

About the State Street Institutional Investor Risk Appetite Indicator

The **Risk Appetite Indicator** tracks institutional investor flows across stocks, bonds, currencies, and commodities, as well as across asset classes by examining equity and cash weights. The indicator captures buying and selling activity by real-money funds and excludes trades by leveraged funds. It is constructed as follows:

1. We measure the net flows (buys minus sells, divided by market capitalization) for 22 distinct dimensions of risk taking, which are listed below.
2. We smooth each flow by taking a 20-day moving average and then convert it into a five-year conditional percentile, with net flows of zero denoting the 50th percentile. In other words, the percentile is above 50 percent when the flow is positive.
3. If an indicator is determined to be risk seeking (averse), flows greater than the 50th percentile denote higher (lower) levels of risk appetite. For example, buying of emerging markets over developed markets would be a risk-seeking flow whereas buying of high-dividend stocks (which tend to be less volatile) would be a risk-averse flow.
4. For each of the 22 component risk dimensions, we then assign a score of +1 if flows are risk seeking and a score -1 if flows are risk averse.
5. We then sum up the scores for the 22 component risk dimensions and divide by the number of components (22) to get a number between -1 (risk averse in every dimension) and +1 (risk-seeking in every direction). This sum is the **Risk Appetite Indicator** for that day.

The 22 dimensions of risk-taking are listed below. The risk dimensions marked with an asterisk (*) are risk-averse flows (which drive the indicator value down) whereas the rest are risk-seeking flows (which drive the indicator value up).

Equity components:

- Emerging market flows minus developed market flows
- Flows into cyclical sectors (like technology) minus flows into defensive sectors (like utilities)
- Shorting of cyclical sectors minus shorting of non-cyclical sectors*

- Flows into higher-beta stocks minus flows into lower-beta stocks (low-beta stocks are less sensitive to market gyrations than high-beta stocks)
- Flows into higher-dividend stocks minus flows into lower-dividend stocks (higher-dividend stocks tend to be more stable whereas lower-dividend stocks tend to be more growth oriented and volatile)*
- Flows into stocks with higher return on equity (relative to their industry) minus flows into stocks with lower return on equity (firms with higher ROE tend to be more resilient during market downturns)*
- Flows into stocks with higher exposure to the business cycle minus stocks with lower exposure to the business cycle

Bond components:

- Flows into short-term sovereign bonds minus flows into long-term sovereign bonds
- Flows into relatively safe “core” countries’ sovereign bonds (US, Germany, United Kingdom)
- Flows into high-yield sovereign bonds
- Flows into high-yield corporate bonds minus flows into investment grade bonds
- Flows into emerging market sovereign bonds minus flows into developed market sovereign bonds

Currency components:

- Flows into higher-yielding currencies
- Flows into lower-yielding currencies*
- Flows into emerging markets currencies
- Flows into the U.S. dollar, a safe haven*

Commodity components:

- Cross-border flows into stocks from commodity producing countries.
- Flows into stocks in the energy and materials sectors
- Flows into stocks that are highly correlated to commodities prices minus flows into stocks with low correlations with commodities prices
- Flows into currencies of commodity producing countries.

Asset allocation components:

- The aggregate change in investors’ equity allocation
- The aggregate change in investors’ cash allocation*

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