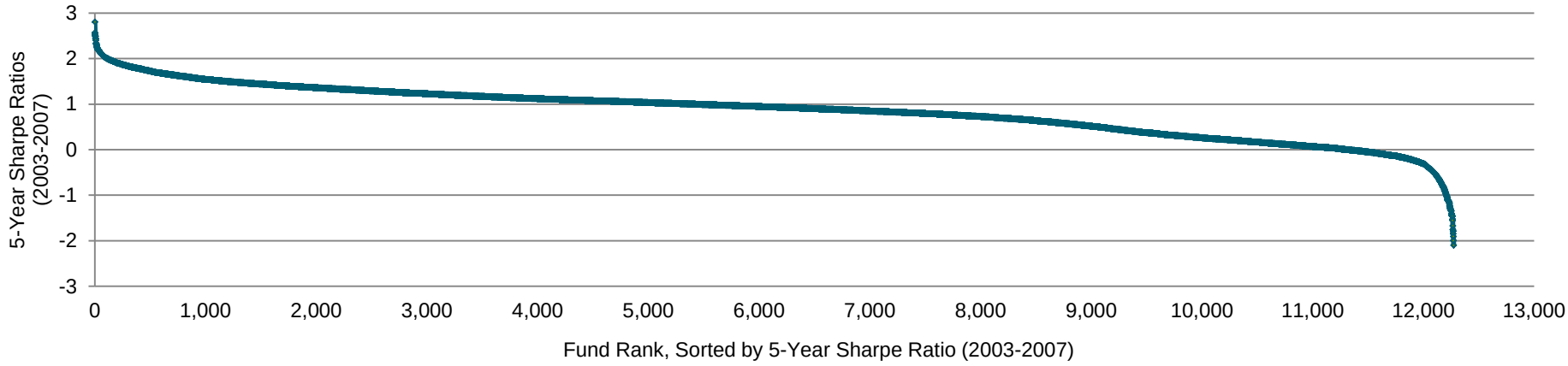
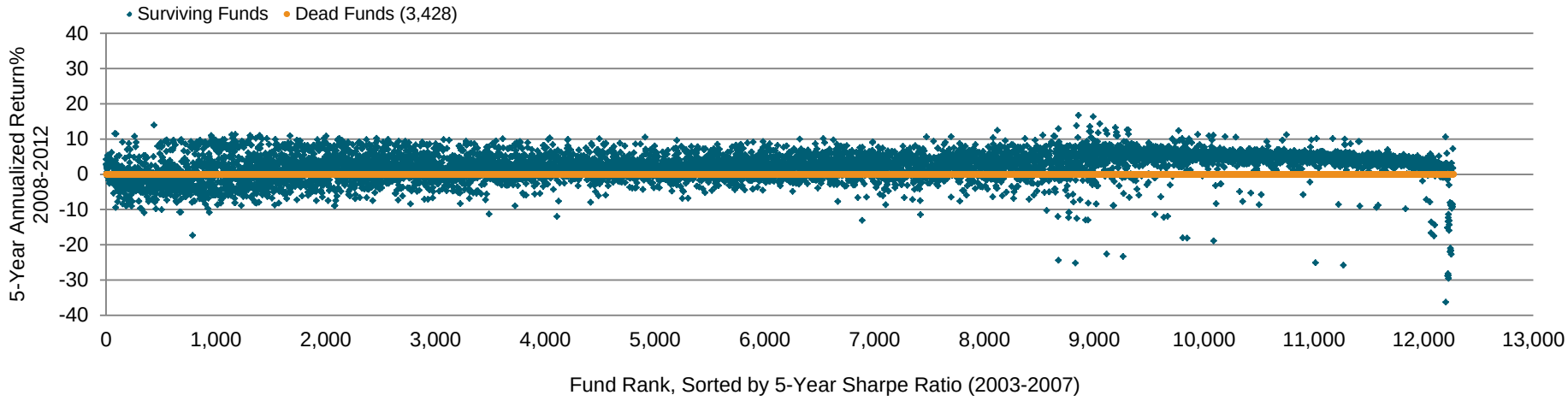
Can Sharpe Ratios Predict Returns?

5-YEAR SHARPE RATIOS (2003–2007)



5-YEAR SHARPE RATIOS (2003–2007) VS. SUBSEQUENT PERFORMANCE (2008–2012)



For illustrative purposes only. Eligible universe is all share classes of US mutual funds with a five-year Sharpe Ratio as of Dec 31, 2007, in Morningstar Direct. Mutual fund universe statistical data and non-Dimensional money managers' fund data provided by Morningstar, Inc. Past performance is no guarantee of future results, and there is always the risk that an investor may lose money.

Some investors look to financial metrics to anticipate future mutual fund winners. But are metrics any better at predicting performance than Morningstar's star ratings system? Let's consider the Sharpe Ratio, a popular metric that measures an asset's return relative to its volatility. In this example, the ratio is calculated by first subtracting the risk free rate from the return of the fund, then dividing by the fund's standard deviation. A positive ratio indicates better historical risk-adjusted performance.

This slide sorts the US fund universe (over 12,000 funds) by five-year Sharpe Ratio (top chart) and shows the funds' subsequent five-year annualized returns, with each fund positioned according to its prior period sort (bottom chart). If a fund's historical Sharpe Ratio has predictive power, one would expect to see higher-ratio funds producing higher relative returns in the subsequent period.

This is not the case. The broad dispersion of five-year returns shows no statistical difference between high- and low-ratio funds. So, funds with high Sharpe Ratios have no better chance than low-ratio funds of delivering exceptional performance in the future.