What is Information Ratio (IR)?

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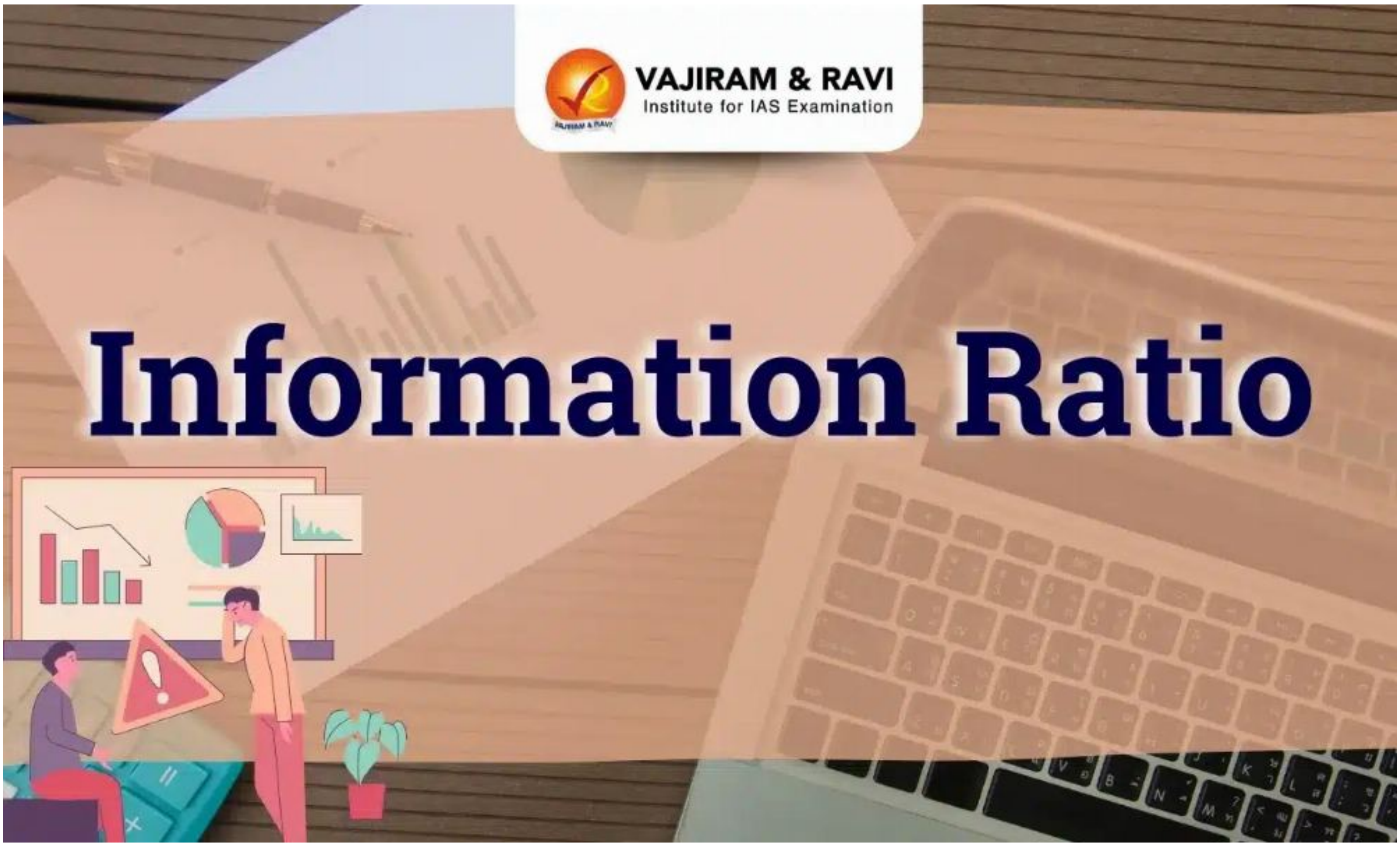

About Information Ratio (IR):

- It's a **metric for measuring how a portfolio** or financial asset **fares in regards to a benchmark**, compared to the volatility of its returns.
    - This **benchmark is usually a market index**, like Nifty 50. It can also be an index representing any specific industry or market sector.
- The **IR depicts how well a portfolio** or asset **is matching and exceeding an index's returns.**
- This metric also **shows the level of consistency** a portfolio is able to achieve **in exceeding the returns of such a benchmark.**
    - To that end, this ratio **also includes** the **standard deviation component**, also **called tracking error**.
    - Tracking error **shows if a portfolio can regularly "track" and exceed its benchmark returns.**
    - **If such tracking error is low**, it **means the portfolio is consistent**. Conversely, if the error is high, it signifies a more volatile performance.
- **Calculation of IR** takes place based on the following formula:
    - **IR = (Portfolio Rate of Returns – Benchmark Rate of Returns)/Tracking Error**

- **Uses**:
  - The IR is primarily used as a **performance measure by fund managers**.
  - In addition, it is frequently used to **compare the skills** and abilities of **fund managers** with similar investment strategies.
  - The ratio **provides investors with insights about the ability of a fund manager** to sustain the generation of excess, or even abnormal (as in “abnormally high”), returns over time.
  - Finally, **some hedge funds** and mutual funds **use the IR to calculate the fees** that they charge their clients (e.g., performance fee).

Q1: What does an information ratio of 0.5 mean?

An IR below 0.5 suggests that the manager may not be effectively utilising their skills to outperform the market, making it a less favourable investment choice. Therefore, investors generally seek strategies or managers with Information Ratios greater than 0.5 for better risk-adjusted returns.

Source: TH
