



PENSION INVESTMENT GLOSSARY

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FOREWORD

This publication is intended to contribute to the understanding by Ukrainians of some of the terms commonly used in capital markets and pension investment. Its purpose is to provide basic financial literacy, essential to the participation of younger citizens in Ukraine’s “three pillar” pension system, launched in 2004. Under Ukraine’s Solidarity or Pay-As-You-Go (Pillar I) system, contributions from current workers and employers provide current pensioners with at least enough income for a basic standard of living. Under Pillar III (Voluntary Accumulation) individual workers’ (and/or employers’) contributions are invested on the capital markets to provide for additional income in retirement. Under Pillar II, which is a part of the reform that has not yet been implemented, a percentage of mandatory pension contributions will also be invested on the capital markets to provide for a portion of future income in retirement. Thus, you need to learn the basics of savings and investment.

The reformed pension system

In July 2003 the Verkhovna Rada approved two new pension laws. The first law is called “On General Mandatory State Pension Insurance.” This law revises the solidarity pension system (Pillar I) for those who have 20 or more years before they reach retirement age, effectively affecting men under 40 and women under 35. These individuals will receive a solidarity pension benefit calculated the same way as for older pensioners. However, the maximum pension benefit from this Pillar I will be about 50% of their salary closest to retirement, as compared with about 75% of salary for older Ukraini-

ans today. To compensate for the reduced solidarity pension benefit, a percentage of the monthly individual contributions to the pension program by younger participants will be invested over their working life into an “accumulation type pension account” (Pillar II). For now, this system has not yet been implemented and the precise details of the accumulation system have not been established. The Verkhovna Rada will have to adopt another law to start this system. What is certain, however, is that this accumulation type pension will feature investment of pension contributions on the capital markets.

The second law adopted by the Verkhovna Rada is titled “Non-State Pension Provision.” It creates what are known as non-state (or private) pension funds (NPFs). These are essentially contractual arrangements into which individuals and/or their employers can make voluntary pension contributions over and above those made to the solidarity system. They are run by private companies – banks, investment companies or by an employer. The contributions to NPFs are invested in order to increase the capital over one’s working career. At retirement age, you convert the sum of your contributions plus any accumulated return that has been earned from your investment into a regular monthly payment. This is called an annuity.

Any contributions paid into accumulation type pensions are your personal property. As such you are able to take certain decisions as to what happens to them.

Investing in capital markets involves risk and the possibility of losses. Pension investments are for the long-term, and over time one should be able to earn an appropriate return to provide income in retirement. Nevertheless, since investments entail risk, you need to make informed decisions about how you will invest your pension contributions. This glossary is designed to help you better understand some of the key terms used in capital markets and in pension investing.





ADMINISTRATOR

The **ADMINISTRATOR** of a **NON-STATE PENSION FUND** means a legal entity that keeps the personified records of fund participants. The administrator enters into contracts on behalf of the fund, and ensuring payment of benefits to pension fund participants.

ANNUITY

A retirement annuity is the regular installment that a fund participant is paid out of his accrued (accumulated) account. Some funds give participants the option to collect their retirement savings in one LUMP SUM payment, rather than receiving pension payments in monthly installments (or ANNUITIES).

ASSET

An asset is any item that has economic value. Examples include cash, securities, real estate, equipment, or an investment. In principle, assets are convertible to cash. Assets can be tangible like real estate or office equipment, or intangible like copyrights or licenses.

ASSET CLASS

An asset class is a group of financial instruments that share similar characteristics, perform similarly in the market, and are prone to similar risks. Examples of asset classes include: stocks, bonds, cash, commodities and real estate. These classes are used to build a PORTFOLIO.

ASSET ALLOCATION

Asset allocation is the strategy of dividing one's investments among different types of assets. It is an investment strategy that

aims to balance risk and reward by apportioning investments across asset classes such as cash, stocks, bonds, real estate, etc. according to such factors as an individual's tolerance for risk or his/her investment time horizon. For instance, younger individuals often have riskier asset allocation strategies (e.g., stocks) because they are young and have time to recover from market downturns, while older investors may have conservative allocations (e.g., mostly bonds) because they need income to live on immediately. A basic principle of asset allocation is to diversify risk.

ASSET MANAGEMENT company/ASSET MANAGER

Is the entity that makes investment decisions on behalf of a client. The asset manager decides what to buy and what to sell on behalf of the pension fund. In Ukraine, the asset management company must be duly licensed by the regulator to perform pension asset management, and the asset manager must make investment (and allocation) decisions according to the INVESTMENT POLICY DECLARATION developed by the board of the pension fund (the fund's governing body).

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BONDS

A bond is a debt instrument issued by central or local governments, or by companies, for the purpose of raising capital. It is a debt security where the issuer owes the investor a debt and is usually obliged to pay interest on the principal amount. Bonds are generally considered lower risk investments. Government or treasury bonds issued by central governments are usually considered safe because they are guaranteed by the state. CORPORATE BONDS are issued by companies and bear interest rates that reflect prices in the bond market and the financial strength of the company.



CAPITAL MARKETS

A **capital market is a market for securities (equity or debt) where governments and companies can raise long-term capital.** Companies, for example, can issue securities in the capital markets to raise money to expand their business operations. These securities can then be traded on the secondary market by the initial buyers, who can then exchange them further.

COMPOUND INTEREST

Compound interest is the practice of calculating interest not only on the initial principal but also on the accumulated interest of prior periods. In essence, you earn interest on prior interest plus principal.

CUSTODIAN

The custodian of a pension fund is the entity that is responsible for the safekeeping and recording of the securities held by the fund. It is also the custodian who executes the investment decisions – the buying and selling orders – made by the asset management company. In Ukraine it is always a bank.



DEPOSITORY

A depository is an entity that is responsible for the safekeeping of SECURITIES, when trades take place and ownership is recorded. It is part of the securities market system that ensures that securities are safe and properly traded.

DISCLOSURE

Disclosure is the act or process of providing information to the public. Information moves markets and prices, and capital markets function better when issuers of securities provide a regular flow of information about their financial situation, their business, and any material event that affects the prospects of the business. Information on pension funds in Ukraine is available at the Pension Fund Electronic Information Disclosure System (PDS), a database on the website of the Financial Services Regulator <http://npf.dfp.gov.ua> [also see the PDS entry in this glossary]. Information disclosure by listed public companies– whose shares are traded on the stock market and invested in by pension funds – will soon be available on the new ESCRIN electronic disclosure system, accessible on the website of the SSMSC, the regulator for capital markets [also see the entry for ESCRIN in this glossary].





DIVERSIFICATION

Diversification means holding assets of different asset classes with the goal to find an optimal balance between risk and return. In some countries the law imposes diversification on pension funds assets by setting limits on investments in certain asset classes, for example limiting the amount that can be allocated to cash or to shares. In Ukraine, for instance, the law limits the amount a pension fund can allocate to bank deposits: the maximum allowed is 40% of assets, and only 10% can be in a single bank.



ESCRIN

Electronic System of Comprehensive Information Disclosure ESCRIN is a new electronic disclosure system for listed

public companies on Ukraine's stock exchanges. Through ESCRIN, the SSMSC requires issuers to file not only quantitative but also qualitative information about the company's financial situation, its management, strategy etc... The information filings by issuers will soon be accessible for free by anyone over the internet through the Securities and Stock Market State Commission (SSMSC) website – <http://eds.ssmc.gov.ua/>.

EQUITY

Equity equals assets minus liabilities. In joint stock companies, this value is referred to as shareholder's equity and in Ukraine as "owned capital." Equity increases with contributions from shareholders and profits, and it decreases with payments to shareholders and losses. In a pension fund, Equity is the Net Asset Value. Investment activities change the Net Asset Value and affect the Unit Value, causing participant's account balances to increase or decrease.

EXCHANGE RATE RISK

Exchange rate risk is the risk that investments are exposed to by the changes in price of the currency they are denominated in. If you borrow funds denominated in US Dollars and the Dollar increases (as measured in Hryvnia) then your loan balance will grow. If you invest in bank deposits denominated in Euros and the price of the Euro decreases, then the value of the bank deposit also decreases (as measured in Hryvnia).



FEES

A fee is the payment deducted for services rendered. Participants in an investment fund or in a pension fund will pay a va-

riety of fees for managing their contributions. Fees are deducted on the basis of the contributions paid and/or a percentage of the NET ASSET VALUE of the individual's funds. In Ukraine, the total amount of administrative fees on a pension fund that can be deducted monthly is limited according to a resolution by the Ukrainian regulator and is charged on both contributions made and the value of a participant's individual account.

FOREIGN INVESTMENT

These are investments made by citizens of one country in the assets of another country. In Ukraine, by law a pension fund cannot invest more than 20% of its total assets in the securities of foreign issuers.



INFLATION

Inflation is the increase of consumer prices, generally resulting in a decrease of purchasing power. When speaking about pension investments, inflation plays a special role. Inflation is one of the reasons why savings are invested on the market: if pension savings were just sitting in a regular bank account they might be losing value because of inflation.

INFLATION-LINKED SECURITIES

Inflation-indexed securities are financial instruments that adjust their value according to inflation. These instruments do not exist in the Ukraine financial market. Inflation-indexed securities are attractive to investors in inflation-prone markets since their value is tied to the inflation rate, and generally earn a return above this rate.

INVESTMENT

Making an investment means committing money or other assets to an enterprise with the expectation of making a profit. For example, buying a car is usually not an investment (unless you use it to set up a taxi service) because its value will decrease with time (no profit). It is simply a big purchase. However, an apartment might be a good investment, if bought at the right price and if the purchase price increases in the future.

INVESTMENT POLICY DECLARATION

An investment policy declaration is the document of a non-state pension fund that outlines its investment strategy. In Ukraine, a non-state pension fund's investment policy is established by the fund's board with the help of investment experts. The declaration, which is registered with the regulatory authorities (the SSMSC and the FSR), is binding for the asset management company. The procedures for approving and amending the investment policy declaration are laid out in the pension fund's charter.



LIABILITY

A liability is a legal obligation to repay a debt. In accounting, liabilities represent all of the financial obligations a business must honor. A private person's liabilities may include mortgages and accumulated taxes. For a pension fund, liabilities represent the charges owed for administrative and other costs.

LIQUIDITY

This concept involves how quickly an asset or investment could be sold or converted to cash. Stock markets are said to be “liquid” if there are a ready supply of buyers and sellers of securities, and an asset can be sold with little effect on the price.

LUMP SUM

A lump sum is a one-time payment of an amount due, instead of periodic installments over time. Some funds give participants the option to collect their retirement savings in one LUMP SUM payment.



NET ASSET VALUE

Net Asset Value is the market value of the fund's assets minus the fund's liabilities. The Net Asset Value represents the total net assets owned by participants and is distributed among participant accounts based upon each participant's ownership holding. Net Asset Value is increased by Profit and contributions by participants, and it is decreased by losses from investments, liabilities, and payment of benefits.

NET ASSET VALUE per UNIT (UNIT VALUE)

Net Asset Value per Unit (Unit Value) is the value of a single unit of an investment fund. A unit signifies ownership of a part of a fund, similar to a Share indicating ownership of a part of a company. The value of a participant's account is equal to the Unit Value multiplied by the number of units owned by the participant. The total number of units in the fund multiplied by the Unit Value equals the Net Asset Value of the fund.

NON-BANK FINANCIAL INSTITUTIONS (NBFI)

An NBFI is an entity that is involved in finance, possibly offering some of the services provided by banks, but is not a bank. Examples include investment funds, pension funds, insurance companies, leasing companies, credit unions etc.

NON-STATE PENSION FUNDS

A non-state pension fund, is a fund that is set up to create a pool of assets with regular contributions with the goal to invest them to generate a long-term profit, and finance the insured person's retirement. Under Ukrainian law, an NPF has the status of a not-for-profit organization. A pension fund collects contributions from fund participants, pools it together, and then invests in STOCKS, BONDS and other SECURITIES, real estate, or even in gold or in cash. Such investment decisions are made by experts, hired by the fund: they are called ASSET MANAGEMENT companies. The fund's asset management company is chosen by the fund on the basis of a tender to ensure transparency and competitiveness. The asset manager is paid through a system of FEES paid by fund participants. In principle, if the asset management company makes the right investment decisions, then the value of the assets will grow (over the long term) and each participant's shares will grow. Pension money accumulated in a pension fund and not paid out shall be inherited by the participant's legal heirs.



PDS – Pension disclosure system

PDS is a fully automated, web-based pension disclosure system. It offers centralized information about Ukrainian non-state

pension funds (NPFs), their results, fund allocation, and the number of participants. The basic performance indicators of NPFs are updated every quarter. The information is accessible free-of-charge on the Financial Services regulator's website – <http://npf.dfp.gov.ua>

PERFORMANCE

Performance is the result (or return) from the investment activities of an entity or fund over a given period of time. Performance is one of the measures used to compare different funds. It can be complex because one needs to evaluate not only the magnitude of the return but also the risk of the return. There are also various ways in which to measure performance. Calculating results (or performance) according to the international standard of “NET ASSET VALUE” is the rule for Ukrainian pension funds. (See Net Asset Value.)

PORTFOLIO (PORTFOLIO MANAGEMENT)

An investment portfolio is an investor's collection of assets, and typically is composed of a selection of bonds, stocks, currency, real estate, and other asset classes. The objective of an optimal portfolio is to maximize returns (profits) while limiting risks through diversification. In pension investing, the appropriate allocation of risk assets in a portfolio varies with the age of the participant. In general, a young person can take on more risk (e.g., a higher allocation to stocks) because he has no need for retirement income, while someone close to retirement (who will need his funds soon) may want to have his portfolio allocated to lower risk asset categories (more bonds).

PROFIT/RATE OF RETURN

Profit is the positive gain on an investment once all expenses are paid. The rate of return is a way of measuring eco-

conomic performance: it measures the return on an investment; in other words how much an investor gets out of his invested capital. There are different ways of calculating a rate of return, so unless companies in a given market, or country or sector agree on a single standard, it may be difficult to compare performance.

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REGULATOR

The regulator is the state body that oversees the activities of pension funds and asset management companies, brokers/traders, stock exchanges etc

In Ukraine regulatory responsibilities are split between the State Commission for Regulation of Financial Services Markets (FSR) and the Securities and Stock Market State Commission (SSMSC).

The State Commission for Regulation of Financial Services Markets of Ukraine (FSR) is responsible for supervision and audits in the area of non-state pension provision, especially NPFs, and imposes sanctions, if needed. The FSR's website is <http://www.dfp.gov.ua>

The for Securities and Stock Market State Commission (SSMSC) supervises and audits asset managers of pension fund assets and custodians, and applies sanctions. The SSMSC's website is <http://www.ssmc.gov.ua>

RISK/REWARD

The risk/reward trade-off principle is the idea that greater reward (or return) is the result of taking greater risk. The risk/return trade-off, for example, is sometimes expressed by the saying that “the type of security one chooses is determined by whether he/she wants to eat well or sleep well.”



SECURITIES

Are contracts that award a stake in certain assets, like stocks and bonds. Securities are an investment instrument.

SHARE

A share is a security that represents a part or a fraction of a company's value. Some shares are traded on the stock market. A pension fund's assets will be (in part) invested in shares traded on stock exchanges.

SECURITIES/ STOCK MARKET

The stock market is a public market for the trading of company stock and some bonds.



TAXES

Taxes are fees levied by a government on an income or an activity. Contributions to pension funds are paid from-pre-tax income. Payouts of pension assets will, however, be subjected to Ukraine's tax law.



YIELD

The yield represents the rate of return of an investment. For a bond, the yield – also called coupon yield– is the interest rate paid on a bond at set dates.

NOTES



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