



iQUANT.pro

GUIDE TO
INVESTMENT TERMS

Empowering Investment Advisors with essential insights.

Dear Investment Advisor

It is with great pleasure we present to you this comprehensive document on investment terms, crafted by iQUANT. In the ever-evolving world of finance, staying up-to-date with the latest investment jargon and concepts is crucial for success. With this in mind, we have meticulously compiled a summary of essential investment terms that will serve as a valuable reference guide for both seasoned professionals and aspiring advisors alike. You will find these terms on our model factcards and portfolio optimizer reports.

At iQUANT, we understand the importance of providing our clients with the knowledge and tools necessary to navigate the intricate landscape of investments. This guide is designed to empower you, the investment advisors, by offering concise and easily understandable explanations of key investment terms. Whether you are discussing investment options with clients, reviewing iQUANT models, or engaging in financial planning discussions, having a firm grasp of these terms is essential for effective communication and decision-making.

We recognize that the financial world is characterized by its fast-paced nature and ever-changing landscape. To that end, we have made it a priority to include the most up-to-date terminology and concepts in this document. Our team of experts has meticulously researched and reviewed the investment industry to ensure that you are equipped with the latest information.

We believe that knowledge is power, and our goal is to empower you to make informed investment decisions for your clients. By understanding the intricacies of investment terms, you can enhance your advisory skills, communicate more effectively with your clients, and ultimately achieve better investment outcomes.

Best regards,



Your Friends at iQUANT.pro

iQ Guide to Investment Terms

COMPOUND ANNUAL GROWTH RATE (CAGR)

CAGR is an abbreviation for Compound Annual Growth Rate. It is a metric used to calculate the average yearly growth rate of an investment over a given time period while accounting for compounding. The compounding effect, which implies that the returns gained in each year are reinvested and contribute to the overall growth of the investment, provides a more accurate picture of investment performance.

iQUANT views CAGR to be superior to average annual return since it represents an investment's true growth rate over time. Average annual return assumes an investment's returns are linear over time, which is frequently not the case. CAGR, on the other hand, accounts for compounding and represents investment growth more accurately.

By using CAGR, advisors can make more informed decisions about the long-term performance of their investments. It helps to understand the true growth rate of an investment over a specified period and enables meaningful comparisons between different investment options. CAGR is a widely used metric in the financial industry as it allows for better evaluation and comparison of investment performance than average annual return.

STANDARD DEVIATION

Standard deviation is a statistical measure that helps us understand the variability or risk associated with an investment's returns. In simple terms, it tells us how much the returns of an investment can deviate from the average or expected return. Think of it as a measure of how volatile or fluctuating an investment's performance can be.

Let's break it down. Imagine you have an investment that provides an average annual return of 8%. However, the actual returns from year to year may not be exactly 8%. Some years, the returns may be higher than 8%, and other years, they may be lower. The standard deviation gives us an idea of how much those returns might deviate from the 8% average.

A higher standard deviation indicates greater variability in returns, which means the investment's performance can be more unpredictable or volatile. On the other hand, a lower standard deviation suggests more stability and less fluctuation in returns. advisors often consider the standard deviation as a measure of risk because higher volatility implies a higher chance of experiencing both positive and negative returns.

SHARPE RATIO

The Sharpe ratio is a popular financial metric that helps advisors estimate an investment's risk-adjusted return (and efficiency). It was created by Nobel winner William F. Sharpe and is widely utilized in the financial industry. The ratio provides useful information about how well an investment has done in relation to its level of risk.

In simple terms, the Sharpe ratio compares the excess return of an investment (above a risk-free rate) to the volatility or risk taken to achieve that return. It quantifies the additional return earned per unit of risk assumed. A higher Sharpe ratio indicates a better risk-adjusted performance, as it suggests that the investment generated more return for each unit of risk taken.

To calculate the Sharpe ratio, we subtract the risk-free rate of return from the investment's average return and divide it by the standard deviation of the investment's returns. The resulting ratio tells us how much excess return the investment generated for each unit of risk. A positive Sharpe ratio implies that the investment has provided a higher return than the risk-free rate, while a negative ratio suggests the investment has underperformed the risk-free rate.

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MAX DRAWDOWN

Max drawdown is a measure used in finance to understand the largest decline or loss an investment has experienced from its peak value to its lowest point before a new peak is reached. In simple terms, it tells you how much an investment has dropped at its worst during a specific period. Imagine riding a roller coaster—the max drawdown is like the steepest dip you experience before the ride starts climbing again.

To calculate max drawdown, you look at the percentage decline from the highest point to the lowest point in the investment's value. It helps advisors gauge the potential downside risk of an investment. For example, if an investment's value reached \$10,000 and dropped to \$7,000 before climbing back up, the max drawdown would be 30% ($[\$10,000 - \$7,000] / \$10,000$).

advisors pay attention to max drawdown as it provides insight into an investment's volatility and potential losses. A smaller max drawdown indicates a more stable investment with smaller fluctuations, which can be desirable for risk-averse advisors. On the other hand, a larger max drawdown suggests higher volatility and the potential for significant losses, which might be suitable for those comfortable with higher risk.

One drawback of using max drawdown as a measure of risk is that it focuses solely on the historical worst-case scenario without considering the context or underlying reasons for the drawdown. Additionally, max drawdown calculations are based on past data, and future drawdowns may be influenced by unforeseen events, such as black swan events, making them difficult to predict or replicate.

ALPHA

In simple terms, alpha represents the excess return generated by an investment after accounting for the expected return based on its level of risk. It is often seen as a measure of the investment manager's skill in generating returns beyond what can be attributed to the general market movements.

Alpha is a crucial concept because it helps evaluate the performance of a particular investment strategy or portfolio manager. A positive alpha indicates that the investment has generated higher returns than expected given its level of risk, suggesting successful stock selection. Conversely, a negative alpha implies that the investment has underperformed its expected returns, potentially indicating an ineffective investment strategy.

For example, let's consider a mutual fund that aims to track the performance of the S&P 500 index, which serves as the benchmark. If the fund generates a return of 10% while the S&P 500 returns 8%, the fund has achieved a positive alpha of 2%. This implies that the fund's manager has made successful investment decisions, resulting in returns that surpass the market's performance. Conversely, if the fund returns 7% while the benchmark returns 8%, it indicates a negative alpha of -1%, suggesting that the fund underperformed the market.

KURTOSIS

Kurtosis is a statistical measure used to determine the shape of a distribution. It reveals the peakedness or flatness of a dataset in comparison to a normal distribution. In layman's terms, kurtosis tells us whether the data has more or fewer outliers or extreme values.

Imagine a graph that represents the distribution of a dataset. If the graph is tall and narrow, it indicates a higher kurtosis value. This means the data is more concentrated around the mean, and there is a higher likelihood of extreme values or outliers. On the other hand, if the graph is flatter and wider, it indicates a lower kurtosis value. This suggests a more spread-out distribution with fewer extreme values.

Kurtosis is useful in various fields, including finance and risk analysis. It helps advisors and analysts assess the potential risk associated with a dataset. A higher kurtosis value implies a higher probability of extreme returns, indicating higher risk, while a lower kurtosis value suggests a lower probability of extreme returns, indicating lower risk. However, it's important to consider other measures alongside kurtosis to get a complete understanding of the dataset's characteristics and potential risks.

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SKEWNESS

Skewness is a statistical measure that helps us understand the asymmetry or "lopsidedness" of a distribution. In simpler terms, it tells us whether the data is more concentrated on one side of the mean compared to the other. Skewness provides valuable insights into the shape of a dataset and the likelihood of extreme values.

Imagine a scenario where you have a dataset of housing prices in a city. If the majority of houses are priced below the average, and there are a few very expensive luxury homes, the distribution of housing prices would be positively skewed. This means the tail of the distribution extends towards higher values, indicating that the dataset is lopsided with more low-priced houses and a few high-priced outliers.

Conversely, if the majority of houses are priced above the average, and there are a few very cheap houses, the distribution of housing prices would be negatively skewed. This means the tail of the distribution extends towards lower values, indicating that the dataset is lopsided with more high-priced houses and a few low-priced outliers.

CAPTURE RATIOS

Capture ratios are statistical measures used to evaluate the performance of an investment relative to a benchmark or index. They provide insights into how well an investment captures or follows the movements of the benchmark. There are two commonly used capture ratios: upside capture ratio and downside capture ratio.

The upside capture ratio measures how well an investment performs in positive market conditions compared to the benchmark. It indicates the percentage of the benchmark's positive returns captured by the investment. A higher upside capture ratio suggests that the investment tends to outperform the benchmark when the benchmark is experiencing positive returns. This can be indicative of strong relative performance during upward market trends.

On the other hand, the downside capture ratio assesses how well an investment holds up during negative market conditions compared to the benchmark. It indicates the percentage of the benchmark's negative returns captured by the investment. A lower downside capture ratio suggests that the investment tends to perform better than the benchmark during market downturns. This indicates potential downside protection and a more conservative approach during market declines.

iQUANT calculates capture ratios based on monthly datapoints.

BETA

Investment beta, also known as beta coefficient or simply beta, is a measure of a stock or investment's sensitivity to changes in the overall market. It helps advisors understand how much an investment's price tends to move in relation to movements in a benchmark, such as the overall stock market. In simple terms, beta provides insight into how volatile or risky an investment is compared to the broader market.

Imagine you're driving on a highway, and the market is like the flow of traffic. Some cars move faster or slower than the average speed of traffic. Investment beta works in a similar way. If a stock has a beta of 1, it tends to move in line with the market, like a car traveling at the same speed as the traffic. A stock with a beta greater than 1 is more volatile than the market, like a car driving faster than the average flow. Conversely, a stock with a beta less than 1 is less volatile than the market, like a car driving slower than the average speed.

Advisors use beta to assess an investment's risk and potential returns. A higher beta suggests higher potential volatility and risk, as the investment tends to magnify market movements. Conversely, a lower beta implies lower volatility and risk. It's important to note that beta is just one of many factors to consider when making investment decisions, and it should be evaluated alongside other fundamental and quantitative analysis.

In addition to a top-line beta, iQUANT also splits beta between up and down markets, giving advisors the ability to assess an investment's risk exposure, understand its behavior during different market conditions, and make informed decisions about portfolio construction and risk management.

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CORRELATION

Investment correlation is a statistical measure that helps us understand the relationship between two or more investments. In simple terms, it tells us how investments move in relation to each other. Correlation ranges from -1 to +1, with different values indicating different types of relationships.

A correlation of +1 means the investments move in perfect harmony, rising and falling together. For example, if two stocks have a correlation of +1, when one stock goes up, the other stock also goes up by a proportional amount. This indicates a strong positive correlation. On the other hand, a correlation of -1 means the investments move in perfect opposition. When one investment goes up, the other goes down by the same proportional amount. This indicates a strong negative correlation. Lastly, a correlation of 0 means there is no relationship between the investments. The movements of one investment have no impact on the other. This indicates no correlation or a weak correlation.

Understanding investment correlation is important for constructing well-diversified portfolios. By combining investments with low or negative correlation, advisors can potentially reduce the overall risk of their portfolios. If one investment is experiencing a decline, another investment with a low or negative correlation may be holding steady or even rising, helping to offset losses.

In addition to top-line correlation, iQUANT also splits correlation between up and down markets. Evaluating correlation in both up and down markets provides valuable insights into the behavior of investments across different market conditions. By evaluating correlation in both up and down markets, advisors can make more informed decisions and build portfolios that are better positioned to navigate different market environments.

RANGE OF CAGRS

As mentioned previously, when evaluating investment performance, one useful measure is the Compound Annual Growth Rate (CAGR). CAGR represents the average annual rate of return over a specific time period, smoothing out the fluctuations and providing a single, comparable metric. However, it's important to consider the range of CAGRs to gain a more comprehensive understanding of investment performance.

The range of CAGRs refers to the variation in annual returns across different time periods. By examining the range, you can assess the consistency and stability of an investment's performance. A narrow range indicates a more consistent and predictable return pattern, suggesting lower volatility and potentially lower risk while a wide range suggests more significant fluctuations in returns, indicating higher volatility and higher risk.

Considering the range of CAGRs is important because it provides insights into the stability and reliability of an investment's performance over time. A narrow range suggests that the investment has consistently delivered returns within a relatively predictable range, giving advisors confidence in its long-term potential. On the other hand, a wide range may indicate periods of exceptional performance alongside periods of underperformance, which could be a concern for advisors seeking consistency.

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