Portfolio Strategy Group | WEALTH ADVISORS

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Financial Definitions: A Reference Guide

Accredited Investor: An individual or entity may qualify as accredited investors if they meet certain wealth, income, or financial sophistication criteria, including (but not limited to):

- Net worth over $1 million, excluding a primary residence
- Income over $200,000 (individual) or $300,000 (with a spouse or partner) for successive years
- Investment professionals in good standing, holding certain securities licenses (Series 7, Series 63, Series 82)
- Family client of a family office that qualifies as accredited
- Knowledgeable employees of a private fund
- Entities with assets over $5 million (corporations, trusts, LLCs, partnerships)

Active Management: An investment strategy where a portfolio manager(s) makes specific buy and sell decisions for an investment portfolio. Investment decisions are typically guided by proprietary research and a stated investment goal (such as to outperform an index). This approach relies heavily on a manager's expertise.

Alternative Investment: A diverse category of financial assets that fall outside of what most people consider the traditional, typically more liquid classes of investing: stocks and bonds.

Asset Allocation: The process and result of dividing an investment portfolio among different asset categories (for example, equities, fixed-income assets, alternatives, and cash), which will vary by investor.

- Each asset class has different risks and return potential, and will behave differently over time. The goal is to identify an investment mix that aligns with an individual's financial goals, time horizon, and appetite for risk.

Assets Under Management (AUM): The total value of all investments held by a portfolio manager or investment company on behalf of clients.

Bear Market: A sustained period where market prices decline - typically defined by a drop of 20% from the previous high. Bear markets can last from months to years and are often accompanied by investor pessimism and a slowing economy.

Bond: Bonds are a type of fixed income security or loan. Bonds are contractual agreements where bondholders lend money to a bond issuer in exchange for predetermined interest payments.

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- Treasury bonds: Bonds issued by the U.S. government, considered to be low risk.
- Municipal bonds: Bonds issued by state municipal or local governments.
- Corporate bonds: Bonds issued by corporations. Typically, corporations have a higher risk of default than a government, requiring them to make higher interest payments.
- Convertible bonds: Hybrid bonds issued by corporations, offering fixed interest payments and a predetermined option to convert to equity shares of the company.
- Zero Coupon Bonds: Bonds issued at a considerable discount to par value which is paid at maturity (in lieu of periodic cash interest payments).
- Callable bonds: These bonds give the issuer flexibility to redeem ("call") the bond prior to scheduled maturity date.

Broker-Dealer: A person or firm in the business of buying and selling securities for its own account or on behalf of customers.

- Broker: A person acts as a broker when they act as an agent or execute orders on behalf of clients.
- Dealer: A person acts as a dealer when they act as a principal or trade for their own account.

Bull Market: A sustained period where stock prices are generally rising, investor demand is high, and prices are rising. Bull markets can last from months to years and are often characterized by investor optimism and strong economic conditions.

Capital Gain: The profit made when from the sale of an investment, or *Total Sale Proceeds – Total Cost.*

Capital Gains Tax: The tax (rate) levied on profit from the sale of a property or investment. The rate applied may vary by length of time the underlying investment was held.

- Capital gains on investments held for more than a year are currently subject to a lower "capital gains" tax rate, while short-term gains are taxed as ordinary income.

Capital Loss: The loss from selling an asset for less than its purchase price. The value of a capital loss is the total proceeds received at sale minus the total cost paid. A capital loss is only "realized" for tax purposes when the position has been exited. A capital loss is unrealized if an asset's market value is less than the cost paid (or, in the case of short positions, if the asset's market value is greater than the proceeds received).

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Cash Balance Plan: A type of defined benefit plan that functions as a hybrid between a typical pension and a 401(k). This structure provides the "security" of a pension, with the transparency of an individual account. Typically:

- The employer makes annual credits to an employee's account (often equal to a percentage of salary).
- The account is credited with interest each year at a rate defined by the plan.
- Changes in the portfolio value do not affect the final benefits received by the employee, as the employer bears investment risk.
- Contributions are tax deductible for the employer and grow tax-deferred for the employee.
- Employees who leave the company can take their vested benefit as a lump-sum payment or roll it into another retirement account.
- At retirement, the employee can receive their benefit as a lump sum or convert it to an annuity stream.

Common Stock: This represents a basic ownership stake in a company that entitles the shareholder to a claim of profits and the right to vote on corporate matters.

Compound Interest: The process of earning interest on both the original investment and on the accumulated interest over time, helping wealth grow faster.

Custodian: A financial institution that holds financial assets such as equities, bonds, mutual funds or exchange-traded funds on behalf of clients. Custodians perform a variety of services including the settlement of trades, collecting of dividends, and handling of corporate actions.

Defined Benefit Plan: Also known as a traditional pension plan, this is an employer-sponsored retirement plan that guarantees a pre-established monthly income stream to an employee upon retirement. The employer bears investment risk.

Defined Contribution Plan: A retirement savings plan where employees and/or employers make tax-advantaged contributions to an account that is intended to fund retirement. The final retirement benefit depends on both total contribution amounts and investment performance, with the employee bearing investment risk.

Derivative: A security whose value is derived from the performance of one or more underlying assets. The derivative itself is typically a contract between two or more parties based on the asset(s), and its value is determined by fluctuations in the underlying asset(s). Common uses are to speculate or hedge investments. Derivatives can be traded privately (over the counter, OTC) or publicly on an exchange.

- Common types of derivatives: Collateralized debt obligations (CDOs), swaps (including credit default swaps, CDS), forwards, futures, and options.

Diversification: The practice of spreading investments across a range of different assets to mitigate risk and reduce exposure to any single security or asset class.

Dividend: A portion of the company's profits which are paid to shareholders. Typically, dividends are paid in cash and are taxed as ordinary income.

Donor Advised Fund (DAF): A charitable giving vehicle to which a donor makes an irrevocable contribution of cash, securities, or other assets. The donor receives an immediate tax deduction, and the donated funds can be invested to grow over time. The donor maintains advisory privileges over donations to 501(c)(3) entities from the Fund.

Equity: Broadly, equity means residual ownership, or total assets minus total liabilities. The term "equity" can be applied to a variety of contexts:

- Financial asset: Shares in a company ("stocks") where initial shareholders provide capital to management and receive a *pro rata* claim to assets and profits in return. Equity holders are the last to be paid in liquidation.
- Accounting: Equity refers to the net value of a company, or an amount equal to Assets- Liabilities
- Real Estate: Portion of property value owned, after subtracting debt and mortgages.

ERISA: The Employee Retirement Income Security Act of 1974 (ERISA) is a federal law which established minimum standards for most retirement and health plans in private industry (including pension plans, 401ks, defined benefit plans, profit sharing plans, and welfare plans). ERISA standards cover several areas:

- Reporting and disclosure
- Fiduciary responsibility
- Claim and appeal process
- Enforcement
- Plan termination

Estate Tax: A tax levied by state, federal, or both governments on the market value of a deceased person's estate before assets are distributed to beneficiaries. An estate tax applies when the value of the deceased's estate exceeds an exclusion limit set by law (and which is subject to change with new regulations).

- Assets transferred to spouses are currently exempt from estate tax.

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Exchange Traded Fund: Professionally managed investment fund that holds a collection of assets (varies by investment objective) and trades on a stock exchange, offering liquidity. ETFs can be actively or passively managed.

- ETFs trade intraday and generally have lower fees with greater tax efficiency compared to actively managed funds.
- ETFs are not required to trade at their net asset value.

Executor: An individual appointed to administer the last will of a deceased person and ensure all assets are accounted for and transferred to the correct beneficiaries.

Fiduciary: A person or organization that acts on behalf of others (i.e., clients) and is required to put that client's interests before their own.

Fixed Income: Investments where a lender provides capital in exchange for regular interest or dividend payments and the return of the original principal amount at a specified maturity date.

- Fixed income is commonly issued by governments or corporations. Common fixed income instruments include bonds, certificates of deposits (CDs), preferred stocks, and bank loans.

Gross: Generally, the total amount (performance, income, revenue, etc…) before any deductions, expenses or taxes are subtracted.

Hedge Fund: A privately offered, actively managed investment fund that may use complex investment strategies to generate returns.

- Generally, hedge funds are structured as a Limited Partnership. Limited partners provide passive capital and the General Partner makes investment decisions. Hedge Fund investors may face restrictions on when and how to access capital.

Hedging: A strategy to reduce overall risk. Often, hedging involves the use of derivatives or balancing long and short positions.

Individual Retirement Account (IRA): A personal tax-advantaged retirement savings account.

- Traditional IRA: Contributions are deducted from taxable income and grow tax deferred. Upon withdrawal, funds are taxed as ordinary income.
- Roth IRA: Contributions are made with after-tax money but are tax-free upon withdrawal.

Inflation: The rate at which the general cost of goods and services rise.

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Inheritance Tax: A tax paid by the beneficiary of assets inherited from a deceased individual.

Internal Rate of Return ("IRR"): A financial metric used to estimate the profitability and potential growth rate of an investment or project considering the time value of money. Calculated as the discount rate which makes the net present value of all cash flows equal zero.

Investment Advisor: A person or company that, for compensation, provides investment advice or portfolio management services.

Investment Objective: A specific financial goal (such as growth, current income or capital preservation) that guides an investor's strategy and decisions. This foundational part of financial planning influences a portfolio's asset allocation and financial risk tolerance.

Investment Policy Statement ("IPS"): A document which outlines the general investment rules, goals, asset allocation and strategies for a portfolio manager or financial advisor and their client. A well-constructed IPS considers the client's objectives, circumstances, and time horizon to guide informed decision making. An IPS can be revisited and revised as circumstances change.

Long Positions: An asset which is purchased and held with the expectation it will increase in value over time.

Marginal Tax Rate: The percentage of tax applied to the very last dollar of income that you earn.

Mutual Fund: A professionally managed investment vehicle that pools money from investors to purchase a portfolio of securities. Investors purchase shares in the fund itself, giving them a *pro rata* claim on the income and value of the fund.

- Shares can be purchased or sold at any time during the day but are priced at the day's closing net asset value.

Net: Generally, the total amount (performance, income, revenue, etc…) after any deductions, expenses or taxes are subtracted**.**

Passive Management: An investment strategy where a portfolio is structured to mirror a specific market index. Investment decisions are driven by the goal of matching the index's performance. This approach typically involves lower costs and broad diversification.

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Pledged Asset Line ("PAL"): A flexible line of credit that allows individuals to borrow money using their non-retirement investment portfolio as collateral. This provides access to liquidity without requiring an investor to sell securities. If the market value of pledged assets declines significantly, an investor can be asked to make a maintenance payment.

Portfolio Manager: A professional who creates and implements investment strategies for clients to achieve their financial goals. This includes making investment decisions, managing risk, and monitoring the portfolio's performance.

Power of Attorney: A legal document where in one person (the principal) grants another trusted person (the 'attorney in fact') the legal authority to act on their behalf. The scope of this authority is highly customizable. A Power of Attorney is commonly used as an estate planning tool to ensure that a trusted individual is authorized to manage a principal's affairs if the principal cannot do so themselves.

- A "durable" power of attorney remains in effect even if the principal becomes incapacitated, ensuring continuous management of affairs during illness or disability.

Preferred Stock: This represents an ownership stake in a company that has a higher claim to earnings than common stock but does not have voting rights attached. It is subordinate to fixed income and paid out before common stock in liquidation. Often, preferred stocks pay a fixed dividend.

Private Equity: An investment class where firms raise capital to acquire and manage private companies or take public companies private with the goal of selling them in the future for profit.

Private Equity Fund: A privately offered, actively managed fund that pools capital to acquire and manage private companies or take public companies private with the goal of selling them in the future for profit.

- Like hedge funds, private equity funds are often structured as Limited Partnerships.
- Private equity funds can have 10+ year terms, making it difficult to access invested capital prior to the fund's liquidation.

Qualified Purchaser: An individual or entity that owns or manages a minimum value of discretionary investments. This is a higher threshold than an accredited investor.

- Qualified individual purchasers must own $5+ million in investments.

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- Qualified investment professional purchasers must manage $25+ million in investments.
- Qualified institutional buyers (QIBs) must manage $100+ million in investments.

Registered Investment Advisor (RIA): A person or firm that provides investment advice and manages client assets while adhering to a strict fiduciary duty. RIAs charge a transparent fee for services, must register with the SEC or a state securities regulator (generally over $100 million requires SEC registration), and provide clients with a transparent Form ADV Part 2 outlining business practices.

Required Minimum Distribution ("RMD"): The minimum amount of money which must be withdrawn annually from certain retirement and tax-deferred accounts.

- RMDs are calculated by dividing the retirement account's prior year-end value by a life expectancy factor published by the IRS.

Risk Tolerance: The degree of an investor's ability and willingness to withstand market volatility and/or periods of negative returns.

- Financial risk tolerance: An objective measure based on an individual's financial situation, income or net worth, time horizon, goals, and financial obligations.
- Emotional risk tolerance: A qualitative measure based on an individual's comfort in experiencing market volatility and bearing risk.

Rollover: A broad term that often refers to extending or transferring an existing financial arrangement. Commonly refers to the transfer of funds from one retirement plan to another.

- 401(k) to IRA rollover: When an individual leaves a job they can move 401(k) funds to an individual retirement account.
- Direct Rollover: When funds are sent directly from an old plan provider to a new provider.
- Indirect Rollover: When an account owner receives funds and must deposit into a new account before a specified time period to avoid penalties.

Roth Retirement Account: An account funded with post-tax earned income during working years. Investments grow tax-free until withdrawal and are not subject to additional taxes.

- These accounts, which are especially valuable for those who expect future earnings to be taxed at a higher rate, have income caps for eligible contributions.
- Beneficiaries are not obligated to pay further taxes (estate taxes excluded).

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Separately Managed Accounts (SMA): An investment account managed by a professional portfolio manager that holds securities for an investor. Unlike a mutual fund, which pools investor assets, an SMA gives the investor direct ownership of the portfolio.

Short Positions: A negative position in an asset which is expected to decrease in value over time. To establish a short position, investors borrow assets from a third party and sell them in the open market. The investor must "cover" the negative position in the future, by buying the asset back, ideally at a lower price.

Traditional Retirement Account: An account funded with pre-tax earned income during working years. Investments grow tax-deferred until withdrawal, usually during retirement, at which point they are generally taxed as ordinary income.

- Beneficiaries must pay taxes on withdrawals from inherited traditional retirement accounts. The rules vary based on the beneficiary's relationship to the deceased.

Trust: Legal arrangements in which one party (the trustee) manages assets for the benefit of another party (the beneficiary or person(s) who receive the benefit of the trust's assets). The person creating the trust is known as the grantor. Typically, the grantor transfers assets to the trust account, which is managed by the trustee for the benefit of the beneficiary.

- <u>Revocable trust</u>: The grantor can modify, amend, or revoke the trust at any time.
- <u>Irrevocable trust:</u> The grantor gives up all control over the assets placed in trust, making the terms of the trust unchangeable by the grantor after its creation.

Trustee: An individual given legal control or powers of administration over assets held in a trust. A trustee should administer assets in accordance with the wishes of the trust.

Venture Fund: This is a type of private equity fund that specifically focuses on startup companies and small companies with long-term growth potential.

Yield Curve: A graphical representation of the interest rates (yields) of bonds with the same credit quality but different maturities, arranged from shortest to longest. Its shape is an important indicator of market expectations and economic outlook.

- Normal (upward sloping) curve: Long term yields are higher than short-term yields. Investors demand additional return for committing money over a longer period, reflecting greater uncertainty over time.

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- Inverted (downward sloping) curve: Long term yields fall below short-term yields. This often signals expectations of an economic slowdown. During downturns, interest rates may be cut to stimulate the economy, or investors may shift from riskier assets into longer-term bonds, pushing bond prices up and yields down.