How to Game Your Sharpe Ratio

Richard Spurgin
Clark University

Please Address Correspondence to:

Richard Spurgin
Assistant Professor of Finance
Clark University
Worcester, MA 01610

Email: rspurgin@clarku.edu
Office: 508-793-7596
Fax: 508-793-8822

How to Game Your Sharpe Ratio

Abstract

This article describes a derivative structure that can induce an upward bias in the measurement of the Sharpe ratio. The structure accomplishes this by shifting returns from the highest monthly return each year to the lowest one. This smoothes observed returns – and lowers observed volatility – without significantly altering the annual return. The objective of the article is to demonstrate how derivatives can be used to appear to improve risk-adjusted return without actually doing so.