Beaumont
CAPITAL MANAGEMENT

Glossary of Terms 2019

As advisors, we know that even accomplished clients can have a lack of understanding of investing principles and risks, industry buzzwords, and jargon used by the financial media. Not to mention the current economic and political climate, which is amplifying emotion and reducing confidence. The increase in industry innovation, changes in economic and political policy, and speculation of a shift to late stages of the economic and business cycles have sparked the proliferation of new buzzwords, industry jargon and concepts that have not been top of mind for some time. Here are some of the most relevant terms for 2019, combined with our terms from past years.

Glossary of Financial Terms:

- **Active Management** can be thought of as any strategy that uses human discretion to decide what the portfolio should own. The manager(s) generally employs some combination of fundamental, quantitative, or technical research in conjunction with their experience, knowledge and judgement to try to find opportunities greater than the market. The fees are typically higher than passive as you are paying the managers for their work.

- **Alpha** is a measure of excess return, usually expressed as a percentage. A positive excess return means that for the risk taken, the reward received was greater than expected. In the industry, it is commonly accepted that a manager with positive Alpha has added value beyond what was available to a passive investor.

- **Annualized Return** is the return an investment provides over a period of time, expressed as a time-weighted annual percentage.

- **Beta** is used to determine the risk-reward profile of an investment relative to the market as a whole. If the beta is greater than one, then the investment is deemed riskier than the market as a whole and if less than 1 then it is less risky than the market. A beta of 1.2 implies that if the index goes up or down 10%, the investment in question can be expected to go up or down 12%.

- **Budget deficit** is when a nation's current expenses exceed revenue during a fiscal year.... A budget deficit requires funding in the form of debt which is usually a Treasury Bill (short term), Note (Intermediate term) or Bond (long term). A high budget deficit can lead to inflation, higher interest rates and slower economic growth which in turn hurts consumers and businesses alike. Ways to reduce a budget deficit would be to raise taxes, cut spending, lower interest rates (a large part of our current deficit is caused by interest due on existing debt) or find other revenue generating activities.

- **Closet Indexing** is a term used to describe funds that claim to actively purchase investments, but wind up with a portfolio not much different from the benchmark. By doing this, portfolio managers are able to achieve returns similar to an underlying benchmark, like the S&P 500® Index, without exactly replicating the index.

- **Consumer Price Index (CPI)** expresses the current prices paid for a basket of goods and services versus the prices paid during the same period in a previous year. CPI is a measure of inflation and is used by the Government to increase social program benefits such as Social Security and Welfare.

- **Cumulative Return** is the aggregate amount an investment has gained or lost over time, independent of the period of time involved (see annualized return).

- **Deflation** is the decline in prices for goods and services or the opposite of inflation. It is usually caused by over production (too much supply) or an economic slowdown where demand decreases. Modest deflation for a short period of time could be beneficial but generally sustained deflation hurts the economy.

- **Dividends** are a portion of the company's earnings that are paid to the shareholders as a reward for their investment in a company's stock. Dividends are paid out by publicly listed companies, mutual funds and exchange traded funds (ETFs) and are typically paid in cash. Larger, established companies with more predictable profits are often the most consistent dividend payers and stocks of these cash flow generating companies typically hold up better in volatile or declining markets. Dividends can be paid regularly (monthly, quarterly or annually), or companies can issue non-recurring, one-time dividends based on performance.

- **Dovish** is one of three (Dovish, Neutral, Hawkish) general outlooks of economic policy advisors (typically a country's central bank or in the U.S. the Federal Reserve) that indicates an easier monetary policy going forward (less expensive and more plentiful money). A change to a Dovish stance usually means the economy is slowing and these policy advisors want to guard against deflation and/or a recession. Policy makers will try to stimulate the economy (get people to spnd money) by lowering interest rates, increasing the money supply, or more recently by buying bonds on the open market (Quantitative Easing or QE). If it is cheaper to borrow money, businesses can expand and consumers may spend more with credit cards or loans to finance larger purchases such as homes and cars.

- **Drawdown** is the measurement of an investment's total decline from its previous peak for a particular period of time. Drawdown is a useful tool to help determine an individual's risk tolerance. This statistic can help investors gauge their risk appetite as previous large drawdowns, or peak to trough declines, may repeat in the future. Since most investors' primary worry is how much they can lose in a bear market, this is often a good measure of an investment's appropriateness to each investor. How large of a drawdown can your client handle before they begin to panic or react with emotion?

- **Earnings** refers to a company's after-tax net income, sometimes known as the bottom line, or a company's profits. Earnings have a dramatic effect on a company's stock price because it is an indicator of the company's profitability and recent success. Earnings are a hot topic right now as earnings expectations are declining. Since investors want future earnings to increase, declining earnings expectations can put pressure on stock prices. We explain this in a more bit more depth in this short article.

- **Economic Cycle** is the fluctuation of the economy between periods of growth and contraction (recession). The four stages of the economic cycle include early, mid, late, and recession (others may refer to see these stages as expansion, peak, contraction and trough). The biggest factors that help determine which stage we are in are Gross Domestic Product (GDP), interest rates, employment and consumer spending. Different industries and sectors perform differently during each phase of the market cycle. If you can identify which stage we are in, it can add value as part of an investment strategy. However, this is a difficult task and often the change in cycle stage is not known until well after the fact.

- **European Central Bank (ECB)** is the central bank of the 19 European Union (EU) countries that have adopted the euro. It administers monetary policy of the eurozone, one of the largest currency areas in the world. The ECB is the Eurozone counterpart to the Federal Reserve Bank (FED) here in the U.S. According to several sources, almost 99% of the world population lives in a country or region with a central bank.

- **Federal Funds Rate** is the interest rate that banks charge other banks for lending them money from their reserve balances on an overnight basis. A bank is required by law to keep a certain percentage of their deposits (money they hold for customers) in an account at a Federal Reserve bank. Any money above that amount can be made available for lending to other banks that may have a shortfall in that reserve. When the FED raises or lowers interest rates, this is the rate that the FED is adjusting. This rate can have a significant effect on the U.S. economy because it is used as a base for the interest rates offered by financial institutions to businesses and consumers.

- **Federal Open Market Committee (FOMC)** is the twelve-member committee, including five Federal Reserve Bank Presidents, within the Federal Reserve System, responsible for open market operations and determining the direction of monetary policy. They are often referred to as "the FED" and they meet eight times a year to decide whether to maintain or change current monetary policy in the U.S.

- **Fundamental Research** is a research method of evaluating an investment in an attempt to measure its intrinsic value, by examining related economic, financial and other qualitative and quantitative factors. The end goal is to use real, public data including macro and micro economic factors, like the overall economy and company management, respectively to decide if the investment is over or undervalued.

- **Gross returns** are the return of an investment over a specified time period before fees, commissions, or other expenses are subtracted.

- **Hawkish** refers to one of three (Dovish, Neutral, Hawkish) general outlooks of economic policy advisors (typically a country's central bank or in the U.S. the Federal Reserve) that wants to guard against excessive inflation when the economy is growing too fast or with too much inflation. The Central bank will try to slow the economy/inflation by raising or maintaining higher interest rates. Hawkish is the opposite of dovish (explained above) and, by raising interest rates and making borrowing more expensive, it curtails excess inflation.

- **Inflation** refers to a general increase in prices paid during a period of time. Inflation indices can also measure the fall in the purchasing power of a currency over time as goods and services become more expensive. Modest inflation is required for economic growth, but high inflation can be detrimental to the economy because prices rise faster than incomes, goods and services become unaffordable, and thus the quality of life deteriorates. Rampant inflation stifles demand, businesses' costs go up while sales slow, and profits fall. This may lead to rising unemployment and business failures.

- **Liquidity** refers to how quickly or easily an asset or security can be converted into cash without unduly affecting the asset's price.

- **Long only** refers to an individual security, mutual fund, ETF or a strategy that is owned outright. There is no margin or borrowing used to buy the security nor are there more exotic entanglements such as inverse, futures or shorting (borrowed stock). An owner of a long position expects the investment to increase in value over time.

- **Monetary policy** is typically determined by the central bank of a country where the central bank formulates, announces and implements any actions that will be taken to achieve macroeconomic objectives like controlling inflation, consumption and growth. These objectives are typically achieved by modifying interest rates, buying or selling government bonds, controlling the money supply, regulating exchange rates and other similar actions, and all of these have a significant impact on the economy.

- **Net returns** are the return from an investment after deducting all fees and expenses incurred by an investor from the gross return.

- **Nominal Gross Domestic Product (Nominal GDP)** is a measurement of the monetary value of all the finished goods and services produced within a country's borders in a specific time period, evaluated at current market prices.

- **OECD (Organization for Economic Cooperation and Development)** is a group of 35 member countries that discuss and develop economic and social policy. OECD members are democratic countries that support free market economies.

- **Passive Management** is often synonymous with index investing. By simply investing in the holdings of the index the strategy follows, the buy and sell decisions are not discretionary but rather based on the rules of the index. If an index fund that you invest in enters a period of failure, then your portfolio will also succumb to the market failure. Costs are typically low as there is little management of the portfolio.

- **Purchasing Managers' Index** focuses on the whole output of producers in the United States or another country. This index is very broad, including not only the goods and services purchased by producers as inputs in their own operations or as investment, but also goods and services bought by consumers from retail sellers and directly from the producer.

- **Quantitative Easing (QE)** is when a central bank purchases Treasury bonds, other bonds or even stocks from the market with the goal of lowering interest rates and stimulating economic activity. QE can also take the form of increasing the money supply to facilitate loans and stimulate economic activity.

- **Quantitative Research** uses mathematical and statistical methods, often aided by computers, to objectively analyze data for the purpose of making quantifiable favorable investments. If the research is not directly actionable, it may be further refined into rules and models for implementation. The advantage of quantitative research, if completed without bias, is that the system should be devoid of emotion and not subject to human interpretation.

- **QE Reversal (Quantitative Tightening or Reverse QE)** is a tool of monetary policy to shrink a Central Bank's Balance Sheet (Balance Sheet Normalization). When central banks use QE, it can create imbalances that need to be remediated over time and QE reversal is one way to do that.

- **Real Gross Domestic Product (Real GDP)** is the inflation adjusted measure that reflects value of all goods and services produced by an economy in a given year. Unlike nominal GDP, it accounts for changes in prices (inflation) to provide a more accurate measurement of economic growth.

- **Rules-Based** is a term often used to describe a Tactical Manager's ongoing process. Most Tactical processes have been created using quantitative and/or technical research. This research is then used to derive rules for managing money. The rules and process of the various strategies will vary, sometimes wildly, but the point is that rules have been created as part of the system to manage assets in a non-emotional, methodical manner.

- **Sectors** (Sector Investing) sectors are areas of the economy in which businesses share the same or a related product or service. There are eleven sectors of the stock market which include areas such as Financials, Utilities, Healthcare, and Energy. Sector investing is a stratgy based on moving investments across these sectors to take advantage of cyclical trends in the overall economy.

- **Sharpe Ratio** is a ratio that tells you how much return was attained per unit of risk.

- **Smart Beta** is often synonymous with Factor Investing. Smart Beta funds typically follow a passive index yet the index is built to own securities with certain investment attributes or factors. Factors generally seek to do one of two things: exploit market inefficiencies to create alpha or harvest a risk premium to realize higher returns through the targeted beta in one or more factors. In short, these factors have the ability to add alpha to portfolio returns.

    - **Single Factor** investing includes funds that focus on a single factor, like value or momentum, when creating an index. **Multi-Factor** investing includes funds that focus on multiple different factors when organizing the weights of a given index.

    - **Smart Beta**, by itself, may not be so smart. While the factor exposure can lend 1-3% of excess returns over time, unfortunately smart beta funds act too similar to the broad markets when they falter. The 6 most common factor ETFs (Dividend, Momentum, Quality, Size, Volatility and value), if held in equal weights, declined the same amount as the S&P 500® Index in the 2007-2009 drawdown.

- **Stagflation** is the state in which an economy is experiencing slow, no or modestly negative economic growth and relatively high unemployment, while being accompanied by rising prices, or inflation. This is the "worst" of many economic scenarios for businesses and consumers as prices keep rising while the economy, income and profits do not keep pace.

- **Standard Deviation** (Volatility) is a measure of the dispersion of a set of data from its mean. It is calculated as the square root of variance by determining the variation between each data point relative to the mean. If the data points are further from the mean, there is higher deviation within the data set.

- **Stock buybacks** are another form of capital return to equity investors similar to a dividend. When buying back stock, a company shrinks its outstanding shares, so remaining owners now own a larger portion of the company. By lowering the number of shares in the market, buybacks increase reported earnings per share (assuming all else equal).

- **Tactical Management** is a type of active portfolio strategy that shifts the percentage of assets held in various asset classes, sectors or individual investments to take advantage of opportunities as they present themselves. Tactical is also unique in that in times of market duress, Tactical managers seek to protect the assets by raising cash, shifting into other asset classes or geographies, or using other types of defensive mechanisms to avoid large losses.

- **Treasury Yield** is the return on investment on the U.S. government's debt obligation. In simpler terms, it's the interest rate the government pays to borrow money or pays an investor who buys "Treasuries". Treasury bills and notes are often thought of as risk-free investments because they are backed by the U.S. Government, which has the ability to print the money required to pay down the debt. The Treasury yield is a benchmark rate which influences other interest rates that individuals pay to borrow money for real estate, vehicles, equipment and the like.

- **U.S. Treasury** is the government department responsible for issuing all Treasury Bills, Notes and Bonds. The IRS and U.S. Mint are among the organizations under the U.S. Treasury umbrella.

- **United States Mexico Canada Agreement (USMCA)** is the trade deal between the USA, Mexico and Canada that was signed on November 30th, 2018 that effectively replaced the NAFTA agreement.

For more insights like these, visit BCM's blog at blog.investbcm.com

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