Investment Lingo in Plain English

It's times like these when most investors are wondering what's going on and what to make of it. As most of us are well aware, when attempting to explain the latest developments, the seers on Wall Street are often tempted to use terms that are either vacuous, silly or just plain pretentious. So here goes my effort to make sense of the excessively confusing verbiage that these folks are intending to pass off as helpful.

Let's begin with market drops, which may be variously described as dips, pullbacks, corrections, bear markets, and OMG. Dips and pullbacks are analogous to bumps in the road. Although the long-term trend of the stock market is higher, it is by no means to be thought of as a superhighway. Most of the time, the market takes two steps forward and one step back, but that's most of the time.

Last year was an anomaly. It was a year in which the market moved almost steadily higher, with nary a hesitation. That was bizarre considering the fact that in most years there is a selloff between 10% and 15% sometime between January and December.

In the wake of that almost total disappearance of volatility, it seems as if the norm is again triple-digit days. A big drop followed by a big bounce over a period of a week or so is unusual; meaningful course reversals take longer.

The technical definition of a correction is a drop of 10% or more. A bear market drop calls for 20% or more. What's OMG? That's what happened on October 19, 1987, when the Dow plunged more than 22% in one day.

OK, let's move on to valuations. These are the relationships between stock prices and underlying earnings. From a market perspective, Wall Streeters often talk about price-earnings ratios, which are prices divided by estimated earnings, but there's more. Investors are generally willing to pay more (i.e., accord higher price-earnings ratios) when companies' projected growth rates are higher. That concept leads to another measure, the price-earnings ratio divided by the projected growth rate. Short form: PEG. For example, a company might carry a price-earnings ratio of 20 times and be projected to grow at 10% a year. Hence, a PEG of 2.0, which these days might be considered reasonable.

For the earnings part of these equations, the Wall Street consensus estimates (found on Yahoo Finance or other sites) are often used. Keep in mind the fact the analysts tend to follow one another, so when there's an earnings surprise on the upside or downside, it is a surprise to most, if not all, of them. The reason is simple enough. When making estimates, it's safe for analysts to keep their estimates close to the consensus. Those who differ on an ongoing basis (and are surprised on an ongoing basis) may well be risking their job security.

Then there's the matter of technical analysis, which is better described as pretending to be able to forecast future stock prices based on past price patterns. Rather than rambling on about this, it's sufficient to say that the guidance provided in this way is approximately as valuable as decision-making using a Ouija board. Even so, despite the reality of its utter lack of merit, there are those who profess, with appropriately solemn presentations, to see what's ahead. Trust me, they don't.

Asset allocation is another key phrase that's widely mentioned and it certainly is important. It's important because how investors divide their assets among the various classes available is usually what determines the success of their efforts. That's even more critical than the selection of investments within the asset classes. Stocks are included for growth. Bonds are included for current income (probably low) and stability. And alternative investments, whose price movements do not move in tandem with stock prices, are included to act as shock absorbers during times of market volatility.

For investors who were 100% invested in U.S. equities from the spring of 2009 until now, it has been easy enough to mistake good fortune with investing expertise. Going forward, given the likelihood of increased volatility and more moderate advances, it will be interesting to learn which description is appropriate. Keeping all of one's eggs in one asset class is not asset allocation. It's a recipe for disaster during times of market turmoil.

From the standpoint of logistics, it's essential to remember that lowering the cost of investing raises the returns on investing. Trading individual stocks should cost no more than $10 a trade, often less, regardless of the size of the transaction. Trading exchange-traded funds or open-end mutual funds should either come with a modest price tag or none at all. These days, quite a few of these funds are on what are known as No Transaction Fee lists at the various brokerage houses. That means, they can be bought at no cost other than their current quotations.

And now, let's review the lexicon of funds with loads, i.e., sales charges. Typically, these charges are attached to Classes A, B or C of the funds involved. Class A means you pay when you buy, which means you start with a loss. Class B means you pay when you sell. Class C means there's a charge every year. That's what the salespeople refer to as a trailer.

All of these are evil and should be avoided like the plague, especially since there are numerous no-load funds available that are every bit as worthy as those that are presented as suitable. In view of the increased attention that is being paid to the fiduciary duty to investors, it seems likely that those cost-ineffective funds that will be fading away.

Investors will far better served by a Wall Street community that makes increased efforts to communicate clearly, rather than using a secret tongue that either confuses and pretends to convey a message when there really isn't any.

Warren Buffett summed it up superbly, saying that whatever comments he makes need to be understood by his sister.