COLUMBIA THREADNEEDLE INVESTMENTS

Digging deeper: Reckoning with risk

3. Sharpe ratio

Sharpe ratio

Category:
Investment insights

The sharpe ratio is a measure of an investment's risk-adjusted return. It measures the excess return for every unit of risk that has been taken to achieve that return.

The sharpe ratio relies on *standard deviation*. Standard deviation measures how much an investment varies from its mean, or average value. The higher the standard deviation, the more volatile the investment is.

The sharpe ratio measures the return of a security or portfolio earned in percentage points (or basis points) above the risk-free rate for each unit of risk taken.

- The higher the sharpe ratio, the better the return on an investment compensates for the additional risk the investor has taken.
- Negative sharpe ratio - the risk-free rate of return would have performed better than the investment.

Formula for calculating the sharpe ratio of a fund:

Sharpe ratio = (Ri – Rf)/SDi

> Ri = return on the investment
> Rf = risk-free rate of return
> SDi = standard deviation of the return on the investment

Example

Ri = return on the investment = 12%

Rf = risk-free rate of return = 3%

SDi = standard deviation of the return on the investment = 4%

Sharpe ratio is (12 – 3)/4 = 2.25

The sharpe ratio is helpful in comparing the risk-adjusted performances of two funds. Even though fund manager A may have achieved a higher actual annualised return than fund manager B, fund manager B may have delivered a better result on a risk-adjusted basis – shown by the higher sharpe ratio.

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