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Direct Indexing: The Democratization of Customized Portfolio Management

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Direct Indexing

THE DEMOCRATIZATION OF CUSTOMIZED PORTFOLIO MANAGEMENT

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Direct indexing, or replicating an index such as the S&P 500 without owning all the underlying securities, has been around for quite some time but off most people's radars for years. Aperio, which is now part of BlackRock, and Parametric Portfolio Associates (Parametric) have been offering direct indexing through separately managed accounts (SMAs) to high-net-worth (HNW) clients since as early as 1987. Several acquisitions (most notably Morgan Stanley picking up Parametric in its acquisition of Eaton Vance), platform launches, and fintech startups entering the space have made headlines, propelling significant interest within the industry.

The opportunity for customization is one of the primary benefits of direct indexing. Figure 1 illustrates an investment product spectrum and where each product or vehicle falls in terms of its accessibility to investors and its ability to be customized. At this point in its evolution, however, direct indexing falls beyond this spectrum. But different providers entering the space are positioning direct indexing products or platforms to compete against a variety of well-established investment vehicles ranging from widely accessible index mutual funds and exchange-traded funds (ETFs) to customized individual SMAs.

Direct indexing has been available to HNW and institutional clients for decades, but the advent of commission-free trading and fractional shares, coupled with advances in technology, has helped to bring the strategy downmarket to retail investors. With this backdrop, Money Management Institute[1] and FUSE Research Network[2] partnered to examine this confluence of trends, its appeal to advisors and investors, the different types of providers entering the space, how they are positioning offerings, and the outlook for direct indexing to bring customized portfolio management to the masses. This article examines the factors driving the surge of industry interest, the reasons advisors and clients might want to use it, and a recent rash of acquisitions that implies that direct indexing may be at the beginning of a strong growth cycle.

THE DEMOCRATIZATION OF DIRECT INDEXING

Direct indexing has been available to HNW clients and institutional investors for many years. The driver of growth was transition management due to large, embedded capital gains in concentrated positions and brokerage accounts. Historically, trading costs and the high share prices of some securities made the strategy too costly to implement for most retail investors.

However, two industry developments have helped to bring direct indexing (and SMAs more generally) further downmarket to investors with $100,000 in investable assets. First, in late 2019, Charles Schwab announced that it would no longer charge commissions on stock and ETF trades, and the other major

Figure 1

DIRECT INDEXING WILL COMPETE WITH SEVERAL INVESTMENT PRODUCTS

	Index Mutual Funds	Index ETFs	Smart Beta ETFs	Model Portfolios	Mutual Fund and ETF Advisory Programs	SMAs
From:	Asset Managers	Asset Managers	Asset Managers	BDs/AMs/FAs	BDs/AMs/FAs	BDs/AMs, TAMPs
To:	Retail Investors	All Investor Segments	All Investor Segments	Retail $25K+	Retail $25K+	HNW $250K+
Through:	Pooled Product	Pooled Product	Pooled Product	Portfolio of MFs/ETFs	Portfolio of MFs/ETFs	Individual Securities Ownership

Direct Indexing

Customization →

← Access

Source: FUSE Research Network

trading platforms quickly followed suit. Consequently, investors can now purchase all the securities in an index and rebalance as necessary without the performance drag of commission costs. Second, at around the same time, brokerages began offering fractional shares of securities. Previously, the high price of some stocks such as Google (GOOGL), which sells for more than $2,200 per share, prohibited small investors from purchasing even a single share, and in cases where they could buy the stock, it could easily exceed its index weight. With fractional shares, investors can purchase each security in the correct proportion to the index. In late January 2022, Fidelity Investments filed with the Securities and Exchange Commission to offer a direct indexing product, Fidelity Managed FidFolios, with a $5,000 minimum investment. At the time of this writing, the product is in the pilot stage but is expected to be available to all investors "in the coming months."

The Schwab and fractional share developments expanded the market opportunity for direct indexing, but from a practical standpoint, initiating all the trades necessary to establish an index position and maintain it through rebalancing was still too time consuming and complicated for the average investor or even most financial advisors. Advances in technology, however, have helped automate the process, allowing advisors to implement a direct indexing strategy almost as easily as they can purchase individual investment products. The type of technology and services offered by different platforms depends on the clientele they serve and the investment goals they are pursuing through direct indexing. The notion that customized portfolio management could become available to all investors has highlighted the benefits direct indexing offers over pooled investment products, including the following:

Transition management. By selling a concentrated stock position over time, investors can take losses elsewhere in the portfolio to offset gains and gradually use the proceeds to diversify into an index-tracking portfolio.

Tax management. Through direct ownership of the index securities, investors can harvest tax losses. In other words, sell securities to realize a loss that then can be used to offset realized gains. If employed on a long-term basis, this strategy can result in material tax savings and deliver positive tax alpha. According to research published in the *Financial Analysts Journal*, the tax alpha (i.e., the excess return of a tax-harvested portfolio over a passive benchmark) was 0.81 percent annualized after liquidation taxes for the period 1995 to 2018 (Chaudhuri et al. 2020).

ESG goals. Much of the recent discussion about direct indexing has focused on how the strategy can be used to align a portfolio with an investor's values and goals. Unlike environmental, social, and governance (ESG)-branded pooled products, which challenge investors, or their advisors, to identify the portfolio that best matches their preferences, direct investing allows the investor to screen in or screen out specific securities. For instance, some investors may choose to screen out stocks of companies that do not adhere to their religious values, and others may wish to include only stocks of companies that meet or exceed a certain environmental or sustainability rating threshold.

Factor investing. Factor investing seeks to implement an approach with a goal of decreasing risk, increasing returns, or improving diversification. For example, an investor pursuing a low volatility factor strategy would emphasize securities with lower-than-average volatility and betas, and an investor interested in a growth factor strategy would emphasize holdings that reflect higher-than-average earnings and sales.

ONE STRATEGY, MANY PATHS

Not all providers offering or planning to offer direct indexing are approaching the strategy with the same goals and clients in mind (see table 1). To help provide a framework for understanding how the direct indexing landscape is evolving, the marketplace has been divided into the following three types of providers:

SMA managers. These providers were in the business of direct indexing long before zero-commission trading, fractional shares, and automated platforms (see sidebar profile on Parametric). They are investment experts that market their private client groups (i.e., Merrill Lynch Private Banking and Investment Group) to registered investment advisors (RIAs) and private banks that serve HNW clients, family offices, and institutions. SMA managers help build individualized solutions for investors by offering high-touch service to advisors.

Technology platforms. These platforms provide advisors with the technology to implement and manage their own direct indexing solutions for clients. These platforms can facilitate the entire process, from account opening and proposal generation to rebalancing, tax management, and performance reporting. Many of these platforms also offer varying levels of investment management support, including do-it-yourself (DIY), help with manager identification, and full outsourcing. Firms providing these platforms seek to serve RIA firms that want to give advisors the resources needed to efficiently build an SMA and direct indexing business. Note that some providers straddle the line between SMA manager and tech platform with capabilities to provide either depending on the type of service being sought.

Advisor or investor DIY direct indexing. This is the latest frontier in direct indexing, and though it is currently small in terms of size and number of providers, it has the potential for significant growth in the coming years. These providers aim to democratize access to direct indexing to individual advisors (currently) and investors (in the future). They provide technology advisors can

Table 1

PATHS TO THE DIRECT INDEXING BUSINESS

	SMA MANAGERS	TECH PLATFORMS	ADVISOR/INVESTOR DIY
Value Proposition	Customized experience for each client tailored to goals and preferences (e.g., tax management, ESG, etc.)	Rules-driven automation that allows for scalability and efficient execution of direct investing	The benefits of customization for anyone who wishes to access them
Est. Market Share	90%	<10%	<1%

use to efficiently conduct analyses and build and manage their own portfolios. In some cases, these firms offer a white-label platform to which advisors can attach their own brands and use to highlight their personal expertise.

MERGERS AND ACQUISITIONS POINT TO SIGNIFICANT MARKET POTENTIAL

With the advent of zero-commission trading and fractional shares have come many projections on the growth potential of direct indexing. These projections range from conservative—direct indexing will slightly outpace the growth rates of ETFs and SMAs over the next five years—to very aggressive—direct indexing (customized portfolios) will result in the near obsolescence of mutual funds and ETFs over the next decade. The direct indexing market is likely too nascent for a precise estimate of its growth potential, but one recent trend portends a surge in development: Since mid-2020, several high-profile acquisitions of direct indexing firms have been announced.

As shown in table 2, most of the acquirees are not household names, and their positions in the space range from venerated SMA managers that cater to advisors serving HNW clients to tech start-up platforms that offer retail advisors and investors the ability to create their own portfolios. What these companies have in common, however, is that they have been purchased by some of the largest asset managers, distributors, and custodians in the industry. Although some of these acquisitions have yet to be completed and most of the acquirors have not disclosed how, exactly, they plan to utilize acquirees, the number of purchases over a short period suggests

PARAMETRIC: A PROFILE

Parametric, launched in 1987, was the creation of three portfolio managers who believed that an investment approach based on evaluating securities' risk-return attributes has the potential to outperform strategies focused on company fundamentals. This premise led to a quantitative, rules-based methodology that relied on technology (though rudimentary at the time) to construct efficient, transparent, risk-managed, and cost-effective portfolios.

Parametric got some attention for its unique approach, but it wasn't until a client asked for a strategy that behaved like an index but also managed taxes that the firm embarked on the business model that would position it to become a major player in the SMA space.

In 2003, Eaton Vance acquired a majority interest in Parametric, which held $4.7 billion in assets under management (AUM) at the time. This partnership allowed Parametric to expand its offerings to include fixed income and other services such as overlay management. Perhaps the biggest benefit, however, came from Eaton Vance's positioning in the advisor market, which greatly expanded distribution opportunities. In fact, by the time it was announced in 2020 that Morgan Stanley would acquire Eaton Vance, Parametric had grown to more than $350 billion in assets and accounted for the majority (61 percent) of Eaton Vance's AUM.

It is difficult to pinpoint Parametric's direct indexing assets because the line where direct indexing ends and SMA management begins is a bit blurry. That said, Parametric has embraced the direct indexing label and is actively promoting the strategy across the industry. The firm sees direct indexing as a way to offer clients increased customization. In an effort to bring its capabilities down-market, Parametric recently introduced Tax Harvest Core Accounts, which are available to investors with as little as $100,000 in assets. The new offering includes two portfolio strategies: one benchmarked to the S&P 500 and the other benchmarked to the Russell 3000. The portfolios invest in sector ETFs, and the firm aims for after-tax returns through tax-loss harvesting and other tax-management strategies. Advisors and their clients will be able to customize each portfolio by restricting sectors, funding positions with cash or in kind, and accessing charitable giving options.

It's not yet clear how Morgan Stanley plans to capitalize on Parametric's leadership position in the customized portfolio management market. Most analysts evaluating the deal, however, agree that Parametric was a primary impetus behind the acquisition, because it gives Morgan Stanley the largest platform in a segment of the industry that is poised for significant growth.

Table 2

INDUSTRY BEHEMOTHS VIE FOR POSITIONING IN THE DIRECT INDEXING MARKET

Acquisition Announcement	Acquiror	Acquiree	Direct Indexing Product/Positioning
May 2020	Schwab	Motif	Motif 500 allows investors ($10,000 minimum) to create customized portfolios by removing stocks or altering the allocations of the S&P 500.
May 2020	Goldman Sachs	Folio	DirectIndexer.com allows advisors to build customized portfolios with as much or as little support as needed.
October 2020	Morgan Stanley	Eaton Vance (including Parametric)	Established SMA manager focused on helping advisors serving HNW clients develop and maintain customized portfolios.
November 2020	BlackRock	Aperio	High-touch, collaborative service to help advisors construct customized portfolios for ultra-high-net-worth clients.
December 2020	JP Morgan	55ip	Platform that allows advisors to build their own branded, index-based portfolios for clients.
June 2021	JP Morgan	OpenInvest	Platform that allows advisors to build customized ESG portfolios.
July 2021	Vanguard	Just Invest	Kaleidoscope is a direct indexing platform that allows advisors to create customized, tax-managed portfolios.
September 2021	Franklin Templeton	O'Shaughnessy Asset Management	Canvas platform offers custom solutions capabilities. Launched in late 2019, it represents $1.8 billion of OSAM's total $6.4 billion in AUM as of August 31, 2021.

the industry is preparing for customized portfolio management, in general, and direct indexing, specifically, to become a competitive battleground.

Some of acquisitions on the list are major purchases that increase scale or expand distribution. For instance, Morgan Stanley's purchase of Eaton Vance makes it one of the largest asset managers in the industry with $1.2 trillion in assets, and Goldman Sachs' acquisition of Folio gives it an entrée into the RIA custodial business. In both cases, however, analysts were quick to point out that these acquisitions give the purchasers ready-built platforms to gain first-mover advantage in the direct indexing market. Also included on the list are small fintech purchases, such as Vanguard's acquisition of Just Invest, a $1-billion direct indexing manager launched in 2016, which provide the acquirors with the underlying technology needed to organically build a direct indexing business through their own vast distribution networks.

A BRIGHT, BUT UNKNOWN, FUTURE

Interest in direct indexing is unlikely to fizzle anytime soon, but it is difficult to predict how the strategy will evolve and which products will build its market share. Direct indexing promises to bring customization to the masses, but there is still a cost differential between these portfolios and very low-cost index funds and ETFs. Although the added cost may be worth it to investors interested in personalized, values-based investing, other benefits of the strategy such as tax management are irrelevant within some investor segments, such as retirement-plan investors.

Technology improvements and increased scale likely will allow providers to trim costs over time. Most, however, are sensitive to direct indexing's potential for cannibalizing their more profitable products and services. Again, transition management addresses a very specific client need that direct indexing can solve better than other strategies or vehicles.

Early growth will be driven by advisors, and adoption likely will depend on the types of clients they serve or how they differentiate their own services in the marketplace. For instance, the strategy may attract advisors serving young, affluent clients who value expressing themselves through portfolio construction, or advisors who want to differentiate their businesses by emphasizing tax management.

Direct indexing represents an opportunity to make customization available to investors of any size. Although the strategy has a way to go to achieve this goal, recent industry developments suggest the industry is preparing for a significant move in this direction. The democratization of custom portfolio management through direct indexing will become a key trend in the investment industry, with implications for all investment management players, from custodians and transfer agents to full-service providers and component manufacturers.

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ENDNOTES

1. About the Money Management Institute (MMI): Established in 1997, MMI is the industry association representing financial services firms that provide financial advice and investment advisory solutions to investors; www.MMInst.org.
2. About FUSE Research Network LLC (FUSE): FUSE was launched in 2008 with the view that research and consulting support for asset managers has failed to evolve with the changing needs of the client. FUSE provides a dynamic research platform that covers our clients' current and future decision areas (strategic and tactical); www.fuse-research.com.

REFERENCE

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