



WHAT IS SORTINO RATIO?

THE EQUITY COMPASS

EDITION
06

The excess return a portfolio earns for every unit of downside risk it takes on.*

*over the risk free rate

Imagine two people driving from Mumbai to Pune.

Both reach in exactly 3 hours. But the journey was very different.

One driver maintained a smooth, steady speed throughout the trip. The other accelerated aggressively, braked suddenly, faced risky overtakes, and experienced multiple stressful moments before still reaching at the same time.

On paper, both journeys achieved the same outcome. But most passengers would clearly prefer the smoother ride.

The **Sortino ratio** works in a similar way.

Like the Sharpe ratio, it measures risk adjusted returns, but focuses specifically on downside risk. Instead of treating all volatility equally, it considers only downside volatility, recognizing that investors are typically more concerned about losses than upside surprises.



DEFINITION

The Sortino ratio measures how efficiently a portfolio generates excess returns relative to its downside volatility.

$$\text{Sortino ratio} = \frac{(\text{Portfolio Return} - \text{Risk Free Rate})}{\text{Downside Deviation}}$$

COMPONENT	WHAT IT MEANS
Portfolio Return	Total return generated by the portfolio over the measurement period
Risk Free Rate	Baseline return available from a near zero risk investment
Downside Deviation	Standard deviation of only the negative returns falling below the target or risk free rate



HOW TO READ THE SORTINO RATIO

RANGE	SIGNAL	INTERPRETATION
3.0 and above	Excellent	Exceptional downside risk efficiency
2.0 to 2.99	Very Good	Strong return relative to downside risk
1.0 to 1.99	Good	Healthy downside reward to risk balance
0.0 to 0.99	Acceptable	Positive but moderate efficiency
Below 0	Weak	Returns fail to compensate for downside risk

Name of MF – Bajaj Finserv Mutual Fund | Registration no. – MF/078/23/04



HYPOTHETICAL EXAMPLE

Three equity funds generate the same annual return of 13%. The risk free rate is 4%, but each fund experiences different levels of downside volatility during the year.

	FUND A	FUND B	FUND C
Portfolio Return	13%	13%	13%
Risk Free Rate	4%	4%	4%
Excess Return	9%	9%	9%
Downside Deviation	9%	18%	6%
Sortino ratio	1.00	0.50	1.50
Verdict	Decent downside efficiency	Higher downside fluctuations	Best downside adjusted return

Fund C generated the same return as the others while experiencing the least harmful downside volatility. That is what a stronger Sortino ratio reflects.

For illustrative purpose only



WHY THE SORTINO RATIO MATTERS

Investors experience volatility differently.

A temporary upward spike in returns is usually welcomed.

A sharp decline, however, creates anxiety, uncertainty, and often emotional decision making.

The Sortino ratio recognises this behavioural reality and gives investors a clearer picture of whether returns are being generated efficiently, without exposing the portfolio to excessive downside risk.

IT IS ESPECIALLY RELEVANT FOR:

Investors approaching financial goals | Conservative or moderate risk investors | Retirement focused portfolios

Strategies focused on mitigating downside risk | Portfolios seeking relatively less volatility in their long term wealth creation



POINTS TO KEEP IN MIND

- A higher Sortino ratio generally indicates better downside risk adjusted performance.
- The ratio depends on the target or risk free rate used in the calculation.
- It is most useful when comparing similar funds or investment strategies.
- Like all ratio based measures, it is historical and not predictive of future performance.
- The ratio should be analysed alongside other portfolio risk and return metrics.

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