Adhesion wealth®

Let’s Stop Talking About Direct Indexing and Start Talking About Solutions

Direct Indexing has become a bit of a buzzword in the financial press. It sounds interesting, but do you really understand the power and potential applications of Direct Indexing for your clients? How can you differentiate your practice and gain value with this unique investment solution when used within a UMA?

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While the decision to use a Direct Index is important, where you choose to house the solution is just as important. Most advisors nowadays use Direct Indexes as a standalone separate account (SMA). Worse yet, some use software to generate trade ideas for the advisor. In fact, according to the 2022 Cerulli Direct Indexing leaderboard, less than 2% of those $208B in assets reported are held within a Unified Managed Account (UMA). Yet shockingly, it is within the UMA structure where the true power of Direct Indexing is unlocked. The intent of this paper is to provide advisors with an actionable blueprint on how to harness the power of the Direct Index and exploit the UMA structure to make it your highly differentiated competitive advantage.

Let's Start with the What, then get to the Why of Direct Indexing?

Index investing has been popular for a number of years. The intent of index investing, also known as passive investments, has been to achieve a 'market return.' For highly efficient asset classes – such as Large Cap, fund managers rarely beat the benchmark. In fact, last year, according to Morningstar, only 26% of fund managers beat their benchmark. So, if excess returns are very difficult to get through active investing, why pay extra for it? This has traditionally been implemented via index mutual funds or ETFs that track an index like the S&P 500.

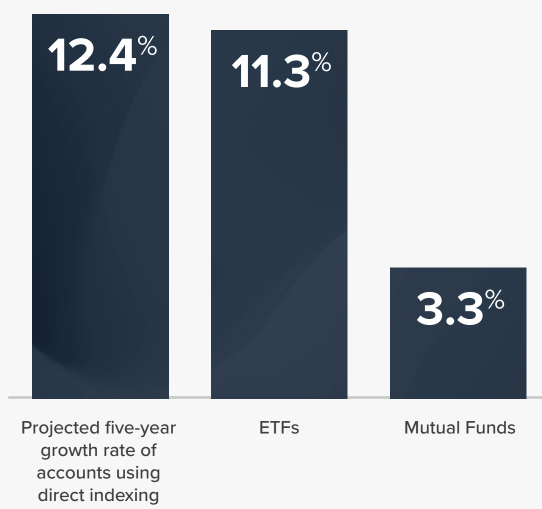
Direct Indexing involves owning all or a representative amount of the securities in an index directly versus through a mutual fund or an ETF. Direct Indexing offers your clients more control over their portfolio while still receiving the benefits of tracking an index. A study done by industry expert Cerulli Associates in August of 2021 showed that the projected five-year growth rate of accounts using direct indexing at 12.4%. This exceeds growth rates for ETFs (11.3%), SMA programs (9.4%) and mutual funds (3.3%).

Innovations in digital investing platforms fueled by technology have made Direct Indexing a more accessible and practical solution for investors seeking more customization in their portfolio. Direct Indexing opens new avenues in investing for your clients. It also offers a wealth of opportunities for those advisors who can master how they construct Direct Indexes for their clients. Perhaps of equal or greater importance is how you are solving real-life situations for clients with Direct Indexing.

>2%

of those $208B in assets reported are held within a Unified Managed Account (UMA).

Cerulli Associates in August of 2021



Innovations in digital investing platforms fueled by technology have made Direct Indexing a solution to more problems than most advisors understand–especially when placed within a multi-manager portfolio. As a result, we encourage advisors and those involved in the discussion around Direct Indexing to shift their focus away from product selling and focus a bit more on solving real-life situations advisors face every day. Specifically, consider these pain points and how a low-cost Direct Index solution can be uniquely leveraged to solve them.

The Problems Direct Indexing Solves When Used in a UMA

1. Cost Savings from Delivering Tax Alpha

Tax alpha represents real savings we've seen with clients at Adhesion who utilize our ongoing tax management program. Tax Alpha is defined as the percentage improvement in returns from reduced tax liabilities. And unlike other arcane, difficult-to-understand conceptual statistics you may have seen, we have tried to keep our statistics easy to understand and client-friendly. In fact, a recent study we conducted showed that advisor clients using an active tax management program built around a Direct Indexing solution achieved a 21% improvement in their tax alpha versus those not using a Direct Indexing approach on our platform.

One area of concern often cited by advisors when confronted with the option of using Direct Indexes is the reality of tax coordination in a single account. While the Direct Index can be used for active harvesting, when it's done in isolation and on a standalone basis, advisors are usually unaware of the purchases occurring in other related accounts, which can thrust the portfolio into a series of embarrassing wash sales. A UMA, on the other hand, can help solve this issue since it houses multiple strategies within a single account. This arrangement allows advisors and clients to hold investments in one place, making monitoring all activity much easier. And, with the entire portfolio managed within a single account, there are many distinct advantages offered - such as active tax-loss harvesting, gains deferral, moving advantageous tax lots into and out of the Direct Index to find harvesting opportunities, and the ability to absorb legacy holdings.

21%

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2. Core Satellite Allocations Can Tilt a Portfolio in a Direction Directly Aligned with Your Client's Goals

The core-satellite asset allocations are another potential benefit of using Directing Indexing within a UMA. This generally refers to building a portfolio anchored around a core of lower-cost, passively managed indexed investments that achieves index-like returns. Then, adding satellite allocations of active managers to seek excess return. Within the indexed core, the advisor can work with the client to tilt the portfolio in a direction directly aligned with the client's goals or emotional tendencies. As an example, popular these days are Direct Indexes with volatility dampening factors embedded within them. A UMA allows the entire allocation to be managed in a single account to facilitate efficient rebalancing, asset allocation changes, cash management, and allocating new investments.

3. Looking for Ways to Defend Fee Compression and Use it in Your Favor?

In a bundled pricing environment, advisor fees go up when product costs decrease. And in this era of advisor fee compression, the lower product costs of Direct Indexing allow you to demonstrate additional value to clients and prospects in terms of how your investment approach can help lower their overall cost of investing. Using Direct Indexes as the primary investment vehicle, or combined in a core-satellite allocation, has the potential to significantly reduce the asset management expenses of a portfolio without sacrificing sophistication or value.

4. Deliver a Level of Personalization that Your Competitors Can't

A Direct Index can be aligned to a client's unique financial, emotional or value-based needs by tilting it towards factors that are important to the investor – such as achieving a specific income level, controlling volatility, or inclusion of specific SRI/ESG issues. As every advisor knows, each client is unique and has a different situation, but the trade-off between personalization and scalability is usually a losing battle.

Direct Indexing inside a UMA offers a potentially excellent solution for clients who can benefit from an indexing approach but whose situation lends itself to more personalization.

5. Tout Your Ability to Design Customized Direct Indexes to Meet Portfolio Needs

Investment personalization also works well for clients with concentrated positions elsewhere in their portfolio. The Direct Index can be customized to reduce or eliminate that holding from inclusion in the Index. Personalization can also adjust the level of holdings in the sector of the concentrated position. For example, if the concentrated position is in a major tech stock, the Index can be personalized around that holding.

If you have clients where concentrated positions are the norm rather than the exception, touting your ability and willingness to design customized Direct Indexes to meet their portfolio needs can be a way to appeal to these clients' needs.

6. Additional Revenue Stream

Advisors can develop their own series of Direct Indexes tailored to different client objectives. They can white label their Indexes and layer an advisory fee on them for clients. The fee would be a part of their overall advisory fee structure.

Adhesion Wealth Advisor Solutions regularly partners with advisors to help them build and maintain custom Direct Indexes on the Adhesion platform. If presented compellingly, this experience can be a difference maker for existing and prospective clients and can provide a new revenue stream from the advisory fees from the customized indexes.

7. Decrease Capital Gains for Breakaway Legacy Assets

When bringing client assets to your new firm, many advisors force clients to sell their positions and start from scratch on their platform. This can trigger hefty capital gains taxes for those clients. Adhesion can absorb low basis holdings for breakaways and their clients by building a Direct Index within our UMA. The portfolio will likely see lower turnover and trading activity by absorbing holdings from a satellite manager into a Direct Index.

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Summary

Direct Indexing is here as a mainstream investment option for HNW clients. Your competitors will likely be offering Direct Indexing. You should be too, but you should be offering a better version of Direct Indexing. Adhesion's UMA is a highly differentiated solution.

Using a UMA in conjunction with Direct Indexing offers a comprehensive and potentially beneficial solution. Not only can you provide Direct Indexing, but you can also do this in conjunction with managing all of their assets in one place. This promotes tax-efficiency and makes asset allocation decisions easier.

While we've discussed UMAs and Direct Indexing in the context of taxable accounts, there are applications for IRAs and other tax-advantaged accounts as well.

Give us a call to learn more about Direct Indexing and UMAs, and how a partnership with Adhesion can potentially benefit your clients and your advisory practice in this competitive environment.

Call 888-295-8351, **email** sales@adhesionwealth.com, **or visit** www.adhesionwealth.com.

Adhesion Wealth is a leading provider of outsourced managed accounts, including sophisticated and customized investment solutions, integrated with practice management tools and outsourced back- and middle-office, to wealth advisory firms. These solutions enable advisors to easily provide separately managed account (SMA) and unified managed account (UMA) portfolios and create personalized solutions for investors. Its platform empowers advisors with highly scalable, flexible, and customized portfolio solutions, enabling them to deliver better investor outcomes.Adhesion Wealth is a wholly-owned subsidiary of AssetMark, Inc. ("AssetMark") is a leading provider of extensive wealth management and technology solutions that help financial advisors meet the ever-changing needs of their clients and businesses.

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