What is the most important measure of risk?

The Sortino Ratio

GRAYSWAN

2026

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Did you know that two investments can deliver the exact same return and appear equally "risky" on paper – yet one may expose investors to significantly larger losses along the way?

Traditional investment risk measures often focus on overall volatility, treating strong positive returns and negative returns as equally "risky". But for most investors, risk is not about making too much money – it is about the possibility of losing it.

This is where downside risk and the Sortino Ratio become important. Understanding the difference can completely change how investors evaluate investment performance, risk, and long-term portfolio quality.

When it comes to investing, the word risk is often used interchangeably with volatility. But while the two are related, they are not the same, and confusing them can lead to the wrong conclusions about an investment.

Volatility simply measures how much returns fluctuate over time. It captures both positive returns movements (when returns are higher than average) and negative returns movements (when returns fall below average). In other words, volatility treats gains and losses as equally "risky."

But from an investor's perspective, this raises an important question:

Is a strong positive return really a risk?

Most investors would say no.

What investors truly worry about is losing money, not making more than expected. This distinction is critical, and it is where traditional risk measures begin to fall short.

THE PROBLEM WITH TRADITIONAL RISK MEASURES

Many commonly used risk measures, such as standard deviation, focus on overall volatility – treating positive returns and negative returns as equally "risky". This means that a fund which experiences large upward swings can appear just as "risky" as one with large downward swings.

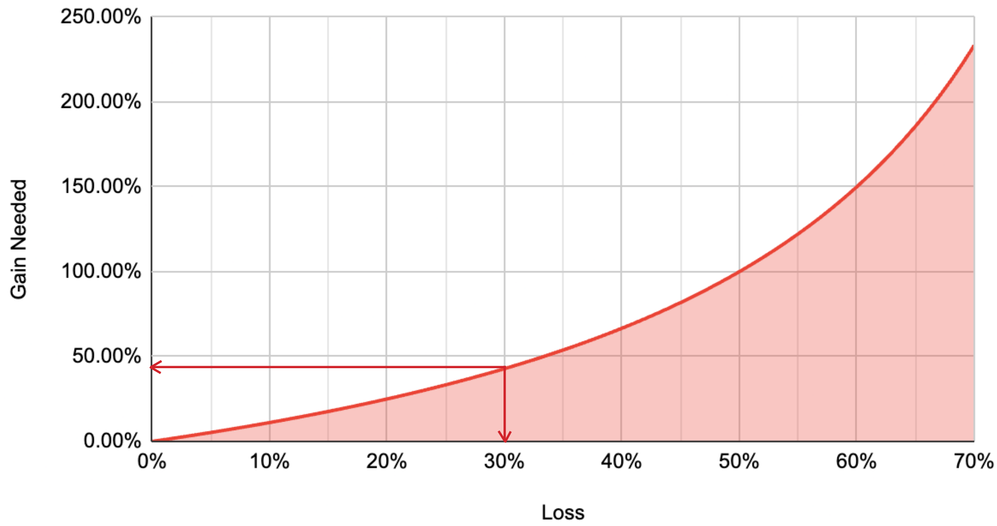
In practice, this creates three problems:

1. Good volatility is penalised (Investors want to participate in the upside). Funds that deliver frequent strong positive returns may look riskier than they truly are
2. Lower volatility does not necessarily mean less risk (Investments can look safer than they are)
3. Overall volatility doesn't tell you anything about the negative returns of the investment. Losses, which matter most to investors, are averaged together with gains

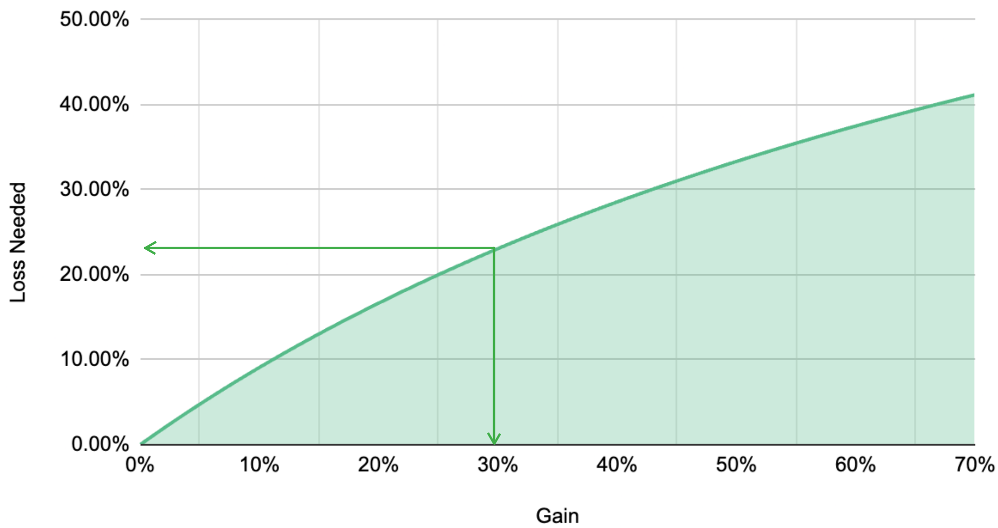
This approach does not reflect how investors experience risk in real life, which is unforeseen capital loss. No investor lies awake at night worrying that their portfolio might perform too well. The concern is quite the opposite.

WHAT INVESTORS REALLY CARE ABOUT: DOWNSIDE RISK

There is no free lunch in investing, and investors must therefore take on risk to achieve their goals. This risk can include unforeseen capital loss or enduring uncomfortable drawdowns. Looking at the Loss Curve below, the more you lose, the exponentially more you need to make back to breakeven. Additionally, looking at the Gain Curve, you can see that despite large gains, you only need to lose proportionally less to breakeven. This imbalance between the effect of losses and gains on your portfolio, make it critical for investors to understand downside risk.



Loss Curve: An investment of R100 that falls by 30% declines to R70. To recover from R70 back to R100 requires a gain of approximately 43%.



Gain Curve: Conversely, if R100 grows by 30% to R130, it only requires a loss of approximately 23% to return to R100.

This illustrates why downside protection and managing losses are so important in long-term investing.

So what is a good measure for how likely an investor is to lose capital? It is the downside risk (downside volatility), not the overall risk (overall volatility), that investors must focus on.

Understanding downside risk has practical outcomes for the investor:

- Less likely to sell when the market bottoms
- Less likely to abandon their long-term investing strategy
- Less likely to make irrational / emotional investment decisions
- Increased ability to stay invested
- Better understanding if an investment meets your risk tolerance
- More confident if an investment helps you to achieve your investment goal

Understanding downside risk can lead to better risk mitigation and a more disciplined investor. It is critical to understand in totality what the returns distribution is telling you about an investment.

However, if investing was just risk mitigation then we would always just hold cash. We invest to grow our capital. So knowing about downside risk, how can we evaluate which investments give sufficient positive returns for their downside risk?

ENTER THE SORTINO RATIO

The Sortino Ratio was developed to solve this exact problem.

Unlike traditional risk measures, the Sortino Ratio only considers downside risk, the outcome investors are trying to avoid (the volatility of negative returns) when assessing risk. It ignores the volatility of positive returns.

The Sortino Ratio tells us how much excess return an investment gives us above the risk-free rate per unit of downside risk:

Sortino = (Annualized Fund Performance-Risk-Free Rate)/(Volatility of Downside Risk)

This is what specifically makes the Sortino Ratio more informative than the classical Sharpe Ratio. While the Sharpe Ratio penalises for overall volatility, Sortino only penalizes for what investors care about, downside risk.

For example, assuming a risk-free rate of 6%:

Fund A	Fund B
Annualized Return = 18%	Annualized Return = 18%
Overall Volatility = 12%	Overall Volatility = 12%
Downside Volatility = 12%	Downside Volatility = 8%

Sharpe A = (18% - 6%) / (12%) = 1
Sharpe B = (18% - 6%) / (12%) = 1

Sortino A = (18% - 6%) / (12%) = 1
Sortino B = (18% - 6%) / (8%) = 1.5

You can see that Fund A and Fund B have the same Sharpe and most investors would think they are comparable but they would be mistaken. Fund B is offering better returns with lower downside risk than Fund A, which is what investors want – sufficiently compensated for the risk they are taking.

In simpler terms:

- Fund A achieves similar long-term returns with the same overall volatility, but experiences large, infrequent drawdowns (high downside volatility)
- Fund B delivers the same returns and overall volatility, but with smaller losses (low downside volatility)

Traditional metrics might treat these funds as equally risky, as shown with the Sharpe Ratio, however this is not true.

A higher Sortino Ratio means:

- The returns generated from the investment are being well rewarded for the risk taken
- The potential for capital loss was well managed and mitigated
- More frequent large gains than losses

The Sortino Ratio is a far more investor-relevant measurement of risk-adjusted performance for comparing investments, and gives better insight to which investments better suit the investor's risk tolerance.

WHY THE RAGING BULL AWARDS EMPHASISE THE SORTINO RATIO

This investor-centric thinking is also why the Raging Bull Awards place significant emphasis on the 5-year Sortino Ratio when assessing fund performance.

By focusing on longer-term downside-adjusted returns, the awards recognise that:

- Consistency matters
- Managing risk through different market cycles is critical
- Protecting capital during difficult periods is just as important as capturing upside in strong markets

It is a recognition that superior investment outcomes are not only about performance numbers, but about discipline, risk control, and sustainability. Unfortunately, in the most recent awards, the South African Multi-Asset Low, Medium and High Equity Fund categories were not included; had they been, our Funds, based on their ratings, ranked in the top quartile. The GraySwan SCI Worldwide Flexible Fund, which is currently in the top quartile over 3 years, is still building towards a full 5-year track record.

GRAYSWAN SCI CAUTIOUS FUND 5-Years	GRAYSWAN SCI MODERATE FUND 5-Years	GRAYSWAN SCI AGGRESSIVE FUND 5-Years	GRAYSWAN SCI WORLDWIDE FLEXIBLE FUND 3-Years
TOP QUARTILE	TOP QUARTILE	TOP QUARTILE	TOP QUARTILE

End of April 2026

THE GRAYSWAN PHILOSOPHY: SLEEP WELL AT NIGHT

At GraySwan, our investment philosophy is Sleep Well At Night.

This means we prioritise:

- Superior risk-adjusted returns
- Thoughtful downside protection
- Participating on the upside with explicit downside protection
- Long-term consistency over short-term noise

Rather than chasing performance at all costs, we focus on building resilient portfolios that rewards clients fairly for the risk they take. Because everyone can chase returns but very few can withstand losses.

The best investment strategy is not the one with the highest return on paper, but the one an investor can confidently stick with over time.

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Sleep Well
At Night