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Custom Indexing: The Next Evolution of Index Investing

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Custom Indexing

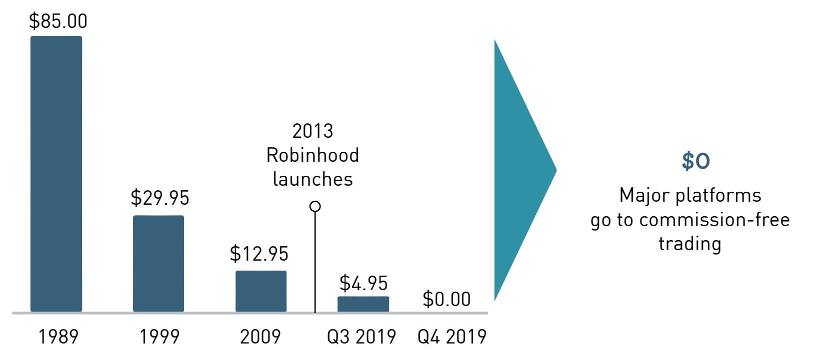
THE NEXT EVOLUTION OF INDEX INVESTING

By Patrick O'Shaughnessy, CFA®

Custom indexing is a technology, and technology often removes barriers. Co-mingled funds and exchange-traded funds (ETFs) sit between investors and the stocks they own. Funds and ETFs are wonderful technologies that have been good to investors. However, in the future, because of custom-indexing software, zero-commission trading, and fractional share trading, more investors will own their shares directly rather than through mutual funds and ETFs.

Figure 1

COMMISSION COST TREND, 1989–2019 ($)



Source: Charles Schwab. Fall Business Update

By 2025, most financial advisors will use web-based software to create and manage custom indexes for clients. Standard indexes have a single methodology; one set of rules dictates what they own and how they rebalance. Standard indexes are one-size-fits-all. Like standard indexes, custom indexes also invest and rebalance according to a defined methodology. The methodology, however, is personalized to an investor's circumstances and preferences, and it can be adjusted easily as an investor's circumstances change. This flexibility is possible because custom indexes are implemented through separate accounts, where investors can directly own a custom mix of individual stocks rather than indirectly owning positions through a collection of funds and ETFs. This is also possible because technology allows advisors to build custom models that meet their capital-market assumptions at scale.

If the past year is any indication of the future, custom indexes will be built using dynamic software. They typically will start with broad market exposure (i.e., beta) and then account for each investor's needs in areas such as taxes and tax treatment, desired returns, income, risk exposures, environmental, social, and governance (ESG), and more.

Custom indexing will win significant share from simple index funds and ETFs as well as basic index proxies implemented through separately managed accounts (direct indexes) because it will continue to offer the benefits of its predecessors (low cost and tax friendliness) and also layer in significant new benefits.

AN INEVITABLE FUTURE

Custom indexing is a great example of a new product that sits on what venture capitalist Josh Wolfe calls an "arrow of progress." In technology, we can observe trend lines—arrows of progress—that show improvement in key product dimensions that matter to customers (e.g., cost, speed, convenience, selection, and personalization). Because technology tends to advance consistently (and exponentially), it's safe to extrapolate these technology-based trends into the future. A simple example is the cost (commission) of a single stock trade for retail investors (see figure 1). Costs marched steadily downward until Robinhood jumped the line and brought them to zero. The other major brokerage platforms then had to follow suit.

An advisory firm starts by building a set of custom-index strategy templates that reflects the firm's investing views (see table 1). These templates are like the set of basic blueprints a homebuilder uses repeatedly before tweaking each home to the needs of each individual homebuyer. Each firm's templates are different, highlighting the power of a fully customizable platform. After building strategy templates, firms further tailor strategy rules at the individual account level, based on specific client circumstances and preferences.

Figure 2 shows a generic picture of how new technology gets adopted within a

Table 1

EXAMPLE STRATEGY TEMPLATES

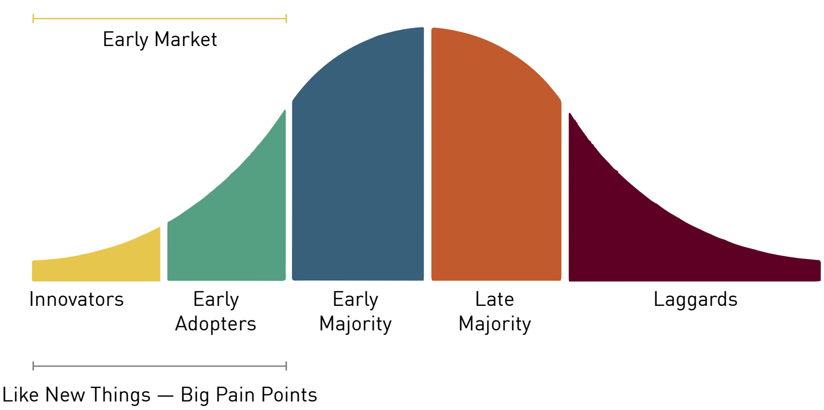
		Allocation		Advisor A	Advisor B	Advisor C	Advisor D
Equity	U.S.	U.S. Large Cap	Passive	100%	37.5%	28.0%	35.0%
			Factor (Value)		12.5%	2.3%	8.3%
			Factor (Momentum)			2.3%	8.3%
			Factor (Shareholder Value)			2.3%	8.3%
			Factor (Dividend/Stability)				25.0%
		U.S. SMID	Passive		7.5%	2.3%	
			Factor (Value)		2.5%	3.4%	
			Factor (Momentum)			3.4%	
			Factor (Dividend/Stability)				
		U.S. Micro	Passive				
			Factor (Value)				
			Factor (Momentum)				
	Int'l	Int'l All Cap	Passive		30.0%	21.6%	15.0%
			Factor (Value)		10.0%	7.2%	
			Factor (Momentum)			7.2%	
			Factor (Dividend/Stability)				
	ESG Thematic Strategies (tilt toward/screen out)		Environmental/Pollution/ Climate Change				Tilt Toward + Screen Out
			Human Rights Violations				Tilt Toward + Screen Out
			Wage & Workplace Equality				Tilt Toward + Screen Out
			Lack of Gun Control Laws				Screen Out Only
			Women Empowerment				Tilt Toward + Screen Out
			Moral/Ethical/Family Decline				Tilt Toward + Screen Out
Fixed Income	Fixed Income		Short Duration/ Medium Credit Risk			20.0%	
			Total	**100%**	**100%**	**100%**	**100%**

population. Today, we are in the "early market" phase of custom indexing. Some registered investment advisors (RIAs) have started to consider and adopt custom-indexing solutions; they are the "innovators" in figure 2. Soon, custom indexing will gain "early adopters." Before long, more advisors will adopt this new technology, because the ability to build a customized strategy will become table stakes for winning new clients and continuing to improve relationships with existing clients.

But rather than focusing on the next year or two, let's look five to 10 years into the future. This makes certain things easier to predict. Looking five to 10 years out,

Figure 2

TECHNOLOGY ADOPTION LIFE CYCLE



Source: YouTube. J. Scott Christianson. "Technology Adoption Life Cycle" it's hard to imagine a world where custom indexing doesn't dominate, because most of the frictions that would have stopped custom indexing—mostly in the form of dollar costs and manual workflows—will have disappeared. Therefore, custom indexing appears to be an inevitability, and advisors should be thinking about how they will embrace this new technology.

HOW WE GOT HERE

Figures 3 and 4 show that each simple step in the indexing progression builds upon the previous step. Direct indexing carried forward the low-cost benefits of simple indexing, and custom indexing will carry forward the benefits of low costs and tax-loss harvesting.

Once advisors adopt custom-indexing solutions, they will not go back to funds because there will be no reason to trade down for less overall functionality. Even those with clients who want to own the S&P 500 with no modifications in a non-taxable account will be able to accommodate that need using a custom-indexing platform.

WHY NOW?

Why haven't custom indexes and custom-indexing platforms appeared until now? Because the required software is hard to build and industry conditions—including zero-commission trading—now are evolved enough to make it possible. For example, my firm's platform was built atop a decade's worth of custom-built internal software. The inspiration was Amazon Web Services' strategy of offering internal tools as external services. It took 10 years to build and refine those tools to handle trading, performance, daily model generation and rebalancing, and account management. These systems are the lifeblood of a separate account asset management business.

LESSONS LEARNED

Customization matters

At my firm, 70 percent of accounts on our custom indexing platform have unique settings. That percentage is expected to grow as advisors continue to get comfortable with this new way of managing clients' money.

Taxes are central

Advisors want more nuanced and useful customized tax features. These features fall into three categories: ongoing tax management, tax-aware transitions, and tax-alpha reporting.

Direct indexing improved simple indexing for taxable investors by generating

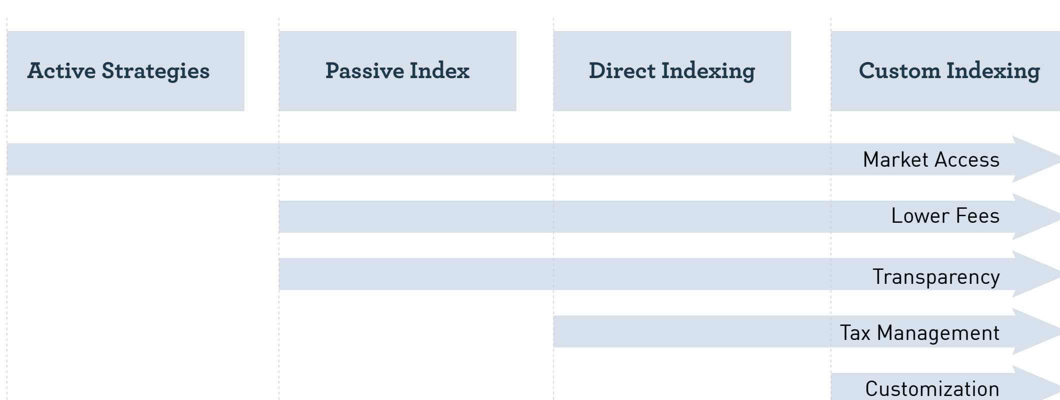
Figure 3

THE HISTORY OF INDEXING

Source: Charles Schwab. Fall Business Update

Figure 4

THE EVOLUTION OF INDEXING



Source: Charles Schwab. Fall Business Update

CUSTOM INDEXING VERSUS DIRECT INDEXING

Custom indexing differs from direct indexing in the following three key areas:

Flexible investment allocations set by you versus pre-packaged products set by them
Custom indexes are customizable. When building an allocation, investment levers can be pulled according to investor objectives. This can be as simple as weighting into passive for tax-management and cost-control or as complex as weighting into any combination of proprietary factors focused on alpha, downside protection, and income. Investors can set these levers as well as asset-allocation, market-cap, and geography inputs with exposure levels ranging from 0 percent to 100 percent, then further customize the portfolio for ESG values. With a custom-indexing platform, investors are not constrained to a pre-determined, off-the-shelf allocation or the watered-down factor definitions ubiquitous in today's direct indexing. See table 1 for examples of strategy templates created by advisors.

Intuitive software interfaces versus brochureware
Custom indexes are built using advisor-driven software that seamlessly connects the workflows of advisors, custodians, and the trading team. The user interface needs to be expertly designed with a focus on ease of use and firm scale. A well-constructed custom-indexing platform means no more clunky, unconnected processes patched together by email threads, paper, and hidden Excel files.

A partnership model where ideas go from theoretical to implementable
Custom indexing is about creating strong partnerships, new opportunities, and solutions for advisors and investors. Creating a custom-indexing platform requires listening to the platform's users, delivering a more-robust toolset, and maintaining an ever-evolving platform for the benefit of all clients.

useful tax losses while sticking close (enough) to the performance of the simple index. Tax losses are important, but so is customization of tax strategy.

Investors and advisors want to customize the following:

- The maximum amount of taxable gains realized while trading, in both dollar and percentage terms
- The tax budget when transitioning from an old portfolio to a new custom index
- The tracking error allowed to generate tax losses (e.g., move it higher in years with lots of gains to offset)

Each requires a large software build, but they are well-used features that help advisors with complex tax planning for clients. Such features can help plan for the cost associated with the transition from an existing portfolio to a custom-index portfolio. An optimization tool takes in the existing portfolio's cost basis, the client's specific tax rates, and the desired custom index to generate a transition plan that attempts to minimize the tax impact of the transition.

Optimizing transitions and ongoing tax management are important, but so are some other details such as the following:

Factor exposures are a means, not an end

Investors often are seeking something other than returns. Risk, income, downside protection, or exposure to innovative companies are also key outcomes that people want to achieve, and they want to use factor-based strategies to achieve those outcomes. Factors are simply tools to improve the probabilities of certain outcomes that investors care about.

ESG is personal

More investors want some consideration of ESG factors in their portfolios, but ESG means different things to different investors. Some care exclusively about eliminating fossil fuels, others seek to avoid unhealthful consumer products, and many want to adjust their portfolios to accommodate a range of issues they deem important. Many are unhappy with ETF-based ESG offerings that often do too many things or don't solve the investor's specific issues. The stricter the ESG settings, the higher the tracking error tends to be in the portfolio, but for many, that is a fine and a fair trade-off.

Custom indexes require custom reporting

One of the largest barriers to making custom indexing work for advisors is ongoing client reporting. After all, if investors have unique strategies, each will have a unique performance.[1] Traditionally, most advisors have all their clients in the same few strategies, so reporting becomes a one-size-fits-all exercise. Custom indexing changes that.

Quantitative research and software development are the competitive battlefields in custom indexing

Building a custom-indexing platform requires two research and development teams: a quantitative investment research team and a software development team. Together, they need to provide advisors with one web-based place to build, track, and report on clients' custom-index strategies. Advisors need to be able to easily create investment templates that address

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CUSTOM INDEXING

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their firm's philosophy, then address each of their clients' unique objectives (with scale in mind). This means that custom-index providers need to be experienced asset management firms that have technology at their core.

WHERE WE GO FROM HERE

Custom indexing may be inevitable within the next five to 10 years, but we all live in the here and now. We focus on the problems directly in front of us, not those around the corner. For RIAs, a switch to a new foundational platform is a huge and time-intensive choice. But those who adopt a custom-indexing approach now will have a significant competitive advantage with clients and prospects. Custom indexing comes with software tools for reporting and other tasks that now require manual work. These software platforms free up time for advisors to focus on what matters most—meeting new clients and doing more for existing clients.

Today, thousands of strategies based on quantitative formulas give investors exposure to themes, factors, or other categories, made available through funds, ETFs, and sometimes separate accounts.

Index investing always has been formulaic. The formula for the first index fund was to buy all listed stocks, weighted by their float-adjusted market cap. Today, thousands of strategies based on quantitative formulas give investors exposure to themes, factors, or other categories, made available through funds, ETFs, and sometimes separate accounts. But in the future, investors no longer will buy into someone else's formula; each investor will buy into a custom formula.

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ENDNOTE

1. Although customization does alter performance, we've found most advisors adopt a firm-level baseline.

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