INVESTMENTS & WEALTH MONITOR

A reprinted article from September/October 2020

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INVESTMENTS & WEALTH INSTITUTE®

DIRECT INDEXING SEPARATELY MANAGED ACCOUNTS

A Tax-Efficient Solution

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When investors think of indexing, they typically think of mutual funds or exchange-traded funds (ETFs) that provide broad market exposure in a tax-efficient and low-cost manner. As the industry has evolved over time, so too has indexing, moving from one-size-fits-all investments to tax-managed customized strategies, otherwise known as direct indexing or index-based separately managed accounts (SMAs). In these portfolios, managers purchase a basket of individual securities that closely resemble the exposures and performance of the index they are trying to replicate.

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Even though direct indexing has been available to institutional investors for decades, the larger minimum account size required to create a custom index portfolio made these types of strategies unattainable for most investors. But along with the democratization of indexing as an investment methodology, technological advancements and decreased trading costs have now made direct indexing a viable option.

With improved accessibility for individual investors through SMAs and lower minimums, these customized strategies provide some of the same benefits as index funds and ETFs, but with greater transparency and tax efficiency (see figure 1). When comparing the three types of index vehicles, each investment has its own nuances and characteristics that may suit investors differently based on the size of the investment account, investing behavior, tax bracket, and other factors that will be explored below.

Figure 1

THE EVOLUTION OF INDEXED INVESTING

Index Funds 1970s	ETFs 1990s	Direct Indexing
Transparency	Transparency	Transparency
Benchmark proxy	Benchmark proxy	Benchmark proxy
Low minimums	Low minimums	High-net-worth-focused
Risk-managed	Risk-managed	Risk-managed
Priced daily	Exchange-traded	Direct ownership
Relatively tax-efficient	More tax-efficient	Actively tax-managed
		Individualized

MUTUAL FUNDS, ETFs, AND DIRECT INDEXING: WHAT ARE THE DIFFERENCES?

Table 1 compares a range of characteristics of index mutual funds, ETFs, and direct indexing. In commingled vehicles such as mutual funds and ETFs, investors own shares in the fund but share the cost basis of the underlying securities with all other shareholders. That means investors have the potential to incur some tax liability should the fund manager sell a highly appreciated position and realize a gain.

By contrast, ETFs have an advantage over traditional mutual funds in that they can offload lower cost basis shares through the redemption process, potentially reducing the need to distribute capital gains to shareholders. Nonetheless, both of these commingled vehicles have the disadvantage of not being able to distribute realized losses on underlying positions to shareholders, although these losses can be used to offset future gains within the fund.

In the absence of taxes, mutual funds and ETFs may be the better option for many investors because their fees are lower and they may have lower tracking

Table 1

INDEX INVESTMENT VEHICLE COMPARISON

	Index Mutual Fund	ETF	Direct Indexing
Benchmark	S&P 500®	S&P 500®	S&P 500®
Typical # holdings	~500 (full replication)	~500 (full replication)	50–300+ (sampled or optimized)
Investor holds individual stocks directly	No	No	Yes
Purchases/sales at net asset value	Yes	No, trades like a stock	No, trades individual stocks
Tracking error to index	Usually <0.10%	Usually <0.10%	Varies, but typically <2%
Typical investment minimum	$100–$3,000	1 share	$100,000
Typical management fee	0.00%+	0.06%+	0.20%+
Dividends distributed	Yes	Yes	Received as paid
Long-term capital gains distributed	Yes	Yes	Only realized when stocks sold
Short-term capital gains distributed	Yes, as ordinary income	Yes, as ordinary income	Only realized when stocks sold
May have capital-gain distributions even if you don't sell	Yes, but not very common	Yes, but not very common	No
Direct benefit from loss harvesting	No, net losses stay in fund	No, net losses stay in ETF	Yes
May be more suitable for:	Small frequent contributions	Tactical trading during the day	Taxable investors and/or those who desire customization or tax management

error. They also tend to be relatively tax-efficient, with few to no capital-gain distributions. They may still distribute dividends, however, lowering the net return after taxes are factored in.

In cases where taxes are a key concern or customization is needed to align with a client's financial objective, a direct indexing portfolio may be a better option. Buying individual securities enables the flexibility to tailor portfolios to the unique needs of each client. Accounts can be customized to exclude an individual security, industry, or sector; create a factor-tilt; or align with a client's values through an environmental, social, and governance screen. By employing these techniques, investors can maintain diversified exposure while targeting portfolios to specific goals. Meanwhile, advisors can coordinate investment activity across the portfolio to avoid unexpected tax outcomes.

For example, an investor with a substantial holding in a bank stock may want to exclude that particular stock from a portfolio, exclude banks as an industry, or avoid the financial sector as a whole. With each layer of customization, tracking error to the benchmark may increase further, but direct indexing truly allows the creation of an individualized index portfolio for each client's needs.

INDEX-BASED SMAs CAN OPTIMIZE TAX BENEFITS

Direct indexing portfolios in taxable accounts are able to utilize active tax-loss harvesting techniques. When these portfolios realize capital losses in excess of capital gains, the net losses may be used to offset gains from other portfolio investments, because the investor owns the stocks directly.

This isn't the case in mutual funds and ETFs, where short-term capital gains are combined and distributed as ordinary income, not as a separate short-term capital-gain distribution. Although tax rates on short-term capital gains and ordinary income are often the same, combining them can be disadvantageous. For example, if an investor has short-term capital losses elsewhere, those losses would not be allowed to net against the short-term capital gains distributed by a mutual fund or ETF.

A separately managed account doesn't have these limitations. Direct indexing puts control back in the hands of the advisor and investor. In addition to greater tax transparency, SMAs provide the ability to actively harvest investment losses on a tax lot level to manage taxable events.

There is no one right answer. Index mutual funds are generally tax-efficient, so they often make sense in a taxable account. But an SMA may provide further tax benefits. The higher the tax bracket or the more sensitive the investor is to taxes, the greater the value the investor may receive from an SMA. Mutual funds and ETFs cannot incorporate existing stock positions, cannot be customized for individuals, and cannot

Table 2

STRATIFIED SAMPLING–SIMPLIFIED ILLUSTRATION

	Sector A	Sector B	Sector C	Sector D
Market cap segment 1	Subgroup A1	Subgroup B1	Subgroup C1	Subgroup D1
Market cap segment 2	Subgroup A2	Subgroup B2	Subgroup C2	Subgroup D2
Market cap segment 3	Subgroup A3	Subgroup B3	Subgroup C3	Subgroup D3
Market cap segment 4	Subgroup A4	Subgroup B4	Subgroup C4	Subgroup D4

Table 3

ILLUSTRATIVE EXAMPLE OF AFTER-TAX PERFORMANCE

	Portfolio	Index	Difference	
Pre-tax return	10.5%	10.0%	0.5%	Pre-tax alpha
After-tax return	11.0%	9.6%	1.4%	After- tax alpha
Tax alpha			0.9%	Tax alpha

Calculations:
Pre-tax alpha = (portfolio pre-tax return) – (index pre-tax return)
After-tax alpha = (portfolio after-tax return) – (index after-tax return)
Tax alpha = (after-tax alpha) – (pre-tax alpha)

distribute net losses. For investors in these situations or who need enhanced tax-management capabilities, SMAs may be the better option.

DIRECT INDEXING PORTFOLIO CONSTRUCTION: TWO WAYS TO SAMPLE

Typically, index-based separate accounts hold a subset of the stocks within an index. One reason for this is that holding all of the stocks in an index such as the S&P 500® would require a very large account. Using a thoughtfully selected subset allows for implementation at much lower minimums. Much of the tax benefit of index separate accounts comes from the proactive tax-loss harvesting that occurs. Owning a subset of the index constituents makes this possible by allowing for the proceeds of sales of tax-loss harvesting trades to be reinvested in other stocks.

There are two primary methods for constructing sampled index portfolios: stratified sampling and sampled optimization.

STRATIFIED SAMPLING

Stratified sampling is an approach that breaks down an index into subgroups—or strata—and then uses a specific methodology to select representative holdings from each. Table 2 shows an example of a stratified sampling approach that breaks down the index first by sector and then by capitalization, creating a matrix of sector/market cap subgroups.

In this simplified example, subgroup A1 might represent mega-cap financial stocks and subgroup B4 could be smaller-cap healthcare stocks. A stratified sampling approach applied to an equity index would choose at least one stock from each of these subgroups and—with a well-designed process—the overall portfolio would exhibit characteristics similar to those of the index and would track the performance of the index reasonably closely.

The implementation of stratified sampling can be quite complex. This is because the process needs to consider how many subgroups to create, how to choose stocks from within those subgroups, how to deal with stocks drifting into other subgroups, and how to weight the selected securities.

SAMPLED OPTIMIZATION

Sampled optimization approaches typically use quadratic optimizers in conjunction with multi-factor risk models that break down security returns into risk factors and measure the historical correlation between them. The risk model helps estimate the tracking error or performance difference between two different groups of securities, such as a sampled portfolio versus the complete index. Constraints can be imposed within the optimizer to limit the number of holdings, apply minimum trade sizes, implement a tracking error budget, etc.

Both approaches have strengths and weaknesses relative to one another.

- Stratified sampling approaches tend to lead to portfolios with fewer names, less trading activity, and more-aggressive tax-loss harvesting.
- Optimized approaches tend to hold more positions, which may require larger account minimums—but may reduce tracking error relative to the underlying index.

EVALUATING INDEX-BASED SMAs

Because index-based SMAs are designed to track an index on a pre-tax basis while maximizing the after-tax return for a client, evaluation of these types of strategies is different than evaluating traditional active managers. Ultimately, the measure of success for a taxable client is the after-tax performance of the portfolio compared to the after-tax performance of the index. This performance difference (referred to as after-tax alpha) can be broken down into two components: pre-tax alpha and tax alpha.

For a portfolio designed to track an index, the objective is to minimize any pre-tax alpha because the intent is to track the index performance as closely as possible. When sampling an index, however, some degree of tracking error is inevitable and this may be positive or negative. Tax alpha can be defined as the incremental benefit associated solely with active tax management.

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A TAX-EFFICIENT SOLUTION

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By subtracting the pre-tax alpha from the difference in after-tax returns, the tax alpha can be isolated (see table 3).

In this example, the pre-tax alpha is 0.5 percent because the portfolio outperformed the index by this amount. On an after-tax basis, the portfolio generated a return of 11.0 percent, outperforming the index after-tax return of 9.6 percent by 1.4 percent. Examining tax alpha helps identify the sources of the difference in performance. Here, the overall outperformance on an after-tax basis was 1.4 percent. Part of that (0.5 percent) was due to tracking error relative to the index, and the remainder (0.9 percent) was due to active tax management.

GREATER AFTER-TAX RETURN POTENTIAL

Ultimately, direct indexing gives advisors another tool for crafting innovative portfolios that solve for acute needs, such as a desire for investment customization or improved tax management. A direct indexing strategy also can work alongside existing, traditional components of a portfolio and aid the reallocation process over time. This puts a considerable level of control back in the hands of the advisor and the investor to be able to alter portfolios without unexpected taxable distributions. Over time, investors also may realize a higher rate of after-tax returns due to active tax-management techniques—allowing them to keep more of what they earn.

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