

GLOSSARY OF INVESTMENT TERMS

A

Active vs. Passive Managers:

An active manager tries to outperform an index over time by actively managing the portfolio—holding fewer names than the index, trading the portfolio, concentrating the portfolio by industry or by economic sector, holding cash or bonds as common stock reserves, etc. The S&P 500 and EAFE are two often-used market indexes. An index manager tries to match the performance of a market index with little or no deviation ("tracking error"). Index managers are often described as passive managers, although it takes "active" buying and selling to match the performance of an index.

Appreciation:

Increase in the value (from date of purchase) of an asset such as a stock, a bond, a commodity or real estate.

Asset Allocation:

The distribution of a pool of assets among various asset classes, including, but not limited to, domestic and foreign bonds, cash, real estate, venture capital, etc.

Asset Classes:

Types of investments commonly divided into the categories of equity (common stock), fixed-income (bonds), cash and cash equivalents and alternative investments (real estate, oil and gas, venture capital, distressed securities, leveraged buyouts, risk arbitrage, etc.).

Average Annual Compound Return (AACR):

AACR is the annual return—that would produce the same end result if compounded over a given period—as a string of different annual returns over that same period. Using AACR allows comparison of managers' performance over a period of years. However, the AACR does not show how volatile returns have been over the period.

B

Balanced Portfolio:

A portfolio in which a manager invests in both common stock and fixed-income instruments according to a predetermined target—e.g., 60 percent common stock, 40 percent fixed-income.

Basis Point:

One one-hundredth of a percent (0.01 percent); 2 percent is equal to 200 basis points. A term commonly used to measure returns, earnings and fees paid to investment managers.

C

Cash Equivalents:

Instruments or investments of such high liquidity and safety that they are virtually as good as cash. Examples include money market funds and treasury bills.

Consumer Price Index (CPI):

Measures the average change in prices (inflation or deflation) over time for a fixed-market basket of goods and services. It is often used to adjust economic and financial data from current (nominal) terms to inflation-adjusted (real) terms. Published monthly by the Bureau of Labor Statistics.

Corporate Form:

A community foundation that is incorporated as a nonprofit corporation. Investment management of assets held by the corporation is the responsibility of the managers or board of the foundation. A community foundation may include both a corporate entity and component trusts. (see *Trust Form*)

Custodian:

A bank or other financial institution that has custody of stock certificates and other assets of a mutual fund, individual, corporation or institution. All custodians can hold assets in safekeeping, collect income on securities in custody, settle transactions, invest cash overnight, handle corporate accounting and provide accounting reports.

D

Derivative:

A security whose price is based on the price of another security. Examples include options, warrants, swaps, futures and forwards.

Diversification:

An attempt to minimize risk by distributing assets among various asset classes or among managers within the same asset class who have different styles.

Due Diligence:

The degree of prudence that might be properly expected from a reasonable person in the circumstances; applicable to foundation personnel who act in a fiduciary capacity. (see *Fiduciary Duty*)

Duration:

A more accurate measure of the interest rate sensitivity of a bond than maturity, duration reflects both the timing and the relative magnitude of a bond's cash flows (both principal and interest payments). Specifically, duration is defined as the weighted average time period to receipt of a bond's cash flows (both principal and interest), with the cash flows discounted to present value using the bond's yield to

maturity. Because a zero-coupon bond has no interim cash flows, its maturity and duration are the same. For other bonds, duration is determined by the bond's maturity, its coupon and its yield to maturity. Used to measure the price sensitivity of a bond. (see *Maturity*)

E

EAFE Index:

Acronym for the Europe, Australia, Far East Index prepared by Morgan Stanley Capital International. The EAFE Index is the most commonly used market benchmark for measuring the performance of international common stock managers. Because the index is weighted by market capitalization, Japanese stocks make up approximately half of the index.

Earned Income:

Dividends and interest payments received or credited to one's account. (see *Return, Total*)

Emerging Markets:

Best represented by developing countries' markets in four major regions: Latin America, East Asia, South Asia and sub-Saharan Africa. The most commonly used benchmark for measuring the performance of emerging markets is the MSCI Emerging Markets Index.

Equity vs. Common Stock:

Common stock represents equity or ownership interest in a corporation; equity can also mean an ownership interest in other asset classes, including real estate, oil and gas, venture capital, etc.

Excise Tax on Net Investment Income:

A tax on the net investment income of private foundations. Normally set at 2 percent per year, the rate may be reduced to 1 percent if the foundation meets certain expenditure requirements.

F

Fiduciary Duty:

The legal responsibility for investing money or acting wisely on behalf of another. Managers of charitable entities have fiduciary obligations to the charity. (see *Due Diligence*)

G

Global vs. International Investing:

Describes opportunities for investing in asset classes. Global investment managers may invest anywhere in the world. International investment managers (often called foreign investment managers) may invest in any country, except the United States.

Hedging:

Hedging can include one or more strategies used to offset specific investment risk. A perfect hedge is one eliminating the possibility of future gain or loss. Examples include owning real estate to protect against inflation; owning high-quality, long-term bonds to protect against deflation (selling stocks short to protect against a downturn in the stock market).

I**Index:**

A standard of measurement, e.g., the Dow-Jones Industrial Average, the S&P 500, the Lehman Bros. Long-Term Bond Index, the Russell 2000, etc. Each of these indexes measures the activity of securities within their universe. There are many indexes. The performance of some investment managers is measured against an appropriately selected index.

International Investing:

The selection of investments for inclusion in a portfolio from outside the United States. Such selections of investments may make up one or more separate asset classes.

Investment Consultants:

Advisors who aid in the investment decisions of individuals and financial committees and officers of institutions. Investment consultants provide information and make recommendations about asset allocation, manager structure, manager review and portfolio performance.

Investment Manager:

An individual, firm or committee responsible for making day-to-day decisions to buy, hold, or sell assets. Also known as money managers or investment advisors.

L**Lehman Brothers Governments Corporate Bond Index:**

A capitalization-weighted index, generally accepted as a proxy for the U.S. taxable-bond market. It is composed of all publicly issued, nonconvertible domestic debt of the U.S. government and of industrial, utility and financial corporations. It includes issues rated BBB or better, with maturities greater than one year and at least \$1 million per value outstanding. Government bonds account for approximately 75 percent of the face value of the index.

Liabilities:

Claims on assets held, excluding ownership equity. For a foundation, payments outstanding for grants authorized and not yet paid or remaining grants to be paid over multiyear periods, are liabilities.

M

Market Capitalization:

The market capitalization of a company is equal to the total number of shares outstanding multiplied by the current price per share.

Maturity:

Maturity measures only the timing of the recovery of the principal and ignores the interim coupon payments of a bond. Bonds with similar durations are more likely to react similarly to changes in interest rates than are bonds with similar maturities but different durations. (see *Duration*)

P

Pass-Through Foundation:

Foundations that receive monies and make distributions to donees, with little or no principal remaining with the foundation.

Percentile Rank:

Ranking of an entity within a comparable universe. In general, 89th percentile means that the entity in question is in the top 11 percent. Some organizations use a different convention: the same entity would be considered to be in the 11th percentile.

Portfolio:

The total investment pool held by an organization; normally divided into several segments such as equities, fixed-income, real estate and the like. The asset allocation of a portfolio will reflect the risk level with which the sponsor is comfortable and will concurrently affect the level of total return.

Portfolio Insurance:

The use of stock index futures by a portfolio manager to protect against market declines. Instead of selling actual stocks as they lose value, managers sell the futures. If the stock continues to drop, they repurchase the futures at a lower price.

Present Value:

Also called time value of money or discounted cash flow, present value is the value today of a future payment discounted at some appropriate compounded interest rate. Used to determine the current value of a future payment or to calculate the amount that must be invested today to achieve a desired value of assets at some future date.

Price-Earnings Ratio (P/E):

The current price of a share of stock divided by the most recently available 12-month earnings per share.

Prohibited Transaction:

One of a number of activities in which certain private foundations and/or foundation representatives may not engage. (see [Disqualified Person](#))

R**Return, Net, of Manager Fees:**

Total return minus managers' fees. (see *Return, Total* below)

Return, Rate of:

The rate of return on an asset or a pool of assets is a measure of investment performance and should always be determined on a total-return basis, i.e., including realized and unrealized changes in market value in addition to earned income (i.e., dividends and interest income). Managers may report returns before or after management advisory fees, but returns are always reported after brokerage and trading costs.

Return, Real:

A real return is the nominal or actual return adjusted for inflation as measured by the Consumer Price Index (CPI). (see *Consumer Price Index*)

Return, Total:

A measure of an investment's return that includes both realized and unrealized changes in market value plus earned income. (see *Earned Income*)

Russell 2000:

A capitalization-weighted, total return index comprising the smallest 2,000 stocks of the Russell 3000. (The Russell 3000 index includes the largest U.S. companies as measured by the market capitalization.) The Russell 2000 provides a useful proxy for the small company universe, with the smallest stocks still large enough to be of interest to the institutional investor.

S**S&P 500:**

The most widely used index of the stock market, the S&P 500 represents about two-thirds of the aggregate market value of all U.S. common stocks. In selecting stocks for inclusion in the index, Standard & Poor's aims to replicate the industry weightings of the market; therefore, it is not the 500 largest stocks. Moreover, 5 percent of the index comprises foreign stocks.

Security:

A general term that refers primarily to stocks and bonds, as compared to other investments such as real estate, limited partnerships and the like. Historically, the term comes from the fact that "security" was

provided by the presentation of a written document reflecting the ownership.

Spending Policy:

An agreed-upon policy that determines what percentage of a group of assets, such as an endowment, should be spent to cover both operating costs and grants of an institution. Typical spending rules combine calculations based on previous years' spending, the current year's income and investment return rates and the policy of the foundation covering grant commitments.

T

Transaction Costs:

Costs of buying or selling a security. Costs include brokerage commission, dealer markdown or markup, fees and taxes.

Trust Form:

A community foundation made up of multiple forms. Investment responsibilities generally remain with the trust department of a bank (or banks) and such trust departments are responsible for the developing and implementing of investment policy. (see *Corporate Form*)

Turnover:

Turnover is a measure of how actively traded a portfolio is. One often-used calculation of turnover is the lesser of security purchases or sales for the period divided by the average total asset value during the period. A portfolio with 100 percent turnover implies that all of the stocks that were in the portfolio at the beginning of the period were sold and replaced by the end of the period. In reality, however, a portion of the portfolio may have been turned over aggressively, while other holdings remained untouched.

Y

Yield:For bonds, yield is annual interest divided by the market value of the bond. For stocks, yield is a security's dividend per share divided by its price per share.

Yield to Maturity:

Used to determine the rate of return an investor will receive if a long-term, interest-bearing investment, such as a bond, is held to its maturity date. Factors involved in calculating the rate of return include purchase price, redemption value, time to maturity, coupon yield and schedule of payments.