# Picking Financial Assets Terminology

**Sudweeks** MBA620/Fin 418-17 Day 17

**% Rank in Category**. This is the number the fund ranks in its category or versus the benchmark. It is the top percentile, i.e., the lower the number the better.

**Actively managed funds**. These are funds where the portfolio managers try to beat the performance of a benchmark through the active purchase and sell of securities in their asset class. Actively managed funds generally have higher management fees which must be overcome through higher returns

**Benchmark**. This is the relevant index for the specific category tracked by Morningstar or other fund monitoring company.

**Capital gains taxes**. Capital gains are realized earnings from selling a financial asset at a profit. It is the sale price less the purchase price, and are divided into short-term and long-term. Short-term capital gains are gains from the sale of an asset where the asset was held for less than 366 days and is taxed at your marginal tax rate. Long-term capital gains are gains on the sale of an asset where the asset was held for more than 366 days and is taxed at a preferential federal rate.

**Category**. These are all funds in the same category as established by Morningstar.

**DALBAR**. A firm that produces the book titled Quantitative Analysis of Investor Behavior which tracks the performance of individual investors over succeeding 20 year periods.

**Diversification**. Diversification is the process of “not putting all your eggs in one basket.” It is your key defense against market risk. Pick a fund with many companies in their portfolios within each asset class.

**Index funds**. These are mutual funds or ETFs which hold specific shares in proportion to those held by a specific index, i.e., the S&P 500 or Russell 2000. Their goal is to match the benchmark performance. Index funds have become the standard against which other mutual funds are judged.

**Interest/coupon payments**. These are payments received as part of the contractual agreement to receive interest payments from a bond. Bonds which have preferential interest tax treatment, i.e., muni’s and Treasuries, must still pay capital gains taxes.

**Cost**. These are the fees and expenses you pay to own a mutual fund or asset. Invest low cost. In a world where investment returns are limited, investment costs of any kind reduce your returns. We recommend you invest in no-load mutual funds to reduce costs.

**Manager Style Drift**. This is a check on the management style. Make sure the managers investment style remains constant. Investment fund managers have no authority to change the asset class. If you purchase a small cap fund, the manager should purchase small cap shares. The fund's prospectus should clearly define the market, size company, and portfolio style tilt.

**Potential Cap Gains Exposure**. This is an estimate of the percent of a funds asset’s that represent capital gains. If this is high, the probability is high that these may come to the investor as capital gains.

**Stock dividends**. Stock dividends are dividends received from a company from the ownership of the company shares. Stock dividends are of two types, qualified or ordinary/not qualified. A qualified dividend is a dividend paid by a U.S. corporation where the investor held the stock for more than 60 days during the 121-day period that begins 60 days before the ex-dividend date (see Teaching Tool 32). An ordinary dividend is a dividend that is not qualified, i.e., you have not held the stock for a long enough time period to get the Federal preferential tax rate.

**Tax Cost Ratio**. This is the percent of nominal Fund return attributable to taxes, assuming the fund is taxed at the highest rate. If a fund had an 8.0% return, and the tax cost ratio was 2.0%, the fund took home (1 + return) \* (1 – tax cost ratio) -1 or (1.08\*.98)-1 or 5.84%.

**Tax Efficiency**. Invest in taxable funds with an eye to obtaining high returns while keeping taxes low. Taxes reduce the amount of money you can use for your personal and family goals. Watch the historical impact of taxes, for it will likely continue. Remember it is not what you earn, but what you keep after taxes that makes you wealthy.

**Tax-adjusted Return**. This is your return after taxes

**Taxes on mutual funds**. Mutual funds are pass through vehicles, which means that taxes are not paid at the Fund level but are passed through to the individual shareholders who must pay the taxes. Mutual fund taxes are mainly capital gains, stock dividends and interest/coupon payments. They are handled the exact same way as the taxes for stocks and bonds discussed earlier.

**Tracking Error**. This is the return on the fund less the return on the benchmark. This tracking error should be small versus your benchmark. Tracking error is the historical difference between the return of a fund (i.e. a mutual fund) and its specific market/sector benchmark or index. The smaller the tracking error, the better the performance of the Index fund relative to the benchmark. However, you won’t complain if the tracking error is positive (i.e., your fund had higher returns than the index or benchmark).

**Turnover**. This is the amount of the portfolio that is bought and sold during a specific period. Keep turnover low, as turnover is a proxy for fund expenses and taxes. The costs associated with turnover are hard to quantify and may not be disclosed in the prospectus. These costs include commissions, bid-ask spreads, and market impact.

**Un-invested Cash**. This is the amount of cash in the portfolio. High cash levels in the portfolio are drags on performance so keep un-invested cash low.