Investment Terms You Should Know

The investment world can be a complicated and overwhelming place to those on the outside. If you're already finance savvy – consider this list a recap and if you're new to the investment world, you're in the right place. Read on for a mini-financial dictionary of investment terms you should know.

1099

An IRS tax form that provides information about many different types of income a taxpayer can receive in addition to compensation from an employer. For example, investment income is included on a taxpayer's Form 1099 if their investments earned dividends and interest in a given year. This is a common form annually provided to a client's CPA during tax season.

Asset Allocation

This is a strategy that adjusts the amounts or percentages you own in certain asset classes in order to balance risk versus reward based on your overall risk tolerance, goals and time frame for holding investments.

Asset Class

A broad category of similar financial investments. The three most common types of asset classes are stocks, bonds, and cash.

Basis Point

A unit of measure for percentages in finance. One basis point equals 1/100th of a percentage point. For example, if you hear that a stock's value increased by 80 basis points, that means its price rose by 0.80%.

Bonds

A bond is a type of debt security similar to a loan. When you buy a bond, you loan money to a company or government who has promised to pay it back at a certain time. Bonds are fixed-income securities because they pay their investors interest (either variable or fixed) along the way.

Bonds are used by corporations and governments to help fund their ventures and are often publicly traded. Bond prices vary depending on many factors. These include the time it takes to mature (i.e. when the bondholder receives the face value of the bond), the credit quality of the bond issuer — meaning the likelihood that the bond issuer will repay the loan, and prevailing interest rates at the time you are buying the bond.

Bonds that pay higher interests to investors often have lower credit ratings, meaning a higher chance of default and longer maturity time frames. These types of bonds are known as high-yield bonds. You might also hear them called "junk bonds." The highest quality bonds have good credit ratings and are known as investment grade, and these are backed by the U.S. government or very stable companies.

Bonds tend to offer more moderate returns and risk when compared to stocks and can sometimes work in a portfolio to even out risk.

Capital Gains

A capital gain is the increase in your investment's value. For example, if you invested $1,000 in the stock market and it grew to $1,500, you would have a capital gain of $500. If you sold that investment, you would have a realized capital gain of $500. A realized capital gain happens when an asset is sold at a profit.

Capital Gains Tax

When you sell an investment at a capital gain (i.e. profit), then your capital gain is taxed. For example, if you bought a stock 5 years ago for $90 and sold it today for $100, you would pay long-term capital gains tax on the $10 profit ($100 FMV (fair market value) – $90 cost = $10 capital gain). Capital gains tax applies to certain accounts. If that investment was in a non-retirement account and you held it for longer than a year, you would pay taxes on this gain at the capital gains rate (0%, 15%, or 20%) and the equivalent state tax rate. Holding an investment for longer than one year before selling it qualifies for federal long term capital gains treatment. If that investment was in a retirement account, then you would not pay taxes on the gain (this is why retirement accounts are called tax-free growth accounts).

Cost Basis

The purchase price for an investment. Investors pay taxes when they sell an asset at a profit, and only pay taxes on the gain, which is the positive difference between its current selling price and the original purchase price.

Employer Match

An employer contribution to a company sponsored retirement plan, in which your employer contributes an amount to your plan equal to a specified percentage of your personal contribution. Your employer is essentially "matching" a portion of your contribution. If your employer provides a company match, you'll typically see language similar to this in your benefits handbook: We will match 50% of your personal contribution to your 401(k) up to 6% of your salary.

Equity

This refers to a degree of ownership in an asset, such as a stock of a publicly traded company. Many times, financial advisors will refer to stocks as "equities" as a result.

Exchange Traded Funds (ETF)

An exchange traded fund (ETF) is similar to a mutual fund in that it pools together funds to purchase a set of stocks, bonds or securities. However it trades throughout the day instead of at the end of the day. The price of an ETF is determined throughout the day and they trade just like stocks.

Note: Most ETFs are passive in nature and therefore tend to come with lower internal expense ratios than similar mutual funds. Be sure to check the expense ratios of any mutual funds or ETFs you're investing in.

Fiduciary

In our industry, a fiduciary is a trusted advisor who is legally obligated to place their client's best interests above their own. Abacus advisors are all fee-only fiduciaries. We don't earn money by trying to sell clients unnecessary investments or products that enrich our company. Our only concern is what is best for our clients. If your financial advisor is not a fiduciary, they are allowed to give you advice or sell you a product that doesn't necessarily benefit you, but enriches their own bottom line.

Fixed Income

This is an investment that pays the investor (or lender) fixed interest payments until maturity; when the investment matures, the investor is repaid the principal amount. Bonds are the most common type of fixed income investment and you might hear an advisor say "fixed income" when discussing your portfolio.

Index Fund

An index fund is a type of mutual fund that invests to track the composition and performance of a particular market index. Let's say you wanted to track larger market indices like the S&P 500. By investing in an index fund designed to match the S&P 500, you could gain broad market exposure that removes some of the guesswork while keeping costs low (i.e. you don't face as many operating costs because your portfolio doesn't change as much, and the fund manager doesn't have to provide research on the companies in their fund.) Index funds can be used in passive investing, where instead of focusing on timing the market in the short-term, you take a long-term strategic approach towards the market.

Market Capitalization

The fair market value of all outstanding shares of a publicly traded company:

Large Cap Stock – Shares of publicly traded companies with a market capitalization of $10 billion or more.

Small Cap Stock – Shares of publicly traded companies with a market capitalization between $300 million and $2 billion.

Why is this important? Large cap stock companies are among the biggest in the world. Small cap stock companies tend to have a shorter track record. When deciding how to grow your investment portfolio (and how much risk you're comfortable with), McDonald's may be more stable than Shake Shack but Shake Shack might offer more growth potential (as just one broad example).

Mutual Funds

A mutual fund pools together money from a group of investors and purchases stocks, bonds and other securities. The fund acts as one investment and as the underlying securities increase or decrease in value, so does the overall value of the fund.

Mutual funds help individuals to take advantage of diversification, asset allocation and professional money management when they're unsure or don't have the time to do it themselves. Each mutual fund has a manager and a strategy for the fund's overall objective, which can be found in the fund's prospectus. Some may be geared towards growth or capital appreciation and others may be geared towards income generation or stability.

Even though a mutual fund may own stocks, bonds and other securities, its price does not fluctuate throughout the day, but instead is set at the end of each trading day. This means that if you want to purchase or sell a mutual fund, you will do so at the end of the day after its price has been set based on the value of its underlying securities.

Note: You'll likely see a variety of mutual fund offerings for you to choose from in your 401(k), 403(b) or TSP plan. Among these options you may see a Target Date Fund, which is a type of mutual fund whose asset allocation is set according to a selected time frame. The allocation becomes more conservative as the "target date" approaches.

Point

Refers to 1% of the outstanding principal on a mortgage loan. For example, a broker could offer to lower the interest rate on a 30-year fixed mortgage by .25% if the homebuyer pays an additional point. On a $200,000 mortgage, a point would cost the homebuyer an additional $2,000 which they could pay up front or add to the loan balance.

REIT (Real Estate Investment Trust)

A type of mutual fund that invests in real estate properties such as apartment buildings, offices, or retail stores. Since traditional real estate investing is highly illiquid, public REITs offer investors diversification by allowing them to invest in real estate while having the liquidity of a mutual fund trading on the stock market.

Risk Tolerance

As an investor, this describes your comfort level with certain levels of uncertainty when it comes to fluctuations (large and small) in the value of your portfolio.

RMD (Required Minimum Distribution)

A required minimum distribution (RMD) is the amount of money that must be distributed (or withdrawn) from an employer-sponsored retirement plan, such as a 401(k), traditional IRA, SEP account, or SIMPLE individual retirement account (IRA) by the account holder upon reaching retirement age. Under current law, RMDs must begin by April 1 of the year following the year the account holder reaches age 72.

Your RMDs are taxed as ordinary income, just like a salary, because the government wants to collect taxes on the money that has been growing tax-free in your account.

An RMD is any amount you must withdraw from a retirement account within a calendar year. Your annual RMD will shift depending on your age, life expectancy, and account balance. RMDs impact your retirement income plan, projected annual tax bill, and retirement lifestyle, making it necessary for you to understand what they are so you can build a plan that works for you.

Russell 3000

A market index that tracks the performance of the 3,000 largest publicly traded U.S. companies. Russell's objective is to give a total view of the U.S. stock market by covering roughly 98% of all tradable stocks.

S&P 500

A market index that tracks the performance of 500 of the largest publicly traded U.S. companies on the New York Stock Exchange. By following the largest U.S. companies, the S&P 500 provides a window into the overall financial health of the U.S. economy.

Stocks

One share of stock represents a single share of ownership (equity) in a company. When you purchase a share of stock, you become a part owner in the company (proportionally to the number of shares owned by others) and you can even vote on how the company operates. The price of the stock will fluctuate up and down over time depending on how much an investor is willing to pay for it (or think it will be worth).

Taxable Account

An individual or joint investment account that can hold assets such as stocks, bonds, mutual funds, and REITs. Unlike retirement accounts, you can deposit or withdraw money without incurring penalties. Investors usually need to sell assets within the account when they need cash, and will also pay capital gains tax if they sell any asset at a gain.

TOD (Transfer On Death)

A designation on an investment account that names a beneficiary to receive the assets within the account upon the account holder's death. TOD generally allows accounts to pass to beneficiaries outside the probate estate, avoiding the time and expense of the probate process. TOD designation is highly recommended to our clients who do not have a living trust. Naming beneficiaries is an important part of fulfilling your post-life wishes and determining your legacy after you've gone.

POD (Payable On Death)

A designation on a bank account or certificate of deposit that names a beneficiary to receive the assets within the account upon the account holder's death. This similarly determines and protects your wishes.

Disclosure

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