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Is Direct Indexing Right For Your Clients?

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Direct indexing has generated a lot of buzz lately in the financial services industry. Large financial services firms such as Schwab, Fidelity and Vanguard have begun offering direct indexing services to retail clients and some are promoting it aggressively. As a result, even if you aren't already using direct indexing with your clients, there's a good chance you'll start to get questions about it.

While direct indexing does offer some very attractive features, it may not be right for everyone. Before we dig into the reasons why direct indexing may not fit in every client's portfolio, it may be helpful to first define direct indexing.

Similar to index funds and passive ETFs, direct indexing strategies offer index-like exposure. They do this through a separately managed account format. However, unlike commingled funds such as index funds or ETFs, investors in direct indexing strategies hold a basket of individual stocks within their account that is constructed to track an index reasonably closely. Typically accounts hold a subset of an index, for example usually around 150-250 stocks in the case of the S&P 500 Index, rather than replicating the entire index, such as index funds and ETFs typically do.

Figure 1: Index investment vehicle comparison

	Index Mutual Fund	ETF	Direct Indexing SMA
Benchmark example	S&P 500®	S&P 500®	S&P 500®
Typical # holdings	Approx. 500 (full replication)	Approx. 500 (full replication)	50–300+ (sampled or optimized)
Hold individual stocks directly	No	No	Yes
Tracking error to index	Usually <0.10%	Usually <0.10%	Varies, but typically <1.5%
Direct benefit from loss harvesting	No, net losses stay in the fund	No, net losses stay in the ETF	Yes
Typical investment minimum	$100–$3,000	1 share	$100,000
Typical management fee	0.03%+	0.06%+	0.30%
May be more suitable for	Small frequent contributions	Tactical trading during the day	Taxable investors, and/or those desiring customization or tax management

Source: Natixis Investment Managers Solutions

Figure 1 compares some of the characteristics of direct indexing to index funds and ETFs.

Direct index strategies sample, or hold a subset of, an index's holdings for several reasons:

- **Allows for lower investment minimums.** Holding all the stocks in an index like the S&P 500 or Russell 1000 would require very high minimum account sizes.
- **Provides flexibility** to sell some positions that decline in value while still holding other stocks that the proceeds can be re-invested into.
- **Allows customization of accounts** to align with investor values, preferences or guidelines.

The primary benefits to be gained from direct indexing are:

- **Generating better after-tax returns** for investors than commingled vehicles like funds or ETFs, primarily through tax loss harvesting.
- **Transitioning low-cost-basis assets into a managed portfolio in a tax efficient manner.** State-of-the-art direct indexing involves managing client portfolios in a highly customized way. These types of approaches can incorporate low basis assets.
- **Customization to align with client desires.** By definition, commingled vehicles like funds and ETFs cannot be customized. The separate account structure of direct indexing allows for customization based on client input.

Now let's examine when and where direct indexing may make sense. The answer depends partly on how the strategy is used within a client's investment portfolio. Here are several scenarios where direct indexing makes sense:

- **An investor with taxable assets looking to get index-like exposure.** Direct indexing can offer substantially better after-tax returns than funds or ETFs. The magnitude of this benefit will depend on the investor's tax rate - the higher the tax rate, the greater the tax benefit. This benefit can be as high as 1%-1.5% or more, annualized over 20-year investment horizons. However, this doesn't come without some risk. Direct indexing strat-

egies don't track index returns exactly because they are sampling the index. This can result in unintentional out- or under-performance. Typically, however, this tracking error tends to be much less than the incremental after-tax benefit over longer periods of time. Direct indexing also costs more. While expense ratios for ETFs have dropped to single digit basis points, management fees for direct indexing tend to be in the range of 20-35 bps.

- **Low-cost basis positions that a client is looking to have professionally managed in a more diversified portfolio.** Highly customized direct indexing strategies can be very effective tools for managing this transition. Some providers can even provide pro-forma analysis of what a transition would look like and help develop a multi-year transition plan.
- **Clients looking to customize their exposure.** Types of customization that can be provided include: incorporating ESG considerations, avoiding companies that are involved in business activities that clients find objectionable, or tilting towards companies that have characteristics desired by the client (e.g. value, dividend yield, quality, etc.).

Just as direct indexing may be beneficial in these scenarios, it may not make sense in other situations. For example, clients who are subject to lower tax rates would get less after-tax benefit from direct indexing and that benefit may not offset the higher cost and tracking error risk of this strategy. Also, assets in qualified accounts will not benefit from the tax aspects of direct indexing, although clients with a desire for customization may still find that feature attractive for qualified assets.

Direct indexing is a powerful tool that can be very beneficial for the right clients and the right situations. While there has been a big surge in attention on these strategies recently, they have been around for several decades. Growing knowledge of the benefits offered by direct indexing has driven rapid growth in these strategies over the past several years. We expect these vehicles will continue to grow in importance for advisors serving high net worth clients.

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