COLUMBIA THREADNEEDLE INVESTMENTS

Digging deeper: Reckoning with risk

4. Sortino ratio

Sortino ratio

Category: **Investment insights**

The sortino ratio is a variation of the sharpe ratio. It differs from the sharpe ratio by distinguishing between negative and positive volatility.

Unlike the sharpe ratio that looks at risk through standard deviations, the sortino ratio uses only downside deviation to identify the extent to which securities/portfolios are exposed to negative returns.

The sortino ratio does not penalise managers for benefiting from upside risk, but concentrates solely on when their investments are exposed to downside risk.

Formula for calculating the Sortino ratio of a fund:

Sortino ratio = Ri – Rf/SDd

- Ri = return on the investment
- Rf = risk-free rate of return
- SDd = standard deviation on the downside

Example

Ri = return on the investment = 12%

Rf = risk-free rate of return = 3%

SDd = standard deviation on the downside = 3%

Sortino ratio is (12 – 3)/3 = 3

This compares favourably with the fund example used in the sharpe ratio factsheet of 2.25 and indicates that the manager has been able to benefit more from upside risk in the market, with better control of the downside risk.

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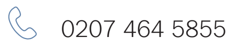
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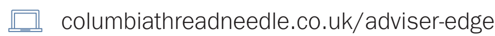
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