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INVESTMENT STRATEGIES

WEALTH THINK

Direct indexing's secret power when stocks head south

By Gregory Kanarian

"Everyone has a plan until they get punched in the face." — Mike Tyson

Advisors are all too familiar with the best laid financial plans getting KO'd by market volatility. When the market is turbulent, it can lead to investors making emotionally charged trading decisions driven by the basic human need to seek safety.

We know that this is counterproductive to long-term goals and that "time in the market" beats "timing the market." Morningstar data spanning a decade reinforces the point that trading in and out of the market can be costly and that investors routinely underperform their own investments.

The research, spanning 2014 to the end of 2023, found that equity fund investors earned a dollar-weighted return of 10%, while the category's total return was 10.8%. In other words, investors lost 0.8% per year by not adhering to a buy-and-hold strategy.

The study further distinguishes between active and passive investments, showing that active equity funds returned 10.4% and passive funds returned 11.2%. Active investors underperformed by 1.2% while passive investors underperformed slightly by 0.2%. Passive investors seem more likely to buy and hold, minimizing the performance gap.

Greg Kanarian, investment strategist at Natixis Investment Managers Solutions

10-year returns

As of Dec. 31, 2023

	Investor return	Total return	Gap
U.S. equity, active	9.2%	10.4%	-1.2%
U.S. equity, passive	11%	11.2%	-0.2%

Source: Morningstar, "Mind the Gap 2024"

Navigating volatile markets

Direct indexing, an equity strategy that seeks to match the performance of an index on a pretax basis and outperform on an after-tax basis, is often lauded for its tax efficiency. Less recognized is the important role it plays in the behavioral aspect of investing, specifically how it helps clients stay invested during volatile markets.

When I present talks on the benefits of direct indexing, I share this quote from "The Simple Path to Wealth" by financial writer JL Collins: "Everybody makes money when the market is on the rise. But what determines whether it will make you wealthy or leave you broken and bloody at the side of the road is your ability to stay the course and ride out the storms."

Financial advisors play a crucial role in helping clients navigate market drawdowns. They listen to client concerns, offer empathy, counsel, perspective and can prevent them from making rash decisions. Advisors know that volatility is the price of admission and double-digit drawdowns are common, even in great years.

Fully invested

But lacking this perspective, a client's urge to do something, anything, to stop the bleeding is real. This is when clients second-guess their investments and their advisors and look to raise cash or sell out of risk assets altogether.

Direct indexing helps clients stay invested during sell-offs by scratching that itch to do something while maintaining market exposure. When volatility rises, the direct indexing manager has more tax-loss harvesting opportunities, allowing them to turn unrealized investment losses into tax write-offs.

Importantly, when a stock is sold for a loss, it's immediately replaced with another index constituent to avoid the wash sale rule, keeping the client fully invested. Since direct indexing accounts are separately managed accounts, the client has full transparency and can see the loss-harvesting trades in real time.

While each direct indexing manager sets their own loss thresholds, they all systematically and proactively tax-loss harvest accounts. Realized losses that exceed the $3,000 ordinary income deduction limit can be carried over to offset future gains when the market eventually recovers.

Being able to see tax-loss harvesting trades reassures clients that their advisor has set them up for success regardless of market conditions. Advisors can illustrate to clients the benefits of ongoing tax management and refocus them on long term financial goals. They can also short-circuit clients' goal-jeopardizing urge to act emotionally.

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