Important Financial Terms & Examples

exampundit

Arbitrage Fund

Definition: Arbitrage fund is a type of mutual fund that leverages the price differential in the cash and derivatives market to generate returns. The returns are dependent on the volatility of the asset. These funds are hybrid in nature as they have the provision of investing a sizeable portion of the portfolio in debt markets.

Description: Arbitrage funds are the panacea for low risk taking investors. In a situation of high and persistent volatility, arbitrage funds provide investors a safe avenue to park their hard earned money. These funds capitalize on the market inefficiencies and generate profits for the investors. As these funds invest predominantly in equities, their tax treatment is at par with equity funds.

Benchmark

Definition: A benchmark is an unmanaged group of securities which are considered as a benchmark to measure a funds/stocks performance. Benchmarks are generally broad market indices like BSE Sensex, CNX Nifty of the Indian stock market with which mutual fund returns are compared.

Description: If a fund returned 59% in a particular year, but the benchmark Sensex returned 70%, this infers the fund underperformed compared to the Sensex benchmark.

A benchmark indicates directly the fund managers performance. For instance, a mutual fund which outperforms the benchmark is a sign of an efficient fund manager.

Benchmark Government Bond

Definition: Benchmark government bond is a debt security issued by the Central government with a residual maturity of 10 years.

Description: This bond is backed by sovereign guarantee. Hence investors don’t face any default risk. At the maturity of one benchmark sovereign bond, another one with the same residual maturity is issued by the Central government.

The coupon rate is decided by way of auction. This bond has the highest liquidity amongst similar maturity bonds. Once fixed, the coupon rate remains constant throughout the term of the bond. Only the yield changes commensurate with the interest rates and accordingly the price of the bond changes. There exists an inverse relationship between the bond yield and its price.

Closed-ended Funds

Definition: The unit capital of closed-ended funds is fixed and they sell a specific number of units. Unlike in open-ended funds, investors cannot buy the units of a closed-ended fund after its NFO period is over.

Description: This means that new investors cannot enter, nor can the existing investors exit till the term of the scheme ends. However, to provide a platform for investors to exit before the term, the fund houses list their closed-ended schemes on a stock exchange.

www.exampundit.in

Trading on a stock exchange enables investors to buy and sell units through a broker in the same manner as transacting the shares of a company. The units may trade at a premium or discount to the NAV depending on the investors expectations of the funds future performance and prospects. The demand and supply of fund units and other market factors also affect their price.

The number of outstanding units of a closed-ended fund does not change as a result of trading on the stock exchange. Apart from listing on an exchange, these funds sometimes offer to buy back the units, thus offering another avenue for liquidity. Sebi regulations ensure that closed-ended funds provide at least one of the two avenues to investors for entering or exiting.

The closed-ended funds are free from the worry of regular and sudden redemption and their fund managers are not worried about the fund size.

Credit Rating

Definition: Credit rating is an analysis of the credit risks associated with a financial instrument or a financial entity. It is a rating given to a particular entity based on the credentials and the extent to which the financial statements of the entity are sound, in terms of borrowing and lending that has been done in the past.

Description: Usually, is in the form of a detailed report based on the financial history of borrowing or lending and credit worthiness of the entity or the person obtained from the statements of its assets and liabilities with an aim to determine their ability to meet the debt obligations. It helps in assessment of the solvency of the particular entity. These ratings based on detailed analysis are published by various credit rating agencies like Standard & Poors, Moodys Investors Service, and ICRA, to name a few.

Debt Funds

Definition: Debt funds are mutual funds that invest in fixed income securities like bonds and treasury bills. Gilt fund, monthly income plans (MIPs), short term plans (STPs), liquid funds, and fixed maturity plans (FMPs) are some of the investment options in debt funds. Apart from these categories, debt funds include various funds investing in short term, medium term and long term bonds.

Description: Debt funds are preferred by individuals who are not willing to invest in a highly volatile equity market. A debt fund provides a steady but low income relative to equity. It is comparatively less volatile.

Duration

Definition: As the term suggests, it is expressed in the form of number of years and measures a bonds sensitivity to change in interest rates. To be specific, it measures the change in market value of security due to 1% change in interest rates.

Description: Usually, the higher the duration, the more is the volatility in the prices. In other words, it is the number of years required to get the present value of future payments from a security/bond.

Entry Load

exampundit
www.exampundit.in

Definition: Mutual fund companies collect an amount from investors when they join or leave a scheme. This fee is generally referred to as a load. Entry load can be said to be the amount or fee charged from an investor while entering a scheme or joining the company as an investor.

Description: Generally, an entry load is collected to cover costs of distribution by the company. Different mutual funds houses charge different fees as an entry load. In India, this charge was usually of about 2.25% of the value of investment. From August 2009, however, SEBI has done away with this practice of charging entry load for mutual funds.

exampundit

Exit Load

Definition: Mutual funds companies collect an amount from investors when they join or leave a scheme. This fee charged is generally referred to as a load. Exit load is a fee or an amount charged from an investor for exiting or leaving a scheme or the company as an investor.

Description: The aim behind the collection of this commission at the time investors exit the scheme is to discourage them from doing so, i.e. to reduce the number of withdrawals by the investors from the schemes of mutual funds. Different mutual funds houses charge different fees as an exit load.

Expense Ratio

Definition: Expense ratio is the fee charged by the investment company to manage the funds of investors.

Description: All the investment companies incur cost for operating mutual funds and they charge a percentage of asset funds to cover the expenses. Suppose the expense ratio is 1 per cent and your investment is Rs 10,000, then Rs 100 is what you pay to the company as operating fee.

Major components of the cost are like legal cost, administration cost, advertising cost and the management cost. This fee is different from the sales fee and commission or the expenses incurred on the buying and selling of portfolio.

Geometric Average Return

Definition: Popularly called Geometric Mean Return, it is primarily used for investments that are compounded. It is used to calculate average rate per period on investments that are compounded over multiple periods.

Gold Fund

Definition: Gold fund, as the name suggests, invests in various forms of gold. It can be in the form of physical gold or stocks of gold mining companies. Gold funds which invest in physical gold offer investors the convenience of buying pure gold at low cost. There is no possibility of theft and you can sell these units at market linked prices anytime.

Description: There are various types of gold funds across the globe:

Gold Mining Funds*:* These funds invest in gold mining companies and returns from such funds are dependent on the performance of these companies. Investment demand for gold is borne out of the economic uncertainties as gold is

www.exampundit.in

considered to be a safe heaven when equity markets are tumbling. Dichotomy between demand and supply also govern the gold prices.

Gold ETFs*:* Gold ETFs are exchange traded funds where the underlying asset is gold. Therefore, value of gold ETF depends upon the price of gold. One needs a demat account to invest in an ETF. The concept of gold ETFs in India was first introduced by Benchmark Asset Management Company, in India.

Gold Fund of Fund (FoF): Gold FoF invests in the units of gold ETF and does not require a demat account.

Information Ratio

Definition: Information ratio shows the consistency of the fund manager in generating superior risk adjusted performance. A higher information ratio shows that fund manager has outshined other fund managers and has delivered consistent returns over a specified period.

Description: Information ratio is useful in comparing a group of funds with similar management styles. It is calculated by dividing the active return of a portfolio by the tracking error. The tracking error is calculated as the standard deviation of the difference between fund return and index return.

Interval Schemes

Definition: Interval schemes combine the features of open-ended and close-ended funds.

Description: The units may be traded on the stock exchange or may be open for sale or redemption during pre-determined intervals at NAV-related prices. Fixed maturity plans, or, FMPs are examples of these types of schemes.

Large And Midcap Funds

Definition: Mutual funds which diversify investments in between large and mid capitalization companies are classified as large and midcap funds. The ratio in which the investment is diversified, between large and mid cap companies, might differ from fund to funds. Due to their exposure in both large and midcap funds, these funds are positioned on a higher risk return tradeoff plane compared to a pure large cap fund.

Description: These funds invest in a mix of large cap and midcap stocks. Due to their exposure in both large and midcap funds, these funds are positioned on a higher risk return tradeoff plane compared to a pure large cap fund.

Large Cap Funds

Definition: There are a plethora of mutual funds available in the market. Funds which invest a larger proportion of their corpus in companies with large market capitalization are called large cap funds.

Description: The criteria for large cap companies may vary. However, these are generally the ones with huge market capitalization. Large cap funds are known to offer stable and sustainable returns over a period of time, but might be outperformed by small and mid cap funds, which have higher risk exposure.

Liquid Funds

www.exampundit.in

Definition: Liquid funds are a type of mutual funds that invest in securities with a residual maturity of up to 91 days. Assets invested are not tied up for a long time as liquid funds do not have a lock-in period.

Description: Return is not guaranteed as the performance of fund depends upon how the market performs unlike fixed deposits which are not dependant on the market. An investor looking for better returns prefers investing in a liquid fund over fixed deposit.

Lumpsum

Definition: A lump sum amount is defined as a single complete sum of money. A lump sum investment is of the entire amount at one go.

For example, if an investor is willing to invest the entire amount available with him in a mutual fund, it will refer to as lump sum mutual fund investment.

Description: Lump sum investment is considered as one way of investing into mutual funds. The other method being that of systematic investment plan, popularly known as SIP. Usually lump sum investments are undertaken by big players and investors, in stocks especially those related to assets that are likely to appreciate in the long term, making the investment profitable except in cases of high volatility.

Maturity Profile

Definition: Maturity is a term defined with respect to bonds which have fixed maturities after which they cease to exist on payment of the principal and the stipulated interest. A maturity profile is the assets profile based on the time remaining to the scheduled or specified maturity.

Description: A funds profile consisting of the allocation of the value of assets in terms of percentage and their time left to maturity respectively is called a maturity profile. Alternatively it is also called a maturity distribution. It gives a summary of the break up of the value of assets with different specified maturities.

Mean

Definition: Mean as a basic statistical measure is defined as an average value attained. With less time and resources available for calculation of complex or complicated measures, mean is considered desirable to get a quick, first hand estimate of future returns based on the data available of the returns from the asset in the past.

Description: In case of a stock, fund or commodity, a mean is defined as an average of returns offered by the assess in the past and is used to predict the future returns it is expected to deliver, calculated on the basis of the past data available.

Mid And Small Cap Funds

Definition: Mutual funds which diversify investments in between mid and small cap companies are termed as mid and small cap funds. The proportion of investments between midcap and small cap may vary from fund to fund.

Description: These funds invest in a mix of midcap and small cap stocks. Due to their exposure in high beta stocks, they are positioned on a high risk return trade-off plane compared to a large cap fund.

www.exampundit.in

Modigliani And Modigliani Rap Measures

Definition: In simple words, it measures the returns of an investment portfolio for the amount of risk taken relative to some benchmark portfolio. Popularly known as Modigliani Risk Adjustment Performance Measure or M2, it was developed by Nobel prize winner Franco Modigliani and his grand daughter Leah Modigliani in the year 1997.

Description: Franco Modigliani and Leah Modigliani believed that an ordinary investor would find it easier to understand the Modigliani measure compared to Sharpe ratio. The reason behind this was that their measure is expressed in percentage points. It shows how well the investor is rewarded for taking a certain amount of risk, relative to the benchmark and the risk free rate.

Multicap Funds

Definition: These are diversified mutual funds which can invest in stocks across market capitalization. In other words, they are market capitalization agnostic. These funds resort to portfolio gyrations commensurate with the market condition.

Description: These funds invest in stocks across market capitalization. That is, their portfolio comprises of large cap, midcap and small cap stocks. They are relatively less risky compared to a pure mid cap or a small cap fund and are suitable for not-so-aggressive investors.

Net Asset Value

Definition: Net asset value(NAV) is the value of a funds asset less the value of its liabilities per unit.

NAV = (Value of Assets-Value of Liabilities)/number of units outstanding

Description: NAV is often associated with mutual funds, and helps an investor determine if the fund is overvalued or undervalued. When we talk of open-end funds, NAV is crucial. NAV gives the funds value that an investor will be entitled to at the time of withdrawal of investment. In case of a close-end fund, which is a mutual fund with fixed number of units, price per unit is determined by market and is either below or above the NAV.

New Fund Offer

Definition: A new fund offer (NFO) is the first time subscription offer for a new scheme launched by the asset management companies (AMCs). A new fund offer is launched in the market to raise capital from the public in order to buy securities like shares, govt. bonds etc. from the market.

Description: NFO is similar to the initial public offer (IPO) with an attempt to raise capital from the market. NFOs are offered for a stipulated period. This means that the investors opting to invest in these schemes at the offer price (in most cases the offer price is fixed at Rs 10) can do so in this stipulated period only. After the NFO period, investors can take exposure in these funds only at the prevailing NAV.

Open-ended Funds

exampundit
www.exampundit.in

Definition: These funds buy and sell units on a continuous basis and, hence, allow investors to enter and exit as per their convenience. The units can be purchased and sold even after the initial offering (NFO) period (in case of new funds). The units are bought and sold at the net asset value (NAV) declared by the fund.

Description: The number of outstanding units goes up or down every time the fund house sells or repurchases the existing units. This is the reason that the unit capital of an open-ended mutual fund keeps varying. The fund expands in size when the fund house sells more units than it repurchases as more money is flowing in.

On the other hand, the funds size reduces when the fund house repurchases more units than it sells. An open-ended fund is not obliged to keep selling new units all the time. For instance, if the management thinks that it cannot manage a large-sized fund optimally, it can stop accepting new subscription requests from investors. However, it has to repurchase the units at all times.

Registrar And Transfer Agents

Definition: Registrar or transfer agents are the trusts or institutions that register and maintain detailed records of the transactions of investors for the convenience of mutual fund houses.

Description: Investors transactions like buying, exchanges, processing of mails and related information, changes in personal data, etc occur frequently and have to be recorded. Registrar & transfer agents have skilled expertise for maintenance of such data on a professional basis, thereby contributing to saving costs and time involved in keeping detailed accurate records of the investor transactions.

Their role also extends to providing information to the investors about new offers, maturity dates and all other investor-friendly information at one place for their reference. Some of the RTAs operating in India are Computer Age Management Services (CAMS), Karvy, and Deutsche Investor Services, among others.

Return Grade

Definition: Grade can be defined as the rating based on a particular attribute of a mutual fund. A return grade is defined as a quality rating of the stock or the bond based on the returns it offers to the investor and is used for the risk-return profile assessment.

Description: Return is one of the most important aspects in the assessment of a mutual fund. Agencies like Value Research, Morningstar etc provide return grades for various commodities, stocks and funds. For example, the Value Research Fund Return Grade tracks the risk-adjusted return of a particular fund to other funds.

This is generally obtained by comparing the funds monthly/weekly return with the monthly/weekly risk-free return to arrive at the funds total return in excess of the risk-free return which is further compared to the average category return to get the final grade. Finally, the risk-adjusted return is compared to the average category return to get the final return score of a particular mutual fund.

Risk Grade

Definition: Grade can be defined as the rating based on a particular attribute of a stock. A risk grade can be explained as a quality rating of a mutual fund based on the risks of losses associated with it and is used for the risk-return profile assessment.

exampundit
www.exampundit.in

Description: Risk is a major factor which contributes in the assessment of the prospects of a mutual fund. The risks that are taken into consideration include absolute losses and losses caused when the mutual fund underperforms compared to a risk-free guaranteed investment like treasury bill. Agencies like Value Research and Morningstar provide risk grades for various mutual funds. For example, the Value Research Fund Risk grade evaluates the risk of loss associated with a particular fund. These are purely quantitative grades and indicate the downside volatility.

To calculate Fund Risk, monthly/weekly fund returns are compared against the monthly risk-free return for equity and hybrid funds and weekly risk-free return for debt funds. For all periods, the magnitude of underperformance is added. This helps us get an idea about the relative underperformance of the fund as compared to the funds category. The relative performance of the fund is called risk score.

Risk Return Trade Off

Definition: Higher risk is associated with greater probability of higher return and lower risk with a greater probability of smaller return. This trade off which an investor faces between risk and return while considering investment decisions is called the risk return trade off.

Description: For example, Rohan faces a risk return trade off while making his decision to invest. If he deposits all his money in a saving bank account, he will earn a low return i.e. the interest rate paid by the bank, but all his money will be insured up to an amount of Rs 1 lakh (currently the Deposit Insurance and Credit Guarantee Corporation in India provides insurance up to Rs 1 lakh).

However, if he invests in equities, he faces the risk of losing a major part of his capital along with a chance to get a much higher return than compared to a saving deposit in a bank.

Scheme Category

Definition: Mutual funds invest in a wide range of schemes catering to different groups of investors. Within schemes, various mutual funds like equity funds, debt funds and hybrid funds etc invest in different categories based on the schemes pre-defined investment objective. The further division of scheme classes is called scheme category.

Description: Equity funds are further divided into a variety of scheme categories like growth funds (which invest into stocks of companies with potential for growth), sector funds (which invest in particular market sectors), small cap funds, value funds (which invest in small to mid cap companies), and diversified funds, among others.

Similarly, debt funds are further categorized into gilt funds, short-term bond funds, long-term bond funds, fixed maturity plans, liquid funds (for short-term investments), etc.

Scheme Class

Definition: Mutual fund schemes extend over a wide range of classes on the basis of various asset classes. In consideration to this, mutual fund houses provide a diversified range of options to the investors in the form of schemes specific to particular asset classes. Major scheme classes are equity schemes, debt schemes, and hybrid schemes, among others.

Description: The various scheme classes have been named as per the asset class they cater to. Like equity funds are those which invest primarily in stocks or equities. Debt funds, on the other hand, invest in fixed income securities,

exampundit
www.exampundit.in

both short-term and long-term securities, while hybrid funds are those funds which invest in a mix of stocks and bonds. This mix of securities may differ in terms of proportions over a period of time or can be fixed.

exampundit

Scheme Options

Definition: There are a number of scheme options available to the investors depending upon how much they want to earn and as per their risk appetite.

Description: As per the investment objective, scheme options available in India are:

Growth Schemes*:* These schemes are appropriate for investors who are looking for capital appreciation in the long run.

Dividend Schemes*:* Dividends are paid out of the distributable surplus of the funds. They are bifurcated into dividend payout and dividend reinvest. In dividend payout, the dividends declared are actually paid out to the investors. Under dividend reinvest, the dividend declared is used to buy additional units to the investors. The NAV falls by the amount of dividend declared.

Bonus Schemes*:* These schemes give bonus units to the unit holders as per a pre-defined ratio.

Sector Specific Funds

Definition: Mutual funds which invest in a particular sector or industry are said to be sector-specific funds. Since the portfolio of such mutual funds consists mainly of investment in one particular type of sector, they offer less amount of diversification and are considered to be risky.

Description: Sector-specific funds are considered to be relatively more risky compared to a diversified fund. As these funds take exposure in a single sector, the concentration risk is high. Their performance is aligned with the performance of the sector in which they are investing. As the exposure is not broad based, it carries a high degree of risk. This type of funds is normally suitable for a highly aggressive investor.

Some of the sector-specific funds are mentioned below:

- ***Banking funds****:* These are sector-specific mutual funds having a portfolio comprising mainly of equities of different banks. So if in general the banking sector is performing well, one can expect good returns.
- ***Pharma funds****:* These are sector-specific mutual funds which have a portfolio comprising mainly of different pharmaceutical companies.
- ***Technology*** *funds:* Sector-specific mutual funds which have a portfolio comprising mainly of IT companies.
- ***FMCG funds****:* Sector-specific mutual funds catering to the investments in the fast moving commodity goods stocks.

www.exampundit.in

Sortino Ratio

Definition: Sortino ratio is the statistical tool that measures the performance of the investment relative to the downward deviation. Unlike Sharpe, it doesnt take into account the total volatility in the investment.

Description: Sortino ratio is similar to Sharpe ratio, except while Sharpe ratio uses standard deviation in the denominator, Frank A Sortino uses downside deviation in the denominator.

Standard deviation involves both the upward as well as the downward volatility.

Since investors are only concerned about the downward volatility, Sortino ratio presents a more realistic picture of the downside risk ingrained in the fund or the stock.

Style Box

Definition: Style box, designed by Morningstar, is a 3x3 square grid which shows the investment style that the fund manager is following to manage the funds portfolio.

Description: For equity funds the horizontal axis of the style box shows the valuation of the fund which is subdivided into categories: value, blend (a value/growth mix) and growth. Growth funds are funds that are expected to grow at a pace that outweighs the average market growth rate.

Value stocks are stocks that are available at a price lower than their intrinsic value, but have a potential to unlock the value in the long run. Blend style of investing combines the features of both value and growth funds. The vertical axis shows market capitalization which is further divided according to company-sizes (based on market-capitalization).

Swap

Definition: Swap refers to an exchange of one financial instrument for another between the parties concerned. This exchange takes place at a predetermined time, as specified in the contract.

Description: Swaps are not exchange oriented and are traded over the counter, usually the dealing are oriented through banks. Swaps can be used to hedge risk of various kinds which includes interest rate risk and currency risk. Currency swaps and interest rates swaps are the two most common kinds of swaps traded in the market.

Systematic Investment Plan

Definition: Systematic Investment Plan is an investment strategy wherein an investor needs to invest the same amount of money in a particular mutual fund at every stipulated time period.

Description: Investing in SIP enables an investor to take part in the stock markets without actively timing them and he/she can benefit by buying more units when the price falls and less units when the price rises. This scheme helps reduce the average cost per unit of investment through a method called Rupee Cost Averaging.

For Example: A person invests Rs 1000 for ten months in SIP. We will find out that the actual average purchase cost of asset would be lower than the average NAV of his investment over 10 months, which is the key benefit of Rupee Cost Averaging.

Actual average purchase cost as per SIP = (1000X10)/ (100+200+67+71+67+50+45+40+37+34) = 14.06

Systematic Transfer Plan

Definition: STP refers to the Systematic Transfer Plan whereby an investor is able to invest lump sum amount in a scheme and regularly transfer a fixed or variable amount into another scheme.

Description: In case of a volatile market, STP helps the investors to periodically transfer funds from one scheme

exampundit
www.exampundit.in

(source scheme) to another (target scheme) and help them save the effort and time by compressing multiple instructions required for redemption from one scheme to invest in the other into a single instruction.

Transfers are usually made from debt funds to equity funds if the market is doing well and vice versa if the market is not performing well. The STP can be classified based on the amount transferred from the source scheme to the target scheme. If a fixed sum is transferred from the source to the target scheme, then its called Fixed STP, and if the sum transferred is the profit part of the investment of source scheme, then its called Capital Appreciation STP.

exampundit

Systematic Withdrawal Plan

Definition: SWP refers to Systematic Withdrawal Plan which allows an investor to withdraw a fixed or variable amount from his mutual fund scheme on a preset date every month, quarterly, semi annually or annually as per his needs.

Description: An investor can customize the cash flows as desired; he can either withdraw a fixed amount or just the capital gains on his investments. SWP provides the investor with a regular income and returns on the money that is still invested in the scheme.

For Example: You have 8,000 units in a MF scheme. You have given instructions to the fund house that you want to withdraw Rs. 5,000 every month through SWP.
On 1 January, the NAV of the scheme is Rs. 10.

Equivalent number of MF units = Rs. 5,000/Rs. 10 = 500

500 units would be redeemed and Rs. 5,000 would be given to you.

Your remaining units = 8,000 - 500 = 7500

Now, on 1 February, the NAV is Rs. 15. Thus, Equivalent number of units = Rs. 5000/Rs. 15 = 333

333 units would be redeemed from your MF holdings, and Rs. 5,000 would be given to you.

Your remaining units = 7500 - 333 = 7167

And so this process continues till the time you want the withdrawals.

Treasury Bills

Definition: These are government bonds or debt securities with maturity of less than a year.

Description: T- bills are issued to meet short-term mismatches in receipts and expenditure. Bonds of longer maturity are called dated securities.

Trustee

Definition: Trustee is an individual who is responsible for a property or an organization on behalf of some other individual or a third party.

Description: Trustee is supposed to make profitable decision for the entity under it authorization. It is a legal

www.exampundit.in

relationship between the trustee and the party, where the trustee is totally responsible for the maintenance, performance, and profitability of the trust under his guidance. Usually the trustee is not to make any profits, for himself, using the resources of the trust.

Ultra Short Term Funds

Definition: Ultra short-term funds invest in fixed-income instruments which are mostly liquid and have short-term maturities.

Description: Ultra short-term funds help investors avoid interest rate risks, yet they are riskier and offer better returns than most money market instruments. Liquid and ultra short-term funds are similar on various lines, yet there are differences between a liquid fund and an ultra short-term fund.

Yield To Maturity

Definition: It is also known as redemption yield. As the name suggests, if an investment is held till its maturity date, the rate of return that it will generate will be Yield to Maturity.

Description: Calculation of YTM is a complex process which takes into account the following key factors:

1. Current Market Price

2. Par Value

3. Coupon Interest Rate

4. Time to maturity

exampundit

www.exampundit.in