Direct Indexing

Direct Indexing Overview

naviter wealth

What is Direct Indexing?
Direct Indexing is the construction of a portfolio of individual securities meant to track a specific index while providing the flexibility to optimize the after-tax returns though systematic tax-loss harvesting. Further benefits include the ability to easily apply ESG and "smart beta" overlays to express your personal investment views.

The history of Direct Indexing?
In the 1970s, mutual funds introduced the concept of indexing which was made popular by The Vanguard Group. A mutual fund would own all of the securities of a selected index, e.g., S&P500 or Russell 1000. The mutual fund would own each security in the same weighting as the index to mirror that index's performance. Over the last two decades, exchange-traded funds (ETFs) have improved upon indexing by lowering costs and providing intra-day trading rather than daily trading after the close of the market. In addition, ETFs have a tax advantage over mutual funds which significantly reduces capital gain distributions.

Although Direct Indexing is not new, it is the most recent improvement upon indexing. ETFs lack one important feature--the ability to allow pass-through losses on the underlying securities. For example, in a year where the Russell 1000 is up in aggregate, but 200 of the individual positions are down, losses on those positions are not allowed to be passed through to the owner. As trading costs fell over the years, large family offices began replicating the indices by buying all of the individual securities that made up those indices. This allowed investors to systematically harvest tax losses across the entire portfolio throughout the year, creating "tax alpha" or the after-tax return improvement over the benchmark.

Current Direct Indexing Landscape
Direct Indexing is a rapidly growing area in the investing arena. Many of the largest financial institutions are moving into the strategy through acquisitions. Morgan Stanley bought Eaton Vance for its subsidiary Parametric which specializes in direct indexing. Blackrock bought Aperio; JP Morgan bought OpenInvest; Vanguard bought JustInvest; and Franklin Templeton bought O'Shaughnessy Asset Management and its direct indexing subsidiary, Canvas.

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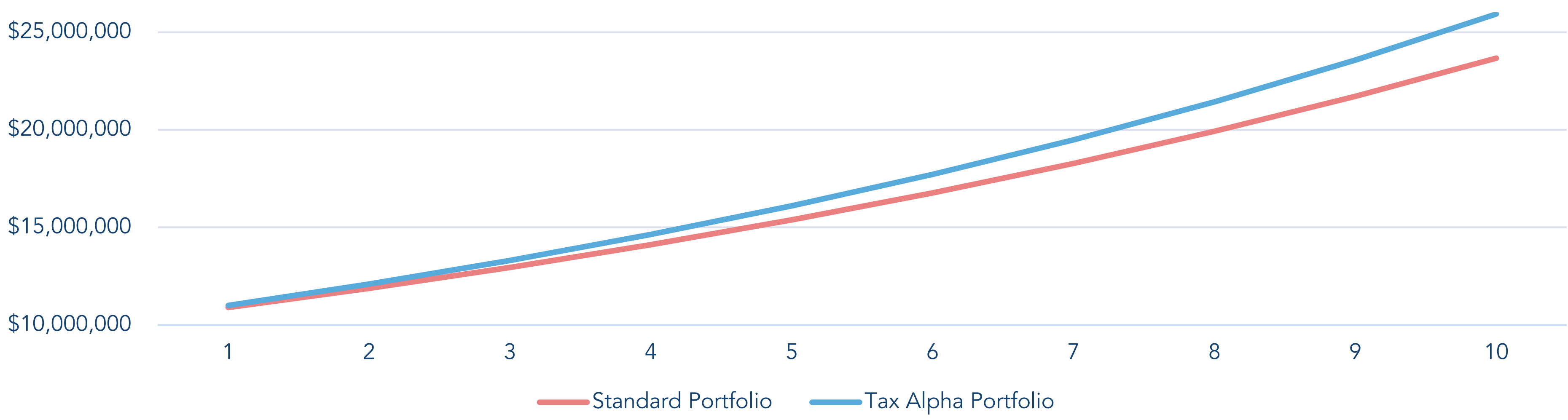
How much tax alpha should I expect from this strategy?
Market returns and volatility affect the outcome of systematic tax-loss harvesting, but over long periods of time, “tax alpha” is 75-100 basis points—a meaningful benefit over simply investing in mutual funds or ETFs. The chart below demonstrates benefit of a 100 basis points after-tax return improvement from 9% to 10%. On a $10MM portfolio, over a 10-year period, the economic improvement is over $2.2MM.

Tax Alpha Advantage



The above chart is for illustrative purposes only.

Direct Indexing Comparison to Mutual Funds & ETFs

Benefit	Mutual Funds	Exchange-Traded Funds (ETFs)	Direct Indexing
Seeks to track the performance of a market index	Yes	Yes	Yes
Lower fees	Yes	Yes	Yes
Tax efficiency	No—subject to capital gains tax	Yes—typically doesn't payout capital gains	Yes—tax management strategies may be applied
Tax loss pass through	No—mutual funds do not pay out realized losses	No—ETFs do not pay out realized losses	Yes—"tax alpha" may be generated through tax loss harvesting
Ability/timing to tax loss harvest	No	In down markets only	Potential in all markets
Availability of customizations	None	None	ESG, SRI, factor tilts and other customizations are available

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