INVESTMENT JARGON

Translated Into Human Words

GW FINANCIAL

The world of finance loves jargon, but it’s overly confusing. Let’s clear the air.

Here’s a concise walk-through of terms that are common, but often not thoroughly understood. I have outlined the jargon using “human words” to make them real. Being comfortable with these terms will lay a strong foundation for the work we do together.

- Julie Bray

P.S. Was this helpful? Let me know with a quick note, please.

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Stocks

By definition: A type of security that signifies ownership in a corporation and represents a claim on part of the corporation's assets and earnings.

What this means…

Owning a stock means that you can claim partial ownership in a company. As an owner, you have a claim on a company's assets and earnings. Hence why returns (i.e. the compensation for owning a stock) is derived from current and future earnings.

What does it mean to be a stockholder?

When you look at your portfolio holdings, you'll likely find a bunch of recognizable company names. The phrase "common stock" might also appear after the company's name. This shows that you own stock in a company. Many people see these stocks as "merely numbers". Being a stockholder isn't a novelty anymore. There aren't any fancy stock certificates, and no one is ever available for the lavish stockholder meetings. The vast majority of stock trading is now handled electronically, which seems to have dehumanized the process.

What people often forget is that a stock represents ownership (or equity) in a business. Your portfolio will have stocks from many different types of companies. This means that you own all of these companies. Granted, you don't have a say in what goes on in the company. However, the decisions made by the company's managers are carried out to provide value for you, the investor. They work to please you! Thus, owning shares represents your vote of confidence in the company and its management.

Companies typically issue stock when they "go public" during an initial public offering (IPO). During this process the company will essentially "sell" their stock for cash, in order to raise money. However, most stock investing activity happens in the "secondary markets". You know this as a stock exchange, such as the NYSE, where buyers and sellers trade stocks. The activity in the stock exchange determines a company's stock price.

Why do people invest in stocks?

Before explaining why people invest in stocks, it's important to distinguish between a stock trader, and a stock investor. A stock trader looks at the stock price and certain metrics in order to buy and sell stock and make a short term profit. Stock traders see stocks as numbers, and develop strategies based on stock price movements. However, a stock investor typically holds a stock for the long term, in hopes of earning a return as compensation for holding the stock. Stock investors evaluate events that affect the long term ownership of the company, particularly the management and profitability of the company. As the client of a financial advisor, you are likely an investor rather than a trader.

People invest in stocks because owning stock means that you have a claim on assets and earnings. Claims on assets only becomes relevant when a company is being acquired or going through bankruptcy. The more important claim is the claim on earnings. When a company earns a profit, shareholders require a return. The company might choose to redistribute these profits to shareholders in the form of dividend payments. Stable and mature companies, such as P&G, do this. The company can also reinvest the profits so that the company can grow and the company's stock can become more valuable. Growth companies often do this, and compensate investors through an increased stock price.

Furthermore, the average return on stocks tends to beat inflation and the return on other savings vehicles. Hence a stock portfolio is a frequently used to save money for the long term, and it's why the stock exchange is such a publicized place.

Bonds

By definition: A debt investment in which an investor loans money to an entity (corporate or governmental) that borrows the funds for a defined period of time at a fixed interest rate.

What this means…

A bond is a loan. It's that simple. Instead of you borrowing money from a bank, a company or government is borrowing money from you.

How do bonds work?

Bonds are an important part of an investor's portfolio, typically providing low but relatively stable returns. A bond can be considered a type of "loan". When a government or a corporation needs money, they can either borrow it from the bank, or they can borrow it from willing investors. When borrowing from investors the company will issue a bond in exchange for the money. The amount of money that is borrowed is called the "face value" or the "principal". The bond will promise the investor periodic interest payments (or coupon payments) over a certain time period. Most bonds are considered "fixed income securities" because the coupon payments are a fixed amount. Bonds typically pay these coupon payments annually, semi-annually or quarterly. At the end of the time period (called the maturity date), the investor is paid back the amount that was borrowed (the principal).

What about the Federal Reserve and interest rates?

Like stocks, bonds can be traded in a secondary market. In the secondary market, bonds will have a "price" that is often higher or lower that the principal amount. A major factor that affects the price of a bond is the market interest rate. The US Federal Reserve has a big influence over the market interest rate in the US. When market interest rates rise, the price of the bond falls, and vice versa. However, this only affects investors that actively trade bonds. On the other hand, investors that hold onto bonds until the maturity date are promised the principal amount, and aren't affected by the price of the bond. Unless a company goes bankrupt, no matter what happens with interest rates, an investor will receive that principal amount at the maturity date.

Why do people invest in bonds?

People invest in bonds because they are less risky than stocks, and still provides a stable return. Keep in mind, whilst stock returns tend to outpace inflation, bond returns are eroded by inflation. Because the coupon payments of the bond tend to be fixed, the payments lose purchasing power as prices rise due to inflation. However, the advantage of bond returns is that they are less risky than stock returns. A company must make their debt payments, before they can declare a profit. Additionally, government bonds are generally considered safer than corporate bonds, since governments are less likely to default on their payments. Hence the coupon payments on your bonds are more guaranteed than your stock returns.

Risk & Return

By definition: The principle that potential return rises with an increase in risk. According to the risk-return tradeoff, invested money can render higher profits only if it is subject to the possibility of being lost.

What this means…

One of the fundamental principles in finance is the concept of risk and return. The more risk you take, the more return you should receive as compensation for bearing that risk.

What is risk, exactly?

Most people perceive risk in a negative way, since they associate it with losing money. What they're concentrating on is the "downside risk", but risk can have upsides as well. The more risky the investment, the more volatile and uncertain it becomes. This means a risky investment has large potential losses, but also large potential gains. Why does this relationship hold? Because return on investment is seen as "compensation" for bearing risk. The more risk you bear, the higher return you should receive.

What does this mean for my portfolio?

In general, stocks are considered riskier than bonds because of how uncertain and volatile the returns are. Remember stock returns are derived from earnings and future growth, which are both uncertain variables. However, a company is legally obliged to make coupon payments on a bond, hence the return on a bond is more certain than stock returns. The compensation for higher risk is a higher average return. On average stocks return about 10% annually, whilst investment grade (AAA) bonds return about 5% annually.

Different stocks and bonds also have different risk characteristics. Stocks from smaller companies tend to be riskier than stocks from larger companies. This is because smaller companies are more likely to fail or be acquired by larger companies, hence future earnings are more uncertain. Bonds are rated on a lettered scale where "AAA" denotes a safer investment, whilst anything below a "BB" is a risky investment. What this means is "AAA" bonds are more capable of making their coupon payments, whilst riskier bonds below "BB" are more likely to go bankrupt. In all cases, the more risky the investment, the higher the potential return.

Individuals also have different tolerances for risk. Generally the older you get, the more risk averse people become. People in the earlier stages of their career are more comfortable with bearing risk, since they have a long period to save for retirement and are more concerned with earning a return. However, people nearing retirement often minimize risk and are more concerned with a stable income. The point is, people increase the risk they take to earn a higher return, and reduce risk when they want a lower but stable return.

Diversification

By definition: A risk management technique that mixes a wide variety of investments within a portfolio. The rationale behind this technique contends that a portfolio of different kinds of investments will, on average, yield higher returns and pose a lower risk than any individual investment found within the portfolio.

What this means…

Remember the saying, " don't put all your eggs in one basket"? This is actually a guiding principle in finance. Except, people in the financial world call it "diversification". Essentially, by spreading out your investment across different companies, industries and asset classes, you lower the amount of risk that you take.

How does diversification work?

Let's take an example of a stock portfolio equally invested in two stocks: Ford and P&G. The two companies are in completely different industries: automotive and household products. Let's say that there's a new teleportation technology that makes cars obsolete. Ford stock would likely decline in value because due to negative earnings prospects, however, P&G is unlikely to be affected. This means that in the portfolio with two stocks, only half the portfolio will decline in value. This is how diversification works. Different companies and different industries are affected by different events. Having a portfolio of several companies is less risky than investing in one company alone. In an ideal situation, the decline of one stock can be compensated by the gain of another stock. The more stocks you have in a portfolio, the less risky it becomes.

How can I diversify my investment?

Investing in different stocks is one way to diversify. Another way to diversify is to invest in different asset classes. In the simplest terms, it means splitting your investment between stocks, bonds and cash. Again, each is affected by different factors. Stocks are affected by earnings, bonds are affected by interest rates, and cash just sits in your bank account. Ideally losses in one part of your portfolio can be compensated by gains in another part.

However, keep in mind that this doesn't eliminate risk. You can reduce risk through diversification up to a certain point. This so-called "un-diversifiable" risk is called market risk. This is the risk borne by investing in the financial market in the first place. You've likely experienced this first hand. On a good day when economic growth is strong, all stocks will tend to do well. Likewise on a bad day when economic growth is weak, all stocks will tend to do poorly. Macroeconomic factors affect all investments, and it's the only risk that you can't avoid. But remember, the economy has cycles: bad economic growth can be compensated during times of strong economic growth.

How Diverse is your PORTFOLIO?

Mutual Funds

By definition: An investment vehicle that is made up of a pool of funds collected from many investors for the purpose of investing in securities such as stocks, bonds, money market instruments and similar assets.

What this means…

Mutual funds pool together money from many different investors, and invest it in a diversified portfolio that meets the needs of the investors, typically for a fee.

You can think of a mutual fund as a chicken pot pie. When you buy shares of a mutual fund, you essentially buy a slice of the pie, which has equal parts chicken, vegetables, gravy and crust. These ingredients can be thought of as the fund's different stock or bond holdings. Instead of spending time and money building a diversified portfolio, you can instead buy into a portfolio that is already managed. The gains and losses experienced by the fund's portfolio is translated into gains and losses in your shares.

There are many different types of mutual funds, depending on the objective of the fund. Some funds are built to track an index, such as the S&P 500, and will be invested in stocks found in the S&P 500. Some funds contain a mix of bonds and stocks. There are even funds that invest in "alternative investments" such as real estate and commodities. Because mutual funds make it easy and cost effective for investors to diversify, it's a popular tool used by financial advisors. You'll likely see several instances of mutual funds in your holdings.