

Is Direct Indexing Right For Me?



KEY TAKEAWAYS

- Direct indexing adds value when working with a taxable client/portfolio
- If you need to transition a portfolio of legacy/inherited securities, direct indexing can help
- A single-stock concentrated position can be addressed in a direct index strategy
- When a client has customization needs, direct indexing can be a great solution

One of the most common questions we receive is, “how do I know if direct indexing makes sense for my client(s)?” This is a great question and is likely one of your first steps of researching separately managed accounts (SMA), direct indexing, and many of the components of direct indexing. Below are some of the most common direct index portfolio scenarios we run into when working with clients:

TAXABLE CLIENT / PORTFOLIO

If you have a taxable client, chances are there are advantages of using a direct index solution. Tax benefits can come in many different forms. Just look at the progression from single security investments to mutual funds to ETFs over the last 100 years. Dating back to the 1920's, it was identified that changing the investment vehicle and structure, allowed an investor to benefit from diversification, ease of access, taxation, and other benefits. Initially, mutual funds provided lower cost access to diversification and capital markets. Subsequently, the industry trend transitioning from Mutual Funds to ETFs provided an investor additional tax benefit from the creation/redemption process allowing in-kind payment so investors would incur less capital gains in the investment vehicle. Direct indexing is the next step in this progression. Owning the underlying securities in an SMA vehicle (which is not the case in ETF and Mutual Fund vehicles) allows the investor to benefit from the gains and losses of the individual securities. The result is a term called “tax alpha.” In simple terms, tax alpha measures how better off your portfolio is on an after-tax basis, when utilization of tax loss harvesting and other tax techniques are taken into consideration. Direct indexing can either defer the realization of gains or realize losses to offset gains elsewhere in the portfolio. Both of which can be very beneficial to a taxable investor

TRANSITION SMA PORTFOLIO

One of the most common scenarios in which a direct index account makes sense is transitioning SMA portfolios

from another advisor/firm. This could be a new client that is coming over from another advisor that used SMA portfolios or maybe your team transitioned from a wirehouse or platform that used SMA portfolios. In either case, a direct index manager can resume management of the SMA portfolio from the old wirehouse/platform to insure there is a smooth transition and no lapse in management of the account. Most of these stocks have some form of embedded gains. Consequently, as an advisor, you can either sell the positions and incur a large tax bill for the client or you can retain the stocks. Direct indexing allows you to retain some positions, defer incurring some gains, but still construct a portfolio that is transparent, tracks an index, and meets your client's overall portfolio allocation goals.

CONCENTRATED POSITIONS

Have you ever worked with a client that has one or a handful of large, concentrated positions? Inevitably, we all run into this scenario and it's a difficult one to overcome. The concentrated position creates several issues including reduced diversification, over-concentration in sectors/industries, and a general deviation from your desired portfolio allocation. Stock specific risk is real, and it can impact your client's long-term investment objectives. Direct indexing can help in a couple of ways. First off, direct index vehicles help an advisor construct a portfolio around the concentrated position to attempt to reduce the concentration and its impact on portfolio allocation, thus reducing idiosyncratic risk caused by the concentrated position. Secondly, direct indexing can generate losses which can then be used to offset gains incurred when you sell out of the concentrated position. SmartHarvest can take this concept a step further by implementing other concentrated position solutions like single stock call writing and synthetic exchange fund creation. These are more advanced solutions that we can implement with third-party partners in the option/derivative space.

GENERAL CUSTOMIZATION

As the section title implies, general customization can include many different client needs. Technically speaking, taxes, concentrated positions, and legacy securities are all client-specific issues that require a truly customized solution. But we can take customization in many other directions allowing for a very customized solution that can address all of a client's needs. Maybe it's socially responsible (SRI/ESG) views a client would like reflected in their portfolio. We can customize stock or industry specific social views or a general theme like human trafficking, animal cruelty, and much more. Maybe your firm has a very specific view on markets that requires a particular asset allocation. This can include a particular exposure to asset classes, factors, securities, sector/industry, etc. All of these can be customized to meet the needs of your firm allocation or client need.

Direct index investing may not be necessary in all scenarios, but it can make a lot of sense for many clients and portfolios. The complexity of these scenarios can be simple; a taxable client that would benefit from tax loss harvesting and superior after-tax returns. Or possibly a complex scenario in which a client has legacy stock holdings, embedded gains, a concentrated position, a very nuanced tax situation, charitable gifting needs, and SRI/ESG views. Most clients only have one or two of these needs, but direct indexing can resolve one or all of these scenarios for you and your clients. Have a particular client situation? Just let us know, we're happy to talk through it with you.

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