ON ONE PAGE

The Sharpe Ratio

Return per unit of risk: why the higher return is not always the better fund.

IN ONE LINE

Divide excess return by volatility to compare funds that take different risks. Annualize consistently and check the tails.

$$\text{Sharpe} = (R_p - R_f) / \sigma_p$$

$$\text{Annual} = \text{monthly} \times \sqrt{12} = \text{daily} \times \sqrt{252}$$

R_p: portfolio return · R_f: risk-free rate · σ_p: standard deviation of excess return

Five rules

1. **Use excess return.** Subtract the risk-free rate before you divide.
2. **Same window, same frequency.** Only compare ratios built the same way.
3. **Leverage leaves it unchanged.** At the risk-free rate, return and risk scale together.
4. **Upside counts as risk.** The Sortino ratio counts only the downside.
5. **Check the tails.** Rare, large losses hide behind smooth returns.

Two funds, one year

Risk-free rate 0.25% a month

	Fund A	Fund B
Return	6.0%	17.3%
Monthly volatility	0.69%	5.10%
Annual Sharpe	**1.22**	**0.82**
Annual Sortino	1.99	1.29

At the same risk

Levered to Fund B's volatility, Fund A would earn about **21.5%** a year above cash, against Fund B's **14.5%**.

Before you sign it off

- [ ] Excess return over the right risk-free rate
- [ ] Same period and frequency across funds
- [ ] Annualized by the square root of periods
- [ ] Sortino and drawdowns checked
- [ ] Smoothed or illiquid prices allowed for



GO DEEPER

Portfolio Metrics II: Sharpe Ratio Explained: From Total Risk to Tail Risk

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The Sharpe ratio explainer

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