An Investor Education Initiative
MIRAE ASSET
Mutual Fund
by Mirae Asset Knowledge Academy

WHAT IS RISK-ADJUSTED RETURN? WHY IS THIS IMPORTANT FOR YOU TO KNOW?

When you compare the performance of two investments or check returns of your portfolio, you should not only consider the returns generated by the investments but also the amount of risk taken to earn these returns. Risk-adjusted return can help you measure the same. It is a concept that is used to measure an investment's return by examining how much risk is taken in obtaining the return. Risk-adjusted returns are useful for comparing various individual securities and mutual funds, as well as a portfolio

How can risk-adjusted returns be calculated?

If we speak of risk-adjusted returns, there are five measures that can be used - Alpha, Beta, R-squared, Standard Deviation and Sharpe Ratio. All of these measures give specific information to investors about risk-adjusted returns. Let's have a closer look at risk-adjusted returns and how they can be measured:

Alpha: If you want to know how well an investment is doing, then Alpha is a good measure. It is simply the measure of an investment against a benchmark index such as the Sensex, Nifty, etc. Alpha provides a picture of the talent of a fund manager or a portfolio manager because you can see if you are getting returns that are outperforming the benchmark.

Beta: Beta is a measure of volatility and indicates how much risk is involved in an investment compared with the broader market. A Beta value against the market. A Beta value higher than 1 will indicate more volatility in your chosen investment as compared to the market.

Standard Deviation: Standard deviation simply measures how much an asset's returns vary over the observed period compared to its mean or average returns. This is a useful measure since you can learn more about how steady an asset's returns are.

R-squared: R-squared is used to see the correlation of a portfolio's price trends with a benchmark. While Alpha measures performance, R-squared is more concerned about movement. This statistical measure is taken in percentage terms and ranges from 1-100. The higher the number, the more your portfolio moves in alignment with the chosen benchmark. A low R-squared number usually suggests less correlation with the index.

Sharpe Ratio: Sharpe ratio basically measures how much return an investor is getting in correlation to the level of risk he is exposing himself to. Basically the Sharpe ratio works by taking into consideration how the asset performed and then subtracting that return from the returns that could have gotten from a risk-free instrument like a government security. Now you take that number and divide it by the standard deviation of the asset. This will provide you the Sharpe ratio. The higher the ratio, the more you are being rewarded for the risk that you are taking.

Why you should account for risk while investing?

Accounting for risk while investing is important because:

1. **It is a measure of fund management:** Measuring risk is a logical and objective method of establishing the skills of your fund manager, advisor or financial consultant. Ideally a fund manager aims to take least risk and deliver superior returns.

2. **Helps gauge investment quality:** You can separate riskier investments from those that are less risky and know exactly what you are investing in without any ambiguity

Risk is also an opportunity

When it comes to investments, just like in life, the higher risk you take, the more the chances that you'll make more returns. So don't simply ignore an investment option which strikes you as risky. Instead, evaluate how much risk you are actually willing to take, and if you are considering said risky product, then also evaluate how much of your portfolio should be invested at such risk levels.

Investing should be based on data and facts, and how much risk you are taking to get the returns you aim for. Assessing the risk-return link will give you an idea about the level of possibility of actually making money on a given investment or suffering a loss. This will help you make informed choices and reduce the element of chance from your portfolio.

Key Takeaways

An investor education initiative by Mirae Asset Mutual Fund.

All Mutual Fund investors have to go through a one-time KYC (Know Your Customer) process. Investors should deal only with Registered Mutual Funds (RMF). For further information on KYC, RMFs and procedure to lodge a complaint in case of any grievance, you may refer the Knowledge Center section available on the website of Mirae Asset Mutual Fund.

Mutual Fund investments are subject to market risks, read all scheme related documents carefully.

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