Tax Alpha and More: Understanding the Value of Direct Indexing

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Direct indexing has experienced a tremendous rise in popularity, leading to increased questions from investors, and forcing advisors to develop a perspective on whether direct indexing fits within their broader offering to clients. As more and more providers have brought direct indexing capabilities to the market, differentiating between these offerings has become difficult. To simplify the landscape, common narratives have formed, often narrowing the scope of direct indexing's usefulness to ultra-high-net-worth clients looking to generate losses – or tax offsets. **The objections below are all common examples of pushback about direct indexing that we think misunderstand the nature and breadth of the benefits direct indexing can provide.**

"Direct indexing doesn't make sense without a multi-million-dollar portfolio."

Changes in technology and trading commissions have led to the decline in investment minimums for direct indexing, and a seven-figure portfolio is no longer required to support these accounts. In fact, some direct indexing providers offer solutions for portfolios below $100k. Most importantly, under today's circumstances, the benefits of direct indexing – tax efficiency and customization – remain salient across account sizes. In fact, younger professionals with sound and growing income streams may be strong candidates for direct indexing. These clients may desire:

a) More optimal tax outcomes
b) Security restrictions to account for existing financial exposures
c) The ability to incorporate their values in their portfolios

Direct indexing can (and should) be a core portfolio solution rather than simply a high net-worth tool.

"ETFs are tax efficient. Why potentially pay more for direct indexing?"

Investors often focus on fees and pre-tax returns, but after-tax returns are what matter for taxable investors and direct indexing strategies may in fact cost less than a common fund model that advisors run.

While exchange-traded funds (ETFs) are tax-efficient, security-level tax loss harvesting common in direct indexing strategies provides even greater tax efficiency. Why? Even in rising markets, an often-large subset of names has negative returns. Direct indexing allows you to harvest these securities – which would otherwise be inaccessible in a fund structure – leaving investors with portfolios that can generate positive overall returns while also passing through realized losses to reduce current and future tax liability. The potential for improved after-tax performance that investors can earn through direct indexing can more than offset any excess fee that may be associated with direct indexing.

It doesn't stop here. Direct indexing can provide even more client value. Specifically, advisors can establish client-specific capital gains budgets and desired levels of aggressiveness in tax loss harvesting to target specific outcomes based on client needs. For example, if a client is selling a business and desires banking losses while maintaining their equity exposure, they could dial up their tax loss harvesting aggressiveness. Packaged investment products simply don't enable the level of tax management flexibility that can be achieved through direct indexing.

"Tax alpha will quickly fade into tax lock."

Tax lock occurs when no more losses can be harvested in a portfolio and tax alpha goes to zero. This is a natural phenomenon arising from the fact that markets go up more than they go down. While studies show this ossification effect in direct indexing accounts, much of the research into tax lock ignores real world implementation considerations, which can delay its onset:

- **Periodic Deposits** – newly deposited cash is used to purchase fresh positions at a cost basis in line with current market values.
- **Dividend Reinvestments** – similarly to deposited cash, dividend reinvestments are also used to establish fresh positions that may more easily become loss harvesting candidates in the future, so long as wash sale limitations are considered.
- **Annual Tax Budget Provision** – a non-zero annual tax budget allows the direct index manager to turnover positions to more closely track the intended index, while simultaneously establishing fresh basis positions.
- **Gifting** – for those interested in gifting, gifting appreciated securities can be an effective way to avoid or reduce the tax consequence associated with lower basis positions outside of the natural parameters of tax loss harvesting.

While tax lock is a real consideration for direct indexing accounts, its effects, when studied in a vacuum, likely do not fully capture the reality of managing live accounts.

Conclusion

Every client is unique, and therefore we like to think of direct indexing capabilities in an individualized way. Instead of positioning direct indexing exclusively as a tax management option, and obsessing over composite level 'tax alpha', we encourage advisors to shift the dialogue with clients to how direct indexing can help them navigate their needs throughout their investment journey.

Investment portfolios should be as dynamic as life: clients need cash, add cash, change advisors, make donations, sell businesses, change risk tolerance or capacity, etc., and thoughtful, bespoke tax management and portfolio design should be a part of each of these common transactions.

- **For individuals that want to go beyond passive,** direct indexing can break the link with market cap weighting, incorporating factor tilts or traditional active management.
- **For clients with unique risk exposures,** direct indexing allows for holdings-level customization to insulate them from additional exposure to risks they bear in other areas of their financial lives.
- **For newly onboarded prospects,** or those looking to adjust their approach, direct indexing can allow you to tax efficiently transition a client's portfolio from legacy holdings to their optimal strategy.
- **For investors that need tax efficient income,** but who hold concentrated positions, direct indexing can be paired with options overlay capabilities in effort to generate cash flow without having to sell concentrated stock at a gain.

Direct indexing is not a narrow tax management solution – it's a powerful solution that empowers advisors to deliver deeply personalized, tax-aware portfolios that help clients more effectively address the realities of their complex financial lives. Advisors who embrace direct indexing as part of their broader investment capabilities will differentiate themselves and their practices, deepening client relationships by providing portfolios built for clients. In a world where personalization is becoming commonplace and after-tax outcomes are of heightened focus, direct indexing is the solution every forward-thinking advisor should be ready to offer.

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