GLOSSARY

CAMBRIDGE ASSOCIATES

Glossary of Terms

ACTIVE VS. PASSIVE MANAGEMENT	The only completely passive portfolio is the global portfolio of all assets, public and private. In practice, therefore, all investors must make some active decisions, even if those are decisions not to hold certain asset classes. In common usage, however, passive investing is often equated with indexing (defined below), and in this context, it means investing with a manager whose sole objective is to match the performance of a given benchmark index at very low cost. (Note that this requires an active decision by the investor as to which index is appropriate). In contrast, active managers attempt to outperform their benchmark through active stock selection, sector rotation, and so on.
ALPHA	Technically, alpha is the difference between the return of a single stock and that of the market as a whole (adjusted for risk). More commonly, however, it is used to denote the difference between the return of an active investment manager and that of the manager's benchmark index, over a given period of time.
ALTERNATIVE INVESTMENTS	Investments outside the standard categories of stocks, bonds and cash. Examples are venture capital, real estate, and oil and gas investments.
ASSET ALLOCATION	The distribution of a pool of assets among various asset classes (e.g., equities, bonds, real estate).
ASSET CLASSES	Different types of investments. Stocks and bonds are broad asset classes; these can be subdivided further, e.g., large-cap stocks or emerging markets bonds.
BASIS POINT	One one-hundredth of a percent or 0.01%. Therefore, 2.0% is equal to 200 basis points.
BENCHMARK	A target, usually an index (i.e. S&P 500, MSCI, NASDAQ) that active managers try to outperform.
BETA	Beta is a relative measure of a security's risk. It measures the sensitivity of a portfolio's rate of return to changes in the market's rate of return and therefore measures the amount of risk in the portfolio that cannot be removed through diversification. The beta of a portfolio is simply a weighted average of the betas of the securities in the portfolio. A "riskless" security is said to have a beta of 0. A security with a beta of 1.0, in theory, has the same "risk" as the market; i.e., on average, every 1% return on the market was associated during the period with a 1% return on the stock. A beta of 0.8 means that on average a 10% return on the market was associated with a return on the stock of 8%. High beta stocks are said to be very volatile, while low beta stocks are said to be very stable.
CAGR	Compound annual growth rate (CAGR) is the rate of return (RoR) that would be required for an investment to grow from its beginning balance to its ending balance, assuming the profits were reinvested at the end of each period of the investment's life span.

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CAPITAL APPRECIATION	Refers to a rise in the value of investments in the portfolio. It is growth in the principal amount invested and distinct from an increase in the value of the portfolio from interest or dividend income.
CAPITALIZATION	[or Market Capitalization; frequently abbreviated as "cap"]: What the stock market says a company is worth. The capitalization of a company is equal to the total number of shares outstanding times the current share price.
CAPITALIZATION WEIGHTED	For an index of common stocks, the price of each component stock weighted by the number of shares outstanding. For a bond index, the price of each bond weighted by the par amount outstanding.
COMMODITIES	Items such as oil and other energy holdings, foods, grains or metals, usually sold in advance on a contract basis. Investors sometimes include commodities contracts in a portfolio as inflation hedges because sharp price increases are often quickly reflected in values of commodities.
CONVERTIBLE BOND	A bond that can be converted into equity at any point in the life of the bond, usually at the discretion of the bondholder.
CORRELATION	A statistical measure of how two securities move in relation to each other. Correlations are used in advanced portfolio management.
DIVERSIFICATION	A risk management strategy that mixes a wide variety of investments within a portfolio. A diversified portfolio contains a mix of distinct asset types and investment vehicles in an attempt at limiting exposure to any single asset or risk. The rationale behind this technique is that a portfolio constructed of different kinds of assets will, on average, yield higher long-term returns and lower the risk of any individual holding or security. Portfolio holdings can be diversified not just across asset classes, but also within classes by investing in foreign markets as well as domestic markets. The idea is that the positive performance of one area of a portfolio will outweigh the negatives in another.
DURATION	A measure of the sensitivity of the price (the value of principal) of a fixed-income investment to a change in interest rates. Duration is expressed as a number of years. Rising interest rates result in falling bond prices, while declining interest rates result in rising bond prices.
EBITDA	EBITDA stands for "earnings before interest, taxes, depreciation, and amortization" and is an alternate measure of a company's financial health and ability to generate cash.

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EMERGING MARKETS	stock and bond markets in small but often fast-growing economies, mostly in Asia and Latin America.
EQUITIES	[used interchangeably with stocks]: Certificates of ownership interest in a corporation.
FIXED INCOME INVESTMENTS	[used interchangeably with bonds]: Interest-bearing certificates issued by governments or corporations. Bonds are essentially IOUs promising full repayment within a specified time. Bondholders do not share in a company's profits (as stockholders do), but they must be paid before stockholders should a company fail.
GLOBAL TACTICAL ASSET ALLOCATION	A top-down investment strategy that attempts to exploit short-term mis-pricings among a global set of assets. The strategy focuses on general movements in the market rather than on performance of individual securities.
GROWTH INVESTING	A style of equity investing that favors companies whose profits may rise significantly in the future, even though their stock prices may already be high. Contrast with value investing.
HEDGE FUND	A mutual fund that uses various strategies to limit investment risk, usually involving paired (hedged) bets: one in favor of an investment and another against a similar investment. Hedge funds are the key components of an absolute return strategy.
HIGH YIELD BONDS	Debt that is rated below investment grade. High yield is usually rated BB or below. The lower rating is indicative of higher risk of default, and therefore the debt carries a higher coupon or yield than investment grade debt. Also referred to as junk bonds.
HURDLE RATE	The minimum return an investment must make before charging an incentive fee. For example, if a Hedge Fund has a hurdle rate equal to the S&P 500 which returns 5% for the month, the Hedge Fund can only start charging an incentive fee on returns above 5%.
INCENTIVE FEE	A fee generally applied by hedge funds which is dependent on the manager's performance. For instance, if the manager has an incentive fee of 20% and a hurdle rate of 5%, the manager takes 20% of the returns that are generated above 5%.

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INFLATION	The decline of purchasing power of a given currency over time. A quantitative estimate of the rate at which the decline in purchasing power occurs can be reflected in the increase of an average price level of a basket of selected goods and services in an economy over some period of time. The rise in the general level of prices, often expressed as a percentage, means that a unit of currency effectively buys less than it did in prior periods. Inflation can be contrasted with deflation, which occurs when the purchasing power of money increases and prices decline.
INVESTMENT GRADE	A rating that indicates that bond has a relatively low risk of default. Investment grade is usually rated BBB or above.
INVESTMENT MANAGER	An individual, firm, or committee responsible for making buy, hold, or sell decisions. Also known as a money manager or an investment advisor.
LARGE-CAP STOCKS	Stocks of large companies, with market capitalizations typically over $8 billion. Often used interchangeably with the S&P 500, a list of the 500 largest U.S. companies.
LEVERAGE	Borrowing money to invest, hoping to earn a higher return than the interest paid on the money borrowed.
LIQUIDITY	The degree to which an investment can be converted to cash without causing losses. Bonds are generally more liquid than stocks, while many alternative investments are highly illiquid.
LOCK-UP PERIOD	A window of time investors in a hedge fund or another closely held investment vehicle are not allowed to redeem or sell shares.
LONG/SHORT INVESTING	A form of investing where the manager holds positions in stocks they find attractive and short-sell stocks they believe will underperform.
MARKETABLE SECURITIES	Stocks, bonds, or notes that are traded in the marketplace.
MATURITY	The time at which a bond is due.

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PORTFOLIO	A term for everything an investor owns.
PRIVATE EQUITY	Ownership interest in companies whose stock cannot be purchased on public stock exchanges.
RATE OF RETURN	The rate of return on a pool of assets is a measure of investment performance and should always be determined on a total return basis. In other words, the rate of return should include realized and unrealized changes in market value in addition to earned income (i.e., dividends and interest income). Managers may report returns before or after management advisory fees, but returns are always reported after brokerage and trading costs.
REAL RETURN	A real return is the nominal or actual return adjusted for inflation. It is calculated using the following formula: (1 + nominal return) / (1 + inflation rate) = (1 + real return). For example, if the nominal return was 10% and the inflation rate 4%, then the real return would be 5.8%.
REBALANCING	Restoring a portfolio to its target asset allocation by selling assets that have risen above their targets and buying those that have fallen below targets.
REIT	[pronounced reet]: Real Estate Investment Trust, a type of investment company that manages a portfolio of real estate for shareholders. The shares they issue—also called REITs—are traded publicly and are thus more liquid than other real estate. A REIT typically holds a diverse basket of properties, ranging from shopping centers and office complexes to apartments and hotels.
RISK-ADJUSTED RETURN	An effort to make apples-to-apples comparisons of different investments. If two investments have the same 10% return, for example, but one is riskier (more volatile), one would prefer the less risky investment. A risk-adjusted return would give the risky asset a "score" that is below 10% and award extra points to the more stable investment.
SECURITIES	Stocks and bonds.
SHORT-SELLING	Selling borrowed shares of a stock only to repurchase at a (hopefully) lower price and returning the shares to the lender. Success depends on correctly judging that a stock's price will fall.
SMALL-CAP STOCKS	Stocks of small companies with market capitalizations typically under $1 billion.

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STANDARD DEVIATION	A commonly used statistic within finance that measures how spread out a dataset can be relative to its average. The more spread out the data, the higher the standard deviation, and the further a data point, or in this case an investment's return, may stray from the average. In a given data set with a normal distribution, roughly 68% of the data points will fall within 1 standard deviation of the average, while 95% of the data points will fall within 2 standard deviations of the average. For example, a volatile or risky stock has a high standard deviation, while the deviation of a stable blue-chip stock is usually rather low.
STRATEGIC ASSET ALLOCATION	A portfolio strategy that involves setting target allocation for various asset classes, and periodically rebalancing the portfolio back to the original allocations. The target allocations depend on a number of factors such as the investor's risk tolerance, time horizon, and investment objectives.
TIPS	Treasury Inflation-Protected Security. An investment which is identical to a U.S. Treasury bond, except that its interest payments are adjusted to eliminate the effects of inflation.
TOTAL RETURN	Change in the market value of an investment, plus income, divided by the starting market value.
TURNOVER	How often a fund churns its portfolio in a given year. For instance, a manager with a $100 portfolio and a 20% turnover would sell $20 worth of securities and buy a new set of securities with the $20. By selling these securities, the fund realizes capital gains which are passed through to investors. Generally, the higher the turnover, the more taxes a manager will generate.
TRACKING ERROR (OR TRACKING VARIABILITY)	The tracking error (or variability) of a portfolio is the degree to which its returns deviate from those of an appropriate benchmark index. An index fund should therefore have virtually no tracking variability; an enhanced index fund a very modest amount of tracking variability; and an actively managed, concentrated portfolio a large measure of tracking variability (see also R^2).

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VALUATION	The analytical process of determining the current (or projected) worth of an asset or a company.
VALUE INVESTING	A style of equity investing. Value investors seek to buy low and sell high by choosing out-of-favor stocks in companies that are fundamentally strong, in the hope that the market will later correct its underestimate and drive the stock's price higher. Contrast with growth investing.
VOLATILITY (BETA)	Measures the sensitivity of the portfolio rate of return to changes in the market rate of return. It is the portion of portfolio risk which is linked to overall market movements, and, is therefore considered to be the non-diversifiable risk of the portfolio. If beta is 1, a one percent increase in the market return will result, on average, in a 1% increase in the portfolio return. When beta is 1, the market return and fund return are equally volatile. The portfolio displays no more risk than the market itself. If a portfolio has a beta of 2, a 10% increase in the market return will result, on average, in a 20% increase in the portfolio return. Thus, if beta is greater than 1, the portfolio is considered more risky (volatile) than the market.
VOLATILITY/ STANDARD DEVIATION	The riskiness of a security is measured by its "volatility," often described as its standard deviation. The standard deviation measures the degree of dispersion of returns, estimating the extent to which actual returns over a period are likely to differ from the average historical return. The larger the standard deviation, the wider the range of likely returns. There is a 66% probability that the actual return in a given period will fall within the range of plus or minus one standard deviation and a 95% probability of the actual return being within two standard deviations. For example, if a stock has an average return of 10% and a standard deviation of 5, then there is a 66% chance of the return falling between 5% and 15% and a 95% chance of the return falling between 0% and 20%. The implicit assumption is that the greater the variability of a rate of return, the greater the risk associated with that return.
YIELD	How much income a fund generates from stock dividends and bond interest. For instance, if a fund holds one stock worth $100 and the stock generates a $2 dividend during the year, the fund will have a 2% yield.