

## Wealth Think When direct indexing is the wrong fit for your client

By Gregory Kanarian

Once a niche strategy for high net worth investors, direct indexing is now mainstream, with over \$1 trillion in assets.

The customizable portfolios consisting of individual securities are an increasingly default solution for advisors seeking tax-efficient equity exposure for clients. In addition to index like performance, they come with the added benefit of systematic tax loss harvesting — something indexed mutual funds and ETFs can't provide.

Most advisor education focuses on the benefits of this strategy. But during a recent webinar, an advisor raised a question I rarely receive: When isn't direct indexing a good fit for a client?

It's a pertinent question. As more tax-managed strategies come to market, an advisor's value lies in their ability to apply the right solution to the right tax problem. Direct indexing is a powerful tool, but it is not a universal solution. The five following scenarios illustrate when it may not be the best strategy for a particular client.

### Qualified retirement accounts

This is the easiest of the bunch. Tax-loss harvesting does not benefit qualified retirement accounts

because losses are not deductible.

Like owning municipal bonds in an IRA, direct indexing in a qualified account is wasteful from an asset location perspective. It can even create wash-sale risk if the direct-indexing manager purchases the same stock loss-harvested in a taxable account, permanently disallowing that loss.

One exception to this rule of thumb involves investors who are focused on personalizing in their retirement account to achieve environmental, social, governance or other aims. For example, S&P 500 exposure that excludes Tesla, REITs and alcohol stocks can be accommodated with direct indexing.

### When outside capital gains are minimal

Clients directing most of their savings into qualified accounts may not benefit from direct indexing as much as those with regular and consistent capital gains. For instance, a married couple, each with a 401(k), can theoretically sock away up to \$144,000 for tax year 2026. But in practice they may be contributing to health savings accounts and 529 plans and have little income left to invest in taxable accounts.



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That means realized losses from direct indexing beyond the \$3,000 annual deduction may not be useful for years to come.

### Clients in lower tax brackets

The case for direct indexing becomes weaker in the lower tax brackets. I often cite the 32% federal bracket — individuals who make above \$201,775 and married couples who make more than \$403,550 — as a rough threshold above which the benefits of loss harvesting and gain deferral from short term to long term gains become meaningfully valuable.

## PORTFOLIO STRATEGIES

An important exception is clients currently in a low bracket who anticipate a sizable future capital gain event. In such cases, direct indexing that results in unused capital losses can carry forward to create a cushion when selling a business, real estate, stock options or concentrated stock generates a large capital gain.

### **When more appropriate solutions exist**

Ironically, one of the biggest obstacles to adopting direct indexing is the tax efficiency of investment vehicles the client already owns. Selling an existing tax-efficient, diversified (i.e., S&P 500) ETF with a low-cost basis to fund a S&P 500 direct indexing account rarely makes sense.

The same is true for an already diversified portfolio of stocks with excessive embedded gains. Recently I talked with an advisor whose client owned 60 large-cap value stocks worth \$3.4 million with a \$500,000 cost basis. Fully transitioning to an S&P 500-tracking direct indexing portfolio would result in modest diversification benefits but would

cost \$2.7 million in realized gains.

When the current portfolio has significant embedded gains but rebalancing is a priority, a tax-aware long-short strategy can be a more appropriate solution. In the above scenario, the \$3.4 million current portfolio would be accepted in-kind, margin established and subsequently purchase growth stocks at a 30% weight. The portfolio manager would then short 30% in value stocks to help tilt the portfolio toward the large-cap core and allow for tax-loss harvesting in both up and down markets.

Tax-aware long-short strategies come with varying degrees of leverage, which can generate more losses and more quickly than long-only direct indexing. For example, if there's an imminent need for losses from a business sale, a 200% long/100% short strategy could potentially harvest 40% in losses in year one compared to, say, 15% for direct indexing. This strategy is most effective when the liquidity event happens early in the tax year to take advantage of several months of market volatility.

Similarly, selling an investment property and plowing the proceeds into direct indexing to harvest losses to offset the real estate gains may not be ideal when a properly structured 1031 exchange can defer all capital gains. The client would need to be comfortable staying invested in real estate, however, rather than diversifying into another asset class.

### **Advisor's fee is too high**

With direct indexing, the expectation is for better after-tax returns and positive tax alpha. But if the manager and advisor's fee on top is too high, it can negate the benefits.

Direct indexing strategies are modestly priced in the 15 to 35 basis point range — more than an S&P 500 ETF but less than an active large cap mutual fund. The value of hiring a direct indexing manager is substantial compared to the hassle of an advisor trying to do it on their own.

As the use of direct indexing continues to grow, advisors can differentiate themselves by knowing when to apply the strategy — and when to take a pass.

Diversification does not guarantee a profit or protect against a loss. Investment strategies discussed are for illustrative purposes only and should not be construed as investment advice.

Alpha is a measure of the difference between a portfolio's actual returns and its expected performance, given its level of systematic market risk. A positive alpha indicates outperformance, and negative alpha indicates underperformance relative to the portfolio's level of systematic risk.

A 1031 exchange allows real estate investors to defer capital gains taxes by reinvesting proceeds from a sold investment property into a like-kind replacement property. A short position is the sale of a borrowed security with the expectation that the asset will fall in value. Short selling is speculative in nature and involves the risk of a theoretically unlimited increase in the market price of the security that can, in turn, result in an inability to cover the short position and a theoretically unlimited loss.

Growth stocks may be more sensitive to market conditions than other equities, as their prices strongly reflect future expectations.

Real estate investing may be subject to risks including but not limited to declines in the value of real estate, risks related to general economic conditions, changes in the value of the underlying property owned by the trust, and defaults by borrowers.

The S&P 500® is widely regarded as the best single gauge of large-cap U.S. equities. The index includes 500 leading companies and covers approximately 80% of available market capitalization.

Tax-loss harvesting is the selling of securities at a loss to offset capital gains tax liability.

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