LCP INSIGHT CLARITY ADVICE

Glossary of investment terms

Click to begin

Welcome to LCP's investment glossary

This document has been put together to help you better understand the key financial terms used in our advice and in the financial press.

You can use the arrow buttons in the top right to navigate your way through the document. You can also use the A-Z footer which will allow you to jump to a specific letter.

We hope you find this document useful. If you have any questions or suggestions, or would like to learn more about LCP's services, then please **contact one of our experts**.

Paul Gibney
Partner

How to use the glossary:
Click on a letter below to jump to terms in that section of the alphabet.

A

ABS

See **asset-backed security**.

Absolute return

Absolute return funds aim to generate a positive **total return** irrespective of investment conditions over a market cycle (usually between three to five rolling year periods).

Active currency

This is an **asset class** in which a **manager** attempts to generate returns through the purchase and sale of different currencies.

Active management

A **portfolio** is managed actively if the **manager** has discretion over what is included in the portfolio, typically relative to some reference portfolio or **index**. This is in contrast to **passive management** where there is no, or very limited, discretion. An actively managed portfolio has the potential to provide higher returns than the comparable passive alternative, but also the risk of lower returns. Active management also typically involves higher fees than passive management.

Active ownership

The exercise of rights as an asset owner. It includes casting votes at shareholder meetings and engaging with investee companies with the aim of improving investment performance. See also **stewardship**.

Active member

An active member is a person who is accruing benefits under a pension scheme as a result of their current employment.

Active share

Active share is a measure of the difference between a **portfolio**'s holdings and those of its **benchmark** and ranges between 0% and 100%. For an active manager, a high active share (60%+) is one measure of outperformance potential.

Activism

The process by which company investors (ie the owners) engage with a company management in order to bring about corporate change. The most visible form of activism is the exercise of voting rights by investors, particularly when used to express disagreement with a given management proposal. See also **stewardship**.

Ad valorem

A fee levied as a percentage (eg 0.5% pa) of the value of assets.

Additional Voluntary Contributions (AVCs)

Extra **contributions** paid by pension scheme members to secure benefits in excess of the standard scheme benefits.

Administrator

The administrator of an investment **fund** is responsible for carrying out day to day administration. This includes activities such as calculating the fund's **Net Asset Value** and preparing its accounts and maintaining its financial records.

Alpha

The term used to refer to returns in excess of an agreed **benchmark** (eg an **index**), which are deemed to be due to **manager** skill rather than simply a reward for exposure to that benchmark (see **beta**). For example, if a manager returns 15% while the corresponding benchmark returns 10%, then the alpha is 5%. Alpha can be positive or negative.

Alternative assets

These are **asset classes** that are now commonly used by pension schemes. Examples include **active currency, commodities, private equity, property, infrastructure** and **hedge funds**. Many alternative asset classes target **absolute returns** rather than **relative returns**, and the **manager** typically charges much higher fees than for "**traditional**" asset classes such as **equities** and **bonds**.

Alternative Investment Market

This is the London Stock Exchange market that is designed to help smaller and medium size companies access capital. It is less regulated than the main market and smaller, so **shares** listed on it tend to be higher **risk** and more difficult to buy and sell.

American option

An **option** that can be exercised before and on its **maturity** date. Contrast with **European option**.

Analyst

An individual who researches companies and provides buy/sell recommendations on its **securities** (eg **equities, bonds**) to investors.

Annual Chair's statement

This is a document that must be produced for trust-based **defined contribution** (DC) pension schemes every accounting year. It covers five specific areas – the default arrangement, processing of core financial transactions, charges and transaction costs, value for members, and trustee knowledge and understanding.

Annual Management Charge (AMC)

An **investment manager** is generally remunerated through receipt of an Annual Management Charge (AMC). The AMC is normally an **ad valorem** amount, but other pricing options can be used, such as a fixed fee, although this is relatively rare. The AMC is not the only expense incurred by investors, and for **pooled** funds some of these other charges are included in the **Total Expense Ratio (TER)**. **UCITS**-compliant funds have to disclose the **ongoing charges** figure, which is similar.

Annuity

A regular **cash** payment made over a period of time or until the occurrence of a particular event. It may be non-increasing, increase at a fixed rate or be linked to some measure such as the **Retail Prices Index** (RPI). A pension in payment is an example of an annuity.

Annuity option

In a **defined contribution** (DC) arrangement, a form of **lifestyle** in which, in the run up to the point at which a member starts to take their benefits, assets are gradually switched into an appropriate mix of bond investments which are then used by the member to purchase an **annuity** (whose price will reflect the price of **bonds**). In practice, it is common as part of the switching process for up to 25% of the member's pension pot to be moved into cash which the member can take as a tax-free cash lump sum when they first start to take their benefits, with the remainder being allocated to annuity purchase.

Arbitrage

Making profits from price differences in the same **security** when it is traded in two or more different markets through simultaneous purchase and sale.

Asset allocation

This refers to the proportion of assets invested in different **asset classes**. For example, the asset allocation for a pension scheme might be 40% **equities**, 50% **bonds** and 10% **property**.

Asset-backed security (ABS)

An asset-backed security is a **security** whose value is backed by a specified pool of assets. The assets backing the security are known as **collateral**. The pool can comprise a range of assets, such as payments due from mortgages, car loans or credit cards. The multi-source nature of the cash flows backing an ABS should be contrasted with the single payment source (ie the issuing company) for a **corporate bond**, an alternative type of **debt** instrument.

Asset class

A group of **securities** which exhibit broadly similar characteristics. Examples include **equities** and **bonds**.

Asset liability modelling

The name given to mathematical modelling techniques used to examine the relative behaviour of assets and **liabilities** in a wide range of "potential financial futures" with the aim being to select an investment mix which provides an optimal and acceptable trade-off between **risk** and **return.**

Asymmetric risk

This exists when an investment is considered to have the potential for only a small positive price movement but a large negative price movement (or vice versa). For example, a **corporate bond** might be expected in most favourable circumstances to show only modest price appreciation, but could fall to zero value in certain adverse situations, for instance, if the issuing company were to **default**.

Assets under management (AUM)

This is simply the amount of investor money that an investment firm manages, either in total or in a particular **asset class**, eg UK **equity**.

AUM

See **Assets under management**.

AVC

See **Additional Voluntary Contributions.**

Backwardation

This describes the situation in which the current **futures** price of an asset is lower than the expected future **spot price**. The term is commonly used in relation to **commodities**. All things being equal, a **manager** can generate a positive "roll return" by buying the future now and receiving the higher spot price at expiry. Contrast with **contango**.

Bail in

Bail ins were introduced following the **global financial crisis** where governments had ploughed hundreds of billions into financial institutions, but bond holders were untouched. Under a bail in, **bond** holders are made to forfeit a portion of their investment in order to ensure that critical parts of the financial infrastructure (eg a bank) can keep running. See **bail out**.

Bail out

Assistance provided to a financial organisation (eg a bank) or a sovereign nation in order to persevere financial stability. A bail out may be in the form of a loan requiring repayment or it may be a straightforward non-repayable handout. Bail outs are provided by **central banks** or from other sources including funds such as the **European Stability Mechanism** (ESM). See **bail in**.

Bank rate (also known as the base rate)

This is the **interest rate** at which the Bank of England lends money overnight to other banks in return for high quality **collateral**. The Bank of England moderates the supply of money to banks, and hence the economy, by raising or lowering the base rate. Short-term interest rates for high quality borrowers typically remain close to this rate.

Basis point

A basis point is one hundredth of one percent (ie 0.01%). For example, 0.30% is often described as 30 basis points.

Basis risk

A term commonly used when describing the imprecise "match" (or "**hedge**") that an actual investment arrangement often provides relative to another asset or reference value. For example, in response to a given change in **interest rates**, the value of a **swap** contract may not change by as much as the corresponding pension scheme **funding target**. This risk is commonly found in **Liability Driven Investment** (LDI) strategies.

Bear market

A period of sustained falls in market prices, particularly with reference to **equity** market prices. Contrast with **bull market**.

Bearer security

An investment for which no ownership record is maintained by the issuer. Whoever physically holds the security document is deemed to be the person entitled to its ownership rights and benefits. Contrast with **registered security**.

Benchmark

A benchmark is a reference measure used for comparative purposes. In **performance monitoring,** the benchmark is typically an **index** against which the **manager**'s performance is judged, such as the **FTSE** All-Share for UK **equities**. In **investment strategy,** the benchmark is the **asset allocation** against which the performance of a pension scheme's actual investment distribution is assessed. A pension scheme's asset allocation benchmark is stated typically in its **Statement of Investment Principles** (SIP).

Best execution

The process of executing a trade at the best price available (net of costs), subject to a variety of factors (eg size of trade, type of trade, customer-specific requirements).

Beta

This is the **return** due to market or **asset class** exposure, rather than the return due to **manager** skill. It is often measured by calculating the return on an **index** or **benchmark**. For traditional **asset classes** such as **equities**, the majority of the investment return is expected to come from beta rather than **alpha**. Beta is also commonly used to describe the likely sensitivity of price movements for a specific **security** relative to the market as a whole. For example, if a **stock** is expected to rise (or fall) by half as much as the market as a whole, it is said to have a beta of 0.5.

Bid price

This is the price at which an investor can sell an asset. Contrast with the higher **offer price**.

Bid to offer spread

This is the difference between the higher **offer price** that an investor pays to buy an asset and the lower **bid price** an investor receives when selling an asset. The wider the **spread**, the higher the cost of buying and selling a given investment. The most **liquid** investments, such as **government bonds**, have low bid to offer spreads whereas less liquid investments, such as **property**, have high bid to offer spreads. Other factors, such as taxes and **commissions**, also affect the size of the bid to offer spread.

Binary

An investment is said to have a binary outcome if it offers two potential outturns, one leading to a significantly higher and one to a significantly lower price or expected **return** than its current one. In practice, the actual outcome is not strictly binary and other possibilities lying between the extremes could also occur. The term is often used in situations where there is great uncertainty and the final position depends largely on one decision or event. For example, a financial organisation may be close to insolvency but there is hope of a **bail out**. This could lead to a binary outcome for its **bonds**. If the rescue materialises, then the price of the bonds should rise very strongly, while if it does not, their price would be expected to fall substantially.

Bloomberg

One of the leading financial information providers. Many investment companies use special Bloomberg computer terminals to access current and historical financial news and data. See also **Thomson Reuters**.

Bond

A bond is a **security** issued to investors by companies, governments (eg **gilt**) and other organisations. In exchange for an upfront payment, an investor normally expects to receive a series of regular interest payments plus, at **maturity**, a final lump sum payment, typically equal to the amount invested originally, or this amount increased by reference to some **index**.

Bonds

Bonds refer to a **bond portfolio** or more generally the **asset class**.

Book value

The price paid originally for an asset. Generally used only for accounting purposes in a limited set of circumstances.

Bottom-up

This is an **active** investment management approach in which a **portfolio** is constructed by focusing initially and primarily on the features of individual companies (rather than broader sector or country characteristics). See also **top-down**. In practice, most traditional active investment management processes combine both bottom-up and top-down techniques.

Breakeven inflation

This is the measure of future **inflation** implied by specified investment markets (most importantly the **gilt** and **swap** markets). The measure is calculated as the difference between **nominal interest rates** and **real interest rates**, as derived from certain types of **security** (ie **gilts** and **index-linked gilts**).

Broker

An individual/company who acts as the middleman between the buyer and seller of a **security**, normally in return for a **commission**.

Bull market

A period of sustained rises in market prices, particularly with reference to equity market prices. Contrast with **bear market**.

Buy & maintain

An approach to investing in credit markets that sits between **active** and **passive** management. Such an approach provides the **portfolio** manager with discretion to select a preferred initial portfolio of **bonds** which is then maintained, only being traded should an opportunity arise to improve the portfolio's risk-adjusted **yield**. The manager will therefore at outset choose bonds that it is comfortable to hold to **maturity**, seeking to minimise the **risk** of **default** as far as possible while generating an acceptable level of **return**. The approach is characterised as a low-turnover approach to accessing market **beta** in a smarter way than traditional passive approaches.

Buy-in

Pension scheme trustees may choose to "buy-in" some of their scheme's expected future benefit payments by purchasing a bulk (ie one covering many individuals) **annuity** contract with an insurance company. This allows the trustees to reduce their scheme's **risk** by acquiring an asset (the annuity contract) whose cash flows are designed to meet ie "match" a specified set of benefit payments under the pension scheme. The contract is held by the trustees and responsibility for the benefit payments remains with the trustees. Common uses of buy-in arrangements have been to cover the payments associated with current pensioners or a subset of those members. Contracts to meet payments to members who are yet to become pensioners can also be purchased.

Buy-out

Pension scheme trustees may choose to "buy-out" some or all of their scheme's expected future benefit payments by purchasing a bulk (ie one covering many individuals) **annuity** contract from an insurance company. The insurer then becomes responsible for meeting pension benefits due to scheme members (effected ultimately by allocating an individual annuity contract to each scheme member). Following a full buy-out, (ie one covering all scheme members) and having discharged all of the trustees' **liabilities**, the pension scheme would normally be wound up.

Call option

An option (but not obligation) to buy an asset at a specified price within an agreed time period or at an agreed future point. See also **put option**.

Capacity

The maximum amount of assets that a **manager** can manage effectively using its particular investment approach for a given type of investment – eg UK **equities**. Ideally, **assets under management** (AUM) are set at a level below the manager's actual capacity, with action taken to ensure that this remains the case (eg closing to new business).

Capital markets

The name given to the various investment venues used by governments and companies to raise longer term (by convention greater than one year) finance.

Carbon emissions

These refer to the release of carbon dioxide, or **greenhouse gases** more generally, into the atmosphere.

Carbon footprint

In an investment context, the total carbon dioxide or **greenhouse gas** emissions generated per amount invested (eg in £m) by an investment fund. Related definitions are used to apply the term to organisations, countries and individuals.

Carbon offsetting

The process of paying someone else to avoid emitting, or to remove from the atmosphere, a specified quantity of **greenhouse gases,** for example through planting trees or installing wind turbines. It is sometimes used to meet **net zero** and other emission reduction targets.

Carbon pricing

The process of applying a cost to emitting carbon dioxide (CO_2) into the atmosphere, per tonne of CO_2 emitted, as an incentive for emitting less. It usually takes the form of a carbon tax or a requirement to purchase emission permits. Putting an economic cost on emissions is widely considered the most efficient way to encourage polluters to reduce their emissions.

Carry trade

This is a transaction whereby an investor hopes to profit by borrowing money in a low **interest rate** currency and investing in a currency which has a high interest rate. For example, in the 1990s Japan had a 0% interest rate while the United States had rates around 5%. Carry trade investors borrowed money in Japan and invested money in the US. The main **risk** of the carry trade is that the low interest rate currency rises rapidly in value against the high interest rate currency.

Cash

A very short-term **liquid** asset. Although the everyday use of the word tends to refer to hard currency and coins, a **manager** will typically use cash to refer also to short-term deposits. A manager often retains a small amount of cash (eg 2% to 3%) within a **portfolio** to make new purchases when the opportunity arises.

Cash option

In a **defined contribution** (DC) arrangement, a form of lifestyle in which, in the run up to the point at which a member starts to take their benefits, assets are gradually moved fully or mostly into cash. The member will then typically take their pension pot as a single cash lump sum or small number of cash lump sums.

Cashflow driven investment

An investment approach which invests in assets that deliver specified cashflows at particular points in the future in order to meet benefit payments as they fall due. Typically, this involves investing in **credit** and secure income assets so as to generate these cashflows with a reasonably high degree of confidence.

Cashflow matching

An approach used to construct an asset **portfolio** that provides cash flows whose timing and size are designed to meet corresponding benefit (eg pension) payments as they fall due.

Catastrophe bond

This is a **bond** issued by an insurance company that pays interest and provides a return of capital to investors in the normal way, except on the occurrence of one or more pre-specified trigger events – eg a hurricane. In those circumstances, the issuer's obligation to make further interest payments or to return capital is either deferred or simply lapses. Catastrophe **bonds** provide insurance companies with an alternative (eg to reinsurance) means of managing **risk**. For investors, catastrophe bonds are investments that offer a return that has a low **correlation** with **traditional asset classes**.

CDO

See **Collateralised Debt Obligation**.

Central bank

The central bank normally fulfils a number of functions. Most importantly, it is responsible for overseeing a country's monetary system, controlling the money supply through the use of **interest rates**. How the money supply is managed will depend upon the particular policy objectives set for the central bank, which might be, for example, to target low and stable **inflation** and/or low unemployment. The central bank also acts as a "lender of last resort" (eg to banks that run short of **cash**) and often has supervisory powers over financial institutions. In the UK, the central bank is the Bank of England, which is independent of government.

Circular economic model

The circular economic model is one based on three principles: 1) reusing products and materials; 2) eliminating waste and pollution; and 3) regenerating the natural system. It is an alternative to the traditional linear economy, which is based on the take-make-waste system of extracting raw materials, turning them into manufactured products and then disposing of them at the end of their useful life.

Clean technology

A range of products, services and processes that reduce negative environmental impacts, for example through reducing the use of natural resources, cutting or eliminating **carbon emissions**, or reducing waste. Once considered a niche area of investment, it is now a focus for many companies. The manufacture of electric vehicles is one example.

Clearing house

An organisation that sits between buyers and sellers, acting as **counterparty** to both, and which is responsible for the **settlement** of trades between those parties.

Climate-tilted index

An index for which constituent security weights have been adjusted (tilted) using one or more climate metrics, eg **carbon emissions**. **Securities** with lower exposure to **climate risk**, or higher exposure to climate opportunities, typically have a higher weight in such indices than in the corresponding **market capitalisation weighted index** and vice versa.

Closed ended

An investment vehicle that has a fixed number of **shares** that can be traded by investors (for example, **investment trusts**). Contrast with **open ended**.

Collateral

Assets pledged against the possibility of **default** by a borrower. Used commonly between the two parties to a **swap**, to reduce the financial impact of the failure of one party to the other party or as protection against failure to repay a loan.

Collateralised Debt Obligation (CDO)

A CDO is a type of **asset-backed security** (ABS) that is backed (ie collateralised) by a pool of **debt** assets, usually **bonds** or loans. Typically, CDOs are split into different tranches (divided by **credit rating** or **maturity**) so that investors can choose an investment whose expected cash flows meet their **risk/return** requirements. "Senior" tranches are considered the safest while "junior" ones offer the highest expected returns but also the highest level of risk.

Collateral Support Annex (CSA)

A Collateral (or Credit) Support Annex is supplemental to an **ISDA** agreement. It specifies how the **credit risk** inherent in **over-the-counter derivatives** is to be mitigated through the transfer of collateral between the counterparties to those derivative contracts, for example **swaps**. The CSA will typically define what types of assets are eligible for use as **collateral** and will also describe the collateralisation process.

Collective investment vehicle

A term used to describe a range of investment fund structures (such as **OEICs**, **unit trusts** and **life funds**), the basic feature of which is that money gathered from a number of investors is **pooled**.

Commercial paper

Short-term (less than one year) unsecured **debt** issued by companies. See also **corporate bond**.

Commission

The fee paid to a **broker** for arranging the purchase or sale of an asset.

Commodities

The **asset class** comprising a range of physical goods. Examples include foodstuffs such as wheat, metals such as copper as well as energy sources such as oil. Commodity prices can be volatile, often as a result of geopolitical and weather events. Commodity prices can rise in response to **inflation** and can also cause inflation to rise. They can be used potentially to mitigate a pension scheme's **inflation risk**.

Consumer Price Index (CPI)

This is the UK's main measure of **inflation** which is calculated in line with international statistical standards. It is used for a wide range of purposes. These include its use as the measure to assess how the Bank of England is performing against its Government-stipulated 2% pa inflation target, as well as to increase state, public sector and statutory minimum pensions, along with some private sector pensions.

Contango

This describes the situation in which the current **futures** price of an asset is above the expected future **spot price**. The term is commonly used in relation to **commodities**. All things being equal, a **manager** would generate a negative "roll return" by buying the future now and receiving the lower spot price at expiry of the futures contract. The manager may invest in a commodity in contango if, for example, it is believed that the future spot price will in fact rise. Contrast with **backwardation**.

Contributions

The amounts paid into a pension scheme by the sponsor and, often, the members as well. Contributions may take the form of regular payments which are part of the **sponsor**'s normal payroll expenses or may be "special contributions" which a sponsor makes, typically to eliminate a **defined benefit** (DB) funding deficit (ie the amount by which a scheme's assets fall short of the target value of assets to meet the scheme's accrued **liabilities**).

Convertible security

An investment that can be exchanged for another type of investment on pre-agreed terms and at pre-agreed future dates. The most common version of this type of **security** is the convertible **bond** which can be converted into the issuer's **equity**.

Convexity

The price sensitivity of a **bond** to **interest rate** movements changes according to the level of interest rates, and convexity is a measure of this sensitivity. In general, bonds with high **duration** are more convex than bonds with low duration and bonds with high **coupons** are more convex than bonds with low coupons.

Corporate bond

Long-term (typically more than one year) **debt** issued by a company. Corporate bonds carry different levels of **credit risk**, which is indicated by their **credit rating** and **credit spread**. See also **commercial paper**.

Corporate governance

The term used to describe the rules and principles applied by investors, in particular shareholders, in managing their relationships with the companies in which they invest, including voting powers where relevant. Also used to describe the framework used by company directors in running a business.

(UK) Corporate Governance code

This consists of a set of principles and provisions whose purpose is to facilitate effective management of listed companies with the aim of delivering long-term corporate success.

Corporate social responsibility

A self-regulating business model that helps a company be socially accountable — to itself, its stakeholders and the public. It considers all aspects of society including the economic, social and environmental. It is also known as corporate citizenship and corporate responsibility.

Correlation

This is a measure of the extent to which the prices of two investments tend to move together. If correlation is strong and positive, it means that if one asset rises in value, the other can be expected to rise in value as well. If correlation is strong and negative, it means that if one asset rises in value, the other asset is expected to fall in value. If correlation is weak, it means that a change in the value of one asset provides little or no information as to how the other asset may change in value.

Counterparty

An individual or organisation participating in a financial transaction – as either the buyer or the seller.

Counterparty risk

This is the **risk** for a given party to a contract that the other party **defaults** on its obligations. For some types of contracts, in order to reduce the potential impact of this risk, both parties will most likely agree to post **collateral** which can be accessed by the non-defaulting party on the default of the other party.

Coupon

This is the name for the regular interest payments received by a **bond** holder.

Covenant

For a **bond**, covenant refers to the ability and willingness of an issuer to meet the payments due on the bond. For a pension scheme, covenant refers to the ability and willingness of the **sponsor** to make up any shortfall between the scheme's assets and the agreed **funding target**.

Covid-19 crisis

This describes the early 2020 falls in many financial markets and subsequent rebound following the global spread of a lethal coronavirus (SARS-CoV-2, first spotted in Wuhan, China). Whilst **equities** fell 30% in the first quarter of 2020, they rebounded strongly and ended the year 15% up overall.

CPI

See **Consumer Prices Index**.

CPIH

This is CPI including an allowance for (owner occupier) housing costs and is the ONS's single preferred measure of **inflation**.

Credit

Another term for company **debt**, used interchangeably with **corporate bonds**.

Credit default swap (CDS)

This is a **derivative** contract between two parties in which the party that sells the contract has to pay the buyer of the contract a specified amount upon the occurrence of certain pre-agreed events, most typically if a company or government **defaults** on its **bonds**. In exchange for this undertaking from the seller, the buyer pays a regular set of premiums throughout the life of the contract. In effect, this arrangement provides bond holders with an insurance policy. Credit default swaps – often referred to as "CDS" – are used as a **hedging** instrument by a **corporate bond manager**.

Credit rating

See **Rating**.

Credit rating agency

There are three main credit rating agencies, **Standard & Poor's**, Moody's and Fitch. They assign a **credit rating** to **bonds** issued by governments and companies. Bonds that are rated BBB or higher (under the Standard & Poor's rating system) are known as **investment grade**, while bonds with a rating below BBB are known as **high yield**.

Credit risk

Another name for **default risk**.

Credit spread

This is the extra **yield** demanded by investors for investing in a **corporate bond** and is calculated as the difference between the (higher) yield on the corporate bond and the yield on a comparable **government bond** (with the same **maturity** and **coupon**). The **spread** is to compensate investors for the higher **default** risk of a company and perhaps also the lower **liquidity** of the **corporate bond**.

Crossing

Crossing is used when assets are transferred between two parties, one buying and one selling, so as to avoid transaction (eg **commissions**) costs. The transfer is normally carried out at **mid price**.

Cryptoasset

Cryptoassets are private digital assets that use cryptography and are designed to work as a medium of exchange. Cryptocurrencies are subsets of cryptoassets.

Cryptocurrency

A digital asset. Currency/coin ownership records are stored in a ledger which is a computerised database that uses cryptography to secure transaction records, to control the creation of additional coins, and to verify the transfer of coin ownership.

CSA

See **Collateral Support Annex**.

Currency risk

The depreciation or appreciation of a non-Sterling asset caused by fluctuations in the price of Sterling relative to the asset's reference currency. For example, while a US **equity** holding might rise by 10%, if Sterling were to rise by 5% relative to the US dollar over the same period, then the resulting increase in equity value would be just 5% for a Sterling investor.

Custodian

An organisation which takes responsibility for the safekeeping and general administration (eg collecting **dividends** and interest due) of an investor's assets.

D

DB

See **Defined benefit**.

DC

See **Defined contribution**.

DR

See **Depository receipt**.

Debenture

A loan/**debt** that is typically secured against specified company assets.

Debt

Money borrowed by a company or government which normally must be repaid at some specified point in the future. See **fixed interest bonds** and **index-linked bonds**. Contrast with **equity**.

Decarbonisation

This describes the process of reducing the emissions of carbon dioxide, or **greenhouse gases** more generally. It can be applied at different levels, eg process, company, sector, portfolio, economy.

Default

When a company or government which has issued a **bond** does not pay either the **coupon** or **principal** due on that bond. In this event, bond holders may have some claim over pre-specified assets. It also describes the situation in which an individual fails to meet loan repayment terms (eg on a mortgage). In this case, the lender can often take control of a given asset (eg a house or car).

Default option

Often used in relation to **defined contribution** (DC) arrangements, the default option is the **fund** or mix of funds in which **contributions** in respect of a member will be invested in the absence of any explicit fund choice(s) by that member. The three broad options members have at retirement are **cash**, **annuity** purchase or **drawdown**.

Deferred member

A deferred member is a person who has benefits in a pension scheme as a result of a previous employment.

Defined benefit (DB)

A pension scheme in which the primary pension benefit payable to a member is based on a defined formula, frequently linked to salary. The **sponsor** bears the **risk** that the value of the investments held under the scheme fall short of the amount needed to meet the benefits. Contrast with **defined contribution** (DC).

Defined contribution (DC)

A pension scheme in which the **sponsor** stipulates how much it will contribute to the arrangement for each individual member, which sometimes will depend upon the level of **contributions** the member is prepared to make. The resultant accumulated fund (or "pot") of money for each member is a function of the investment returns achieved (net of expenses) on the contributions and how long the money is invested. DC members typically use their accumulated pot for one of three purposes – **annuity** purchase, **cash** or **drawdown**. In contrast to a **defined benefit** (DB) scheme, the individual member bears the **risk** that the investments held are insufficient to meet the desired level of benefit. The vast majority of newly established UK pension schemes are defined contribution.

Deflation

The opposite of **inflation** – ie a fall in the general level of prices.

Depository receipt (DR)

A depository receipt is a **security** which is traded on a local stock exchange representing ownership of **shares** in a foreign publicly listed company. A depository receipt can represent part of a share, a single share or multiple shares. They are usually denominated in US dollars, but some are euro denominated. Investors can find them more convenient than dealing directly in the relevant overseas markets. American depository receipts (ADR) are traded on US stock exchanges while global depository receipts (GDR) are usually traded on European markets.

Derivative

An investment instrument whose value is based upon (ie derived from) the value of an underlying asset or set of assets. See **forward contracts, futures, options, swaps** as examples.

Developed markets

These are the leading industrialised nations such as the UK, the US and Japan. They tend to have longer established financial markets and to be politically stable. Contrast with **emerging markets**.

DGF

See **Diversified Growth Fund**.

Dilution levy

A charge levied on an investor entering or leaving a **pooled** fund to ensure that the other fund investors do not share in the trading costs associated with that investor's purchase or sale. It may be applied only to transactions that are large compared to the value of the overall fund, although in some instances it applies to all transactions.

Discount rate

The rate of interest applied to a set of future cash flows to calculate their **present value**.

Disinflation

A slow down in the rate of **inflation** – eg a reduction in the rate of inflation from 4% pa to 3% pa.

Diversification

The process of investing in a number of different **asset classes** and individual investments within those asset classes so as to reduce exposure to any one specific source of **risk**.

Diversified Growth Fund (DGF)

Diversified Growth Funds are **pooled** investment funds that invest in a wide range of **asset classes**, with the allocations to those asset classes often being managed on an **active** basis as market conditions change. Many such funds have an objective referenced to a cash **benchmark**, eg cash +4% pa.

Dividend

This is the regular payment made by companies to their **equity** shareholders. The timing and amount of dividends received by holders of ordinary **shares** (the most common type of share) are at the discretion of the company. Holders of **preferred shares** receive preferred dividends. These are of a fixed amount though it is at the company's discretion whether to pay them. However, any unpaid preferred dividends must be paid before ordinary dividends can be paid. Dividends are normally paid twice a year and consist of an "interim" and "final" payment.

Dividend yield

The annual payout per **share**, expressed as a proportion of the current share price.

Domicile

This is the place where a **fund** or investment vehicle is legally registered – eg UK, Ireland or Cayman Islands. Domicile determines the regulatory and supervisory framework which applies to the fund, including the level of investor protection.

Downgrade

This occurs when a **rating agency** concludes that a particular company or government has become more likely to **default** on its **debt** obligations. Once its **credit rating** is downgraded, an issuer may find it harder to borrow additional money from investors or may find it can only do so at a significantly increased cost – ie by paying a much higher **interest rate**. Certain investors – eg pension schemes – may have minimum credit rating requirements. This may mean that following a downgrade, the affected issuer's debt may be subject to selling pressure, potentially leading to a further deterioration in price.

Drawdown

This is the term used to describe the largest loss made on an investment over a certain period. It is measured from the peak of an investment's value to the lowest point. The term is also used to describe the situation in which an investor agrees to invest a certain amount of money in a particular **asset class** (eg private equity) and the money is invested (ie drawn down) gradually as and when investment opportunities arise. Each such payment is known as a "drawdown".

Drawdown option

In a **defined contribution** (DC) arrangement, a form of lifestyle in which, in the run up to the point at which a member starts to take their benefits, assets are gradually switched into an appropriate mix of investments from which the member can source (or "**drawdown**") an income while leaving the balance of their pension pot invested to provide future growth and income. In practice, it is common as part of the switching process for up to 25% of the member's pension pot to be moved into cash which the member can take as a tax-free cash lump sum when they first start to take their benefits, with the remainder being allocated to drawdown.

Duration

This is the measure of the sensitivity of the value of an asset (such as a **bond**) or a **liability** (such as a pension scheme cash flow) to changes in **interest rates**. For example, an asset or liability with a duration of 10 is expected to rise (fall) in value by 10% following a 1% fall (rise) in interest rates. Pension schemes can reduce the sensitivity of their **funding level** (the value of assets held relative to the target value of assets) to changes in interest rates by purchasing assets of similar duration to the liabilities, a technique that underlies **Liability Driven Investment** (LDI).

Earnings per share

A metric used to measure the profitability of a company. It is defined as net income divided by the number of **shares** in issue.

EBITDA

Earnings before Interest, Taxes, Depreciation and Amortisation – is an accounting measure which, by stripping out certain deductions (such as depreciation of IT equipment) can provide an indication of a company's current operating profitability.

ECB

See **European Central Bank**.

Efficient market

A market in which **security** prices rapidly reflect all known information, as per the **Efficient Market Hypothesis** (EMH). The more efficient the market, the more difficult it is for an **active manager** to outperform the market. The US **equity** market is commonly considered to be an example of a relatively efficient market. Contrast with **inefficient market**.

Efficient Market Hypothesis (EMH)

The EMH asserts that investment markets are "informationally efficient". This means that, once **risk** is taken into account, it is not possible to outperform a market consistently simply by using information available at the time the investment is made. The EMH has various forms – "weak" (**security** prices incorporate all historic publicly available information), "semi-strong" (in addition to historic publicly available information, security prices also reflect any new information immediately) and "strong" (security prices reflect all publicly available information as well as information only available to company insiders).

EFSF

See **European Financial Stability Facility**.

Emerging markets

These are developing nations such as China, Russia, India and Brazil. Their investment markets are characterised by higher levels of **risk** and often higher investment **returns** (than **developed markets**). In the past at least, some developing countries have been seen as less politically stable than those in the developed world. The development of natural resources is often an important feature of such economies. Contrast with **developed markets**.

Emerging market debt

Emerging market debt is **debt** issued by either **emerging markets** governments or companies. Compared with its **developed market** equivalent, emerging market debt has been perceived as riskier and has typically therefore offered higher prospective returns.

Emerging Market Multi-Asset Funds (EMMAF)

Emerging Market Multi-Asset Funds are a type of fund which has a remit to invest across emerging **equity, bond** and currency markets, with the aim of delivering **emerging market** like equity returns but with significantly lower than emerging market equity **volatility**.

EMH

See **Efficient Market Hypothesis**.

Engagement

Dialogue between investors and relevant parties with the aim of preserving and enhancing the long-term value of assets on behalf of clients and beneficiaries. Relevant parties include companies in which the investor holds equity or debt, regulators, policymakers and other stakeholders. See also **Stewardship**.

Environmental, social and governance (ESG)

An umbrella term that encompasses a wide range of factors that may have been overlooked in traditional investment approaches. Environmental considerations might include physical resource management, pollution prevention and **greenhouse gas** emissions. Social factors are likely to include workplace diversity, health and safety, and the company's impact on its local community. Governance-related matters include executive compensation, board accountability and shareholder rights. See also **ethical investment** and **responsible investment** (RI).

Equities

Equities refer to an **equity portfolio** or more generally the **asset class**.

Equity

Through purchase on either the **primary market** or the **secondary market**, company equity gives the purchaser part-ownership in that company, and hence a **share** of its profits, typically received through the payment of **dividends**. Equity also entitles the holder to vote at shareholder meetings. Note that equity holders are entitled to dividends only after other obligations, such as interest payments to debt holders, have first been paid. Unlike **debt**, equity is not normally contractually repayable.

ESG

See **Environmental, social and governance**.

ESM

See **European Stability Mechanism**.

ETF

See **Exchange-traded fund**.

Ethical investment

An approach that selects investments on the basis of an agreed set of **environmental, social and governance** (ESG) criteria that are motivated by ethical considerations. These can be positive – eg choosing companies involved in water conservation, or negative – eg not choosing companies involved in the arms trade. See also **responsible investment** (RI).

European Central Bank (ECB)

The ECB is the **central bank** for Europe's single currency, the euro. The ECB's main task is to maintain price stability in the euro area. The euro area comprises 19 European Union countries.

European Financial Stability Facility (EFSF)

An initial funding programme created on 9 May 2010 by European Union members, financed by Eurozone states, whose purpose was to provide financial assistance to states that required it, with the aim of preserving financial stability across the eurozone. Ireland, Portugal and Greece received aid from the programme. Post 1 July 2013, the EFSF stopped new financing programmes or loan facility agreements, following the establishment of its successor, the **European Stability Mechanism** (ESM).

European option

An **option** that can be exercised on its **maturity** date only. Contrast with **American option**.

European Stability Mechanism (ESM)

Established with effect from 1 July 2013, the European Stability Mechanism (ESM) is the Eurozone's permanent crisis resolution mechanism for the countries of the euro area. The ESM issues **debt** instruments in order to finance loans and other forms of financial assistance to euro area Member States.

Ex-ante

From the Latin meaning "before the event". It is often used in connection with **tracking error**. Thus ex-ante tracking error is a predicted measure of tracking error. Contrast with **ex-post**.

Exchange-traded fund (ETF)

An ETF has features which resemble those of both a marketable **security** and an **index-tracking** fund. It is like a security in that buy and sell prices are provided for the ETF throughout the trading day, based upon the **Net Asset Value** of the underlying investments – eg **equities** or **bonds** – held within it. It is like an index-tracking fund in that typically, those investments are designed to provide exposure to a particular index – eg the **FTSE** 100.

Ex-post

From the Latin meaning "after the event". It is often used in connection with **tracking error**. Thus, ex-post tracking error is an historic measure of tracking error. Contrast with **ex-ante**.

Face value

This is the amount of money that an investor will receive from a **bond** when it matures.

Fallen angel

A **bond** whose **credit rating** has been downgraded from an **investment grade** rating to a **high yield** rating (the opposite of a **rising star**).

Fat tails

This is the term used to describe the tendency of investments to have a greater likelihood of extreme **returns** than would be indicated by traditional modelling of potential returns. This appears to be particularly so for extremely negative returns. The term is derived from graphs of investment returns showing more return observations in the tails (the extremities of the returns distribution) than expected. See also **standard deviation**.

Fed(eral) Funds Rate

This is the rate at which US banks lend money to one another.

Fiduciary duty

A legal obligation of one party (a fiduciary) to act in the best interests of another. Fiduciaries are people or legal entities that are entrusted with the care of money or **property** on behalf of others. They include pension scheme trustees.

Financially material considerations

These are factors which could have a significant impact on the value of an investment and should be considered by investors when making decisions. Legislation means that UK pension scheme trustees must take such factors into account. The term is often used when referring to **environmental, social and governance** (ESG) considerations although it is not limited to these issues.

Fiscal policy

The way in which government spending and taxation is used either to stimulate or to slow down the economy. See also **monetary policy**.

Fixed income

This is the **asset class** comprising **bonds** and other **debt** instruments. The name is derived from the fixed set of cash flows payable (**coupons** and **principal** repayment) on such instruments, although some bonds may have variable cash flows (such as **index-linked bonds**). It is important to note that although the cash flow amounts may be fixed or variable, the market value of the bond varies, for example, as **interest rates** change.

Fixed interest bonds

These are **bonds** that pay a fixed amount of interest at set periodic intervals for their entire lifetime before repayment of the **principal**. For example, a bond might pay 5% pa until **maturity** with **cash** payments being made every six months. Contrast with **index-linked bonds**.

Floating rate bond

A **bond** whose **coupon** payments are set periodically according to a specified market **interest rate**, for example **SONIA**.

Forward contract

An agreement for delivery of a specified asset at an agreed future date, for a price agreed up-front. Forward contracts are not normally traded on a recognised exchange. Compare with **futures** contract.

FTSE Russell

This is one of the main UK based financial data providers and is pronounced "Footsie Russell". It is owned by the London Stock Exchange Group and calculates many of the benchmark indices used to measure **equity** and **bond** market performance.

Fund

A pool of money collected from a group of investors and then invested on their behalf to achieve a pre-agreed objective (eg outperform the FTSE All Share index). A fund can be either **open ended** or **closed ended**.

Fund of hedge funds

An investment **fund** which invests in a range of **hedge funds**. A fund of hedge funds **manager** researches individual hedge funds and constructs a **portfolio** of them. Hedge funds behave quite differently to **traditional asset classes** and so require specialised research. Funds of hedge fund managers charge their own layer of fees on top of the fees charged by the underlying hedge fund managers.

Funding level

The value of assets divided by the value of the **liabilities** as defined by the **funding target** for a **defined benefit** (DB) pension scheme at the calculation date.

Funding target

The value of the assets that is calculated (on a given set of assumptions determined by the trustees) as being required at the calculation date in order for a pension scheme to meet its **liabilities**.

Future

A contract for delivery of a specified asset at a future date at a price agreed up-front. Futures differ from **forward contracts** in that they are standardised. They are traded in specified sizes, on recognised exchanges, and are **marked-to-market**, thereby requiring **margin** payments. They are commonly used in **commodity** markets where the transportation of the good (such as oil) has to be organised well in advance, but are also available for many other assets such as currencies, **equities** and **bonds**.

Gamma short squeeze

The widespread buying of **call options** causing a rapid rise in the **share** price of a company, which in turn forces **short** investors to buy back the shares they have sold, pushing the **share** price up even further.

GDP

See **Gross Domestic Product**.

Gearing

See **Leverage**.

Gilt

This is a **bond** issued by the UK government and is also a type of **government bond**. They are called gilts as the bond certificates originally had a gilt edge to indicate their high quality and thus very low probability of **default**.

Global financial crisis

The name given to events spanning 2007–2009. The lead up to the period was characterised by excessive **risk** taking by banks and is most remembered for the September 2008 failure of Lehman Brothers and the huge market turmoil that this caused. Governments and **central banks** across the world, both individually and collectively, were forced to provide massive support to financial institutions in order to avert the collapse of the financial system.

Government bond

This is a **bond** issued by a government. The bonds issued by the UK government are called **gilts** while US government bonds are called **Treasuries**. Bonds issued by **developed markets** governments are deemed to have the lowest risk of **default** of all bonds, while bonds issued by governments of **emerging markets** nations can be much riskier. The government bonds of developed nations are used as a proxy for a "risk-free" investment. **Yield curves** can be derived from the **yields** on government bonds.

Green bond

A **bond** issue whose proceeds are used to fund new and existing projects with specific environmental benefits such as renewable energy and energy efficiency projects.

Greenhouse gases

These are gases that have been and continue to be released into the Earth's atmosphere. Greenhouse gases trap radiation from the sun which subsequently heats the planet's surface (giving rise to the "greenhouse effect"). Carbon dioxide and methane are two of the most important greenhouse gases.

Greenwashing

Claims, typically in marketing material, that mislead consumers and investors into believing that a company's products are more environmentally friendly than they actually are.

Gross

Any performance returns that are quoted "gross" are before the deduction of investment management fees, including **performance fees**. Contrast with **net**.

Gross Domestic Product (GDP)

This is the value of all goods and services produced in a country over a given period, typically a year. A related measure is GDP per capita (ie per person) which gives a better indication of a country's wealth.

Group Personal Pension (GPP)

A Group Personal Pension (sometimes called a "GPP") is a type of **defined contribution** (DC) pension arrangement. It is normally established by a company with a pension provider – typically an insurance company – on behalf of a group of employees. This grouping allows the company to negotiate better terms – eg lower investment management charges – than individuals would receive from the provider directly. However, while termed a group arrangement, it is important to note that in practice, each employee has their own individual contract with the pension provider. A GPP is sometimes referred to as a form of contract-based DC scheme so as to distinguish it from a trust based DC scheme.

Growth investing

Investing in **stocks** that are expected to exhibit above average earnings growth. See also **value investing**.

Hedge/Hedging

This is an attempt to manage the **risk** of the fall in the value of one asset ("Asset A") by purchasing another offsetting asset ("Asset B"). The aim is for the value of Asset B to respond in an equal and opposite manner to Asset A to a given set of factors. For example, you could try to hedge the risk of wet weather if you own **equity** in an ice-cream company by buying equity in an umbrella company.

For a pension scheme, hedging is also used to refer to investment in assets which behave in the same or a similar way to liability cashflows in response to a range of economic factors – eg changes in interest rates and inflation – with the objective being to reduce both the likelihood and size of any divergence between the value of the scheme's assets and its funding target.

Hedge fund

There are many different types of hedge fund and there is no set definition of what a hedge fund is. However, they typically have at least some of the following characteristics: they are less regulated than **traditional investments**; they aim to produce **absolute returns** rather than **relative returns**; they use **short** as well as **long** investments; they are **leveraged**; they are traded more actively than traditional assets and the fees charged on them are much higher, almost always including **performance fees**.

High yield bonds

These are **bonds** issued by companies with low credit quality, ie below **investment grade** (BBB under the **Standard & Poor's rating** system). They offer investors a higher yield but carry a greater risk of **default**. They are also known as **junk bonds**.

High water mark

Used in conjunction with **performance fees**, a high water mark is used to record the highest outperformance level reached by an **investment manager** over a specified period – eg from the start of the mandate. Further performance fees are only charged if subsequent performance exceeds the high water mark. Its purpose is to stop investors paying twice for the same performance, for example, if the manager's returns followed a sharp "saw tooth" pattern.

IE01

This is a measure of the sensitivity of an investment's value to changes in **inflation** expectations. Specifically, it measures the change in **present value** for a 1 **basis point** (0.01%) general increase in inflation expectations.

IMA

See **Investment Management Agreement.**

Impact investing

This involves investing with the primary goal of achieving specific, positive social and/or environmental benefits while also delivering a financial **return**. Impact investing creates a direct link between **portfolio** investments and their socially beneficial activities; historically most such activity has occurred in unlisted assets.

Implementation Statement

An Implementation Statement must be produced by trustees of **defined benefit** (DB)**, defined contribution** (DC) and hybrid pension schemes with at least 100 members. It has to be included as part of the annual scheme report and accounts and be published online. Its purpose is to explain how over the course of the year, the trustees have acted in accordance with the policies and objectives detailed in the scheme's **Statement of Investment Principles** (SIP). The details of what has to be included differ between DB schemes and DC/hybrid schemes.

In specie

The transfer of assets from one fund or **portfolio** to another in the form of actual **securities** (eg BT **shares**) rather than **cash**. This avoids the costs of selling assets with one **manager** and buying the same assets with another manager.

Index

An index is constructed from **securities** comprising a given **asset class** using a predefined set of rules and is used as a representative measure of the performance of that asset class – eg the **FTSE** All-Share index for UK **equities**. Indices are often used as **benchmarks**.

Index-linked bonds

This is a **bond** whose **coupon** and **maturity** payments are linked to some **index**. The most important examples are index-linked **gilts**, whose coupon and maturity payments are linked to the UK **Retail Prices Index** (RPI). Contrast with **fixed interest bonds**.

Index-tracking

The process of replicating the returns on a given **index**. Also known as **passive management.**

Inefficient market

A market in which **security** prices do not rapidly reflect all known information, as per the **Efficient Market Hypothesis** (EMH). The more inefficient the market, the easier it is for an **active manager** to outperform the market. Some **emerging markets** are considered to be examples of relatively inefficient markets. Contrast with **efficient market**.

Inflation

This is a rise in the general level of prices. In the UK it is measured chiefly by the **Consumer Prices Index** (CPI) and the **Retail Prices Index** (RPI).

Inflation risk

On the asset side, this is the risk that the value of an asset, (such as a fixed interest bond), will fall if **inflation** expectations rise. On the liability side, this is the risk that a pension scheme's **funding target** will rise if inflation expectations rise. When considering the assets and liabilities together, this is the **risk** that, following a rise in future inflation expectations, a pension scheme's funding target rises by more than the value of its assets.

Inflation swap

This is a **swap** contract whereby one party pays a fixed stream of payments in exchange for a stream of payments that varies with actual **inflation** rates. Inflation swaps are useful for **hedging** a pension scheme's **inflation risk** – to do so, the pension scheme would pay a fixed amount and receive an inflation-linked amount. A rise in inflation expectations would typically increase the scheme's **funding target** but the scheme would benefit from an offsetting increase in the value of its inflation swap.

Information barriers

These are virtual barriers set up between different parts of a financial organisation to ensure that sensitive information is available only to those parts of the organisation with a legitimate right to use it. These barriers take the form of restricted access to certain offices areas and computer databases. For example, an **investment bank** which is advising a company on an **equity** issue would be expected to ensure that this confidential information is not available to other staff involved, say, in the bank's equity trading division.

Information ratio

The ratio of **alpha** (added value) to the **standard deviation** of that alpha. A high information ratio means that the **investment manager** has added more return per unit of risk taken. For example, an information ratio consistently above 0.5 for an **active equity** manager would be considered very good. See also **Sharpe ratio**.

Infrastructure

This is an **asset class** which invests in the large-scale public systems, services and facilities, such as power, road or water systems, which are necessary for the functioning of a modern economy. Infrastructure investments aim to generate stable, long-term **inflation**-linked cash flows. They do though often have **leverage** similar to **private equity**, which can impact the stability of the actual cash flows delivered to investors.

Initial Public Offering (IPO)

Initial Public Offering is the process of first making a company's **shares** tradable on a public market.

Integrated risk management (IRM)

Integrated risk management is an approach used by **defined benefit** (DB) pension scheme trustees to identify, manage and monitor the wide range of **risks** (relating to investment, funding and **covenant**) which might impact the chances of meeting their scheme's overall objectives.

Interest rate risk

On the asset side, this is the **risk** that the value of an asset, such as a **bond**, will fall if **interest rates** rise. The sensitivity of the value of an asset to changes in interest rates is measured by **duration**. On the liability side, this is the risk that a pension scheme's funding target will rise if interest rates fall. The sensitivity of the **funding target** to changes in interest rates is measured by **duration**. When considering the assets and liabilities together, this is the risk that, following a fall in interest rates, a pension scheme's funding target rises by more than the value of its assets.

Interest rate swap

This is a **swap** contract whereby one party agrees to pay a fixed rate of interest in exchange for a floating rate of interest. **Interest rate** swaps are useful for **hedging** a pension scheme's fixed **liabilities**. For example, where scheme members receive a fixed rate benefit every year, a pension scheme could enter into a swap contract to pay a floating rate of interest and receive a fixed rate of interest. A fall in interest rates would typically increase the scheme's **funding target** but the scheme would benefit from an offsetting increase in the value of its interest rate swap.

Interest rate(s)

Effectively, the amount paid by a borrower to a lender to borrow money. The interest rate can be fixed or variable and can be set for a very short (eg overnight) or for a very long (eg 50 years) period of time. It is normally expressed as a percentage of the amount borrowed, or this amount increased in line with some agreed measure.

Internal rate of return (IRR)

This is the **discount rate** at which the **present value** of all of the positive cash flows from an investment equals the present value of all of the negative cash flows from the investment.

International Swaps and Derivatives Association (ISDA)

See **ISDA agreements**.

Investment adviser

This refers to (part of) a firm, such as LCP, or to an individual within such a firm that provides investment advice across a wide range of areas such as **investment strategy** and **investment manager** selection. Such advice is normally provided to institutional clients, including pension scheme trustees and companies, rather than to individuals.

Investment bank

Investment banks are the main intermediaries of the institutional (as opposed to retail) financial world. Examples include Goldman Sachs and JP Morgan. Their roles include advising governments and companies on mergers and acquisitions and raising capital. They also act as middlemen in **equity, bond** and **derivative** trades.

Investment grade

These are **bonds** which have a **rating** equal to or higher than a certain level – eg BBB under the **Standard & Poor's** rating system. They are generally seen as good quality bonds with low probability of **default**. Many institutions such as pension schemes or insurance companies can only hold bonds which are of investment grade quality.

Investment Management Agreement (IMA)

An Investment Management Agreement is the form of legal document often used to set out the terms on which an **investment manager** will manage assets on behalf of an investor. It therefore covers a wide range of issues such as the **investment objective**, the performance **benchmark**, fees, the investment restrictions that apply to the mandate and how communications are to be delivered between the two parties.

Investment manager

This is an organisation that manages investments, including pension scheme assets. Such firms are often referred to simply by the term "**manager**".

Investment objective

Simply, an investor's desired outcome, for example a return of 1% pa above a specified **index** over rolling three year periods.

Investment performance

The **total return** delivered over a specified period – eg 10% over one year.

Investment strategy

The decision as to the proportions of a **portfolio** to invest in different **asset classes**, for example 60% **equities**, 30% **bonds**, 10% **property**. Research indicates that the investment strategy decision typically accounts for the majority of returns rather than the choice of which **manager** to appoint to manage each asset class. Investment strategy normally refers to longer term (eg three years plus) asset allocation decisions. See also **tactical asset allocation**.

Investment Sub-Committee (ISC)

As part of their governance structure, many pension scheme trustees have set up an Investment Sub-Committee. The ISC is usually a subset of the full trustee board. Its job is to monitor investment-related matters and to recommend action to the trustee board and/or act on its pre-agreed executive powers. Particularly in the case of large trustee boards, having an ISC normally leads to faster decision-making, which can often be beneficial.

Investment trust

A **closed ended** fund that invests in other companies and whose **shares** are traded on an exchange.

IPO

See **Initial Public Offering**.

IRR

See **Internal rate of return**.

ISC

See **Investment Sub-Committee**.

ISDA agreements

ISDA agreements provide the legal structure allowing an **investment manager** to transact **over-the-counter derivatives** (such as an **interest rate swap** or an **inflation swap**) with third parties (eg an **investment bank**) on behalf of their **segregated** pension scheme clients. These derivative instruments are often used as part of a **Liability Driven Investment** (LDI) strategy.

J-curve

Descriptive of the usual pattern of returns for a **private equity** investor, in which negative returns initially (due to the initial investment of cash) are expected to be more than compensated for over the life of the investment as the investments made start to deliver positive cash flows.

Junk bonds

An alternative name used to describe a **high yield bond**.

Key Investor Information Document (KIID)

A KIID is a two page document which must be provided to investors in **UCITS** compliant funds. It has to provide a short description of **investment objectives**, past performance, ongoing charges and **risk** profile.

Knock-out option

An **option** that is worthless at expiry if the price of the underlying asset on which the option is written reaches a specified level at any time during the life of the option.

LCP Horizon

The online technology developed by LCP which helps trustees and sponsors of **defined contribution** (DC) schemes meet their governance, communications and investment needs, enabling them to take effective, measurable actions to help members.

LCP LifeAnalytics

A tool developed by LCP that allows trustees and sponsors to robustly measure the longevity **risk** that a **defined benefit** (DB) pension scheme is running by analysing a scheme's membership right down to an individual member level. It helps pension schemes determine best estimate longevity assumptions and provides a longevity **Value at Risk** (VaR) measure over the relevant time horizon for the pension scheme (eg a 10 year journey plan) and for any probability level. The longevity VaR produced by LCP LifeAnalytics can be fully integrated with LCP's funding and investment platform, **LCP Visualise**, to give a combined risk measure covering both longevity and investment risks.

LCP Visualise

An online modelling tool developed by LCP that gives pension scheme trustees and sponsors real-time access to the facts and figures they need to make better decisions. It provides funding, investment, covenant and **risk** analysis of their pension scheme which is fully integrated with LCP's consulting services.

LDI

See **Liability Driven Investment**.

Leverage

This has two meanings. Firstly, it is used to describe the relative amounts of **debt** and **equity** in a company's capital structure. For example, 80% debt/20% equity can be described as four times leveraged. The term leverage is also used in the **derivatives** markets and describes the ratio of the nominal value of the derivative contracts held to the amount of **cash** available to support those contracts. When an investor's market views are correct (wrong), leverage enhances (reduces) the returns achieved. In effect, leverage increases the **risk** of the investment.

Leveraged loans

This is a **fixed income asset class** comprising loans in relatively highly leveraged (using the first definition above under **leverage**) companies. These loans pay a floating rate of return, expressed as a **spread** over a reference interest rate. They have similar **credit risk** characteristics to those of **high yield bonds**, though they typically provide investors with greater protection since they may have a charge over some form of company **collateral**. **Private equity** firms use leveraged loans as part of their capital financing structure, for example, when conducting the purchase of public companies.

Liability

An obligation to make a payment in future. An example of a liability is the pension benefit "promise" made to a **defined benefit** (DB) pension scheme member, such as the series of **cash** payments made to the member in retirement. The more distant the liability payment, the more difficult it often is to predict what it will actually be and hence what assets need to be held to meet it.

Liability Driven Investment (LDI)

An investment approach which focuses more (than has traditionally been the case) on matching the sensitivities of a pension scheme's assets to those of its underlying **liabilities**; this may be in response to changes in certain factors, most notably **interest rates** and **inflation** expectations.

LIBOR

This stands for "London Interbank Offered Rate". For several decades, LIBOR, based on banks' submissions of their interbank borrowing rates, was widely used as an interest rate benchmark for many products, such as short-term **debt** investments and **derivative** contracts. **LIBOR** is being replaced in the UK by **SONIA**.

Life fund

A life fund is a type of **pooled** investment vehicle offered as an investment option under a life insurance policy. Access to this type of arrangement is restricted typically to certain types of investors, for example pension scheme trustees.

Lifestyle

Often offered as an option (and very often the **default option**) for **defined contribution** (DC) arrangements, lifestyle is a term-to-retirement dependent **investment strategy**. While retirement remains in the distant future, a member's **contributions** are invested normally in a range of assets (eg **equities**) expected to deliver "real" returns (ie above **inflation**). In the run up to retirement, the member's contributions are moved gradually into an appropriate mix of assets whose final allocation depends upon whether the member has chosen a **drawdown**, **cash** or **annuity option**.

Liquidity

This is a measure of how quickly an asset can be sold for **cash** without causing a significant change in its price. **Equities** which are traded often, such as those of Vodafone, are very liquid while equities in very small companies are much less liquid.

Log normal

A type of statistical distribution often used to model **share** prices.

Long

When an investor benefits from a rise in the price of an asset, they are said to have a "long position" or simply to be "long the asset". With **traditional assets** such as **equities** or **bonds**, a long position simply means buying the asset, but it can be more complicated with **derivatives**. Contrast with **short**.

Long lease property

Investment in the development and/or management of **property** holdings which are let to users where lease lengths are typically in excess of 10 years. Long lease property investments may include offices, retail and industrial warehousing, but also student accommodation, care homes and hotels.

Longevity swap

A longevity **swap** is an agreement between two parties (typically a pension scheme and either an **investment bank** or insurance company) to exchange streams of payments; one of which is "fixed", based on a pre-agreed set of demographic and other assumptions and the other of which is variable, or "floating". Typically, the pension scheme will receive the floating stream of payments (which corresponds to the pension payments it is obliged to pay based on its actual experience) and the bank/insurer receives the fixed stream. The floating stream of payments will continue until pension payments cease, regardless of how long the members covered by the swap actually live. As a result, the longevity swap eliminates the risk to the pension scheme that members covered by the payments live longer than expected. Of course the pension scheme will be worse off (compared to not entering the swap) if scheme members do not live as long as predicted under the longevity swap.

Manager

See **investment manager**.

Manager research

The process undertaken by an investment adviser such as LCP in order to understand which **investment manager** offers the most appropriate products for our clients. This involves regular meetings with each manager and an assessment of their capabilities across a range of criteria relative to those of other managers.

Margin

The **collateral** that an investor may be required to pledge to cover **mark-to-market** losses made on an investment. Commonly used within **futures** and **swap** contracts.

Mark-to-market

The process of assigning a value to a financial instrument based on its current market price or the current market price for a similar instrument or instruments. This is often for accounting purposes or to determine whether **collateral** should be paid under a **derivative** contract. This process may be difficult if the asset type is complex or traded infrequently.

Market capitalisation weighted index

In a market capitalisation weighted **index**, the allocation to each **security** in the index is based upon its market capitalisation (effectively a measure of its size) as a proportion of the aggregate market capitalisation of all the securities within the index. For a given type of security – eg **shares** – market capitalisation is calculated by multiplying the current market price of the shares by the number of shares in issue. For example, if the total value of the **FTSE** 100 index is £2tn and HSBC is valued at £80bn, then HSBC represents 4% of the index. Most indices and **passive** investment vehicles are market capitalisation weighted. Contrast with **non market capitalisation weighted index**.

Markets in Financial Investments Directive (MiFID II)

The Markets in Financial Instruments Directive is a European directive first enacted on 1 November 2007. Its purpose is to harmonise the regulation of investment services across the European Union and to increase cross-border competition among financial firms. On 3 January 2018, an updated version of the directive came into force designed to increase transparency and better protect investors.

Master Trust

A Master Trust is a **defined contribution** (DC) investment scheme which has a series of separate underlying sections to which unrelated employers can make contributions on behalf of their workforce. Overall, governance and oversight of the Master Trust is provided by a trustee board (the master trust trustees).

Maturity

For a **bond**, the length of time (eg 10 years) until receipt of the final interest payment and return of the loan amount.

Mid price

This is the price, usually halfway, between the **offer price** at which an investor can buy an asset and the **bid price** at which the investor can sell an asset. In some cases, it can lie closer to the offer price or the bid price; for example, there may be costs associated with purchase (eg **stamp duty**) that do not occur on sale.

MiFID II

See **Markets in Financial Investments Directive.**

Momentum investing

An investment approach that involves buying **stocks** or other **securities** that have exhibited strong positive returns over the recent past (eg the past three to twelve months) in the belief that the observed trend will persist.

Monetary policy

The use of increases or cuts in **interest rates** and the money supply (via methods such as **quantitative easing**) in order to stimulate or slow down the economy. See also **fiscal policy**.

Money markets

The markets in which companies and governments borrow from investors for short periods of time (from one day to one year). Contrast with **capital markets**.

Money weighted rate of return

The **total return** on an investment **portfolio** over a specified period of time which is not adjusted to take account of the timing of cash flows. See also **time weighted rate of return**.

Multi-asset credit

A strategy which provides investors with a low governance way to access multiple types of credit-related **asset classes.** Typical investments include (but are not limited to) **high yield bonds**, **leveraged loans**, structured **debt** and emerging market credit. Portfolio manager performance is typically measured against a “cash+” type target.

Myners Investment Principles

First produced in 2001 by Paul (now Lord) Myners, there are two sets of investment principles, one for **defined benefit** (DB) and one for **defined contribution** (DC) pension schemes. The original principles have since been modified. They are now known as the (2008) Myners Investment Principles for DB schemes and the Investment Governance Group Principles for DC schemes, each comprising six principles. They are designed to improve the overall level of UK institutional pension scheme governance, in particular with respect to investment decision making.

N

National Employment Savings Trust (NEST)

NEST is the name for the personal accounts scheme established as part of the reforms of the UK pensions system under the Pensions Act 2008. It is run by the NEST Corporation, a public body accountable to Parliament via the Secretary of State for Work and Pensions. From October 2012 onwards, the government required employers to introduce auto-enrolment, under which most employees joined a workplace pension scheme unless they actively opted out of it. NEST is the default pension scheme for those employees whose employer decided not to offer an appropriate alternative arrangement.

Net

Any performance returns that are quoted "net" are after the deduction of investment management fees, including **performance fees**. Contrast with **gross**.

Net Asset Value (NAV)

Often used in connection with a **collective investment vehicle**, the NAV of a fund represents the total (**mid price**) value of the fund's assets less any accrued **liabilities**.

Net Asset Value Per Share (NAV per share)

This is simply the **Net Asset Value** (NAV) divided by the number of **shares** (or units) in issue.

Net zero

This describes the situation in which total **greenhouse gas** emissions released into the atmosphere are equal to those removed. This can be considered at different levels, eg company, investor, country or global.

NextGenerationEU (NGEU)

The NGEU is a temporary €750bn (2018 prices) EU stimulus package which, together with the EU's long-term budget, is aimed at rebuilding a post-Covid Europe. The NGEU is financed by the issue of common EU **debt**. Much of the money raised will be spent on research and innovation, fair climate and digital transitions programmes as well as preparedness and resilience against future crises. Money is allocated to EU governments as a mix of loans and grants following approval by Brussels of their proposed spending plans.

Nominal interest rate

The nominal interest rate is the rate of interest before taking **inflation** into account. See also **real interest rate**.

Non market capitalisation weighted index

A non market capitalisation weighted **index** is simply an index for which the index weights are calculated with reference to some factor or set of factors other than **market capitalisation**. For example, these could include the relative size of a company's sales, profit, cash flow, or some combination of these. Non market capitalisation weighted indices provide investors with an alternative method of **passive** investment. Contrast with **market capitalisation weighted index**.

Non-financial factors

For the purpose of UK pension scheme legislation, these are deemed to be the views of pension scheme members or beneficiaries including (but not limited to) their ethical views, their views in relation to social and environmental impact, and the present and future quality of life of the members and beneficiaries. Pension scheme trustees may choose, but are not required, to have a policy on taking into account non-financial factors when making investment decisions.

OEIC

See **Open Ended Investment Company**.

Offer price

This is the price at which an investor can buy an asset (ie be "offered" the asset). Contrast with the lower **bid price**.

Ongoing charges

The ongoing charges figure encompasses charges made to/by **funds**, typically including the **Annual Management Charge** (AMC), custody fees and other expenses, eg audit fees. These other expenses may vary and depend on a number of factors, including fund size. Ongoing charges exclude **transaction costs** (the costs such as brokerage incurred when buying and selling investments) which are additional expenses borne by the fund and therefore by fund investors. Since 1 July 2012, **UCITS** compliant funds must publish a **Key Investor Information Document** (KIID) which includes the ongoing charges figure.

Open ended

A **fund** that can issue additional units or **shares** to investors wishing to enter the fund. Contrast with **closed ended**.

Open Ended Investment Company (OEIC)

An Open Ended Investment Company (pronounced "oick") is a **collective investment vehicle** created by an **investment manager** in the form of a company. The company acts as an "umbrella" structure accommodating a range of sub-funds, each of which has its own investment mandate – eg UK **equity fund**, US equity fund, UK **corporate bond** fund etc. One of the key features of an OEIC is that the investment manager must create or redeem **shares** at the request of the shareholder.

Opportunistic credit

An umbrella term for an approach to **credit** investment with a higher than average **risk**/reward profile that can take advantage of: short-term pricing opportunities involving high quality companies facing short-term difficulties (stressed debt), companies experiencing **liquidity** or operational issues and potential bankruptcy (distressed debt), and complex situations requiring specialist industry or legal expertise (restructuring opportunities).

Options

These are **derivatives** which give the buyer the right – but not the obligation – to buy (or sell) an asset at a price agreed now at some future date. The price paid for the option is called the premium. Compare **American** and **European options**.

OTC

See **over-the-counter**.

Out of market risk

Normally used to describe the short-term **risk** of missing out on the return on a market because of not being invested in that market. For example, during a UK **equity** asset transfer between two managers, some or all of the funds transferred may effectively be held in **cash** for a few days while settlement proceeds are awaited from the outgoing manager. If the UK equity market rises in this time, then these returns will have been forgone. The risk can be managed in a number of ways, for example, by the use of an **in specie** transfer.

Over-the-counter (OTC)

This refers to the private direct trades in **derivatives** which take place between two parties (typically an **investment bank** and another institution such as a pension scheme or an **investment manager**) rather than those which take place on a public, regulated exchange. These trades are typically customised and the intention at the outset is usually that the buyer will hold the instrument until **maturity**.

Over-boarding

Used to describe the situation in which an individual takes on too many company board roles, calling into question their ability to effectively discharge all of those responsibilities.

Paris Agreement

The Paris Agreement is an international agreement, adopted by nearly 200 countries at the UN climate conference in Paris in December 2015, which sets out a global framework to limit global warming to well below 2°C above pre-industrial times while pursuing efforts to limit it to 1.5°C.

Passive management

A passive **investment manager** constructs a **portfolio** with the aim of replicating, rather than outperforming, the performance of an appropriate **benchmark** such as the **FTSE** All-Share **index**. **Passive management** aims to capture the market **beta** and normally has much lower fees than the equivalent **active management**. See **index-tracking**.

Pensions Climate Risk Industry Group (PCRIG)

Operating between mid-2019 and January 2021, PCRIG provided non-mandatory industry-wide guidance for UK pension scheme trustees on climate-related risks and aligning their scheme with the recommendations of the **Task Force on Climate-related Financial Disclosures** (TCFD).

Performance attribution

The process used to determine which decisions – **stock selection** (eg owning/not owning HSBC) and/or **asset allocation** (eg being overweight/underweight US **equities**) – led to out– or underperformance over a given period (eg one year) relative to the **benchmark**.

Performance fees

These are fees charged by an **investment manager** in addition to any base or **ad valorem** fee. They become payable if the actual return achieved by the investment manager exceeds the **benchmark** return by a pre-specified amount (which could be zero). Performance fees are sometimes subject to a **high water mark**.

Performance monitoring

This is the process whereby investors review regularly each appointed **investment manager**. This includes comparison of the investment manager's performance against the agreed **investment objective**.

Platform

In the context of a **defined contribution** (DC) pension scheme, a platform is an investment structure established by a pension provider (eg an insurance company) which offers a wide range of investment **funds**. These normally comprise both the provider's own ("in-house") funds as well as third party ("external") funds. Members of pension schemes which are on the platform will then have access to some or all of the available funds, with details of the precise fund offering depending upon those responsible for the pension scheme – eg the trustees in the case of a trust based arrangement and the company in the case of a contract based (such as a **Group Personal Pension** or a **Stakeholder Pension**) arrangement.

Pooled

A feature of a **collective investment vehicle** whereby an investor's money is aggregated (ie "pooled") with that of other investors to purchase assets. Investors are allotted a share of those assets in proportion to their contribution. Ownership is represented by the number of "units" allocated – eg if the asset pool is worth £1m and there are 1m units, then each unit is worth £1. Pooled funds offer smaller investors an easy way to gain exposure to a wide range of investments, both within markets (eg by buying units in a UK **equity** fund) as well as across markets (eg by buying units in both a UK equity fund and a UK corporate bond fund). Pooled investments have some drawbacks. For example, any individual investor is unlikely to be able to influence the manager's **corporate governance** policy or the precise **investment objective** of the pooled fund. An alternative approach is to invest on a **segregated** basis.

Portfolio

A collection of **securities** (eg UK **equities**) or **asset classes** (eg global equities, UK **bonds**, and UK **property**).

PPP

See **Purchasing Power Parity**.

Preference share

A **share** that ranks above ordinary shares in a company's financial structure, and which entitles the holder to a fixed **dividend**. Dividends on preference shares must be paid before dividends on ordinary shares can be paid.

Present value

The value, in today's money, of a series of future expected cash flows, discounted back to the present at a chosen **discount rate**.

PRI

See **Principles for Responsible Investment**.

Price-earnings ratio (P/E ratio)

This is the ratio of market value to earnings. It can be calculated both for individual **equities** (**share** price/earnings per share) and for a market as a whole.

Primary market

The market where new company and government **equity** or **bond** issues are sold directly by **investment banks** to investors via **Initial Public Offerings** (IPOs). These issues then become publicly traded investments on **secondary markets** such as the London Stock Exchange.

Prime broker

A prime broker is an **investment bank** or other financial organisation which provides important investment services to professional investors, most commonly **hedge funds**. These services include broking ie buying and selling **securities** on the investors' behalf, as well as the provision of finance/loans which allow the investor to **leverage** its assets. In addition, the prime broker will also act as **custodian** and provider of other administrative services. It is important to note that an investor's assets held by a prime broker may not be held separately ("ring-fenced") from the assets of the prime broker itself. If the prime broker becomes insolvent, then the recovery of those assets in full by the investor may prove to be difficult.

Principal

The outstanding balance on a loan/**bond**, typically repayable on **maturity**.

Principles for Responsible Investment (PRI)

A United Nations-supported initiative that encourages and supports **responsible investment** (RI). Investors can publicly demonstrate their commitment to RI by signing up to the six principles.

Private equity

This **asset class** involves investment in the **equities** (or sometimes other **security** types) of companies or funds that are not publicly quoted. Private **equity** companies often buy listed companies ("de-listing" them in the process) and then seek to improve operational and financial performance over the short to medium term (eg five years) before selling them back to trade buyers or relisting them. Private equity investment often involves high levels of **leverage**, typically structured as illiquid **closed end** schemes with comparatively high fees. Because private equity is seen as higher **risk**, investors typically expect higher returns compared with listed equity.

Property

An **asset class** which involves investing in the development and/or the management of property. For pension scheme trustees, property investment normally refers to commercial property such as offices, shops and factories, rather than to residential opportunities, although the latter is becoming a more common part of institutional **portfolios**. **Returns** come from rental income and capital appreciation.

Purchasing Power Parity (PPP)

The PPP is a theory of long-term equilibrium in exchange rates based on relative prices. For example, if the price of a basket of goods in the UK is £100 and the same basket costs $200 in the USA, then the PPP exchange rate would be £1:$2. For a variety of reasons, the PPP rate and the actual market exchange rate can differ markedly, for example where a country chooses to manage its exchange rate relative to some reference currency, often the US$.

Put option

An option (but not obligation) to sell an asset at a specified price within an agreed time period or at an agreed future point. See also **call option.**

PV01

This is a measure of the sensitivity of an investment's value to changes in **interest rates**. Specifically, it measures the change in **present value** for a 1 basis point (0.01%) general increase in interest rates.

Q

QE

See **Quantitative easing**.

Qualitative

This refers to any process in which investment decisions are based primarily on an investor's experience and judgement. See also **quantitative**.

Quantitative

This refers to any process in which investment decisions are based primarily on mathematical analysis. It is often referred to as "quant". The investment processes for some **asset classes**, such as **active currency**, are often highly quant-based while those used for others, such as **property**, make relatively little use of quant analysis. See also **qualitative**.

Quantitative easing (QE)

A method of increasing the money supply in order to stimulate the economy whereby a country's monetary authorities offer to buy specified **securities** (eg **government bonds**) in exchange for **cash**. The hope is that the cash will be used to fund productive economic activity. QE was first adopted by the Bank of England in 2009 when conventional **monetary policy** techniques (ie reduction in **interest rates**) had been largely exhausted.

Rating

This is a measure of the likelihood of a **bond** to **default**. Ratings are assigned by **ratings agencies** such as **Standard & Poor's**, Moody's or Fitch. In Standard & Poor's case, the ratings are on a scale from AAA (called triple A), which denotes the lowest probability of default, down to D, which denotes a bond in default. Bonds that are rated BBB or higher are called **investment grade** and bonds rated lower than BBB are called **high yield** (also known as junk). The bond issuer pays for the rating and is prepared to do so since a rating makes a bond marketable to a large investor base. In addition, the higher the rating, the lower the **interest rate** the issuer will have to pay, which lowers the overall cost of funding to the issuer.

Rating agency

See **Credit rating agency**.

Real interest rate

The excess of the **nominal interest rate** over **inflation**.

Real rate risk

On the asset side, this is the **risk** that the value of an asset (eg an **index-linked bond**) will fall following a rise in **real interest rates**. On the liability side, this is the risk that a pension scheme's **funding target** will rise following a fall in **real interest rates**. When considering the assets and liabilities together, this is the risk that, following a fall in real interest rates, a pension scheme's **funding target** rises by more than the value of its assets.

Rebalancing

The process of realigning a **portfolio**'s asset mix back into line with a **benchmark asset allocation**.

Redemption yield

The **total return** (interest and capital) that an investor will earn from holding a **bond** until its **maturity**.

Registered security

An investment that is registered in the issuer's records and whose payments (eg **dividends** and interest) are due to the registered holder. Contrast with **bearer security**.

Relative returns

Returns which are calculated relative to a **benchmark** return such as the **FTSE** All-Share **Index**. Generating returns above the benchmark is considered to be a favourable outcome for the **manager**, even if the actual return is negative. The performance of a manager for **traditional asset classes** such as **equities** and **bonds** is normally measured on a relative basis. For example, if a manager returns 12% and the benchmark return is 10% then the relative return is +2%.

Repo

A repo trade is a type of loan between two financial institutions. The borrower "sells" an asset (normally a **bond**) to the lender in exchange for **cash**. At the same time, there is an agreement by the borrower to repurchase the asset at some specified future date for a higher price. The **interest rate** implicit in this higher price is similar to the interest rate on a traditional secured loan.

Responsible investment (RI)

Responsible investment (RI) is the process by which **environmental, social and governance** (ESG) issues are incorporated into the investment analysis and decision-making process, and into the oversight of investments through **stewardship** activities. It is motivated by financial considerations and aims to improve risk-adjusted returns.

Retail Prices Index (RPI)

This is a historical measure of inflation which is now not recognised as a national statistic. It uses a different calculation methodology to the **Consumer Price Index** (CPI), one which is now widely accepted as being flawed, leading to an upwards bias in reported inflation (RPI has been c1% pa above CPI over the last decade). RPI is still produced and is used for calculating inflation increases for the income and redemption proceeds of index linked gilts as well as many private sector pensions. It is expected that RPI is to be fully aligned with **CPIH** from 2030 onwards.

Return

See **Total return**.

Return driven investment

An investment approach that focuses on generating the specific ("required") investment return needed to meet a particular investment objective (eg for a pension scheme, to be fully funded on a given basis in x years' time). In order to deliver the required investment return, such a strategy often holds a broad spread of assets, appropriately weighted to minimise the overall level of portfolio risk, consistent with the required return.

RI

See **Responsible investment** (RI).

Rights issue

The sale of further **shares** by a company to existing shareholders in order to raise **cash** (eg to fund business expansion).

Rising star

A **bond** whose **credit rating** has been upgraded from a high **yield** rating to an **investment grade** rating (the opposite of a **fallen angel**).

Risk

In broad terms, this is the chance that the actual outcome is different from what was expected. For example, one definition of risk is the chance that an investment will return less than anticipated. In general, financial markets offer a risk/reward balance, whereby the greater the potential reward, the greater the level of risk that must be assumed. An investment's risk is made up of many different factors, some of which may not be apparent until they materialise. **Standard deviation** is often used as a measure of risk.

Risk free rate

The return offered by an investment whose payments are believed to be guaranteed, most commonly taken to be the **debt** of creditworthy countries.

Risk premium

The expected return from a given investment in excess of the **risk free rate** and which is required to compensate the investor for the **risk** of the investment.

RPI

See **Retail Prices Index**.

S

Screening

An investment approach used to select companies based on pre-defined criteria, typically ethical or **environmental, social and governance** (ESG) factors. An investor may use a negative screen (which excludes certain companies based on their involvement in activities, sectors or practices deemed undesirable) or a positive screen (which includes certain companies based on desirable practices).

Scrip dividend

The payment of a **dividend** in the form of additional **shares** rather than as **cash**.

Secondary market

A market on which an existing **security**, such as a **bond** or an **equity** is traded, such as the London Stock Exchange. Contrast with **primary market**.

Securities/security

A general name for any financial instrument which entitles the holder to a share of cash flows. Often referred to in the plural as securities. Examples include **equities** and **bonds**.

Securities lending

Securities lending is the practice whereby a **security**, such as an **equity** or a **bond** is lent on a temporary basis by the owner to other market participants in exchange for a fee. A typical lender would be an **investment manager**, while typical borrowers include **investment banks** and **short**-sellers. As part of the securities lending process, **collateral** is passed from the borrower to the lender. In the event that the borrower does not return the securities, the lender is able to sell the **collateral** and use the proceeds to replace the missing securities. The securities can be recalled at any time by the lender, who typically retains all ownership rights associated with the securities (eg **dividend** payments), except for voting rights. Security lending fees vary by market and by security type, but are typically relatively low. A significant proportion of securities lending is carried out on large **passive portfolios** which, because of their relatively static composition, are an ideal borrowing source. Also known as **stock** lending.

Segregated

A segregated investment approach ensures that an investor's investments are held separately from those of other investors. This approach offers great flexibility – for example, the investor can stipulate the precise **investment objective** to be followed and can dictate which **securities** can or cannot be held.

Settlement period

The settlement period is the time that elapses between an investment sale or purchase being made and the corresponding **cash** amount either being received or delivered in return for the investment. Settlement periods are quoted typically as “T+1”, “T+2” etc where the “T” stands for the transaction day with the number representing the number of days between the transaction and settlement.

Share

This is the name for the individual units of **equity** in a company. Often referred to in the plural, shares may also be referred to as **stock** or equity.

Share buy-back

The repurchase by a company of its own **shares**. It is sometimes used instead of **dividends** as a way of returning money to shareholders.

Sharpe ratio

A measure of the amount of return generated in excess of the return from a **risk free** asset per unit of **risk**. See also **information ratio**.

Short

When an investor benefits from a fall in the price of an asset, they are said to have a “short position” or simply to be “short the asset”. Being short an asset is generally more complex to manage than being **long** the asset. For example, to short an equity requires the “investor” to borrow the **equity** (for a fee), to then sell the equity and finally to buy it back at some future date, at which point the expectation/hope is that the price has fallen. Contrast with **long**.

SICAV

A type of **open ended** investment vehicle which is commonplace in various European countries.

SIP

See **Statement of Investment Principles**.

Socially Responsible Investment (SRI)

An investment approach which takes account of the social, ethical and/or environmental policies of investee companies. It is often motivated by a desire to do social good as well as generate financial returns. See also **responsible investment** (RI).

SONIA

See **Sterling Overnight Index Average**.

Special purpose acquisition company

Commonly known as a SPAC. A SPAC is a listed company that raises capital from investors while having initially no commercial operations of its own. The capital raised is used to acquire privately-held companies and to help those companies grow.

Sponsor

This is the entity that supports a pension scheme, primarily through the payment of **contributions** to meet some or all of the specified scheme benefits. Sponsors are most commonly private sector employers, or the government/local authorities in the case of public sector arrangements.

Spot price

The spot price is the price that would be paid for an asset if it was purchased in the market for immediate delivery. This is in contrast to the **futures** price or **forward** price, which are the prices to be paid for assets to be delivered at some agreed future date. Spot, future and forward prices are most commonly associated with **commodity** and currency markets where deferred delivery is common.

Spread

Since relative prices are important in finance, there are many different types of spread such as **credit spreads** or **swap spreads**. However, this is most commonly the difference in the buying price and the selling price of an asset – the **bid-offer spread**. It can also be the difference in the expected return between two assets with similar characteristics.

SRI

See **Socially Responsible Investment**.

Stagflation

This describes a scenario in which low economic growth is accompanied by high **inflation**.

Stakeholder pension

A stakeholder pension is a type of **defined contribution** (DC) personal arrangement, with certain distinguishing features, such as a legal cap on the level of investment management charges that can be levied and low minimum contribution levels. Both individual and group stakeholder pension schemes exist.

Stamp duty

Stamp duty is a type of asset purchase tax. Most importantly in the UK, it may be levied on an **ad valorem** basis on certain UK **equity** and **property** purchases. Ad valorem UK equity stamp duty is 0.5%, while for commercial property it is normally up to 5% of the total value.

Standard & Poor's

This is a US-based financial services company. Its principal operations are the provision of **credit ratings**, which are paid for by **debt** issuers, and financial data, such as the provision of the US S&P 500 **equity index**. There are also other **rating agencies**, for example, Moody's.

Standard deviation

This is a statistical measure of **volatility** and is an indication of the range of potential outcomes. For example, if an investment has an expected return of 10% and a standard deviation of 5%, then in the long run, one would expect the returns for that investment to lie within the range of 5% (10% – 5%) to 15% (10% + 5%) in two years out of every three. However, actual investment returns typically do not conform fully to the pattern implied by the standard deviation. In particular, extreme investment returns can occur with a higher than expected frequency, particularly on the down side. Hence, standard deviation understates investment **risk**, but is still a useful summary measure. See also **fat tails**.

Statement of Investment Principles (SIP)

This is a document – normally referred to as the "SIP" – which the trustees of most occupational pension schemes are required to produce. Legislation details minimum SIP requirements although many SIPs go beyond this and are designed to provide an overview of the trustees' overall investment policies and arrangements. Trustees need to take written advice (normally from their **investment adviser**) on their SIP when first drafted and on any subsequent changes, and must consult the **sponsor** on the SIP contents before it is finalised. In any event, the SIP needs to be reviewed at least every three years.

Sterling Overnight Index Average (SONIA)

SONIA is calculated as the weighted average **interest rate** on all unsecured overnight transactions in the Sterling market. For any given term (eg one day, one week, one month), it is measured each day over the period to produce a final interest rate at the end of the borrowing period. It is a (nearly) risk-free rate as it does not include any term bank **credit risk** or **liquidity** premium. It has replaced **LIBOR** as the reference interest rate in a wide range of contracts, eg **derivatives**.

Sterling share class

If a fund has investors from different currency areas such as the UK, Eurozone and the US, then the **fund** manager may establish various share classes, including a **Sterling share class** for UK investors. This means that the investor holds a Sterling denominated investment, although many of the underlying fund investments may not be Sterling denominated.

Stewardship

This is defined in the **UK Stewardship Code** 2020 as "the responsible allocation, management and oversight of capital to create long-term value for clients and beneficiaries leading to sustainable benefits for the economy, the environment and society". The term is sometimes used in a narrower sense, focusing on monitoring, **engagement** and voting in relation to investments, with the aim of preserving and enhancing their value.

(UK) Stewardship Code

Complementary to the **(UK) Corporate Governance Code**. It sets high stewardship standards for asset owners and managers, and for service providers that support them, through a set of "apply and explain" principles accompanied by reporting expectations.

Stochastic model

A model in which at least one input parameter is randomised. The model is run many times, with the random input parameter changing each time, to generate a distribution of outcomes.

Stock

This is the name for individual units of **equity** in a company. Stock may also be referred to as **shares** or **equity**.

Stock selection

An **active management** technique that describes the process of investing in individual **securities** in proportions that differ from the weightings of those securities in the reference **benchmark**. It is also used to refer to the **alpha** – positive or negative – generated relative to the benchmark by doing so.

Stranded assets

Assets that have suffered an unanticipated loss of value before the end of their expected useful economic life. The term is most often applied to fossil fuel investments in the context of climate policy, where legislative and market developments may result in assets being worth less than the value recorded on company balance sheets.

Structured equities

A portfolio of **equity derivatives** designed to deliver a pre-defined pattern of **returns**, over a set time period, depending upon broader equity market returns.

Sub-prime

Describes the class of mortgages and other loans issued to individuals deemed to be at high risk of **default**.

Sustainable development goals (SDGs)

A set of 17 goals, spanning a wide range of social and environmental themes, that were adopted by all United Nations Member States in 2015 as part of the 2030 Agenda for Sustainable Development. An increasing number of investors are seeking to measure the alignment of their portfolio with the SDGs, particularly those that adopt sustainable or **impact investing** approaches.

Sustainable investing

An approach in which an assessment of the environmental and social sustainability a company's products and practices is a key driver in the investment decision. **Environmental, social and governance** (ESG) analysis therefore forms a cornerstone of the investment selection process.

Swaps

Swaps are **derivative** contracts between two parties in which those parties agree to exchange one set of cash flows for another. Swaps are most often used for hedging purposes (see **interest rate swap** or **inflation swap**) although they can also be used for speculative ie profit generation purposes. While a swap will have zero (or close to zero) initial value for both parties, the relative values of the swapped cash flows can change due to a variety of factors (eg interest rate changes). Whichever party has "lost" on the swap must post collateral daily to back this loss, thus reducing the impact of **counterparty risk** on **default** to the other party. See **mark-to-market**.

Swap spread

The difference between a given **swap** rate/return and the return on an equivalent government **bond**. The spread reflects the relative creditworthiness of the swap **counterparty** and the government, but in practice is also influenced by supply and demand factors. For example, a pension scheme may have entered into an **interest rate swap** to receive fixed interest payments (from say an **investment bank**) and make floating interest payments. Assume that the fixed rate is set at 4.8% pa. If an equivalent government security delivers only 4.5% pa, then the swap spread in this instance is 0.3% pa. If the counterparty meets its side of the swap, then the pension scheme benefits from this additional return.

Swaption

A specific type of **derivative** that gives the buyer the right – but not the obligation – to enter into a **swap** agreement at a future date or within a given period. See also **option**.

Switching mechanism

A system which is established in advance to move an investor's assets between different **asset classes** based upon the relative performance of those asset classes. For example, a **switching mechanism** could be established to switch a pre-determined amount from **equities** to **bonds** when equities outperform bonds by 10% from a pre-defined position.

T

Tactical asset allocation

This is an investment approach in which a **manager** seeks to generate returns, over the shorter term, by investing **long** or **short** in those **asset classes** which are expected to outperform or underperform respectively. The approach is implemented typically either wholly or largely via **derivative** contracts. See also **investment strategy**.

Task Force on Climate-related Financial Disclosures (TCFD)

A group of senior preparers and users of financial disclosures from G20 countries, established by the international Financial Stability Board in 2015. The TCFD has developed a set of recommendations for climate-related financial **risk** disclosures for use by companies, financial institutions and other organisations to inform investors and other parties about the climate-related risks they face.

Tech bubble

A stock market bubble caused by speculation on Internet-related companies between 1997 and 2000.

Tenor

The length of time remaining before a financial contract expires. Often used interchangeably with **maturity**.

TER

See **Total Expense Ratio**.

Thematic investing

This involves investing in companies in a way that reflects a particular investment theme or set of themes. These themes might be as part of a traditional investment approach – eg focusing on digitalisation, demographics – or as part of more **ESG**-related considerations such as renewable energy, waste and water management, education or healthcare innovation.

Thomson Reuters

One of the leading financial information providers. See also **Bloomberg**.

Time weighted rate of return

The **total return** on an investment **portfolio** over a specified period of time which is adjusted for the timing of cash flows and is often used to assess manager performance. See also **money weighted rate of return**.

TIPS

See **Treasury Inflation Protection Securities**.

Top-down

This is an **active** investment management approach in which a **portfolio** is constructed by focusing primarily on broader sector or country characteristics rather than on the features of individual companies. See also **bottom-up**. In practice, most traditional active investment management processes combine both bottom-up and top-down techniques.

Total Expense Ratio (TER)

The TER encompasses charges made to/by **funds**, typically including the **annual management charge** (AMC), performance related fees, custody fees and other expenses – eg audit fees. These additional expenses may vary and depend on a number of factors such as fund size. TERs exclude **transaction costs** (the costs such as brokerage incurred when buying and selling investments), which are additional expenses borne by the fund and therefore by fund investors.

Total return

This is the return on an asset taking account of both price appreciation and any income received. For performance measurement purposes, the total return normally assumes that income received is reinvested in the same asset. For example, the total annual return on an **equity** is the increase (or decrease) in the price of the original investment, plus the additional value of any reinvested **dividends**.

Tracking error

A measure of the variability of the returns of an investment relative to a **benchmark**. Most commonly expressed in terms of the **standard deviation** of returns relative to the benchmark. It can be calculated on either an "**ex-ante**" or "**ex-post**" basis.

Traditional investments

UK pension schemes once invested almost exclusively in a relatively small number of **asset classes**, predominately **equities** and **bonds**. As a result of the emergence of new/alternative asset classes, such as **diversified growth funds** and **hedge funds**, equities and bonds are sometimes referred to as "traditional investments".

Transaction costs

The costs incurred when buying or selling a **security**.

Transitional Pathway Initiative (TPI)

A global, asset owner led initiative which assesses companies' preparedness for the transition to a low carbon economy. Data provided by the TPI can help investors with investment research, decision-making, company engagement and voting.

Transition risk

The risk of financial losses that could result from the significant policy, legal, technology, behavioural and market related changes that may occur as economies transition to a lower-carbon future.

Treasuries

The US equivalent of the UK's conventional **gilts**. They are split by **maturity** into T-bills (maturities of up to 1 year), T-notes (1 to 10 years) and T-bonds (greater than 10 years).

Treasury Inflation Protected Securities (TIPS)

The US equivalent of the **UK's index-linked gilts**.

Triple bottom line

A holistic approach to measuring a company's performance on environmental, social, and economic issues. The triple bottom line approach to management focuses not just on the economic value (profit) they add, but also on the environmental and societal value they add or detract.

Unconstrained

Any investment where the manager has much less constraint placed on their investment discretion than normal. Commonly, unconstrained refers to a manager who takes no account of any **benchmark**. An unconstrained approach generally increases the **risk** of an investment and places a higher emphasis on manager skill.

UCITS

UCITS is an acronym for Undertaking for Collective Investment in Transferable Securities, created under European legislation. It is now a common **pooled** investment structure, since it provides significant investment flexibility, particularly in the use of **derivative** instruments.

Unit trust

A **collective investment vehicle** in which money from a number of investors is **pooled** together and invested collectively in a spread of investments such as UK **equities** or **bonds**. Each investor owns a number of units, the value of which depends on the overall value of the trust's investments and the total number of units. An authorised unit trust can be sold to the general public. An unauthorised unit trust cannot be sold to the general public and is marketed to institutional investors such as pension scheme trustees.

Value at Risk (VAR)

This is a statistical measure of the **risk** of loss on a **portfolio**. For a given portfolio, time period and confidence level, the VAR is the threshold value such that the probability that the loss on the portfolio exceeds the VAR is equal to 100% minus the confidence level. For example, a portfolio with a 1 year, 90% confidence level VAR of £10m would have a 10% (ie 100 – 90) chance over a 1 year period of falling in value by £10m or more. In the context of a pension scheme, VAR can also be used to measure the extent to which the value of a scheme's portfolio of assets might diverge from its **funding target**. VAR came in for criticism during and following the "credit crunch", when it became clear that some investors had relied too heavily on the measure, which they had derived in the first place from unrealistic investment models (ie ones which assigned too low a probability to large losses).

Value investing

Investing in **equities** that are believed to be underpriced (for example based on a high **dividend yield** or a low **P/E ratio**). See also **growth** investing.

Void rate

The proportion of a **property portfolio** that is vacant and hence not earning any rental income.

Volatility

The term volatility is used to describe the extent to which the price of an investment – for example an individual security (eg BP shares) or a whole market (eg UK **equities**) varies over time. It can be expressed in a number of different ways, with a common approach being the **standard deviation**.

Volatility index

A volatility **index** is designed to provide a snapshot of the consensus view of future market **volatility** over the short term. The most widely used volatility index is the VIX Index, which provides one measure of the expected volatility of the S&P 500 index over the next 30 days.

(International) Withholding tax

A tax levied on the investment income earned by nonresident investors. There may though be agreements in place between countries which allow certain investors to avoid such a tax.

With profits

With profits is a type of investment **fund** normally accessed via an insurance policy. With profits provides a number of benefits. These include a guarantee that the amount paid out will not be less than the amount paid in, as well as the addition of regular guaranteed bonuses and possibly a final bonus, which increase the policy value. These guarantees apply in certain circumstances only, for example, at policy maturity or on the policyholder's death. For reasons such as poor transparency and lack of investment control, with profits is little used by pension schemes nowadays, with the exception of **Additional Voluntary Contribution** (AVC) arrangements for which it remains relatively popular.

Y

Yield

This has a number of meanings. It is most commonly used with regard to **fixed income**. The current yield on a **bond** is the annual **coupon** expressed as a percentage of the current market price. For example, if a bond issued at £100 has a 6% annual coupon and a current market price of £120, then the current yield is 5%. It can also refer to the yield to **maturity**, which is also known as the gross redemption yield (GRY). This is simply the **internal rate of return** (IRR) for the bond. The GRY is only relevant for a bond held to maturity. If the bond is sold before maturity then the actual yield is likely to be different to the GRY.

Yield curve

This is a graph which sets out the **yield** to **maturity** on **bonds** with different terms to maturity. Maturity is plotted on the x-axis and yield on the y-axis.

Zero-coupon bond

This is a **bond** that only returns its **face value** at **maturity** ie no interest payments are received before that. They are often issued by governments (at a discount to their face value) and are considered useful in determining the **yields** prevailing at different points on the **yield curve**.

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