

Volume 28, Issue 6**Research Announcement****What does the risk-appetite index measure?**

Miroslav Misina
Bank of Canada

Abstract

Explanations of changes in asset prices as being due to exogenous changes in risk appetite assume that changes in asset prices due to changes in risk aversion can be uniquely identified, and that some quantitative measure can capture these in isolation. One such measure, the risk-appetite index, is based on the rank correlation between assets' riskiness and excess returns. The author seeks to provide a theoretical foundation for this measure. The arguments behind the index are given in two propositions and these are derived within a class of well-specified asset-pricing models. His results indicate that, whereas the exclusive attribution of the rank effect to changes in risk aversion is problematic in general, a specific set of circumstances can be identified in which this attribution is permissible. The key assumption is identified, and its empirical implications are examined.

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Miroslav Misina
Bank of Canada
mmisina@bankofcanada.ca