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Commentary

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MARKETS

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Understanding the relationship between risk and return is crucial to investment.

Sharpe Ratio is a statistical measure used to look at performance in risk-adjusted terms. It divides a portfolio's excess return over the risk-free rate by the volatility risk - i.e, standard deviation - of the portfolio's returns.

A ratio higher than zero indicates the degree to which investors were rewarded for accepting greater risk than from cash investments. The higher the Sharpe ratio, the greater the reward for risk taken.

Let's examine the risk return ratio for New Zealand Equity Trusts in the Diversified Growth category, tabled above.

The New Zealand Guardian Trust Small Companies fund posted a one-year return of 26.39%. Its Sharpe ratio is 6.46 for the same period. The second highest one-year return was 20.65%, earned by the New Zealand Funds Management New Zealand Equity Fund. A Sharpe ratio of 4.81 has been calculated for this fund. The Trustees Executors New Zealand Sharemarket (B) Trustees Fund returned 20.48%; 3.17 is its Sharpe ratio. These ratios show that all three funds were well rewarded for the level of risk they undertook over the year.

The Guardian Trust fund in particular, exhibits very favourable risk-adjusted performance over the period.

Lower returns do not necessarily equate to poor Sharpe ratios.

The Westpac Selected New Zealand Shares fund has a Sharpe ratio of 2.14, and a return of 10.94%. The ratio for the Joseph Banks New Zealand Equity Fund is 2.07, and its return is 12.42%. Both funds exhibit fair returns in risk-adjusted terms. Conversely, the Renouf New Zealand Equity Fund posted a return of 4.56% for the year. Its Sharpe ratio is negative, indicating this fund was poorly rewarded for the degree of risk it assumed.

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