times and the London Stock Exchange.

fully funded

Relates to a situation where a scheme’s assets are sufficient to meet its liabilities (i.e. the scheme’s assets are sufficient to meet its current and future benefit obligations).

fund manager

Usually a member of an investment management team who is responsible for ensuring that client portfolios are invested in accordance with agreed mandates and are kept in line with the asset mix specified by the investment team. The fund manager may also be responsible for client reporting and relationship management. (See also investment manager.)

fund of funds

Pooled fund which invests in other funds rather than directly in underlying securities. Differs from a manager of managers in that it is a combination of funds, each of which is separately available. A manager of managers appoints underlying managers to invest separate portions of a single fund. (See also manager of managers.)

fundamental analysis

Assessment of a company's share value and potential for future cash flows, profit and dividends based on accounting, economic and business information (hence fundamental factors). (See also technical analysis.)

funding level

For a pension fund, the ratio of the fund's assets to its liabilities. Normally relates to defined benefit pension funds and used as a measure of the fund's ability to meet its future liabilities.

funding risk

Possibility that a defined benefit plan fails to accrue sufficient assets to meet the liabilities as and when they fall due (or more generally the likelihood that funding deteriorates).

futures contract

Forward contract that is traded on an organised exchange and subject to the guidelines and rules applied by that exchange. The features distinguishing the futures market from the forwards market are that the futures market uses a clearing house facility, margin payments are required and the terms of futures contracts are standardised. Establishes an obligation to the buyer and seller (or subsequent holders of the contract) to settle the contract through purchase or sale of the underlying asset at the exercise date.

futures exchange

Market in which futures contracts are transacted.

futures margin

When a futures contract is initiated, a deposit (the initial margin) is paid to the future exchange. This normally represents a small percentage of the value of the contract and helps in protecting the exchange against defaults. As the value of the contract changes, additional payments may be requested (the variation margin).

G

GAAP

Generally Accepted Accounting Principles. For pensions accounting in the UK, GAAP will be FRS17 and in the US FAS87.

GARP

Growth at right (or reasonable) price; a description of the approach some fund managers use to identify potential share purchases.

GDP

See gross domestic product.

gearing

- From an accounting point of view, the amount of a company's total borrowings divided by its share capital. High gearing means a proportionately large amount of debt, which may be considered more risky for equity holders.
- In investment analysis, a highly geared company is one where small changes in underlying conditions produce big swings in profits. Gearing can be financial or operational, if, for example, a company has large fixed overheads.

general partner (private equity)

Manager of the limited partnership — typically the investment manager. (See limited partnership [private equity].)

gilt (-edged)

Bond issued by the UK government. The payments on the gilt may be either fixed (fixed-interest gilt) or increase with inflation (index-linked gilt). So called because certificates used to be gilt-edged.

gilt repo

Practice of selling gilts and simultaneously entering into an agreement to repurchase them at a fixed time and price. A technique used to fund temporary cash shortfalls and long gilt positions, or to gear portfolios by borrowing against gilts. Buying gilts with a resale agreement is called a reverse and is a means of lending cash on a collateralised basis.

gilt strip

See STRIPS.

GIPS™

See Global Investment Performance Standards.

Global Investment Performance Standards (GIPS™)

Set of minimum performance presentation standards for investment managers. Maintained by the CFA Institute and intended for global use.

global tactical asset allocation

Form of tactical asset allocation that employs derivatives, among other strategies, to take positive and negative positions on equity and bond mandates and currencies that the manager's research indicates are relatively attractively/unattractively valued.

GNP

See gross national product.

government bond

Bond issued by a government. In the UK these are called gilts.

governance

Describes the organisation, control and administration usually carried out by a body or committee.

Greeks

Set of financial ratios pertaining to derivative valuation, designated by the Greek letters delta (Δ), gamma (γ), rho (ρ), theta (θ) and vega (v). They are used to represent the factors that result in changes in value of a derivative contract.

green investing

Investment which actively considers a company's effect on the environment.

greenback

Colloquial term for the US dollar.

gross asset value (real estate)

Sum total of property values held in portfolio (See also net asset value [real estate].)

gross domestic product (GDP)

Total market value of finished goods and services produced in a country in a given year.

gross national product (GNP)

Gross domestic product with the addition of income from abroad by domestic residents, minus income earned in the domestic markets accruing to foreigners abroad.

growth fund

Fund that has the aim of achieving capital appreciation, typically an equity portfolio that has the aim of achieving capital appreciation by investing in growth stocks.

growth investor/manager

Investor who seeks out growth stocks.

growth stock

Stock that is expected to achieve above average earnings growth. Growth stocks normally have a high P/E ratio relative to the market as a whole, as investors anticipate that earnings will increase in the future.

growth style

Investment style focussing on growth stocks.

H

haircut

Difference between the quoted market value of an asset and the value attributed to the asset for the purpose of holding it as collateral.

Hang Seng Index

Principal Hong Kong share price index.

hard currency

Generally refers to currencies of developed economies but is often restricted to refer to the major global currencies, that is, the US dollar, the euro and the yen. (See also soft currency.)

hedge fund

Fund that seeks to generate investment returns by using non-traditional investment strategies, utilising mechanisms such as short selling, leverage, program trading, arbitrage, and tools such options, futures, swaps and forwards (derivatives in general).

hedging

Action taken to protect the value of a portfolio against a change in market prices, often by offsetting the exposure to a specific risk by entering a position in an investment with the exact opposite pay-off pattern. It is usually used to reduce or eliminate risk, although similar techniques can also be used to speculate in a market.

Hedge Funds Standards Board (HFSB)

Industry body responsible for creating and monitoring best practice standards for hedge fund managers. It is an independent body, and compliance with the standards by hedge funds is voluntary.

high yield bond

See junk bond.

high yield stocks

Shares which have a higher than average dividend yield or those where a relatively high proportion of the total return is derived from dividend income. Typical examples of high yield stocks are utilities.

historic volatility

Volatility as mathematically determined from price fluctuations of the underlying asset over a past specified period of time. (See also implied volatility.)

house view

Formal opinion formed on an issue by an organisation as a whole.

hurdle rate

Minimum rate of return required before a prerequisite profit is made or a performance fee is paid.

hyperinflation

Describes extremely high rates of inflation. Usually coincides with general economic collapse.

IAS19

See International Accounting Standard 19.

IE01

The change in present value of an asset or liability for a 1 basis point change in the implied inflation curve used to value the asset or liability.

IIMR

See UK Society of Investment Professionals.

illiquid

Investment that cannot be quickly converted into cash at a predictable price — for example, real estate and thinly traded securities.

IMA

See investment management agreement.

IMC

See Investment Management Certificate.

immunisation

Matching of assets and liabilities so that each is affected equally by changes in the external environment. For example, a pension plan may be at least partly protected from any change in the cost of buying an annuity by purchasing a long dated bond. While a fall in interest rates will increase the price of an annuity, this will be offset by a corresponding increase in the value of the bond.

implemented consulting

Combined service offered by consultants, whereby trustee clients delegate a range of fiduciary functions to the consultants to implement on behalf of the trust.

implementation shortfall

Quantitative measure of the cost of the transition, which includes both direct and indirect costs. It compares the actual value of the portfolio at the end of the transition process with the value that would have resulted had the transition been implemented instantaneously and at no cost at the outset.

implied volatility

Volatility as calculated by determining the variable in the relevant option pricing formula (e.g. Black-Scholes) based on market option prices. (See also historic volatility.)

IMRO

Investment Management Regulatory Organisation.

in-specie transfer

Direct transfer of a basket of stocks from one manager's portfolio to another without disinvesting and reinvesting.

in-the-money

Indicates whether a traded option has positive intrinsic value. If current market prices make it beneficial to exercise an option, the option has value and is therefore in the money. With call options it is where the exercise price is below the current price of the underlying security. With put options it is the reverse. (See also intrinsic value.)

income bond

Bond that promises to pay interest only when earned by the issuer.

income stock

See high yield stock.

indenture

Written agreement between the issuer of a bond and bondholders that specifies maturity date, interest rate, convertibility and any other options.

index

- a. Measure updated regularly that gives a representation of the movement in value of a particular market or a specified group of securities.
- b. List of prices or other characteristics representing a particular group of goods or services which gives an indication of movements over time — for example, the Retail Prices Index, the Average Earnings Index and the Retail Sales Index.
- c. To invest in line with the index weightings.

index fund

See index-tracking fund.

indexation

- a. Use of index funds. (See also passive management.)
- b. Adjustment of payments or values in line with movements in a particular index of prices or earnings.

index-linked gilt

UK government stock with the interest payments and the final redemption proceeds linked to the Retail Prices Index. Such stocks provide protection against inflation whereas conventional gilts do not.

index-tracking fund

Investment fund which aims to match the returns on a particular market index. The fund may hold all the stocks in the particular index (known as replication) or, more commonly, use a mathematical model to select a sample that will perform as closely as possible to the index (known as sampling). Also known as an index fund.

industry sector

Companies listed on stock exchanges are usually categorised according to their principal area of activity, for example, banks, building materials, electronics, food producers, health care, leisure, oils, pharmaceuticals and retailers.

inflation

Measure of the rate of increase in prices, for example, the movement over time in the Retail Prices Index. (See also index.)

inflation hedge ratio

The inflation PV01 of assets divided by the inflation PV01 of liabilities.

inflation swap

Exchange of two cash flows, one based on an agreed inflation rate for a period and the other based on the actual inflation rate for that period. Typically, the inflation basis will be LPI or RPI.

information ratio

Ratio of excess return to risk taken (as measured by tracking error). Hence, a measure of risk-adjusted return.

initial margin

Returnable collateral that must be deposited by a futures market participant when initiating an open position. It is also required of writers of options.

initial public offering (IPO)

First public sale of a company's equity resulting in a quoted stock price on a securities exchange.

initial yield (real estate)

Annual rent divided by the value of the property.

inside information

Price-sensitive information that is not publicly available — information which only employees or management of a company are likely to know.

insider trading

Illegally trading in shares when in possession of price-sensitive information that is not known to the market.

Institute for Investment Management and Research (IIMR)

See UK Society of Investment Professionals.

institutional fund

Assets managed on an organisation rather than individual level. Types include pension plans, insurance funds, corporate funds, charities and banks.

institutional investors

Investment managers managing money on behalf of institutional and other third-party funds.

inter-bank rate

Rate at which banks bid for or offer funds to each other in a particular market.

interest

Return earned on funds which have been loaned or invested (i.e. the amount a borrower pays to a lender for the use of his/her money).

interest hedge ratio

The interest rate PV01 of assets divided by the interest rate PV01 of liabilities.

interest rate collar

Simultaneous purchase and sale of a cap and a floor with the aim of maintaining interest rates within a defined range for a borrower or lender. The premium income from the sale of the floor reduces or offsets the cost of buying the cap.

interest rate swap

Exchange of two sets of cash flows, usually one based on a fixed interest rate and the other on a floating interest rate.

internal rate of return (IRR)

Constant rate of return that makes the present value of all future cash flows from an investment equal to its purchase price. This is the calculation method usually used for assessing returns from private equity.

International Accounting Standard 19 (IAS19)

Accounting standard (of the International Accounting Standards Board) which sets out the accounting treatment of retirement benefits such as pensions. Currently adopted as standard in Europe.

International Swaps and Derivatives Association (ISDA)

Trade organisation of participants in the market for over-the-counter derivatives. Responsible for creating the standardised ISDA Master Agreement.

intrinsic value (of an option)

Difference between the strike price of a traded option and the market value of the underlying security. (See also at-the-money, in-the-money, time value.)

investment

Asset acquired for the purpose of producing income and/or capital gains for its owner.

investment advice

Advice about investment issues given formally by a suitably qualified person (as defined by the 1995 Pensions Act). The scope of advice might incorporate asset allocation strategy, appointment of investment managers and performance measurement.

investment adviser

See investment consultant.

investment analyst

Individual who specialises in the analysis of companies and their performance. An analyst normally gathers information by studying the information contained in company annual reports, researching the product markets in which a particular company operates, visiting manufacturing sites and meeting with key company personnel. Analysts may also analyse markets and economies.

investment bank

Bank that offers a range of financial services, usually including fund management and advisory work, such as takeover and merger assistance, as well as corporate finance, including the placing of new share and bond issues, arrangement of loan or credit facilities, and stockbroking services.

investment committee

Appointed subgroup of a plan's trustee board responsible for various aspects of the plan's investments.

investment constraints

See constraints.

investment consultant

Person or firm that is suitably qualified to give investment advice (as defined by the 1995 Pensions Act) to trustees or other responsible bodies.

investment grade

Bond rating of equal or greater than BBB (with S&P) or Baa3 (with Moody's), indicating low uncertainty as to the issuer's ability to meet the obligations undertaken in the bond. (See also low grade.)

investment management agreement (IMA)

Important legal document that defines the relationship between an investor and the investment manager. It usually incorporates guidelines and objectives.

Investment Management Certificate (IMC)

UK benchmark examination for individuals engaged in discretionary or advisory management of investments, overseen by SIP.

investment manager

Organisation that invests assets on behalf of third parties for a fee. Can also refer to the individual responsible for day-to-day management of the assets, although this individual is more often referred to as a fund manager or portfolio manager.

investment manager guidelines

Statements contained in an investment management agreement that restrict, permit or prohibit a manager from certain investments when managing a specific mandate.

investment objectives

Results desired by an investor or fund. They may be expressed as a specific performance target or a general statement of intent.

investment performance

Total return earned on a portfolio of assets over a particular period.

investment performance measurement

Calculation and analysis of investment performance usually including a review of sector strategy and stock selection. Returns may be compared with a benchmark fund or index or with the actual returns achieved by other managers or portfolios. (See also WM Performance Services.)

investment philosophy

Set of principles or systems used by investors to govern the way they manage portfolios.

investment risk

- a. Risk that an asset will not deliver the expected returns (or meet the objectives) for which it is held.
- b. Chance that a permanent loss will be sustained on an investment through company failure, default on loans, fraud or other factors.
- c. Volatility in the value of a security or market, usually measured as the standard deviation of returns over a given period.

investment strategy

Investor's long-term distribution of assets among various asset classes, taking into consideration, for example, goals of the trustee group, attitude to risk and timescale, etc.

investment structure

Way in which fund managers are employed to invest assets, in particular the type of investment managers employed (specialists, multi-asset, active or passive) and the number of managers employed. Also called investment manager structure.

investment team

Group of individuals in an investment management organisation who are responsible for the construction of portfolios and the performance of funds under management. The team may include some or all of the following: a strategy specialist, economists, fund managers, investment analysts, equity and bond dealers, currency specialists, derivative specialists, property specialists and money dealers.

investment trust

Closed-end fund quoted on a stock exchange that holds/manages shares and investments in other companies. The closed-end nature means that the price of the fund fluctuates in line with supply and demand as well as in line with the value of the underlying investments. Thus, investment trusts may trade at a premium or discount (usually the latter) to the value of the underlying investments.

investment policy implementation document (IPID)

Document which serves as an adjunct to the SIP, setting out greater detail on, for example, the funds in which a scheme is invested, its strategic benchmark allocations and tolerance ranges for rebalancing around the central benchmark.

IPO

See initial public offering.

IRR

See internal rate of return.

IRS

Internal Revenue Service. It is a branch of the US Department of Treasury and is the country's tax collection agency.

ISDA

See International Swaps and Derivatives Association.

ISDA Master Agreement

Bilateral derivative trading agreement containing general terms and conditions (such as provisions relating to payment netting, basic covenants, events of default and termination). The Master Agreement does not, by itself, include details of any specific derivatives transactions the parties may enter into. These will be covered in an adjoining Schedule and in the Credit Support Deed/Annex. (See also Credit Support Deed.)

ISIN

International Securities Identification Numbering system advocated by the G30. The ISIN code is a unique 12-digit code given to a security and is used worldwide.

issued share capital

Portion of a company's authorised share capital that has been issued by the company (i.e. is publicly held).

issuing house

Financial institutions, often merchant banks, that act as intermediaries between companies seeking capital and the investors prepared to supply it.

J

J-curve effect (private equity)

Illustrative payoff profile for private equity investments, in terms of which short-term losses are expected to be offset by greater profits in the longer term.

JGB

Japanese government bond.

junk bond

Company bond that has been given a low rating/sub-investment grade by credit rating agencies. Junk bonds offer higher expected returns to compensate for the increased risk. (See also distressed debt.)

K

Keynesian economics

School of economic thought (named after John Maynard Keynes) which advocates government intervention and spending to manage the economy, promote growth and control prices.

kurtosis

Measure of the relative peakedness or flatness of a statistical distribution compared to the normal distribution (a statistical distribution often used as a fairly good approximation of reality because it is mathematically easy to manipulate). A normal distribution has kurtosis of 3. Higher kurtosis indicates a relatively peaked distribution and a higher frequency of observations in the tails of the distribution. Lower kurtosis indicates a relatively flat distribution. Equity market returns generally have a higher kurtosis than the normal distribution — in other words, they are “fat-tailed”.

L

laissez faire

View that markets are efficient and government intervention in the economy should be minimised.

large cap stock

Stock with a market capitalisation of among the largest within a market — for example, the capitalisation of one of the top 100 companies in the UK as represented by the FTSE 100 index. In the US, it is defined as a stock with a market capitalisation of over US\$5 billion. (See also small cap stock, mid cap stock.)

last look

Practice of allowing one bank the opportunity to match the pricing arrangements available from other banks in the market, as a condition for their services being employed.

league table

Ranking table of the comparative performance of investment managers or funds in, for example, the Mercer MPA, Russell/Mellon or WM Company surveys. Also called peer group analysis. (See also Mercer Manager Performance Analytics.)

lease

Written agreement under which a property owner allows a tenant to use the property for a specified rent and period of time.

leasehold

Right to hold or use property for a fixed period of time at a given price, without transfer of ownership, on the basis of a lease contract.

leverage

Use of borrowed money to over-invest a portfolio which magnifies both gains and losses. This may be achieved by derivative instruments. Also refers to the debt/equity ratio in a company's balance sheet.

leveraged buyout

Use of borrowed money, usually from private equity investors, to purchase a company. A leveraged management buyout (LMBO) is the purchase of a company, using leverage, by the company's management. (See also private equity.)

Local Government Pension Scheme (LGPS)

Public sector pension scheme for individuals working in local government, local authorities and other public services.

liabilities

Financial obligations — for example, money owed to banks or future pension payments — that must be met to satisfy the contractual terms of the obligation. Liabilities may be time-based (i.e. payable at a specific time) or contingent upon the occurrence of a future event (e.g. retirement, death). (See also asset/liability modelling.)

liability-driven investing (LDI)

Process whereby an investment strategy is set with explicit reference to a specific set of liabilities.

LIBID

London Interbank Bid Rate. The interest rate at which London based banks are prepared to borrow money from other banks, in a specified currency and for a specified period. (See also LIBOR.)

LIBOR

London Interbank Offered Rate. The interest rate at which London-based banks are prepared to lend money to other banks, in a specified currency and for a specified period. (See also LIBID.)

LIBOR-LIBID spread

Difference between the interest rates at which banks will lend to and borrow from one another, typically at least 12.5 bps but sometimes wider (especially for longer periods). This spread is important in swap dealing since cash deposited by companies seldom earns more than LIBID and the floating side of most swaps requires payment of LIBOR.

life company fund

Pooled fund that is operated by a life assurance company. Such funds are similar to unit trusts except that investors own a life assurance policy rather than units.

lifestyle/lifecycle

Adjustment of a member's defined contribution plan asset allocation in line with set measures, for example, years to retirement. The purpose is to reduce risk of loss of pension-buying power as the member approaches retirement.

LIFFE

See London International Financial Futures and Options Exchange.

limited partnership (private equity)

Structure typically used for private equity funds. Investors are limited partners. (See also general partner.)

limited price indexation (LPI)

Method commonly used to increase pensions in payment. The increase is based on the RPI with an annual cap of usually 5% or 2.5% per annum, and pensions are not reduced if the RPI falls over the year.

liquid market

Market with a high degree of liquidity, often resulting from a large number of buyers and sellers. There can be large variations in the liquidity of different equity markets, with the most liquid being the large international markets — New York, Tokyo and London.

liquidity

- a. Degree to which an asset or portfolio is easily marketable or turned into cash. The most liquid equity stocks are those of the large blue chip companies quoted on the large international markets. Liquidity can be measured by considering trading volume relative to a company's issued share capital.
- b. Proportion of liquid assets such as cash and short-term instruments in a portfolio.

liquidity premium

Additional return required to compensate an investor for an investment with lower liquidity than cash. Also known as liquidity risk premium.

listed (stock)

Stock traded on a registered stock exchange — for instance, the NYSE or the LSE.

listing

Acceptance of a security for trading on a registered exchange.

listing particulars

Detailed information a company is required to give about itself when it applies to be listed on a stock exchange. It is published in the form of a prospectus.

loan stock

Another name for a bond, normally used to denote loans issued by non government bodies such as companies.

loan-to-value (real estate)

Debt expressed as a percentage of property value. The greater the loan-to-value, the greater the amount of gearing employed.

London Interbank Offered Rate

See LIBOR.

London International Financial Futures and Options Exchange (LIFFE)

Largest UK futures and options market.

long bias

Long/short fund with a net long position and therefore positive exposure to an increase in the underlying market.

long bond

Bond that has more than 10 years to run to maturity.

long position

State of actually owning a security, contract or commodity. (See also short position.)

long/short fund

Hedge fund comprising a mixture of long and short positions in the same asset class or market. The net market exposure could be long or short (see market-neutral fund). A subgroup of long/short funds, also known as extension strategies and 120/20 or 130/30 funds, where the fund short sells — for example, 20% of the total value of the fund — and uses the proceeds to increase the fund's long position.

low grade

Bond rating of lower than BBB, indicating some uncertainty as to the issuer's ability to meet the bond's obligations. (See *also* investment grade.)

LPI

See limited price indexation.

LSE

London Stock Exchange.

lump sum

Payment of a one-off amount as opposed to a series of periodic payments. Most pension funds allow members to take a lump sum on retirement in return for a reduced pension (a process sometimes called commutation).

M

M&A

See mergers and acquisitions.

managed fund

Pooled fund that invests across a wide range of asset classes.

management buy-in (MBI)

Purchase of a controlling interest of a company by an outside investor where either new management is implemented or existing management is retained.

management buyout (MBO)

Repurchasing of all, or the majority of, a company's outstanding shares by a firm's own management.

management charges

Fees levied by investment managers, usually in the form of a percentage of assets under management (typically either on a fixed scale or on a sliding scale that decreases with fund size). The charge is based on the fund managers' services and usually also includes fund administration costs. In addition, in the case of some pooled funds, a charge may be made on new contributions. (See *also* performance-related fee.)

manager monitoring

Quantitative review of an investment manager's performance against his or her benchmark and within any specified guidelines (e.g. risk control), and a qualitative review of the prospects for future performance from the manager.

manager of managers

Single fund manager who appoints a series of underlying managers in each asset class. Often these underlying managers are specialists targeting higher outperformance. The managers' styles should complement each other within each asset class to avoid style biases. The manager of managers is responsible for monitoring, hiring and firing the underlying managers.

manager structure

Combination of investment managers to run a specified pool of assets (e.g. a pension plan's assets). (See also core/satellite, specialist management.)

mandate

Description of the fund management requirements that an investor demands from a manager — for example, high-risk global equity management. May include performance targets set by reference to a benchmark.

margin

- a. Procedure allowing investors to borrow against their existing holdings to buy more securities.
- b. Collateral required as security against open positions in derivative markets.

market

Public place where buyers and sellers make transactions, directly or via intermediaries.

market breadth

Proportion of the total market that is taking part in the market's up or down move.

market capitalisation

Total market value of securities issued by a company, industry, sector or market(s). It is calculated by multiplying the market price per share by the number of shares issued.

market cycle

See economic cycle.

market index

See index.

market indicators

Technical measurements used by market analysts to forecast the market's direction, such as the volume of trading or the direction of interest rates.

market inefficiency

Condition in which current security prices do not reflect all the publicly available information about a security, such as when some investors receive information before others, or when some investors do not effectively analyse the available information.

market maker

Organisation that undertakes to buy and/or sell certain securities whenever demand or supply exists at their quoted prices. Market makers quote firm buying and selling prices for the shares in which they wish to deal.

market-neutral fund

Long/short fund with no net bias to the underlying market.

market price

Security's last reported sale price (if on an exchange) or its current buying and selling prices (if over the counter) — that is, the price as determined dynamically by buyers and sellers in an open market. Also known as market value.

market risk

Risk, representing the probability of an adverse change in value, which is common to an entire class of assets or liabilities. It is the level of risk in the market that cannot be eliminated by diversification. Also known as systematic risk. (See *also* non-diversifiable risk.)

market timer

Investor who believes that he/she can predict the timing of changes in future market directions and invests based on this belief.

market value

See market price.

market weight

When the allocations to securities in a portfolio are the same as the allocations to securities in a representative sample of the market.

marketability

Measure of the ease with which a security may be bought or sold. If there is an active marketplace for a security, it has good marketability. Marketability is similar to liquidity, except that liquidity implies that the value of the security is preserved, whereas marketability simply indicates that the security can be bought and sold easily. However, low marketability may lead to a widening of the spread between buying and selling processes.

mark-to-market

Recording of the market price or value of a security, portfolio or account on a regular basis, to calculate profits and losses or to confirm that margin requirements are being met.

marketweight

Specific rating within a three-part credit rating system which indicates whether a fixed income security should be bought (overweight), sold (underweight) or held (marketweight). (See *also* overweight, underweight.)

maturity date

Date upon which the last payment is made under a fixed interest stock or bond.

maturity value

Amount that will be received at the time a security is redeemed at its maturity.

MBI

See management buy-in.

MBO

See management buyout.

mean

Average amount or value.

mean reversion theory

Theory that assumes financial ratios and asset class returns have long-term equilibria (means), and that when there is a deviation from these equilibria, reversion to the equilibrium (mean) can be expected.

median

Value of the middle figure in a distribution of values that have been ranked according to size. For example, a median performance among a universe of five managers would be the third-ranked manager. A median return is not the same as the mean and may be above or below it depending on the distribution of returns.

Mellon Analytical Services

One of the main service providers in the UK that independently analyses the performance of pension funds and their investment managers. Owned by Mellon Financial Corporation. Formerly known as Russell/Mellon and Combined Actuarial Performance Services (CAPS).

member profiling (defined contribution)

Analysis of the investment decisions made by members of a defined contribution pension scheme. Member profiling enables trustees to determine the investment options that are being selected by various scheme members and how these options change with respect to factors like age, gender, appetite for risk and salary. Based on the results of the member profiling, trustees are able to improve the investment fund range available to the members of the scheme.

 Mercer Manager Performance Analytics™

Tool developed by Mercer providing comprehensive analysis of investment performance and risk against peer groups, industry medians or relevant index benchmarks.

 Mercer MPA™

See Mercer Manager Performance Analytics.

mergers and acquisitions

Combining two companies to create one larger company that is expected to be more valuable than the individual companies on their own. In an acquisition, one company is a clear buyer aiming to completely take over a “target” company. The target company ceases to exist whilst the buyer company’s shares continue to be traded. In a merger, two companies (usually of similar size) cease to exist as individual companies (with separate stock on the market) and agree to operate as a completely new company with new stock being issued.

mezzanine (private equity)

Company whose flotation on a quoted market is imminent.

mezzanine debt

Hybrid between debt and equity. Often, for example, low-priority debt packaged together with an equity warrant.

MFR

See minimum funding requirement.

mid cap stock

Stock with a middle-ranking market capitalisation within a market — for example, in the UK a mid cap stock is normally considered to be one placed in the FTSE Mid 250 index. In the US, it is defined as a stock with a market capitalisation of between US\$1 billion and US\$5 billion. (See also small cap stock, large cap stock.)

mid price

Average of the bid and offer price of a security. (See also ask price, bid price, offer price.)

MIFID

Markets in Financial Instruments Directive (November 2007). Aims to introduce a single market and regulatory regime for investment services across the 30 member states of the European Economic Area. Its three major objectives are: (1) creating a unified market in investment services for the EU; (2) responding to changes in EU security markets; and (3) protecting investors against fraud and anti-competitive behaviour.

migration risk

Risk that a bond will be downgraded to a lower rating by one of the independent ratings agencies, reflecting its likelihood of default. As a bond migrates downward its price falls.

minimum funding requirement (MFR)

Funding regime for UK-defined benefit pension schemes introduced in 1997 and phased out from September 2005.

modern portfolio theory (MPT)

Blanket name for the quantitative analysis of assets and optimisation of their collective composition, based upon their expected return, expected risk (standard deviation) and correlations. According to MPT, investors should only invest in portfolios (constituting of the previously analysed assets) which generate the highest return at any given level of risk.

modified duration

Level of price sensitivity resulting from small changes in the yield to maturity of a bond. It is measured as the percentage change in the bond's price for a small change in the yield. (See also duration.)

MOM

See manager of managers.

momentum

Extent to which stock market values are supported by a strong level of trading activity and investor interest. Also refers to an investment style of purchasing stocks that have recently exhibited strong price growth.

monetary policy

Management of the economy by use of interest rates and money supply. Monetary policy can be used to reflate or deflate the economy. Interest rates used to be set in the UK by the Chancellor of the Exchequer. In June 1997, however, control over setting interest rates was passed to the Bank of England Monetary Policy Committee (MPC).

money at call

Debt which must be paid upon demand.

money market

Market for short-term loans and deposits.

money purchase

See defined contribution.

money-weighted rate of return

Calculation of the actual return achieved over a period, taking into account actual cash flow experienced by an investor. Since the calculation does not adjust for the timing of cash flows, it is not suitable for comparative analysis of investment manager's performance, since external cash flows are usually beyond the manager's control. Also called internal rate of return. (See also time-weighted rate of return.)

Moody's

Independent rating agency which assesses the creditworthiness of companies and their debt. The highest rating awarded is AAA, and the lowest is D. Other well known agencies are Standard & Poor's and Fitch Ratings.

Morgan Stanley Capital International (MSCI) indices

Family of indices covering most main stock markets and regions worldwide.

mortgage-backed securities (MBS)

Investment instrument that represents ownership of an interest in a group of mortgages. Principal and interest from the individual mortgages are used to pay principal and interest on the MBS.

moving average

Indication of market trends obtained by averaging prices/indices over continuously moving periods, for example, over 30 or 90 days.

MSCI

See Morgan Stanley Capital International indices.

multi-asset management

Where an investment manager's mandate covers a number of different asset classes — for example, UK equities, US equities, UK and overseas fixed income, and cash — and is measured against either a specific or non-specific benchmark. (See also balanced management, specialist management.)

multi-strategy fund

Usually a fund offered by a single investment manager investing in a range of in-house sources of both market risks (beta) and active management techniques. Generally targeted at absolute returns.

mutual fund

US name for an open-ended pooled fund operated by an investment manager.

Myners Code

Set of voluntary principles for UK pension funds encompassing governance, investment decision-making and reporting, arising from the Myners Review and revised from time to time. (See also Myners Review.)

Myers Review

Review carried out by Paul Myers on behalf of the UK government. The review, published in March 2001, investigated the challenges facing institutional investment decision making and recommended that pension fund trustees follow a set of principles known as the Myers Code. (See also Myers Code.)

N

NAFTA

See North American Free Trade Agreement.

naked call

Where the writer of a call option (the “seller”) does not own the underlying security (this is also known as an “uncovered” position). This is a bearish position because the writer expects the stock price to fall. By not holding the underlying security, the writer is essentially exposed to an unlimited loss.

naked put

Where the writer of a put option (the “seller”) does not own the corresponding short position in the underlying security (this is also known as an “uncovered” position). This is a bullish position because the writer expects the stock price to rise. By not holding the underlying security, the writer is essentially exposed to a loss equal to the value of the options’ strike price.

narrow market

Market with little trading activity. Because of the low volume of trading it displays high volatility, high spreads and low liquidity.

NASDAQ

National Association of Securities Dealers Automated Quotations System. US stock exchange that has a particular emphasis on developing and technology companies. The NASDAQ Composite Index is an index covering all stocks in the NASDAQ market.

National Employment Savings Trust

National pension scheme set up to help people on low to moderate incomes with no access to proper employment pension schemes save for an income in retirement. (See also Personal Accounts Delivery Authority.)

national income (NI)

Annual income earned by a country for its production of goods and services.

NAV

See net asset value.

negative convexity

When a bond’s price rises less for a downward move in yield than its price declines for an equal upward move in yield.

negative yield curve

Described as being negative (or inverted) when the yields on short-term bonds are higher than the yields on long-term bonds. This can imply that interest rates are expected to decline, or that there is excess demand for long-term bonds.

NEST

See National Employment Savings Trust.

net asset value (NAV)

Total market value of assets minus its total liabilities. The unit price of an open-ended pooled fund is calculated with reference to the NAV of the fund (the NAV of a unit being the NAV of the fund divided by the total number of units in the fund). The market price of shares in a closed-end pooled fund may stand at either a discount or premium to NAV. (See *also* closed-end fund.)

net asset value (real estate)

Gross asset value less the value of debt (leverage) in a property fund. (See *also* gross asset value [real estate].)

net domestic product

Gross domestic product after deductions for the depreciation of a country's capital goods.

net income

Company's gross sales revenues minus taxes, interest, depreciation and other expenses.

net operating income (NOI)

Gross sales revenue minus operating expenses. There is no deduction for taxes or interest.

net position

Where a fund can short sell securities, the net position refers to the level of a fund's exposure to market risk. For a long/short equity fund, if a fund is 100% long and 30% short, then the net position is 70% (also known as net exposure). Traditional investment funds are 100% long.

net present value (NPV)

Present value of expected future cash flows minus any initial and ongoing investment costs. Often used in capital budgeting to determine whether or not to make an investment (if negative, the investment should not be made).

New York Stock Exchange (NYSE)

Largest stock exchange in the US.

Nikkei

Tokyo Stock Exchange's headline index. It covers only a relatively small number of stocks (225).

nil cost (specific to derivatives)

Simultaneous purchase and sale of options on the same underlying security for the same period with the same premium but at different strike prices.

no-load

Without any sales charge. (See *also* front-end load.)

NOI

See net operating income.

nominal interest rate

Interest rate in monetary terms, unadjusted for inflation. (See *also* real interest rate.)

nominal rate of return

Rate of return expressed only in monetary terms — that is, not adjusted for inflation.

nominal spread

Difference between the redemption yield on a specific bond, and the redemption yield of a gilt of the same maturity. Not considered a good measure of differential pricing, as it does not take into account how changes in the shape of the overall yield curve may impact on relative market values. (See also option-adjusted spread, Z-spread.)

nominal value

Of a bond, its par or face value on which interest and capital repayments are based. Of an equity, the book value at which the shares were issued.

nominee

Person or company that is registered as the owner of a security. The assets of segregated pension plans are usually held in nominee accounts which, for convenience, are registered in the name of the investment management company. However, the pension plan remains the beneficial owner of the securities.

non-diversifiable risk

Risk inherent in a particular market. Owning a greater number of securities from that market will not reduce (diversify away) this risk. Also known as systematic risk.

non-interest bearing note

Type of zero coupon bond.

non-private customer

Category of investor (as required by the FSA) given limited protections under the conduct of business rule. (See also private customer.)

non-rated bond

Bond which has not been rated by a large rating agency (e.g. Moody's or S&P) and therefore carries the risk of potentially being poor quality.

non-systematic risk

Risk attributable to an individual company, pertaining to factors not associated with the sector or broader market. The impact of non-systematic risk factors can be reduced by the diversification of a portfolio.

normal distribution

The most common type of distribution for a variable whereby the probability distribution plots all of its values in a symmetrical fashion and most of the results are situated around the probability's mean. Often associated with the term bell curve, this terminology is an extension of the fact that the graph used to depict a normal distribution consists of a bell-shaped line.

normal yield curve

Described as being normal when the yields on short-term debt are lower than the yields on long-term debt. Also known as a positive yield curve.

North American Free Trade Agreement (NAFTA)

Agreement promoting free trade between the United States, Canada, and Mexico.

note

Short-term debt instrument, usually with a maturity of five years or less.

notional amount

Notional amount for a derivative contract is the quantity/value of the underlying securities to which the contract applies.

novation

Substitution of a new entity for one of the parties to an agreement (e.g. a swap agreement), with the consent of each of the parties involved.

NPV

See net present value.

NYSE

See New York Stock Exchange.

**OECD**

See Organisation for Economic Co-operation and Development.

OEIC

See open-ended investment company.

offer price

Price at which a security or a unit in a pooled fund can be purchased — usually higher than the bid price. (See also ask price, bid price, mid price.)

Official Journal of the European Union

Official publication in which all tenders above a defined monetary value for services issued by public sector organisations within the European Union must be advertised. This includes tenders for investment managers to take on mandates issued by Local Government Pension Schemes.

offshore company

Company incorporated in a country other than that in which its main operations take place, usually where there is little government control and/or low taxes.

OJEU

See Official Journal of the European Union.

OPEC

See Organization of Petroleum Exporting Countries.

open position

Normally used in the context of exchange-traded futures and options. It denotes a position that is exposed to movements in the price of the futures and options.

open-ended funds

Collective investment schemes in which the number of units in the fund varies from day to day according to the number of investors wishing to buy or sell holdings in the fund. The price of units is set by the manager of the scheme by reference to the net asset value of the fund. (See also closed-ended fund, net asset value.)

open-ended investment company (OEIC)

Type of open-ended pooled fund vehicle (see open-ended funds), legally set up as a company and similar to a unit trust in practical operation.

opening price

Price at which a security commences trading at the opening of a trading day.

operating cash flow

Value of cash moving through an organisation as a result of its operational (rather than financial) activities.

operational risk

Risk arising from failed processes in carrying out a company's business functions.

opportunity cost

Cost of missing out on the best choice when making an investment decision. For example, a large fund may be too big to purchase an attractive share without moving the market price against itself, and would miss out on this opportunity compared with a smaller fund that would not move the price.

optimisation

Creation of a portfolio which will give the highest expected total return for a given set of forecasts and estimated risks. (See also efficient frontier, modern portfolio theory.)

option

Right, but not obligation, to buy or sell a security at an agreed price within an agreed time period. (See also call option, put option.)

option-adjusted spread (OAS)

Fixed number of basis points that would need to be added to the gilt yield curve at all durations to equate the market price of a bond with the present value of the bond's future payments, taking into account any options inherent in the bond. Bond options include the right (of the borrower) to repay capital prior to the bond's maturity date, or the right (of the lender) to demand early repayment of capital. Using the OAS rather than the nominal spread allows for direct comparison between option-free bonds and those that have put or call features. (See also Z-spread, nominal spread.)

option writer

Person who "sells" an option. The writer has the obligation to buy/sell the underlying security at the request of the option buyer.

ordinary share

Share in the ownership of a company that gives the holder the right to receive distributed profits and to vote at general meetings of the company. An ordinary shareholder ranks behind all other creditors/investors if the company is wound up.

organic growth

Where a company grows its existing business as opposed to growth through mergers or acquisitions.

Organisation for Economic Co-operation and Development (OECD)

International Paris-based organisation consisting of developed European countries as well as the USA, Canada and Australia. Its mandate is to promote economic and social welfare in each of its member states.

Organization of Petroleum Exporting Countries (OPEC)

Group of countries that collaborate in order to manage their exportation of crude oil to the rest of the world.

OTC

See over the counter.

out-of-market risk

Risk that a portfolio misses out on the returns from a particular market because it is not invested in the market at the time.

Out-of-market risk potentially arises during transitions when cash from selling assets is not immediately available for reinvestment.

out-of-the-money

Option that has no intrinsic value. That is, an option which it would not be worthwhile to exercise immediately — for example, a call option with an exercise price above the current underlying share price, or a put option with an exercise price below the current underlying share price.

outperformance

Used to refer to the performance of a portfolio relative to its benchmark — a portfolio is said to outperform if its return is greater than that of its benchmark. Underperformance is defined similarly.

over the counter (OTC)

Any market which does not operate through a recognised exchange — for example, foreign exchange market, any non-standard option contract.

overlay manager

Investment manager engaged to generate additional returns or to reduce risk through the management of a derivative portfolio which does not impact on the underlying assets held. (See also currency overlay, protection overlay, tactical asset allocation overlay.)

Overnight Index Swap (OIS)

An interest rate swap involving the overnight rate being exchanged for a fixed interest rate. Generally short-term, the interest of the overnight rate portion of the swap is compounded and paid at reset dates, with the fixed leg being accounted for in the swap's value to each party.

overvalued

Security that a fund manager perceives to be worth less than its market price, based on some other valuation criteria.

overweight

- a. Exposure to a specific asset (or asset class) which is higher than the proportion it represents in the market index or benchmark against which the portfolio is measured. Investment managers may take overweight positions in shares or sectors they expect to outperform in order to add value to the portfolio.
- b. Specific rating within a three-part credit rating system which indicates whether a fixed income security should be bought (overweight), sold (underweight) or held (marketweight). (See also marketweight, underweight.)

P

P&L

See profit and loss statement.

Pacific Rim

Far Eastern countries and markets bordering the Pacific area.

PADA

See Personal Accounts Delivery Authority.

Pan-European fund

Vehicle that invests across all European countries including the UK.

parity (convertible bonds)

State in which the value of the equity (or other underlying security) is equivalent to the value of the bond on conversion.

par value

See nominal value.

passive investor

Investor who does not get closely involved with investee companies. Normally invests as a member of a syndicated deal or via a pooled fund.

passive management

Portfolio which aims to replicate a particular market index or benchmark fund and does not attempt to actively manage the portfolio. (See also active management, indexation.)

peer group analysis

See league table.

pension

Regular, periodic payment to an individual, usually following cessation of employment. This benefit will often be defined benefit or defined contribution in nature. (See also defined benefit, defined contribution.)

Pension Protection Fund (PPF)

Independent body set up by the UK government in 2005 with the aim of providing financial assistance to the members of defined benefit pension schemes whose scheme sponsor becomes insolvent. The PPF is funded by a levy imposed on all defined benefit pension schemes. (See also defined benefit, scheme sponsor.)

Pensions Act 1995

Major piece of legislation that was introduced with effect from April 1997. The Act required trustees for the first time to produce and maintain a statement of investment principles (SIP) and introduced the minimum funding requirement (MFR).

Pensions Act 2004

Major piece of legislation following the Pensions Act 1995. Introduced a new statutory funding regime to replace the minimum funding requirement. Under this, pension funds are required to produce a statement of funding principles setting out how they intend to achieve/maintain full funding. Also formally established the Pension Protection Fund (PPF). (See also Pension Protection Fund.)

P/E ratio (price earnings ratio)

Commonly used indicator of the value of a stock, calculated as a company's current share price divided by its earnings per share. A high P/E ratio may be justified because a company is expected to increase its earnings per share or it may indicate simply that the company is expensive.

percentile

Relative ranking (in hundredths) of a particular portfolio (or manager) in a league table of returns. For example, a percentile ranking of 15 indicates that 14% of portfolios performed better and 85% produced a lower return.

performance attribution

Process which assigns over- or underperformance to the different steps taken in the investment management process, such as asset allocation, stock selection, currency management, etc. Used as a means to show where value has been added/lost.

performance measurement

Calculation of a fund's historic return on its investments. This can be performed on total assets or on individual asset classes. For the purposes of analysing a manager's performance relative to a benchmark, performance is calculated on a time-weighted rate of return basis which is unaffected by the size and incidence of external cash flows (which are outside the manager's control).

performance-related fee

Investment management fee determined by the degree of overperformance relative to an agreed benchmark.

permitted investments

Investments detailed in an investment management agreement in which a manager may invest.

perpetual bond

Bond that is issued with no redemption or maturity date. The coupons on a perpetual bond are paid indefinitely.

perpetuity

Stream of cash flows that theoretically will last forever.

Personal Accounts Delivery Authority (PADA)

Public organisation responsible for setting up and managing a national trust-based pension scheme for low to moderate income earners. (See also National Employment Savings Trust.)

PFI

See private finance initiative.

plan sponsor

Employer that sets up and funds a pension plan for its employees. Also called scheme sponsor.

plain vanilla

Describes financial instruments, especially bonds and derivatives, in their most basic form or with standard features. Opposite of exotic.

Ponzi scheme

Fraudulent investment scheme which provides returns to investors either by using the funds already paid into the scheme by investors or by using the funds paid in by subsequent investors. The returns provided to investors in a Ponzi scheme are usually abnormally high or consistent. A Ponzi scheme usually collapses since the scheme makes no actual investments and requires continuous inflows of new capital to ensure that the money going into the scheme exceeds the money being paid out of the scheme as investment returns. In 2008, a Ponzi scheme operated by Bernard Madoff for several years collapsed. As a result, Madoff was responsible for the largest financial fraud to be committed (allegedly) by a single individual.

pooled fund

Vehicle in which a number of investors (including pension schemes) pool their assets so that they can be managed on a collective basis. This usually suits small to medium-size investors wishing to invest in a broad spread of investments or larger investors wishing to gain exposure to a specialised sector. Shares in a pooled fund are denominated in units that are repriced regularly to reflect changes in the underlying assets. This allows investors to value their holdings and provides a basis upon which transactions in units can take place. Unit trusts are examples of pooled funds.

portable alpha

See alpha transfer.

portfolio

Block of assets generally managed under the same mandate.

portfolio insurance

Any one of several techniques used to change systematically an investment portfolio's market exposure in response to prior market movements, with the objective of avoiding large losses and securing as much participation as possible in any favourable market movements. These techniques often feature a principal guarantee. (See also principal guarantee.)

portfolio manager

See fund manager.

PPF

See Pension Protection Fund.

pre-hedging

Practice of a bank assembling a position over a period of time prior to entering into a swap contract — this reduces the bank's risk of hedging the swap position and is only legal when authorised by the client.

preference share

Type of share which gives the holder an entitlement to a fixed rate of dividend that is paid before any dividends are paid to ordinary shareholders. In the event of a company wind-up, preference shareholders rank ahead of ordinary shareholders as creditors.

premium

- a. For securities selling above par, the difference between the price of a security and par.
- b. Amount that must sometimes be paid above par in order to call an issue — that is, a call premium.
- c. Occasionally used and interchangeable with margin or spread when the latter two refer to a percentage above a given amount or rate.

prepayment risk

Risk which affects investors in CDOs and MBSs that the borrowers/writers of the underlying debt may choose to repay the loan early if interest rates fall, under conditions where investors are unable to reinvest the proceeds to achieve the redemption yield targeted at outset.

present value

Value in today's terms of future cash flows discounted at some appropriate rate of interest.

price earnings ratio

See P/E ratio.

price-to-book ratio

Comparison of a security's market value with its book value, calculated by dividing the current closing price of a security by the latest published book value per share.

primary market

Market in which securities are sold at the time they are first issued. (See also secondary market.)

prime

Describes a property investment that is highly regarded in terms of location, age and condition, quality of tenant, size, and lease structure.

prime broker

Agent, usually an investment bank, offering a suite of services including securities lending, cash management and execution of leverage trades. The services of a prime broker are most often used by hedge fund investors in the interests of managing absolute return investments.

prime rate

Minimum interest rate in the US that commercial banks will charge borrowers. (See also base rate.)

principal

Capital element of a bond that is normally repaid at par value (usually 100) at the end of the term of the bond. (See also nominal value.)

principal guarantee

Feature of certain portfolio insurance products, usually achieved by investing part of the principal amount in a zero coupon bond that will eventually return the amount invested over the agreed period of the investment. (See also cushion, portfolio insurance.)

private customer

Category of investor (as required by the FSA), typically small companies/trusts, which, as one of the more vulnerable investor categories, are given significant protection under the conduct of business rule. (See also non-private customer.)

private equity

Shares in unquoted companies. Usually high risk, high return in nature.

private finance initiative (PFI)

System for providing capital assets for the provision of public services. Typically, the private sector designs, builds and maintains infrastructure and other capital assets and then operates those assets to sell services to the public sector. In most cases, the capital assets are accounted for on the balance sheet of the private sector operator. The pricing basis for the services provided almost invariably includes an inflationary element.

profit and loss statement

Summary of a company's revenues and expenses over a specific period, which shows whether the company has made a profit or a loss. Also known as an income statement.

program trading

Computerised trading used primarily by institutional investors, typically for large volume trades, where orders from the trader's computer are entered directly into the market's computer system and executed automatically.

property unit trust

Unit trust that invests in commercial properties on behalf of third parties, usually pension schemes and charities.

prospectus

Legal document offering securities for sale. Provides potential investors with detailed information on the operations and business plans of the issuing company and their objectives or intentions for the use of the money.

protection overlay

Portfolio management technique by which an investment manager aims to protect the capital value of a portfolio through risk management techniques such as dynamic hedging.

proxy voting

Delegation of voting rights without attendance at a shareholders' meeting.

prudence

Legal principle of “the prudent man” is a measure by which the decision making of the individual or organisation could be evaluated in comparison with what a reasonable person would have been expected to do.

prudent man rule

Common rule pertaining to fiduciary duty in Anglo-Saxon countries. The OECD states the rule in terms of the following broad principle: “A fiduciary should discharge his or her duties with care, skill, prudence and diligence that a prudent person acting in a like capacity would use in the conduct of an enterprise of like character and aims.” Applications vary by country.

Prudential Regulation Authority (PRA)

Independent body formed as one of the successors to the Financial Services Authority (FSA), focusing on the prudential regulation and supervision of the financial services industry in the UK.

public offering

Offering for sale of a new issue of securities to the general investing public. Securities of such an offering will generally be placed through a syndicate, will have securities issued in small denominations and will be listed on a stock exchange. An IPO is the first public offering of a security.

put-call parity

Relationship that always exists between the price of a European put option and a European call option on the same underlying asset at the same strike price.

put option

Option which gives the purchaser the right, but not the obligation, to sell an asset at an agreed price or an agreed date (European option) or before an agreed date (American option). (See also call option.)

puttable bond

Bond that can be redeemed before maturity at the option of the bondholder.

PV01

The change in present value of an asset or liability for a 1 basis point change in the nominal yield curve used to value the asset or liability.

Q

QE

See quantitative easing.

qualitative analysis

Assessing the value of an investment by examining mainly non-numeric characteristics such as management, people, process, etc.

quantitative (quant) analysis

Use of mathematical and statistical techniques to make investment decisions. (See also chartism, fundamental analysis.)

quantitative easing

Process by which a country's central bank tries to stimulate the economy by increasing the amount of money in circulation.

Quantitative easing is used in instances when the central bank's interest rate cannot be lowered any further because it is zero or very close to zero. The central bank effectively prints new money and uses the new money to buy fixed interest securities from companies, usually banks. The intention is to encourage banks to increase their lending, which should eventually reduce the cost to consumers of borrowing from banks and stimulate consumer spending. However, quantitative easing may fail if institutions do not increase their lending despite the actions of the central bank. In addition, quantitative easing may lead to an over-stimulation resulting in a rapid increase in inflation over time. Quantitative easing was adopted by the central banks of several countries during the global financial crisis of 2008/2009.

quarterly

Every three months. Usually refers to three-month periods ending 31 March, 30 June, 30 September and 31 December.

quartile

One quarter of a sample. If returns of portfolios (or managers) are ranked in a league table, then, for example, a second quartile ranking indicates that 25% of portfolios performed better and 50% achieved a lower return — that is, the return was in the second quarter (or 25%) of the returns. (See also bottom quartile, top quartile.)

quorum

Minimum number of members (on an investment committee or board of trustees in the case of pension schemes) that is needed for a binding decision to be taken.

R

rack rent

Rent that would be received on a property if it were leased on the open market. The current rent may be greater or less than the rack rent depending on the terms of the lease and how the market has moved since the last rent review.

rally

Considerable and sustained increase in the price of a security or value of a market.

random walk theory

Theory that the price of an asset follows a random path and therefore past price movements cannot be used to predict future price movements.

rating (credit)

See credit rating.

real asset

Asset whose value is linked (directly or indirectly) to inflation. Equities, property, forestry, venture capital and inflation-linked bonds are often considered to be real assets. (See also fixed interest asset.)

real estate

Property in land, building or housing, as distinct from personal property (e.g. cars); also known as physical property, to distinguish itself from property trusts.

real interest rate

Interest rate adjusted for inflation. If the nominal interest rate is 6% and inflation is expected to be 2% then the real interest rate is 4%. The definitions of real yield, real rate of return, etc., are similar.

real return

Inflation-adjusted return.

rebalancing

Making adjustments to a portfolio to counteract the fact that different assets have performed differently over a period, and thus comprise different percentages of the portfolio than originally intended.

recession

Two or more consecutive quarters of negative GDP growth in an economy.

redemption

Repayment of an investor's principal in a security, such as a bond, at or prior to maturity.

redemption date

See maturity date.

redemption yield

Calculation of the return that an investor will earn on a bond if he or she holds it to redemption, taking into account income and any capital gain or loss that will be made at the maturity date.

registrar

Organisation appointed to record the issue and ownership of company securities.

rehypothecation

Means by which a prime broker gains access to bank loans. The prime broker's clients (predominantly hedge funds) are required to post collateral with the prime broker for services such as securities lending or leveraged investment transactions. Rehypothecation occurs when the prime broker subsequently reuses the collateral that was originally posted by its client(s) to obtain a loan itself from a bank.

relative return

Asset's or portfolio's return over a period of time relative to that of a chosen benchmark. Calculated as the difference between the asset's absolute return and the benchmark's performance.

reinvestment

Using the dividends, interest or profits from an investment to buy more of that investment.

REIT (real estate investment trust)

Particular type of pooled fund that invests in the property sector.

rental value growth

Growth in the rent of a property that could be charged if the unit was let in the open market on the valuation date.

replacement ratio (defined contribution)

Amount of income (actual or projected) that can be secured by an individual's accumulated retirement savings at retirement, expressed as a proportion of his or her income before retirement.

REPO

See repurchase agreement.

repurchase agreement (REPO)

Agreement to sell securities, usually bonds, to another party and to buy them back at a specified date and price.

responsible investment

Integration of environmental, social and corporate governance (ESG) considerations into investment management processes and ownership practices in the belief that those factors can have an impact on financial performance.

responsible investment policy statement

General (usually public) statement on responsible investment adopted by boards of trustees or directors that directs investment staff practices and decisions. This can be included within a broader investment policy statement and/or developed as a standalone responsible investment policy statement.

retail fund

Assets managed on behalf of the direct public in the form of a pooled fund.

Retail Prices Index (RPI)

Measure of price inflation in the UK. It measures the average change from month to month in the prices of goods and services purchased by most households in the United Kingdom. Used for uprating state pensions and benefits and calculating payments due on index-linked gilts. (See also Consumer Prices Index.)

retained earnings

Company earnings that are not paid out as dividends.

return

Increase in value of an investment over a period of time, expressed as a percentage of the value of the investment at the start of the period. (See also money-weighted rate of return, time-weighted rate of return.)

return on equity (ROE)

Company earnings divided by shareholders' funds. Provides an indication to shareholders of how effectively their money is being used by the company.

return seeking assets (RSA)

A generic term which refers to the proportion of a scheme's assets invested in securities whose value is expected to increase over time, at a faster rate, compared to its liabilities.

reversionary yield (real estate)

Estimated market rental value divided by the property value (market value of rent may differ from actual rental currently being earned).

rights issue

Issue by a company of rights to sell new shares to existing shareholders in proportion to their holdings. For example, a one-for-two issue allows each shareholder to buy one new share for every two held. Rights issues are a means of raising additional funds to finance acquisitions, capital investment or reduce debt.

ring-fencing

Act of separating investors' assets from those assets used to determine an investment bank's net value. The ring-fenced assets are usually held in separate offshore accounts and are therefore protected from claims by creditors of the investment bank in the event of the bank's failure.

risk

- a. Likelihood of a return different from that expected and the possible extent of the difference. Downside risk is the likelihood of a loss, or a return less than expected on an investment.
- b. Also used to indicate the volatility of different assets. (See also cash flow risk, funding risk, investment risk, market risk, solvency risk.)

risk-adjusted return

Any measure of the return earned by an investment that is adjusted to take into account the level of risk taken to achieve it.

risk averse

Preference of an individual or entity for avoiding risk, however defined. In terms of returns a risk-averse investor would seek a less volatile return unless he or she were adequately compensated for the risk.

risk-free rate of return

Yield on a riskless investment (generally one that has a government-backed guarantee and a known rate of return). For example, the yield on a government-issued three-month security is often taken as a measure of the three-month risk-free return against which other riskier assets are measured.

risk premium

Additional return relative to the risk-free return expected from a risky asset to compensate for the additional risk. (See also equity risk premium.)

risk/return trade-off

Amount of expected return that must be sacrificed in order to reduce risk.

risk tolerance

Extent to which an investor is prepared to accept volatility or risk in a portfolio.

ROE

See return on equity.

rolling period returns

Annualised returns over a given period ending with the date stated. This allows investors to compare the returns achieved over a specified period of time leading up to various dates over the holding period of their investments.

rolling settlement

System for settling share transactions under which bargains are settled a number of days after being transacted.

RPI

See Retail Prices Index.

running yield

Annual income on an investment divided by its current market value, for example the dividend yield on equities.

S

S&P 500 index

US large cap stock market index maintained by Standard & Poor's. Its 500 constituents represent over 80% of US equities by market capitalisation.

S&P Composite 1500 Index

Combination of the S&P 500, S&P MidCap 400 and S&P SmallCap 600 indices. The 1,500 constituents represent 90% of US equities by market capitalisation.

safe haven

Investment whose value is expected to remain relatively stable during periods of high market volatility. For example, during the credit crunch of 2008, there was a "flight to quality" when many investors viewed government bonds as a safe haven from corporate debt of questionable credit quality and for which there was perceived to be a high risk of default.

sale and leaseback

Sale of an asset to a financial institution that then leases it back to the seller. It is used by companies to raise capital and may provide tax benefits.

satellite manager

See core/satellite.

scenario analysis

Quantitative analysis of the financial impact on an investor's assets and liabilities of a defined set of economic and financial conditions, usually projected over the medium term. (See also asset/liability modelling.)

scheme sponsor

Employer that sets up and funds a pension plan for its employees. Also called plan sponsor.

Screening

Examination of various securities, usually through computer models, to identify certain predetermined factors such as valuations, earnings, liquidity, etc., with a view to the exclusion of those securities not meeting the criteria from an investment portfolio.

scrip dividend

Payment of dividends in the form of additional shares rather than cash.

scrip issue

See bonus issue.

SDRT

See stamp duty reserve tax.

SEAQ

See Stock Exchange Automated Quotations System.

SEC

See Securities and Exchange Commission.

secondary market

Market in which securities are traded after they have been issued. (See also primary market.)

secondary purchase

Purchase of a holding in an existing private equity fund from an investor who needs to sell. It can often be bought at a significant discount.

sector

Stock markets are divided into sectors which comprise companies from the same industry — for example, telecommunications sector, oil sector, media sector, etc.

secular trend

Long-term change attributable to an important fundamental shift in the economy or business environment that is not related to seasonal or cyclical factors. For example, industrialisation, globalisation. (See also cyclical trend.)

secured bond

Bond for which the issuer has set aside assets as collateral to ensure principal repayment and encourage timely interest payments.

Securities and Exchange Commission (SEC)

Regulatory authority for the US securities industry.

securities lending

Process where one investor lends stock to another investor. The borrowing investor has to issue collateral to the stock lender and usually borrows stock to engage in “short selling” aiming to profit from falling stock prices. The lending investor usually lends the stock to gain a return in the form of interest received from the borrower. Passive fund managers may engage in stock lending and use the earned interest to help regulate their fund returns so that they are more in line with benchmark returns.

securitisation

Process of creating a tradable financial instrument by combining other non-tradable, usually loan-based assets and marketing them to investors.

securitised property

Shares in property companies or in real estate investment trusts (REITs).

security

- a. Term for fixed interest stocks or ordinary shares or, in general terms, for any tradable financial instrument giving title to property or claims on income payments.
- b. Assets or collateral pledged to support debt obligations.

segregated portfolio

Investment portfolio which is managed on behalf of a single client and has separately identifiable assets. (See also pooled fund.)

self-invested personal pension (SIPP)

Investment vehicle that allows an individual to save for retirement by picking his or her own investments. The SIPP is essentially a UK government-approved tax wrapper which allows the individual to take advantage of tax savings on profits and income earned on his or her investments.

senior debt

Debt issued by a company that has to be repaid before all other creditors in the event of the company's liquidation. Senior debt is usually secured by providing some form of collateral assets.

sensitivity analysis

Analysis using mathematical tools of the extent to which small changes in a particular variable, such as the weighting in a certain security or market, may impact on portfolio return or volatility.

settlement

Payment or collection of proceeds after trading a security. Settlement usually takes place some time after the deal and price are agreed.

share

See ordinary share.

share blocking

Mechanism that prevents investors who wish to vote their shares at annual meetings from trading for a defined period of time prior to the meetings.

share buyback

Company's repurchase of its own shares. Typically increases the market price of the remaining shares because each remaining share now represents a larger claim on earnings and assets.

shareholder activism

Public or confrontational approach to shareholder engagement. In addition to shareholder engagement, pressure can be exerted on companies through strategic divestment or attempts to influence public opinion.

Sharia investment

Investment in companies whose practices conform with Islamic law.

Sharpe ratio

Statistical measure of reward per unit of risk. Developed by William F. Sharpe, it is calculated as the excess return over the risk-free return divided by the standard deviation of the excess returns. (See also Sortino ratio.)

shift

Measure of the degree to which a yield curve has moved upwards or downwards, across all maturities, without changing its overall curvature and slope.

short bias

Long/short fund with a net short position and therefore positive exposure to a decrease in the underlying market.

short position

Situation in which an investor sells a stock that the investor does not own. The investor is expecting the stock value to fall, thereby making a profit when the position is closed at the lower price. (See also long position.)

short-term investment fund

Alternative to a cash account which holds short-term, low risk investments. Often used by investors holding large cash sums and have not decided where to invest these funds for the longer term.

SIA

Statement of investment arrangements.
See SIP.

SICAV

Legal structure of investment vehicle that is common in some western European countries, for example, Luxembourg, Switzerland, Italy, Spain, Belgium and France. A SICAV is open-ended, which means that new investors into the scheme are not required to buy units from existing investors. Instead, new units will be created which investors may purchase.

sin stock

Stock of a company that provides goods or services that the investor has deemed unethical. Common examples include the stocks of companies that are involved in the production or provision of tobacco, alcohol, armaments, pornography or gaming facilities.

SIP

- a. Statement of investment principles.
- b. See UK Society of Investment Professionals.

SIPP

See self-invested personal pension.

SIV

See structured investment vehicle.

skewness

Describes asymmetry from the normal distribution in a set of statistical data. Skewness can come in the form of “negative skewness” or “positive skewness”, depending on whether data points are skewed to the left (negative skew) or to the right (positive skew) of the data average.

small cap stock

Stock with a market capitalisation of among the smallest within a market, although the definition of what is small is to some extent arbitrary. In the UK, it is usually defined as a stock with a capitalisation below that of the top 350 companies in the UK as represented by the FTSE Small Cap Index. (See also large cap stock, mid cap stock.)

socially responsible investment (SRI)

Idea and practice of investing based on ethical criteria, whereby companies contribute to the welfare of society. (See also ethical investment.)

Society of Investment Professionals (SIP)

UK member society of the Association for Investment Management and Research (AIMR), an international non-profit organisation of investment practitioners and academics. SIP oversees the Investment Management Certificate.

soft commission

Arrangement whereby a fund manager directs commissions to a broker which are then used to purchase goods or services from a third party for the benefit of the fund manager. There are detailed FSA rules on the types of goods and services that may be softened.

soft currency

Currency of a country that is emerging or less developed with political and economic uncertainty. These countries tend to have currencies with volatile exchange rates. (See also hard currency.)

solvency risk

Risk that an investor's assets will be insufficient to meet its liabilities in the future. Used in the case of UK defined benefit pension plans, where liabilities are calculated as the costs of securing annuities with an insurer in the event of a plan wind-up. In the case of insurance companies, usually by reference to the statutory solvency tests.

Sortino ratio

Modification of the Sharpe ratio. Calculated as the difference between the actual return and the risk-free return, divided by the downside risk. Here, downside risk is a measure of deviation of historical returns falling below a specified target rate of return. (See also Sharpe ratio.)

sovereign debt

Bonds issued by a government.

specialist management

Where an investment manager's mandate is restricted to a specific asset class or sectors, for example, UK equities. Internationally, there is a strong trend towards specialist management (away from a balanced or multi-asset approach). (See also balanced management, multi-asset management.)

speculation

Investment in highly risky securities with the expectation of making a profit from price increases. In some instances, the speculator's decisions are not based on sound investment principles.

spot exchange rate

Exchange rate for immediate delivery. (See also forward exchange rate.)

spot interest rate

Interest rate quoted on a day for loans made that day.

spot price

Present market price of a commodity, currency or investment instrument.

spread

Difference between the buying and selling price or, in the case of corporate bonds, between the gilt yield and the corporate bond-specific yield.

spread betting

Regulated activity in which wagers are made on the range of possible outcomes of chosen events. The spread-better makes a profit or loss based on the difference between the actual outcome and the spread-better's prediction.

SRI

See socially responsible investment.

SRPA

See Style Research Portfolio Analyzer.

SSAP24

UK accounting standard for the disclosure of pension costs. Now replaced by FRS17.

stagflation

Period characterised by low economic growth and high unemployment, and accompanied by increasing inflation.

stakeholder pensions

Money purchase pension arrangements principally designed for people without access to employer-sponsored pension arrangements and provided by commercial financial services companies. Stakeholder pension schemes must satisfy a number of minimum government standards to ensure security, flexibility and value for money for members.

stamp duty

Tax paid (in the UK and some other countries) by the purchaser on the transfer in beneficial ownership of certain types of asset — for example, UK equities and property. Stamp duty depends upon there being a document which can be stamped. For that reason, stamp duty reserve tax was introduced in the UK in 1986 to cater for paperless transactions in shares. (See also stamp duty reserve tax.)

stamp duty reserve tax (SDRT)

Tax paid on the transfer in beneficial ownership of certain types of asset, for example, units in UK unit trusts which invest in UK equities or property. (See also stamp duty.)

Standard & Poor's (S&P)

Independent rating agency which assesses the creditworthiness of companies and their debt. The highest rating awarded is AAA, and the lowest is D. Other well-known rating agencies are Moody's and Fitch.

standard deviation of return

Statistical measure of the historical variability of returns relative to their mean (or expected return). An indicator of the degree to which an asset's or portfolio's returns deviate over a specific period in absolute terms or relative to another asset or benchmark portfolio. (See also mean, expected return.)

statement of investment principles (SIP)

Statement setting out the investment policy being followed by a UK pension plan. Under the Pensions Acts 1995 and 2004, it is a legal requirement to have a SIP and keep it up to date. Regulations set out a minimum level of content, and the Myners Code recommends further additions to the SIP. (See also Myners Code, Pensions Act 1995.)

start-up

Finance used to form a completely new company that aims to develop a new and unproven product or service.

Sterling Overnight Interbank Average Rate (SONIA)

An index that tracks Sterling overnight funding rates for trades that occur in off hours. It is the rate that underpins the calculation of an interest rate curve used for discounting sterling OTC derivatives that are transacted under "clean CSAs". It is also the required rate of interest to be paid to counterparties on any cash received as collateral to support derivative positions.

STIF

See short-term investment fund.

stochastic modelling

Statistical technique used in asset/liability modelling to estimate the probability of certain events occurring. It does this by simulating many possible outcomes for the factors affecting the assets and liabilities of the investor. A large number of outcomes are generated in order to derive a mean expected outcome and a statistical distribution of outcomes. (See also asset/liability modelling.)

stock exchange

Market for trading in securities.

Stock Exchange Automated Quotations (SEAQ) system

Screen-based trading system that shows bid and offer price quotations of all market makers in the UK.

stock lending

Lending of stock from one investor to another that entitles the lender to continue to receive income generated by the stock plus an additional payment by the borrower. There is potential risk as the lender may be exposed if the borrower defaults, but the exposure is controlled through high quality collateral (e.g. gilts) provided by the borrower that is marked to market daily. Investors may wish to borrow stock to cover short positions, for example. (See also mark-to-market, short position.)

stock selection

Selection by investment managers of a portfolio of stocks in a particular market or sector, usually based on technical or fundamental analysis and usually with the aim of achieving a return superior to the overall market or sector or benchmark thereof.

stock-specific risk

Risk arising from a single stock holding, usually where the holding represents a position against a benchmark, in which case the term refers to risk relative to the benchmark.

straddle

Purchase or sale of call and put options for the same underlying asset with the same expiry date and strike price.

strangle

Purchase or sale of call and put options with the same expiry date but with different strike prices.

strategic asset allocation

Benchmark allocation between the main asset classes with the aim of meeting the investor's risk and return objectives. Also known as investment strategy or strategic allocation and sometimes prefixed with "long-term". (See also benchmark, investment strategy.)

strike price

Price at which the holder of a call (put) option has the right to buy (sell) the underlying security.

STRIPS

Separately Traded Registered Interest and Principal Securities. Instruments created when the components of a bond (the principal and the coupons) are separated and traded individually. (Converts a coupon-paying bond into a series of zero coupon bonds.) (See also coupon, principal, zero coupon bond.)

structured investment vehicle (SIV)

Pooled investment vehicle which attempts to profit by exploiting differentials in short- and long-term interest rates. SIVs are often set up by banks as independent units which do not impact directly on the bank's balance sheet. In the stock market crash of 2008, SIVs became unpopular when it was revealed that they had been heavily invested in non-transparent asset-backed securities.

style

Approach followed by an active investment manager in selecting stocks. (See also growth investor/manager.)

style drift

Tendency of a portfolio manager to stray from its investment philosophy and process to boost short-term returns.

Style Research Limited

Firm providing tools for the analysis of equity portfolios at the stock level, which identify the particular style characteristics of the portfolio and highlight the components of risk relative to the portfolio's benchmark.

Style Research Portfolio Analyzer

Tool developed by Style Research Limited for analysis of portfolio style bias and risk.

subordinated debt

Debt which ranks after all other debts to be repaid if a company is liquidated. Subordinated debt will be repaid before shareholders. (See also senior debt.)

sub-prime

Describes loans which are considered inferior or sub-quality due to the high risk of default by borrowers. Sub-prime loans granted in the United States property market are generally considered to have sparked the credit crisis of 2008.

supranational debt

Bond issued by an agency sponsored by a group of national governments — for example, the World Bank.

survivorship bias

Tendency for samples of asset class returns to include only the funds that survived until the end of the measurement period. Funds that close due to poor performance are often excluded, and sample average return is thus biased upwards.

swap

Instrument designed to permit investors to exchange payment streams for their mutual benefit. Payments can be based on interest rates, currencies or equity returns.

swap spread

Difference in the yield available on a generic swap and a government bond. The difference arises mainly as a result of the credit risk on the swap. (See also credit spread.)

swaption

Option granting the buyer the right, but not the obligation, to enter into an interest rate swap on pre-defined terms.

syndicated investment

Investment which has been spread amongst several institutional backers, generally because it is too large for a single investor to provide all the finance required.

synthetic investment

An investment which simulates the return of an actual investment, but the return is actually created by using a combination of financial instruments, such as options contracts or an equity index and debt securities, rather than a single conventional investment.

systemic failure

Failure of the entire financial system due to a domino effect in the collapse of multiple financial institutions (e.g. banks).

systematic risk

See market risk.

T

T+1, T+2, T+3

Abbreviations that refer to the settlement date of security transactions. The T stands for the day the transaction takes place. The numbers 1, 2 and 3 denote how many days after the transaction date the settlement or the transfer of money and security ownership takes place.

T-bill/T-bond

See treasury bill, treasury bond.

TAA

See tactical asset allocation.

tactical asset allocation (TAA)

Short-term deviation from a strategic asset allocation to exploit predicted short-term relative movements in markets with the aim of generating excess return relative to a benchmark (typically, the strategic asset allocation). (See also strategic asset allocation.)

tactical asset allocation overlay

Portfolio management technique which gains exposure to asset classes through derivatives rather than physical securities. Its economic exposure is typically much larger than the assets of the overlay portfolio, which are used to fund margin payments and close off positions. As a result, it is used as an overlay to a larger fund to adjust its asset allocation with the aim of taking advantage of short-term movements and opportunities in the markets.

tail risk

A form of portfolio risk that arises when the possibility that an investment will move more than three standard deviations from the mean or expected return, is greater than what is shown by a normal distribution.

takeover

Corporate action where one company makes a bid to acquire another. If the target company is publicly traded, the acquiring company will make an offer for the outstanding shares.

TALF

See term asset-backed securities loan facility.

target firm

Firm that has been targeted by another firm for a takeover.

TARP

See Troubled Asset Relief Program.

technical analysis

Attempt to predict share price movements on the basis of past patterns. (See also chartism.)

tender

Method of issuing securities whereby investors are invited to bid, subject to a minimum price. The allocation of the securities is made according to the prices bid.

tenor

Length of a swap contract.

TER

See total expense ratio.

term (of a bond)

Period remaining until the final payment.

term asset-backed securities loan facility (TALF)

Second economic measure implemented by the Federal Reserve in the United States, in which US\$800 billion was issued to Congress to remove toxic securities from US banks' balance sheets during the 2008 credit crunch. (See also Troubled Asset Relief Programme.)

term deposit

Bank deposit for a fixed period of time. The interest rate may be fixed at outset, or variable.

term structure of interest rates

Yield curve displaying the relationship between spot rates of zero coupon securities and their term to maturity.

thin market

Market with few bid and ask offers. The market is characterised by low liquidity, high spreads, and high volatility. Also known as a narrow market.

tier 1 capital

Describes the capital adequacy of a bank. Tier 1 capital is core capital that includes equity capital and disclosed reserves.

tier 2 capital

Describes the capital adequacy of a bank. Tier 2 capital is secondary bank capital that includes items such as undisclosed reserves, general loss reserves and subordinated term debt.

tiger economy

Nickname given to the economies of Southeast Asia encompassing markets such as Indonesia, Singapore, Malaysia, Thailand, South Korea and China.

tilt

Adoption of a particular view on a sector by overweighting or underweighting that sector relative to the portfolio benchmark (e.g. a portfolio which was overweight resource shares and underweight industrials would be described as having a tilt towards resources and away from industrials).

time value (of an option)

Part of a traded option's value that can be attributed to the possibility of future market movements adding to the value of the option. It is reflected by the difference between the traded price of the option and the intrinsic value of the option. (See also intrinsic value.)

time-weighted rate of return

Rate of return on an asset or portfolio that adjusts for the effect of cash flows. The time-weighted return can be used to compare portfolio performances against each other and against market indices. (See also money-weighted rate of return.)

TIPS

See Treasury Inflation Protection Securities.

Tokyo Stock Price Index (TOPIX)

Index measuring the share prices of selected companies listed on the Tokyo Stock Exchange.

top-down

Approach to investment analysis which starts from macroeconomic factors (GDP growth, interest rates, inflation, etc.) and business cycle analysis to identify a portfolio distribution across asset classes, then a country/currency mix, a sector distribution and ultimately a stock selection. It is the converse of the bottom-up approach. (See also bottom-up.)

TOPIX

See Tokyo Stock Price Index.

top quartile

Quartile ranking that is in the top 25% of returns. (See also bottom quartile.)

Toronto Stock Exchange (TSX)

Largest stock exchange in Canada, historically home to a large number of natural resource companies.

total expense ratio

Total costs experienced by investors in an investment fund, divided by the total asset value of the fund. The total costs include management fees (asset-based or performance-related), transactions costs, broking fees and auditor fees, among others.

total rate of return swap (TRORS)

Contract in which one party receives interest and/or dividend payments plus any capital gains and losses over the payment period on a reference asset (or index, or portfolio of assets), while the other receives a specified fixed or floating cash flow unrelated to the credit-worthiness of the reference asset. (Payments are usually based on the same notional amount.)

total return

Overall return on a stock or portfolio taking into account changes in capital values and income earned.

toxic asset

Asset for which for which the secondary market has disappeared, on the basis that the asset is expected to incur significant future losses. Investors holding toxic assets may be forced to sell these at large discounts to book value, in order to raise liquidity and stabilise their balance sheets.

tracking error

Measure of the variability of investment returns relative to a benchmark or index. It is usually expressed as the annualised standard deviation of relative returns. Can be expressed as either ex-post, which is simply the historical tracking error, or ex-ante, which is a forward-looking estimate of the future tracking error. (See also ex-post, ex-ante.)

tranche

Packages created when a bond's cash flows are repackaged as a collateralised debt obligation (CDO) or a portfolio of securities is repackaged as a collateralised mortgage obligation (CMO). Each tranche has a different risk/return profile, and the tranches trade separately from one another.

transaction costs

Costs incurred when buying or selling securities. These include brokers' commissions and spreads (the difference between the price the dealer paid for a security and the price he or she can sell it for), market impact (security price movements brought about by trading activity) and opportunity costs.

transition manager

Manager whose specific role is to transition one portfolio of assets to another whilst minimising direct and indirect costs.

treasury bill

Bond issued by a government with a maturity of one year or less. Also called a T-bill in the US.

treasury bond

Bond issued by a government — for example, US treasuries.

Treasury Inflation-Protected Securities (TIPS)

Index-linked (i.e. inflation-linked) bonds issued by the US government.

trend analysis

Type of technical analysis used to determine or locate significant trends in a security.

triple bottom line

Holistic approach to measuring a company's performance on environmental, social and economic issues. The triple bottom line focuses companies not just on the economic value they add but also on the environmental and social value they add or destroy.

Troubled Asset Relief Program (TARP)

Initial economic measure implemented by the Federal Reserve in the United States in which US\$700 million was issued to Congress to remove toxic mortgage-backed securities from US banks' balance sheets during the 2008 credit crunch. (See also term asset-backed securities loan facility.)

trust deed

Most UK pension schemes are formally established as trusts, and the trust deed is the governing document specific to each scheme. The trust deed will set out the trustees' investment powers and any specific restrictions on permitted investments, etc.

trustee

Individual or organisation responsible for the management and administration of a trust, for example, a pension plan, on behalf of the beneficiaries of that trust.

turnaround

Situation where a company that has had poor performance for an extended period of time experiences a reversal of fortune.

turnover

Measure of the level of trading in a market or portfolio. Usually expressed as the sum of the total value of purchases and sales in a period as a percentage of the portfolio value.

two and twenty

Fee structure usually employed by hedge fund and some private equity managers, with a base fee of 2% of the fund's asset value plus a fee of 20% of the outperformance of the fund.

U

UCITS

Undertakings for Collective Investments in Transferable Securities. The UCITS legislation governs how a fund can be marketed within the European Union and is designed to allow cross-border fund sales to investors of different nationalities. To obtain UCITS status a fund must invest within defined but wide parameters.

UK Society of Investment Professionals (UKSIP)

UK member society of the CFA Institute. Formed by a merger between the Institute of Investment Management and Research (IIMR) and the London Society of Investment Professionals (LSIP).

UKIPS

See United Kingdom Investment Performance Standard.

UKSIP

See UK Society of Investment Professionals.

unauthorised unit trust

Unit trust that is suited to the needs of institutional investors but cannot be marketed to the general public.

underlying security

Shares (or other securities) on which a derivative instrument is based.

underperformance

See outperformance.

undersubscribed

Situation where the demand for a new issue of securities is less than the number of shares issued. This is sometimes referred to as an under-booking.

undervalued

See overvalued.

underweight

- a. Exposure to a specific asset (or asset class) which is lower than the proportion it represents in the benchmark against which the portfolio is measured. (See also overweight.)
- b. Specific rating within a three-part credit rating system which indicates whether a fixed income security should be bought (overweight), sold (underweight) or held (marketweight). (See also overweight, marketweight.)

underwriting

Guarantee by an investor (usually an investment bank) to a company issuing new shares or bonds that it will buy any remaining shares or bonds that are not bought by other investors. For providing this service, the underwriter will receive a fee but bears the risk that investors will not fully take up the issue and the underwriter will be left with a large holding of stock.

United Kingdom Investment Performance Standard (UKIPS)

Incorporates GIPS and replaces the Pension Fund Investment Performance Codes (PFIPC). This has been approved by the National Association of Pension Funds (NAPF). (See also GIPS.)

unit-linked fund

Pooled fund usually operated by an insurance company or investment manager where the value of an investor's holding in the fund is represented by the number of units held multiplied by the unit price.

unit price

Value of a pooled fund unit, which may be a bid, offer or mid price. The unit price is determined by reference to the net asset value of the fund. Units may be “accumulation”, where income distributions are reinvested, or “distribution”/“income”, where income is paid away to unit holders.

unit trust

Pooled fund that is established under trust law in the UK. Unit trusts may be authorised or unauthorised. Only authorised unit trusts may be advertised for sale to the general public. The unit trust will create and cancel units as investors invest and disinvest — the number of units in existence from time to time will therefore vary and it is not necessary for buyers to be matched with sellers.

universe

Term sometimes used to describe the total number of operators or competitors in a particular field, or the number of available stocks from which a portfolio is selected. Investment manager performance surveys are also referred to in this way.

unlisted (stock)

Company that is not available for purchase or sale through the stock market.

unrealised profit/loss

The expected gain/loss on an investment which remains unrealised until the investment or underlying securities have been cash settled.

unsecured debt

Debt obligation with no collateral, and backed only by the debtor’s creditworthiness.

unwind

Reversal of an investment decision. For instance, an investor who has bought a share can unwind the position by selling the share.

upper quartile

See top quartile.

V

valuation

Process of determining the value of a portfolio of assets, including any accrued income. (See also actuarial valuation.)

value at risk (VaR)

Technique to analyse variations in performance and to estimate the amount by which a portfolio could underperform.

value date

Date agreed between parties for the settlement of a transaction.

value investment

Approach to investment which places emphasis on identifying shares which are believed to be underpriced (on the basis of indicators such as P/E ratio and dividend yield) by the market.

variance

Degree to which a given set of number/ data points vary about the mean. It is the square of the standard deviation.

VC

See venture capital.

venture capital (VC)

Investment in a company that is at a relatively early stage of development and is not listed on a stock exchange. A venture capitalist raises money from investors to invest in such opportunities. These investments are typically risky but potentially very profitable. Generally considered a sub-sector of the private equity market.

vesting

Acquisition by a pension plan member of an absolute right to an immediate or deferred benefit by fulfilling prescribed conditions, especially service requirements.

vintage year (private equity/ infrastructure)

Year in which a fund is closed and makes its first investment.

VIX

Widely used index maintained by the Chicago Board of Exchange, reflecting the expectation of volatility in the market over the next 30-day period.

void rate (real estate)

Percentage of a property that is vacant at a point in time.

volatility

Variability of the price of a security. Typically quantified as standard deviation. (See *also* standard deviation of return.)

volatility swap

Forward contract for which the underlying is the volatility of a given product. This is a pure volatility instrument allowing investors to speculate solely upon the movement of a stock's volatility without the influence of its price.

volume

Number of shares or contracts traded in a security or an entire market during a given period, often used in the context of average daily or weekly volume.

volume weighted average price (VWAP)

Benchmark for trading efficiency. It measures the average price at which a share is traded in the market over a period, and can be compared against the price actually achieved by a fund manager. VWAP is calculated by adding up the monetary value traded for every transaction (price times number of shares traded) and then dividing by the total number of shares traded in the period.

voting rights

Entitlement of an ordinary shareholder to participate in the running of a company by voting on resolutions.

voting shares

Shares that give the stockholder the right to vote at company meetings — for example, on the election of directors.

vulture fund

Fund which buys securities in distressed investments, such as high-yield bonds in or near default, or equities that are in or near bankruptcy.

W

warehousing

Practice by a bank of taking on inflation supply (e.g. from a private finance initiative [PFI] deal) and keeping this inflation on its books with the expectation of hedging it in the future by entering into an inflation swap with a pension fund.

warrant

Certificate, attached to a security, entitling holder to buy a specific amount of securities at a specific price. Warrants are valid for a specified period of time which may lapse either before or, in the case of warrants to purchase common stock, on or after the maturity of the debt security. Warrants are usually detachable and may be traded independently of the debt security. Effectively warrants are long-term call options.

weak form efficiency

One of the different degrees of the efficient market hypothesis (EMH), suggesting that current stock prices reflect and incorporate all relevant historic information. The weak form therefore implies that technical analysis based on such historic information cannot be used to predict future stock prices.

weighted average cost of capital (WACC)

Calculation of a firm's overall cost of capital that weights each source of finance proportionately (i.e. equity and debt).

weighted average return

Rate of return that is weighted to take into account the relative sizes of the various assets or funds which make up the sample.

weighting

Proportion of an index or portfolio made up of an individual or group of items, usually expressed as a percentage — for example, the percentage of a portfolio invested in a region or any one stock.

white knight

Friendly potential bidder for a company usually sought out as an alternative to a hostile bidder.

widow and orphan stock

Safe stock considered suitable for highly risk-averse investors.

Wilshire 5000 Index

Total market index measuring the performance of all US-headquartered equity securities with readily available price data. It is the most comprehensive index for the US equity market.

wind-up

Process by which a company ceases to operate as a going concern, and its assets and property are liquidated in order to repay creditors.

withholding tax

Tax levied by overseas governments on dividends paid abroad. This may not be reclaimable, even by tax-exempt investors.

with-profits fund

Investment product usually issued by an insurance company, which pays bonuses to policyholders from the profits made on the underlying investments. Policyholders may receive bonuses regularly and/or on maturity. The underlying assets of the with-profits fund usually include equities, bonds and property.

WM company

One of the main service providers in the UK that independently analyses the performance of pension funds and their investment managers.

WM Performance Services

One of the main service providers in the UK that independently analyses the performance of pension funds and their investment managers. Part of the State Street group of companies.

World Trade Organisation

Supranational body established to encourage and supervise international trade between member nations.

writer

Organisation or individual who sells (or grants) an option.

write-down

Investment which has been valued significantly below its original cost, but which is likely to recover at least part of its cost.

write-off

Investment from which there is no likelihood of any recovery of the amount invested.

W-shaped recovery

Describes the change of an economic indicator, such as unemployment or GDP, during a recession when the indicator experiences a sharp decline, followed by a rally back to original levels, and then a fall in value followed by another sharp rise.

Y

yield

Return on an investment expressed as a percentage. Most often used to refer to the gross redemption yield on a bond, being the return to a purchaser if the bond is held to maturity ignoring taxes and the prospect of default. Another term for interest rate. (See also nominal interest rate, real interest rate, redemption yield, running yield.)

yield curve

Relationship between redemption yields and terms to maturity. (See also redemption yield, term.)

yield curve risk

Risk of bond price volatility due to changes in the shape of the yield curve.

yield gap

Difference between the redemption yield on long dated bonds and the average equity dividend yield.

yield spread

Differences in yields available on different types of bond, for example, government and corporate bonds.

yield-to-maturity

See redemption yield.

YTD

Year to date.

Z

Z-spread

Fixed number of basis points that would be added to the gilt yield curve at all durations so that the present value of a bond's future payments equals its market price. Z-spread is a measure of a bond's credit risk. Therefore, it will be zero for gilts and high for low quality corporate debt. (See also nominal spread, option-adjusted spread.)

zero cost

Simultaneous purchase and sale of options on the same underlying security for the same period, with the same premium, but at different strike prices. Hence, instruments such as zero cost collars (see collar hedge) can be engineered.

zero coupon bond

Bond that pays no coupons. It is sold at a discount to its face value (assuming interest rates are positive) and matures at its face value after a specified term. (See also coupon.)

zero coupon yield curve

Graphic representation of the market yields for zero coupon securities plotted against the maturity of those securities.

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| Chile | Mexico | Switzerland |
| Colombia | Netherlands | Taiwan |
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