# A Glossary of Investment Terms

This glossary has been compiled to help you understand some of the investment terms you may encounter.  It is by no means a complete technical dictionary.

## A

### Absolute Return Funds

While the value of an absolute return fund may fall as well as rise, it will aim to make positive returns whether the overall market is up or down.  While such a fund may invest in many of the traditional asset classes – equities, bonds, property and cash – it will also use derivatives to try and gain additional returns and guard against market falls.

### Active Management

Active management refers to a management strategy where the manager makes investment decisions with the goal of outperforming an index or achieving a particular objective (for instance an absolute return).  Actively managed funds are typically more expensive to run than index funds and the performance between / of managers can vary considerably over time.  Active management is required to 'beat the market'.

### Alpha

Alpha is used to measure the value added or subtracted by a fund's manager.   A positive alpha is the extra return awarded to the investor for taking a risk instead of accepting the market return and this can be attributed to the difference the manager makes.

### Alternative Assets

'Alternatives' include venture capital, non-venture private equity, hedge funds, distressed securities, oil and gas partnerships, commodities, timber and other alternatives to the four traditional asset classes.

### Asset Classes

These are the basic building blocks of an investment strategy.  There are four traditional asset classes – shares (equities), bonds (fixed interest investments), property (usually commercial) and cash (or cash equivalents).  In recent years these have been joined by an array of 'alternative' asset classes such as hedge funds, commodities and private equity.

### Asset Allocation

Asset allocation refers to the allocation of an investment portfolio across a number of different asset classes to achieve the benefits of diversification.

## B

### Basis Point

A basis point is one one-hundredth of a percent or 0.01% -  so 50 basis points is 0.5%.

### Bear / Bear Market

Bear is a term describing an investor who thinks a market will decline. A Bear Market is a market where prices are falling over an extended period.

### Beta

Beta is the measurement of a fund's relative volatility to a market index. A fund with a beta greater than

1.0 is more volatile than the market while a fund with a beta less than 1.0 is less volatile than the market. A beta of 1.0 indicates the stock moves in step with the market.

### Blue Chip

Shares in large companies presumed to be among the safer investments on an exchange.

### Bonds

A debt investment, with which the investor loans money to an entity (company or government) that borrows the funds for a defined period of time at a specified interest rate. The indebted entity issues investors a certificate, or bond, that states the interest rate (coupon) that will be paid and when the loaned funds are to be returned (the maturity date).

### Bond Ratings

Bonds are rated by independent rating agencies according to their quality.  Two of the most well known rating agencies are S&P and Moody's.

| Rating | S&P | Moody's |
|---|---|---|
| Highest quality | AAA | AAA |
| High quality | AA | AA |
| Upper medium quality | A | A |
| Medium grade | BBB | BAA |
| Somewhat speculative | BB | BA |
| Low grade, speculative | B | B |
| Low grade, default possible | CCC | CAA |
| Low grade, partial recover possible | CC | CA |
| Default, recovery unlikely | C | C |

### Bottom up Investing

An approach that focuses on individual shares rather than the significance of market or economic cycles.  It assumes that individual companies can do well even in an industry that is not performing well.   Bottom up investing relies on a thorough understanding at the company level.

### Bull / Bull Market

An investor who believes that the market is likely to rise. A Bull Market is a market where prices are rising over an extended period.

## C

### Capital Risk

The risk that an investor will lose some or all of the money they have invested.

### Correlation

A standardised measure of the relative movement between two variables, eg between two asset classes.  The degree of correlation is measured on a scale of –1 to +1. If two variables move up or down together, they are positively correlated (closer to 1). If they tend to move in opposite directions, they are negatively correlated (closer to -1).  The closer to zero, the less correlated they area.

### Currency Risk

The risk that arises from holding an investment in a foreign currency and thereby being exposed to fluctuations in exchange rates.  Also known as ‘exchange rate’ risk.

## D

### Default Funds

The term commonly given to pension funds chosen by employers, trustees or plan providers for employees who do not wish to choose their own funds.  Increasingly common, default funds do not seek to provide the individual with the best possible investment solution for their own personal circumstances; rather the objective is to provide a reasonable investment solution for the average investor.

### Derivatives

Financial contracts whose value is tied to an underlying asset, such as futures and options. A derivative can be either a risky or low-risk investment depending on the type of derivative and how it is used.

### Diversification

Arguably the single most effective way of reducing investment risk, diversification is the term for minimising risk by investing across a wide range of investments, consistent with the concept of ‘not having all your eggs in one basket’.  This is done at a portfolio level by investing across numerous asset classes; at an asset class level by investing across numerous funds; and at a fund level by investing in wide range of shares, bonds, properties, etc.

### Diversified Growth Funds

Diversified Growth Funds (or DGFs) invest in alternative as well as traditional asset classes, offering a high degree of diversification in an attempt to reduce volatility.  Typically DGFs have active managers undertaking dynamic asset allocation, frequently monitoring and changing the asset allocations depending on market conditions.

## E

### Emerging Markets

Emerging markets typically include markets within countries that have an underdeveloped or developing infrastructure with significant potential for economic growth. Investments in emerging markets can be very volatile and may also involve currency risk, political risk and liquidity risk.  Those investing do so in the anticipation that the reward will be worth the risk.

### Ethical Investing

Also known as socially-conscious or socially responsible investing, ethical investing describes a strategy that seeks to combine financial return with social good.

## F

### FTSE 100

The Financial Times Stock Exchange 100 stock index, a market cap weighted index of stocks traded on the London Stock Exchange. Similar to the S&P 500 in the United States.

### Funds

A fund is a way of investing money with other people to participate in a wider range of investments than may be feasible for an individual investor and to share the costs of doing so.

### Fund of Funds

A fund that invests in other funds, typically diversifying across a variety of investment managers and investment strategies.

### Fund switching

The reallocation of money between funds.

## G

### Geographical Spread

The distribution of a portfolio over different parts of the world either by countries or larger areas, for example the Far East.

### Gilts

Bonds issued and guaranteed by the British government to raise funds and traded on the

Stock Exchange. A relatively risk-free investment, gilts bear fixed interest and are usually redeemable on a specified date.  According to the redemption date, gilts are described as short (up to five years), medium, or long (15 years or more).

### Glide-path

The term used to describe the de-risking trajectories of lifestyling strategies and target date funds as they move to less volatile investments the closer they get to a selected retirement date.

## H

### Hedge

Any transaction with the objective of limiting exposure to risk, such as changes in exchange rates or prices (inflation).

### Hedge Fund

Many hedge funds share a number of characteristics: they hold long and short positions, use leverage to enhance returns, pay performance or incentive fees to their managers, have high minimum investment requirements and target absolute returns. Managers of hedge funds typically have very broad investment powers.

### High-Yield Bond

Often called junk bonds, these are low grade fixed income securities of companies that show significant upside potential. The bond has to pay a high yield due to significant credit risk.

## I

### Index

An arithmetic mean of selected stocks intended to represent the behaviour of the market or some component of it. One example is the FTSE 100 which adds the current prices of the one hundred FTSE

100 stocks and divides the results by a pre-determined number, the divisor. There are a very large number of indices available for funds to benchmark against or replicate.

### Index Funds

Also known as 'tracker' funds, index funds attempt to replicate – before charges - the performance of an index rather than beat it. Index funds are typically cheaper to run than actively managed funds and can therefore provide cost effective access to market like returns. It is important to have a good understanding of the index being tracked.

### Index Linked Gilt

A gilt the interest and capital of which change in line with the Retail Price Index.

### Investment Grade

Something classified as investment grade is, by implication, medium to high quality. In the case of a bond, holding a rating of BBB or higher.

## J

### Junk Bond

A bond below 'investment grade' that pays a high yield due its greater credit risk.

## L

### Lifestyling

Lifestyling strategies assume that people should take less investment risk as they approach retirement, on the basis that they have larger funds to protect and less time to recover from a market shock. They are designed help investors take more risk when they are younger, usually through a higher exposure to shares (equity), and de-risk as they get closer to retirement, usually by reducing the equity content. It is not uncommon for pension providers to offer multiple, risk based lifestyling strategies – e.g. Cautious, Balanced, etc. Lifestyling strategies work by automatically switching funds in the years leading up to retirement. They can vary considerably in terms of how they invest and the period over which they de-risk.

### Liquidity

How easy it is to for an asset to be bought or sold in the market without affecting the asset's price or alternatively how quickly if need be an asset can be turned into cash. Investing in illiquid assets is riskier because there might not be a way for you to get your money out of the investment without incurring some form of financial penalty, if you can get it out at all.

## M

### Managed Funds

Managed funds are broad based funds, also known as mixed or multi-asset funds, that invest in several types of asset class to reduce the risk of a loss in a downturn (the principle of diversification). Managed funds tend to invest in traditional asset classes only. Pension providers commonly offer a number of managed / mixed funds by risk profile e.g. Cautious Managed, Balanced Managed, Adventurous Managed, etc.

### Management Fees

Also known as Annual Management Charges (AMCs) these are the fees taken by a fund manager for managing the fund, usually expressed as a percentage. For example, if at the end of a period the investment is valued at £1 million and the management fee is 1.2%, then the fee would be £12,000. As a rule of thumb, the more active the management, the more esoteric the investment, the higher the management charge.

### Market Risk

The risk that the value of an investment will go down due to market factors; or put another way, the risk from changes in market prices.

### Market Timing

The practice of allocating assets by switching into investments that appear to be beginning an upward trend and switching out of investments that appear to be starting a downtrend.

### Money Market Funds

Funds that invest in short term highly liquid money market instruments. Commonly use to ‘park’ money between investments, especially during periods of market uncertainty.

### Multi-Manager Funds

Funds that allocate assets to a number of managers with different investment styles. This methodology facilitates a high degree of diversification and accordingly the potential for a greater spread of risk.  However, they also introduce another layer of management fees, increasing costs.  Funds of funds are a classic multi-manager product.

## O

### Offshore

Investments located or based outside one's national boundaries, typically to access preferential tax treatments and fund legislation.

### Overweight

Refers to an investment position that is larger than the generally accepted benchmark. For example, if a fund normally holds a portfolio whose weighting of cash is 10%, and then increases cash holdings to 15%, the fund might be said to be ‘overweight’ in cash.

## P

### Passive Management

An investment strategy where a fund manager makes few (if any) decisions, most commonly ascribed to the management of Index or Tracker  funds where the objective is to mirror the performance of a particular index, such as the FTSE100.

### Private Equity

When equity capital is made available to companies or investors, but not quoted on a stock market. The funds raised through private equity can be used to develop new products and technologies, to expand working capital, to make acquisitions, or to strengthen a company's balance sheet.

## Q

### Qualitative Analysis

Analysis that uses subjective judgment in evaluating funds based on non-financial information, such as management expertise.

### Quantitative Analysis

Analysis that uses measurable and verifiable data to evaluate funds, such as financial ratios.

## R

### Reckless conservatism

A phrase that has evolved to describe the risk of taking too little risk and therefore ruling out the potential upside that may be necessary for an investor to meet their long term objectives, e.g. to retire.

### Risk

One of the most important things to be aware of when considering any investment is the risk that is being taken for the potential reward.  Investment risks include capital risk, currency risk, liquidity risk and market risk.

### Risk premium

The additional reward for holding a risky investment rather than a risk free investment.  The risk premium can be expressed as the expected rate of return from an investment – such as a share - above the risk-free rate of return.

### Risk-Free Rate of return

The quoted rate of return on an asset that has virtually no risk. In the UK this is commonly held to be the interest rate you get on gilts, on the basis that the UK government is one of the least likely entities in the world to default on a loan.

## S

### Sector

A distinct subset of the market or economy whose participants share similar characteristics. The Association of British Insurers (ABI) Sectors were introduced in 1997 to group together pension funds operating similar investment strategies to allow investors and financial advisers to more easily locate and compare them on a like for like basis.

### Shares

Shares represent units of ownership in a company (otherwise known as equity).  In the event of the company going bankrupt share holders' claims are subordinate to the claims of preferred shareholders and bondholders.

### Sharpe Ratio

The Sharpe ratio attempts to show whether the returns on a fund are because of smart investment decisions or a result of excess risk.   The greater a fund's Sharpe ratio, the better its risk adjusted performance has been.

### Standard Deviation

Tells us how much the return on a fund is deviating from the expected normal returns.  A volatile share will have a high standard deviation while the deviation of a stable blue chip share will be lower.

## T

### Target Date Funds

Target Date Funds (TDFs) exist to achieve a similar objective to Lifestyling, but with 'de-risking' taking place within the fund rather than by switching between funds.  Popular with pension plans in the US and increasingly available in the UK, target date funds de-risk according to what is commonly referred to as their 'glide-path'.    Glide paths differ from fund to fund, as does the asset allocation funds seek to provide at their target date.

### Top-Down Investing

An investment strategy that starts with the economy and trying to work out which industries or sectors will generate the best returns, before looking at individual companies within those chosen industries.  Analysis at the company level is the final step.

## V

### Venture Capital

Money and resources made available to start-up firms and small businesses which are perceived to offer exceptional growth potential.

### Volatility

The relative rate at which the price of a fund moves up and down. Volatility is found by calculating the annualised standard deviation of a daily change in price (how much it varies). If the price of an investment moves up and down rapidly over short time periods, it is said to have a high volatility. If the price almost never changes, it is said to have a low volatility. Volatility is a common measure of risk.

## Y

### Yield

The annual rate of return on an investment, usually expressed as a percentage of the investment's cost, current value or face value.