

Digging deeper: Reckoning with risk

5. Information ratio

Information ratio

The information ratio is used to assess the risk-adjusted performance of active fund managers. It shows how consistently a manager has outperformed a benchmark index.

The information ratio uses the *tracking error* of a fund (the amount of risk taken compared with the benchmark).

- If the information ratio is negative, it means that investors would probably have achieved a better return by using a passive fund that tracks the benchmark.
- If the information ratio is positive, the fund manager has added value through active management rather than simply by taking on more risk.
- The higher the information ratio, the more consistently the fund manager has outperformed the benchmark – and the more value has been added.

Formula for calculating the information ratio of a fund:

Information ratio = $(R_p - R_b)$ /tracking error

- > R_p = portfolio return
- > R_b = benchmark return

Example

R_p = portfolio return = 12%

R_b = benchmark return = 8.5%


Tracking Error = 4%

Information ratio = $(12 - 8.5)/4 = 0.88$


The information ratio is valuable because it provides a clear way of assessing whether active management has been effective.

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insights**

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