FINANCIAL DICTIONARY

AGENCIES: Shorthand market terminology for any obligation issued by a government-sponsored entity (GSE), or a federally related institution. Obligations of GSEs are not guaranteed by the full faith and credit of the US government. There are eight GSEs, five of which are currently active in the new issue market. The five include:

ASKED: The price at which a seller offers to sell a security.

AVERAGE LIFE: In mortgage-related investments, including CMOs, the average time to expected receipt of principal payments, weighted by the amount of principal expected.

BANKER'S ACCEPTANCE: A money market instrument created to facilitate international trade transactions. This instrument is highly liquid and safe because the risk of the trade transaction is transferred to the bank that "accepts" the obligation to pay the investor.

BENCHMARK: A comparative base for measuring the performance or risk tolerance of the investment portfolio. A benchmark should represent a close correlation to the level of risk and the average duration of the portfolio's investments.

BID: The price at which a buyer offers to buy a security.

BOND: A bond is essentially a loan made by an investor to a division of the government, a government agency, or a corporation. The bond is a promissory note to repay the loan in full at the end of a fixed time period. The date on which the principal must be repaid is the called the maturity date, or maturity. In addition, the issuer of the bond, that is, the agency or corporation receiving the loan proceeds and issuing the promissory note, agrees to make regular payments of interest at a rate initially stated on the bond. Interest from bonds is taxable based on the type of bond. Corporate bonds are fully taxable, municipal bonds issued by state or local government agencies are free from federal income tax and usually free from taxes of the issuing jurisdiction, and Treasury bonds are subject to federal taxes but not state and local taxes. Bonds are rated according to many factors, including cost, degree of risk, and rate of income.

BROKER: A broker brings buyers and sellers together for a transaction for which the broker receives a commission. Broker generally does not hold inventory or make a market for securities.

CERTIFICATE OF DEPOSIT (CD): A CD is a note issued by a bank for a savings deposit that an individual agrees to leave invested in the bank for a certain term. At the end of this term, on the maturity date, the principal may either be paid to the individual or rolled over into another CD. Interest rates on CDs between banks are competitive. Monies deposited into a CD are insured by the bank, thus they are a low-risk investment. Maturities may be as short as a few weeks or as long as several years. Most banks set heavy penalties for premature withdrawal of monies from a CD. Large-denomination CD's are typically negotiable.

COLLATERAL: Securities, evidence of deposit or other property that a borrower pledges to secure repayment of a loan. Also refers to securities pledged by a bank to secure deposits of public monies.

COLLATERALIZED MORTGAGE OBLIGATIONS (CMO): Classes of bonds that redistribute the cash flows of mortgage securities (and whole loans) to create securities that have different levels of prepayment risk, as compared to the underlying mortgage securities.

COMMERCIAL PAPER: The short-term unsecured debt of corporations or companies.

COMPREHENSIVE ANNUAL FINANCIAL REPORT (CAFR): The official annual report for the City of Los Angeles. It includes combined statements for each individual fund and account group prepared in conformity with GAAP. It also includes supporting schedules necessary to demonstrate compliance with finance-related legal and contractual provisions, extensive introductory material, and a detailed Statistical Section.

CONVEXITY: Measures the rate of change in a bond's sensitivity to interest rate moves. It's the rate of change in a bond's duration (price volatility).

COST YIELD: The annual income from an investment divided by the purchase cost. Because it does not include the effect of premiums and discounts which may have been included in the purchase cost, it is an incomplete measure of return.

COUPON: (a) The annual rate of interest that a bond's issuer promises to pay the bondholder on the bond's face value. (b) A certificate attached to a bond evidencing interest due on a payment date.

CURRENT YIELD: The annual income from an investment divided by the current market value. Since the mathematical calculation relies on the current market value rather than the investor's cost, current yield is unrelated to the actual return the investor will earn if the security is held to maturity.

DEALER: A dealer, as opposed to a broker, acts as a principal in security transactions, selling securities from, and buying securities for, its own position.

DEBENTURE: A bond secured only by the general credit of the issuer.

DEFAULT: To default is to fail to repay principal or make timely interest payments on a bond or other debt investment security. Also, a default is a breach of or failure to fulfill the terms of a note or contract.

DELIVERY VERSUS PAYMENT (DVP): A securities industry procedure whereby payment for a security must be made at the time the security is delivered to the purchaser's agent.

DERIVATIVES: (1) Financial instruments whose return profile is linked to, or derived from, the movement of one or more underlying index or security, and may include a leveraging factor, or (2) financial contracts based upon notional amounts whose value is derived from an underlying index or security (interest rates, foreign exchange rates, equities or commodities).

DISCOUNT: The difference between the par value of a bond and the cost of the bond, when the cost is below par. Some short-term securities, such as T-bills and banker's acceptances, are known as **discount securities**. They sell at a discount from par, and return the par value to the investor at maturity without additional interest. Other securities, which have fixed coupons, trade at a discount when the coupon rate is lower than the current market rate for securities of that maturity and/or quality.

DISCOUNT SECURITIES: Non-interest bearing money market instruments that are issued a discount and redeemed at maturity for full face value, *e.g.*, U.S. Treasury Bills.

DIVERSIFICATION: Dividing investment funds among a variety of securities offering independent returns.

DURATION: The weighted average time to maturity of a bond where the weights are the present values of future cash flows. Duration measures the price sensitivity of a bond to changes in interest rates. (See Modified Duration)

EFFECTIVE DURATION: also known as Option-Adjusted duration measures the responsiveness of bond prices to changes in interest rates after taking into account the fact that the cash flow expected from a bond could change because of the bond's embedded call features or options.

FEDERAL CREDIT AGENCIES: Agencies of the Federal government set up to supply credit to various classes of institutions and individuals, *e.g.*, S&L's, small business firms, students, farmers, farm cooperatives, and exporters.

FEDERAL DEPOSIT INSURANCE CORPORATION (FDIC): A federal agency that insures bank deposits, currently up to $100,000 per deposit.

FEDERAL FUNDS RATE: The rate of interest charged by banks for short-term **OVERNIGHT** to other banks. The Federal Reserve Bank through open-market operations establishes this rate.

FEDERAL HOME LOAN BANKS (FHLB): Government sponsored wholesale banks (currently 12 regional banks) that lend funds and provide correspondent banking services to member commercial banks, thrift institutions, credit unions and insurance companies. The mission of the FHLBs is to liquefy the housing related assets of its members who must purchase stock in their district Bank.

FEDERAL NATIONAL MORTGAGE ASSOCIATION (FNMA): FNMA, like GNMA was chartered under the Federal National Mortgage Association Act in 1938. FNMA is a federal corporation working under the auspices of the Department of Housing and Urban Development (HUD). It is the largest single provider of residential mortgage funds in the United States. Fannie Mae, as the corporation is called, is a private stockholder-owned corporation. The corporation's purchases include a variety of adjustable mortgages and second loans, in addition to fixed-rate mortgages. FNMA's securities are also highly liquid and are widely accepted. FNMA assumes and guarantees that all security holders will receive timely payment of principal and interest.

FEDERAL OPEN MARKET COMMITTEE (FOMC): Consists of seven members of the Federal Reserve Board and five of the twelve Federal Reserve Bank Presidents. The President of the New York Federal Reserve Bank is a permanent member, while the other Presidents serve on a rotating basis. The Committee periodically meets to set Federal Reserve guidelines regarding purchases and sales of Government Securities in the open market as a means of influencing the volume of bank credit and money. The FOMC establishes monetary policy and executes it through temporary and permanent changes to the supply of bank reserves.

FEDERAL RESERVE SYSTEM: The central bank of the United States created by Congress and consisting of a seven member Board of Governors in Washington, D.C., 12 regional banks and about 5,700 commercial banks that are members of the system.

FFCB: The Federal Farm Credit Bank System provides credit and liquidity in the agricultural industry. FFCB issues discount notes and bonds.

FHLB: The Federal Home Loan Bank provides credit and liquidity in the housing market. FHLB issues discount notes and bonds.

FHLMC: Like FHLB, the Federal Home Loan Mortgage Corporation provides credit and liquidity in the housing market. FHLMC, also called "FreddieMac" issues discount notes, bonds and mortgage pass-through securities.

FNMA: Like FHLB and FreddieMac, the Federal National Mortgage Association was established to provide credit and liquidity in the housing market. FNMA, also known as "FannieMae," issues discount notes, bonds and mortgage pass-through securities.

GNMA: The Government National Mortgage Association, known as "GinnieMae," issues mortgage pass-through securities, which are guaranteed by the full faith and credit of the US Government.

GOVERNMENT NATIONAL MORTGAGE ASSOCIATION (GNMA or Ginnie Mae): Securities influencing the volume of bank credit guaranteed by GNMA and issued by mortgage bankers, commercial banks, savings and loan associations, and other institutions. Security holder is protected by full faith and credit of the U.S. Government. Ginnie Mae securities are backed by the FHA, VA or FmHA mortgages. The term "pass throughs" is often used to describe Ginnie Maes.

HEDGE: Hedging is a strategy of reducing risk by offsetting investments with investments of opposite risk. Risks must be negatively correlated in order to hedge each other; for example, an investment with high inflation risk and low immediate returns with investments with low inflation risk and high immediate returns. Long hedges protect against a short-term position and short hedges protect against a long-term position.

LEVERAGE: Borrowing funds in order to invest in securities that have potential to pay earnings at a rate higher than the cost of borrowing.

LIQUIDITY: The ease with which investments can be converted to cash at their present market value. Liquidity is significantly affected by the number of buyers and sellers trading a given security and the number of units of the security available for trading.

LOCAL GOVERNMENT INVESTMENT POOL (LGIP): The aggregate of all funds from political subdivisions that are placed in the custody of the State Treasurer for investment and reinvestment, **I.E., LAIF**.

MARKET RISK: Market risk is the risk that investments will change in value based on changes in general market prices.

MARKET VALUE: The price at which a security is trading and could presumably be purchased or sold.

MARKING TO MARKET: The process of posting current market values for securities in a portfolio.

MASTER REPURCHASE AGREEMENT: A written contract covering all future transactions between the parties to repurchase–reverse repurchase agreements that establishes each party's rights in the transactions. A master agreement will often specify, among other things, the right of the buyer-lender to liquidate the underlying securities in the event of default by the seller-borrower.

MATURITY: The date upon which the principal or stated value of an investment becomes due and payable.

MEDIUM TERM NOTES (MTN): Unsecured, investment-grade senior debt securities of major corporations that are sold either on a continuous or an intermittent basis. MTNs are highly flexible debt instruments that can be structured to respond to market opportunities or to investor preferences.

MODIFIED DURATION: The percent change in price of a bond with no embedded options for a 100 basis point change in yields. Modified duration is the best single measure of a portfolio's or security's exposure to market risk.

MONEY MARKET: The market in which short-term debt instruments (bills, commercial paper, bankers' acceptances, etc.) are issued and traded.

MORTGAGE PASS-THROUGH SECURITIES: A securitized participation in the interest and principal cash flows from a specified pool of mortgages. Principal and interest payments made on the mortgages are passed through to the holder of the security.

NET ASSET VALUE (NAV): NAV is the price of a share in a mutual fund or investment company. This price is calculated once or twice daily. Net asset value is the amount by which the assets' value exceeds the company's liabilities. It is calculated by adding up the market value of all securities owned by the company, subtracting the company's liabilities, and dividing this value by the number of shares of the company outstanding. Thus, the NAV indicates the current buying or selling price of a share in an investment company.

OFFER: The price asked by a seller of securities. (When you are buying securities, you ask for an offer.) See Asked and Bid.

OPEN MARKET OPERATIONS: Purchases and sales of government and certain other securities in the open market by the New York Federal Reserve Bank or directed by the FOMC in order to influence the volume of money and credit in the economy. Purchases inject reserves into the bank system and stimulate growth of money and credit; sales have the opposite effect. Open market operations are the Federal Reserve's most important and most flexible monetary policy tool.

OPTION: A marketable security contract that fixes the purchase price of some other security at a point in time.

PEFCO: The Private Export Funding Corporation assists exporters. Obligations of PEFCO are not guaranteed by the full faith and credit of the US government.

PORTFOLIO: Collection of securities held by an investor.

PREMIUM: The difference between the par value of a bond and the cost of the bond, when the cost is above par.

PREPAYMENT SPEED: A measure of how quickly principal is repaid to investors in mortgage securities.

PREPAYMENT WINDOW: The time period over which principal repayments will be received on mortgage securities at a specified prepayment speed.

PRIMARY DEALER: A group of government securities dealers who submit daily reports of market activity and positions and monthly financial statements to the Federal Reserve Bank of New York and are subject to its informal oversight. Primary dealers include Securities and Exchange Commission (SEC)-registered securities broker-dealers, banks, and a few unregulated firms.

PRUDENT INVESTOR RULE: An investment standard of accountability that applies to fiduciaries.

QUALIFIED PUBLIC DEPOSITORIES: A financial institution which does not claim exemption from the payment of any sales or compensating use or ad valorem taxes under the laws of this state, which has segregated for the benefit of the commission eligible collateral having a value of not less than its maximum liability and which has been approved by the Public Deposit Protection Commission to hold public deposits.

QUOTATION: A quotation, or quote, refers to the current price of a security, be it either the highest bid price for that security or the lowest ask price, as provided by a broker or dealer.

RATE OF RETURN: The yield obtainable on a security based on its purchase price or its current market price. This may be the amortized yield to maturity on a bond the current income return.

REALIZED YIELD: The change in value of the portfolio due to interest received and interest earned and realized gains and losses. It does not give effect to changes in market value on securities in the portfolio not yet sold.

REGIONAL DEALER: A financial intermediary that buys and sells securities for the benefit of its customers without maintaining substantial inventories of securities and is not a primary dealer.

REPURCHASE AGREEMENT (RP, Repo): Short-term purchases of securities with a simultaneous agreement to sell the securities back at a higher price. From the seller's point of view, the same transaction is a **reverse repurchase agreement**.

SAFEKEEPING: A service to customers rendered by banks for a fee whereby securities and valuables of all types and descriptions are held by the bank in the customer's name.

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SECONDARY MARKET: A market made for the purchase and sale of outstanding issues following the initial distribution.

SECURITIES AND EXCHANGE COMMISSION (SEC): A federal government agency comprised of five commissioners appointed by the President and approved by the Senate. The SEC was established to protect the individual investor from fraud and malpractice in the marketplace. The Commission oversees and regulates the activities of registered investment advisers, stock and bond markets, broker/dealers, and mutual funds.

SEC RULE 15C3-1: See Uniform Net Capital Rule.

SLMA: The student loan marketing association, also known as "SallieMae," provides liquidity to private lenders who make various types of loans for education. SLMA currently issues floating rate notes.

Federally related institutions are arms of the federal government. Most do not issue securities directly into the market. Those, which do issue directly, include the following:

STRUCTURED NOTES: Notes issued by Government Sponsored Enterprises (FHLB, FNMA, SLMA, etc.) and Corporations that have imbedded options (e.g., call features, step-up coupons, floating rate coupons, derivative-based returns) into their debt structure. Their market performance is impacted by the fluctuation of interest rates, the volatility of the imbedded options and shifts in the shape of the yield curve.

TOTAL RATE OF RETURN: A measure of a portfolio's performance over time. It is the internal rate of return that equates the beginning value of the portfolio with the ending value, and includes interest earnings and realized and unrealized gains and losses on the portfolio.

TREASURY BILLS: A non-interest bearing discount security issued by the U.S. Treasury to finance the national debt. Most bills are issued to mature in three months, six months, or one year.

TREASURY BONDS: Long-term coupon-bearing U.S. Treasury securities issued as direct obligations of the U.S. Government and having initial maturities of more than 10 years.

TREASURY NOTES: Medium-term coupon-bearing U.S. Treasury securities issued as direct obligations of the U.S. Government and having initial maturities from two to 10 years.

TVA: The Tennessee Valley Authority provides flood control and power and promotes development in portions of the Tennessee, Ohio and Mississippi River valleys. TVA currently issues discount notes and bonds.

UNDERWRITER: An underwriter is an individual distributing securities as an intermediary between the issuer of the security and the buyer.

UNIFORM NET CAPITAL RULE: Securities and Exchange Commission requirement that member firms as well as nonmember broker-dealers in securities maintain a maximum ratio of indebtedness to liquid capital of 15 to 1; also called net capital rule and net capital ratio. Indebtedness covers all money owed to a firm, including margin loans and commitments to purchase securities, one reason new public issues are spread among members of underwriting syndicates. Liquid capital includes cash and assets easily converted into cash.

U.S. TREASURY OBLIGATIONS (TREASURIES): Securities issued by the U.S. Treasury and backed by the full faith and credit of the United States. Treasuries are considered to have no credit risk and are the benchmark for interest rates on all other securities in the US and overseas. The Treasury issues both discounted securities and fixed coupon notes and bonds.

- **Treasury Bills:** All securities issued with initial maturities of one year or less are issued as discounted instruments, and are called Treasury Bills (T-bills). The Treasury currently issues three-month and six-month T-bills at regular weekly auctions. It also issues "cash management" bills as needed to smooth cash flows.

- **Treasury Notes:** All securities issued with initial maturities of two to ten years are called Treasury Notes (T-notes), and pay interest semi-annually.

- **Treasury Bonds:** All securities issued with initial maturities greater than ten years are called Treasury Bonds (T-bonds). Like Treasury Notes, they pay interest semi-annually.

VOLATILITY: Volatility is an indicator of expected risk. It demonstrates the degree to which the market price of an asset, rate, or index fluctuates from average. Volatility is calculated by finding the standard deviation from the mean, or average, return.

WARRANT: A warrant is similar to an option, giving the holder the right to purchase securities at a set price for a specific period of time. Warrant certificates last longer than options, typically holding value for a few years or indefinitely. Warrants are often traded as securities at a price that reflects the underlying security.

YIELD: The rate of annual income return on an investment, expressed as a percentage. Yield does not include capital gains. (a) **INCOME YIELD** is obtained by dividing the current dollar income by the current market price for the security. (b) **NET YIELD** or **YIELD TO MATURITY** is the current income yield minus any premium above par or plus any discount from par in purchase price, with the adjustment spread over the period from the date of purchase to the date of maturity of the bond.

YIELD TO MATURITY: The annualized internal rate of return on an investment that equates the expected cash flows from the investment to its cost.