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Financial glossary — 65

All glossary terms in alphabetical order, with examples.

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Active management

A management style in which the manager selects securities with the aim of beating the benchmark index, generally at higher cost.

APR

Annual percentage rate: the overall yearly cost of a loan, including interest and charges. It is the number to use when comparing loans.

Asset allocation

The way invested money is split between different categories of instruments, such as shares, bonds and cash. It is the decision that most affects the overall level of risk.

Benchmark

A reference index against which the result of a fund or portfolio is compared, for example the main companies of a market.

Bond

A debt security: the buyer lends money to the issuer, which undertakes to pay interest and repay the capital at maturity.

Capital

The sum of money originally invested or lent, as distinct from the interest or returns it produces.

Capital gain

The gain realised by selling an instrument at a higher price than it was bought for. It is normally subject to tax.

Capital loss

The loss realised by selling an instrument at a lower price than it was bought for.

Compound interest

Interest calculated on both the initial capital and the interest already earned.

Compounding

The mechanism by which interest earned is added to capital and in turn earns interest.

Example (hypothetical): 1,000 euros at 3% a year become 1,030 after one year and 1,060.90 after two: in the second year interest is calculated on 1,030.

Conflict of interest

A situation in which whoever advises on or sells a product has an interest of their own that may differ from the client's. The rules require it to be managed and disclosed.

Coupon

The interest paid periodically by a bond to its holder.

Example (hypothetical): A 1,000 euro bond with a 3% annual coupon pays 30 euros a year, before tax.

Credit rating

A summary opinion, issued by specialised agencies, on an issuer's ability to repay its debts. It is an opinion, not a guarantee.

Credit risk

The possibility that the issuer of a bond fails to pay interest or repay the capital.

Currency risk

The possibility that the value of a foreign-currency investment changes because of exchange-rate movements.

Current account

The bank product for managing everyday income and payments. It offers immediate availability and, as a rule, little or no interest.

Deposit protection

A scheme that protects bank deposits up to a limit set by law per depositor and per bank. It does not cover investments.

Diversification

Spreading money across different instruments, issuers, sectors and countries so that the result does not depend on a single one. It reduces specific risk, not general market risk.

Dividend

The part of profits a company decides to distribute to its shareholders. It is not owed and may vary or be suspended.

Duration

A measure, expressed in years, of how sensitive a bond's price is to changes in interest rates: the higher it is, the more the price reacts.

Emergency fund

A reserve of immediately available money set aside for the unexpected. It comes before any investment.

ETF

A fund, usually passively managed, whose units trade on an exchange like a share. It tracks an index and follows it, including downwards.

Financial advice

A personal recommendation on financial instruments, based on a person's circumstances. It is an activity reserved for authorised firms and individuals.

Fixed and variable rate

With a fixed rate the interest stays the same for the whole term; with a variable rate it follows a market benchmark and the instalment can go up or down.

Government bond

A bond issued by a state to finance its borrowing needs.

Household budget

The statement of a household's income and spending over a period. It shows how much the household is able to save.

Inflation

The general rise in prices over time, which reduces the purchasing power of money.

Example (hypothetical): With hypothetical inflation of 2% a year, after ten years you need about 122 euros to buy what costs 100 today.

Interest rate

The price of money: the percentage paid by the borrower, or received by the lender, over a year.

Intermediary

A bank, investment firm or other authorised entity that provides investment services on behalf of clients.

Investment fund

A vehicle that pools the money of many savers and invests it in a set of securities according to a stated policy.

Issuer

The government or company that issues a bond or share and takes on the related obligations towards those who buy it.

KID

A short, standardised document with the key information on an investment product: objectives, risk indicator, scenarios and costs.

Leverage

The use of borrowed money or derivatives to increase exposure to an investment. It amplifies both gains and losses.

Example (hypothetical): With leverage of 5, a 10% market fall corresponds to a 50% loss on the sum committed.

Liquidity

The ease with which an instrument can be turned into cash, quickly and without losing value. It also refers to available cash.

Liquidity risk

The possibility of not being able to sell an instrument when needed, or only at an unfavourable price.

Management fee

The annual cost a fund deducts from its assets to pay its manager. It reduces the return even though it never appears as a separate charge.

Market index

A basket of securities representing a market or sector, used to measure its performance.

Market risk

The possibility that the value of an investment falls because of general market movements. It cannot be removed by diversification.

Maturity

The date on which a bond or fixed-term deposit ends and the capital is repaid.

Mortgage

A long-term loan, usually secured on a property, repaid in instalments.

Nominal interest rate

The pure interest applied to a loan, excluding other charges.

Ongoing costs

The costs paid every year for holding a product, such as management fees. Their effect builds up over time.

Passive management

A management style that tracks a market index without trying to beat it, generally at lower cost.

Pension fund

A form of supplementary pension that invests contributions in order to pay an income or a lump sum at retirement.

Portfolio

The set of financial instruments held by a person or a fund.

Prospectus

An official, detailed document describing an offer of financial instruments and the related risks, approved by the competent authority.

Purchasing power

The quantity of goods and services that a given sum of money can buy. It falls when prices rise.

Real return

The return net of inflation: it shows how much purchasing power has changed.

Example (hypothetical): A 3% return in a year when prices rise by 2% corresponds to a real return of about 1%.

Rebalancing

Periodically bringing a portfolio's proportions back to those originally set, after markets have shifted them.

Recommended holding period

The minimum time for which, according to the manufacturer, the product should be held; it is stated in the KID.

Regular savings plan

A way of investing through periodic payments of a constant amount instead of a single lump sum. It spreads the entry point over time; it does not remove risk.

Regulated market

An authorised and supervised trading venue, with rules on admission of securities, price transparency and the conduct of trading.

Replacement rate

The ratio between the first pension and the last income from work.

Example (hypothetical): With a replacement rate of 60%, a final income of 2,000 corresponds to a pension of about 1,200.

Return

The result of an investment over a period, expressed as a percentage of the sum invested. It can be positive or negative.

Risk profile

A summary of a person's knowledge, financial situation and objectives, used by the firm to assess which investments suit them.

Saving

The part of income that is not spent and is set aside.

Savings account

An account intended for savings on which the bank pays interest, often higher if the money is locked in for a period.

Share

A unit of ownership in a company. It gives a right to part of the profits, if distributed, and its value depends on the market price; there is no repayment of capital.

Simple interest

Interest calculated only on the initial capital, without taking account of interest already earned.

Spread

The difference between two rates or two prices. Used, for example, for the yield gap between government bonds of different countries, or between buying and selling price.

Stock exchange

An organised, regulated market where financial instruments such as shares, bonds and ETFs are traded.

Suitability assessment

The check, compulsory for a firm giving advice, that an investment suits the client's knowledge, situation and objectives.

Supplementary pension

The set of pension arrangements, collective and individual, that top up the compulsory state pension.

Time horizon

The period for which an investment is expected to be held before the money is needed.

Volatility

A measure of how much an instrument's price fluctuates over time. The higher it is, the wider the swings, up and down.

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