INFORMATION RATIO(IR)

The Information Ratio (IR) measures a portfolio's risk-adjusted excess returns over a benchmark. Following SEBI mandates, Indian Asset Management Companies (AMCs) must publicly disclose the IR for all equity-oriented mutual fund schemes on a daily basis to increase transparency.

The IR measures the excess returns of an investment relative to its benchmark, adjusted for risk.

The IR provides a clear indication of how well the fund is performing relative to the benchmark and a positive and higher IR suggests better performance.

How it is calculated:

(Portfolio Rate of Returns less Benchmark Rate of Returns) / Standard Deviation of Excess Return

<Excess Return= Portfolio Rate of Returns less Benchmark Rate of Returns>

What it means:

•Portfolio Return: The annualized return generated by the fund/portfolio during a particular period.

• Benchmark Return: The annualized return of a comparable index (e.g., NIFTY 50, Nifty 500, etc).

• Standard Deviation of Excess Return: Measures how much a funds return deviate from its benchmarks return over time.

Illustration:

Example 1	**Example 2**	**Example 3**
3-year Fund Return: 12% 3-year Benchmark Return: 9% 3-year Standard Deviation: 4% **3-year Information Ratio**: (12%-9%) / 4% = 0.75	3-year Fund Return: -3% 3-year Benchmark Return: -9% 3-year Standard Deviation: 7% **3-year Information Ratio:** (-3%) – (-9%) / 7%: 0.85	3-year Fund Return: 8% 3-year Benchmark Return: 12% 3-year Standard Deviation: 5% **3-year Information Ratio:** (8%-12%)/5%: -0.8

It suggests that for every 1% of risk taken, the fund has generated an additional 0.75% return over the benchmark.	It suggests that for every 1% of risk taken, the fund has generated an additional 0.85% return over the benchmark. The fund has fallen less than the benchmark.	This means that for every 1% of risk taken, the fund has underperformed the benchmark by -0.80%.

How to interpret Information Ratio

- **0.5 and Above:** Generally considered good, showing that the manager is consistently beating the benchmark with reasonable risk control.
- **1.0 or Higher:** Excellent. Indicates a fund manager who is consistently delivering outperformance with well-controlled volatility.
- **Negative IR:** A red flag. It indicates that the fund manager is taking active risks but is still failing to beat the benchmark.

Key Takeaways for Investors

- **Consistency over Raw Returns:** A fund with an average absolute return of 15% might have a *lower* IR than a fund with a 12% return if the first fund had erratic, wild swings in active returns.
- **Fund Manager Skill:** A high IR justifies paying higher fees for active management because it shows the manager creates value efficiently.
- **Check the Timeframe:** A single-quarter or one-year IR can be skewed by short-term luck. Always look for IR disclosures spanning **3-year, 5-year, or 10-year periods** to accurately gauge manager skill.
- **Benchmark Alignment:** IR is only meaningful if the benchmark chosen accurately represents the fund's investment style.
- Compare Information Ratios within the same peer group and similar time period. Large Cap vs Large Cap. Small Cap vs Small Cap and so on.
- Compare Information Ratio with other metrics like Sharpe Ratio, Sortino Ratio and Alpha while evaluating a fund.

What are the Limitations of IR?

Investors with varying risk-aptitudes and investment objectives might have a dissimilar understanding of the ratio. It depends on factors such as income and age.

Moreover, two portfolios may not share a similar construct, with differing asset allocation, securities, and entry points, changes in fund manager and investment style etc. Therefore, a comparison between the two might be skewed. Hence, it's always best to utilise the Information ratio in conjunction with other metrics for a more grounded understanding.

Summing up, Information Ratio can be a useful metric to assess the skills and stock picking ability of fund managers to understand how they have performed over long run. Note that a higher IR does not mean that the fund will continue to beat its benchmark and peer group forever. That said, it gives a fair idea about the fund's risk and outperformance.

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• Nomination is advisable for all folios opened by an individual, especially with sole holding, as it facilitates an easy transmission process.

This communication is a part of the investor education and awareness initiative of Unifi Mutual Fund.

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