GLOSSARY

Active portfolio strategy
A strategy that uses available information and forecasting techniques to seek better performance than a buy and hold portfolio. Related: Passive portfolio strategy.

Alpha
Measure of risk-adjusted performance. An alpha is usually generated by regressing the security or mutual fund's excess return on the S&P 500 excess return. The beta adjusts for the risk (the slope coefficient). The alpha is the intercept. Example: Suppose the mutual fund has a return of 25%, and the short-term interest rate is 5% (excess return is 20%). During the same time the market excess return is 9%. Suppose the beta of the mutual fund is 2.0 (twice as risky as the S&P 500). The expected excess return given the risk is 2 x 9%=18%. The actual excess return is 20%. Hence, the alpha is 2% or 200 basis points. Alpha is also known as the Jensen Index.

Arbitrage Pricing Theory (APT)
An alternative model to the capital asset pricing model developed by Stephen Ross and based purely on arbitrage arguments. The APT implies that there are multiple risk factors that need to be taken into account when calculating risk-adjusted performance or alpha.

Benchmark
The performance of a predetermined set of securities, used for comparison purposes. Such sets may be based on published indexes or may be customized to suit an investment strategy.

Beta
The measure of a fund's or a stock's risk in relation to the market or to an alternative benchmark. A beta of 1.5 means that a stock's excess return is expected to move 1.5 times the market excess returns. E.g., if market excess return is 10%, then we expect, on average, the stock excess return to be 15%. Beta is referred to as an index of the systematic risk due to general market conditions that cannot be diversified away.

Capital Asset Pricing Model (CAPM)
An economic theory that describes the relationship between risk and expected return, and serves as a model for the pricing of risky securities. The CAPM asserts that the only risk that is priced by rational investors is systematic risk, because that risk cannot be eliminated by diversification. The CAPM says that the expected return of a security or a portfolio is equal to the rate on a risk-free security plus a risk premium multiplied by the assets systematic risk. Theory was invented by William Sharpe (1964) and John Lintner (1965).

Capitalization method
A method of constructing a replicating portfolio in which the manager purchases a number of the most highly capitalized names in the stock index in proportion to their capitalization.

Delta
The ratio of the change in price of a call option to the change in price of the underlying stock. Also called the hedge ratio. Applies to derivative products. Measure of the relationship between an option price and the underlying futures contract or stock price. For a call option, a delta of 0.50 means a 50 cent rise in option price for every dollar that the stock goes up. As options near expiration, in-the-money call option contracts approach a delta of 1.0, while in the money put options approach a delta of -1.

Delta hedge
A dynamic hedging strategy using options that involves the constant adjustment of the number of options used, as a function of the delta of the option.

Diversification
Dividing investment funds among a variety of securities with different risk, reward, and correlation statistics so as to minimize unsystematic risk.

Enhanced indexing
Also called indexing-plus, an indexing strategy whose objective is to exceed or replicate the total return performance of some predetermined index.

Fair value
In the context of futures, the equilibrium price for futures contracts. Also called the theoretical futures price, which equals the spot price continuously compounded at the cost of carry rate for some time interval. More generally, fair value for any asset simply refers to the perception that it is neither underpriced (too cheap) nor overpriced (too expensive).

Index fund
Investment fund designed to match the returns on a stock market index. Mutual fund whose portfolio matches that of a broad-based index such as the S&P 500 and whose performance therefore mirrors the market as represented by that index.

Incremental costs and benefits
Costs and benefits that would occur if a particular course of action is taken, compared to those that would have obtained if that course of action had not been taken.

Lambda
The ratio of a change in the option price to a small change in the option volatility. It is the partial derivative of the option price with respect to the option volatility.

Optimization approach to indexing
An approach to indexing that seeks to optimize some objective, such as to maximize the portfolio yield, to maximize convexity, or to maximize expected total returns.

Passive portfolio strategy
A strategy that involves minimal expectational input, and instead relies on diversification to match the performance of some market index. A passive strategy assumes that the marketplace will reflect all available information in the price paid for securities, and therefore, does not attempt to find mispriced securities. Related: Active portfolio strategy.

Portfolio insurance
A strategy using a leveraged portfolio in the underlying stock to create a synthetic put option. The strategy's goal is to ensure that the value of the portfolio does not fall below a certain level.