

# **“Whatchu Talkin’ ‘Bout, Willis?!” — The Importance of Proper Language in Financial Literacy**

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*Words matter. The use of imprecise or improper words can introduce an element of confusion or ambiguity. In finance, accuracy in language is particularly important because clarity of communication can impact on deals, valuations, and investment decisions. The use of sloppy words or statements can also lead to questions about the individual’s professionalism, competence, and degree of financial literacy. Finance professionals such as analysts and financial planners should give thoughtful attention to the terminology they express, as subtle differences or miscommunications could lead to decision-making errors or introduce questions about the credibility and professionalism of the individual.*

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## **INTRODUCTION**

In the finance profession, like in other careers, using the correct terminology enhances credibility and professionalism. One would not feel confident if their physician uses wrong or inaccurate terminology. For example, if when examining the wrist, the doctor calls it the arm. Technically, the wrist is part of the arm, but being precise about the location produces more confidence in the patient’s doctor. Calling it the wrist would be more accurate and more professional. The same applies to finance, especially when communicating with clients or with others in the financial circle. Finance has its own lingo, jargon and vocabulary. Finance professionals should not be sloppy with the words used as it, too, will introduce questions or concerns with the client about credibility, professionalism and even competence. In personal areas, dealing with associates, and communicating with clients, using improper or imprecise language reflects on the individual’s level of financial literacy. This paper identifies five common finance terms that are regularly misused or misunderstood and could form a foundation for a lecture or, presentation, or reading assignment to finance students about the importance of using precise and correct language.

## **RELEVANT LITERATURE**

The Financial Literacy and Education Commission (FLEC) was created by statute in 2003 and is comprised of 23 federal government entities charged to improve the financial literacy and education of Americans (FLEC, 2020). The motivation for this charge is the concern that many individuals do not understand basic principles to perform even simple financial decisions. The evidence of a deficiency in connecting the financial dots is compelling. Many of the supporting studies focus on college students on the threshold of a career [(Chen and Volpe, 1998), (Volpe, Chen and Liu, 2006), (Annabi, González-

Ramírez and Müller, 2018)] and working adults (Volpe, Chen and Liu, 2006), and they find that most across these levels lack the financial literacy to make independent financial decisions.

Former Federal Reserve Chairman Alan Greenspan is concerned about financial literacy and articulates the importance of raising interest in finance and economics to prepare the next generations to understand and communicate more clearly financial issues they may confront (Greenspan, 2003). Mandell and Klein (2009) link a lack of clarity in financial concepts with poor financial decision-making. The mainstream press also acknowledges a troubling connection between the comprehension and application of finance and economics concepts, and contends that speaking money clearly and accurately is the world's most important language [(Velshi and Romans, 2011), (Lanchester, 2015)].

The government and higher education have concerns about the consequences of a lack of financial knowledge in the community. The base of understanding financial and economic issues and models is, of course, necessary for everyone, especially those who work in finance and claim expertise to help those with less knowledge navigate the often rough finance waters. In addition to that finance knowledge base, however, those professionals need an ability to deliberately communicate that knowledge and advice accurately and meaningfully. Using sloppy and ambiguous language is not professional and does not help strengthen financial literacy. Five basic terms are often carelessly presented accompanied with simple corrective explanations and illustrations for why clarity and precision matter.

## **THE MARKET**

It is not uncommon for finance professionals to greet each other with “how did the market do today?” The issue with that question is really the subjective definition of the market being considered. A market is a system, location, or infrastructure where exchange occurs and prices are determined. There are many markets including the used car market, the real estate market, the sports futures betting market, and the gold market. When we hear the question “how did the market do today?”, most of us default to the stock market, but even there the stock market has many locations and measurements. Most default to the Dow Jones Industrial Average (DJIA) when referring to the market, but the DJIA is a very narrow sample comprised of only 30 large, mature, U.S. stocks. Consequently, the DJIA might not do a good job representing all markets, or even just the entire stock market, but that's the one that we default to in our language of finance.

Bill Gross used to manage PIMCO, the world's largest fixed income management company. If we asked Bill Gross “how did the market do today?”, he would not default to the DJIA or even the stock market because Bill Gross's world is fixed income securities. He would likely tell you how the interest rate market did or how the corporate bond market or Treasury securities markets did. “Market” is too ambiguous and subjective, so, when asked “how did the market do today?”, understanding that the market can be many different things to different people, a more professional answer may be “which market?”.

## **EX ANTE AND EX POST**

Ex ante and ex post are common Latin terms used in financial and economic research. They are also part of most presentations involving the estimation or calculation of returns. Ex Ante is usually denoted with a carrot (^) on top of a number or a symbol and represents expected, predicted, estimated, or guessed. It's an anticipated number or expression. Ex Ante returns have not happened yet. They are forward-looking and in the future. Ex Ante addresses how we think we'll do next year if we deal with portfolio management or returns. Ex Ante is not what happened but what we think will happen. An analyst constructs a portfolio representing an opinion or outlook going forward. Those projections may be correct or wrong. That outcome is unresolved because the performance is still to come because it is Ex Ante and has not happened yet. Going into a football game, a team has made preparations and they believe the game will be won. That is Ex Ante. The game still needs to be played, but the expectation or anticipation is a win. The game has to be played before we can see if the expectation is fulfilled.

Ex Post, on the other hand, has happened. Ex post is actual, historical, and factual. It is in the past. A portfolio manager measuring the fund's performance last quarter is performing an Ex Post calculation. It

already happened and is real, factual data. There is no prediction here, but only actual results. The football game was played and time has run out. The players are leaving the field. The game is finished and the score and the victor are known. That is Ex Post.

Ex Ante has not happened yet but is expected or anticipated. Ex-post has happened. It's in the past. It answers the question, "how did we do" rather than "how do we think we'll do"? A good way to remember the difference and to use the correct term is summarized below:

Ex Ante = anticipated

Ex Post = past

## MARKET CAPITALIZATION (SIZE)

The size of a company can be quantified by many different measures such as sales, number of employees, and number of stores. The most common way to measure the size of a company is by market capitalization (market cap). Market cap for a public company is the product of the number of shares outstanding and the current price per share. If there are 1 million shares outstanding, and each share has a current price of \$45.50, then the market cap or size of the company would be \$45.5 million.

$$\text{Market Cap} = \# \text{ of shares outstanding} * \text{price per share}$$

There are two reasons why understanding market cap is important to the finance professional. First, market cap can impact on the way the portfolio is constructed and securities are selected. Suppose a portfolio manager is limited by market cap to the kinds of securities that can comprise the portfolio. In that case, additional care must be given in selecting those securities to comply with any size parameters. For example, if a fund is restricted to small caps, then that fund is limited to securities qualifying as small cap. Market cap distinctions, however, are subjective. The size demarcations for what is large or small when it comes to cap sizes is not officially standardized or agreed upon, so managers need to define those size levels themselves. Table 1 presents a possible market cap size definition. One manager may define large cap as \$40 billion to \$200 billion, but a different manager may define large as some other range. Some managers may not even have mega-cap or micro cap ranges. They might just organize market caps as small, medium, or large. The analyst or the portfolio manager determines the names of the size categories or how many there are and the size ranges within the categories.

**TABLE 1  
POSSIBLE MARKET CAP SIZE LEVELS**

Market Cap	
Mega Cap	> \$200,000,000,000
Large Cap	\$40,000,000,000 - \$200,000,000,000
Mid Cap	\$5,000,000,000 - \$40,000,000,000
Small Cap	\$500,000,000 - \$5,000,000,000
Micro Cap	< \$500,000,000

Vanguard is a popular investment company that does research and manages money. Part of that process has been to construct funds based on firm size. According to the Vanguard definition, large cap is companies with a market cap greater than \$21 billion. Their process for that cap definition is that Vanguard isolates the 200 largest companies in the economy as the "large cap" ones. Since the 200th largest company has a market cap of \$21 billion, the Vanguard large cap base is that amount. Morningstar is another popular company and it defines large cap at \$15 billion and higher. The E\*Trade stock screener identifies large

companies as greater than \$10 billion in market cap. Each of these firms uses different subjective metrics for defining large cap.

Consider analysts from Vanguard and Morningstar, and a customer using E\*Trade's screener looking for large cap companies. Each one is considering Southwest Airlines (LUV) which has a market cap currently a little less than \$15 billion. The Vanguard large-cap manager would not be able to buy \$15 billion LUV because it doesn't qualify within Vanguard's large cap definition \$21 billion. LUV is too small for Vanguard's large cap distinction. Morningstar defines large at \$15 billion, so LUV is in the conversation, although it may be in a gray market cap area for them. LUV qualifies as large for the E\*Trade screener customer because the E\*Trade threshold is \$10 billion plus. Based on a quantitative definition of what constitutes as large, the same company – LUV – is eligible for portfolio inclusion cleanly by using only an E\*Trade screener. Vanguard disqualifies LUV because it violates the large cap definition, and Morningstar has LUV in a gray area. Consequently, portfolio managers must exhibit thoughtful care in determining the size levels, especially if a size-related investment strategy binds them because it could influence the construction of the portfolio.

The second issue whereby market cap matters is that it can impact on how the performance of a manager is evaluated. Two important metrics for judging a portfolio manager's performance are absolute return and relative return. Absolute return is simply comparing the portfolio's return to 0. If the return is positive, then the manager beat the benchmark of 0. For example, a portfolio producing a return of 8.4% indicates the manager beat the benchmark of 0 by 8.4%. On the other hand, a return of -3.6% indicates the portfolio underperformed the bench. Absolute return is just comparing a portfolio return to 0.

Relative return is judged against some deliberately selected benchmark that makes sense for managing the portfolio. A possible benchmark to judge how a portfolio performed is to compare the returns to those of the S&P 500 Index, which is a very common large cap benchmark. This Index, however, is narrow, just like the Dow Jones Industrial Average. The S&P 500 Index is comprised only of the 500 largest U.S. companies. If the portfolio includes small cap or mid cap companies, or European, Asian, and Latin American companies, then being benched against the S & P 500 Index might not be a good object for comparison because the Index and the portfolio are very different in terms of risk, firm size and geographic exposure. A distorted or inaccurate judgement of portfolio performance then ensues.

For example, a small cap fund manager defines small cap and then selects eligible assets for the portfolio. After a period, the return is -7.25%. The absolute return is -7.25% as the absolute bench is 0%. Consequently, this manager was beaten by the competition of 0%. Now consider the relative performance whereby the portfolio manager chose the S&P 500 Index as the benchmark for judging performance. During the same period, the S&P 500 Index generated a return of -2.8%. The manager lost 7.25% and the S&P 500 Index lost 2.8%. Relative return is the difference between how the manager did compared to the bench return. For this portfolio, the relative return is -4.45%, indicating that the portfolio manager underperformed the bench.

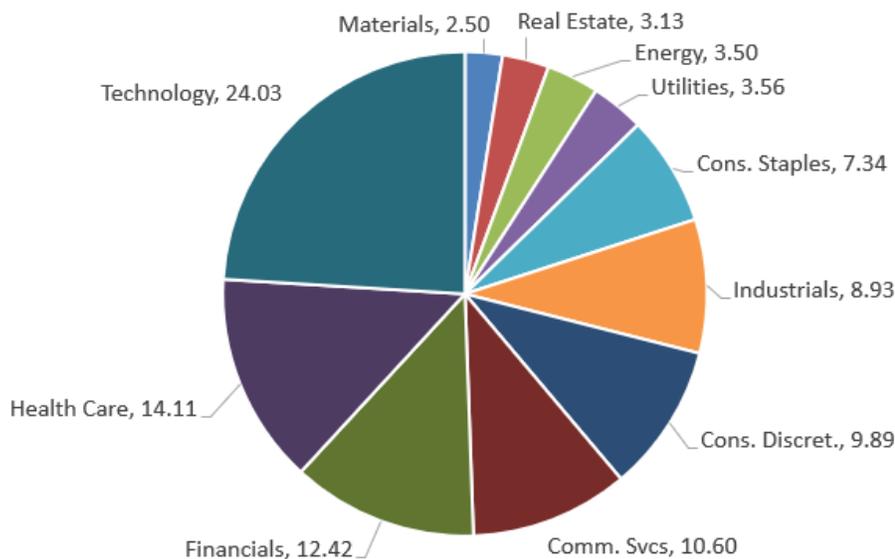
In this example, the large cap S&P 500 Index is not a good choice for comparison given that the portfolio under management is comprised of small cap firms. Large caps are generally less risky than small caps, and it looks like this may have been when the stock market was going down. Small caps tend to go down more than large caps in a falling environment. By comparing a risky portfolio against a less risky index or benchmark, it is almost expected that the small-cap portfolio would underperform a less risky index. A better benchmark would be the Russell 2000 Index, a small-cap index comprised entirely of small-cap stocks, just like the portfolio. Perhaps over the same period, the Russell 2000 return is -8.15%. Considering absolute returns, zero beat the Russell 2000 Index as well as the portfolio. However, comparing the portfolio return to the Russell 2000 - an appropriate benchmark now - the relative return is positive (-7.25% - -8.15% = 0.90%). The portfolio beat the bench by 0.90%. Although the portfolio lost money with a negative absolute return, the decline in value is almost 1% smaller than that of the benchmark. This relative performance measure is more accurate than that reflected by using the very dissimilar large cap S&P 500 Index. When constructing a way to judge returns, selecting a benchmark that is a fair representation of what the comparison portfolio looks like is especially important if the portfolio to be judged has size distinctions. In such a situation, a size-based index would be appropriate because selecting

the wrong benchmark can impact performance evaluation and lead to an incorrect conclusion about the quality of the portfolio performance.

## SECTOR AND INDUSTRY

Sector and industry are not synonyms to be used interchangeably. Sectors are broad, and industries are the slices of the sectors, where the economy as a whole is the pie. Sectors are the slices of the economic pie, and industries are pieces of the respective sectors. Figure 1 presents the 11 sectors of the economy as defined by the S&P 500 with the percentage weight of each sector.

**FIGURE 1**  
**SECTORS BASED ON THE S&P 500 INDEX**



Consider the Health Care sector. It's not the Health Care industry, but the Health Care sector and within the sector are industries. Some industries in the Health Care sector are the Pharmaceuticals, Biotech, and Medical Devices industries. Within the Consumer Discretionary sector are the Automotive industry and Restaurant industry. Within the Industrial sector are the Defense industry and Airlines industry. Referring to Pharmaceuticals as the Pharmaceuticals sector, would be sloppy and imprecise, much like expressing the wrist as an arm from earlier, and it would not enhance our credibility. Furthermore, calling it the Health Care industry, would expose us as not understanding the distinction between sectors and industries, and that would again challenge our credibility and level of financial literacy. It is the Health Care sector and the different parts within the sector are the industries. The economy is the pie, the sectors are the slices, and industries are the bites or pieces from the pie.

Standard & Poor's is just one service that defines the sectors in our economy. Just like with cap size distinctions, sector definitions are also subjective. Figure 2 is from FINVIZ.com and decomposes the Health Care sector into a heatmap of the industries. Finviz decomposes the other ten sectors into similar heatmaps. This heatmap shows each industry in the Health Care sector and the companies within each industry. For example, MRK (Merck) is in the Drug Manufacturers – General industry of the Health Care sector. The size of each box represents the market cap of each company. The size of each industry reflects its relative exposure in the industry. The industry size reflects the degree of exposure in the sector. The returns are stock returns for the past year.

**FIGURE 2  
HEATMAP OF HEALTH CARE SECTOR**



**BASIS POINTS**

Talking about interest rates can be confusing. Consider this statement – “interest rates were 10%, but they have risen 5%”. What’s the new interest rate? Some might say it is 15%. Rates were 10%, add another 5% and the new interest rate is 15%. Or perhaps the new interest rate is 10.5%, because if interest rates rose 5%, that’s 5% of 10%, which is 0.5%. The new rate is 10.5% (10% + 0.5%). They can’t both be correct, so which one is it? Is it 15% or 10 1/2%? Both increase interest rates by 5%, so that question has ambiguity or confusion.

Basis points corrects or clarifies our reference to interest rate changes in the value of an instrument or an asset or in values expressed as a percentage change. 100 basis points equals 1%, so half a percent change equals 50 basis points. A 0.1% change is 10 basis points, and a 0.01% change or one 100th of a percent change is 1 basis point.

If we hear interest rates were 10% but have risen 5%, and we want to know the new interest rate, it could be restated in basis points to defuse any confusion. Basis points becomes the standard measurement or expression. Interest rates that were 10%, and have risen 500 basis points, would produce a new rate of 15% because 500 basis points is 5%. If interest rates are 10% and rise 50 basis points, then the new rate is 10.5% because 50 basis points is half a percent. Basis points prevents any misunderstandings about rate changes.

Basis points is also common finance language that prevents an awkward presentation. If interest on a junk bond goes from 12% to 12.01%, we could express that change as 0.01%. Although that would be a correct statement, it is awkward talking that way. It is also awkward saying the rate rose 1/100<sup>th</sup> of a percent, although it is also correct. Professional finance language would be to refer to that 12% to 12.01% change as rates rose by one basis point.

Additionally, if the portfolio return was 7.35% in 2022, and in 2023 the return was 7.29%, the year-to-year change in return is .06% or 6/100<sup>ths</sup> of a percent. Those are also awkward descriptions of the change

in performance. There is a more professional way of expressing these interest rate changes, and that way is with basis points. The portfolio return is six basis points less this year over last year.

There is another reason to become comfortable integrating basis points into discussing rate or return measures. Fees to manage money are usually expressed in basis points of assets under management (AUM). If the portfolio value is \$250,000, a professional money manager will require a fee to manage the funds, and that fee is usually expressed in basis points of AUM. The common range of fees for managing a portfolio of \$250,000 is 75 basis points to 150 basis points. The fee in dollars would be  $250,000 * 0.0075 = \$1,875$ . The AUM of \$250,000 is multiplied by the fee in basis points (0.0075 or 75 basis points).

## CONCLUSIONS

Finance is not simply crunching numbers on a calculator in a back room. That quantitative aspect, of course, is true, because finance is applied math. But it also requires the clear and accurate communication of that math. This paper forms a base for a lecture or presentation emphasizing the need for financial professionals, who are experts, after all, to speak finance properly and not in a sloppy, ambiguous, or confusing way. Doing so will make an impact on enhancing financial literacy among students, clients and professionals.

## ENDNOTE

- <sup>1.</sup> From popular culture, this is a recurring question posed by the character Arnold Jackson (played by Gary Coleman) in the TV show *Different Strokes* which aired from 1978-1985.

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