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INVESTMENT MANAGEMENT

How to Talk to Your Clients About .... Sharpe Ratio

For many investors today, when weighing investment strategies or picking between two funds, their most common question is: what's the expected return? While the question is understandable, it's only half the picture. Investors also need to consider the amount of risk involved. Fortunately, there is a measure that can help investors make these determinations—the Sharpe Ratio.

The ratio, created by Nobel laureate William Sharpe, measures return against risk. In other words, how much does an investor stand to lose in pursuit of a projected amount of risk.

For example, S&P 500 ETF SPY has a 3-Year trailing Sharpe ratio of 0.82. Whereas the 3x leveraged version of S&P 500, the ETF SPXL, only has a Sharpe ratio of 0.68, implying that you took much more risk in proportion to the return benefit if you invested in the leveraged ETF. [1]

Here's how we at Astor think about the Sharpe Ratio:

- The Sharpe Ratio is an important measure for investors who, in general, are taking on more risk these days in order the pursue the same amount of return.
- The Sharpe Ratio is a way to evaluate to funds in the context of the same market conditions. Even when two funds are similar, there may be enough differences between them to result in considerably different Sharpe Ratios.

Using the Sharpe Ratio reminds investors that projected return needs to be viewed in the context of the risk involved.

[1] *Source: http://performance.morningstar.com/funds/etf/ratings-risk.action?t=SPXL&region=usa&culture=en-US*

Please contact Astor with any questions or comments

info@astorim.com

T: 800.899.8230