Ethical Investors

GLOSSARY OF FINANCIAL TERMS

A

Accrual - this term is used to describe the way in which company pension scheme benefits are accumulated. The rate of accrual, in conjunction with the number of years of membership, determines the amount of pension. For example, the standard maximum rate of accrual allowed by the Inland Revenue is 1/60th per year. After 40 years' service, a member would be able to retire on a pension of 40/60ths of final working salary, or 2/3rds. The common rate of accrual is 1/80th per year for the NHS, Civil Service, Local Government and Teachers' Pension Schemes.

Added years – if you are a member of a company pension scheme, and will not receive the maximum benefit from the scheme, it may be possible to buy extra years' service in the scheme. This only applies to final salary arrangements, where purchasing extra years will give a guarantee of a higher pension in retirement. See also AVCs.

Additional Voluntary Contributions (AVCs) – if you are a member of your employer's pension scheme, but will not receive maximum pension benefits, you can make additional voluntary contributions, or top-up payments, over and above any contribution to the main pension scheme. Payment can be made to an 'in-house' arrangement, or to a 'free standing' arrangement. The former is a scheme set-up by and run by the company offering the main company pension scheme. The latter arrangement is one an individual sets up with an insurance company of their choice. This is the option followed by most ethical investors, as it allows the individual and their adviser to choose the best company offering the most suitable ethical fund.

Annuity - this is a payment for a fixed term or for life. Conventionally, an annuity is bought with a lump sum from a Pension policy, at the time of retirement. An annuity can be bought at any time an income is needed. Once bought, an annuity cannot normally be changed by the applicant or the insurance company. For this reason, careful consideration is needed when selecting the company. If you are retiring with a Personal Pension fund, you do not have to buy the annuity form your pension company. All companies offer the Open market Option, whereby your accumulated fund can be transferred free of charge to the insurance company offering the best annuity rates.

Annual Management Charge - when money is invested with an insurance or investment company, the fees for managing the funds are usually expressed as a percentage of the amount invested. This is known as the Annual Management Charge. This charge is solely for the management of money, and is separate to any charges relating to the specific product. (see also TER).

Appreciation – see Capital Growth

B

Bonds - this is a term that is used to describe a number of investment instruments, and can often be misleading. Traditionally, the term bond is used to describe a loan from one organisation to another company or an individual. The Bond will have a redemption date, and during the term of the loan the issuing company pays a pre-determined rate of interest. Examples are Corporate Bonds and Gilts (issued by Governments). Another contract often referred to as a Bond is a lump sum investment contract issued by a life company, more properly called an Insurance/Investment Bond (see later). Banks and Building Societies also have savings accounts they call Bonds; this normally describes an account which has a fixed rate of interest and the account must be held for a minimum fixed term.

Bid/Offer spread - when money is invested, whether it is as a lump sum or a regular payment to almost any plan, your money buys units in the fund of your choice. The units are bought at the offer price. IN other words, if you invest £1000, and the offer price is £1, you will buy 1000 units in the fund. When you want to value your investment, you do not use the offer price, but a lower price known as the Bid price. The difference between the offer price and the bid price is known as the Bid/Offer spread. This is a charge the investment company will make when setting-up your plan. In virtually all cases where there is a Bid/Offer spread, there will be no charges levied when you sell your investment. You are therefore paying at the time the investment is made, but there will be no charge when the investment is redeemed.

C

Capital Growth - increasing the value of your money to keep pace with inflation is an essential part of financial planning. The act of increasing value is known as capital growth. Houses increase in value over time, Building Society accounts increase when interest is added and shares increase over time (although share prices can fall as well as rise). All of this appreciation is capital growth. If the rate of growth is less than inflation, then effectively your money is devaluing over time.

Historically, this is most usually case for small to medium size amounts held in Building Society accounts. If the rate of growth is the same as the rate of inflation, your funds have effectively stood still, neither increasing nor decreasing. If the capital growth rate is more than the prevailing rate of inflation, then your capital has growth in real terms, in other words you are adding real value to your funds. Over the medium to long term, real capital growth is best achieved via investment in stocks and shares.

Collective Investments - these are investments involving the pooling of the funds of a large number of people. By pooling funds the collective buying power is significantly improved. This allows a larger number of shares to be bought by the group, thus ensuring the widest possible spread of risk. You also benefit from the investment expertise of the managers appointed to run the funds. The most common forms of collective investments are Unit Trusts and Investment Trusts.

Commission - this used to be the most common method of remuneration for the majority of financial advisers, whether they are independent advisers, or agents of a particular company (this includes **banks** and **building societies**). The insurance company issuing the relevant policy makes the commission payment; it is not paid directly by the client. The commission cost is included as part of the overall charges levied by the insurance or investment company. Whether one is investing a lump sum or making regular payments, the policy charges will include an element to cover the commission payment. Since January 2013 commission payments have been banned on the majority of investment/pension contracts. Advisers are required to charge a fee for initial and ongoing advice, although commission can still be paid on pure life assurance policies.

Company pension scheme - this is a plan established by an employer for the benefit of employees. Employees can elect to join this scheme, although since March 1988 scheme membership cannot be made a condition of service. Under most circumstances it is accepted as best practice to join an employer's pension scheme. However, individual circumstances may mean that some may be better off with a Personal Pension or other retirement plan. Company pension schemes can either be administered on a FINAL SALARY or MONEY PURCHASE basis. It is common for Company Schemes to include additional benefits such as Death in Service or Permanent Health Insurance.

Compound interest – the accrual of interest where the earned interest is added to the original capital and future interest is earned on the increasing sum.

Corporate Bonds – these are loans issued by trading companies where a fixed rate of interest is paid over a fixed term, at the end of which the company pays back the loan. Once issued, the Bonds can be traded on the market and the capital price of the Bond will fluctuate based on market conditions and sentiment.

CPI (Consumer Price Index) – this is now beginning the replace RPI as a general measure of the rate at which prices are increasing. The items included in the 'basket' of goods and services is broader than those used for RPI and are therefore felt to be more reflective of the actual rate of price increase that people are finding in their daily lives.

Critical Illness Cover - it is possible to have an insurance policy that will pay a lump sum on the diagnosis of a critical illness. The most common illnesses covered are heart attack, stroke and cancer, but these plans can cover an extremely wide range of serious and debilitating illness such as Multiple Sclerosis, Parkinson's Disease, M.E. and Alzheimer's Disease. The purpose of the plan is to provide a lump sum at what is likely to be a very difficult time. If a change in lifestyle is needed, a lump sum in the bank will make the decision making process easier.

D

Discretionary Fund Management - the safest way to invest in the stock market for smaller sums (below £100,000) is via a collective investment scheme such as a Unit Trust. However, if an individual, charity or company has a larger sum to invest it is possible to obtain the spread of risk in the same way as a Unit Trust. A Discretionary Fund Management arrangement allows a personal investment portfolio to be established, taking into account both personal ethical and financial criteria. Ethical Investors, where applicable, can introduce clients to a select number of managers who are familiar with running ethically screened portfolios. Via our sister company, Ethical Screening, we can also offer a comprehensive and personalised ethical screening service.

Dividend - when a trading company makes a profit, it is common to distribute this profit to those who own the company. This distribution of profit is called a dividend payment. This payment is treated as income by the shareholder, and is often referred to as the yield. This annual income is separate to the movement in the share price, and this is the fundamental difference between investing in the stock market and investing in Bank or building society accounts.

Defined Benefit scheme - this term refers to the way a company pension scheme is administered. Often referred to as a Final Salary scheme, the benefits on retirement are expressed as a percentage of final working salary, the amount being dependent upon the rate of ACCRUAL. Schemes established on this basis are usually considered to be the best pension schemes, although younger employees who are unlikely to stay with their employer for very long may benefit from a MONEY PURCHASE arrangement.

Defined Contribution Scheme - this term refers to the way a company pension scheme is administered. Unlike a final salary scheme where the retirement benefits are clearly defined, under a Defined Contribution Scheme it is the premium/investment which is defined, and the pension benefits which are unknown. On retirement, a member's pension is dependent upon the size of the investment fund that has been built-up.

The two factors influencing the size of the fund are the amount of money that has been invested and the rate of investment return achieved over the years. For younger employees with short service, the investment of their funds for maximum profit may provide higher benefits than under a Defined Benefit Scheme.

E

Equities – a generic term used to describe shares.

Escalation - when starting an individual pension it is possible to elect for the premiums to rise by a predetermined rate each year. The rise can be by a fixed percentage, the prevailing rate of inflation or the National Average Earnings Index. The same term can also be used for protection policies such as Level Term Assurance, Family Income Benefit, Critical Illness and Permanent Health Insurance, where the amount of benefit, and the premiums, rise each year.

F

Family Income Benefit - rather than receive a lump sum in the event of death, as one would with a Level Term Assurance plan, cover can be arranged as a Family Income Benefit. The cover is paid out in the form of an income from the date of death until the expiry of the policy. This income would be completely free of all taxes, the benefits are guaranteed and can rise in line with inflation, or by a fixed amount each year.

Fixed Interest – a term used to describe investments such as Corporate Bonds and Gilts. A fixed level of interest, based on the original issue value is paid during the fixed term of the contract. At the end the investment is redeemed at the original issue price. Between issue and redemption the capital value can fluctuate due to factors such as market sentiment and interest rates

Free Standing AVC - see AVC

Fund - when investing with an insurance or investment company, the premiums of individuals are 'pooled' together in a single fund. This large fund can buy and sell shares more economically and with a wider spread than any individual could achieve on their own.

G

Gilts - these are loans made to the Government, also known as Government Stock. The stock is bought by an individual, either directly from the National Stock Register, or via a stockbroker. The Gilts are issued for a fixed term, and during the term a guaranteed rate of interest will be paid. At the end of the term a guaranteed sum is returned to the investor. If the Gilt was bought when originally issued, the investment would have produced a steady level of income and the original investment will have been returned. If the stock was bought after issue, and the price paid for the stock was below the guaranteed price, known as par, then on maturity a capital gain will have been achieved. This gain is exempt from Capital Gains Tax. If, however, the stock was purchased at a price above par, then on maturity there will be a capital loss.

Growth - this is a term usually associated with investment in the stock market. It refers to the increase on the amount originally invested. This is also referred to as the increase in capital.

H

Hedge – this is a term is used in many different ways in investment circles but for the purposes of offering advice you might see us refer to it when we recommend investments to you. If we had a crystal ball and knew exactly which fund would be the best to hold over the next 10 years, then we would only ever recommend that fund to our clients. We don't have one, so we 'hedge' our advice by recommending a range of funds. In this way, there is a better chance that you will have some money in the best performing fund and, crucially, won't have all your money in the worst performing fund. In a similar way a fund manager hedges when they run an ethical fund; if they knew the best single company to invest in they would only buy shares in that company. Instead, they will invest in a range of companies across different sectors and areas to spread the risk or 'hedge' their investment decisions. As with all investment, the main aim is to have a basket where the number of things doing well outnumber the number of things that are doing badly!

Hedge Fund – similar to a Unit Trust or OEIC, but often far less transparent. There are no ethical Hedge Funds available to us and these do not, therefore, form part of the advice offered to clients

I

Index-linked - this term is used to describe the linking of an item to the rate of inflation.

Inflation – this is the rate at which the price of goods and services rises each year. When one is investing or saving, it is essential that each year the rate of growth or interest one achieves each year at least matches the rate of inflation. If this does not happen, the real value of one's money reduces. If this continues over several years the buying power of one's money can be seriously reduced. Historically, this is the situation most commonly found with Building Society investments.

Interest - this is the common term used to describe the rate of return on money deposited in Building Society and Bank accounts. It is also used in relation to the income received on investments in GILTS. On the opposite side, interest is charged on loans.

Interest only mortgage - during the term of the mortgage, only interest on the loan is paid to the lender. At the end of the term the original capital sum borrowed must be repaid to the lender. This capital sum can come from a maturing endowment policy, Personal Equity Plans or even a Personal Pension.

Investment Trust - this is a trading company which is established with the sole aim of using the capital raised from its share issues to invest on the stock market. The profit a company makes determines the overall value of the shares. Unlike a Unit Trust, however, there is an additional factor influencing the value of the shares. As the shares in the company are freely traded, just like any other quoted company, the stock market sentiment towards the company will have an influence on the value of the shares. If there is great demand for the shares, the value will rise. If there is little interest the value will fall. Therefore, even if the underlying investments are increasing in price, if the MARKET in general does not favour the shares the price per share could fall in value.

Individual Savings Account (ISA) – technically now known as a NISA because the old Cash and Stocks & Shares options have been merged into a single "put it where you want to" allowance. All interest paid on cash holdings is free of tax and all capital growth from investment options is free of capital gains tax. If Corporate Bonds are held in an ISA the income paid is also free tax (received gross). There are ethical options for Cash, Fixed Interest and share based ISAs.

J

Joint life – this is a term used to describe the owners of, normally, a life assurance policy. If there is only one person insured on a policy, it is known as a single life plan. Where a protection policy is arranged with, say, a husband and wife as the people covered by the plan, it is known as 'joint life'. A joint life plan can be 'first death' or 'second death'. The former means that the policy pays out when the first of the insureds dies (after which the policy ceases) and the latter only pays out on the death of the second of the two policyholders to die. Each variation has its own place in financial planning when using protection policies to cover liabilities, debts or as part of estate planning. It is also possible to have a 'joint life' annuity, where the ongoing income for life is paid to one person and then continues on their death to the survivor until they die.

K

Key person insurance – this type of insurance policy is usually taken out by a business (or charity) where the organisation would stand to suffer significant loss of income/profits if a key member of staff were to die or become unable to work. The insurance policy provides a lump sum or ongoing income to the business to allow the organisation to buy in the expertise of the deceased member of staff until such time as a replacement can be found.

L

Level Term Assurance – see Term Assurance

M

Money Purchase - this term is used to describe the way pension benefits accrue, either in a Personal Pensions, AVC or a Defined Contribution Company Pension Scheme. The value of the pension fund on retirement depends upon the amount of money which has been invested and the rate of growth achieved.

Market (the) - see Stock Market

N

National Savings - a way of saving with the Government, rather than a Bank or Building Society. The products include Premium Bonds, Index-Linked certificates, Pensioner Bonds and Children's Bonds. In some cases the rates of interest are tax free, others are paid without deduction of tax, but tax may be due if the investor is a taxpayer.

National Average Earnings Index- each year a figure is published for the average national income. Comparing one year with the previous year's average income will give the average rise. Historically, incomes rise at a faster rate than inflation. Therefore, a pension in retirement which is linked to the National Average Earnings Index, will rise much faster over the years than one linked to RPI.

O

Open Ended Investment Company – very similar to a Unit Trust, but the fund has a single pricing structure (does not have a bid/offer spread). Most investment companies have progressively switched their Unit Trusts to OEICs as it provides them and investors with greater flexibility. (see Unit Trust).

Open Market Option (OMO) – most commonly associated with Personal Pensions where investors have the right to take their accumulated pot, free of any charges, to any other pension/annuity provider at the point of retirement.

P

Permanent Health Insurance (PHI) – these plans provide a regular income in the event of your becoming unable to work through accident or illness. The income is paid to you either until you return to work or until your normal retirement date. In the event of a claim, the payment of the income will start after an agreed period, known as either the Waiting Period or the Deferred Period. The longer the period between the accident or illness and the date of the first payment, the lower the premium.

Pound cost averaging – if you invest a one-off amount on a single day, the markets could move up or down shortly after you invest. If markets go down, then with hindsight it would have been better to wait and invest your lump sum after the fall.

We can't use foresight to tell us when to invest and hindsight can't unravel an investment that has already been made so it is possible to invest the same one off amount in small sums spread over time (days, weeks or months). By spreading the investment dates it smoothes out the price at which you eventually invest in the markets. If prices fall after the first investment the second investment will buy into the market at a lower price and therefore benefit more quickly when things turn up again. Most pension investment automatically takes advantage of pound cost averaging because most pension contributions are invested monthly. Thos who invest in an ISA, for example, at £X per month also benefit from the long term effect of smoothing out the investment dates.

R

Repayment Mortgage – under such a mortgage arrangement, your monthly payments to the lender consist of both capital and interest. Over the course of the mortgage you slowly repay the capital until on expiry of the mortgage term the loan is fully repaid.

Retail Prices Index (**RPI**) – simply, this is the rate by which the prices of goods have increased, usually expressed as the increase over the previous year. There are different permutations of RPI, one figure including mortgage interest and the other excluding this factor. When investing, it is vital that all of one's investments at the very least keep pace with inflation. This means that over the years your capital can buy the same goods, even though their prices are rising. If your investments achieve a rate of return higher than inflation, this is known as real growth. The difference between the growth achieved and RPI is called the real rate of return (see also CPI).

Risk - it is important to understand the real meaning of risk. Money that is held in a deposit account seems to be safe, but it is not really secure in the long term if it is declining in value because of inflation, i.e. the rate of interest being earned is less than the rate of inflation. Over the long term, shares have generally provided substantially higher returns for investors than cash deposits or fixed-interest securities. However, shares can fluctuate in value and should not normally be regarded as short-term investments. Therefore, striking a balance between cash and shares is essential when constructing an investment strategy.

S

Securities – a generic name used to describe things such as Corporate Bonds and Gilts.

Shares – shares are the 'commodity' of the stock market. Companies issue shares in order to raise capital to fund the business. These shares are freely traded on the stock market. The value of shares varies depending upon the demand for each share. Where there is an excess of buyers, a share price moves up. Where there is an excess of sellers, the share price moves down.

Stock market – commonly abbreviated to *the market*, this is where stocks and shares are traded. These shares can be bought and held by individuals or more commonly the shares are bought and held in investment funds such as Unit Trusts, OEICs and Investment Trusts.

T

TER (Total Expense Ratio) – traditionally the ongoing annual charge on an investment fund, the AMC, was all that was quoted, and used to compare one fund to another. In the spirit of greater transparency, funds are now quoting their TER. The TER is mostly made up of the AMC, but does have, on top, small extra charges that apply to the fund, such as trading fees, legal fees, auditor fees and other operational expenses. For example, on a 'clean share class' investment fund with an AMC of 0.75%, the extras might amount to 0.15%, bringing the total cost of investing in the fund to 0.9%. Whilst AMCs on most funds tend to be the same, we do find that the TER can be quite different form fund to fund. However, it is not necessarily the case that a fund with a higher TER is worse than a cheaper fund; we need to look at why a fund has higher charges and are they justify. If, for example, the fund manager is more active in trading shares and this has generated a higher overall investment return compared to the fund's peers, then the higher dealing charges reflected in the higher TER are completely justified.

Term Assurance - Under a Term Assurance contract, you select the level of cover and the term of the policy. If death occurs within the term, the Sum Assured is paid-out as a one off lump sum. This lump sum is normally invested to generate an income to replace that that has been lost, to pay-off a Mortgage or to assist with the costs of paying other people to look after children. The amount of income generated will depend upon where the money is invested and economic conditions at the time.

Top-up Pensions – see AVCs

U/ V

Unit Trust – a unit trust is a pooled fund of stock market investments divided into equal portions called units. Many thousands of investors pool their funds in a Unit Trust and are given a number of units, relating to the amount invested. The unit prices are calculated regularly - normally on a daily basis. Two prices are quoted: the higher - offer price - is the price the investor pays to buy units and the lower - bid price - is the price that the investor will receive on selling units. Unit trusts normally pay dividends to investors twice a year. The dividends from Unit Trusts are known as the Yield. The price of units is governed by the value of the underlying securities in the fund. This price will rise and fall with movements in the price of assets in which the unit trust is invested. The value of a unit trust investment and the income from it can therefore go down as well as up.

W

Whole of Life policies– these are life assurance policies which offer a combination of savings and protection. They are reasonably flexible contracts where the savings/life cover ratio can be amended to suit your changing circumstances. At times when you need the highest level of cover a lower proportion will go into savings and vice versa. The plans can be surrendered at any time, and the longer the plans are in force the greater the possible surrender value. However, these plans should not be seen as savings schemes, but protection policies. If cover is no longer needed and the plan has a cash-in value, that should be seen as an advantage. As savings plans in their own right, they are very poor vehicles.

X/Y/Z

Yield – this is a term which can cause great confusion amongst new investors. We are all used to the way Building Societies and Banks present their interest rates to us, but when it comes to investment on the stock market there is a significant difference in the way the information is presented. If you think of the rate of interest from a Building Society account as being the yield, you know how much your account will grow by each year. However, when considering investment in shares (and this includes Personal Equity Plans, Unit Trusts, Investment Bond and any other plan containing shares), the term yield does not describe growth.

If you buy a share in XYZ Plc, you will pay the buying price for the share. When you wish to sell, you will e offered the prevailing sale price for your share. When you do sell, the intention is that you are selling at a higher price than you paid for the share. This is the growth associated with your investment. Whilst you hold the share in XYZ, the company will pay two dividends each year, representing your share in the company's profits. These dividend payments are known as the YIELD on the share. Therefore, when comparing an investment in a Building Society account with a share, the interest rate is on the former the yield, but with the share the yield is the amount of dividend income you receive. On top of this you are aiming for growth in the value of the share as well.

Ethical
Investors

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