S&P Dow Jones Indices

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# Examining the Growth of Decrement Indices

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## OVERVIEW FROM A GLOBAL PERSPECTIVE

A decrement is an overlay applied to a given base index. A decrement index is constructed by deducting a predefined dividend or fee at predefined intervals from the total return of the base index.

S&P Dow Jones Indices (S&P DJI) has been publishing decrement indices since 2016. Initially using the term "synthetic" or "premium" in index names, we subsequently unified the naming convention to "decrement" indices. We have developed a transparent decrement framework through a series of decrement indices, including the S&P 500 Decrement Indices, S&P ESG Decrement Indices, and multi-asset decrement indices.

The decrement methodology can be overlaid on any of our globally accepted, independent underlying indices. The parameters used in the calculation of decrement indices can be customized based on product issuer or market participant requirements.

## CHANGES IN DEMAND

One key trend we observed in 2021 was further expanding demand in Asia and the U.S. Being the first region to enter a zero or negative interest rate regime, Europe is ahead of other regions in the development of decrement index-linked products. A low-rate environment makes it challenging for issuers to provide attractive terms and triggers the search for a new underlying asset that could deliver cheaper optionality. Decrement indices were designed to provide a solution for this challenge. With interest rates dropping further globally after the pandemic began, we started to see growing demand for decrement indices in Asia and the U.S. as well.

Another key trend has been increasing interest in ESG and thematic benchmarks as the underlying indices for decrement strategies. ESG and megatrend investing have been growing steadily over time, and they tend to land in the spotlight during extreme events, such as the global pandemic. With ESG and thematic investing growing at a faster pace since the pandemic started, decrement strategies on these topics are picking up globally.

*This article was first published in SRP's SRPReports: Indexing and Structured Products (Oct. 8, 2021).*

## NEED FOR FURTHER EDUCATION

*With interest rates dropping globally after the pandemic began, we started to see growing demand for decrement indices in Asia and the U.S.*

Decrement indices are often wrapped up into structured products and sometimes marketed in similar ways as products based on their underlying headline indices. It is possible that there is still a lack of education on how decrement indices work and the important practical implications for end users.

Compared with conventional price return indices, decrement indices could allow product structurers to attract potential investors with favorable terms, such as higher participation rates and improved capital protection. However, depending on whether the fixed synthetic dividend is greater or less than the actual realized dividend received, the decrement index could underperform or outperform the corresponding price return index. So, it's important to select an underlying index that aligns with the objective of the structured product. The deduction method also matters. Market participants should be aware that fixed percentage and fixed point deduction may deliver significantly different returns in volatile markets.

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Different from decrements, which are based on a transparent and well-defined methodology, ESG investing lacks a common standard. Despite the growing volume of ESG data, there are concerns around inconsistent ESG metrics across agencies and different types of reporting and disclosure across countries. Without a uniform methodology to quantify ESG factors and to regulate ESG reporting, it can be challenging for market participants to differentiate genuine ESG from green-washing.

A solution may appear in the coordinated efforts from governments and industries over time. For example, the EU is taking a step forward to try to define ESG labels and regulate sustainable investing through the Sustainable Finance Taxonomy Regulation. S&P DJI has also successfully launched the S&P PACT™ Indices (S&P Paris-Aligned & Climate Transition Indices), which are aligned with the EU's minimum standards for low-carbon benchmarks under the EU Benchmark Regulation. Despite these advancements, there is still a long way to go to improve standards and encourage higher levels of ESG adoption.

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## DIFFERENTIATING BETWEEN THE INDICES

To help market participants understand the benefit and risk of decrement indices as well as the various methods used, S&P DJI has released educational content through different channels.

Deciphering Decrement Indices is a four-minute motion graphic video we produced to provide an easy-to-digest overview on how decrement indices work, their characteristics and potential applications.

*We have launched many ESG decrement indices globally, especially in the European region.*

For investors seeking a deeper understanding of the decrement methodology with illustrative examples, they can read our paper entitled A Guide to S&P Decrement Indices.

Finally, to check out our existing offerings and parameters used in our index offerings, S&P Dow Jones Indices Decrement Indices Parameters is a convenient reference.

## INDICES RESPONDING TO NEEDS OF THE CURRENT ENVIRONMENT

We have launched many ESG decrement indices globally, especially in the European region. These indices use various methods to integrate ESG considerations, such as broad ESG, climate, ESG thematics, ESG multi-asset strategies and so on.

*These indices integrate ESG considerations, such as broad ESG, climate, ESG thematics, and ESG multi-asset strategies.*

One example that innovatively examines companies by their ESG scores and their ESG score improvements is the S&P Eurozone 30 ESG-Momentum Select Equal Weight 50-Point Decrement Index. It is designed to measure the performance of 30 stocks with the greatest S&P DJI ESG Score momentum, excluding companies in the lowest 30% by S&P DJI ESG Score within the S&P Eurozone BMI, less a fixed fee of 50 points per year.

We have also launched many multi-asset decrement indices. For example, the S&P Balanced Global Bond and Equity Futures 0.4% Decrement Index is a multi-asset strategy designed to limit volatility while delivering consistent performance through various market cycles and economic conditions. A 0.4% fee is deducted from the index performance per year. It is a typical example of packaging a quantitative investment strategy with a risk control mechanism into an investable index. By exploiting the complementarity and negative correlations between equities and bonds, the index has historically demonstrated the ability to outperform, especially during periods of crisis.

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