

Investment

Glossary of terms

A bewildering array of terminology is used within the pension fund investment industry, ranging from technical and lengthy definitions to pure and simple jargon. The purpose of this brief glossary of terms is to highlight those expressions which plan fiduciaries are likely to encounter in the course of fulfilling their investment responsibilities.

Absolute return

The concept that returns from certain investment vehicles, or investment classes, should provide a consistent, positive level of return in each calendar year, regardless of the return on quoted markets.

Active fund management

A manager that seeks to outperform the benchmark return.

Active risk

A statistical measure of the likely range of returns for a portfolio around the benchmark. A figure of 1 percent suggests that, two years in three, performance is likely to be within 1 percent of the benchmark return, and one year in three it is likely to be outside that range. Active risk can be measured by the tracking error.

Alpha

The manager's return less an appropriate benchmark return (or beta).

Annual yield

The annual income received from an investment expressed as a percentage of the capital value of the investment.

Asset allocation

The split of a fund's assets between asset classes and/or markets, such as UK equities, overseas equities, fixed interest securities, index linked securities, property and cash. The long-term strategic asset allocation of the fund reflects the guidelines set by the trustees with regard to

their investment objectives. An investment manager may aim to add value to any such broad guidelines over the short term by making tactical asset allocation decisions based on perceived pricing anomalies.

Asset-liability modeling

A risk assessment tool, whereby asset and liabilities are projected over a number of years using a range of investment scenarios. The results are used to assess the financial consequences of management actions. This is also known as a cashflow model.

Basis point

A measurement equal to 1/100 of 1 percent (0.01 percent). An expression commonly used in investment managers' fee rates, that is, 30 basis points would be an annual fee of 0.30 percent of the fund value.

Benchmark

A yardstick against which the investment performance of an investment manager can be compared for the purposes of determining investment skill. For a particular asset class the benchmark might be either the relevant market index return (for example the FTSE All-Share Index for UK equities), or an industry average return of investment managers operating under similar guidelines (for example Russell/Mellon CAPS UK equity median).

Beta

A measurement of the extent to which an individual security or a portfolio fluctuates in comparison with the market as a whole. Beta (β) is a statistical estimate of the average percentage change in a portfolio or security's rate of return when a 1 percent change in the market occurs. Commonly used in an investment strategy context to refer to the extent that the return of an investment strategy is driven by market returns (alpha is the remainder).

Beta prime

Beta is the market return. Beta prime is a reshuffling of the index weights to extract a 'relatively-passive' return advantage. The term 'relatively passive' refers to the method of extracting the return advantage (or alpha) being rules based and relatively transparent.

Bid/offer spread

The difference between the price that a market maker is willing to pay for a security (bid price) and the price at which the market maker is willing to sell the same security (offer price), representing his profit. This is also known as the market-maker's turn. The bid/offer spread can be applied to the unit price of a pooled investment vehicle. In this case the spread does not usually reflect an investment management fee, but rather the expenses incurred in acquiring or realizing units.

Bond

A certificate of debt, that is, an 'IOU' issued by companies, governments, and so on, usually paying interest and traded in a market.

Bottom up

An expression commonly used to explain the technique of selecting stocks within a particular market by reference first and foremost to the stock itself, for example ICI, rather than the market sector in which that stock is categorized, for example Chemicals. Opposite of top down.

Cashflow model

A projection of income and expenditure, and assets and liabilities into the future using a set of projection assumptions.

Commodities

Commodities are typically basic raw materials such as: energy (oil, gas, petroleum, and so on), livestock (cattle and pigs), agriculture (corn, coffee, cotton, and so on), industrial metals (aluminum, copper, and so on) and precious metals (gold, silver, platinum, and so on). While the value of other asset classes depends on expectations of future economic conditions, the value of commodities is determined by current market conditions. There are two possible methods of investing in commodities, either investing in 'physicals' or investing in 'futures'.

Core manager

A core manager is an active manager who runs a portfolio invested in a highly controlled fashion in an attempt to provide a stable and predictable return relative to a benchmark.

Corporate bonds

Debt issued by companies. The existence of credit risk in these instruments leads investors to demand a higher yield on their investment.

Correlation

A measure of the extent to which two securities or asset classes move together. A correlation between two assets of less than one suggests that there is a diversification benefit from investing in that combination of assets.

Credit default swap

A credit default swap (CDS) is a swap designed to transfer the credit risk of bonds between parties. It is an agreement between a protection buyer and a protection seller whereby the buyer pays a periodic fee in return for a contingent payment by the seller upon a credit event (such as a certain default) happening in the reference entity. A CDS is often used like an insurance policy, or hedge for the holder of debt, though because there is no requirement to actually hold any asset or suffer a loss, a CDS is not actually insurance.

Credit rating

A rating given to a company/security/entity to assess its future financial security. Credit ratings of BBB or higher are considered to be 'investment grade'.

Credit risk

The risk that a lender assumes when providing capital to a borrower. It is primarily the risk of default by the borrower (where the borrower becomes unable or unwilling to repay the debt), but is also the risk that the probability of default may increase. Corporate bonds and derivatives are examples of securities with credit risk.

Cyclical stocks

Shares whose performance moves in line with the economic cycle, that is, the shares tend to perform well in periods of expansion, prosperity and recovery but might decline in periods of recession.

Demographic factors

The projection assumptions relating to population changes, for example proportions of members retiring, leaving, dying or joining a pension plan.

Derivative

A contract specifying a payoff at some point in the future, with the payoff derived from the value of some underlying asset. Types of derivative are futures contracts, options and swaps.

Deterministic

A single set of projection assumptions that produce the expected (average) outcome from a cashflow model with no allowance for potential variations. Contrast with stochastic projection assumptions.

Distressed debt

Corporate bonds of companies that have either filed for bankruptcy or appear likely to do so in the near future. The strategy of distressed debt firms involves first becoming a major creditor of the target company by snapping up the company's bonds at pennies on the pound. This gives them the leverage they need to call most of the shots during either the reorganization, or the liquidation, of the company. In the event of a liquidation, distressed debt firms, by standing ahead of the equity holders in the line to be repaid, often recover all of their money, if not a healthy return on their investment. Usually, however, the more desirable outcome is a reorganization, which allows the company to emerge from bankruptcy protection. As part of these reorganizations, distressed debt firms often forgive the debt obligations of the company, in return for enough equity in the company to compensate them. (This strategy explains why distressed debt firms are considered to be private equity firms.)

Diversification

An effective spread of investments to reduce the likelihood that the adverse performance of individual securities or asset classes will significantly affect the overall performance of the portfolio.

Dividend

Cash payment that may be made to shareholders by a company each year. Normally paid in two six-monthly installments, an interim dividend followed by a final dividend once the company's profitability for the complete financial year has been assessed by its directors.

Dividend yield

Expressed as a percentage, it is calculated by dividing the dividend payable per share by the market price of the share.

Duration

A measure of the average maturity of the stream of payments generated by a financial asset. It is an important measure of the interest rate exposure of a fixed interest portfolio.

Emerging market

A stock market in a developing country such as Turkey, Argentina or India. These stock markets are expected to offer higher returns than in more developed markets due to rapid industrialization. A higher level of risk/volatility is also expected to accompany returns in these areas.

Emerging market debt

Emerging market debt is typically issued by an emerging market government, and sometimes an emerging market company. The credit quality tends to be below investment grade although recently has trended towards higher credit quality. In the very long term this is to be expected as countries move towards developed country status.

Fundamental analysis

Analysis of a company and its share price by examining its recent performance and predicting future levels of profits and dividends. This will involve a comprehensive assessment, both qualitative and quantitative, of a company's structure, accounts, management, products, assets, and so on. Contrast with 'quantitative fund management'.

Funding level

Ratio of assets to liabilities expressed as a percentage. For example a 110 percent funding level implies assets are 10 percent greater than liabilities.

Futures contract

An obligation to make or take delivery of a specified quantity of an underlying asset at a particular time in the future and at a price agreed upon when the contract was originated. The asset could be a commodity, a bond, a currency, an equity, a market index, and so on. Futures can be used as short-term speculative investments (see gearing) or as a way to hedge an existing risk.

Gilt

A gilt or gilt-edged security is a bond issued in the UK by the UK Government. There is virtually no possibility of the Government defaulting on its interest or redemption payments.

Governance

The operation and oversight of a pension fund. The governing body is responsible for administration, but may employ other specialists, such as actuaries, custodians, consultants, asset managers and advisers to carry out specific operational tasks, or to advise the plan administration or governing body. The governance budget of a pension plan refers to the amount of expertise and time available (both internal and external) to operate the plan.

Growth investor

Growth managers tend to focus on companies with above average profit growth (either historical or prospective). Typical growth factors include positive sales and earnings growth, high return on equity, positive forecasted earnings growth and positive earnings revisions. Growth factors tend to be less correlated than value factors. For instance, some managers focus on long-term growth whereas other managers are more driven by earnings momentum.

GTAA

Global tactical asset allocation (GTAA) is usually a model-driven strategy that uses derivatives to switch between equity markets, bond markets, commodity markets and currency markets, and also between regions within equities and bonds depending on how attractive groups of investments are relative to the others. GTAA is best employed on an unconstrained basis to most efficiently access manager skill. The objective of GTAA strategies is to provide absolute returns, regardless of the market conditions. GTAA is a type of hedge fund.

Hedge funds

Hedge fund managers attempt to produce targeted returns or absolute performance, regardless of the underlying trends in the financial markets. They implement a wide array of trading and longer-term strategies, from equity, fixed-income, commodities, or mathematical algorithms, however they each strive to capture market inefficiencies. Hedge funds will often use shorting to benefit from decreases in prices, and often employ significant leverage to increase the size or exposure of a position.

Hedging

An operation to secure an investor against a potential loss, often applied to the currency markets.

High alpha bonds

A high alpha bond mandate is aiming to exploit the skill of a bond manager and take advantage of opportunistic investments in the broadest possible investment universe. A high return mandate's sources of outperformance include global duration, currency management, high yield debt, emerging market debt, long-short positions, credit default swaps, mortgage-backed securities and options. For long-term mandates, there is often a focus on long-term misvaluations in these areas. These mandates employ the use of derivatives.

High yield debt

The high yield (corporate bond) market consists of bonds issued by companies with a credit rating below investment grade (that is, speculative grade or below BBB-). This lower credit rating reflects the expectation that these issuers are much more likely to default on their bonds compared with issuers of investment grade bonds. The U.S. has by far the largest high yield market in the world, accounting for over 80 percent of total corporate issuance, with Europe being the second market. Most managers focus on the BB-B (higher quality) spectrum as these have historically delivered the best risk-adjusted returns. The portfolios are typically well diversified to reduce the impact of individual defaults. Besides defaults, market returns are driven by ratings up and downgrades, changes in spread over government bonds and changes in yield on government bonds.

Indexation (index-tracking)

A passive investment management approach designed to mimic the investment performance of a specific market index.

Index linked gilt

A bond issued by the UK Government with its interest payment and redemption value both linked to an index which measures inflation to give a rate of return in excess of the rate of inflation, if the bond is held to redemption.

Inflation swap

An agreement whereby two parties agree to exchange two sets of cashflows. One party will agree to pay cashflows increasing at a fixed rate of interest to the other party, in

exchange for receiving cashflows increasing at the realized rate of inflation.

Information ratio

A risk adjusted measure of performance calculated as return above the benchmark divided by tracking error. The information ratio is an important measure of the financial efficiency of a portfolio.

Infrastructure

Infrastructure is a diverse asset category that encompasses a large and varied number of investments, such as toll roads, airports, pipelines, telecom networks and electricity generation facilities. A common denominator is that all these offer a basic service upon which a community depends. The creation of investable infrastructure securities (whether debt or equity) is driven, in the very first instance, by governments. Given the nature of the service, governments will always have a (political) interest in these projects. The securities represent the non-government interest. Infrastructure securities are a sub-sector of the wider bond and (private) equity markets. Their specific characteristics, however, often lead market participants to view them as a separate asset category.

Interest rate swap

An agreement whereby two parties agree to exchange two sets of cashflows. Usually one party will agree to pay cashflows increasing at a fixed rate of interest, in exchange for cashflows increasing at a floating (or short-term) rate of interest (for example LIBOR). On occasion, the two cashflows are linked to two floating rates of different terms (for example three-month LIBOR for six-month LIBOR).

Investment policy/strategy

The proportion of assets that are held in broad asset classes (UK equities, overseas equities, property, fixed interest, index-linked gilts, and so on). This is the key driver of the future performance of a pension fund.

Leverage

Financial leverage takes the form of a loan or other borrowings (debt), the proceeds of which are reinvested with the intent to earn a greater rate of return than the cost of interest. Leverage allows greater potential return to the investor than otherwise would have been available. The potential for loss is also greater because if the investment becomes worthless, not only is that money lost, but the loan still needs to be repaid.

Leveraged loans (or secured loans)

These are syndicated loans to U.S. and European sub-investment grade borrowers. In this case, the term 'leverage' relates to the underlying structure rather than the investor's portfolio.

LIBID

Stands for London Interbank BID rate, which is the short-term (30-180 days) rate at which large international banks will pay other large international banks for accepting deposits.

LIBOR

Stands for London Interbank Offered Rate, which is the short-term (30-180 days) rate at which large international banks will lend to other large international banks in London. LIBOR is slightly higher than LIBID.

Liquidity

The ability of investors to convert securities to cash at a price similar to the price of the previous trade in the security, assuming no significant new information has arrived since the previous trade. Equivalently, the ability to sell an asset quickly without having to make a substantial price concession.

Liquidity premium

The premium investors in illiquid assets demand in order to compensate them for the subsequent unavailability of their capital.

Long/short equity

Long/short equity is a type of hedge fund strategy that is similar to 'traditional' equity mandates but allows managers to sell borrowed shares (see 'Shorting'). While a long-only manager can easily overweight a stock, the maximum underweight position is to take a 0 percent weighting, no matter how negative the manager views this stock. Both theory and evidence suggest that this leads to sub-optimal portfolios. In managing long-short mandates, investment managers buy ('go long') stocks that they believe will increase in value and sell ('go short') their poorly rated stocks. If a manager can predict both the longs and the shorts correctly, they can benefit from both sides of the equation.

Long-term long-only (LTLO)

Long-term long-only equity portfolios are generally totally benchmark insensitive. The stocks are typically bought

based on a long-term (five years plus) time horizon, and portfolios are generally very concentrated (30-50 stocks) with low turnover (and trading costs) as a result. The investment managers that manage these portfolios focus on buying securities that will increase in value over the longer term, more or less irrespective of how market indices perform. Typically these investment managers are small 'boutique' organizations that have constraints on the volume of assets they can manage.

Lower quartile result

The 7,500th highest ranked outcome (out of 10,000) from the cashflow model or sample. One in four decades would produce a result as bad or worse than this.

Market index

An index is normally constructed of representative companies or stocks within a particular stock market, for use as a proxy for the relevant market against which to measure the performance of both individual shares and portfolios (for example FTSE All Share Index).

Market timing

An asset allocation decision in which investments are increased in asset classes expected to perform well, and subsequently decreased in those expected to perform poorly.

Maturity

The date at which a loan, bond, mortgage or other debt/security becomes due and is to be repaid.

Median result

The 5,000th highest ranked outcome (out of 10,000) from the cashflow model or sample. This corresponds with the most realistic assessment for the pension plan. Half of results are better and half worse than this outcome.

Neutral assumptions

A particular set of projection assumptions that assume that yields will remain, on average, at their current levels and that dividends on equities will grow in line with gross domestic product (GDP) growth over the projection period.

Option

The right, but not the obligation, to buy (call option) or sell (put option) a specific security at a specified price (the exercise price), at or within a specified time, whatever happens to its market price. This right can usually only be

obtained by payment of an amount (known as the premium) to the writer of the option. Pension funds can use options as hedging instruments.

Outcome

A single result (out of 10,000) of a particular statistic of interest (for example ratio of assets to liabilities) arising from the cashflow model.

Passive fund management

A term generally applied to the technique of indexation, although it could relate to any portfolio which is not actively managed and has low stock transaction levels.

Performance attribution

The identification of sources of returns for a portfolio or security over a particular time period.

Pooled fund management

Investing alongside other investors with similar objectives within a pooled portfolio of assets, in order to benefit from economies of scale and to gain exposure to a more diversified spread of investment than could otherwise be achieved by investing directly in stocks and shares (that is, segregated fund management). A pooled fund investor's share of the overall portfolio is usually denoted by a number of units, the unit price reflecting the price movements of the underlying securities within the pooled (or unitized) investment vehicle.

Present value of total employer contributions

The sum of contributions paid by the employer over the projection period discounted back to today's monetary terms.

Private equity

Private equity represents investment in unquoted and/or unlisted companies, ranging from venture capital through to provision of finance to well-established businesses.

Projection assumptions

A set of assumptions (for example investment returns, salary increases, rates of retirement, and so on) describing the future behavior of assets and liabilities over the projection period. These assumptions may vary for each year of the projection period and are distinct from the plan's valuation assumptions. Projection assumptions may be deterministic or stochastic.

Projection period

The period of time over which cashflows are projected into the future, typically 10 years.

Property

Institutional investment in property is primarily attained via commercial buildings (offices, warehouses and retail – high street shops, shopping centers and retail warehouses).

Quantitative fund management

An investment management approach concentrating upon statistical and numerical analysis rather than the qualitative/fundamental approach of researching companies and company management.

Rebalancing

A policy of re-weighting the asset allocation of a portfolio or benchmark periodically. The aim is to keep the asset allocation in line with the target strategy.

Risk

In its simplest sense risk might be regarded as the uncertainty associated with investment, that is, being unable to guarantee the future return. Generally speaking there is a trade-off between risk and return, where the higher the risk of an investment, the higher the expected return (although with hindsight, not necessarily actual return). There are a number of definitions and statistical measures of risk, and all investors should relate their own attitude towards risk to their specific circumstances and requirements.

Risk budget

The amount of investment risk (often defined in VAR 95 terms), relative to the liabilities, a pension plan wishes to take. Risk budgeting is a risk modeling tool (similar to asset-liability modeling), which aims to define the risk budget and allocate it between different investments in the most efficient manner. Risk budgeting typically has a shorter outlook than asset-liability modeling, and can also assess how to allocate the risk budget between different types of investment management, as well as different asset classes.

Satellite manager

A satellite manager runs portfolios managed more aggressively in search of higher returns, with a view to achieving better than benchmark performance on the total assets of the fund.

Scenario

Usually means an alternative set of projection assumptions used to sensitivity test the results.

Shorting

Shorting is a way to profit from the decline in price of a security, such as stock or a bond. Shorting a stock implies an anticipation that the stock price is going down, a short seller can borrow a security and sell it, expecting that it will decrease in value so that they can buy it back at a lower price and keep the difference.

Standard deviation

A measure of the average dispersion of a set of numbers (for example a series of investment returns) away from their average amount.

Stochastic

A set of projection assumptions that incorporates a random variable calibrated to reflect real life uncertainty. The existence of a random element allows us to simulate many (typically 10,000) possible outcomes from a cashflow model and hence the level of risk taken when a particular investment policy is adopted.

Stock selection

The process of operating a portfolio within any given asset class, usually with the objective to outperform a relevant benchmark, by the successful buying and selling of individual stocks within that asset class.

Strategic asset allocation (SAA)

Long-term asset allocation set with reference to a fund's liability profile, cashflow and funding level and to long-term assumptions of expected future return in each asset class. It does not take into account short-term pricing anomalies between asset classes.

Style

The 'style' of an investment manager refers to an element of active management that describes the way in which investment philosophy (beliefs about what factors drive stock prices) and investment process are combined to try to add value to portfolios in order to outperform the benchmark.

Swap

An agreement whereby two parties agree to exchange two sets of cashflows, where the two cashflows will be linked to

the changes in different financial or economic variables in some pre-specified manner.

Top down

The opposite of bottom up, where emphasis is placed primarily upon sector or country selection, with stock selection taking place subsequently.

Tracking error

The volatility of the return relative to the benchmark, calculated as the standard deviation of the return relative to the benchmark (also known as active risk).

Upper quartile result

The 2,500th highest ranked outcome (out of 10,000) from the cashflow model or sample. One decade in every four would lead to a result as good or better than this.

Valuation assumptions

The assumptions used by the plan actuary to perform the triennial actuarial valuation of the plan. Valuation assumptions normally include margins for prudence and hence differ from best estimate projection assumptions.

Value investor

Value managers seek to outperform the market through the exploitation of pricing anomalies, looking for situations where the market underestimates a company's current worth relative to specific factors. Typical value factors are often accounting variables, for example low P/E ratio (market price to earnings), high dividend yield (dividend to market price), and low price to book ratio (market price to book value). These factors tend to be highly correlated.

VAR 95 (value at risk)

A measure of loss (\$million) due to investment risk. Losses at least this severe should be expected to occur one year in twenty (5 percent of the time). VAR 95 is the 9,500th highest ranked outcome (out of 10,000) of the cashflow model or sample.

Volatility

Term commonly applied to a stock to indicate the degree of variability of its price over time, in particular compared with the overall market. One measure of volatility involves the calculation of the standard deviation of past returns.

Yield

The ratio (expressed as a percentage) of annual income to market value of asset(s). Can also be used as an abbreviation for the redemption yield on bonds (which calculates the return from income and capital combined).

Yield curve

The yield curve shows the redemption yield for bonds with differing lengths of time to their maturity. It can be used by an investor both to identify market expectations concerning the future level of interest rates, and to spot any anomalous pricing differentials between two different securities.

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