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What Are Risk-Adjusted Returns?

Standard deviation and the Sharpe ratio help investors measure risk and return

By
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When you hear financial experts talk about risk-adjusted returns, what do they mean? It may sound complicated, but the concept is simple.

It means that when comparing investment returns like those from mutual funds, it can be misleading to just look at the headline figures. For instance, at first glance it might seem that a fund that gained 12% last year is better than one at 9%. In reality, it depends on how much risk was involved in generating those profits. The more risk, the less the returns are worth.

There are many ways to measure risk, but the simplest is to look at volatility, says William Silber, a finance professor at New York University's Stern Business School. "If I am expecting to get 15%, then how likely is it that I get 30% or minus 15%?" he says. The more volatile an investment, the more likely either extreme is in such an example.

You can measure volatility by calculating standard deviation (there are online calculators for this). The smaller it is, the lower the risk.

A more-complicated way to adjust for risk is to calculate whether the risk is worth the chance that you will lose. Put another way: How much more return are you getting than you would in a riskless investment? Treasurys are considered risk-free.

Financial professionals calculate something called the Sharpe ratio. It looks at returns relative to risk-free interest rates and volatility.

"You want a big Sharpe ratio," says Prof. Silber. "That means you get an extra return [over risk-free returns] that is bigger than the variability."

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