Using the Netto Number to Measure Return per Unit of Risk for any Investment

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John Netto

www.uorlegal.com

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- Derivatives Cross-Asset Class Trader for 22 years
- Author of "***The Global Macro Edge – Maximizing Return Per Unit-of-Risk***"
- Featured in "Unknown Market Wizards: Best Traders You've Never Heard of" by Jack Schwager - (2020,2023)
- US Marine Corps Veteran (1993-2002)
- Founder and Managing Attorney at Unit of Risk Legal Advisors – uorlegal.com
- Chief Legal Macro Strategist at Rareview Capital (SEC Registered Investment Adviser)
- Based in Las Vegas, NV

Practice Areas:

- DERIVATIVES TRADING AND FINANCIAL MARKETS DISPUTES
- FINANCIAL REPORTING - LOSS CONTINGENCY LITIGATION
- TRUST CREATION AND ESTATE PLANNING
- TRANSACTIONAL AND BUSINESS MATTERS
- VA DISABILITY CLAIMS & BENEFITS REVIEW
- CIVIL LITIGATION AND FAMILY LAW DISCOVERY MATTERS
- REAL ESTATE OPTION STRUCTURING & CONTRACT DRAFTING
- APPELLATE ADVOCACY
- FUND FORMATION AND TRADING-RELATED INTELLECTUAL PROPERTY PROTECTION
- LITIGATION CLAIM RECOVERY CONCIERGE
- FINRA AND MULTIJURISDICTIONAL LOCAL COUNSEL SUPPORT

"Simplicity is the ultimate sophistication."

Leonardo da Vinci

Goals of Presentation

- Understand a framework for measuring how to risk a little to make a lot
- How a compensation structure based on Return Per Unit-of-Risk, UoR™, can benefit fund managers and investors alike

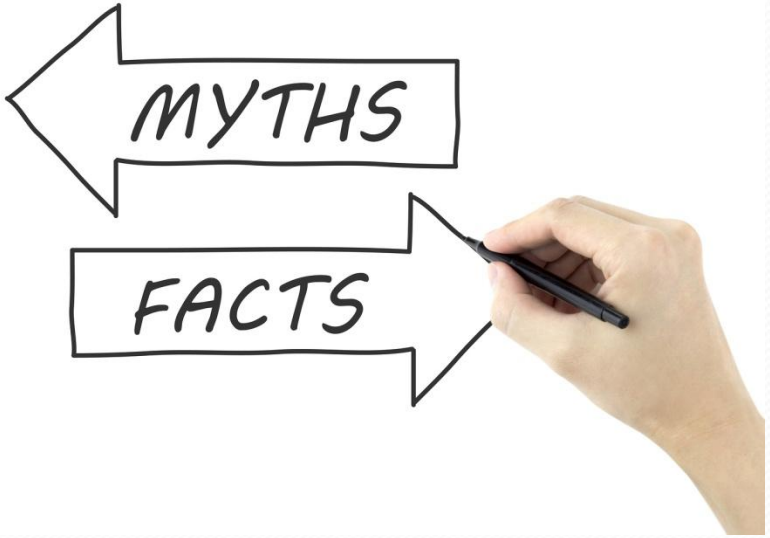
- Implementing "The Netto Number™" as a tool to reward alpha without overpaying for beta

History as a Liquidity Provider

- Many factors in trading I learned as liquidity provider in high school (sentiment, spots of value, counterparty risk, liquidity, discipline, acting on imperfect information, asymmetrical opportunities, black swans, and need to innovate)
- Wanted more reflective metric to payout my clients, dampen volatility
- Progressive Point Spread vs. Conventional Point Spread
- Conventional is binary outcome, Progressive paid based on degree of win or loss
- Under this spirit I approached this book and was the inspiration for this presentation

The Global Macro Edge: Maximizing Return Per Unit-of-Risk

- More risk equals more return
- Money always find its most efficient home
- Emotions are your biggest enemy
- Diversification is the only strategy you need
- There was more opportunity in the past
- Compensation should be based on returns



Myth #6: Compensation Should Be Based on return

- What's wrong with status quo of paying someone a percentage of what they make?
  - Potentially undermines entire investment process
  - May have you overpaying for beta
  - Doesn't put a structure in place which is goal congruent, but asymmetrical
  - Precludes managers from making more when they truly deliver alpha

Example of Current Compensation Structure

- Example of two 20 percent payouts on $10 MM investment with 1.5 mm Unit-of-Risk (UoR™)
- Scenario 1
  - Manager A makes the account $1 mm and had max adverse excursion of $1 mm. Earns 20 percent incentive fee or 200k using current system.
- Scenario 2
  - Manager B makes the account 2 MM and had max adverse excursion of $300k and earns 20 percent incentive fee or 400k.

Why does Manager A earn same incentive percentage as manager B when risk-adjusted performance was so different?

Solution - Netto Number™ Formula

Profits / Risk Factor

$$\left(\frac{\text{Profits}}{\left(\frac{\left(\begin{array}{c}\text{Unit-of-Risk = UoR}\\ +\\ \text{Max Drawdown}\end{array}\right)}{2}\right)}\right) = \text{Risk Factor}$$

$$= \frac{\text{Profits}}{\text{Risk Factor}} = \text{Netto Number}$$

$$\left(\frac{\text{Profits} = 100\text{k}}{\left(\frac{\left(\begin{array}{c}\text{UoR} = 1\text{ Million}\\ +\\ \text{Max Drawdown} = 500\text{k}\end{array}\right)}{2}\right)}\right) = 750\text{k}$$

$$= \frac{100\text{k}}{750\text{k}} = 0.133$$

Netto Number	Incentive Fee %	Netto Number	Incentive Fee %	Netto Number	Incentive Fee %
.01-.05	1	.86-.90	18	1.80-1.875	35
.06-.10	2	.91-.95	19	1.876-1.95	36
.11-.15	3	.96-1.00	20	1.95-2.025	37
.16-.20	4	1.01-1.05	21	2.026- 2.10	38
.21-.25	5	1.06-1.10	22	2.10- 2.175	39
.26-.30	6	1.11-1.15	23	2.176- 2.25	40
.31-.35	7	1.16-1.20	24	2.251- 2.325	41
.36-.40	8	1.21-1.25	25	2.326- 2.40	42
.41-.45	9	1.26-1.30	26	2.40- 2.475	43
.46-.50	10	1.31-1.35	27	2.476- 2.55	44
.51-.55	11	1.36-1.40	28	2.56- 2.625	45
.56-.60	12	1.41-1.45	29	2.63- 2.70	46
.61-.65	13	1.46-1.50	30	2.71-2.80	47
.66-.70	14	1.51-1575	31	2.81-2.90	48
.71-.75	15	1.576-1.65	32	2.91-3.0	49
.76-.80	16	1.66-1.725	33	3.01 and above	50
.81-.85	17	1.726-1.80	34		

Solution – Pay Retroactively for Return Per Unit-of-Risk (UoR™)

- The Netto Number™ is a ratio that measures Return Per UoR
- Focus is balanced between Numerator, or Profits and Denominator, or Risk Factor
- Simple Equation : Profits / Risk Factor
- Higher Netto Number™ is better Return Per UoR, lower is worse
- It's retroactive, so only pay commensurate with Return Per UoR
- Larger the Risk Factor => lower the Netto Number => lower the Netto Number => lower incentive fee
- Two inputs in Risk Factor:
  - Unit-of-Risk (UoR™)
  - Max Negative Drawdown

Netto Number™ Input: Risk Factor (RF)

- Serves as the context for the profits
- Two inputs in Risk Factor – Unit-of-Risk (UoR™) and Max Adverse Excursion
- Size of UoR™: ½ of Risk Factor
- Max Adverse Excursion: ½ of Risk Factor
- Combine the two of those and divide by 2. This number becomes base to measure against P and L.
- Apples-to-Apples comparison of manager performance
- If investor has UoR™ of 1 mm and there was a max negative drawdown of 500k. Then the metric used to determine performance will be $750k. 1 mm plus 500k equals 1.5 mm. Divide this by 2 and you have 750k.

Applying The Netto Number™

- 20 percent incentive fee on $10 MM investment with 1.5 mm UoR™, or "The Budget"

- Scenario 1
  - Manager A makes the account $1 mm and had max drawdown of $1 mm.
  - Earns 200k in incentive fees using conventional system.
  - Using "Netto Number" Manager A would earn 10 percent, or 100k in incentive fees

- Scenario 2
  - Manager B makes the account $2 MM and had max negative drawdown of $300k.
  - Earns 400k in incentive fees using conventional system.
  - Using "Netto Number" this Manager would earn 30 percent, or 600k in incentive fees

On a portfolio level this can have profound influence on paying for alpha while not overpaying for beta.

Netto Number	Incentive Fee %	Netto Number	Incentive Fee %	Netto Number	Incentive Fee %
.01-.05	1	.86-.90	18	1.80-1.875	35
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Unit-of-Risk (UoR™) = The Risk Budget

- To Maximize Return Per UoR™, must define in advance what you are risking.
- Level manager is judged on
- UoR is investor's "budget". The brakes on a portfolio
- Value of UoR™ = half of the average used in Risk Factor of "Netto Number" e.g. 1 mm

$$\left(\frac{\left(\text{Unit-of-Risk = UoR} + \text{Max Drawdown} \right)}{2} \right) = \text{Risk Factor}$$

Unit-of-Risk UoR™ in Netto Number

- Unit-of-Risk, UoR™
  - UoR™ is a predetermined threshold by both the manager and investor of absolute dollars/percentage of account investor is willing to lose with a strategy. When this level is hit, the trading ceases. Period.
  - Investor must be rewarded for taking on more risk in the same way a manager is rewarded for high returns relative to an actual lower UoR™. "Flexibility premia"
  - If UoR is higher, this will increase RF in "Netto Number". If it's lower, then it will be more favorable to payout
  - More AUM, higher the UoR™. Will force manager to think about **capacity constraints** of strategy because it impacts payout.

Max Adverse Excursion

- Comprises other half of Risk Factor in "Netto Number"
- "Max Adverse Excursion" (Hybrid of Calmar and Sortino)
- Based on daily info, not monthly or quarterly
- For purposes of "Netto Number" Manager not punished for drawdown from gains, only drawdown which sends principle negative

$$\left(\frac{\left(\text{Unit-of-Risk = UoR} + \text{Max Drawdown} \right)}{2} \right) = \text{Risk Factor}$$

Max Adverse Excursion- Example

- Account is up $1 mm and has max negative drawdown of 400k. ROMAD of 2.5
- If account, or initial investment, never goes negative this factor is 0
- Don't want to punish a strategy which steps it up with profits as drawdown from P and L highs is different than drawdown which sends account negative
- Time period is predetermined by manager and investor

Netto Number™ Combines them both

- Netto Number determines what % of profits manager receives
- Numerator = account profits (100k, 500k, 1 mm etc)
- Denominator, or RF = average of UoR and Max Adverse Excursion (UoR™ of $1 mm, MAE of 500k = 1 mm + 500k / 2 = 750k)
- Netto Number = Account profits divided by 750k
- Netto Number indicates what incentive fee manager receives (see table)

$$\frac{\text{Profits}}{\left(\frac{\text{Unit-of-Risk = UoR} + \text{Max Drawdown}}{2}\right)} = \text{Risk Factor}$$

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- Incentive Fee ranges from 1-50 percent
- Creates a goal-congruent incentive framework based on risk-adjusted performance & performance on actual risk capital.
- Solves problem of backward-looking performance metrics by defining actual risk at play unlike other traditional performance ratios
- Payment works retroactively following predetermined time period
- Multiple uses : Can be a “hurdle” in performance, compare strategies, trades, managers, portfolios b/c of UoR input

$$\left(\frac{\text{Profits}}{\left(\frac{\text{Unit-of-Risk = UoR} + \text{Max Drawdown}}{2}\right)}\right) = \text{Risk Factor}$$

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Netto Number™ Formula

$$\left(\frac{\text{Profits}}{\left(\frac{\text{Unit-of-Risk = UoR} + \text{Max Drawdown}}{2}\right)}\right) = \text{Risk Factor}$$

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Netto Number™ Payout Scale using $750k as the Risk Factor

Total Account Profits	Incentive Payout	Total Account Profits	Incentive Payout
100k = Netto Number of .133 100/750 = .133	3 percent 3 percent of 100k= $3,000	$1 mm = NN of 1.33 1 mm / 750k = 1.33	27 percent 27 % of 1 mm = $270k
375k = Netto Number of .50 375/750 = .50	10 percent 10 percent of 375k = $37,500	$1.5 mm = NN of 2 1.5/.75 = 2	36 percent 36 % of 1.5 mm = $540k
500k = Netto Number of .67 500/750 = .67	14 percent 14 percent of 500k = $70,000	$3 mm = NN of 4 3 / .75 = 4	50 percent 50 percent of 3 mm = $1.5 mm
$700k = Netto Number of .93 700/750 =.93	19 percent 19 percent of 700k = $133,000		

Example 1 – Netto Number™

- $10 Million "trading level" with a $2 million risk budget
- 1 year time frame
- Account returns 500k with max Negative drawdown of 1 million dollars

- Add both max negative DD (1mm) plus UoR ($2 mm) = 3 MM
- Divide $3 mm by 2 = $1.5 MM Risk Factor
- Now divide profits of $500k by 1.5 mm = Netto Number of .33
- Look at scale and .33 = 7 percent incentive fee
- 7 percent of 500k is 35k
- Much more equitable than 100k incentive fee from conventional structure

Example 2 - Collective2.com – Protean

Protean (92462952) Trade It | Share | Tweet | New Trade | Market | Manage

Created by: John Netto

Started: 02/2015 | Mostly Futures; (some stocks, options) | Last trade: Today

Subscription terms. Subscriptions to this system cost $5.00 per month.

16.0%	13.6%	105	55.2%	1.6 : 1	75.0%
Cumul. Return	Max Drawdown	Num Trades	Win Trades	Profit Factor	Win Months

Typical Broker Commission and AutoTrade Fees

Hypothetical Monthly Returns (includes system fee and Typical Broker commissions and fees)

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2015		+6.8%	(7%)	+9.7%	+6.5%								+16.0%

Hypothetical Performance

Zoom 1m 3m 6m YTD 1y All From Feb 11, 2015 To May 26, 2015

Model Account Details

System Developers may want to use this information to adjust their trade sizes, or merely to understand the magnitudes of the nearby chart.

Started	$250,000
Buy Power	$310,932
Cash	$310,932
Equity	$0
Cumulative $	$60,932
Total System Equity	$310,932
Margined	$0
Open P/L	$0

Performance Metrics

Strategy began	2/11/2015
Age	105 days ago
What it trades	Futures
# Trades	105
# Profitable	58
% Profitable	55.20%
Avg trade duration	11.8 hours
Max peak-to-valley drawdown	13.62%
drawdown period	Feb 27, 2015 - March 23, 2015
Cumul. Return	15.9%
Avg win	$2,815
Avg loss	$2,177
W:L ratio	1.60:1
Open PL	$0.00
Open PL (start day)	$0.00
Open PL Change $	$0.00
Open PL Change %	n/a
Close PL	$60,932
Closed PL (start day)	$60,932
Closed PL Change $	$0.40
Closed PL Change %	n/a
Equity	$310,932
Equity (start day)	$310,932
Equity Change $	$0.40
Equity Change %	n/a

GENERAL STATISTICS	
Age	105
# Trades	105
Starting Unit Size	260000
Avg Trade Length	0.5
PROFIT	
Profit Factor	1.6
SORTINO STATISTICS	
Sortino Ratio	4.380
CALMAR STATISTICS	
Calmar Ratio	11.041
Ann Return (w trading costs)	65.1%
SHARPE STATISTICS	
Sharpe Ratio	2.630
Ann Return (Compnd, No Fees)	112.4%
Chance of 10% account loss	18.50%
Chance of 20% account loss	n/a
Chance of 30% account loss	n/a
Chance of 40% account loss	n/a
Chance of 50% account loss	n/a
PROFIT STATISTICS	
APD	0.26
DRAW DOWN STATISTICS	
Max Drawdown	13.6%

Example 2 – Protean

- 250k account size, UoR™ of 50k
- 1 year time frame
- Account returns 64 percent, or 160k with max Negative drawdown of $16k

- Add up amount of risk budget of $50k with amount of Max Neg DD of 16k (50,000+ 16,000 = 66,000)
- Divide this amount by two … 33,000
- Divide $160k (profits) by $33k gives a Netto Number™ of 4.84
- 4.84 pays 50 percent… of 160k= $ 80k incentive fee
- Net to Investor is 80k on a max neg DD of 16k… Excellent Return over Max Neg Drawdown and Return per UoR (80k vs 50k UoR)

Implementation – 3 Phases (6 months -6 yrs)

- Phase I – (6-24 months) Early Adoption - Used as benchmark to assess current Hedge Fund Performance and one-off compensation deals, e.g. paying manager 10 percent too much or too little. Given lockups and other legacy issues redoing the compensation structure overnight is challenging
- Phase II – (18-48 months)
  - Implemented at smaller fund and proprietary trader level
  - managers of medium sized funds with capacity who are maximizing UoR
  - those who want to ratify their value proposition
- Phase III – (4-6 years)Last will be larger funds who will be considered irrelevant by not adapting this structure. This will lead to another iteration of measures for Return per UoR for mainstream financial products and services in the future.

Issues this structure will face

- **Has potential to change how managers and investors define and pay for alpha in $3 Trillion Industry**
- It takes 10 seconds more to compute than conventional 20 percent
- Legacy – managers making their money from AUM and beta will resist
- Manager running less AUM can earn same incentive fees - so organically shifts focus from aggregating assets to maximizing return per unit-of-risk.
- Accountability - one thing to talk about risk management, another thing to have it woven into compensation
- Paradox of investors hurting themselves. Focus on Nominal percentage instead of UoR.
  - Would rather pay 20 percent and have net higher drawdowns and lower returns than pay 50% and have lower drawdowns and higher net return to risk budget.
  - Onus is on manager/consultants to explain net result and not a percent of compensation
- Implementation takes time and understanding
- Adoption of Netto Number will stimulate more investment. Demonstrate the market is the best at policing itself. Innovation can be more powerful than regulation at attracting market participants
- Needs to be marketed from a “only pay for what you get” and maximize return per unit-of-risk.
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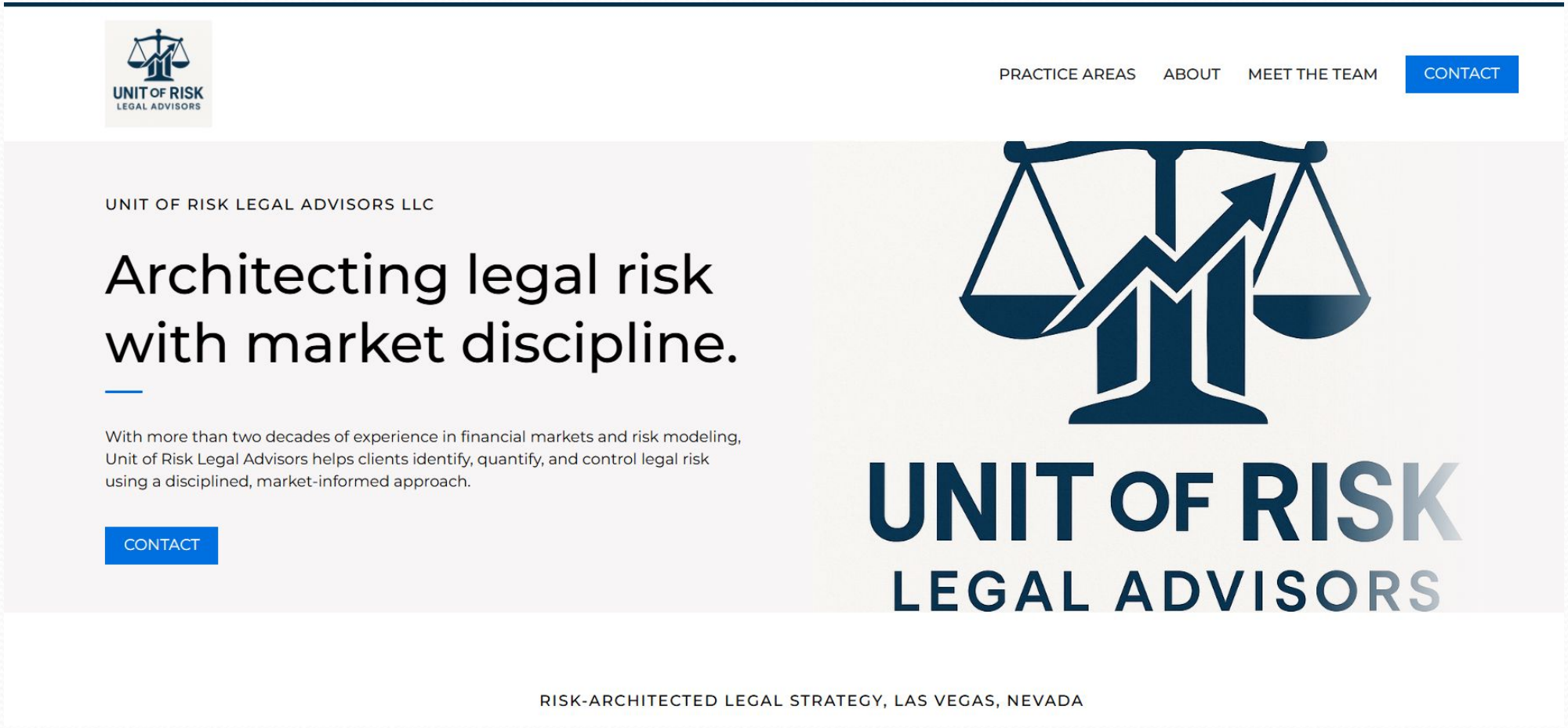
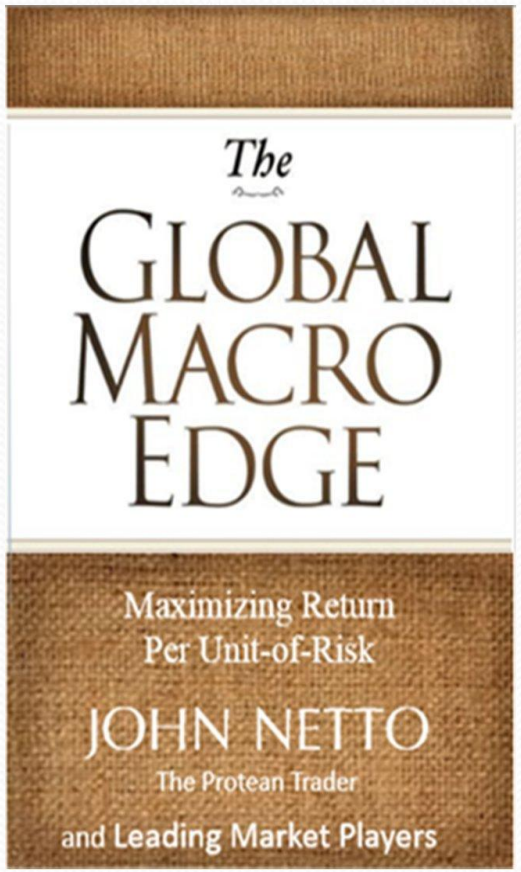


Contact - john@uorlegal.com



Thank you!

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