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DIRECT INDEXING

It's All About Customization

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INVESTMENTS & WEALTH INSTITUTE®

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Direct indexing—it's a term many in the investment community seem to have latched on to. It neatly and efficiently gets at what high-net-worth investors increasingly seek: the market exposure of an exchange-traded fund (ETF) but with access to the underlying securities in the portfolio. Yet although use of the term continues to grow, it undersells many of the benefits and the true potential of this area of investing.

Is there a better term? I prefer “custom separately managed accounts.” It doesn't roll off the tongue quite as easily, but it features a word often missing from the direct indexing conversation: custom. Why stop at mimicking an index's holdings when investors have the opportunity to do much more, such as manage taxes, blend benchmarks, introduce factor tilts, express environmental, social, and governance (ESG) investing views, and so on. These accounts don't just offer market exposure. They add real value in multiple dimensions.

Even though I and others in the industry use direct indexing as shorthand for custom separately managed accounts (SMAs), I believe custom SMAs offer a good deal more than direct indexing, and the growth of these accounts indicates that the custom SMA is here to stay.

BENEFITS OF CUSTOMIZATION

The crux of direct indexing is customization. It's everything. No two custom SMAs need be alike when there's the

ability for tax-loss harvesting on individual securities to achieve higher after-tax performance, to tailor ESG criteria to each client's principles, and to tilt a portfolio to factors such as value or momentum.

Many investors can benefit from it, and advisors who offer it get to create something that builds a foundational connection with clients.

DIRECT INDEXING ISN'T FOR EVERYONE

The value of customization can vary depending on an investor's specific profile, but the ideal candidate is an investor who, among other things:

- Funds a portfolio with securities
- Is in a higher tax bracket
- Has a long-term investment focus
- Has convictions about ESG or responsible investing

Those whose profiles don't align with customization might not see much value in direct indexing, especially after considering the product from a cost perspective. That's right, customization does have costs. Relative to commingled vehicles such as ETFs, custom SMAs have higher fees, greater tracking error, and added operational complexity.

Many investors who don't naturally benefit from customization—at least beyond its costs—should continue to get market exposure through funds and ETFs. But it's important to add that funds, ETFs,

and custom SMAs aren't mutually exclusive. All have important roles in the investment ecosystem.

WHAT DOES DIRECT INDEXING'S RISE MEAN FOR FINANCIAL ADVISORS?

Just as index investing has changed the way financial advisors serve clients, the rise of direct indexing also is changing the business of financial advice. Advisors who once counted on their ability to pick stocks—or to select managers to pick stocks—to fully offset client fees and taxes have had to adjust their approach.

Finding the right mix of active and passive solutions for clients is now paramount. Clients want portfolios that combine both approaches, with a keen eye for risk, fees, taxes, and performance that each approach, and a combination of both, can offer. It's no longer enough for advisors to hang their hats on producing alpha. They can't promise it, and over the long run most will find it elusive.

Instead, advisors increasingly are growing their businesses by acknowledging that investing is changing; making room in their practices for transparent, low-cost, rules-based products; and redefining their value proposition to clients.

Advisors can capture additional benefits beyond commingled funds by offering clients custom direct indexing solutions built around tax management, responsible investing, and long-term exposures

beyond cap-weighted indexes, such as factor investing. (And let's not forget that successful advisors also are building financial plans, putting together the right asset allocations, reporting on performance, and considering clients' estate-planning needs and charitable-giving inclinations.)

Direct indexing, like index investing, will continue to reshape conversations about investing. It's helping advisors think realistically and holistically about what's best for clients.

CUSTOMIZED SEPARATELY MANAGED ACCOUNTS: A HIGH BAR

New direct indexing providers tend to underestimate the challenges created by customization and focus exclusively on the technology by way of algorithms, portfolio construction, and user interfaces. But that's only part of the story. Providers need a full cast of distribution, marketing, client consultation, implementation, and service to defend and deliver the promise of customization. This is a high bar.

That's why the majority of market share tends to go to providers with established technology and intellectual property, a track record of success, and teams of people with the experience to deliver with ease.

HOW TO CHOOSE A CUSTOM SMA PROVIDER

Many in the investing community criticize SMAs as overpromising and underdelivering on customization—the primary reasons these accounts exist. Critics note that although all SMAs offer investors ownership of individual securities, in most accounts customization is suppressed in favor of a cookie-cutter approach to portfolio construction.

As new custom SMA providers pop up in response to growing demand, it's important to remember that not all providers are created equal. When done right, a truly custom SMA can combine

the benefits of consistent broad market exposure with personalization, flexibility, and security-level transparency.

Does the provider you're evaluating have what it takes to deliver on the full potential of an SMA? Here are factors to consider during the vetting process:

Expertise. It's critical to assess a provider's expertise and request proof of the provider's capabilities. Consider the sophistication level of its service teams and whether they're well versed in investment strategy and able to deliver the high level of consultative service custom SMAs require. From understanding client needs before constructing a portfolio to post-implementation reporting, client service is key.

Scalable platform. A customized SMA manager must have a scalable and efficient investment platform to handle a growing number of individual accounts. You also want to ensure a provider's technology can support portfolio management and reporting. Internal technology developed to address an SMA inherently can deliver more functionality than off-the-shelf solutions, providing confidence in the implementation of customized exposures. Ensure your SMA manager's technology delivers reporting that produces clear insights into your clients' unique circumstances.

Types of exposures. Ask about the provider's ability to deliver individualized exposures beyond traditional cap-weighted indexes. Is the provider flexible enough to offer global exposures? What about factors—not just standard ones such as value and momentum but blends of different factor strategies? And what about different asset types, such as options or fixed income? Beyond customized market exposure, many investors will seek to incorporate customized ESG features. To ensure a manager has the resources to customize an SMA that can be aligned with client values, consider the

SMA provider's range of ESG offerings, the team focused on ESG research and implementation, their proxy-voting policies, and how shareholder engagement is incorporated into offerings.

Accessibility. Beyond access to a dedicated client service team, ask whether investment professionals are available for in-depth conversations. Portfolio managers, investment strategists, and researchers should be accessible and able to partner with the client service team to deliver tailored solutions to advisors and their clients.

Research capabilities. The provider should have a research team that can respond quickly to clients' unique requests. Does the research team generate new ideas in tax-managed investing, for example, or regularly gather new data to make the case for ESG? Does the provider have teams dedicated to testing hypotheses, busting myths, and diving deeply into the issues that really matter to investors—or should matter, if only they were aware of them?

Tax management. For many high-net-worth investors, taxes can represent a larger drag on returns than fees or trading costs, and taxes often have a major impact on long-term portfolio growth. Your SMA provider should take a rigorous approach to tax management. Find out how long they've been tax-managing portfolios. It's one thing to say you do it, but it's quite another to have deep experience and expertise in this hard-to-get-right field. Ask whether the provider can fund accounts in cash and transition in-kind securities. Funding an SMA with preexisting securities and then tax-efficiently transitioning to an index-like portfolio is a major benefit over ETFs. Ideally the SMA provider will help fund the account in a manner that avoids unintended gains and aligns trades with your clients' tax and risk sensitivity. Finally, spend time understanding the provider's approach to harvesting tax losses—especially if a client has multiple SMAs. Gauge whether the manager can

coordinate tax management across all portfolios to ensure that losses realized in one account aren't washed out by trading in another account.

THE BOTTOM LINE

Just as investors and advisors for decades have been compelled by indexing's overwhelming logic, direct indexing also is reshaping conversations about investing. It's making advisors think holistically about what's best for clients. At the same time, more and more investors are pressing

advisors for greater customization and resisting one-size-fits-all portfolio solutions.

Advisors should think hard about both the benefits and costs of direct indexing for each of their clients. The last thing an advisor should do is put clients in portfolios they're unsuited for or that fail to properly deliver the benefits of direct indexing.

Successfully managing an SMA isn't easy. Too often investors default to a

commingled fund or accept an SMA offering with little room for customization. It's worth the time it takes to find a provider that can continuously monitor client portfolios, systematically harvest for tax losses, allow customization to express your clients' values, and target common or bespoke market segments. ●

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