Glossary

Note:
1. *Italicized* words are listed elsewhere in the glossary.
2. A number of Web sites contain comprehensive financial glossaries. See, for example, **www.finance-glossary.com** and **www.duke.edu/~ charvey/Classes/wpg/glossary.htm**.

A

Abnormal return Part of return that is not due to marketwide price movements.

Absolute priority Rule in bankruptcy proceedings whereby senior creditors are required to be paid in full before junior creditors receive any payment.

Accelerated depreciation Any *depreciation* method that produces larger deductions for depreciation in the early years of a project's life.

Accounts payable (payables, trade debt) Money owed to suppliers.

Accounts receivable (receivables, trade credit) Money owed by customers.

Accrued interest Interest that has been earned but not yet paid.

ACH *Automated Clearing House.*

Acid-test ratio *Quick ratio.*

Adjusted present value (APV) *Net present value* of an asset if financed solely by equity plus the *present value* of any financing side effects.

ADR *American depository receipt.*

Adverse selection A situation in which a pricing policy causes only the less desirable customers to do business, e.g., a rise in insurance prices that leads only the worst risks to buy insurance.

Affirmative covenant Loan *covenant* specifying certain actions that the borrower must take.

Agency costs Losses that arise when an agent (e.g., a manager) does not act solely in the interests of the principal (e.g., the shareholder).

Agency theory Theory of the relationship between a principal, e.g., a shareholder, and an agent of the principal, e.g., the company's manager.

Aging schedule Summary of age of *receivables* that are outstanding from each customer.

AIBD Association of International Bond Dealers.

All-or-none underwriting An arrangement whereby a security issue is canceled if the *underwriter* is unable to resell the entire issue.

Alpha Measure of portfolio return adjusted for effect of market.

Alternative minimum tax (AMT) A separately calculated minimum amount of tax that must be paid by corporations or individuals.

American depository receipt (ADR) A certificate issued in the United States to represent shares of a foreign company.

American option *Option* that can be exercised any time before the final exercise date (cf. *European option*).

Amex American Stock Exchange.

Amortization (1) Repayment of a loan by installments; (2) allowance for *depreciation.*

AMT *Alternative minimum tax.*

Angel investor Wealthy individual who provides capital for small start-up businesses.

Annual percentage rate (APR) The interest rate per period (e.g., per month) multiplied by the number of periods in a year.

Annuity Investment that produces a level stream of cash flows for a limited number of periods.

Annuity due *Annuity* whose payments occur at the start of each period.

Annuity factor *Present value* of $1 paid for each of *t* periods.

Anticipation Arrangement whereby customers who pay before the final date may be entitled to deduct a normal rate of interest.

Appraisal rights A right of shareholders in a *merger* to demand the payment of a fair price for their shares, as determined independently.

Appropriation request Formal request for funds for a capital investment project.

APR *Annual percentage rate.*

APT *Arbitrage pricing theory.*

APV *Adjusted present value.*

Arbitrage Purchase of one security and simultaneous sale of another to give a risk-free profit.

"Arbitrage" or "risk arbitrage" Often used loosely to describe the taking of offsetting positions in related securities, e.g., at the time of a takeover bid.

Arbitrage pricing theory (APT) Model in which expected returns increase linearly with an asset's sensitivity to a small number of pervasive factors.

Arranger Lead *underwriter* to a *syndicated loan.*

Articles of incorporation Legal document establishing a corporation and its structure and purpose.

Asian currency units Dollar deposits held in Singapore or other Asian centers.

Asian option *Option* based on the average price of the asset during the life of the option.

Asked price (offered price) Price at which a dealer is willing to sell (cf. *bid price*).

Asset-backed securities Securities issued by a special-purpose company that holds a package of assets whose cash flows are sufficient to service the *bonds.*

Asset stripper Acquirer who takes over firms in order to sell off a large part of their assets.

Asymmetric information Difference in information available to two parties, e.g., a manager and investors.

At-the-money option Option whose exercise price equals the current asset price (cf. *in-the-money option, out-of-the-money option*).

Auction market Securities exchange in which prices are determined by an auction process, e.g., *NYSE* (cf. *dealer market*).

Auction-rate preferred A variant of *floating-rate preferred* stock where the dividend is reset every 49 days by auction.

Authorized share capital Maximum number of shares that a company can issue, as specified in the firm's *articles of incorporation.*

Automated Clearing House (ACH) Private electronic system run by banks for high-volume, low-value payments.

Automatic debit *Direct payment.*

Availability float Checks deposited by a company that have not yet been cleared.

Aval Bank guarantee for debt purchased by *forfaiter.*

B

BA *Banker's acceptance.*

Backdating Discredited practice of using hindsight to select a grant date for at-the-money executive stock *options* when the stock price (and therefore *exercise price*) were unusually low.

Backwardation Condition in which *spot price* of commodity exceeds price of *future* (cf. *contango*).

Balloon payment Large final payment (e.g., when a loan is repaid in installments).

Bank discount Interest deducted from the initial amount of a loan.

Banker's acceptance (BA) Written demand that has been accepted by a bank to pay a given sum at a future date (cf. *trade acceptance*).

Barrier option *Option* whose existence depends on asset price hitting some specified barrier (cf. *down-and-out option, down-and-in option*).

Basel Accord International agreement on the amount of capital to be maintained by large banks to support their risky loans.

Basis point (bp) .01%.

Basis risk Residual risk that results when the two sides of a hedge do not move exactly together.

Bearer security Security for which primary evidence of ownership is possession of the certificate (cf. *registered security*).

Bear market Widespread decline in security prices (cf. *bull market*).

Behavioral finance Branch of finance that stresses aspects of investor irrationality.

Benchmark maturity Maturity of a newly issued Treasury bond.

Benefit–cost ratio One plus *profitability index.*

Bermuda option *Option* that is exercisable on discrete dates before maturity.

Best-efforts underwriting An arrangement whereby *underwriters* do not commit themselves to selling a security issue but promise only to use best efforts.

Beta Measure of *market risk.*

Bid price Price at which a dealer is willing to buy (cf. *asked price*).

Big Board Colloquial term for the New York Stock Exchange.

Bill of exchange General term for a document demanding payment.

Bill of lading Document establishing ownership of goods in transit.

Binomial method Method for valuing *options* that assumes there are only two possible changes in the asset price in any one period.

Blue-chip company Large and creditworthy company.

Blue-sky laws State laws covering the issue and trading of securities.

Boilerplate Standard terms and conditions, e.g., in a debt contract.

Bond Long-term debt.

Bond rating Rating of the likelihood of bond's default.

Bookbuilding The procedure whereby *underwriters* gather nonbinding indications of demand for a new issue.

Book entry Registered ownership of stock without issue of stock certificate.

Book runner The managing *underwriter* for a new issue. The book runner maintains the book of securities sold.

Bought deal Security issue where one or two *underwriters* buy the entire issue.

BP *Basis point.*

Bracket A term signifying the extent of an *underwriter's* commitment in a new issue, e.g., major bracket, minor bracket.

Break-even analysis Analysis of the level of sales at which a project would just break even.

Bridge loan Short-term loan to provide temporary financing until more permanent financing is arranged.

Bull–bear bond *Bond* whose *principal* repayment is linked to the price of another security. The bonds are issued in two *tranches:* In the first the repayment increases with the price of the other security; in the second the repayment decreases with the price of the other security.

Bulldog bond *Foreign bond* issue made in London.

Bullet payment Single final payment, e.g., of a loan (in contrast to payment in installments).

Bull market Widespread rise in security prices (cf. *bear market*).

Butterfly spread The purchase of two *call options* with different *exercise prices* and simultaneous sale of two calls exercisable at the average of these two exercise prices. Provides a bet that the share price will stay within a narrow range.

Bund Long-term German government *bond.*

Buyback *Repurchase agreement.*

C

Cable The exchange rate between U.S. dollars and sterling.

Call option Option to buy an asset at a specified exercise price on or before a specified exercise date (cf. *put option*).

Call premium (1) Difference between the price at which a company can call its *bonds* and their *face value;* (2) price of a call *option.*

Call provision Provision that allows an issuer to buy back the *bond* issue at a stated price.

Cap An upper limit on the interest rate on a *floating-rate note.*

CAPEX Capital expenditure.

Capital asset pricing model (CAPM) Model in which expected returns increase linearly with an asset's *beta.*

Capital budget List of planned investment projects, usually prepared annually.

Capitalization Long-term debt plus *preferred stock* plus *net worth.*

Capital lease *Financial lease.*

Capital market Financial market (particularly the market for long-term securities).

Capital market line A plot of the set of portfolios with the highest *Sharpe ratio.* The line passes through the risk-free interest rate and the *tangent efficient portfolio* of risky assets.

Capital rationing Shortage of funds that forces a company to choose between worthwhile projects.

Capital structure Mix of different securities issued by a firm.

CAPM *Capital asset pricing model.*

Captive finance company Subsidiary whose function is to provide finance for purchases from the parent company.

Caput option *Call option* on a *put option.*

CAR Cumulative *abnormal return.*

CARDs (Certificates for Amortizing Revolving Debt) *Pass-through securities* backed by credit card *receivables.*

Carried interest A proportion of the profits to which *private equity* partnerships, etc. are entitled.

Carry trade Borrowing in country with low interest rate to relend in another country with a higher rate.

CARs (Certificates of Automobile Receivables) *Pass-through securities* backed by automobile *receivables.*

Carve-out Public offering of shares in a subsidiary.

Cascade Rational herding in which each individual deduces that previous decisions by others may have been based on extra information.

Cash and carry Purchase of a security and simultaneous sale of a *future,* with the balance being financed with a loan or *repo.*

Cash budget Forecast of sources and uses of cash.

Cash cow Mature company producing a large *free cash flow.*

Cash cycle The time from a firm's payment for raw materials until the payment for the finished product from the customer.

Cash-deficiency arrangement Arrangement whereby a project's shareholders agree to provide the operating company with sufficient *net working capital*.

Catastrophe bond (CAT bond) *Bond* whose payoffs are linked to a measure of catastrophe losses such as insurance claims.

CAT bond *Catastrophe bond*.

CBD Cash before delivery.

CD *Certificate of deposit*.

CDS *Credit default swap*.

CEO Chief executive officer.

Certainty equivalent A certain cash flow that has the same present value as a specified risky cash flow.

Certificate of deposit (CD) A certificate providing evidence of a bank time deposit.

CFTC Commodity Futures Trading Commission.

CFO Chief financial officer.

Chaebol A Korean conglomerate.

Chapter 7 Bankruptcy procedure whereby a debtor's assets are sold and the proceeds are used to repay creditors.

Chapter 11 Bankruptcy procedure designed to reorganize and rehabilitate defaulting firm.

Check conversion When customer writes a check, information is automatically captured and his bank account immediately debited.

Check 21 Check Clearing for the 21st Century Act allows banks to process checks electronically.

CHIPS *Clearinghouse Interbank Payments System*.

Chooser option Holder decides whether it is a *call option* or *put option*.

Clean price (flat price) *Bond* price excluding *accrued interest* (cf. *dirty price*).

Clearinghouse Interbank Payments System (CHIPS) An international wire transfer system operated by a group of major banks for high-value dollar payments.

CLO *Collateralized loan obligation*. Also CDO (collateralized debt obligation) and CMO (collateralized mortgage obligation).

Closed-end fund Company whose assets consist of investments in a number of industrial and commercial companies.

Closed-end mortgage Mortgage against which no additional debt may be issued (cf. *open-end mortgage*).

CMOs *Collateralized mortgage obligations*.

COD Cash on delivery.

Collar An upper and lower limit on the interest rate on a *floating-rate note*.

Collateral Assets that are given as security for a loan.

Collateralized loan obligation (CLO) A security backed by a pool of loans and issued in *tranches* with different levels of seniority.

Collateralized mortgage obligations (CMOs) A variation on the mortgage *pass-through security* in which the cash flows from a pool of mortgages are repackaged into several *tranches* of *bonds* with different maturities.

Collateral trust bonds *Bonds* secured by *common stocks* or other securities that are owned by the borrower.

Collection float Customer-written checks that have not been received, deposited, and added to the company's available balance (cf. *payment float*).

Commercial draft (bill of exchange) Demand for payment.

Commercial paper Unsecured *notes* issued by companies and maturing within nine months.

Commitment fee Fee charged by bank on an unused *line of credit*.

Common-size financial statements Balance sheet where entries are expressed as proportion of total assets and income statement where entries are expressed as a proportion of revenues.

Common stock Security representing ownership of a *corporation*.

Company cost of capital The expected return on a portfolio of all the firm's securities.

Compensating balance Non-interest-bearing demand deposits to compensate banks for bank loans or services.

Competitive bidding Means by which public utility *holding companies* are required to choose their *underwriter* (cf. *negotiated underwriting*).

Completion bonding Insurance that a construction contract will be successfully completed.

Composition Voluntary agreement to reduce payments on a firm's debt.

Compound interest Reinvestment of each interest payment on money invested to earn more interest (cf. *simple interest*).

Compound option Option on an *option*.

Concentration banking System whereby customers make payments to a regional collection center. The collection center pays the funds into a regional bank account and surplus money is transferred to the company's principal bank.

Conditional sale Sale in which ownership does not pass to the buyer until payment is completed.

Conglomerate merger *Merger* between two companies in unrelated businesses (cf. *horizontal merger, vertical merger*).

Consol Name of a perpetual *bond* issued by the British government. Sometimes used as a general term for *perpetuity.*

Contango Condition in which spot price of a commodity is below that of the *future* (cf. *backwardation*).

Contingent claim Claim whose value depends on the value of another asset.

Contingent project Project that cannot be undertaken unless another project is also undertaken.

Continuous compounding Interest compounded continuously rather than at fixed intervals.

Controller Officer responsible for budgeting, accounting, and auditing in a firm (cf. *treasurer*).

Convenience yield The extra advantage that firms derive from holding the commodity rather than the *future.*

Conversion price *Par value* of a *convertible bond* divided by the number of shares into which it may be exchanged.

Conversion ratio Number of shares for which a *convertible bond* may be exchanged.

Convertible bond *Bond* that may be converted into another security at the holder's option. Similarly convertible *preferred stock.*

Convexity In a plot of a *bond*'s price against the interest rate, convexity measures the curvature of the line.

Corporate venturing Practice by which a large manufacturer provides financial support to new companies.

Corporation A business that is legally separate from its owners.

Correlation coefficient Measure of the closeness of the relationship between two variables.

Cost company arrangement Arrangement whereby the shareholders of a project receive output free of charge but agree to pay all operating and financing charges of the project.

Cost of (equity) capital *Opportunity cost of capital.*

Counterparty Party on the other side of a *derivative* contract.

Coupon (1) Specifically, an attachment to the certificate of a *bearer security* that must be surrendered to collect interest payment; (2) more generally, interest payment on debt.

Covariance Measure of the co-movement between two variables.

Covenant Clause in a loan agreement.

Covered option *Option* position with an offsetting position in the underlying asset.

Cramdown Action by a bankruptcy court to enforce a plan of reorganization.

Credit default swap (CDS) *Credit derivative* in which one party makes fixed payments while the payments by the other party depend on the occurrence of a loan default.

Credit derivative Contract for *hedging* against loan default or changes in credit risk (e.g., *credit default swap*).

Credit rating Debt rating assigned by a rating agency such as Moody's or Standard & Poor's.

Credit scoring A procedure for assigning scores to borrowers on the basis of the risk of default.

Cross-default clause Clause in a loan agreement stating that the company is in default if it fails to meet its obligation on any other debt issue.

Cum dividend *With dividend.*

Cum rights *With rights.*

Cumulative preferred stock Stock that takes priority over *common stock* in regard to dividend payments. Dividends may not be paid on the common stock until all past *dividends* on the *preferred stock* have been paid.

Cumulative voting Voting system under which a stockholder may cast all of his or her votes for one candidate for the board of directors (cf. *majority voting*).

Current asset Asset that will normally be turned into cash within a year.

Current liability Liability that will normally be repaid within a year.

Current ratio *Current assets* divided by *current liabilities*—a measure of liquidity.

Current yield *Bond coupon* divided by price.

D

Data mining (data snooping) Excessive search to find interesting (but probably coincidental) behavior in a body of data.

DCF *Discounted cash flow.*

DDM *Dividend discount model.*

Dealer market Securities exchange in which dealers post offers to buy or sell, e.g., *Nasdaq* (cf. *auction market*).

Dealer paper *Commercial paper* sold through a dealer rather than directly by the company.

Death spiral convertible *Convertible bond* exchangeable for shares with a specified market value.

Debenture Unsecured *bond*.

Debtor-in–possession financing (DIP financing) Debt issued by a company in *Chapter 11 bankruptcy*.

Decision tree Method of representing alternative sequential decisions and the possible outcomes from these decisions.

Defeasance Practice whereby the borrower sets aside cash or *bonds* sufficient to service the borrower's debt. Both the borrower's debt and the offsetting cash or bonds are removed from the balance sheet.

Degree of operating leverage (DOL) The percentage change in profits for a 1% change in sales.

Delta *Hedge ratio*.

Depository transfer check (DTC) Check made out directly by a local bank to a particular company.

Depreciation (1) Reduction in the book or market value of an asset; (2) portion of an investment that can be deducted from taxable income.

Derivative Asset whose value derives from that of some other asset (e.g., a *future* or an *option*).

Designated market maker Member of *NYSE* responsible for market in specified securities (formerly called "specialist").

Diff *Differential swap*.

Differential swap (diff, quanto swap) Swap between two *LIBOR* rates of interest, e.g., yen LIBOR for dollar LIBOR. Payments are in one currency.

Digital option *Option* paying fixed sum if asset price is the right side of *exercise price*, otherwise zero.

Dilution Diminution in the proportion of income to which each share is entitled.

DIP financing *Debtor-in–possession financing*.

Direct deposit The firm authorizes its bank to deposit money in the accounts of its employees or shareholders.

Direct lease *Lease* in which the *lessor* purchases new equipment from the manufacturer and leases it to the *lessee* (cf. *sale and lease-back*).

Direct payment (automatic debit, direct debit) The firm's customers authorize it to debit their bank accounts for the amounts due (cf. *direct deposit*).

Direct quote For foreign exchange, the number of U.S. dollars needed to buy one unit of a foreign currency (cf. *indirect quote*).

Dirty price *Bond* price including *accrued interest*, i.e., the price paid by the bond buyer (cf. *clean price*).

Discount bond Debt sold for less than its *principal* value. If a discount bond pays no interest, it is called a "pure" discount, or *zero-coupon*, bond.

Discounted cash flow (DCF) Future cash flows multiplied by *discount factors* to obtain *present value*.

Discount factor *Present value* of $1 received at a stated future date.

Discount rate Rate used to calculate the *present value* of future cash flows.

Discounted payback rule Requirement that discounted values of cash flows should be sufficient to pay back initial investment within a specified time.

Discriminatory price auction Auction in which successful bidders pay the price that they bid (cf. *uniform price auction*).

Disintermediation Withdrawal of funds from a financial institution in order to invest them directly (cf. *intermediation*).

Dividend Payment by a company to its stockholders.

Dividend discount model Model showing that the value of a share is equal to the discounted value of future *dividends*.

Dividend reinvestment plan (DRIP) Plan that allows shareholders to reinvest dividends automatically.

Dividend yield Annual *dividend* divided by share price.

DOL *Degree of operating leverage*.

Double-declining-balance depreciation Method of *accelerated depreciation*.

Double-tax agreement Agreement between two countries that taxes paid abroad can be offset against domestic taxes levied on foreign *dividends*.

Down-and-in option *Barrier option* that comes into existence if asset price hits a barrier.

Down-and-out option *Barrier option* that expires if asset price hits a barrier.

DRIP *Dividend reinvestment plan*.

Drop lock An arrangement whereby the interest rate on a *floating-rate note* or *preferred stock* becomes fixed if it falls to a specified level.

DTC *Depository transfer check*.

Dual-class equity Shares with different voting rights.

Dual-currency bond *Bond* with interest paid in one currency and *principal* paid in another.

DuPont formula Formula expressing relationship between return on assets, sales-to-assets, profit margin, and measures of leverage.

Duration The average number of years to an asset's *discounted cash flows*.

Dutch auction In a Dutch auction investors submit the prices at which they are prepared to buy (or sell) the security. The purchase price is the lowest price that allows the firm to sell (or buy) the specified amount of the security.

E

EBIT Earnings before interest and taxes.

EBITDA Earnings before interest, taxes, depreciation, and *amortization*.

EBPP *Electronic bill presentment and payment.*

Economic depreciation Decline in *present value* of an asset.

Economic exposure Risk that arises from changes in real exchange rates (cf. *transaction exposure, translation exposure*).

Economic income Cash flow plus change in *present value.*

Economic rents Profits in excess of the competitive level.

Economic value added (EVA) A measure of *residual income* implemented by the consulting firm Stern Stewart.

Efficient market Market in which security prices reflect information instantaneously.

Efficient portfolio Portfolio that offers the lowest risk (*standard deviation*) for its *expected return* and the highest expected return for its level of risk.

EFT *Electronic funds transfer.*

Electronic bill presentment and payment (EBPP) Allows companies to bill customers and receive payments via the Internet.

Electronic funds transfer (EFT) Transfer of money electronically (e.g., by *Fedwire*).

Employee stock ownership plan (ESOP) A company contributes to a trust fund that buys stock on behalf of employees.

Entrenching investment An investment that makes particular use of the skills of existing management.

EPS Earnings per share.

Equipment trust certificate Form of *secured debt* generally used to finance railroad equipment. The trustee retains ownership of the equipment until the debt is repaid.

Equity (1) *Common stock* and *preferred stock.* Often used to refer to common stock only. (2) *Net worth.*

Equity-linked bond *Bond* whose payments are linked to a stock market index.

Equivalent annual cash flow (or cost) *Annuity* with the same *present value* as the company's proposed investment.

ESOP *Employee stock ownership plan.*

ETF *Exchange-traded fund.*

Euribor *Euro interbank offered rate.*

Euro interbank offered rate (Euribor) The interest rate at which major international banks in Europe lend euros to each other.

Eurobond *Bond* that is marketed internationally.

Eurocurrency Deposit held outside the currency's issuing country (e.g., euroyen, or *eurodollar deposit*)

Eurodollar deposit Dollar deposit with a bank outside the United States.

European option *Option* that can be exercised only on final exercise date (cf. *American option*).

EVA *Economic value added.*

Event risk The risk that an unanticipated event (e.g., a takeover) will lead to a debt default.

Evergreen credit *Revolving credit* without maturity.

Exchange of assets Acquisition of another company by purchase of its assets in exchange for cash or shares.

Exchange of stock Acquisition of another company by purchase of its stock in exchange for cash or shares.

Exchange-traded fund (ETF) A stock designed to track a stock market index.

Ex dividend Purchase of shares in which the buyer is not entitled to the forthcoming *dividend* (cf. *with dividend, cum dividend*).

Exercise price (strike price) Price at which a *call option* or *put option* may be exercised.

Expectations theory Theory that *forward interest rate* (*forward exchange rate*) equals expected *spot rate.*

Expected return Average of possible returns weighted by their probabilities.

Ex rights Purchase of shares that do not entitle the owner to buy shares in the company's *rights issue* (cf. *with rights, cum rights, rights on*).

Extendable bond *Bond* whose maturity can be extended at the option of the lender (or issuer).

External finance Finance that is not generated by the firm: new borrowing or an issue of stock (cf. *internal finance*).

Extra dividend *Dividend* that may or may not be repeated (cf. *regular dividend*).

F

Face value *Par value.*

Factoring Arrangement whereby a financial institution buys a company's *accounts receivable* and collects the debt.

Fair price provision *Appraisal rights.*

Fallen angel *Junk bond* that was formerly *investment grade.*

FASB Financial Accounting Standards Board.

FCIA Foreign Credit Insurance Association.

FDIC Federal Deposit Insurance Corporation.

Federal funds Non-interest-bearing deposits by banks at the Federal Reserve. Excess reserves are lent by banks to each other.

Fedwire A wire transfer system for high-value payments operated by the Federal Reserve System (cf. *CHIPS*).

Field warehouse Warehouse rented by a warehouse company on another firm's premises (cf. *public warehouse*).

Financial assets Claims on *real assets.*

Financial engineering Combining or dividing existing instruments to create new financial products.

Financial lease (capital lease, full-payout lease) Long-term, noncancelable lease (cf. *operating lease*).

Financial leverage (gearing) Use of debt to increase the *expected return* on *equity.* Financial leverage is measured by the ratio of debt to debt plus equity (cf. *operating leverage*).

Firm commitment Arrangement whereby the *underwriter* guarantees to sell the entire issue.

Fiscal agency agreement An alternative to a bond *trust deed.* Unlike the trustee, the fiscal agent acts as an agent of the borrower.

Flat price *Clean price.*

Flipping Buying shares in an *IPO* and selling immediately.

Float *See availability float, collection float, payment float.*

Floating lien General *lien* against a company's assets or against a particular class of assets.

Floating-price convertible *Death spiral convertible.*

Floating-rate note (FRN) *Note* whose interest payment varies with the short-term interest rate.

Floating-rate preferred *Preferred stock* paying dividends that vary with short-term interest rates.

Floor planning Arrangement used to finance inventory. A finance company buys the inventory, which is then held in trust by the user.

Flow-to-equity method Discounted value of cash flows to equityholders.

Foreign bond A *bond* issued on the domestic *capital market* of another country.

Forex Foreign exchange.

Forfaiter Purchaser of promises to pay (e.g., *bills of exchange* or *promissory notes*) issued by importers.

Forward cover Purchase or sale of forward foreign currency in order to offset a known future cash flow.

Forward exchange rate Exchange rate fixed today for exchanging currency at some future date (cf. *spot exchange rate*).

Forward interest rate Interest rate fixed today on a loan to be made at some future date (cf. *spot interest rate*).

Forward rate agreement (FRA) Agreement to borrow or lend at a specified future date at an interest rate that is fixed today.

FRA *Forward rate agreement.*

Free cash flow Cash not required for operations or for reinvestment.

Free-rider problem The temptation not to incur the costs of participating in a decision when one's influence on that decision is small.

FRN *Floating-rate note.*

Full-payout lease *Financial lease.*

Full-service lease (rental lease) *Lease* in which the *lessor* promises to maintain and insure the equipment (cf. *net lease*).

Fundamental analysis Security analysis that seeks to detect misvalued securities by an analysis of the firm's business prospects (cf. *technical analysis*).

Funded debt Debt maturing after more than one year (cf. *unfunded debt*).

Futures contract A contract to buy a commodity or security on a future date at a price that is fixed today. Unlike forward contracts, futures are traded on organized exchanges and are *marked to market* daily.

G

GAAP Generally accepted accounting principles.

Gamma A measure of how the *option delta* changes as the asset price changes.

Gearing *Financial leverage.*

General cash offer Issue of securities offered to all investors (cf. *rights issue*).

Gilt A British government *bond.*

Golden parachute A large termination payment due to a company's officers if they lose their jobs as a result of a *merger.*

Goodwill The difference between the amount paid for a firm in a *merger* and its book value.

Governance The oversight of a firm's management.

Gray market Purchases and sales of securities that occur before the issue price is set.

Greenmail Situation in which a large block of stock is held by an unfriendly company, forcing the target company to repurchase the stock at a substantial premium to prevent a takeover.

Greenshoe option *Option* that allows the *underwriter* for a new issue to buy and resell additional shares.

Growth stock *Common stock* of a company that has an opportunity to invest money to earn more than the *opportunity cost of capital* (cf. *income stock*).

H

Haircut An additional margin of *collateral* for a loan.

Hedge fund An investment fund charging a performance fee and open to a limited range of investors. Funds often follow complex strategies including *short sales.*

Hedge ratio (delta, option delta) The number of shares to buy for each *option* sold to create a safe position; more generally, the number of units of an asset that should be bought to hedge one unit of a liability.

Hedging Buying one security and selling another to reduce risk. A perfect hedge produces a riskless portfolio.

Hell-or-high-water clause Clause in a *lease* agreement that obligates the *lessee* to make payments regardless of what happens to the *lessor* or the equipment.

Highly leveraged transaction (HLT) Bank loan to a highly leveraged firm (formerly needed to be separately reported to the Federal Reserve Board).

High-yield bond *Junk bond.*

HLT *Highly leveraged transaction.*

Holding company Company whose sole function is to hold stock in the firm's subsidiaries.

Horizontal merger *Merger* between two companies that manufacture similar products (cf. *vertical merger, conglomerate merger*).

Horizontal spread The simultaneous purchase and sale of two *options* that differ only in their exercise date (cf. *vertical spread*).

Hurdle rate Minimum acceptable rate of return on a project.

I

IBF *International banking facility.*

IMM *International Monetary Market.*

Immunization The construction of an asset and a liability that have offsetting changes in value.

Implied volatility The volatility implied by *option* prices.

Imputation tax system Arrangement by which investors who receive a *dividend* also receive a tax credit for corporate taxes that the firm has paid.

Income bond *Bond* on which interest is payable only if earned.

Income stock *Common stock* with high *dividend yield* and few profitable investment opportunities (cf. *growth stock*).

Indenture Formal agreement, e.g., establishing the terms of a *bond* issue.

Indexed bond *Bond* whose payments are linked to an index, e.g., a consumer price index (see *TIPS*).

Index fund Investment fund designed to match the returns on a stock market index.

Indirect quote For foreign exchange, the number of units of a foreign currency needed to buy one U.S. dollar (cf. *direct quote*).

Industrial revenue bond (IRB) Bond issued by local government agencies on behalf of *corporations.*

Initial public offering (IPO) A company's first public issue of *common stock.*

Inside director Director who is also employed by the company.

In-substance defeasance *Defeasance* whereby debt is removed from the balance sheet but not canceled (cf. *novation*).

Intangible asset Nonmaterial asset, such as technical expertise, a trademark, or a patent (cf. *tangible asset*).

Integer programming Variant of *linear programming* whereby the solution values must be integers.

Interest cover *Times interest earned.*

Interest rate parity Theory that the differential between the *forward exchange rate* and the *spot exchange rate* is equal to the differential between the foreign and domestic interest rates.

Intermediation Investment through a financial institution (cf. *disintermediation*).

Internal finance Finance generated within a firm by *retained earnings* and *depreciation* (cf. *external finance*).

Internal growth rate The maximum rate of firm growth without *external finance* (cf. *sustainable growth rate*).

Internal rate of return (IRR) *Discount rate* at which investment has zero *net present value.*

International banking facility (IBF) A branch that an American bank establishes in the United States to do eurocurrency business.

International Monetary Market (IMM) The financial futures market within the Chicago Mercantile Exchange.

Interval measure The number of days that a firm can finance operations without additional cash income.

In-the-money option An *option* that would be worth exercising if it expired immediately (cf. *out-of-the-money option*).

Investment-grade bond *Bond* rated at least Baa by Moody's or BBB by Standard and Poor's or Fitch.

IOSCO International Organization of Securities Commissions.

IPO *Initial public offering.*

IRB *Industrial revenue bond.*

IRR *Internal rate of return.*

IRS Internal Revenue Service.

ISDA International Swap and Derivatives Association.

ISMA International Securities Market Association.

Issued share capital Total amount of shares that are in issue (cf. *outstanding share capital*).

J

Junior debt *Subordinated debt.*

Junk bond (high-yield bond) Debt that is rated below an *investment-grade bond.*

Just-in-time System of inventory management that requires minimum inventories of materials and very frequent deliveries by suppliers.

K

Keiretsu A network of Japanese companies organized around a major bank.

L

LBO *Leveraged buyout.*

Lease Long-term rental agreement.

Legal capital Value at which a company's shares are recorded in its books.

Legal defeasance *Novation.*

Lessee User of a leased asset (cf. *lessor*).

Lessor Owner of a leased asset (cf. *lessee*).

Letter of credit Letter from a bank stating that it has established a credit in the company's favor.

Letter stock Privately placed *common stock,* so called because the *SEC* requires a letter from the purchaser that the stock is not intended for resale.

Leverage See *financial leverage, operating leverage.*

Leveraged buyout (LBO) Acquisition in which (1) a large part of the purchase price is debt-financed and (2) the remaining *equity* is privately held by a small group of investors.

Leveraged lease *Lease* in which the *lessor* finances part of the cost of the asset by an issue of debt secured by the asset and the lease payments.

Liabilities, total liabilities Total value of financial claims on a firm's assets. Equals (1) total assets or (2) total assets minus *net worth.*

LIBOR *London interbank offered rate.*

Lien Lender's claims on specified assets.

Limited liability Limitation of a shareholder's losses to the amount invested.

Limited partnership *Partnership* in which some partners have *limited liability* and general partners have unlimited liability.

Limit order Order to buy (sell) securities within a maximum (minimum) price (cf. *market order*).

Linear programming (LP) Technique for finding the maximum value of some objective function subject to stated linear constraints.

Line of credit Agreement by a bank that a company may borrow at any time up to an established limit.

Liquid asset Asset that is easily and cheaply turned into cash—notably cash itself and short-term securities.

Liquidating dividend *Dividend* that represents a return of capital.

Liquidator Person appointed by unsecured creditors in the United Kingdom to oversee the sale of an insolvent firm's assets and the repayment of debts.

Liquidity-preference theory Theory that investors demand a higher yield to compensate for the extra risk of long-term *bonds.*

Liquidity premium (1) Additional return for investing in a security that cannot easily be turned into cash; (2) difference between the *forward interest rate* and the expected *spot interest rate.*

Liquid yield option note (LYON) *Zero-coupon,* callable, puttable, *convertible bond.*

Loan origination fee Up-front fee charged by the lending bank.

Lockbox system Form of *concentration banking.* Customers send payments to a post office box. A local bank collects and processes the checks and transfers surplus funds to the company's principal bank.

London interbank offered rate (LIBOR) The interest rate at which major international banks in London lend to each other. (LIBID is London interbank bid rate; LIMEAN is mean of bid and offered rate.)

Long hedge Purchase of a *hedging* instrument (e.g., a *future*) to hedge a short position in the underlying asset (cf. *short hedge*).

Longevity bonds *Bonds* that pay a higher rate of interest if a high proportion of the population survives to a particular age.

Lookback option *Option* whose payoff depends on the highest asset price recorded over the life of the option.

LP *Linear programming.*

LYON *Liquid yield option note.*

M

MACRS *Modified accelerated cost recovery system.*

Maintenance margin Minimum margin that must be maintained on a *futures* contract.

Majority voting Voting system under which each director is voted upon separately (cf. *cumulative voting*).

Management buyout (MBO) *Leveraged buyout* whereby the acquiring group is led by the firm's management.

Mandatory convertible *Bond* automatically convertible into equity, usually with a limit on the value of stock received.

Margin Cash or securities set aside by an investor as evidence that he or she can honor a commitment.

Marked to market An arrangement whereby the profits or losses on a *futures* contract are settled up each day.

Market capitalization Market value of *outstanding share capital.*

Market capitalization rate *Expected return* on a security.

Market model Model suggesting a linear relationship between actual returns on a stock and on the market portfolio.

Market order Order to buy or sell securities at the prevailing market price (cf. *limit order*).

Market risk (systematic risk) Risk that cannot be diversified away.

Market-to-book ratio Ratio of market value to book value of firm's *equity.*

Market value added Difference between market value and book value of firm's *equity.*

Maturity factoring *Factoring* arrangement that provides collection and insurance of *accounts receivable.*

MBO *Management buyout.*

MDA *Multiple-discriminant analysis.*

Medium-term note (MTN) Debt with a typical maturity of 1 to 10 years offered regularly by a company using the same procedure as *commercial paper.*

Merger (1) Acquisition in which all assets and liabilities are absorbed by the buyer (cf. *exchange of assets, exchange of stock*); (2) more generally, any combination of two companies.

MIP (Monthly income preferred security) *Preferred stock* issued by a subsidiary located in a tax haven. The subsidiary relends the money to the parent.

Mismatch bond *Floating-rate note* whose interest rate is reset at more frequent intervals than the rollover period (e.g., a note whose payments are set quarterly on the basis of the one-year interest rate).

Modified accelerated cost recovery system (MACRS) Schedule of *depreciation* deductions allowed for tax purposes.

Modified IRR *Internal rate of return* calculated by first discounting later cash flows back to earlier periods so that there remains only one change in the sign of the cash flows.

Momentum Characteristic of stocks showing persistent recent high returns.

Money center bank A major U.S. bank that undertakes a wide range of banking activities.

Money market Market for short-term safe investments.

Money-market deposit account (MMDA) A bank account paying *money-market* interest rate.

Money-market fund *Mutual fund* that invests solely in short-term safe securities.

Monoline Insurance company that insures debtholders against the risk of default.

Monte Carlo simulation Method for calculating the probability distribution of possible outcomes, e.g., from a project.

Moral hazard The risk that the existence of a contract will change the behavior of one or both parties to the contract; e.g., an insured firm may take fewer fire precautions.

Mortality bonds *Bonds* that pay a higher rate of interest if there is a sharp rise in the death rate.

Mortgage bond *Bond* secured against plant and equipment.

MTN *Medium-term note.*

Multiple-discriminant analysis (MDA) Statistical technique for distinguishing between two groups on the basis of their observed characteristics.

Mutual fund Managed investment fund whose shares are sold to investors.

Mutually exclusive projects Two projects that cannot both be undertaken.

N

Naked option *Option* held on its own, i.e., not used for *hedging* a holding in the asset or other options.

Nasdaq National Association of Security Dealers Automated Quote System. A U.S. stock exchange whose dealers tend to specialize in high-tech stocks.

Negative pledge clause Clause under which the borrower agrees not to permit an exclusive *lien* on any of its assets.

Negotiated underwriting Method of choosing an *underwriter.* Most firms may choose their *underwriter* by negotiation (cf. *competitive bidding*).

Net lease *Lease* in which the *lessee* promises to maintain and insure the equipment (cf. *full-service lease*).

Net present value (NPV) A project's net contribution to wealth—*present value* minus initial investment.

Net working capital *Current assets* minus *current liabilities.*

Net worth Book value of a company's *common stock,* surplus, and *retained earnings.*

Nominal interest rate Interest rate expressed in money terms (cf. *real interest rate*).

Nonrefundable debt Debt that may not be called in order to replace it with another issue at a lower interest cost.

NOPAT Net operating profit after tax.

Normal distribution Symmetric bell-shaped distribution that can be completely defined by its mean and *standard deviation.*

Note Unsecured debt with a maturity of up to 10 years.

Novation (legal defeasance) *Defeasance* whereby the firm's debt is canceled (cf. *in-substance defeasance*).

NPV *Net present value.*

NYSE New York Stock Exchange.

O

OAT (Obligation assimilable du Trésor) French government *bond.*

Odd lot A trade of less than 100 shares (cf. *round lot*).

Off-balance-sheet financing Financing that is not shown as a liability in a company's balance sheet.

Offer price *Asked price.*

OID debt *Original issue discount debt.*

Old-line factoring *Factoring* arrangement that provides collection, insurance, and finance for *accounts receivable.*

On the run The most recently issued (and, therefore, typically the most liquid) government *bond* in a particular maturity range.

Open account Arrangement whereby sales are made with no formal debt contract. The buyer signs a receipt, and the seller records the sale in the sales ledger.

Open-end mortgage Mortgage against which additional debt may be issued (cf. *closed-end mortgage*).

Open interest The number of currently outstanding *futures* contracts.

Operating cycle The time from a firm's initial purchase of raw materials until the payment from the customer for the finished product.

Operating lease Short-term, cancelable *lease* (cf. *financial lease*).

Operating leverage Fixed operating costs, so called because they accentuate variations in profits (cf. *financial leverage*).

Opportunity cost of capital (hurdle rate, cost of capital) *Expected return* that is foregone by investing in a project rather than in comparable financial securities.

Option See *call option, put option.*

Option delta *Hedge ratio.*

Original issue discount debt (OID debt) Debt that is initially offered at a price below *face value.*

OTC *Over-the-counter.*

Out-of-the-money option An *option* that would not be worth exercising if it matured immediately (cf. *in-the-money option*).

Outstanding share capital *Issued share capital* less the *par value* of shares that are held in the company's treasury.

Oversubscription privilege In a *rights issue,* arrangement by which shareholders are given the right to apply for any shares that are not taken up.

Over-the-counter (OTC) Informal market that does not involve a securities exchange.

P

Partnership Joint ownership of business whereby general partners have unlimited liability.

Par value (face value) Value of a security shown on the certificate.

Pass-through securities *Notes* or *bonds* backed by a package of assets (e.g., mortgage pass-throughs, *CARs, CARDs*).

Path-dependent option *Option* whose value depends on the sequence of prices of the underlying asset rather than just the final price of the asset.

Payables *Accounts payable.*

Payback rule Requirement that project should recover its initial investment within a specified time.

Pay-in-kind bond (PIK) *Bond* that allows the issuer to choose to make interest payments in the form of additional bonds.

Payment float Company-written checks that have not yet cleared (cf. *availability float*).

Payout ratio *Dividend* as a proportion of earnings per share.

PBGC Pension Benefit Guarantee Corporation.

P/E ratio Share price divided by earnings per share.

PERC (Preferred equity redemption cumulative stock) *Preferred stock* that converts automatically into equity at a stated date. A limit is placed on the value of the shares that the investor receives.

Perpetuity Investment offering a level stream of cash flows in perpetuity (cf. *consol*).

PIK *Pay-in-kind bond.*

PN *Project note.*

Poison pill Includes a variety of takeover defenses, notably the right of existing shareholders to acquire stock at a discount if a bidder acquires a minimum number of shares.

Poison put A *covenant* allowing the *bond*holder to demand repayment in the event of a hostile *merger.*

Pooling of interest Method of accounting for *mergers* (no longer available in the USA). The consolidated balance sheet of the merged firm is obtained by combining the balance sheets of the separate firms (cf. *purchase accounting*).

Position diagram Diagram showing the possible payoffs from a *derivative* investment.

Postaudit Evaluation of an investment project after it has been undertaken.

Praecipium Arrangement fee for *syndicated loan.*

Preemptive right Common stockholder's right to anything of value distributed by the company.

Preferred stock Stock that takes priority over common stock in regard to *dividends.* Dividends may not be paid on *common stock* unless the dividend is paid on all preferred stock (cf. *cumulative preferred stock*). The dividend rate on preferred is usually fixed at time of issue.

Prenegotiated bankruptcy *Chapter 11* bankruptcy where only principal creditors have agreed to the reorganization plan before filing (cf. *prepackaged bankruptcy*).

Prepack *Prepackaged bankruptcy.*

Prepackaged bankruptcy (prepack) Bankruptcy proceedings intended to confirm a reorganization plan that has already been agreed to informally.

Present value Discounted value of future cash flows.

Present value of growth opportunities (PVGO) *Net present value* of investments the firm is expected to make in the future.

PRIDE Similar to a *PERC* except that as the equity price rises beyond a specified point, the investor shares in the stock appreciation.

Primary issue Issue of new securities by a firm (cf. *secondary issue*).

Prime rate Benchmark lending rate set by U.S. banks.

Principal Amount of debt that must be repaid.

Principal–agent problem Problem faced by a principal (e.g., shareholder) in ensuring that an agent (e.g., manager) acts on his or her behalf.

Private equity *Equity* that is not publicly traded and that is used to finance business start-ups, *leveraged buyouts,* etc.

Private placement Issue of *bonds* or *stock* that is placed privately with a few investors and is not then publicly traded.

Privileged subscription issue *Rights issue.*

Production payment Loan in the form of advance payment for future delivery of a product.

Profitability index Ratio of a project's *NPV* to the initial investment.

Pro forma Projected.

Project finance Debt that is largely a claim against the cash flows from a particular project rather than against the firm as a whole.

Project note (PN) *Note* issued by public housing or urban renewal agencies.

Promissory note Promise to pay.

Prospect theory A theory of asset pricing suggested by the observation of behavioral psychologists that investors have a particular aversion to losses even if very small.

Prospectus Summary of the *registration* statement providing information on an issue of securities.

Protective put *Put option* that is combined with holding in the underlying asset.

Proxy vote Vote cast by one person on behalf of another.

Public warehouse (terminal warehouse) Warehouse operated by an independent warehouse company on its own premises (cf. *field warehouse*).

Purchase accounting Method of accounting for *mergers.* The assets of the acquired firm are shown at market value on the balance sheet of the acquirer (cf. *pooling of interest*).

Purchase fund Resembles a *sinking fund* except that money is used only to purchase bonds if they are selling below their *par value.*

Put–call parity The relationship between the prices of European *put* and *call options.*

Put option *Option* to sell an asset at a specified *exercise price* on or before a specified exercise date (cf. *call option*).

PVGO *Present value of growth opportunities.*

Pyramid Created by forming a *holding company* whose only asset is a controlling interest in a second holding company, which in turn has a controlling interest in an operating company.

Q

q Ratio of the market value of an asset to its replacement cost.

QIBs *Qualified institutional buyers.*

Quadratic programming Variant of *linear programming* whereby the equations are quadratic rather than linear.

Qualified Institutional buyers (QIBs) Institutions that are allowed to trade unregistered stock among themselves.

Quanto swap *Differential swap.*

Quick ratio (acid-test ratio) Measure of liquidity: (cash + marketable securities + *receivables*) divided by *current liabilities.*

R

Range forward A *forward exchange rate* contract that places upper and lower bounds on the cost of foreign exchange.

Ratchet bonds Floating-rate *bonds* whose coupon can only be reset downward.

Rate-sensitive bonds *Bonds* whose coupon rate changes as issuer's credit-rating changes.

Real assets *Tangible assets* and *intangible assets* used to carry on business (cf. *financial assets*).

Real estate investment trust (REIT) Trust company formed to invest in real estate.

Real interest rate Interest rate expressed in terms of real goods, i.e., *nominal interest rate* adjusted for inflation.

Real option The flexibility to modify, postpone, expand, or abandon a project.

Receivables *Accounts receivable.*

Receiver A bankruptcy practitioner appointed by secured creditors in the United Kingdom to oversee the repayment of debts.

Record date Date set by directors when making dividend payment. *Dividends* are sent to stockholders who are registered on the record date.

Recourse Term describing a type of loan. If a loan is with recourse, the lender has a general claim against the parent company if the *collateral* is insufficient to repay the debt.

Red herring Preliminary *prospectus.*

Refunding Replacement of existing debt with a new issue of debt.

Registered security Security whose ownership is recorded by the company's *registrar* (cf. *bearer security*).

Registrar Financial institution appointed to record issue and ownership of company securities.

Registration Process of obtaining *SEC* approval for a public issue of securities.

Regression analysis In statistics, a technique for finding the line of best fit.

Regular dividend *Dividend* that the company expects to maintain in the future.

Regulation A issue Small security issues that are partially exempt from *SEC registration* requirements.

REIT *Real estate investment trust.*

Rental lease *Full-service lease.*

Replicating portfolio Package of assets whose returns exactly replicate those of an *option.*

Repo *Repurchase agreement.*

Repurchase agreement (RP, repo, buy-back) Purchase of Treasury securities from a securities dealer with an agreement that the dealer will repurchase them at a specified price.

Residual income After-tax profit less the *opportunity cost of capital* employed by the business (see also *Economic Value Added*).

Residual risk *Specific risk.*

Retained earnings Earnings not paid out as *dividends.*

Return on equity Usually, equity earnings as a proportion of the book value of equity.

Return on investment (ROI) Generally, book income as a proportion of net book value.

Revenue bond Municipal *bond* that is serviced out of the revenues from a particular project.

Reverse convertible Bond that gives the issuer the right to convert it into common stock.

Reverse FRN (yield curve note) *Floating-rate note* whose payments rise as the general level of interest rates falls and vice versa.

Reverse split Action by the company to reduce the number of outstanding shares by replacing two or more of its shares with a single, more valuable share.

Revolving credit Legally assured *line of credit* with a bank.

Rights issue (privileged subscription issue) Issue of securities offered to current stockholders (cf. *general cash offer*).

Rights on *With rights.*

Risk premium Expected additional return for making a risky investment rather than a safe one.

Road show Series of meetings between a company and potential investors before the company decides on the terms of a new issue.

ROI *Return on investment.*

Roll-over CD A package of successive *certificates of deposit.*

Round lot A trade of 100 shares (cf. *odd lot*).

RP *Repurchase agreement.*

R squared (R^2) Square of the *correlation coefficient*—the proportion of the variability in one series that can be explained by the variability of one or more other series.

Rule 144a *SEC* rule allowing *qualified institutional buyers* to buy and trade unregistered securities.

S

Sale and lease-back Sale of an existing asset to a financial institution that then *leases* it back to the user (cf. *direct lease*).

Salvage value Scrap or resale value of plant and equipment.

Samurai bond A yen *bond* issued in Tokyo by a non-Japanese borrower (cf. *bulldog bond, Yankee bond*).

SBIC Small Business Investment Company.

Scenario analysis Analysis of the profitability of a project under alternative economic scenarios.

Season datings Extended credit for customers who order goods out of the peak season.

Seasoned issue Issue of a security for which there is an existing market (cf. *unseasoned issue*).

SEC Securities and Exchange Commission.

Secondary issue (1) Procedure for selling blocks of *seasoned issues* of stock; (2) more generally, sale of already issued stock.

Secondary market Market in which one can buy or sell *seasoned issues* of securities.

Secured debt Debt that, in the event of default, has first claim on specified assets.

Securitization Substitution of tradable securities for privately negotiated instruments.

Security market line Line representing the relationship between *expected return* and *market risk.*

Self-liquidating loan Loan to finance *current assets.* The sale of the current assets provides the cash to repay the loan.

Self-selection Consequence of a contract that induces only one group (e.g., low-risk individuals) to participate.

Semistrong-form efficient market Market in which security prices reflect all publicly available information (cf. *weak-form efficient market* and *strong-form efficient market*).

Senior debt Debt that, in the event of bankruptcy, must be repaid before *subordinated debt* receives any payment.

Sensitivity analysis Analysis of the effect on project profitability of possible changes in sales, costs, and so on.

Serial bonds Package of *bonds* that mature in successive years.

Series bond *Bond* that may be issued in several series under the same *indenture.*

Shark repellant Amendment to company charter intended to protect against takeover.

Sharpe ratio Ratio of portfolio's *risk premium* to its risk (*standard deviation*).

Shelf registration A procedure that allows firms to file one *registration* statement covering several issues of the same security.

Shogun bond Dollar *bond* issued in Japan by a nonresident.

Short hedge Sale of a *hedging* instrument (e.g., a *future*) to *hedge* a long position in the underlying asset (cf. *long hedge*).

Short sale Sale of a security the investor does not own.

Sight draft Demand for immediate payment (cf. *time draft*).

Signal Action that demonstrates an individual's unobservable characteristics (because it would be unduly costly for someone without those characteristics to take the action).

Simple interest Interest calculated only on the initial investment (cf. *compound interest*).

Simulation *Monte Carlo simulation.*

Sinker *Sinking fund.*

Sinking fund (sinker) Fund established by a company to retire debt before maturity.

SIV (structured investment vehicle) A fund that typically invested in mortgage-backed securities, which it financed by issuing senior and junior *tranches* of *asset-backed commercial paper* and longer-term *notes.*

Skewed distribution Probability distribution in which an unequal number of observations lie below and above the mean.

SPE *Special-purpose entity.*

Special dividend (extra dividend) *Dividend* that is unlikely to be repeated.

Specialist *Designated market maker.*

Special-purpose entity *Partnerships* established by companies to hold certain assets and obtain funding. May be used to obtain off-balance-sheet debt for the parent.

Specific risk (residual risk, unique risk, unsystematic risk) Risk that can be eliminated by diversification.

Spinning The *underwriter* of an *IPO* unethically allots a portion of offering to senior management of a client company.

Spin-off Distribution of shares in a subsidiary to the company's shareholders so that they hold shares separately in the two firms.

Spot exchange rate Exchange rate on currency for immediate delivery (cf. *forward exchange rate*).

Spot price Price of asset for immediate delivery (in contrast to forward or futures price).

Spot rate Interest rate fixed today on a loan that is made today (cf. *forward interest rate*).

Spread Difference between the price at which an *underwriter* buys an issue from a firm and the price at which the underwriter sells it to the public.

Staggered board Board whose directors are elected periodically, instead of at one time.

Standard deviation Square root of the *variance*—a measure of variability.

Standard error In statistics, a measure of the possible error in an estimate.

Standby agreement In a *rights issue,* agreement that the *underwriter* will purchase any stock not purchased by investors.

Step-up bond *Bond* whose *coupon* is stepped up over time (also step-down bond).

Stock dividend *Dividend* in the form of stock rather than cash.

Stock split "Free" issue of shares to existing shareholders.

Straddle The combination of a *put option* and a *call option* with the same *exercise price*.

Straight-line depreciation An equal dollar amount of *depreciation* in each period.

Strike price *Exercise price* of an *option*.

Stripped bond (strip) *Bond* that is subdivided into a series of *zero-coupon bonds.*

Strong-form efficient market Market in which security prices reflect instantaneously all information available to investors (cf. *weak-form efficient market* and *semistrong-form efficient market*).

Structured debt Debt that has been customized for the buyer, often by incorporating unusual *options.*

Subordinated debt (junior debt) Debt over which *senior debt* takes priority. In the event of bankruptcy, subordinated debtholders receive payment only after senior debt is paid off in full.

Subprime loans The most risky category of loans.

Sum-of-the-years'-digits depreciation Method of *accelerated depreciation*.

Sunk costs Costs that have been incurred and cannot be reversed.

Supermajority Provision in a company's charter requiring a majority of, say, 80% of shareholders to approve certain changes, such as a *merger.*

Sushi bond A *eurobond* issued by a Japanese corporation.

Sustainable growth rate Maximum rate of firm growth without increasing financial leverage (cf. *internal growth rate*).

Swap An arrangement whereby two companies lend to each other on different terms, e.g., in different currencies, or one at a fixed rate and the other at a floating rate.

Swaption *Option* on a *swap.*

Sweep program Arrangement whereby bank invests a company's available cash at the end of each day.

Swingline facility Bank borrowing facility to provide finance while the firm replaces U.S. *commercial paper* with eurocommercial paper.

Syndicated loan A large loan provided by a group of banks.

Systematic risk *Market risk.*

T

Take-or-pay In *project finance,* arrangement where parent company agrees to pay for output of project even if it chooses not to take delivery.

Take-up fee Fee paid to *underwriters* of a *rights issue* on any stock they are obliged to purchase.

Tangent efficient portfolio The portfolio of risky assets offering the highest risk premium per unit of risk (*standard deviation*).

Tangible asset Physical asset, such as plant, machinery, and offices (cf. *intangible asset*).

Tax-anticipation bill Short-term bill issued by the U.S. Treasury that can be surrendered at *face value* in payment of taxes.

T-bill *Treasury bill.*

Technical analysis Security analysis that seeks to detect and interpret patterns in past security prices (cf. *fundamental analysis*).

TED spread Difference between *LIBOR* and U.S. *Treasury bill* rate.

Tender offer General offer made directly to a firm's shareholders to buy their stock.

10-K Annual financial statements as filed with the *SEC.*

10-Q Quarterly financial statements as filed with the *SEC.*

Tenor Maturity of a loan.

Terminal warehouse *Public warehouse.*

Term loan Medium-term, privately placed loan, usually made by a bank.

Term structure of interest rates Relationship between interest rates on loans of different maturities (cf. *yield curve*).

Throughput arrangement Arrangement by which shareholders of a pipeline company agree to make sufficient use of pipeline to enable the pipeline company to service its debt.

Tick Minimum amount the price of a security may change.

Time draft Demand for payment at a stated future date (cf. *sight draft*).

Times-interest-earned (interest cover) Earnings before interest and tax, divided by interest payments.

TIPS (Treasury Inflation Protected Securities) U.S. Treasury *bonds* whose *coupon* and *principal* payments are linked to the Consumer Price Index.

Toehold Small investment by a company in the shares of a potential takeover target.

Tolling contract In *project finance*, arrangement whereby parent company promises to deliver materials to project for processing and then to repurchase them.

Tombstone Advertisement listing the *underwriters* to a security issue.

Trade acceptance Written demand that has been accepted by an industrial company to pay a given sum at a future date (cf. *banker's acceptance*).

Trade credit *Accounts receivable.*

Trade debt *Accounts payable.*

Tranche Portion of a new issue sold at a point in time different from the remainder or that has different terms.

Transaction exposure Risk to a firm with known future cash flows in a foreign currency that arises from possible changes in the exchange rate (cf. *economic exposure, translation exposure*).

Transfer agent Individual or institution appointed by a company to look after the transfer of securities.

Translation exposure Risk of adverse effects on a firm's financial statements that may arise from changes in exchange rates (cf. *economic exposure, transaction exposure*).

Treasurer Principal financial manager (cf. *controller*).

Treasury bill (T-bill) Short-term discount debt maturing in less than one year, issued regularly by the government.

Treasury stock *Common stock* that has been repurchased by the company and held in the company's treasury.

Trust deed Agreement between trustee and borrower setting out terms of a *bond*.

Trust receipt Receipt for goods that are to be held in trust for the lender.

Tunneling Actions by a controlling shareholder to transfer wealth out of the firm (e.g., by supplying goods at an inflated price).

U

Underpricing Issue of securities below their market value.

Underwriter Firm that buys an issue of securities from a company and resells it to investors.

Unfunded debt Debt maturing within one year (cf. *funded debt*).

Uniform price auction Auction in which all successful bidders pay the same price (cf. *discriminatory price auction*).

Unique risk *Specific risk.*

Unseasoned issue Issue of a security for which there is no existing market (cf. *seasoned issue*).

Unsystematic risk *Specific risk.*

V

Value additivity Rule that the value of the whole must equal the sum of the values of the parts.

Value at risk (VAR) The probability of portfolio losses exceeding some specified proportion.

Value stock A stock that is expected to provide steady income but relatively low growth (often refers to stocks with a low ratio of market-to-book value).

Vanilla issue Issue without unusual features.

VAR *Value at risk.*

Variable-rate demand bond (VRDB) Floating-rate *bond* that can be sold back periodically to the issuer.

Variance Mean squared deviation from the expected value; a measure of variability.

Variation margin The daily gains or losses on a *futures* contract credited to the investor's margin account.

Vega A measure of how the *option* price changes as the asset's volatility changes.

Venture capital Capital to finance a new firm.

Vertical merger *Merger* between a supplier and its customer (cf. *horizontal merger, conglomerate merger*).

Vertical spread Simultaneous purchase and sale of two options that differ only in their *exercise price* (cf. *horizontal spread*).

VIX A measure of the *implied volatility* of stocks in the S&P 500 Index.

VRDB *Variable rate demand bond.*

W

WACC *Weighted-average cost of capital.*

Warehouse receipt Evidence that a firm owns goods stored in a warehouse.

Warrant Long-term *call option* issued by a company.

Weak-form efficient market Market in which security prices instantaneously reflect the information in the history of security prices. In such a market security prices follow a random walk (cf. *semistrong-form efficient market* and *strong-form efficient market*).

Weighted-average cost of capital (WACC) *Expected return* on a portfolio of all the firm's securities. Used as *hurdle rate* for capital investment.

White knight A friendly potential acquirer sought out by a target company threatened by a less welcome suitor.

Wi. When issued.

Winner's curse Problem faced by uninformed bidders. For example, in an *initial public offering* uninformed participants are likely to receive larger allotments of issues that informed participants know are overpriced.

With dividend (cum dividend) Purchase of shares in which the buyer is entitled to the forthcoming *dividend* (cf. *ex dividend*).

Withholding tax Tax levied on *dividends* paid abroad.

With rights (cum rights, rights on) Purchase of shares in which the buyer is entitled to the rights to buy shares in the company's *rights issue* (cf. *ex rights*).

Working capital *Current assets* and *current liabilities*. The term is commonly used as synonymous with *net working capital*.

Workout Informal arrangement between a borrower and creditors.

Writer *Option* seller.

X

xd *Ex dividend.*

xr *Ex rights.*

Y

Yankee bond A dollar *bond* issued in the United States by a non-U.S. borrower (cf. *bulldog bond, Samurai bond*).

Yield curve *Term structure of interest rates.*

Yield curve note *Reverse FRN.*

Yield to maturity *Internal rate of return* on a bond.

Z

Zero-coupon bond *Discount bond* making no *coupon* payments.

Z-score Measure of the likelihood of bankruptcy.