PEARSON NEW INTERNATIONAL EDITION

Global Investments

Bruno Solnik Dennis McLeavey

Sixth Edition

ALWAYS LEARNING

PEARSON

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Glossary

accrued interest Interest earned but not yet due and payable. This is equal to the next coupon to be paid on a bond multiplied by the time elapsed since the last payment date and divided by the total coupon period. Exact conventions differ across bond markets.

actuarial yield The total yield on a bond, obtained by setting the bond's current market value equal to the discounted cash flows promised by the bond. Also called *yield to maturity*.

agency trade A trade in which a broker acts as an agent only, not taking a position on the opposite side of the trade.

AIMR See *CFA Institute*.

American Depositary Receipt (ADR) A certificate of ownership issued by a U.S. bank to promote local trading in a foreign stock. The U.S. bank holds the foreign shares and issues ADRs against them.

American-type option An option that can be exercised at any time before expiration.

amortizing swap An interest rate swap with a decreasing notional principal amount.

arbitrage The simultaneous purchase of an undervalued asset or portfolio and sale of an overvalued but equivalent asset or portfolio, in order to obtain a riskless profit on the price differential. Taking advantage of a market inefficiency in a risk-free manner.

arbitrage approach A common approach used to value derivative securities, based on an arbitrage strategy involving the underlying securities.

ask price The price at which a market maker is willing to sell a security; also called *offer price*.

asset allocation Dividing of investment funds among several asset classes to achieve diversification.

at-the-money option An option for which the strike (or exercise) price is close to (at) the current market price of the underlying asset.

back-to-back Transactions in which a loan is made in one currency against a loan in another currency.

balance of payments A record of all financial flows crossing the borders of a country during a given time period (a quarter or a year).

balance of trade See *Trade balance*.

base currency A reference currency chosen by an investor to value a portfolio.

basis The difference between the futures (or forward) price of an asset and its spot (or cash) price. The basis can be expressed as a value or as a percentage of the spot price.

basis point One hundredth of 1 percent (0.01%).

basis risk The risk that arises from fluctuation in the basis.

basis swap An interest rate swap involving two floating rates.

bear floating-rate note (bear FRN) A note that benefits investors if interest rates rise.

bearer security A negotiable security. All cash flows paid on the security are remitted to its bearer. No register of ownership is kept by the issuing company.

benchmark A standard measurement used to evaluate the performance of a portfolio. The benchmark may be some passive index or the aggregate performance on a universe of comparable portfolios (see *Composite*).

benchmark bond A bond representative of current market conditions and used for performance comparison.

beta (β) A statistical measure of market risk on a portfolio; traditionally used to estimate the elasticity of a stock portfolio's return relative to the market index.

bid–ask spread The difference between the quoted ask and bid prices.

bid price The price at which a market maker is willing to buy a security.

bilateral arbitrage With reference to currencies, an arbitrage involving two currencies only.

Black-Scholes or Black-Scholes-Merton formula A standard option pricing formula derived by F. Black and M. Scholes and also by R. Merton.

bond A long-term debt security with contractual obligations regarding interest payments and redemption.

book value The accounting value of a firm.

bottom-up investing With respect to investment approaches, a focus on selecting individual securities with whatever allocation of money to asset classes, countries, or industry securities results.

bourse A French term often used to refer to a stock market.

Brady bonds Bonds issued by emerging countries under a debt-reduction plan named after Mr. Brady, former U.S. Secretary of the Treasury.

break-even exchange rate The future exchange rate such that the return in two bond markets would be even for a given maturity. Also called *implied forward exchange rate*.

Bretton Woods The site of a 1944 conference that led to the establishment of a semifixed exchange rate system.

broker An agent who executes orders to buy or sell securities on behalf of a client in exchange for a commission.

bull floating-rate note (bull FRN) A floating-rate note whose coupon increases if interest rates drop; an inverse floater.

call auction See *Fixing*.

call option A contract giving the right to buy an asset at a specific price on or before a specified date.

cap A contract on an interest rate, whereby at periodic payment dates, the writer of the cap pays the difference between the market interest rate and a specified cap rate if, and only if, this difference is positive. This is equivalent to a stream of call options on the interest rate.

cap option A contract on an interest rate, whereby the seller of the cap option periodically pays to the buyer the difference between the market interest rate and the specified cap rate if, and only if, this difference is positive. This is equivalent to a stream of call options on the interest rate.

capital account A component of the balance of payments that reflects unrequited (or unilateral) transfers corresponding to capital flows entailing no compensation (in the form of goods, services, or assets). Examples include investment capital given (without future repayment) in favor of poor countries, debt forgiveness, and expropriation losses.

capital asset pricing model (CAPM) An equilibrium theory that relates the expected return of an asset to its market risk (see *Beta*).

cash-and-carry arbitrage An arbitrage strategy with a simultaneous spot purchase and forward sale of an asset. The reverse transaction (borrowing the asset, selling it spot, and buying it forward) is known as a reverse cash and carry, or as a carry-and-cash arbitrage. These arbitrages lead to a relation between spot and forward, or futures, prices of the same asset.

cash settlement A procedure for settling futures contracts in which the cash difference between the futures price and the spot price is paid instead of physical delivery.

CFA Institute The global, not-for-profit association of investment professionals that awards the CFA designation; formerly the Association for Investment Management and Research (AIMR).

chartism A subjective forecasting analysis based on the study of charts; also called *technical analysis.*

clean price The price of a bond obtained as the total price of the bond minus accrued interest. Most bonds are traded on the basis of their clean price.

clearinghouse An organization that settles and guarantees trades in some financial markets.

closed-end fund An investment company with a fixed number of shares. New shares cannot be issued and the old shares cannot be redeemed. Shares are traded in the marketplace, and their value may differ from the underlying net asset value of the fund.

collateralized debt obligation (CDO) A set of structured notes backed by a pool of assets such as a portfolio of bonds or loans.

composite A universe of portfolios with similar investment objectives.

conditional correlation Correlation of two variables conditional on some information set.

conditional variance Variance of a variable conditional on some available information set.

consumer price index (CPI) A price index defined on a basket of goods consumed.

contract for difference (CFD) A contract between an investor and a broker in which the investor receives (or pays) the difference between the price of the underlying share when the contract is closed and the price when the contract was opened.

convertible bond A type of corporate debt that can be exchanged for shares of stock.

convexity A measure of the change in duration with respect to changes in interest rates.

co-opetition A term from game theory referring to cooperation along the value chain.

cost of carry The cost associated with holding some asset, including financing, storage, and insurance costs. Any yield received on the asset is treated as a negative carrying cost.

covered option An option position that is offset by an equal and opposite position in the underlying security.

credit spread A yield premium required by investors who purchase risky corporate bonds; also called *quality spread*.

cross rate The exchange rate between two currencies, derived from their exchange rates with a third currency.

currency exposure The sensitivity of the asset return, measured in the investor's domestic currency, to a movement in the exchange rate.

currency-option bond A bond in which the coupons and/or the principal may be paid in more than one currency, at the option of the bondholder.

currency overlay In currency risk management, the delegation of the management of currency risk in an international portfolio to a currency specialist.

currency swap A contract to exchange streams of fixed cash flows denominated in two different currencies.

current account A component of the balance of payments covering all current transactions that take place in the normal business of the residents of a country, such as exports and imports, services, income, and current transfers.

data mining Refers to spurious associations that arise by chance when performing repeated studies of a database.

dealer An agent that buys and sells securities as a principal (for its own account) rather than as a broker for clients. A dealer may function, at different times, as a broker or as a dealer. Sometimes called a *market maker*.

default risk The risk that an issuer will be unable to make interest and principal payments on time.

default swap An exchange of a fixed or floating coupon against the payment of a loss caused by default on a specific loan or bond; also called *credit swap*.

delta (δ) Ratio of change in the option price to a small change in the price of the underlying asset. Also equal to the derivative of the option price with respect to the asset price.

delta hedge A dynamic hedging strategy using options with continuous adjustment of the number of options used, as a function of the delta of the option.

derivatives Securities bearing a contractual relation to some underlying asset or rate. Options, futures, forward, and swap contracts, as well as many forms of bonds, are derivative securities.

devaluation Deliberate downward adjustment of a currency against its fixed parity.

direct exchange rate The amount of local or domestic currency required to purchase one unit of foreign currency.

direct quote An exchange rate quotation that gives the value of the foreign currency in terms of units of the domestic currency.

distressed investing An investment strategy that relies on purchase of securities in companies that are in poor financial condition.

dual-currency bond A bond with coupons fixed in one currency and principal repayment fixed in another currency.

duration A measure of an option-free bond's average maturity. Specifically, the weighted average maturity of all future cash flows paid by a security, in which the weights are the present value of these cash flows as a fraction of the bond's price. More importantly, a measure of a bond's price sensitivity to interest rate movements (see *Modified duration*).

EAFE index A stock index for Europe, Australia, and the Far East published by Morgan Stanley Capital International.

early stage With reference to venture capital financing, the stage associated with moving into operation and before commercial manufacturing and sales have occurred. Includes the start-up and first stages.

earnings multiplier See *Price–earnings ratio.*

econometric model A statistical model that analyzes complex correlations between variables.

economic risk As used in currency risk management, the risk that arises when the foreign currency value of a foreign investment reacts systematically to an exchange rate movement.

efficient frontier The set of all efficient portfolios for various levels of risk.

efficient market A market in which any relevant information is immediately impounded in asset prices.

efficient portfolio A portfolio that provides the best expected return for a given level of risk.

electronic communication networks Order-driven trading systems in which the book of limit orders plays a central role.

electronic crossing networks Order-driven trading systems in which market orders are anonymously matched at prespecified times at prices determined in the primary market for the system.

employee stock options Employee compensation in the form of company stock.

endogenous growth theory A theory of economic growth that does not assume that the marginal productivity of capital declines as capital is added.

euribor Interbank offer rate for short-term deposits in euros. Euribor is determined by an association of European banks.

euro The common currency of many European countries.

eurobond See *International bond.*

eurocurrency market Interbank market for short-term borrowing and lending in a currency outside of its home country. For example, borrowing and lending of U.S. dollars outside the United States. Thus, it is an offshore market escaping national regulations. This is the largest money market for several major currencies.

European Monetary System A formal arrangement linking some, but not all, of the currencies of the EU.

European Union (EU) A formal association of European countries founded by the Treaty of Rome in 1957. Formerly known as the EEC.

European-type option An option that can be exercised only at expiration.