FIDUCIARY ESSENTIALS FOR DEFINED BENEFIT PLANS

GLOSSARY

ACTIVE MANAGEMENT: A form of investment management that involves buying and selling financial assets with the objective of earning returns greater than a specified benchmark.

ACTIVE MANAGEMENT RETURN: The difference between a portfolio's return and the benchmark's return.

ACTIVE MANAGEMENT RISK: The risk taken by an active portfolio manager to earn active management returns by taking positions different from the benchmark; typically measured by the standard deviation of active management returns.

ACTUARY: A person or firm that specializes in estimating the liabilities associated with a benefit plan or an insurance trust.

ACTUARIAL ACCRUED LIABILITY: In the context of a defined benefit pension plan, that portion of the present value of benefits promised to employees that will not be provided through future normal cost. Stated differently, it is the present value of benefits already earned by employees.

ACTUARIALLY DETERMINED CONTRIBUTION (ADC): A target or recommended contribution to a defined benefit plan for the reporting period, determined in conformity with Actuarial Standards of Practice (ASOP) based on the most recent measurements available when the contribution for the reporting period was adopted.

ACTUARIAL VALUE OF ASSETS (AVA): The value of pension plan investments used by the actuary for the purpose of an actuarial valuation. Actuaries often select an asset valuation method that smoothes the effect of short-term volatility in the market value of assets.

ACTUARIAL VALUATION: The determination, as of a point in time (the actuarial valuation date), of the service cost, total pension liability, and related actuarial present value of projected benefit payments for pension performed in conformity with Actuarial Standards of Practice unless otherwise specified by the Government Accounting Standards Board (GASB).

ACCUMULATED BENEFIT OBLIGATION (ABO): The ABO is the actuarial present value of expected future benefit payments attributed by the pension benefit formula based only on the employees' accumulated service to the measurement date. The ABO is based on the assumption that no future pension benefits, or increases in benefits based on futures salary increases, will accrue in the future.

ALPHA: The amount of return expected from an investment from its inherent value.

ANNUITY - A contract that guarantees a series of future payments to a party, the annuitant, beginning at a specified point in time and continuing to a specified future point in time or terminating at the date of the annuitant's death.

ANNUAL REPORT: The yearly audited record of a corporation or a mutual fund's condition and performance that is distributed to shareholders.

ANNUAL REQUIRED CONTRIBUTION (ARC) - The actuarially determined pension fund contribution in a single year is the sum of two factors:

- The cost of pension benefits being accrued in the current year (known as the normal cost), plus
- The cost to amortize, or pay off, the plan's unfunded liability.

ARC was introduced by GASB in 1994 in Statements 25 and 27; however, they were superseded by GASB Statements 67 and 68, which eliminated the ARC as a required disclosure. Public retirement systems that to continue to calculate an ARC are required to publish it along with the assumptions used to make the calculation.

ANNUALIZED: A procedure where figures covering a period of less than one year are extended to cover a 12-month period.

ANNUALIZED RATE OF RETURN: The average annual return over a period of years, taking into account the effect of compounding. Annualized rate of return also can be called compound growth rate.

APPRECIATION: The increase in value of a financial asset.

ASSET ALLOCATION: Investment strategy that apportions a portfolio's assets according to the investor's goals, risk tolerance, and investment horizon. Allocation typically involves selecting assets representing different asset classes. The assets in each class have different levels of risk and return, and may behave differently over time.

ASSET CLASS: A broadly defined generic group of financial assets, such as stocks or bonds.

AVERAGE MATURITY: For a bond fund, the average of the stated maturity dates of the debt securities in the portfolio. Also called average weighted maturity. In general, the longer the average maturity, the greater the fund's sensitivity to interest-rate changes, which means greater price fluctuation. A shorter average maturity usually means a less sensitive - and consequently, less volatile - portfolio.

BALANCED FUND: Mutual funds that seek both growth and income in a portfolio with a mix of common stock, preferred stock or bonds. The companies selected typically are in different industries and different geographic regions.

BASIS POINT: One one-hundredth of a percentage point, or 0.01%; 100 basis points (bps) add up to 1%.

BEAR MARKET: A bear market is a prolonged period of falling stock prices, usually marked by a decline of 20% or more. A market in which prices decline sharply against a background of widespread pessimism, growing unemployment or business recession. The opposite of a bull market.

BENCHMARK: A portfolio with which the investment performance of an investor can be compared for the purpose of determining investment skill. A benchmark portfolio represents a relevant and investable alternative to the investor's actual portfolio and, in particular, is similar in terms of risk exposure.

BENEFITS: Periodic payments promised or expected to be made to the designated beneficiaries of a pool of assets.

BENEFIT MULTIPLIER: A fixed percentage that is typically used, in conjunction with an employee's final average salary and years of service, to determine an employee's pension benefits.

BENEFIT POLICY: Term used to describe the basis for which employees earn benefits in the plan.

BETA: A relative measure of the sensitivity of an asset's return to changes in the return on the market portfolio.

BLUE CHIP: A high-quality, relatively low-risk investment; the term usually refers to stocks of large, well-established companies that have performed well over a long period. The term Blue Chip is borrowed from poker, where the blue chips are the most valuable.

BOARD OF TRUSTEES: A governing board elected or appointed to direct the policies of an institution.

BOND (FIXED-INCOME SECURITY): A type of investment in which the holder lends money to another entity and is then entitled to periodic payments of interest and a return of the principal at a specified time in the future. In summary, a bond acts like a loan or an IOU that is issued by a corporation, municipality or the U.S. government. The issuer promises to repay the full amount of the loan on a specific date and pay a specified rate of return for the use of the money to the investor at specific time intervals.

BOND FUND: A mutual fund that invests exclusively in bonds.

CENSUS DATA: Per capita claims costs along with participant demographics are used to estimate future benefit payments. Examples of so-called "census" data that may be accumulated for purposes of the pension plan include:

- Date of birth;
- Gender;
- Date of hire;

- Business unit;
- Hourly/salaried employee;
- Marital status and spouse's date of birth; and
- Retirement date.

COMMITTEE OF SPONSORING ORGANIZATIONS OF THE TREADWAY COMMISSION (COSO): Organization that published *Internal Control: An Integrated Framework, Enterprise Risk Management – Integrated Framework*, and *Guidance on Monitoring Internal Control Systems* and several other internal control framework-related tools.

COMMON STOCK (EQUITY; STOCK): Legal representations of an ownership position in a corporation.

COMPREHENSIVE ANNUAL FINANCIAL REPORT (CAFR): Financial report that contains, at a minimum, three sections: (1) introductory, (2) financial, and (3) statistical, and whose financial section provides information on each individual fund and component unit.

CONFLICT OF INTEREST: A situation in which the actions of a person who has a duty to one party could benefit that person (or a related party) at the expense of the party to whom the duty is owed.

CORRELATION: A statistical measure of the covariation of two random variables (i.e., how much two asset returns change together).

DEFINED BENEFIT (DB) PLAN: Employee retirement plan established and maintained by an employer that uses a predetermined formula to calculate the amount of an employee's retirement benefit. Early DB plans (referred to as flat benefit plans) were commonly a set dollar amount that was the same for all employees, regardless of their actual compensation, or a fixed percentage of an employee's compensation. Any employee who worked for the company a minimum number of years received the same dollar amount or fixed percentage upon retirement. Today, DB plans and their formulas are more likely to take into consideration an employee's years of service; such plans are called unit benefit plans. Employer contributions to DB plans are determined actuarially. No individual accounts are maintained, as is done for defined contribution plans. In the United States, ERISA and federal tax laws consider any plan that is not an individual account plan to be a defined benefit plan.

DEFINED CONTRIBUTION (DC) PLAN: As defined by federal law, a plan that provides an individual retirement account for each participant with benefits based solely on (1) the amount contributed to the participant's account plus (2) any income, expenses, gains, losses and forfeitures from other participants. Contributions to an account may be made by the employee or the employer. Defined contribution plans include 401(k), 403(b) and 457 plans.

DEMOGRAPHIC ASSUMPTIONS: The calculation of expected benefits for plan participants requires the use of assumptions about the demographics of plan participants. Examples of such demographic assumptions include estimates of:

- Life expectancy or mortality;
- Expected retirement age;

- Employee turnover; and
- Other factors such as probability of disability, marital status, and dependency status.

DIVERSIFICATION: The process of investing in more than one type of asset to reduce the risk of the entire portfolio

EAFE INDEX: An equity market index that includes securities from countries in Europe, Australasia, and the Far East with well-developed capital markets. US and Canadian securities are not included.

EXPECTED RETURN (PROJECTED RETURN): The return on a security (or portfolio) that an investor anticipates receiving over a given time horizon.

EXPENSE RATIO: Annual fee that a mutual fund or exchange-traded fund charges its shareholders for fund administration, management, operating, and distribution services, expressed as a percentage of the market value of the fund's assets.

FIDUCIARY: Person or institution legally responsible for the management, investment, and distribution of a fund. The trustees and administrators who are responsible for the oversight of employee benefit trust funds are considered fiduciaries. Federal law defines a fiduciary as any person who (1) exercises any discretionary authority or control over the management of a plan or the management or disposition of its assets; (2) renders investment advice for a fee or other compensation with respect to the funds or property of a plan or has the authority to do so; or (3) has any discretionary authority or responsibility in the administration of a plan.

FIDUCIARY DUTY: A legal or ethical relationship of confidence or trust between one party and another party or parties.

FUNDED RATIO: Ratio of the value of a fund's assets to the value of the fund's liabilities.

FUNDING POLICY: Statement(s) clarifying the goals and objectives of a benefits plan, and how to achieve them. This policy should include the amounts and timing of contributions by employers and participants.

GAAFR: Acronym for *Governmental Accounting, Auditing, and Financial Reporting*, a publication of GFOA. Also known as the "Blue Book." Various editions of this book have been published since the mid-1930s.

GASB: The Government Accounting Standards Board provides accounting rules for state and local governments.

GFOA: Acronym for the Government Finance Officers Association. For well over a century, the Government Finance Officers Association has promoted accountability and transparency in financial reporting by United States state and local governments. https://www.gfoa.org/

GOVERNANCE STRUCTURE: A set of processes by which a fund is managed for the benefit of some group of beneficiaries.

GROWTH STOCKS: The stocks of companies that have experienced or are expected to experience earnings-per-share growth higher than the market as a whole. Growth stocks also tend to display high price-to-earnings ratios relative to the market.

HEDGE FUND: A form of active management distinguished by a lack of traditional guidelines or benchmarks; a hedge fund typically uses derivatives, leverage, and/or short selling. The term is often synonymous with absolute return fund; sometimes associated with alternative investments.

HIGH-YIELD (JUNK) BONDS: Below-investment-grade bonds (a credit rating below BBB from S&P, or below Baa from Moody's) that have higher current yields (coupon payment divided by current market price) than other investment-grade bonds of similar maturity because of greater uncertainty of coupon and principal payment.

INFORMATION RATIO: A risk-adjusted measure of portfolio active management performance. Mathematically, over an evaluation period, it is the annualized ratio of active management return to active management risk, where risk is measured as the standard deviation of the portfolio's active management returns.

INTERNAL RATE OF RETURN: See money-weighted rate of return.

INVESTABLE UNIVERSE: The aggregate of securities that is appropriate and available for selection under a particular investment mandate.

INVESTMENT COMMITTEE: A group of individuals who are responsible for determining the investment policy of a fund.

INVESTMENT CONSULTANT: A professional (usually associated with a firm) who offers advisory services to a fund, most often in the areas of asset allocation, investment policy, and manager selection.

INVESTMENT-GRADE BONDS: Generally, bonds that possess bond ratings of BBB (Standard & Poor's) or Baa (Moody's Investment Services) or higher. Such ratings permit them to be purchased by regulated financial institutions, such as banks.

INVESTMENT MANAGER: A person or entity that creates and manages portfolios of securities for clients.

INVESTMENT POLICY: Commonly used to describe how contributions to an employee benefit plan are to be utilized from the time they are received until benefits are paid. It is a critical component of the investment process and involves determining a fund's mission, objectives, and attitude toward the trade-off between expected return and risk.

INVESTMENT POLICY STATEMENT (IPS): A formal written document describing a fund's investment policy. Sometimes described as a Statement of Investment Policy, SIP.

INVESTMENT RETURN: The percentage change in the value of an investment in a financial asset (or portfolio of financial assets) over a specified time period.

INVESTMENT RISK: The potential for loss accepted by an investor in the pursuit of investment return; alternatively, the uncertainty associated with the end-of-period value of an investment.

INVESTMENT SKILL: The ability of an active manager to select portfolios that consistently have average returns greater than a given performance benchmark.

LIABILITY: The present value of the accrued benefits promised to the beneficiaries of a fund.

LIQUIDITY: Property of a security that allows investors to convert the security into cash at a price similar to the price of the previous trade in the security (assuming that no significant new information has arrived since the previous trade).

MANDATE: Strategy or performance benchmark used by an investment manager on behalf of and at the direction of a client.

MARKET CAPITALIZATION: Aggregate market value of a security, equal to the market price per unit of the security multiplied by the total number of outstanding units of the security.

MARKET CYCLE: A period of time over which a particular security market moves from one peak to another or from one trough to another.

MARKET INDEX: A collection of securities whose values are averaged to reflect the overall investment performance of a particular market for financial assets.

MONEY MARKET INVESTMENT: A short-term, highly liquid debt instrument, including commercial paper, banker’s acceptances, and U.S. Treasury and agency obligations. Asset-backed securities, derivative instruments, and structured notes are *not* encompassed by this term.

MONEY-WEIGHTED RATE OF RETURN (INTERNAL RATE OF RETURN): The rate of return on a portfolio over a particular period of time. It is the discount rate that equates the present value of cash flows into and out of the portfolio, plus the portfolio's ending value, to the portfolio's beginning value.

MUTUAL FUND: A managed investment company of the open-end type, with an unlimited life, that stands ready at all times to purchase its shares from its owners and usually will continuously offer new shares to the public.

NET ASSET VALUE PER SHARE (NAV): The amount of net assets attributable to each share of capital stock outstanding at the close of a period. In the context of a mutual fund, it is the value per share of net assets calculated at the close of every business day. NAV is the redemption price of a mutual fund share.

NORMAL COST: The cost of the pension benefits earned in the current year.

OTHER POSTEMPLOYMENT BENEFITS (OPEB): Consists of (1) benefits (such as death benefits, lie insurance, disability, and long-term care) that are paid in the period after employment and are provided separately from a pension plan, as well as (2) postemployment healthcare benefits paid in the period after employment, regardless of the manner in which they are provided.

OVERFUNDED: The status of a fund whose assets are greater in value than the associated plan's liabilities.

PASSIVE MANAGEMENT (INDEXING): The process of buying and holding a well-diversified portfolio designed to produce substantially the same returns as a specified market index.

PAY-AS-YOU-GO RETIREMENT SYSTEM: A system in which current benefits are paid out of the current year's contributions. Social Security is largely a pay-as-you-go program. This means that today's workers' pay Social Security taxes into the program and money flows back out as monthly income to beneficiaries. By contrast, defined benefit pension plans in the private sector and in state and local government are generally pre-funded systems.

PEER GROUP: A set of investors (funds or managers) whose returns are used for a comparison with those of a given fund to determine how the given fund ranks among similar funds.

PENSION: A steady income given to a person as the result of service (e.g., employee, military) that begins when a specific event (e.g., disability, retirement) occurs. Pensions are typically paid monthly and based on factors such as years of service and prior compensation. The payment may be made by a government, employer, pension fund, or life insurance company.

PENSION EXPENSE: An accrual measure of the current year's outflow of resources associated with the employer's pension. Calculation of pension expense is based on the change in the employer's pension liability, adjusted for deferred portions, if any, of (1) differences between and expected and actual experience, (2) differences between projected and actual earnings on plan investments, and (3) changes of assumptions or other inputs.

PERFORMANCE APPRAISAL: The part of the performance evaluation process that attempts to determine whether the investment returns over an evaluation period have been achieved by skill or luck.

PERFORMANCE ATTRIBUTION: The part of the performance evaluation process that identifies sources of returns for a portfolio relative to a designated benchmark over an evaluation period.

PERFORMANCE EVALUATION: A component of the investment process involving periodic analysis of how a portfolio performed in terms of both returns earned and risks incurred.

PERFORMANCE MEASUREMENT: The part of the performance evaluation process that calculates a portfolio's rate of return over an evaluation period.

PLAN PARTICIPANT: A member of a defined-benefit or defined-contribution plan to whom benefits are promised or are being paid. Plan participants may be actives (currently employed) or retired.

POLICY ASSET MIX: A set of asset classes and desired percentage allocations to each class such that the total portfolio displays the investor's desired risk and expected return profile; also referred to as the "policy portfolio," "policy benchmark," "policy asset allocation," or "strategic asset allocation."

POSTEMPLOYMENT BENEFITS (PEB): Benefits that are paid subsequent to a termination of employment in exchange for services rendered during employment. Consists of pensions and other postemployment benefits (OPEB).

PRE-FUNDED RETIREMENT SYSTEM: A system in which the benefits to be paid during retirement are paid for before retirement begins. Typically, regular contributions for each worker are made into a retirement fund during the course of that worker's career, starting with the first paycheck and continuing until the last. These contributions are invested, and contributions accumulated investment earnings pay for benefits in retirement.

PRIVATE EQUITY: A broad asset class generally involving buyouts, venture capital, and distressed debt converted into equity.

PROJECTED BENEFIT OBLIGATION (PBO): The projected benefit obligation is the actuarial value of all expected future benefit payments attributed to the pension benefit formula to employee service rendered to date. Measurement of the PBO should reflect future compensation levels to the extent that defined benefits are compensation-related, in accordance with an appropriate projected unit credit method. Future compensation levels should be consistent with the formula defining the pension benefit and include an estimate of future compensation levels of individual employees covered by the plan, including changes attributed to general price levels, productivity, seniority, and promotion, depending upon the pension benefit formula.

PUBLIC EMPLOYEE RETIREMENT SYSTEM (PERS): A special-purpose government that administers one or more pension plans; may also administer other types of employee benefit plans, including postemployment healthcare plans and deferred compensation plans.

REAL ESTATE: An investment in land and physical structures intended to provide a stream of rental or lease income and possibly capital appreciation.

REALIZED GAINS AND LOSSES: The difference between the carrying value of an asset (cost basis) and its price at the time of sale. The term *unrealized gains and losses* is used to describe the difference between carrying value and market price prior to sale.

REBALANCING: The process of buying and selling assets to restore a fund to its policy asset mix after market movements or net cash flows have changed the actual market weights of the various asset classes.

RECORD KEEPER: An investment organization responsible for maintaining the financial and investment details of the individual participants' records in a retirement plan.

RELATIVE PERFORMANCE: The difference between a portfolio's return and the benchmark's return.

REPLACEMENT RATIO (REPLACEMENT RATE): Ratio which compares a household's post-retirement income from all sources (Social Security, pensions, and savings) to its income before retirement. The replacement ratio is a common measure of determining retirement income adequacy.

RISK BUDGETING: A risk management technique in which assets are allocated efficiently so that the expected return of each asset is proportional to its contribution to portfolio risk.

RISK CAPACITY: Financial ability of an investment organization to withstand adverse investment results.

RISK MANAGEMENT: A part of the investment process in which the risks of a portfolio are identified and quantified; strategies are then developed to control those risks.

RISK TOLERANCE: The trade-off between risk and expected return demanded by a particular investor.

SCENARIO ANALYSIS: A process whereby, for the purpose of designing appropriate investment strategies, an investor considers a number of possible future economic investment environments and the likelihood of those environments occurring.

SEPARATELY MANAGED ACCOUNT (SMA): An investment vehicle that takes in funds from a single investor and uses the proceeds to purchase financial assets for the sole benefit of that investor. The investor directly owns all assets held in the account. Also called "separate account."

SHARPE RATIO: A risk-adjusted measure of portfolio performance in which risk is measured by the standard deviation of the portfolio's returns. Mathematically, over an evaluation period, it is the annualized ratio of the excess return (the actual return less the risk-free return) of the portfolio divided by the portfolio's standard deviation.

SMOOTHING: The process of amortizing investment gains and losses over a period of time. For example, rather than using the market value of a fund's assets in determining the balance sheet entry, actuaries may calculate an actuarial value of assets (AVA) by taking, say, a five year average of assets. This can help to reduce volatility in contribution rates.

STAFF: The professionals who, on a day-to-day basis, administer the investment program of a fund.

STANDARD DEVIATION: A statistical measure of the variability (range of potential outcomes) of investment returns.

STOCK: See common stock.

STRESS TEST: A form of analysis in which one estimates the impact of various adverse situations on the returns of a portfolio.

TIME-WEIGHTED RATE OF RETURN: The rate of return on a portfolio over a particular period of time. Effectively, it is the return on $1.00 invested in the portfolio at the beginning of the measurement period.

TOTAL PENSION LIABILITY (TPL): GASB Statements No. 67 and 68, which became effective in 2014 and 2015, require all plans to report a standardized measure of actuarial liability, referred to as the *Total Pension Liability*. TPL must be calculated using a uniform cost method (the individual entry age cost method) rather than the actuarial cost method the plan uses to determine contribution amounts, and it must be calculated using a discount rate that under certain circumstances may be lower than the investment return assumption used for funding purposes. Additionally, each plan is required to disclose how sensitive its Total Pension Liability is to changes in the discount rate. For some plans a different liability measurement is used as part of the process of determining amounts that should be contributed to fund the plan.

TRUSTEE: Person, bank, or trust company that has fiduciary responsibility for a pool of assets, i.e., responsibility over the receipt, disbursement and investment of property or funds for the benefit of another party. When this responsibility is not exercised by a bank or trust company, it is usually exercised by a board of trustees with each trustee given one vote.

UNCERTAINTY: The state of incomplete knowledge about the present and future with respect to an investment.

UNCORRELATED: The condition in which the returns of two or more assets do not go in the same direction at the same time.

UNDERFUNDED: The status of a fund whose assets are less in value than the liabilities for which those assets exist.

UNFUNDED ACTUARIAL ACCRUED LIABILITY (UAAL): <u>Under now superseded standards</u>, it was the amount by which the actuarial accrued liability for postretirement benefits exceeds the actuarial value of fund assets. This value could be negative, in which case it was described as a negative unfunded actuarial accrued liability, or a funding excess. Also referred to as unfunded actuarial liability.

VALUE STOCKS: Value stocks tend to display low price-to-earnings ratios relative to the market, and especially when compared to growth stocks.

VENTURE CAPITAL: A form of private equity involving non-publicly-traded equity investments in which a general partner provides capital to an entrepreneur to begin or grow an enterprise with the intention of eventually making a profit by taking the company public or selling it to another business.
VESTING: Process by which a participant obtains nonforfeitable rights to benefits, such as an employee retirement plan. Typically, these rights accrue based on an employee's years of service to an employer.

VOLATILITY: The characteristic that financial asset returns vary over time in unpredictable ways or amounts. This term is often used interchangeably with "standard deviation of the asset's returns."