

Due Diligence: 10 Questions to Ask Your Direct Index Manager



EXECUTIVE SUMMARY

The direct index industry is quickly becoming a very crowded space. While it is important to note there are some similarities across the entire direct index space, there are also significant differences. As is the case in most things, not all direct index managers are created equal. The purpose of this document is to help inform a prospective advisor about questions/topics that are specifically important in the direct index manager due diligence process.

1. The How does your team work with our advisors once we become clients?

Although this topic seems intuitive, it is essential to the post-due diligence process. Be sure to ask very specific questions with additional follow-up questions to drill down to the actual day-to-day process. Find out who will be helping answer questions, run analysis, help with client calls, meeting prep, etc. What's the turn-around time for certain deliverables? Is it the same for a \$200k, \$2M, and/or \$20M account?

2. What resources are available to our advisors?

Specifically, ask whether your team will have immediate, direct access to investment professionals, portfolio managers, SRI/ESG specialists, and other theme-specific specialists. Clarify whether the same resources are available regardless of total firm AUM, advisor AUM, account size, etc (this is VERY important). You will be surprised to see the vast differences in direct index manager service models across these parameters. Also ask what material/analysis does the manager make available to their advisor clients, can it be white-labeled and branded to my firm? Most direct index managers do not provide this, but it is definitely worth asking. (hint: SmartHarvest does!)

3. What is your cost structure? Does this same cost structure apply to ALL your clients?

Pricing in the separate account space can get very confusing very quickly. Unlike commingled mutual funds and ETFs, SMA fee structures often have thresholds, AUM caveats, pass-through fees, add-on fees, relationship pricing, waterfall or step tiers, etc. Primarily look for two things: (1) simple, easy to explain fee schedule and (2) equality across all clients (every client gets the same schedule, regardless of size/complexity). SmartHarvest offers a simple 20bps fee for all services (including factors, SRI/ESG, model portfolio management, custom tax management, white-label content, a single portfolio manager point of contact, etc.) Our relationship pricing reduces the cost further and it decreases in "step-tiers," meaning when a threshold is met, all assets drop to that price (most direct index managers don't do this, they use a

blended fee of all tiers which ends up being more expensive than the step-tier method). Our price structure is among the most competitive in the direct index space.

4. What is your firm's ownership structure? Do you compete with my advisors?

This is a very important question to either ask or research on your own, especially after the consolidation/acquisitions of direct index managers that began in 2020. The investment/advisory industry's largest banks, wirehouses, and investment managers bought the majority of direct index managers in the marketplace starting back in 2020. Even now, there are very few truly independent direct index managers. Direct index accounts tend to be large, core holdings of your client's portfolios. If the direct index manager's core business is wealth advisory, it means they're employing tens of thousands of advisors that compete with you for your clients. Consequently, you may not want them directly managing the largest portfolios of your largest clients. Keep in mind, direct index managers that are owned by a wirehouse, global bank, or mega-investment manager aren't going to tell you this is a concern. Consequently, independent research and talking with colleagues using direct indexing, etc. will be a good resource here. SmartHarvest is 100% independent, funded and founded by advisors just like yourself, and direct indexing is all we do.

5. Do you have composite return information you can provide?

As you know, this is a standard due diligence question to ask any investment manager you're contemplating using. In the direct index space, the format and calculation methodology of returns can vary significantly across managers. Every direct index account is unique to the owner of that respective account, which is why the returns have to be compiled into a composite to generate a fair representation of the return expectation across many accounts. For this reason, S&P 500 is typically provided because it's the most commonly used target/benchmark. Depending on the size of the direct index manager, other targets/benchmark composites may be available. Other factors include (1) pre or post tax, (2) gross or net of fees, (3) total or price return, (4) cash funded, security funded, or both. Remember, none of these are "bad" or "good" it's just important to ask and understand the methodology being used to ensure you are comparing apples to apples.

6. What customization do you make available to clients? Is it available to all account sizes? Is there an additional cost?

Customization is a key component of what makes direct indexing unique. In direct indexing, the amount of customization can be significant, so this topic covers a few different questions to ask. Many direct index managers have templates, models, and/or restrictions on what you can and cannot create in your direct index account. Others will promise extensive customization (factors, SRI/ESG, target benchmarks, etc.) but it comes at an additional cost and/or has account size minimums. This is a question you will definitely want to ask a referral advisor because there can sometimes be a difference between what's promised in the sales process and reality. SmartHarvest offers unlimited customization at the same low cost, regardless of account size..

7. How does your direct index firm handle legacy ETFs, Mutual Funds, bonds, etc. (non-individual stock legacy holdings)?

Unfortunately, the default in the direct index space is to exclude all of these from the analysis. In fact, some direct index managers will reject a transition analysis submission if any of these holdings are included. A good direct index manager will tell you these are not an exclusion, but a conversation. ETF's trade like stocks, are diversified, and are part of the client's overall allocation, so they shouldn't necessarily be excluded. However, they also come with an expense ratio, may not be easily sold over time, and don't require a lot of work for the direct index manager. Consequently, a good direct index manager will discuss these tradeoffs

with you. SmartHarvest will manage these in the client's account because it's what's in their best interest. In most cases, we can even waive billing on concentrated positions and funds (more on that below!).

8. How do you work with concentrated positions?

Concentrated positions are a common topic in the direct index space because direct indexing is one of only a few ways to tax-efficiently work out of concentrated positions. Alternatives include exchange funds, option overlays, and/or gain realization. Some managers request the concentrated position be held outside of the account, some prefer it in the account (so you don't over-allocate to that stock exposure). Unfortunately, most managers also charge on the concentrated position in the account, but some do not. This is why it's important to clarify in advance of selecting a direct index manager. In most cases, SmartHarvest will not charge on the concentrated position.

9. Is your business model robo-website based, portfolio manager based, or some combination?

There's a wide range of business models here. Direct indexing started as a very personalized, custom solution, however, as direct index managers began consolidating into wirehouses and banks, the model has moved to a more vanilla, website-based robo-offering. Not necessarily good or bad, depends on your preference. We find that direct indexing is much more personal and nuanced than ETF/Mutual Fund investing, requiring reporting, client communication, coordination of client-specific tax parameters, changes in client tax events, etc. Also, an optimizer is only as good as the skilled portfolio manager who is also managing the account. Rarely is an optimized portfolio truly optimized if it's simply entered into an online form, run through an online automated optimization process, and provided back to the advisor. One last point of consideration here is, who is available to help if/when the need comes? A website chat, an entry-level team member that's never worked on the actual portfolio, or a skilled portfolio manager that manages your actual portfolio? At SmartHarvest every client works with a dedicated Portfolio Manager that not only manages their accounts, but is also available for calls, client meetings, webinars, and will even prepare notes/observations for advisors in advance of their client calls..

10. In 1 minute, describe to me what separates you from other direct index managers?

SmartHarvest is a full-service, boutique direct index manager. Direct indexing is all we do. We broke-away from the industry's largest direct index managers as they were being acquired by the world's largest banks, wirehouses, and investment managers.

We're 100% independent, we don't employ thousands of advisors that compete with you for your clients, and we were funded and founded by advisors just like you.

Direct indexing is, and always has been, a great solution. We just felt direct indexing should be offered in the best interest of the advisors and end-clients we serve, not the bottom line of big investment firms. Low cost, best-in-class service, unlimited customization, and complete transparency are the pillars of what we provide to all advisors regardless of size and affiliation. SmartHarvest – By Advisors, For Advisors!

Connect with SmartHarvest → smartharvestportfolios.com
info@smartharvestportfolios.com
(888) 542-2982