

What's all the buzz about? What is Direct Indexing?



THE HISTORY OF DIRECT INDEXING

- Direct Indexing dates back to the 1980's. The original academic that began writing about the benefits of tax management in equity portfolios was James Garland.
- Since then, many academics have studied the positive effects of tax management in index equity portfolios; James Garland, David Stein, PHD, Rob Arnott, and Robert Jeffrey to name a few.
- The term "Direct Indexing," was coined when the idea was first commercialized by an investment management firm in 1992. That being said, other firms certainly managed taxes in equity portfolios before that, however in a less focused, systematic way than traditional Direct Indexing.
- Numerous academic papers have analyzed the benefits of direct indexing, most of which settling on an after-tax benefit of around 50 – 150bps depending on inputs like cost, volatility, and other market conditions.

WHAT IS DIRECT INDEXING?

- The simplest definition of Direct Indexing is, "Replicating the risk/return profile of an index pre-tax and seeking to outperform after-tax through tax management techniques."
- The biggest difference between a Direct Index and an ETF/Mutual Fund Index strategy is the investment vehicle. Direct Index accounts utilize the Separately Managed Account structure so that the investor actually owns the individual securities.
- Ownership of the securities is what allows the investor to also own the losses harvested in the account, also known as "Tax Loss Harvesting."
- A Direct Index strategy uses a daily portfolio optimization process to sample the index so that it replicates the performance of the index but also allows for the purchase and sale of securities to capture these losses.
- A simple example is selling Coca-Cola to harvest a loss and purchasing Pepsi as a replacement so the portfolio still tracks the index. In reality, the optimizer is much more sophisticated. It looks at various risk factors of the securities in the portfolio and buys a basket of replacement securities that more closely replicate the removed Coca-Cola stock.

- One common misconception is that Direct Indexing is a form of active management and/or stock picking. This is not true at all. The optimizer and portfolio managers have no views on individual stocks. The portfolio is broadly diversified across hundreds of stocks with the sole performance objective of tracking the performance of the selected index.

WHAT'S NEW IN DIRECT INDEXING?

- Primarily, there have been two big improvements in Direct Indexing that have made it more widely available to investors: (1) improvements in investment technology and (2) increased ability to customize.
- Customization – Today's direct index accounts can track indices, ETFs, and blended model portfolios. Investors can implement factors, socially responsible views, and many other methods to make a portfolio bespoke and unique to each individual investor.
- Technology – Technology now makes the implementation of direct indexing very seamless and easy. Custodians have done away with transaction costs and have made the account setup process much easier for advisors.

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