APPENDIX C

GLOSSARY OF TERMS

This glossary was compiled from the following sources.

Eugene B. Burroughs, CFA, **Investment Terminology (Revised Edition**), International Foundation of Employee Benefit Plans, Inc., 1993.

John Downes, Jordan Elliot Goodman, **Dictionary of Finance and Investment Terms (Third Edition)**, Barron's Educational Series, Inc.

John W. Guy, **How to Invest Someone Else's Money**, Irwin Professional Publishing, Burr Ridge, Illinois.

Donald B. Trone, William R. Allbright, Philip R. Taylor, **The Management of Investment Decisions**, Irwin Professional Publishing, Burr Ridge, Illinois.

Donald B. Trone and William R. Allbright, **Procedural Prudence for Fiduciaries**, self-published, 1997.

Active Management A form of investment management which involves buying and selling financial assets with the objective of earning positive risk-adjusted returns compared to a relative "passive" index.

AIMR Performance Presentation Standards These standards, effective January 1, 1993, are designed to promote full disclosure and fair representation in the reporting of investment results in order to provide uniformity in comparing manager results. These standards include ethical principles and apply to all organizations serving investment management functions. Compliance is verified at two levels: Level 1 and Level 2. (Level 2 is a more comprehensive verification process). Specific information regarding these standards can be obtained by calling **AIMR** at (804) 980-3547.

Alpha This statistic measures a portfolio's return in excess of the market return adjusted for risk. It is a measure of the manager's contribution to performance with reference to security selection. A positive alpha indicates that a portfolio was positively rewarded for the residual risk, which was taken for that level of market exposure.

Arithmetic Return The sum of the period returns divided by the number of periods. This is the simple average return and should be contrasted with **Geometric Return**.

Asset Allocation The process of determining the optimal allocation of a fund's portfolio among broad asset classes.

Basis Point 100 Basis Points = 1%

Best Execution This is formally defined as the difference between the strike price (the price at which a security is actually bought or sold) and the "fair market price", which involves calculating opportunity costs by examining the security price immediately after the trade is placed. Best execution occurs when the trade involves no lost opportunity cost, for example, when there is no increase in the price of a security shortly after it is sold.

Beta A statistical measure of the volatility, or sensitivity, of rates of return on a portfolio or security in comparison to a market index. The beta value measures the expected change in return per one percent change in the return on the market. Thus, a portfolio with a beta of 1.1 would move 10% more than the market.

Board Room Risk The risk that trustees will not ride out short-term volatility (and therefore wind up altering a sound long-term strategy) due to pressure put on them in their role as trustees.

Cash Sweep Accounts A money market fund into which all new contributions, stock dividend income and bond interest income is placed ("swept") for a certain period of time. At regular intervals, or when rebalancing is necessary, this cash is invested in assets in line with the asset allocation stipulated in the IPS.

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Commingled Fund An investment fund that is similar to a mutual fund in that investors purchase and redeem units that represent ownership in a pool of securities. Commingled funds are usually offered through a bank-administered plan allowing for broader and more efficient investing.

Commission Recapture An agreement by which a plan Fiduciary earns credits based upon the amount of brokerage commissions paid. These credits can be used for services that will benefit the plan, such as consulting services, custodian fees, or hardware and software expenses.

Correlation Coefficient Correlation measures the degree to which two variables are associated. Correlation is a commonly used tool for constructing a well-diversified portfolio. Traditionally, equities and fixed-income asset returns have not moved closely together. The asset returns are not strongly correlated. A balanced fund with equities and fixed-income assets represents a diversified portfolio that attempts to take advantage of the low Correlation between the two asset classes.

Defined Benefit Plan A type of employee benefit plan in which employees know (through a formula) what they will receive upon retirement or after a specified number of years of employment with an employer. The employer is obligated to contribute funds into the defined benefit plan based on an actuarially determined obligation that takes into consideration the age of the workforce, their length of service and the investment earnings that are projected to be achieved from the funds contributed. Defined Benefit Plans are over funded if the present value of the future payment obligations to employees is less than the current value of the assets in the Plan. It is under funded if the obligations exceed the current value of these Plan assets. The **Pension Benefit Guarantee Corporation** insures a specified amount of these future pension benefit payments on a per employee basis.

Defined Contribution Plan A type of employee benefit plan in which the employer (Fiduciary) makes annual contributions (usually discretionary in amount or possibly based on a percentage of the profits of the company e.g. **Profit Sharing Plan**) into the plan for the ultimate payment to employees at retirement. Each employee's account value will be determined by the contribution made, the earnings achieved and (usually a vesting percentage - e.g. 20% per year after one year of service).

Directed Brokerage Circumstances in which a board of trustees or other fiduciary requests that the investment manager direct trades to a particular broker so that the commissions generated can be used for specific services or resources. See **Soft Dollars**.

Dollar-weighted Rate of Return Method of performance measurement that calculates returns based on the cash flows of a security or portfolio. A dollar weighted return applies a discounted cash flow approach to obtain the return for a period. The discount rate that equates the cash inflow at the end of the period plus any net cash flows within the period with the initial outflow is the dollar-weighted rate of return. This return is also referred to as the internal rate of return (IRR).

Economically-Targeted Investment (ETI) Investments where the goal is to target a certain economic activity, sector or area in order to produce corollary benefits in addition to the main objective of earning a competitive risk-adjusted rate of return.

Emerging Markets Managers who primarily concentrate on investments in newly emerging second and third world countries in the regions of the Far East, Africa, Europe, and Central and South America. These portfolios are characterized by aggressive risk/return profiles that generate high volatility in search of high returns.

End Point Sensitivity The performance of a manager/fund may vary depending on which ending time periods are used to analyze performance. Therefore it is important to look at performance for a number of market cycles or time periods to gain an accurate assessment of the manager/fund's performance.

Equal Weighted In a portfolio setting this is a composite of a manager's return for accounts managed that gives equal consideration to each portfolio's return without regard to size of the portfolio. Compare to **Size Weighted Return**. In index context, equal weighted means each stock is given equal consideration to the index return without regard to market capitalization. The Value Line Index is an example of an equal weighted index.

Equilibrium Spending Rate Specific to foundations and endowments, the "spending rate" which offsets inflation and additional cost increases.

9.0%	-	3.5%	-	1.5%	=	4%
(return)		(inflation)		(cost increases)		(equilibrium spending rate)

ERISA The Employee Retirement Income Security Act is a 1974 law governing the operation of most private pension and benefit plans. The law eased pension eligibility rules, set up the **Pension Benefit Guaranty Corporation**, and established guidelines for the management of pension funds.

Exculpatory A clause or set of regulations, such as the "safe harbor rules," which generally frees trustees from responsibility and liability.

Family Office The Family Office is typically a staff of at least one attorney and/or accountant and administrative support person established by wealthy families (generally families with more than $50 million in assets) who are responsible for planning the budget, paying the bills, and making investment decisions. The structure of the office, or the ownership of the assets, often takes the form of either a trust or corporation. Family Offices evolved from the need to: (1) centralize the management of investable assets and to provide record keeping, tax planning and other personal services to the family members; (2) anticipate the need to serve more than one or two generations which required a more formal structure to be put in place; and (3) coordinate their philanthropic services, interests and activities through one entity.

Fiduciary Indicates the relationship of trust and confidence where one person (the fiduciary) holds or controls property for the benefit of another person. For example, the relationship between a trustee and the beneficiaries of the trust.

> Any person who (1) exercised any discretionary authority or control over the management of a plan or the management or disposition of its assets, (2) render investment advice for a fee or other compensation with respect to the funds or property of a plan, or has the authority to do so, or (3) has any discretionary authority or responsibility in the administration of a plan.

Funding-Support Ratio The *funding-support ratio* (the fraction of the budget supported by the fund) is the key strategic variable used by experienced committees to track and manage contributions to an institution's or recipient's annual budget. Although increasing the spending rate increases the fund's current contribution to the overall budget, more spending obviously means less reinvestment, a smaller growth rate and, all other things being equal, a lower funding support ratio in the future.

Geometric Return A method of calculating returns which links portfolio results on a quarterly or monthly basis. This method is best illustrated by an example, and a comparison to **Arithmetic Returns**, which does not utilize a time link. Suppose a $100 portfolio returned +25% in the first quarter (ending value is $125) but lost 20% in the second quarter (ending value is $100). Over the two quarters the return was 0% - this is the geometric return. However, the arithmetic calculation would simply average the two returns: (+25%)(.5) + (-20%)(.5) = +2.5%.

Global Equity Managers who invest in both foreign and domestic equity securities but excludes regional and index funds. Theses products will exhibit risk/return profiles similar to the MSCI World Index.

Global Fixed-Income Managers who invest in both foreign and domestic fixed-income securities. These funds seek to take advantage of international currency and interest rate movements, differing bond yields, and/or international diversification.

Guaranteed Investment Contracts (GICs) Contract between an insurance company and a corporate profit sharing or pension plan that guarantees a specific rate of return on the invested capital over the life of the contract. Although the insurance company takes all market, credit and interest rate risks on the investment portfolio, it can profit if its returns exceed the guaranteed amount. For pension and profit-sharing plans, guaranteed income contracts are a conservative way of assuring beneficiaries that their money will achieve a certain rate of return.

Hedge A transaction or strategy designed to reduce risk. This typically involves short selling, futures contracts, options and similar strategies. The strategy usually also reduces potential reward.

High Yield A fixed income investment strategy where the objective is to obtain high current income by investing in lower rated, higher default-risk fixed-income securities. As a result, security selection focuses on credit risk analysis. See **Junk**.

Index Fund A passively managed investment in a diversified portfolio of financial assets designed to mimic the performance of a specific market index.

Intermediate A fixed income investment strategy where the objective is to lower interest rate risk by investing only in intermediate-term securities. The average portfolio maturity is typically five to seven years and duration of more than 3.5 but less than 6.0 years.

International Equity: Funds that invest in non-US stocks, primarily in developed countries around the world, although most International funds include an allocation to emerging markets as well.

Investment Grade Refers to the **Quality Rating** of bond issue. Securities rated AAA to BBB are typically referred to as investment grade securities. *See also junk bonds.*

Large Cap Blend: Domestic equity funds that invest in stocks that represent the largest 5% of the top 5,000 US stocks and where the combination of the median stocks P/E and P/B is between value and growth styles.

Large Cap Growth: Domestic equity funds that invest in stocks that represent the largest 5% of the top 5,000 US stocks and where the combination of the median stocks P/E and P/B is greater than blend (core) managers.

Large Cap Value: Domestic equity funds that invest in stocks that represent the largest 5% of the top 5,000 US stocks and where the combination of the median stocks P/E and P/B is less than blend (core) managers.

Liquidity Risk The risk that there will be insufficient cash to meet the fund's disbursement and expense requirements.

Lost Opportunity Risk The risk that through inappropriate **Market Timing** strategies a fund's portfolio will miss short-term or long-term market opportunities.

Marked-to-Market The daily process of adjusting the value of a portfolio to reflect daily changes in the market prices of the assets held in the portfolio.

Market Capitalization A common stock's current price multiplied by the number of shares outstanding. It is the measure of a company's total value on a stock exchange.

Market Timing A form of **Active Management** that moves funds between asset classes based on short-term expectations of movements in the capital markets. (Not recommended as a prudent process.) It is very difficult to improve investment performance by attempting to

forecast market peaks and troughs. A forecasting accuracy of at least 71% is required to outperform a buy and hold strategy.

Market Weighted Typically used in an index composite. The stocks in the index are weighted based on the total **Market Capitalization** of the issue. Thus, more consideration is given to the index's return for higher market capitalized issues than smaller market capitalized issues.

Maturity The date on which a bond's par value becomes due and payable.

Mid Cap Managers who invest primarily in middle capitalization range companies with market capitalizations between core equity companies and small capitalization companies. Domestic equity funds that invest in stocks between the largest 5% - 20% of the top 5,000 US stocks.

Money Markets Financial markets in which financial assets with a maturity of less than one year are traded. Money market funds also refer to open-end mutual funds that invest in low-risk, highly liquid, short-term financial instruments and whose net asset value is kept stable at $1 per share. The average portfolio maturity is 30 to 60 days.

Morgan Stanley Capital International EAFE Index (MSCI EAFE) The EAFE Index is composed of approximately 1000 equity securities representing the stock exchanges of Europe, Australia, New Zealand, and the Far East. The index is capitalization weighted and is represented in US dollars.

NASDAQ Composite Index The NASDAQ Index is composed of all the common stick issues traded on the NASDAQ National Market System. The index is capitalization weighted.

New York Stock Exchange (NYSE) Index This index is a composite of all the common stock issues listed on the New York Stock Exchange. The index is capitalization weighted.

Passive Management For a given asset class, the process of buying a diversified portfolio that mimics the overall performance of the asset class (i.e. the relevant market index).

Profit Sharing Plan Retirement plan that receives contributions as a percentage of the company's profits. See **Defined Contribution Plan**.

Proxy Voting A written authorization given by a shareholder to someone else to vote his or her shares at a stockholders annual or special meeting called to elect directors or for some other corporate purpose.

Quality Rating The rank assigned a security by such rating services as Moody's and Standard & Poor's. The rating may be determined by such factors as: (1) the likelihood of fulfillment of dividend, income and principal payment obligations, (2) the nature and provisions of the issue and (3) the security's relative position in the event of liquidation of the company. Bonds assigned the top four grades (AAA, AA, A, BBB) are considered "**Investment Grade**" because

they are eligible bank investments as determined by the Comptroller of the Currency. Rating, whether for stocks or bonds, must be used with care due to a tendency of the rating service to recognize changes in financial condition after they occur rather than as they are anticipated to occur.

Real Estate Investment Trust (REIT) An investment fund whose objective is to hold real estate-related assets, either through mortgages, construction and development loans, or equity interests.

Residual Risk Residual risk is the unsystematic, firm-specific, or diversifiable risk of a security or portfolio. It is the portion of the total risk of a security or portfolio that is unique to the security or portfolio itself and is not related to the overall market. The residual risk in a portfolio can be decreased by including assets that do not have similar unique risk. For example, a company that relies heavily on oil would have the unique risk associated with a sudden cut in the supply of oil. A company that supplies oil would benefit from a cut in another company's supply of oil. A combination of the two assets helps to cancel out the unique risk of the supply of oil. The level of residual risk in a portfolio is a reflection of the "bets" which the manager places in a particular asset class or sector. Diversification of a portfolio can reduce or eliminate the residual risk of a portfolio.

Risk-adjusted Return The return on an asset or portfolio, modified to explicitly account for the risk of the asset or portfolio.

Risk Free Rate of Return The return on a 90-day Treasury bills. This is used as a proxy for no risk due to its US Government issuance and short-term maturity. The term is really a misnomer since nothing is free of risk. It is utilized since certain economic models require a "risk free" point of departure. See **Sharpe Ratio**.

R-squared (R^2) Formally called the coefficient of determination, this measures the overall strength or "explanatory power" of a statistical relationship. In general, a higher R^2 means a stronger statistical relationship between the variables that have been estimated, and therefore more confidence in using the estimation for decision-making.

S&P Rating The Standard and Poor's market weighted average rating of all of the rated securities in a portfolio. Stock ratings are intended to provide an objective measure of the risk of a company in terms of the perceived level of stability in earnings and dividends. Securities that are not rated by S&P are excluded from the weighted average rating.

Safe Harbor Rules A series of guidelines which when in full compliance *may* limit a fiduciary's liabilities.

Sharpe Ratio This statistic is a commonly used measure of risk-adjusted return. It is calculated by subtracting the **Risk-free Return** (usually 3 Month Treasury Bill) from the portfolio return and dividing the resulting "excess return" by the portfolio's total risk level (standard deviation). The result is a measure of return gained per unit of total risk taken. The Sharpe ratio can be used to compare the relative performance of managers. If two managers

have the same level of risk but different levels of excess return, the manager with the higher Sharpe ratio would be preferable. The Sharpe ratio is most helpful when comparing managers with both different returns and different levels of risk. In this case, the Sharpe ratio provides a per-unit measure of the two managers that enables a comparison.

Short Bond: Also, used as a proxy for GICs, Stable Value Funds and Money Markets. Fixed income funds of investment grade securities that have duration of more than 1.0 but less than 3.5 years or an average effective maturity of more than 1.0 but less than 4.0 years.

Size Weighted In a portfolio setting this is a composite of a manager's return for accounts managed that weights each portfolio's return based on the size of the account. Compare to **Equal Weighted Return**. In index context, size weighted means each stock is given unequal consideration to the index return because it takes into consideration market capitalization of each stock. The Standard & Poor's 500 Index is an example of a size-weighted index.

Small Cap Domestic equity funds that invest in stocks that represent the smallest 80% of the top 5,000 US stocks. The cut-off point for small capitalization varies from manager to manager, but on average is the amount is around $1 billion.

Socially-Targeted Investment An investment that is undertaken based upon social, rather than purely financial, guidelines. See also **Economically-Targeted Investment**.

Soft Dollars The portion of a plan's commissions expense incurred in the buying and selling of securities that is allocated through a **Directed Brokerage** arrangement for the purpose of acquiring goods or services for the benefit of the plan. In many soft dollar arrangements, the payment scheme is effected through a brokerage affiliate of the consultant. Broker-consultants servicing smaller plans receive commissions directly from the counseled account. Other soft dollar schemes are effected through brokerages that, while acting as the clearing/transfer agent, also serve as the conduit for the payment of fees between the primary parties to the directed fee arrangement.

Standard Deviation A statistical measure of portfolio risk. It reflects the average deviation of the observations from their sample mean. Standard deviation is used as an estimate of risk since it measures how wide the range of returns typically is. The wider the typical range of returns, the higher the standard deviation of returns, and the higher the portfolio risk. If returns were normally distributed (i.e. has a bell shaped curve distribution) then approximately 2/3 of the returns would occur within plus or minus one standard deviation from the sample mean.

Standard & Poor's 500 Composite Stock Index An index of stocks composed of 400 industrial, 40 utilities, 40 financial firms and 25 transportation issues. The index is **market weighted**. The Index is widely used as a benchmark for account performance measurement. Mutual funds and common trust funds have been organized to duplicate this index. See **Index Fund**.

Standard & Poor's Mid Cap Index A composite of 400 medium capitalization domestic common stocks. Stocks in this index are not included in the Standard & Poor's 500 Index. The index is capitalization weighted.

Strategic Asset Allocation Rebalancing back to the normal mix at specified time intervals (quarterly) or when established tolerance bands are violated (±10%).

Style The description of the type of approach and strategy utilized by an investment manager to manage funds. The style is determined by, as an example for equities, portfolio characteristics such as: market capitalization of issues, price to earnings ratio and dividend yield. Some equity styles include Growth, Value, Yield, Core and Small Cap.

Systematic Risk attributable to common macroeconomic factors and sometimes referred to as market risk. It is the part of a security's total risk that is related to movements in the market portfolio and therefore cannot be diversified away.

Tactical Asset Allocation The "first cousin" to **Market Timing**, as it uses certain "indicators" to make adjustments in the proportions of portfolio invested in three asset classes - stocks, bonds, and cash.

Time Weighted Rate of Return Method of performance measurement that strips the effect of cash flows on investment performance by calculating sub period returns before and after a cash flow and averaging these sub period returns. Because dollars invested do not depend on the investment manager's choice, it is inappropriate to weight returns within a period by dollars.

Trading Costs Behind investment management fees, trading accounts for the second highest cost of plan administration. Trading costs are usually quoted in cents per share. Median institutional trading costs range around 5 to 7 cents per share.

90-Day US Treasury Bill The 90-Day T-Bill provides a measure of risk less return. The rate of return is the average interest rate available in the beginning of each month for a T-Bill maturing in 90 days.

Unsystematic Risk A risk pertaining to one element in a large environment or system. The risk of one stock is unsystematic, while the risk of the entire market of which it is an element is systematic. See **Systematic Risk**.

Value Equity Managers who invest in companies believed to be undervalued or possessing lower than average price/earnings ratios, based on their potential for capital appreciation.

Variance The Variance is a statistical measure that indicates the spread of values within a set of values. For example, the range of daily prices for a stock will have a variance over a time period that reflects the amount that the stock price varies from the average, or mean price of the stock over the time period. Variance is useful as a risk statistic because it gives an indication of how much the value of a portfolio might fluctuate up or down from the average value over a given time.