FUNDAMENTAL CONCEPTS OF INTERNATIONAL FINANCE

FIXED INCOME SECURITIES

I Government Securities

Treasuries

These are the most liquid securities in the capital markets. The US Treasury issues bills, notes and bonds, plus inflation-indexed securities. T-bills are simple IOU-like instruments, with only one cash flow at maturity. The others pay semi-annual coupons. IIS pay a real interest rate plus an amount indexed to the inflation rate, hence their total coupon is not known in advance. Bonds may be callable, that is, repayable prior to maturity at the Treasurys option; notes may not be.

The Treasury abides by a regular schedule of security issuance, which is managed buy the Federal Reserve. Because they are risk-free, the bonds serve as the benchmark for all other fixed income securities. However, their risklessness is only in the narrow sense of being credit risk-free. Except in quite restrictive instances, investment in Treasury issues does entail a number of different interest rate related risks.

Strips

Zero coupon bonds, strips arise from separating the cash flows from Treasury bonds and selling each individually. The Treasury does not issue strips directly; stripping is left to dealers, who also reconstitute strips into whole bonds.

Mortgage instruments

An ever-expanding market, the most actively traded of these are groups of individual mortgages pooled together and backed by the U.S. Treasury so called pass-thrus and therefore have no credit risk. US agencies also issue pass-thrus. Non-agency or government backed mortgages are purchased as whole loans.

Agency issues

These are federally created entities with specific mandates. They are active borrowers in the capital markets (and in derivatives). Their relationships with the U.S. Treasury are vague and not consistent across agencies, hence their credit-worthiness is below Treasuries. They are becoming a larger presence in the capital markets, especially as the Treasury market contracts. Liquidity for agency debentures, in general, is high.

II Money Markets

Comprise instruments of very short maturity. They are issued by banks (e.g., deposits), firms (commercial paper) and the government (T-bills) and its agencies (discount notes). Securities dealers finance their inventory in this market as well (via repurchase agreements). Liquidity is quite good, especially for Eurodollar deposits. The impact of central bank monetary policy changes and the economy's dynamics on financial markets are initially felt here.

III Corporate Securities

Investment grade bonds

Debt instruments issued buy private sector firms. In the investment grade class, payment of promised cash flows will likely be made in a timely fashion but credit risk does exist. Rating agencies summarize credit risk with a letter grade. Yields quoted as "spread" to Treasuries.

A diverse set of issuers: industrials, utilities, financials and foreign. Liquidity varies greatly.

Medium term notes

A relatively new type of corporate bond, following a different registration procedure (off the shelf) which allows for quick issuance. Today they are distinguished more by the "structured" nature of their cash flows than by maturity.

Speculative grade bonds

Rated below investment grade by the rating agencies. Within this class, payments of promised cash flows are at risk. Bonds are often structured to preserve cash up front, such as deep discount or two-step coupons. Credit spreads are quite sensitive to overall level of economic activity.

IV Asset Backed Securities

Home mortgages

Earliest and still predominant form of collateral for this asset class. Pass-thrus were the first form of securitization. In order to make pre-payment risk more acceptable to investors, a large portion of mortgages are today repackaged into collateralized mortgage obligations, which allows for a host of structures and derivatives.

Other asset-backed

Originally created to relieve bank balance sheets. Credit card and automobile loans are the most popular collateral; home equity loans more recently introduced. Other deals include business equipment, student loans, and manufactured housing. Because these are not government or agency guaranteed, underwriter embeds various forms of credit enhancements.

V International Instruments

Securities belong in this category if their cash flows are denominated in foreign currency or if the issuer is a foreign entity.

Yankee bonds

Issued in the US market by foreign entities; dollar denominated.

Foreign bonds

Primarily government obligations; denominated in the home currency. Therefore, these securities introduce a new variable to the portfolio: foreign exchange risk.

Eurobonds

Not necessarily international by strict definition. Nevertheless, in some classifications are considered foreign securities as they are originated and traded outside the home country. Denominated in any currency, issued by foreign and domestic entities.

Emerging markets

Government, agency and corporate bonds of developing countries. The unique aspect here is sovereign risk, a special type of credit risk arising when the government or sovereign impedes the cash flows of a security to the investor. Further, investors face possibility of foreign exchange inconvertibility.

VI Municipal Securities

These are bonds of state and local governments and agencies and other political divisions. They are usually free of federal income tax, as well as state tax of their own domicile. Therefore, their yield is below that of taxable entities.

VII Equities

These represent ownership in a company, as opposed to loans to the company. Stockholders, therefore, receive cash flow only when the firms suppliers of labor, intermediate materials, government services and credit are fully paid.
In terms of hierarchy in event of bankruptcy, common stockholders are lowest on the scale, but they are usually the ones with voting rights.

Stocks are valued fundamentally according to the firms expected future earnings, hence are very sensitive to macro-economic dynamics. But they have a significant interest rate component as well.

Stocks typically separated into growth and value, but many other classifications are possible. More established issues trade on stock exchanges, with newer concentrated in technology issues traded over the counter.

Preferred stockholders are entitled to a dividend before common shareholders. Since they, too, are equity, non-payment of dividends is not a default.

Tracking stocks are a recent invention. These are a special class of common stock, structured to track the value of a subsidiary of the parent company. Tracking shareholders do not own the subsidiary; their shares are in the parent.

Convertible bonds (and convertible preferreds) are debt instruments with an option for the holder to convert into shares. Hence, have a very strong equity component and trade in the equity market.

VIII Equity Instruments in the Fixed-Income Markets

Preferred stock, with a semi-fixed dividend, are usually considered a fixed-income substitute and, therefore, trade in the fixed income markets. New Trust Preferreds have become popular for issuers and investors, as they provide tax advantages to the former, yield advantages to the latter.

Notes linked to stock indices or individual stocks are an indirect way to achieve equity exposure by way of the fixed income market.

DERIVATIVE INSTRUMENTS

I Introduction

Unlike cash instruments, which represent a loan or investment made at the present, derivatives represent contracts entered into by market participants for future performance. In general, the cash flow, hence the value, of a derivative instrument is "derived" from the performance of another instrument or index. In some cases (e.g., options) cash is advanced at the derivative's inception, in other cases (e.g., interest rate swaps) not.

Because of this derivation, the price movements of derivatives are closely linked to that of the security underlying the derivative. This property allows derivatives to be used to either hedge an existing exposure or synthesize one. In a portfolio context, they can be used to alter the risk/return configuration.

II Forward Contracts

Forward loans are contracts to borrow and lend at future dates, with either the interest rate or the formula for determining the rate generally fixed when the contract is entered into. Traditional forward loans are technically not derivatives since they are not derived from other instruments. However, they are the precursor to actual derivatives.

Many securities trade for forward settlement, that is, whereas all the terms of the trade including the price are set on the trade date, the actual transfer of cash for the asset occurs at a later date. This is, therefore, a forward contract. The fair forward price equals the cash price less the net carry the earnings from the security less its financing cost covering the period until the settlement date.

Foreign exchange trades actively in a forward market. Here, too, the forward exchange rate equals the spot rate less the net carry, which reflects the difference in interest rates between the two currencies. The forward price is quoted as a difference the spread from the cash exchange rate.

Forward rate agreements (FRAs) are contracts calling for the lender to receive a bank deposit, rather than the borrowers own IOU. In fact, there is no delivery, but a cash settlement equal to the difference between the contracted interest rate and the prevailing market rate on the settlement date.

III Futures Contracts

Futures contracts are forward contracts initiated and traded on an organized futures exchange. In addition to the standardization of contract terms (unlike non-futures forwards whose terms are freely negotiated by the counterparties), futures are distinguished by daily marking-to-market of outstanding positions and by the exchange guaranteeing contract performance.

Futures contracts call for either an actual delivery of the underlying asset on the settlement date, or a final marking-to-market (cash settlement). Either way, arbitrage forces a strong link between the futures contract price and the cash price of the instrument. This is what allows futures to be used to hedge cash instruments, leverage positions, synthesize assets and transform a portfolios risk exposure. Liquid contracts exist for government bonds, Eurodollar deposits (the futures counterpart to FRAs), foreign currency, non-dollar bonds and stock indices.

IV Interest Rate Swaps

An agreed upon exchange of a series of future cash flows based on an index, swaps have transformed the financial marketplace. Vanilla swaps represent an agreement to exchange a floating for a fixed rate of interest, for a specific term, based on a notional amount of funds. They are economically similar to a set of interest rate futures contracts (but are transacted over-the-counter). Hence, their pricing is largely based on futures. Swaps were originally created as an alternative-financing tool for borrowers. But they have evolved into a method for dealers and investors to hedge market exposure as well as create different types and degrees of financial exposure.

Second generation swaps allow for all kinds of underlying indices and rates; for example, equity index swaps, which replace the fixed interest side of the swap with the total return of a stock index, or basis swaps under which two money market rates are exchanged. Swaps can be callable, forward starting, zero coupon or amortizing.

V Options

Options are classified as derivative instruments since their cash flows depend on the performance of an underlying instrument. However, they are actually purchased," not just contracted, so that cash is paid at the outset of the options contract.

Options confer a *right* of exercise on the purchaser to either borrow or lend, purchase or sell rather than an obligation. They, therefore, contain an independent feature: volatility sensitivity. This puts them into a class by themselves, as no other instruments are as directly affected by volatility. In fact, in most instances, options are described by referring to the volatility estimate underlying their valuation.

Historically, options began as an equity derivative. In the fixed income markets today, option contracts are written on:

- bonds
- interest rates (caps & floors)
- futures contracts
- foreign exchange
- swaps

Additionally, many fixed income cash instruments have options "embedded" in their structure (such as callable corporate bonds and mortgages), so understanding their price dynamics requires knowledge of options.

The simplest options are valued according to the position of the underlying asset on the expiration date. Path-dependent options (referred to as exotic options) are valued according to the path the underlying instrument takes in arriving at its value on the expiration date. Examples are: knock-out, average rate and early exercisable (American style) options. These are created to either reduce the cost of the option, or to conform to the existing or desired market exposure of the contract participants.

VI Credit Derivatives

This is the newest class of derivatives. What differentiates them from the more standard derivatives is the underlying security. Rather than government bonds or bank deposits, they cover instruments with credit risk. They allow market participants to isolate and, therefore, hedge, leverage and synthesize the credit aspect of a security. Default swaps, spread options and total return notes are examples of credit derivatives.

VII Structured Notes

These are hybrid securities/derivatives. Essentially, these are notes or bonds (or bank deposits) tailored to the needs of a particular investor or group of investors. They can provide market exposure without actual entry into a market. Swaps also allow derivative-type, or leveraged, "bets" to be made by investors who must be invested in cash securities. Further, they can be constructed to isolate a "bet" in ways traditional securities or derivatives cannot.

VIII Equity-Linked Fixed-Income Instruments

A structured-type product, these provide fixed-income investors with an equity kicker. One example is convertible bonds and convertible preferred stocks. These are, of course, not new to the financial markets. But their reincarnation into different forms is a relatively new development (e.g., PERCS).

Equity-Linked Notes (or CDs) are technically a fixed-income instrument, but have the economic exposure of the equity market.

SPREAD CONCEPTS

The concept of spreads the difference in interest rate or yield between related instruments is crucial in todays sophisticated financial markets. It is relevant to investors choosing among competing instruments and strategies, to traders taking outright and relative value positions, and to analysts who need to understand relationships among instruments and make a statement about relative richness and cheapness.

Credit

A non-government obligation must provide a yield greater than that of a government to compensate for credit risk; i.e., the risk of default. This is true of agency and corporate bonds, and even of bonds issued by foreign governments in the domestic (Yankee) market. The difference between the yields is termed the credit spread or the credit risk premium.

Within the corporate (or Yankee) sector, bonds of different grades will command different spreads according to the degree of default risk. The market also refers to spreads between grades, as well as between the corporate and Treasury bond.

Bank

Bank liabilities carry a higher yield similar maturity government securities for the same reason. The difference between the yield is called the TED spread, as it measures the difference between Treasury obligations and Eurodollar deposits (or synthetic Eurodollar securities for longer maturities).

Interest rate swap yields, to a large extent, reflect the risk of the banking system. Hence, the spread between interest rate swaps and associated Treasury yields also qualifies as a bank spread.

Curve

This refers to the difference in yields between bonds of different maturities; i.e., on different points along the yield curve. While very short and very long issues are usually paired (e.g., the three year-thirty year spread), market participants also focus on spreads where maturities do not differ so sharply.

Money market curve spreads refer to yield differences for maturities in the money market; i.e., within one year.

Option-adjusted

Many securities contain options within their structure, termed embedded options. After estimating the value of the options (in yield terms), netting it from the securitys measured yield results in an option-adjusted yield. Subtracting the yield of the associated riskless bond produces the option-adjusted yield. This represents the securitys true spread.

INVESTOR TYPES

Mutual fund ("closed" and "open") managers

A mutual fund brings together relatively small individual portfolios in order to make more efficient and diversified investments. Funds may be "open" to additional investors after the initial underwriting period, and allow redemptions by selling shares back to the fund. Or, they may be "closed," in which case the shares trade like equities. ("Unit trusts" and "investment trusts" in the United Kingdom.) Specialized, or sector, funds have enjoyed spectacular growth in recent years, in response to low domestic interest rates and greater awareness of opportunities abroad.

The funds are regulated by the S.E.C. as to their investments and advertising practices.

Pension funds

These are corporate or publicly sponsored retirement plans. Very rate of return conscious, they are amenable to new markets and ideas. Pension consultants have become quite influential, both in terms of the markets their clients choose to enter (asset allocation), and in their evaluation of portfolio managers. Some consultants manage "portfolios of managers."

Pension plans can be of the defined benefit or defined contribution type. The public funds are regulated by the states. Investment limitations are often similar to the statutes prescribed for insurance companies. Private funds are overseen jointly by the Labor Department and IRS. They are bound by the "prudent man" rule.

Insurance companies (life; property & casualty)

Life companies need current income to meet liabilities. Burnt by the real estate and low grade bonds legacies of the 1980s, they have in recent years become more conservative, upgrading the credit quality of their portfolios.

P&Cs move between taxable and tax-exempt securities based on the "natural disaster cycle." The alternative minimum tax has complicated investment choices.

Insurance companies (life; property & casualty), contd.

Insurance company investment practices are constrained by state laws. The statutes prescribe the amount of capital ("surplus") that must be maintained for specific investments. They also set limits as to certain types of risky securities. Insurance companies are also concerned with showing a stable flow of earnings, which affects their investment decisions.

Individuals investors

Vary greatly in their appetite for risk, so are difficult to compartmentalize. Invest directly or via trust accounts established for them. Family offices are a recent innovation. When targeted for retirement, investments tend to be more conservative.

Endowments and Foundations

Funds managed similarly to pension funds, but in some ways more like individuals.

Speculators

An important class because of their typically large size trades in any given transaction. Relatively short term investment horizon, so typically care little for yield. Tolerance of risk is high.

Hedge funds

Theoretically a mutual fund, but with little regulation. Represent a limited number of sophisticated investors (recently increased to 499 maximum), with large minimum investments. Do not only speculate; many concentrate on relative value trades. May short securities, use derivatives, are highly leveraged and access any market.

Bank portfolios

These are treated separately from banks' dealer accounts. In this position they are longer term investors, seeking to maximize portfolio value through both current income and total return, rather than bid-asked spreads.

Banks are regulated by a number of different agencies, depending on their form of organization. In addition, banks can now create securities subsidiaries, which are overseen by a separate set of rules.

Savings Banks/Thrifts

Historically investors in mortgages and mortgage-backed instruments. Also buy government and corporate bonds. Significant interest rate risk, as liabilities are generally short term.

Corporate cash managers

These seek temporary outlets for available cash, so require liquidity and safety. Some, though, can be quite aggressive.

Municipalities

Two sources of investible funds: 1) Similar to corporations, municipalities often have cash flow for temporary investment; 2) Following a bond issue, local governments will invest proceeds until drawn upon.

RISK AND OTHER INVESTMENT CONSIDERATIONS

I Liquidity

Liquidity may or may not be an important issue in asset choice. Insurance companies typically are buy and hold investors. They sell bonds either when they feel an issuer's credit situation is about to deteriorate, or when, for business reasons, cash must be raised. Indeed, the new accounting rules for insurers have made buy-and-hold strategies even more prevalent. Insurers' need for liquidity, therefore, is secondary.

Cash managers, on the other hand, place primary emphasis on liquidity and safety, and typically sacrifice yield to achieve these qualities in their portfolios.

Mutual funds stand in the middle. That is, all else the same they would prefer more liquid bonds, but are not ready to sacrifice a lot of yield (as long as the bonds are marketable, of course, which typically precludes private placements.) The same is true, but in different degrees, for individuals and banks.

II A Taxonomy of Risk

Interest Rate

Investors, traders, non-financial firms and financial intermediaries all have horizons the point in time that an asset needs to be turned into cash to meet a financial obligation or purchase goods and services. If the asset matures or throws off cash flows prior to the horizon date then those cash flows need to be reinvested producing a return unknown at the time of the initial purchase of the asset. This is termed *reinvestment risk.*
If the asset matures past the horizon date, it needs to be sold. The sale price is also unknown at the investments inception, producing what is known as *capital risk.* Capital risk the risk of price fluctuation of an asset when liquidated arises from a number of sources, including the overall level of interest rates, shape of the yield curve, credit spread and various options possibly attached to the asset.

An instrument whose principal may be paid prior to its stated maturity subjects the investor to *call risk.* Typically, the instrument will be called if rates drop low enough to make new borrowing cheaper. The holder of the security will then reinvest the proceeds at the now lower interest rate. There is also price risk since, even if the instrument may not yet be called, movements in market interest rates affect the likelihood of a *future* call, which becomes reflected in the instruments price *now*.

Credit/Default

If an asset is an obligation of a non-government entity, the investor faces the risk of non-payment. This is manifested in two ways. One, the borrower simply does not make the required cash payments in full or on time. This is *default risk*, and depends on the probability of default as well as any recovery value in the event of default. Even while a borrower is fully meeting obligations, market participants are assessing the likelihood of future default. A change in the markets assessment of the probability will the cause the assets price to change. This is termed *credit risk*.

Prepayment/Extension

A class of assets, namely mortgages and other asset-backed securities, presents another type of cash flow uncertainty. These consumer liabilities allow prepayment of principal, which means that the timing of cash flows are not known. This is not the same as the call risk of a corporate bond. In that case, although the path of interest rates which precipitates a call is unknown, the response of the firm is determined by economic considerations and, thereof, known. In these cases, on the other hand, a significant portion of payments are not economically determined. The owner of the asset, therefore, is subject to *prepayment risk*, if principal is returned faster than excepted, and *extension risk*, if prepayments slow from their expected pace.

Counterparty

Alternatively called *contract risk* or *performance risk, counterparty risk* is relevant to financial arrangements derivatives between two parties that do not involve an extension of cash at the outset. It reflects the risk that one of the parties to the contract will not perform according to its terms. If, during the term of the contract, there is an accumulation of cash owed by one party to the other, the possibility of not receiving that cash becomes, technically, default risk.

Volatility

Financial instruments with any sort of optionally are exposed to another parameter volatility. This is obviously relevant to explicit puts and calls, where the *volatility risk* refers to that of the underlying asset. But it also applies to options contained in cash instruments, such as callable, putable and convertible bonds, or the options embedded in structured notes in general. Derivative instruments themselves can have options included in them, such as a callable swap, or the sellers option embedded in many government bond futures contracts.

Foreign Exchange

An asset denominated in a currency other than the home currency presents the investor with *foreign exchange risk*. This is the risk that, even if the price of the asset is unchanged, the foreign currencys exchange rate into the home currency can fluctuate, sometimes wildly.

Sovereign

Financial obligations of developing economies involve a number of risks that are relatively new, and not well understood. These include the risk that the country may be unwilling to honor its obligations, may not be able to procure foreign exchange to repay foreign currency denominated debt, may make its currency inconvertible into foreign currencies or impose other currency controls, or may simply make collection of debt difficult for foreign investors. Although these may seem like credit or default risk, the underlying determinants of these risks are far different, and have therefore become known a *sovereign risk*. Another aspect of this risk is the possibility that the currency rabidly depreciates, possibly approaching zero, a qualitatively different risk that the standard foreign exchange risk, which is a more continuous variable. These risks will also apply to non-government obligations of developing countries, which have their own credit risk as well.

Equity

The risks enumerated here are mostly fixed income related. However, many fixed income instruments have equity components, hence *equity risk*. Bank deposits and corporate notes linked to equity indices are obvious examples. These, plus convertible bonds and convertible preferred stock, incorporate *direct* equity risk. Even non-convertible bonds may have an *indirect* equity exposure. This is particularly true of speculative grade bonds, as the firms stock price behavior may provide information as to its creditworthiness.

Spread

This risk applies to trading strategies which involve two (or more) instruments. A yield curve trade, for example, is a position based on the difference between yields of different maturity bonds. A basis trade typically refers to opposite positions in cash bond and futures contracts. A mortgage-government trade or swap-bond trade is a simultaneous long position in one instrument and short in the pother. In all cases, the trade is subject to the difference in yield between the two instruments involved in the trade *spread risk*, sometimes referred to as *basis risk* or *cross-market risk*, depending on the particular trade.

Yield Curve

Actually a type of spread risk, this refers to the relative yield positions of bonds according to their respective maturities. A longer maturity bond is subject to the risk of overall interest rate movements, plus the volatility of the spread between its yield and the rate on overnight borrowing. A *yield curve trade* a simultaneous long and short position with respect to two bonds on different points on the yield curve is subject only to yield curve risk since the long and short positions (if properly weighted) cancel out the overall interest rate exposure.

III Investment Constraints

Most investors follow certain guidelines which limit the investment choice. For example, they may impose maximum maturities, or prohibit certain types of credit risk from their portfolios. Others will require diversification of assets, a less limiting restriction. Still others, and this is a shrinking group, will not get involved with derivatives.

IV Tax, Accounting and Regulatory Concerns

Tax

Tax issues drive some investments. Individuals will include municipal securities in their portfolio because of their favorable tax treatment. Insurance companies will do some trades that produce a capital gain to offset previous losses, and vice-versa. Firms will buy preferred stock since a portion of the dividends is not taxed.

Accounting

Futures contracts require marking-to-market. Some investors (and dealers) will mark to market their cash instruments. Others are required by regulators to record changes in the book value of securities as they approach maturity.

Regulatory

Regulations may drive some investments. Money market funds, for example, may not invest more than a maximum percent in any one name. Life insurance companies have to abide by their statutes in their portfolio decisions. Pension funds have specific fiduciary responsibilities to their beneficiaries.

BASIC TERMINOLOGIES OF FINANCE

1. ACCELERATION CLAUSE provision, normally present in an INDENTURE agreement, mortgage, or other contract, that the unpaid balance is to become due and payable if specified events of default should occur. Such events include failure to meet interest, principal, or sinking fund payments; insolvency; and nonpayment of taxes on mortgaged property.

2. BANKER'S ACCEPTANCE time draft drawn on and accepted by a bank, the customary means of effecting payment for merchandise sold in import-export transactions and a source of financing used extensively in international trade. With the credit strength of a bank behind it, the banker's acceptance usually qualifies as a MONEY MARKET instrument. The liability assumed by the bank is called its acceptance liability

3. BOOKKEEPING assets, liabilities, income, and expenses as represented by individual ledger pages to which debit and credit entries are chronologically posted to record changes in value. Examples are cash, accounts receivable, accrued interest, sales, and reporting such information is called accounting. Practitioners of accounting are called accountants.

4. ACCOUNT BALANCE net of debits and credits at the end of reporting. Term applies to a variety of account relationship, such as with banks. credit card companies, brokerage firm, and stores, and to classifications of transaction you are on. For example, your bank balance is an asset account to you and a liability account to the bank. Your credit card(debit)balance is a liability account to you and an asset account(account receivable) to the credit card cpmpany.

5. ACCOUNTS PAYABLE amounts owing on open account to creditors for goods and services. Analysts look at the relationship of accounts payable to purchases for indications of sound day-to-day financial management.

6. ACCOUNTS RECEIVABLE money owed to a business for merchandise or services sold on open account, a key factor in analyzing a company's LIQUIDITY-its ability to meet current obligations without

additional revenues.

7. ADJUSTABLE RATE MORTGAGE(ARM) mortgage agreement between a financial institution and a real estate buyer stipulating predetermined adjustments of the interest rate at specified intervals. Mortgage payments are tied to some index outside the control of the bank or savings and loan institution, such as the interest rates on U.S. Treasury bills or the average national mortgage rate. Adjustments are made regularly, usually at intervals of one, there, or five years. In return for taking some of the risk of arise in interest rates, borrowers get lower rates at the beginning of the ARM than they would if they took out a fixed rate mortgage covering the same term. A homeowner who is worried about sharply rising interest rates should probably choose a fixed rate mortgage, whereas one who thinks rates will rise modestly, stay stable, or fall should choose an adjustable rate mortgage. Critics of ARMs charge that these mortgages entice young homeowners to undertake potentially onerous commitments

8. AFTER-HOURS DEALING OR TRADING trading of stocks and bonds after regular trading hours on organized exchanges. his may occur when there is a major announcement about positive or negative therefore soar or plummet from the level at which it closed during regular trading hours. Some brokerage firms specialize in making over-the-counter markets around the clock to accommodate after-hours dealing.

9.AFTERTAX BASIS basis for comparing the returns on a corporate tax able bond and a municipal tax-free bond. For example, a corporate bond paying 10% would have an aftertax return of 6.4% for someone in the 36% tax bracket. So any municipal bond paying higher than 6.4% would yield a higher aftertax return

10. AGGRESSIVE GROWTH MUTUAL FUND mutual fund holding stocks of rapidly growing companies. While these companies may be large or small, they all share histories of and prospects for above-average profit growth. Aggressive growth funds are designed solely for capital appreciation, since they produce little or no income from dividends. This type of mutual fund is typically more volatile than the overall stock market, meaning its share will rise far more than the average stock during bull markets and will fall much farther than the typical stock in a bear market. Investors in aggressive gro조 funds time. Aggressive growth funds are also called maximum capital gain funds or capital

appreciation funds

11. AIR PCOKET STOCK stock that falls sharply, usually in the wake of such negative news as unexpected poor earnings. As shareholders rush to sell, and few buyers can be found, the price plunges dramatically, like an airplane hitting an air pocket.

12 AMORTIZATION accounting procedure that gradually reduces the cost value of a limited life or intangible asset through periodic charges to income, For fixed assets the term used is DEPRECIATION, and for wasting assets(natural resources) it is depletion, both terms follow the conservative practice of writing off, through amortization, INTANGIBLE ASSETS such as goodwill, It is also common practice to amortize any premium over par value paid in the purchase of preferred stock or bond investments. The purpose of amortization is to reflect resale or redemption value.
Amortization also refers to the reduction of debt by regular payments of interest and principal sufficient to pay off a loan by maturity applicable charges to income in accordance with a predetermined schedule. While this is normally done systematically, charges to profit and loss are permissible at any time in any amount of the remaining discount and wxpense. Such accounting is detailed in a company's annual report.

13. ARBITRAGE profiting from differences in price when the same security, currency, or commodity is traded on two or more markets. For example, an aritrageur simultaneously buys one contract of gold in the New York market and sells one contract of gold in the Chicago market, locking in a profit because at that moment the price on the two markets is different. (The arbitrageur's selling price is higher than the buying price.) Index arbitrage exploits price differences between STOCK INDEX FUTURES and underlying stocks. By taking advantage of momentary disparities in prices between markets, arbitrageurs perform the economic function of making those markets trade more efficiently

14. ASSET ALLOCATION MUTUAL FUND mutual fund that switches between stocks, bonds, and money market securities to maximize shareholders's returns while minimizing risk. Such funds, which have become extremely popular in recent years, relieve individual share holders of the responsibility of timing their entry or exit into different markets, since the fund manager is making those decisions. Theoretically, asset allocation funds provide a built-in buffer against

declining stock and bond prices because the manager can move all the fund's assets into safe money market instruments. On the other hand, the manager has flexibility to invest aggressively in international and domestic stocks and bonds if he or she sees bull markets ahead for those securities

15 ASSET BACKED SECURITIES bonds or notes backed by loan paper or accounts receivable originated by banks, credit card companies, or other providers of credit and often “ enhanced” by a bank LETTER OF CREDIT or by insurance coverage provided by an institution other than the issuer. Typically, the priginator of the loan or accounts receivable paper sells it to a specially created turst, which repackages it as securities with a minimum denomination of $ 1000 and a term of five years or less. The securities are then underwritten by brokerage firms who reoffer them to the public. Examples are CERIFICATES FOR AUTOMOBILE RECEIVABLES(CARs) and so-called plastic bonds, backed by credit card receivables, Because the institution that originated the underlying loans or receivables is neither the obligor nor the guarantor, investors should evaluate the quality of the original paper, the worth of the guarantor or insurer, and the extent of the protection.

16. BACK OFFICE bank or brokerage house departments not directly involved in selling or trading, The back office sees to accounting records, compliance with government regulations, and communication order processing can be slowed by massive volume : this is called a back office crunch.

17. BAILING OUT selling a security or commodity quickly without regard to the price received. An investor bails out of a position if losses are mounting quickly and he or she is no longer able to sustain further losses. For example, someone who has sold a stock short may bail out by covering his or her position at a loss if the stock rises sharply.

18. BALANCE SHEET financial report, also called statement of condition or statement of financial position, showing the status of a company's assets, liabilities, and owners' equity on a given date, usually the close of a month. One way of looking at a business enterprise is as a mass of capital(ASSETS) arrayed against the sources of that capital(LIABILITIES and EQUITY). Assets are equal to liabilities and equity쇼, and the balance sheet is a listing of the items making up the two sides of the equation. Unlike a PROFIT AND LOSS STATEMENT, which shows the results of operations over a period of time, a balance sheet shows the state of affairs at one point in time. It is a snapshot,

not a motion picture, and must be analyzed with reference to comparative prior balance sheets and other operating statements.

19. BANK HOLDING COMPANY company that owns or controls two or more banks or other bank holding companies. As defined in the Bank Holding Company Act of 1956, such companies must register with the BOARD OF GOVERNORS of the FEDERAL RESERVE SYSTEM and hence are called registered bank holding companies. Amendments to the 1956 act set standards for acquisitions (1966) and ended the exemption enjoyed by one-bank holding companies (1970), thus restricting bank holding companies to activities related to banking.

20. BANK LINE bank's moral commitment, as opposed to its contractual commitment, to make loans to a particular borrower up to a specified maximum during a specified period, usually one year. Because a bank line-also called a line of credit-is not a legal commitment, it is not customary to charge a commitment fee. It is common, however, to require that compensating balances be kept on deposit-typically 10% of the line, with an additional 10% of any borrowings under the line. A line about which a customer is officially notified is called an advised line or confirmed line. A line that is an internal policy guide about which the customer is not informed is termed a guidance line.

21. BANKRUPTCY state of insolvency of an individual or an organization-in other words, an inability to pay debts. There are two kinds of legal bankruptcy under U.S. law: involuntary, when one or more creditors petition to have a debtor judged insolvent by a court; and voluntary, when the debtor brings the petition. In both cases, the objective is an orderly and equitable settlement of obligations.

The 1978 Bankruptcy Reform Act removed some of the rigideties of the old law and permitted more flexibility in procedures. The Bankruptcy Reform Act of 1984 curtailed some of the more liberal provisions (mainly affecting consumer bankruptcy) of the 1978 act.

Chapter 7 of the 1978 act, dealing with LIQUIDATION, provides for a court-appointed interim trustee with broad powers and exports of goods and services; the capital account covers movements of investments; and the gold account covers gold movements. The balance of payments helps a country evaluate its competitive strengths and weaknesses and forecast the strength of its currency. From the standpoint of a national economy, a surplus on a part of the balance of payments is not necessarily good, nor is a deficit necessarily bad; the state of the national economy and the manner of financing the deficit are important considerations. See also BALANCE OF TRADE.

22. BALANCE SHEET financial report, also called statement of condition or

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Chapter 11, which deals with REORGANIZATION of businesses, provides that, unless the court rules otherwise, the debtor remains in possession of the business and in control of its operation. Debtor and creditors are allowed considerable flexibility in working together.

Chapter 12, which deals with debt adjustment or reorganization for individuals, allows people to put forward a plan to repay creditors over time, usually from future income. Most consumer reorganizations take place under Chapter 13 of the bankruptcy law. A Chapter 13 bankruptcy normally requires monthly payments to the bankruptcy trustee for a period of three to five years. Once payments have been completed under the plan, the debtors are entitled to a discharge. Chapter 13 reorganizations also allow debtors to keep more property than in a Chapter 7 liquidation.

26. BANK WIRE computerized message system owned and administered by about 250 participating banks in about 75 U.S. cities. Like the FED WIRE, the bank wire transmits large dollar credit transfer information. It also provides information about loan participations, securities transactions, Federal Reserve System funds borrowings, credit history, the payment or nonpayment of "wire fate"items, and other essential matters requiring prompt communication.

27. BASE RATE interest rate charged by banks to their best corporate customers in Great Britain. It is the British equivalent of the PRIME RATE in the United States. Many other consumer loan rates are pegged to the base rate in Britain.

28. BASIS POINT smallest measure used in quoting yields on bills, notes, and bonds. One basis point is .01%, or one one-hundredth of a percent of yield. Thus, 100 basis points equal 1%. A bond's yield that increased from 8.00% to 8.50% would be said to have risen 50 basis points.

29. BEAR person with a pessimistic market outlook. Contrast with BULL.

30. BEAR MARKET prolonged period of falling prices. A bear market in stocks is usually brought on by the anticipation of declining economic activity, and a bear market in bonds is caused by rising interest rates.

31. BEAR RAID attempt by investors to manipulate the price of a stock by selling large numbers of shares short. The manipulators pocket the difference between the initial price and the new, lower price after this maneuver. Bear raids are illegal under Securities and Exchange Commission rules, which stipulate that every SHORT SALE be executed on an UPTICK (the last price was higher than the price before it) or a ZERO PLUS TICK (th last price was unchanged but higher than the last preceding different price).

32. BEAR TRAP situation confronting short sellers when a bear market reverses itself and turns bullish. Anticipating further declines, the bears continue to sell, and then are forced to buy at higher prices to cover. See also SELLING SHORT.

33. U.S. Treasury bill: commonly called bill or T-bill by money market people, a Treasury bill is a short-term (maturities up to a year), discounted government security sold through competitive bidding at weekly and monthly auctions in denominations from $10,000 to $1 million.

34. BLACK FRIDAY sharp drop in a financial market. The original Black Friday was September 24, 1869, when a group of financiers tried to corner the gold market and precipitated a business panic followed by a depression. The panic of 1873 also began on Friday, and Black Friday has come to apply to any debacle affecting the financial market.

35. BLACK MONDAY October 19, 1987, when the Dow Jones Industrial Average plunged a record 508 points following sharp drops the previous week, reflecting investor anxiety about inflated stock price levels, federal budget and trade deficits, and foreign market activity. On Monday, October 27, 1997, the Dow dropped 554 points, precipitated by economic and currency upheaval in Southeast Asia. While the point drop set a new record, the percentage decline based on a higher Dow was far less than in 1987. That 1997 day is also called Bloody Monday. Many blamed PROGRAM TRADING for the extreme VOLATILITY.

36. BOND DISCOUNT amount by which the MARKET PRICE of a bond is lower than its FACE VALUE. Outstanding bonds with fixed COUPONS go to discounts when market interest rates rise. Discounts are also caused when supply exceeds demand and when a bond's CREDIT RATING is reduced. When opposite conditions exist and market price is higher than face value, the difference is termed a bond premium. Premiums also occur when a bond issue with a CALL FEATURE is redeemed prior to maturity and the bondholder is compensated for lost interest. See also ORIGINAL ISSUE DISCOUNT.

37. BOND RATING method of evaluating the possibility of default by a bond issuer. Duff & Phelps/MCM, Standard & Poor's, Moody's Investors Service, and Fitch's Investors Service analyze the financial strength of each bond's issuer, whether a corporation or a government body. Their ratings range from AAA (highly unlikely to default) to D (in default). Bonds rated BB or below are not INVESTMENT GRADE-in other words, institutions that invest other people's money may not under most state law buy them. See also PATING.

38. BOND SWAP simultaneous sale of one bond issue and purchase of

another. The motives for bond swaps vary: maturity swaps aim to stretch out maturities but can also produce a profit because of the lower prices on longer bonds; yield swaps seek to improve return and quality swaps seek to upgrade safety; tax swaps create tax-deductible losses through the sale, while the purchase of a substitute bond effectively preserves the investment. See also SWAP, SWAP ORDER.

39. BREAKEVEN POINT

Finance: the point at which sales equal costs. The point is located by breakeven analysis, which determines the volume of sales at which fixed and variable costs will be covered. All sales over the breakeven point produce profits; any drop in sales below that point will produce losses.

Because costs and sales are so complex, breakeven analysis has limitations as a planning tool and is being supplanted by computer based financial planning systems. See also LEVERAGE(operating).

Securities: dollar price at which a transaction produces neither a gain nor a loss.

In options strategy the term has the following definitions:

1. long calls and short uncovered calls: strike price plus premium.
2. long puts and short uncovered puts: strike price minus premium.
3. short covered call: purchase price minus premium.
4. short put covered by short shock: short sale price of underlying stock plus premium.

40. BRIDGE LOAN short-term loan, also called a swing loan, made in anticipation of intermediate-term of long-term financing.

41. BULL MARKET prolonged rise in the prices of stocks, bonds, or commodities. Bull markets usually last at least a few months and are characterized by high trading volume.

42. BUYBACK purchase of a long contract to cover a short position, usually arising out of the short sale of a commodity. Also, purchase of identical securities to cover a short sale. Synonym: short covering. See also STOCK BUYBACK.

Bond buyback: corporation's purchase of its own bonds at a discount in the open market. This is done in markets characterized by rapidly rising interest rates and commensurately declining bond prices.

43. BUYOUT purchase of at least a controlling percentage of a company's stock to take over its assets and operations. A buyout can be accomplished through negotiation or through a tender offer. A LEVERAGED BUYOUT occurs when a small group borrows the money to finance the purchase of the shares. The loan is ultimately repaid out of cash generated from the acquired company's operations or from the sale of its assets. See also GOLDEN

PARACHUTE.

44. CALLABLE redeemable by the issuer before the scheduled maturity. The issuer must pay the holders a premium price if such a security is retired early. Bonds are usually called when interest rates fall so significantly that the issuer can save money by floating new bonds at lower rates. See also CALL PRICE; DEMAND LOAN.

45. CALL OPTION right to buy 100 shares of a particular stock or stock index at a predetermined price before a preset deadline, in exchange for a premium. For buyers who think a stock will go up dramatically, call options permit a profit from a smaller investment than it would take to buy the stock. These options can also produce extra income for the seller, who gives up ownership of the stock if the option is exercised.

46. CALL PREMIUM amount that the buyer of a call option has to pay to the seller for the right to purchase a stock or stock index at a specified price by a specified date.

In bonds, preferreds, and convertibles, the amount over par that an issuer has to pay to an investor for redeeming the security early.

47. CAP

Bonds: highest level interest rate that can be paid on a floating-rate debt instrument. For example, a variable-rate note might have a cap of 8%, meaning that the yield cannot exceed 8% even if the general level of interest rates goes much higher than 8%.

Mortgages: highest interest rate level that an adjustable-rate mortgage(ARM) can rise to over a particular period of time. For example, an ARM contract may specify that the rate cannot jump more than two points in any year, or a total of six points during the life of the mortgage.

Stocks: short for CAPITALIZATION, or the total current value of a company's outstanding shares in dollars. A stock's capitalization is determined by multiplying the total number of shares outstanding by the stock's price. Analysts also refer to small-, medium- and large-cap stocks as a way of distinguishing the capitalizations of companies they are interested in. Many mutual funds restrict themselves to the small-, medium or large-cap universes. See also COLLAR.

48. CAPITAL FLIGHT movement of large sums of money from one country to another to escape political or economic turmoil or to seek higher rates of return. For example, periods of high inflation or political revolution have brought about an exodus of capital from many Latin American countries to the United States, which is seen as a safe haven.

49. CAPITAL GAIN difference between an asset's adjusted purchase price

and selling price when the difference is positive. According to the TAXPAYER RELIEF ACT OF 1997, a long-term capital gain is achieved once an asset such as a stock, bond, or mutual fund has been held for at least 12 months. Such long-term gains are taxed at a maximum rate of 20% for taxpayers in the 28% tax bracket or higher. Those in the 15% tax bracket pay a 10% tax on long-term capital gains. Selling assets for a profit after holding them for less than 12 months generates short-term capital gains, which are subject to regular income tax rates. Assets purchased starting January 1,2000 and held for at least five years qualify for a maximum capital gains tax rate of 18% for those in the 28% tax bracket or higher, and 8% for those in the 15% tax bracket. Capital gains are reported on Schedule D of a tax return.

50. MANAGEMENT FEE charge against investor assets for managing the portfolio of an open-or closed-end MUTUAL FUND as well as for such services as shareholder relations or administration. The fee, as disclosed in the PROSPECTUS, is a fixed percentage of the fund's net asset value, typically between 0.5% and 2% per year. The fee also applies to a MANAGED ACCOUNT. The management fee is deducted automatically from a shareholder's assets once a year.

51. MANAGING UNDERWRITER leading-and origination-investment banking firm of an UNDERWRITING GROUP organized for the purchase and distribution of a new issue of securities. The AGREEMENT AMONG UNDERWRITERS authorizes the managing underwriter, or syndicate manager, to act as agent for the group in purchasing, carrying, and distributing the issue as well as complying with all federal and state requirements; to form the selling group; to determine the allocation of securities to each member; to make sales to the selling group at a specified discount-or CONCESSION-from the public offering price; to engage in open market transactions during the underwriting period to stabilize the market price of the security; and to borrow for the syndicate account to cover costs. See also FLOTATION COST; INVESTMENT BANKER; UNDERWRITE.

52. HEDGE FUND private investment partnership (for U.S. investors) or an off-shore investment corporation (for non-U.S. or tax-exempt investors) in which the general partner has made a substantial personal investment, and whose offering memorandum allows for the fund to take both long and short positions, use leverage and derivatives, and invest in many markets. Hedge funds often take large risks on speculative strategies, including PROGRAM TRADING, SELLING SHORT, SWAPS, and ARBITRAGE. A fund need not employ all of these tools all of the time; it must merely have them at its disposal. Since hedge funds are not limited to buying securities, they can potentially profit in any market environment, including one with sharply declining prices. Because they move billions of dollars in and out of markets quickly, hedge funds can have a significant impact on the day-to-day trading

developments in the stock, bond, and futures markets.

Hedge funds entitle the general partner to an additional incentive management fee based upon positive returns-the higher the returns, the higher their fee. Hedge funds require that 65% of all investors be of the accredited type, defined as an individual or couple who have a net worth of at least $1 million, or an individual who had income in the previous year of at least $200,000, or a couple with at least $300,000 of income in the previous year. In reality, though, an investor needs much more than that.

The funds also require substantial minimum investments that can make it hard even for accredited investors to ante up. Minimums typically range from about $250,000 to $10 million. An investor gives up liquidity in hedge funds. They typically have a one-year lock-up for first-time investors.

53. HIGH-YIELD BOND bond that has RATING of BB or lower and that pays a higher yield to compensate for its greater risk. See also JUNK BOND.

54. INVESTMENT LETTER in the private placement of new securities, a letter of intent between the issuer of securities and the buyer establishing that the securities are being bought as an investment and are not for resale. This is necessary to avoid having to register the securities with the Securities and Exchange Commission. (Under provisions of SEC Rule 144, a purchaser of such securities may eventually resell them to the public of certain specific conditions are met, including a minimum holding period of at least two years.) Use of the investment letter gave rise to the terms letter stock and letter bond in referring to unregistered issues. See also LETTER SECURITY.

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56. KNOCK-OUT OPTION form of derivative that gives the buyer the right, but not the obligation, to buy an underlying commodity, currency, or other position at a preset price. Unlike regular options, however, knock-out options expire worthless, or are "knocked out" if the underlying commodity or currency goes through a particular price level. For example, a knock-out option based on the value of the U.S. dollar against the German mark gets knocked out if the dollar falls below a specified exchange rate against the

mark. Regular options can have unlimited moves up or down. Knock-out options are much cheaper to buy than regular options, allowing buyers to take larger positions with less money than regular options. Knock-out options are frequently used by hedge funds and other speculators.

57. LEVERAGE

Operating leverage: extent to which a company's costs of operating are fixed (rent, insurance, executive salaries) as opposed to variable(materials, direct labor). In a totally automated company, whose costs are virtually all fixed, every dollar of increase in sales is a dollar of increase in operating income once the BREAKEVEN POINT has been reached, because costs remain the same at every level of production. In contrast, a company whose costs are largely variable would show relatively little increase in operating income when production and sales increased because costs and production would rise together. The lever age comes in because a small change in sales has a magnified percentage effect on operating income and losses. The degree of operating leverage-the ratio of the percentage change in operating income to the percentage change in sales or units sold-measures the sensitivity of a firm's profits to changes in sales volume. A firm using a high degree of operating leverage has a breakeven point at a relatively high sales level.

Financial leverage: debt in relation to equity in a firm's capital structure-is LONG-TERM DEBT (usually bonds), PREFERRED STOCK, and SHAREHOLDERS' EQUITY-measured by the DEBT-TO-EQUITY RATIO. The more long-term debt there is, the greater the financial leverage. Shareholders benefit from financial leverage to the extent that return on the borrowed money exceeds the interest costs and the market value of their shares rises. For this reason, financial leverage is popularly called trading on the equity. Because leverage also means required interest and principal payments and thus ultimately the risk of default, how much leverage is desirable is largely a question of stability of earnings. As a rule of thumb, an industrial company with a debt to equity ratio of more than 30% is highly leveraged, exceptions being firms with dependable earnings and cash flow, such as electric utilities.

Since long-term debt interest is a fixed cost, financial leverage tends to take over where operating leverage leaves off, further magnifying the effects on earnings per share of changes in sales levels. In general, high operating leverage should accompany low financial leverage, and vice versa.

Investments: means of enhancing return or value without increasing investment. Buying securities on margin is an example of leverage with borrowed money, and extra leverage may be possible if the leveraged security is convertible into common stock. RIGHTS, WARRANTS, and OPTION contracts provide leverage, not involving borrowings but offering the prospect of high return for little or no investment.

58. MANAGEMENT FEE charge against investor assets for managing the portfolio of an open-or closed-end MUTUAL FUND as well as for such services as shareholder relations or administration. The fee, as disclosed in the PROSPECTUS, is a fixed percentage of the fund's net asset value, typically between 0.5% and 2% per year. The fee also applies to a MANAGED ACCOUNT. The management fee is deducted automatically from a shareholder's assets once a year.

59. MANAGING UNDERWRITER leading-and originating-investment banking firm of an UNDERWRITING GROUP organized for the purchase and distribution of a new issue of securities. The AGREEMENT AMONG UNDERWRITERS authorizes the managing underwriter, or syndicate manager, to act as agent for the group in purchasing, carrying, and distributing the issue as well as complying with all federal and state requirements; to member; to make sales to the selling group at a specified discount-or CONCESSION-from the public offering price; to engage in open market transactions during the underwriting period to stabilize the market price of the security; and to borrow for the syndicate account to cover costs. See also FLOTATION COST; INVESTMENT BANKER; UNDERWRITE.

60. MONEY MARKET market for SHORT-TERM DEBT INSTRUMENTS-negotiable certificates of deposit, Eurodollar certificates of deposit, commercial paper, banker's acceptances, Treasury bills, and discount notes of the Federal Home Loan Bank, Federal National Mortgage Association, and Federal Farm Credit System, among others. Federal funds borrowings between banks, bank borrowings from the Federal Reserve Bank WINDOW, and various forms of repurchase agreements are also elements of the money market. What these instruments have in common are safety and LIQUIDITY. The money market operates through dealers, MONEY CENTER BANKS, and the Open Market Trading DESK at the New York가 Federal Reserve Bank. New York가 City is the leading money market, followed by London and Tokyo. The dealers in the important money markets are in constant communication with each other and with major borrowers and investors to take advantage of ARBITRAGE opportunities, a practice which helps keep prices uniform worldwide. See also MONEY MARKET FUND.

61. MORTGAGE-BACKED CERTIFICATE security backed by mortgages. Such certificates are issued by the FEDERAL HOME LOAN MORTGAGE CORPORATION, and the FEDERAL NATIONAL MORTGAGE ASSOCIATION. Others are guaranteed by the GOVERNMENT NATIONAL MORTGAGE ASSOCIATION. Investors receive payments out of the interest and principal on the underlying mortgages. Sometimes banks issue certificaters backed by CONVENTIONAL MORTGAGES, selling them to large instiutional investors. The growth of mortgage-backed certificates and the secondary mortgage

market in which they are traded has helped keep mortgage money available for home financing. See also PASS-THROUGH SECURITY.

62. **MUNICIPAL BOND** debt obligation of a state or local government entity. The funds may support general governmental needs or special projects. Prior to the TAX REFORM ACT OF 1986, the terms municipal and tax-exempt were synonymous, since virtually all municipal obligations were exempt from federal income taxes and most from state and local income taxes, at least in the state of issue. The 1986 Act, however, divided municipals into two broad groups: (1) PUBLIC PURPOSE BONDS, which remain tax-exempt and can be issued without limitation, and (2) PRIVATE PURPOSE BONDS, which are taxable unless specifically exempted. The tax distinction between public and private purpose is based on the percentage extent to which the bonds benefit private parties; if a tax-exempt public purpose bond involves more than a 10% benefit to private parties, it is taxable. Permitted private purpose bonds (those specified as tax-exempt) are generally TAX PREFERENCE ITEMS in computing the ALTERNATIVE MINIMUM TAX, and effective August 15, 1986, are subject to volume caps. See also ADVANCE REFUNDING; GENERAL OBLIGATION BOND; HOSPITAL REVENUE BOND; INDUSTRIAL DEVELOPMENT BOND; LIMITED TAX BOND; MUNICIPAL INVESTMENT TRUST; MUNICIPAL REVENUE BOND; SINGLE STATE MUNICIPAL BOND FUND; SPECIAL ASSESSMENT BOND; TAXABLE MUNICIPAL BOND; TAX-EXEMPT SECURITY; UNDERLYING DEBT; YIELD BURNING.

63. **MUTUAL FUND** fund operated by an INVESTMENT COMPANY that raises money from shareholders and invests it in stocks, bonds, options, futures, currencies, or money market securities. These funds offer investors the advantages of diversification and professional management. A management fee is charged for these services, typically between 0.5% and 2% of assets per year. Funds also levy other fees such as 12_{B}-1 FEES, EXCHANGE FEES and other administrative charges. Funds that are sold through brokers are called LOAD FUNDS, and those sold to investors directly from the fund companies are called NO-LOAD FUNDS. Mutual fund shares are redeemable on demand at NET ASSET VALUE by shareholders. All shareholders share equally in the gains and losses generated by the fund.

Mutual funds come in may varieties. Some invest aggressively for capital appreciation, while others are conservative and are designed to generate income for shareholders. Investors need to assess their tolerance for risk before they decide which fund would be appropriate for them. In addition, the timing of buying or selling depends on the outlook for the economy, the state of the stock and bond markets, interest rates, and other factors.

64. **NEGATIVE PLEDGE CLAUSE** negative covenant or promise in an INDENTURE agreement that states the corporation will not pledge any of its assets if doing so would result in less security to the debt-holders covered

under the indenture agreement. Also called covenant of equal coverage.

65. NEGATIVE YIELD CURVE situation in which yields on short-term securities are higher than those on long-term securities of the same quality. Normally, short-term rates are lower than long-term rates because those who commit their money for longer periods are taking more risk. But if interest rates climb high enough, borrowers become unwilling to lock themselves into high rates for long periods and borrow short-term instead. Therefore, yields rise on short-term funds and fall or remain stable on long-term funds. Also called an INVERTED YIELD CURVE.

66. NONPRODUCTIVE LOAN type of commercial bank loan that increases the amount of spending power in the economy but does not lead directly to increased output; for example, a loan to finance a LEVERAGED BUYOUT. The Federal Reserve has on occasion acted to curtail such lending as one of its early steps in implementing monetary restraint.

67. OFFSHORE term used in the United States for any financial organization with a headquarters outside the country. A MUTUAL FUND with a legal domicile in the Bahamas or the Cayman Islands, for instance, is called on offshore fund. To be sold in the United States, such funds must adhere to all pertinent federal and state regulations. Many banks have offshore subsidiaries that engage in activities that are either heavily regulated or taxed or not allowed under U.S. law

68. OPEN-MARKET OPERATIONS activities by which the Securities Department of the Federal Reserve Bank of New York-popularly called the DESK-carries out instructions of the FEDERAL OPEN MARKET COMMITTEE designed to regulate the money supply. Such operations involve the purchase and sale of government securities, which effectively expands or contacts funds in the banking system. This, in turn, alters bank reserves, causing a MULTIPLIER effect on the supply of credit and, therefore, on economic activity generally. Open-market operations represent one of three basic ways the Federal Reserve implements MONETARY POLICY, the basic ways the Federal Reserve implements MONETARY POLICY, the others being changes in the member bank RESERVE REQUIREMENTS and raising or lowering the DISCOUNT RATE charged to banks borrowing from the Fed to maintain reserves.

69. OPTION PREMIUM amount per share paid by an OPTION buyer to an option seller for the right to buy (call) or sell (put) the underlying security at a particular price within a specified period. Option premium prices are quoted in increments of eighths or sixteenths of 1% and are printed in the options tables of daily newspapers. A PREMIUM of $5 per share means an option buyer would pay $500 for an option on 100 shares.

70. OUTSTANDING

1. uppaid; used of ACCOUNTS RECEIVABLE and debt obligations of all types.

2. not yet presented for payment, as a check or draft.

3. stock held by shareholders, shown on corporate balance sheets under the heading of CAPITAL STOCK issued and outstanding.

71. OVER THE COUNTER (OTC)

1. security that is not listed and traded on an organized exchange.

2. market in which securities transactions are conducted through a telephone and computer network connecting dealers in stocks and bonds, rather than on the floor of an exchange.

Over-the-counter stocks are traditionally those of smaller companies that do not meet the LISTING REQUIREMENTS of the New York Stock Exchange or the American Stock Exchange. In recent years, however, many companies that qualify for listing have chosen to remain with over-the counter trading, because they feel that the system of multiple trading by many dealers is preferable to the centralized trading opproach of the New York Stock Exchange, where all trading in a stock has to go through the exchange SPECIALIST in that stock. The rules of over-the-counter stock trading are written and enforce largely by the NATIONAL ASSOCIATION OF SECURITIES DEALERS(NASD), a self-regulatory group. Prices of over-the-counter market. Other over-the-counter markets include those for government and municipal bonds. See also NASDAQ.

72. PIPELINE term referring to the underwriting process that involves securities being proposed for public distribution. The phrase used is "in the pipeline." The entire underwriting process, including registration with the Securities and Exchange Commission, must be completed before a security can be offered for public sale. Underwriters attempt to have several securities issues waiting in the pipeline so that the issues can be sold as soon as market conditions become favorable. In the municipal bond market. the pipeline is called the "Thirty Day Visible Supply"in the Bond Buyer newspaper.

73. PORTFOLIO combined holding of more than one stock, bond, commodity, real estate investment, CASH EQUIVALENT, or other asset by an individual or institutional investor. The purpose of a portfolio is to reduce risk by diversification. See also PORTFOLIO BETA SCORE; PORTFOLIO THEORY.

74. POSITION

Banking: bank's net balance in a foreign currency.

Finance: firm's financial condition.

Investments:

1. investor's stake in a particular security of market. A LONG POSITION

equals the number of shares owned; a SHORT POSITION equals the number of shares owed by a dealer or an individual. The dealer's long positions are called his inventory of securities.

2. Used as a verb, to take on a long or a short position in a stock.

75. PREMIUM BOND bond with a selling price above face or redemption value. A bond with a face value of $1000, for instance, would be called a premium bond if it sold for $1050. This price does not include andy ACCRUED INTEREST due when the bond is bought. When a premium bond is called before scheduled maturity, bondholders are usually paid more than face value, though the amount may be less than the bond is selling for at the time of the CALL.

76. PRIMARY DEALER one of the three dozen or so banks and investment dealers authorized to buy and sell government securities in direct dealings with the FEDERAL RESERVE BANK of New York in its execution of Fed OPEN MARKET OPERATIONS. Such dealers must be qualified in terms of reputation, capacity, and adequacy of staff and facilities.

77. PRIMARY MARKET market for new issues of securities, as distinguished from the SECONDARY MARKET, where previously issued securities are bought and sold. A market is primary if the proceeds of sales go to the issuer of the securities sold. The term also applies to government securities auctions and to opening option ad futures contract sales.

78. PRIME RATE base rate that banks use in pricing commercial loans to their best and most creditworthy customers. The rate is determined by the Federal Reserve's decision to raise or lower prevailing interest rates for short-term borrowing. Though some banks charge their best customers ore and some less than the official prime rate, the rate tends to become standard across the banking industry when a major bank moves its prime up or down. The rate is a key interest rate, since loans to less-credit worthy customers are often tied to the prime rate. For example, a BLUE CHIP company may borrow at a prime rate of 8%, but a less-well-established small business may borrow from the same bank at prime plus 2, or 10%. Many consumer loans, such as home equity, automobile, mortgage, and credit card loans, are tied to the prime rate. Although the major bank prime rate is the definitive "best rate" reference point, many banks, particularly those in outlying regions, have a two-tier system, whereby smaller companies of top credit standing may borrow at an even lower rate.

79. PROXY

In general: person authorized to act or speak for another.

Business:

1. written POWER OF ATTORNEY given by shareholders of a corporation,

authorizing a specific vote on their behalf at corporate meetings, Such proxies normally pertain to election of the BOARD OF DIRECTORS or to various resolutions submitted for shareholder' approval.

2. person authorized to vote on behalf of a stockholder of a corporation.

80. RATE OF RETURN

Fixed-income securities (bonds and preferred stock): CURRENT YIELD, that is, the coupon or contractual dividend rate divided by the purchase price. See also YIELD TO AVERAGE LIFE; YIELD TO CALL; YIELD TO MATURITY.

Common stock: (1) dividend yield, which is the annual dividend divided by the purchase price. (2) TOTAL RETURN rate, which is the dividend plus capital appreciation.

Corporate finance: RETURN ON EQUITY or RETURN ON INVESTED CAPITAL.

Capital budgeting: INTERNAL RATE OF RETURN.

81. REIMBURSEMENT paying someone back for out-of-pocket expenses. For example, a company reimburses employees for their out-of-pocket business-related expenses when employees file expense reports. Insurance companies reimburse policyholders for out-of-pocket expenses incurred paying medical bills (for health insurance) or for home repairs (homeowner's insurance).

82. REPURCHASE AGREEMENT (REPO; RP) agreement between a seller and a buyer, usually of U.S. government securities, whereby the seller agrees to repurchase the securities at an agreed upon price and, usually, at a stated time. Repos, also called RPs or buybacks, are widely used both as a money market investment vehicle and as an instrument of Federal Reserve MONETARY POLICY. Where a repurchase agreement is used as a short-term investment, a government securities dealer, usually a bank, borrows from an investor, typically a corporation with excess cash, to finance its inventory, using the securities as collateral. Such RPs may have a fixed maturity date or be OPEN REPOS, callable at any time. Rates are negotiated directly by the parties involved, but are generally lower than rates on collateralized loans made by New York banks. The attraction of repos to corporations, which also have the alternatives of COMMERCIAL PAPER, CERTIFICATES OF DEPOSIT, TREASURY BILLS and other short-term instruments, is the flexibility of maturities that makes them an ideal place to "park" funds on a very temporary basis. Dealers also arrange reverse repurchase agreements, whereby they agree to buy the securities and the investor agrees to repurchase them at a later date.

The FEDERAL RESERVE BANK also makes extensive use of repurchase agreements in its OPEN MARKET OPERATIONS as a method of fine tuning the MONEY SUPPLY. To temporarily expand the supply, the Fed arranges to buy securities from nonbank dealers who in turn deposit the proceeds in their commercial bank accounts thereby adding to reserves. Timed to coincide with whatever length of time the Fed needs to make the desired adjustment, usually 1 to 5 days, the dealer repurchases the securities. Such transactions are made at the Federal Reserve DISCOUNT RATE and accounts are credited in FEDERAL FUNDS. When it wishes to reduce the money supply temporarily, the Fed reverses the process. Using a procedure called the MATCHED SALE PURCHASE TRANSACTION, it sells securities to a nonbank dealer who either draw down bank balances directly or takes out a bank loan to make payment, thereby draining reserves.

In a third variation of the Repurchase agreement, banks and thrift institutions can raise temporary capital funds with a device called the retail repurchase agreement. Using pooled government securities to secure loans from individuals, they agree to repurchase the securities at a specified time at a price including interest. Despite its appearance of being a deposit secured by government securities, the investor has neither a special claim on the securities nor protection by the FEDERAL DEPOSIT INSURANCE CORPORATION in the event the bank is forced to liquidate.

83. REVERSE LEVERAGE situation, the opposite of FINANCIAL LEVERAGE, where the interest on money borrowed exceeds the return on investment of the borrowed funds.

84. RISK PREMIUM in PORTFOLIO THEORY, the difference between the RISK-FREE RETURN and the TOTAL RETURN from a risky investment. In the CAPITAL ASSET PRICING MODEL (CAPM), the risk premium reflects market-related risk (SYSTEMATIC RISK) as measured by BETA. Other models also reflect specific risk as measured by ALPHA.

85. ROAD SHOW presentation by an issuer of securities to potential buyers about the merits of the issue. Management of the company issuing stocks or bonds doing a road show travels around the country presenting financial information and an outlook for the company and answering the questions of analysts, fund managers, and other potential investors. Also know as a dog and pony show.

86. ROLLOVER

1. movement of funds from one investment to another. For instance, an INDIVIDUAL RETIREMENT ACCOUNT may be rolled over when a person retires into an ANNUITY or other form of pension plan payout system. Balances in regular IRAs can be rolled over into ROTH IRAS, although income taxes will be due on untaxed earnings in the regular IRA account. When a BOND or CERTIFICATE OF DEPOSIT matures, the funds may be rolled over into another bond or certificate of deposit. A stock may be sold and the proceeds rolled over into the same stock, establishing a different cost basis for the shareholder.

2. term often used by banks when they allow a borrower to delay making a PRINCIPAL payment on a loan. Also a country that has difficulty in meeting its debt payments may be granted a rollover by its creditors. With governments themselves, rollovers in the form of REFUNDINGS or REFINANCINGS are routine.

87. SAMURAI BONDS bonds denominated in yen issued by non-Japanese companies for sale mostly in Japan. The bonds are not subject to Japanese withholding taxes, and therefore offer advantages to Japanese buyers.

88. SECONDARY MARKET

1. exchanges and over-the-counter markets where securities are bought and sold subsequent to original issuance, which took place in the PRIMARY MARKET. Proceeds of secondary market sales accrue to the selling dealers and investors, not to the companies that originally issued the securities.

2. market in which money-market instruments are traded among investors.

89. SOFT DOLLARS means of paying brokerage firms for their services through commission revenue, rather than through direct payments, known as hard-dollar fees. For example, a mutual fund may offer to pay for the research of a brokerage firm. The broker might agree to this arrangement if the fund manager promises to spend at least $100,000 in commission with the broker that year. Otherwise, the fund would have to pay a hard-dollar fee of $50,000 for the research. Compare with HARD DOLLARS.

90. SOVEREIGN RISK risk that a foreign government will default on its loan or fail to honor other business commitments because of a change in national policy. A country asserting its prerogatives as an independent nation might prevent the REPATRIATION of a company or country's funds through limits on the flow of capital, tax impediments, or the nationalization of property. Sovereign risk became a factor in the growth of international debt that followed the oil price increases of the 1970s. Several developing countries that borrowed heavily from Western banks to finance trade deficits had difficulty later keeping to repayment schedules. Banks had to reschedule loans to such countries as Mexico and Argentina to keep them from defaulting. These loans ran the further risk of renunciation by political leaders, which also would have affected loans to private companies that had been guaranteed by previous governments. Beginning in the 1970s, banks and other multinational corporations developed sophisticated analytical tools to measure sovereign risk before committing to lend, invest, or begin operations in a given foreign country. Throughout periods of worldwide economic volatility, the United States has been able to attract foreign investment because of its perceived lack of sovereign risk. Also called country risk or political risk.

91. SPREAD

Commodities: in futures trading, the difference in price between delivery months in the same market, or between different or related contracts.

Fixed-income securities: (1) difference between yields on securities of the same quality but different maturities. For example, the spread between 6% short-term Treasury bills and 10% long-term Treasury bonds is 4 percentage points (2) difference between yields on securities of the same maturity but different quality. For instance, the spread between a 10% long-term Treasury bond and a 14% long-term bond of a B-rated corporation is 4 percentage points, since an investor's risk of default is so much less with the Treasury bond.

Foreign exchange: spreading one currency versus another, or multiple spreads within various currencies. An example would be a long position in the U.S. dollar versus a short position in the Japanese yen or the Euro. An example of an intermonth spread would be a long March spot position in Swiss france versus a short March position in market. Interest rate differentials often have significant impact.

Options: position usually consisting of the long call and one short call option, or one long put and one short put option, with each option representing one "leg" of the spread. The two legs, if taken independently, would profit from opposite directional price movements. Spreads usually have lower cost and lower profit potential than an outright long option. They are entered into to reduce risk, or to profit from the change in the relative prices of the options.

Stacks and bonds: (1) difference between the bid and offer price. If a stock is bid at $45 and offered at $46, the spread is $1. This spread narrows or widens according to supply and demand for the security being traded. (2) difference between the high and low price of a particular security over a given period.

Underwriting: difference between the proceeds an issuer of a new security receives and the price paid by the public for the issue. This spread is taken by the underwriting syndicate as payment for its services. A security issuer receives $98 from the offering.

92. STOCK OPTION

1. right to purchase or sell a stock at a specified price within a stated period. OPTIONS are a popular investment medium, offering an opportunity to hedge positions in other securities, to speculate in stocks with relatively little investment, and to capitalize on changes in the MARKET VALUE of options contacts themselves through a variety of option strategies.

2. widely used form of employee incentive and compensation, usually for the executives of a corporation. The employee is given an OPTION to purchase its shares at a certain price (at or below the market price at the time the option is granted) for a specified period of year.

93. SUBORDINATED junior in claim on assets to other debt, that is, repayable only after other debts with a higher claim have been satisfied. Some

subordinated debt may have less claim on assets than other subordinated debt; a junior subordinated debenture ranks below a subordinated DEBENTURE, for example.

It is also possible for unsubordinated (senior) debt to become subordinated at the request of a lender by means of a subordination agreement. For example, if an officer of a small company has made loans to the company instead of marking a permanent investment in it, a bank might request the officer's loan be subordinated to its own loan as long as the latter is outstanding. This is accomplished by the company officer's signing a subordination agreement.