Risk-Adjusted Performance

How to measure it and why.

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Investors and financial analysts have long been interested in measuring the performance of portfolio managers. Initially performance was evaluated by comparing the total returns of a managed portfolio with those of an unmanaged portfolio chosen at random (the dartboard portfolio). Later the concept of efficiency was introduced, and managers were benchmarked against the unmanaged "market" or a capitalization-weighted portfolio consisting of the entire market. Recently, the benchmarks have been revised to reflect more closely the investments relevant to the portfolio manager under evaluation.

While the benchmarks may have improved, the industry continues to focus almost exclusively on total return. Yet total return is an incomplete measure of the performance of a portfolio because it ignores risk. It is well known that investors can increase expected returns simply by accepting a greater level of risk, or uncertainty in the range of possible outcomes, implying a greater chance of loss. Uncertainty, and therefore risk, can be measured by "dispersion." That is, for any given level of expected return, the greater the dispersion in possible outcomes, the riskier the investment.

The explanation commonly offered for this trade-off between risk and return is that investors do not like risk, and therefore require compensation for uncertainty in the form of a "risk premium." In fact, this explanation does not provide an operational basis for assessing risk, because appropriate premium levels would vary across individuals and with the composition

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