Reviewing Common Investment Terms

Having a firm understanding of common financial terms helps ensure that you stay well informed about your portfolio's progress and positioning. This reference sheet provides a definition and importance of some common investment terms that you may encounter during discussions with your BMO Nesbitt Burns Investment Advisor or when reviewing information about your account.

Investment Funds

Term	Definition	Why it is important?
Mutual fund	A mutual fund is a pool of money collected from many investors and managed by a professional portfolio manager. Each investor owns "units" of the fund that reflect the share of the fund they own.	A mutual fund allows individuals with smaller amounts of money to access specific investment strategies that would otherwise be difficult to implement on their own without pooling assets with other investors. Mutual funds give investors access to a large number of securities and provides a level of diversification that may not be achievable individually.
Exchange traded fund (ETF)	Exchange traded funds are similar to mutual funds in that they invest in specific asset classes and investment strategies. The majority of ETFs are designed to track a stock, bond or other investment index (known as passive investing). Unlike mutual funds, ETFs are bought and sold like stocks, allowing investors to buy and sell shares throughout the day at quoted prices.	Because of their flexibility and relatively lower cost compared to mutual funds, ETFs have become a popular option amongst investors. They can provide quick and low cost access to a multitude of markets, whether it is equities, fixed income or alternative investments. Although the majority of ETFs were originally designed to track a specific index passively, more and more ETFs are now mirroring mutual fund strategies with professional portfolio managers making investments on behalf of the ETF.
Hedge fund	Hedge fund is a broad definition for pooled vehicles that focus on alternative forms of investing. Originally, hedge funds referred to funds that attempted to offset (or "hedge") possible losses in equity or other markets. Today hedge fund refers to a wider array of alternative investment strategies that are different from mutual funds because they can use sophisticated derivatives and leverage to achieve returns.	Due to their inherent complexity, hedge funds are only offered to investors who have significant assets, a certain level of financial acumen and appetite for risk. Hedge funds levy fees differently than mutual funds – charging an annual management fee plus a performance fee when the fund outperforms a designated benchmark or threshold. Because the term hedge fund has now become a "catch all" category for a wide variety of strategies, each hedge fund should be evaluated on its own merits and risk. A true hedge fund can help protect investors' money when markets are falling.
Fund distributions	During the year, funds (including ETFs) may earn interest and dividend income on the securities they own on behalf of unit holders. Funds pass on these dividends and interest to unit holders via fund distributions.	Depending on the fund, distributions may be received as cash payouts or reinvested in additional units or shares of the fund.

Portfolio Management

Term	Definition	Why it is important?
Time horizon	The length of time you plan to hold a security or remain invested.	By knowing your time horizon, your Investment Advisor can better understand the level of investment risk that you should assume and is better informed to make recommendations for your portfolio.
Risk tolerance	The level of investment risk or degree of variability in investment returns you can comfortably accept within your portfolio.	Risk tolerance level is considered when your Investment Advisor recommends investments for your portfolio. Generally, the greater the risk associated with an investment, the greater the potential for variability in its price, and the possibility that the investment will lose value.
Asset allocation/ Asset mix	Asset allocation is the strategic distribution of investments between equities, bonds and cash (and cash equivalents); each will have different levels of risk and return and perform differently over time.	Asset allocation is a main determinant of the variability of a portfolio's investment performance. Your Investment Advisor balances risk versus reward by adjusting the asset mix of your portfolio according to your risk tolerance, goals and investment time horizon.
Market value	The value of an investment at the end of the trading day. For example, the market value of an equity is calculated by multiplying its closing price by the number of shares owned.	Market value provides investors with an estimate of the value of their investments. Your BMO Nesbitt Burns account statement will quote the market value of your investments as of the last day of the month.
Adjusted cost base	The adjusted cost base (ACB) is the original cost (also called book value) of an investment – adjusted for any additional purchases or sales, reinvested distributions, return of capital and purchase/sales charges.	The ACB is used to determine the amount of profit (or loss) when selling an investment and the resulting amount of capital gains (or losses) for income tax purposes.
Unrealized capital gains	The theoretical increased value of an investment since its purchase date, if it was to be sold.	Allows investors to estimate the amount of capital gains tax that would be payable if the investment was sold. If you own multiple stocks, knowing the capital gains liability for each investment will provide you with some flexibility when deciding if it makes sense to sell one security over another, from an income tax perspective.
Realized capital gains	The amount of the capital gain that is 'realized' when you sell a stock.	Helps investors determine their actual capital gains tax liability for the year. One half of the excess of the proceeds of the sale over the original cost (adjusted cost base) will be calculated as capital gains income on your income tax return.
Dividend	When a company makes a profit, they may elect to share a portion of the earnings with their shareholders by paying a dividend. Dividends are generally paid quarterly or annually and an investor will receive a specified amount of money, as decided by the company, for each share owned.	Investors seeking a stable income stream will often invest in companies with a history of paying regular dividends. Dividend payments from Canadian corporations receive preferential tax treatment by both the federal and provincial governments.

Performance Measurement

Term	Definition	Why it is important?
Dollar weighted rate of return	A method of calculating the rate of return earned by a portfolio. It takes into account the size and timing of cash flows (including contributions and withdrawals) when calculating a portfolio's performance.	This calculation places a greater emphasis on performance that occurs when cash flows are paid or received near the beginning of the measurement period.
Time weighted rate of return	A method of calculating the rate of return earned by a portfolio. It eliminates the distorting effect created by cash flows (including contributions and withdrawals) when calculating a portfolio's performance.	This calculation places portfolio manager returns on an even playing field, allowing investors to compare performance without the distortion of cash flows.
Real rate of return	The return you earn on an investment after inflation.	It provides the level of purchasing power of an investment after allowing for the impact of inflation. For example, if an investment earns interest of four per cent and the annual inflation rate is one per cent, the real rate of return for the year is three per cent.
Inflation	Inflation is a measure of the increase in the cost of goods and services, as measured by the Consumer Price Index (CPI) in Canada.	Over time, inflation can erode the purchasing power of your capital. Assuming a two per cent rate of inflation, $100 today will only be worth $66.80 in 20 years.
Benchmark	A benchmark is a standard that is used to measure a portfolio's performance. A portfolio will be compared to its benchmark to determine if the two performed at a similar level.	A benchmark provides an investor with a method to monitor the performance of a portfolio manager versus the marketplace as a whole. Benchmarks may include a broad market index or an index more specific to the portfolio manager's investment style.
Sharpe ratio (risk-adjusted returns)	The Sharpe ratio is a risk versus return statistic that represents the added value to a portfolio over the risk-free-rate (T-Bill Rate) for each additional unit of risk assumed.	Generally a higher Sharpe ratio is preferred. A higher ratio means that for each additional unit of risk the portfolio manager assumed, they are achieving a higher relative return.
Beta	A measure of the volatility of a security's price compared to the market as a whole. If a security has a beta of one, its price tends to move up and down with the market. However, a beta of less than one indicates the security's price is less volatile than the market. Likewise, if a security's beta is greater than one, its price is more volatile than the market.	Beta helps portfolio managers assess the volatility of investments when selecting investments for a portfolio.
Value added	Value added is the amount of return a portfolio earned over its benchmark. For example, if the benchmark returned 10 per cent and the portfolio returned 12 per cent, the portfolio has value added of two per cent.	Value added helps investors measure a portfolio manager's performance by showing the return of a portfolio over (or under) its benchmark.

Alpha	Measures the risk-adjusted added value an active portfolio manager adds above and beyond the passive benchmark.	Allows an investor to measure the portfolio manager's ability to outperform their benchmark for the amount of market risk in the portfolio.

Fixed Income

Term	Definition	Why it is important?
Accrued interest	The interest due on a bond or other fixed income securities since the last interest payment was made.	The buyer of a bond pays the market price plus accrued interest to the seller. The amount will be equal to the coupon period (usually semi-annual) times the number of days between the last coupon payment and the settlement date.
Duration	Duration provides a measure of how sensitive a bond's price is to changes in interest rates.	When interest rates increase, bond prices decline. Likewise, when interest rates decline bond prices increase. A bond's duration is expressed in "years" and allows investors to compare the impact that changing interest rates will have on a fixed income investment. Also, the longer the maturity, the longer the duration of the bond. Depending on the prevailing interest rates at the time, investors may choose to purchase fixed income investments with a longer (or shorter) duration.
Coupon	A coupon states the interest rate an issuer promises to pay the holder of a bond until maturity. The annual payment is usually divided into semi-annual installments. The coupon interest rate is normally fixed for the term of the bond. Some securities may be issued with variable or step-up coupon rates or may have different payment frequencies.	If interest rates fall below the bond's coupon rate, its price (or value) will increase. The reverse is true if interest rates rise above the bond's coupon rate. When a bond's price increases above its face value, it is said to be trading at a premium while a price below face value is called a discount.
Yield-to-maturity	The annual return an investor can expect to receive if a bond purchased today is held until its maturity date, assuming all coupon income is reinvested at the yield-to-maturity.	Provides a useful measure to help investors compare the expected returns of varying bonds with different coupon rates and maturity dates.
Current yield	The rate of actual cash flow as a per cent of the purchase price. It is calculated by dividing the annual interest received on the bond by the purchase price.	Like yield-to-maturity, the current yield is a useful measure to help investors compare bonds with different coupon rates.
Real return bond	Government of Canada bonds that have been specifically designed to offset the impact of rising inflation. This is achieved by applying an inflation compensation to the principal of the bond.	Real return bonds help clients protect their portfolio from the impact of inflation.

Basis point	A unit of measure that equals one, one hundredth of one per cent.	Allows investors to easily understand the changes that occur in a bond's yield. For example, if a bond's yield increases from 3.25% to 3.50%, the bond's yield is said to have increased by 25 basis points.
GIC	An investment that is issued by Canadian banks and trust companies and provides a guaranteed return over a specified period of time.	GICs are included in an investment portfolio to provide low risk rates of return. At maturity, the original amount invested is returned to the investor.

If you have any questions about the terminology above, or if there is other investment terminology you would like explained, please contact your BMO Nesbitt Burns Investment Advisor.

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