

The Importance of Risk Adjusted Returns

In this week's article I look at some of the key metrics used at Whitechurch Securities in fund selection and highlight the importance of using risk adjusted measures of returns when evaluating the skill of an investment manager.

Measuring performance within the context of a risk-based framework is one of many key tools needed in order to avoid inadvertently introducing bias within a client's investment portfolio. This approach can help prevent buying "flavour of the month" investments at the top of their cycle.

Key Risk-Adjusted Return Measures

Sharpe Ratio

The Sharpe ratio measures the return in excess of the risk free rate divided by the volatility of that investment. This therefore shows the ratio of return "per unit of risk".

Sortino Ratio

This ratio is an adaptation of the Sharpe ratio. Sortino takes the portfolio's return and divides this by the portfolio's "Downside risk" Downside risk is the volatility of returns below a specified level, typically the portfolio's average return or returns below zero. Sortino shows the ratio of return generated "per unit of downside risk".

Information Ratio

The Information Ratio (IR) measures the excess returns of the portfolio in comparison to its benchmark, divided by the volatility of those excess returns. IR therefore not only shows the portfolio managers' ability to add value over the benchmark, but also by taking the volatility of those excess

returns, attempts to measure the consistency with which the manager can add value. The higher the information ratio, the more consistent the outperformance.

R-Squared Analysis

R-Squared measures how reliable the chosen benchmark is for comparison purposes, or more accurately how much of the deviations in the portfolio can be explained by movements within the benchmark. Passive funds will have a very high R-squared value, and extremely active funds will have lower R-Squared values. If a fund has both strong outperformance and a high R-Squared value this is a good indication the manager has added value. However, strong outperformance coupled with a very low R-Squared ratio will mean more investigation is required to identify the source of outperformance. For example, the manager may have had a large bias towards small caps but was using a multi-cap benchmark or peer group such as the FTSE All Share or IA UK Equity Income.

How can these measures help in practise?

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Numerous academic papers have been published over the previous two decades to show how investment inflows tend to follow periods of strong performance. According to analysis from Thomson Reuters, funds that achieve first quartile performance over 3 or 5 years tend to attract the lion's share of inflows into that sector. (Thomson Reuters - Returns and Sales: The relationship between fund performance and net sales in the UK, 2012)

Source:

<http://funds.uk.reuters.com/UK/pdf.asp?language=UNK&dockey=1523-4458-50FPJOGEH6PSBHJRLM2UHJKDP4>

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We believe this focus on recent absolute performance suggests the existence of a significant behavioural bias within the retail investment industry, and leads to increased short-termism within markets. Retail Investors and investment advisers who are swayed by strong recent investment performance could risk falling foul of a number of behavioural traps. Consider the chart below:



Beware of Past Performance

If historic investment returns alone were to drive investment decisions, and fund sales data suggests this is the case, then at the top of a market cycle those funds that have taken the greatest risks will often attract the greatest inflows, and vice versa. This selection bias may not be well aligned with the investors' market outlook and will add to the cyclical nature of the investment selection process.

Looking Under the Bonnet

We consider performance in the context of the key measures outlined above, which helps establish the source of investment returns. We ask whether top quartile returns could have been generated simply through taking greater risk than the market? Conversely, following a period of market stress, could those top quartile returns have been generated by having a defensive investment philosophy?

The Sharpe and Sortino ratios will establish how efficient the manager's risk taking has been generating returns, the information ratio will hint at evidence of investment manager skill, and R-Squared will show how relevant the manager's chosen benchmark is to the fund - Does the fund have a mid or small cap bias but has chosen to benchmark against a more conservative multi-cap index or peer group? Does the investment style differ drastically from the benchmark/market/peer group? R-Squared will identify the existence of any substantial difference.

By combining these ratios and applying them to a peer group, we gain far greater clarity as to the behaviour of the funds within that sector. This simple approach will identify clues as to the likely source of investment returns and will flag-up any areas warranting further qualitative analysis in our search for outperforming funds.

Important notes - please read: The past is not an indication to future performance. The value of investments and any income they produce can go down as well as up and you may not get back the full amount invested. The stockmarket should not be considered as a suitable place for short-term investments. Taxation: Levels and bases of, and reliefs from, taxation are subject to change and are dependent on the circumstances of the investor. This publication is approved by Whitechurch Securities Limited which is authorised and regulated by the Financial Conduct Authority. All contents of this newsletter are deemed to be correct at the date of printing. We have made great efforts to ensure the accuracy of the information provided and do not accept responsibility for errors or omissions. This bulletin is intended to provide helpful information of a general nature and is not a specific recommendation to invest. The contents may not be suitable for everyone. We recommend you take professional advice before entering into any obligations or transactions.