

Twitter Thread by Quant Guy



Quant Guy

@QuantMan_

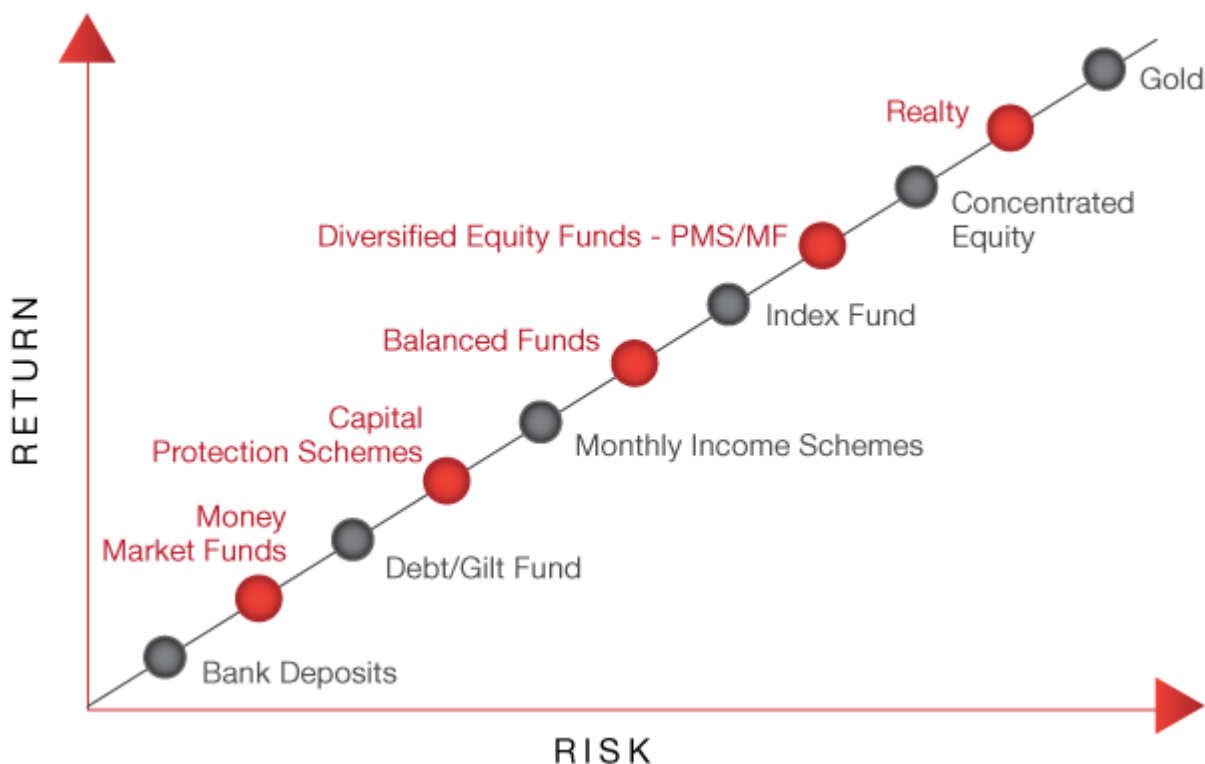


Lets talk about returns (risk adjusted!)

We are used to seeing % returns made against capital or even % made against margin blocked.

This is a wrong way to see the strategy performance due it doesn't take into account the risk taken to generate that return.

(1/3)



Thus the formula to calculate the "risk adjusted return" is:

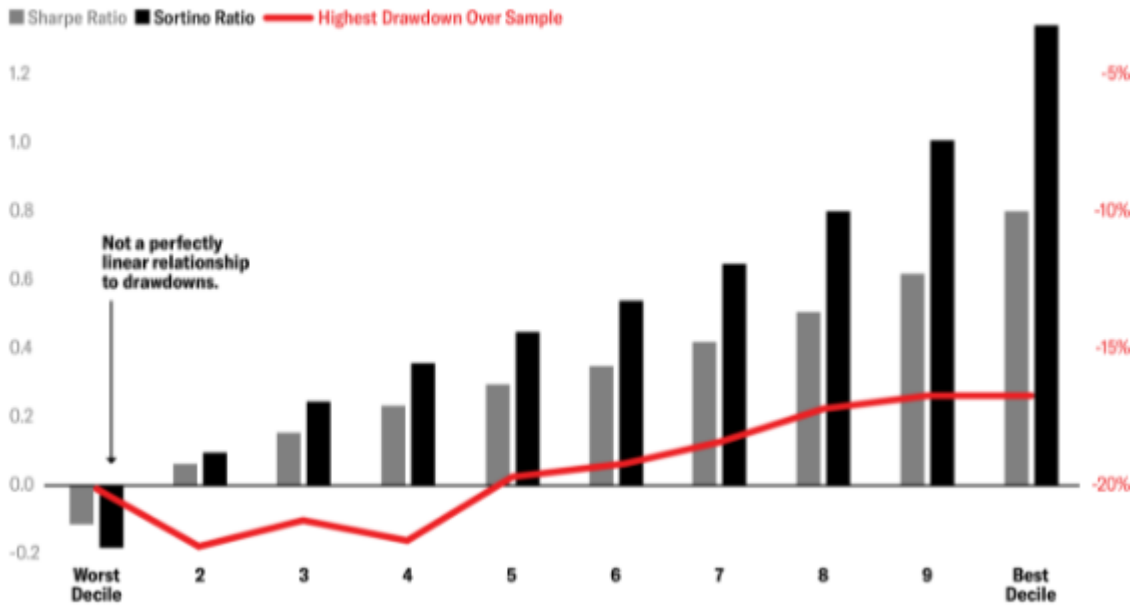
$$\text{Sharpe ratio} = (\text{Current Return} - \text{Risk Free Rate}) / \text{Stdev}(\text{Historical Returns})$$

Lower Sharpe ratio means the strategy is unsustainable even if profit factor and win% are satisfactory.

(2/3)

Sharpe Ratio *Already* Captures Left Tail

Drawdowns are larger for strategies with lower Sharpe ratios



Source: Kessler, Scherer, and Harries, "Value by Design?" *The Journal of Portfolio Management*, 2020.

Some tips:

- Calculate the Sharpe Ratio of the entire portfolio vs individual stock
- Track the Sharpe Ratio regularly as it can vary based on historical performance
- Even a low return portfolio/strategy can have higher Sharpe Ratio if the risk undertaken is less!

(3/3)