# Glossary

*A collection of definitions related to finance and investing.*

**Absolute Return**

*A category of investment strategies that seek to generate returns that are uncorrelated to stock and bond markets. It is sometimes used as a synonym for hedge funds, but while some hedge fund strategies qualify—such as Equity Market Neutral and Global Macro—many hedge funds have tended to incorporate passive market exposure into their portfolios.*

**Active Management**

*Any investment approach other than one aiming to match the performance of a passive benchmark index, or a buy-and-hold portfolio. Examples of active management strategies include long-only strategies aiming to beat a benchmark, long/short absolute return strategies, and indeed any strategy that deviates from market-cap weighted indices. The precise boundary between passive and active management may be debatable for multi-asset class portfolios, where the true "market" may not be known or investable.*

**Alpha**

1. *From a statistics perspective: An unexplained average return.*
2. *From an industry perspective: Returns generated by skilled active managers. For a benchmark-oriented strategy, alpha is measured by portfolio returns in excess of benchmark returns.*
3. *More broadly: Returns that cannot be explained by exposure to common risk factors, and may stem from a variety of sources, including security selection, market timing, portfolio management, execution or risk control.*

**Alternative Beta**

*Exposures to alternative risk factors. Alternative risk factors are well-known, empirically-tested, sources of return that can be systematically harvested through dynamic long/short strategies. They can be thought of either as returns that underlie "classic" hedge fund strategies (hedge fund risk premia) or the returns from "classic" styles (style premia), such as value, momentum, carry and defensive. Exposure to these risk factors results in alternative risk premia, or rewards for assuming active, systematic risk (risk that in the context of modern portfolio theory cannot be diversified away).*

**Alternative Investment**

*Alternatives are typically thought of as investments other than long-only stocks and bonds. Generally they can be divided into two categories: alternative asset classes, such as private equity and commodities; and alternative strategies, such as classic styles or hedge fund investments. Alternative asset classes are usually long-only and benchmark-oriented, while alternative strategies are commonly long/short and compared to their peers or a cash benchmark.*

**Alternative Risk Premia**

*The rewards for bearing alternative risk exposure, or the rewards for assuming active, systematic risks (risks that in the context of modern portfolio theory cannot be diversified away). Alternative risk exposures are well-known, empirically-tested, sources*

*of return that can be systematically harvested through dynamic long/short strategies. They can be thought of either as returns that underlie "classic" hedge fund strategies (hedge fund risk premia) or the returns from "classic" styles (style premia), such as value, momentum, carry and defensive.*

**Asset Class**

*A group of securities that share financial characteristics, and tend to behave similarly. Traditional asset classes include stocks and bonds, and alternative asset classes include private equity and commodities.*

**Benchmark**

*A pre-defined portfolio, index or strategy against which the performance of an active strategy is compared, or which a passive strategy seeks to match. For an active long-only strategy, the benchmark is often a market index with similar risk characteristics to the active strategy. For an absolute return strategy, the benchmark is usually the risk-free rate.*

**Beta**

1. *Statistics: A measure of one "dependent" variable's sensitivity to another "independent" variable, often the equity market. Beta (the regression slope coefficient) is the product of the relative volatility of the dependent and independent variables and the correlation between the two.*
2. *More practical: A security (or strategy's) sensitivity to a particular risk factor. For example, an equity index fund's beta to the equity market will likely be 1.0. A twice-levered equity index fund's beta to the equity market will likely be about 2.0.*

**Capital Allocation**

*Making portfolio allocation decisions based on nominal or dollar values. Investors who make decisions based on dollars may build portfolios with concentrated risk exposures. For example, the traditional 60/40 stock/bond portfolio is roughly 90% dominated by equity risk. As such, investors should look beyond capital-based asset allocation to better understand a portfolio's true risk exposures.*

**apital Asset Pricing Model**

*A model that describes the pricing of risky assets. It relates a stock's expected return only to its beta, or sensitivity to the overall stock market.*

**Carry**

*A style premia strategy that seeks to capture the tendency of higher-yielding assets to provide higher returns than lower-yielding assets. Generally, carry can be thought of as the expected return on an asset assuming its price doesn't change, and is derived from yield or income.*

**Convertible Arbitrage**

*A "classic" hedge fund strategy that generally buys a convertible bond and short-sells the relevant stock. It aims to capture the discount (illiquidity premium) of convertible bonds relative to the fair value of their constituent parts (bond + equity call option). It may also hedge out other risks, such as changing interest rates or the bond's creditworthiness.*

**Correlation**

1. *Statistics: A measure of how variables — such as securities prices, interest rates or volatilities — move in relation with another, taking a value between -1 and +1. Positive correlation implies that as one price moves, either up or down, the*

*other price tends to move in the same direction. Negative correlation means that when one price moves, the other price tends to move in the opposite direction. If the correlation is zero, the movements in the two prices (or other variables) have no detectable relationship.*

2. *More practical: Correlation is an important consideration for portfolio construction and diversification. A combination of unrelated (or uncorrelated) assets can results in higher risk-adjusted returns. Conversely, incorporating an asset that is highly correlated to the existing portfolio does little to improve a portfolio's efficiency.*

**Dedicated Short Bias**

*A "classic" hedge fund strategy that generally maintains net short equity exposure. It profits from the inability for many investors to go short companies that are overpriced relative to their fundamentals.*

**Defensive**

*A style premia strategy that aims to invest in assets with lower risk and higher quality in order to generate higher risk-adjusted returns.*

**Discretionary Investing**

*An investment philosophy in which the manager makes a subjective judgment call on market conditions and then trades based on these opinions. This is in contrast to a quantitative approach.*

**Diversification**

*Diversification can be achieved along many dimensions, such as by geography, asset class, risk factor, strategy style, or indicator. The goal of diversification is to eliminate systematic (or market risks), which are typically not rewarded. When the focus is on the diversification of specific risks, diversification means reducing exposure to specific risks that are undesirable because they are unrewarded. When the focus is on the diversification of systematic risks, it means efficient allocation to factors that bring positive, long-term rewards. Diversification has famously been called the only free lunch that markets have to offer in that a combination of uncorrelated strategies can result in higher risk-adjusted returns.*

**Efficient Frontier**

*A concept in modern portfolio theory that describes the highest expected returns available for a given volatility, under a no-leverage constraint.*

**fficient Market Hypothesis**

*The hypothesis that security prices fully reflect all available information. In practice, the EMH cannot be tested directly independent of a pricing model; to determine if security prices fully reflect all available information, a model that explains how prices are supposed to reflect this information must also be proposed.*

**Equity Market Neutral**

*A "classic" hedge fund strategy that generally maintains neutral equity market exposure. It aims to capture systematic mispricing in global equity markets, typically between different stocks in the same sector.*

**Event-Driven Arbitrage**

*A "classic" hedge fund arbitrage strategy that seeks to exploit pricing inefficiencies that may occur before or after corporate events such as bankruptcies, mergers, acquisitions or spinoffs.*

**Excess Return**

*Strictly speaking (and especially for absolute return strategies) this is the return in excess of a pre-defined "risk-free" rate, typically the return on Treasury Bills or other sovereign cash instruments. For long-only strategies, it may refer to the return in excess of a benchmark; this is also called the active return.*

**Factor Investing**

*An investment strategy based on the assumption that there are sources of risk that compensate investors with returns. Traditionally, the primary factor is the market (as in the well-known three-factor model of Fama and French), while other factors may be value or momentum. Portfolios can be formed based on single factors (i.e., equity value) or multiple factors (i.e., equity value and equity momentum). Where factors have low correlations to each other, combining multiple factors can be a powerful investment tool offering improved risk-adjusted returns.*

**Fixed Income Arbitrage**

*A "classic" hedge fund strategy that aims to capture a range of mispricings in global bond and currency markets, including those created by market participants who are not profit-maximizing.*

**Global Macro**

*A "classic" hedge fund strategy that trades based on movements in economic variables. It aims to capture mispricings across major global asset classes, including stock, bond, currency and commodity markets.*

**Hedge Fund**

*A commingled investment vehicle that typically uses active strategies employing leverage, short-selling and/or derivatives in an attempt to provide positive returns regardless of moves in broad stock or bond markets. Hedge funds are usually subject to lighter regulation than other investment funds, and marketed to more sophisticated investors.*

**Index**

*A weighted "basket" of securities — stocks, bonds, commodities or other tradable assets — used to track the performance of a particular market. Construction varies from index to index, with "capitalization-weighted indices" being among the most popular (e.g., S&P 500). Others include price-weighted indices (e.g., Dow Jones Industrial Average), indices weighted according to fundamental measures (e.g., fundamental indices), and ones that are weighted according to risk measures (e.g., MSCI Minimum Volatility Index).*

**Information Ratio**

*A measure of a portfolio's risk-adjusted returns relative to a benchmark. It is typically used for a long-only strategy and measures 'alpha' (active return over a benchmark) per unit of tracking error (how much active risk the strategy takes relative to its benchmark).*

**Long/Short Equity**

*A "classic" hedge fund strategy that maintains long and short positions in equity markets. It pursues a range of opportunities in global stock markets, including relative value between sectors and growth-based stockpicking.*

**Long-Only**

*Any investment strategy that does not involve short-selling of securities or of derivatives. The returns of long-only strategies are usually highly correlated to the broader markets from which they select their investments. Their performance is often (but not always) measured relative to a market benchmark.*

**Long-Short**

*Any investment strategy that takes both long and short positions in securities or derivatives, usually in an attempt to reduce*

*exposure to broad market moves. Long-short strategies may have a directional bias and are not necessarily managed to be market-neutral.*

**Managed Futures**

*A "classic" hedge fund strategy that invests long or short in futures contracts on a variety of commodities, as well as financial futures on equity indices, Treasuries and currencies. It profits from the tendency of assets to exhibit short-and long-term trends.*
*Tags:*

**Market Neutral**

*A type of long-short strategy that sizes its long and short positions in an effort to minimize or eliminate exposure to broad market moves. Market neutral strategies can be particularly valuable diversifiers alongside portfolios dominated by market directional risks.*

**Market Risk Premia**

*The rewards for bearing asset class risk exposure. An example includes the equity risk premium for investing in stock markets.*

**Minimum Variance**

*Used to describe the portfolio with the lowest variance (or volatility squared), given a universe of securities. For example, the minimum variance portfolio for stocks in the S&P 500 would be the portfolio of stocks in the S&P that results in the lowest overall portfolio variance. From the standpoint of the Efficient Frontier, the minimum variance portfolio is represented by the left-most point on the curve.*

**Modern Portfolio Theory**

*A theory of how to build a portfolio that maximizes expected return given a level of volatility or that minimizes volatility for a given level of expected return. This can be done by varying the weights given to various assets taking into account estimates of their expected returns and volatilities, and the correlations between them.*

**Momentum**

*A style premia strategy that aims to take advantage of the tendency for an asset's recent relative performance to continue in the near future.*

**Mutual Fund**

*A commingled open-ended investment vehicle that is typically regulated and accessible to the general public, either directly or through registered investment advisors. Mutual funds may invest in stocks, bonds or other securities, cash, or alternative investments.*

**Net Asset Value**

*The total value of an investment vehicle's assets less the value of its liabilities. Changes in NAV may be caused by investment returns or by investor flows. The NAV per share reflects the value of each unit of investment. The net return on an investment at redemption is approximately the change in NAV per share less fees.*

**Passive Management**

*An investment approach aiming to match the performance of a passive benchmark index or portfolio, without making use of return forecasts. This is in contrast to active management. Strictly speaking, only a capitalization-weighted buy-and-hold portfolio is passive, since all other portfolios—including "smart beta" indices—involve tilts away from the market portfolio and*

*require active rebalancing.*

**Quantitative Investing**

*An investment philosophy in which systematic model- or rule-based criteria are used to make investment decisions. This is in contrast to a discretionary approach.*
*Tags:*

**Risk Allocation**

*Making portfolio allocation decisions based on risk units, rather than nominal or capital dollars. Investors tend to achieve a better balanced portfolio if they make allocations in volatility (or risk) units, not dollars.*

**Risk Premia**

*The rewards for taking risk in given strategies or asset classes. Examples include long-only market risk premia and long/short alternative risk premia.*

**Sharpe Ratio**

*1. Mathematically: the annualized return in excess of cash (total return − risk-free return) divided by the annualized standard deviation (or volatility) of returns.*

*2. More practical: A measure of a portfolio's risk-adjusted performance. In general, the higher the Sharpe ratio, the more an investor should be compensated for bearing risk. Though the Sharpe Ratio does not reflect all kinds of risks. For example, it does not describe how or when losses occurred, nor does it provide information on the liquidity of the underlying investment.*

**Style Premia**

*A source of alternative return backed by economic theory and decades of data across geographies and asset groups. Style exposure can be achieved in a long-only portfolio, by over-weighting securities with positive style attributes (e.g., value stocks). However, a market-neutral long/short portfolio seeks to provide more active and efficient style exposure while maintaining low correlation to traditional markets.*

**Traditional Investment**

*A category of investment strategies that are generally considered to include long-only stock and bond strategies, with long-only benchmarks, such as the MSCI World or Barclays Aggregate.*

**Trend-Following**

*A style premia strategy that is related to momentum and involves buying assets that have recently performed well and shorting assets that have recently lost money. It differs from momentum investing in that momentum buys assets that have done well relative to their peers, while trend-following considers each asset independently. As a result, trend-following strategies can at times take highly market directional positions.*

**Value**

*A style premia strategy that aims to take advantage of the tendency for relatively cheap assets to outperform relatively expensive ones.*

**Volatility**

1. *Statistically: A measure of the variation in returns for a given investment. Volatility is the same as standard deviation, and is typically shown as an annualized number over time.*
2. *More practical: Volatility can be used to gauge the likelihood of realizing (or failing to realize) a given return target. It allows us to better assess how realized returns can vary around expected returns.*
3. *Other applications: Can be used to effectively manage risk through volatility targeting.*

**Volatility Targeting**

*A method to effectively manage risk. Because volatility can be reasonably well predicted over short horizons, it can be a useful risk management input. A volatility-targeted portfolio invests fewer dollars when markets are more volatile and more dollars when markets are less volatile. The goal is to achieve more consistent portfolio risk, regardless of market volatility, which may provide investors a 'smoother ride.' A volatility-targeted portfolio must be actively managed because the volatility forecast changes over time.*

**Beta**

*1. Statistics: A measure of one variable's sensitivity to another variable, usually equity risk. It is similar to correlation, but is not constrained to the range of −1 to +1. An asset's equity market beta (the regression slope) is the product of the relative volatility of the asset versus equity market and the correlation between the two.*

**Total Return**

1. *The total return of an investment including the price change and yield income/carry.*
2. *A category of investment strategies that are generally flexible with regard to market exposure. These include many tactical asset allocation funds and Risk Parity, which are typically long-biased, but which can vary their exposure to underlying markets based on market conditions.*