Direct Indexing

By Glen Goland, JD, CFP®
Senior Wealth Advisor,
Senior Investment Advisor

The structure of investor portfolios has changed dramatically over the last 100 years and now, technology is pushing this evolution in a new direction in 2023. In this article, Senior Wealth Strategist Glen Goland, JD, CFP®, discusses the introduction of direct indexing and how it can benefit an investment portfolio.

A brief history for context

In the early 1900s, most investors held stocks and bonds of individual companies. Several Boston-based firms (MFS, Putnam, and Pioneer) launched mutual funds in the 1920s and over the next fifty or so years, the universe of actively managed mutual funds grew in popularity. Then, later in the century, indexed strategies appeared on the market (through companies like Vanguard, iShares, and SPDR). Investors have poured money into index funds over the last three decades and now, the largest 15 mutual funds in the world are passive index strategies, most of them set to mirror those stocks in the S&P 500.

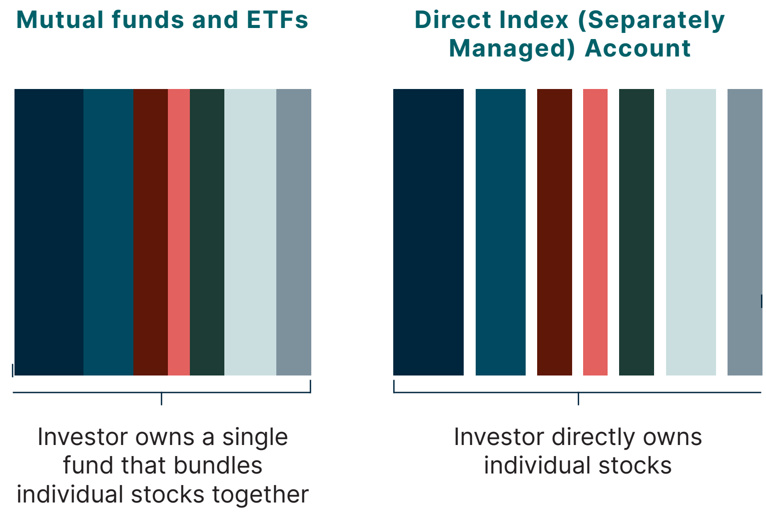
The introduction of direct indexing

The trading costs associated with buying and selling individual stocks have largely been eliminated over the last five years at most large brokerage firms thanks to technological enhancements and efficiencies. The elimination of these fees, combined with increased investor appetite for passive indexed strategies, has led to the development of direct indexing.

Direct indexing is a process whereby a mutual fund company offers to build a portfolio that will replicate the performance of a chosen index (much like those popular index mutual fund and ETFs), but will do so by purchasing individual shares of the underlying companies in your account instead of selling you a proportionate interest in their index fund. Those equities are then managed as a separately managed account with individual control over each holding.

The benefits of direct indexing

There are four primary benefits to owning individual equities through a direct index instead of owning the index fund itself.



Control over taxable gains

First, investors in a direct index do not have to manage the taxable capital gain distributions that mutual funds often distribute in December. Investors in a direct index have control over how much gain is recognized and when it's realized, as the investor can set the parameters around rebalancing and gain recognition.

Tax efficiency

The second advantage is that algorithmic trading has made direct indexes far more adept at capturing short-term tax losses than most stock brokers can manage to do manually. The direct index is examining each holding in the portfolio throughout every trading day and constantly looking to book tax losses when appropriate. This tax efficiency is very powerful in volatile markets, such as the one we are currently navigating: harvesting losses daily is helping investors generate healthier after-tax returns than they would otherwise be realizing.

Gifting advantages

Direct indexes can be better gifting devices than mutual funds because a direct index allows you to select and gift only those stocks that have appreciated the most, rather than gifting a piece of an entire fund. "Gifting the winners and selling the losers for tax purposes" is a fantastic long-term strategy for many investors, and a direct index maximizes this efficiency.

Portfolio flexibility and intentional investing

Finally, owning individual equities allows for far more flexibility in portfolio construction than a one-size-fits-all mutual fund. Some investors have substantial holdings in individual equities and a direct index can be built around these positions, rather than on top of them like a mutual fund. For other investors, this benefit manifests by allowing them to exclude companies or industries that do not align with their values.

Arnerich Massena has a number of clients who have built their wealth at an employer using company stock, and direct indexing allows us to build U.S. equity positions around their concentrated company stock.

Direct index costs

Direct indexing tends to be inexpensive: most of the decision making is done when setting up the guidelines for the portfolio and after that, trades are largely executed by machines. The low-fee, high tax-efficiency of these accounts is a large part of why they are spiking in popularity for families that need help managing the tax burden brought about by their portfolios.

Direct indexing drawbacks

There are a few drawbacks to direct indexes that investors ought to be aware of. First, most companies will not fund a direct index position with less than $250,000 — as they need sufficient amounts of cash to build out the equity position.

Next, the majority of the benefit of these accounts comes from tax efficiency, so there may not be as compelling a need to review direct indexing for a retirement account(s).

In addition, investors should be aware that direct indexing adds a layer of complexity to portfolios, and that they may receive proxy notices and other communications required by public companies to provide their shareholders.

Finally, there is limited availability to foreign stocks (which trade in ADRs instead of shares here in the U.S.) in direct index accounts, so many advisors are centering their direct indexing efforts on U.S. equities for the time being. Diversification to international equities must be added through other vehicles.

Direct Indexing can be an inexpensive and tax-efficient way to access U.S. public markets. The Arnerich Massena team has been direct indexing with Just Invest, one of the pioneers in this space, over the last five years. We are thrilled that Just Invest was recently acquired by Vanguard and has been folded into their fund complex. Please speak with your Arnerich Massena advisor if you have questions about whether direct indexing is a strategy you ought to consider.

Investors should be aware that investing in direct index securities contains the risk of loss.