

Ways Advisors Are Failing To Maximize Direct Indexing

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Opinion

Just 2% of assets are offered via a Unified Managed Account framework.

Direct indexing continues to gain popularity as investors seek out personalized options and demand lower costs. Direct indexing, which involves owning a representative amount of the securities in an index vs. a mutual fund or ETF, can have a multitude of benefits—including potentially reduced costs, individual tax lot ownership and increased tax efficiencies, on top of screening for personal preferences and greater portfolio customization.

However, it's not just enough to implement direct indexing—It's how you implement it. While many advisors are currently leveraging or looking to leverage direct indexing, a large percentage of those may be missing out on helping their clients reach its true potential. This is because we often see advisors or asset managers implement an index strategy inside an SMA or as a standalone advisor model, while also allocating the client with other managers in different accounts. This is selling the strategy's true potential short for several reasons.

To “supercharge” direct indexing, it should be delivered in a single multi-manager account via a Unified Managed Account framework to help realize its full benefits, something that is being done to only 2% of direct indexing assets, according to Cerulli. This allows a direct index to be placed at the core of an account, with satellite holdings wrapped around it, which has a number of benefits for both the client and the advisor.

Direct indexing can be a great way to incorporate tax loss harvesting, which can help investors generate tax alpha, even amid severe market fluctuations. Investors can gain access to opportunities to harvest capital losses at the individual security level, while still maintaining a consistent exposure to the reference index. This can allow direct indexing to produce similar pre-tax returns as an ETF strategy but with short-term realized capital losses.

However, if this is only being done in a standalone SMA, with additional managers held in other account registrations, there is no way to manage wash sales across the entire portfolio, nor transfer holdings into and out of the core nor determine proper over and under weightings. Put simply—one

hand won't know what the other hand is doing. If a client's portfolio is allocated over various managers in separate accounts, you can't see over the "walls" that those account numbers create. An advisor or manager may make a smart change to a taxable portfolio, but unforeseen tax consequences can occur if assets are spread out across different accounts.

This frequently results in disallowed losses due to wash sales and actually ends up penalizing the investor. Oftentimes, the full impact of the disallowed losses is not recognized until either presented by the custodian at year-end or when your client is working with their tax preparation professional—someone by whom advisors want to be trusted for business development purposes.

Managing Core-Satellite Allocations

Many advisors choose to leverage a core-satellite approach to building a portfolio—creating a "core" allocation to low-cost, indexed solutions in efficient asset classes, and "satellites" of actively managed investments in inefficient asset classes to seek excess return. The advisor can work with the client to tilt the indexed core toward their goals and preferences. Doing this within a UMA allows the entire allocation to be managed in a single account to facilitate efficient rebalancing, asset allocation changes and additions, and cash management.

Additionally, investors and advisors can reduce overall administration with only one portfolio to manage, cutting down on the time and difficulty of keeping track of investments in multiple places.

Decreasing Capital Gains for Breakaway Legacy Assets

When switching firms, many advisors force clients they are bringing over to sell their positions and start from scratch on the new platform, which can trigger significant capital gains taxes for those clients. Breakaway advisors can work with a provider to build a direct index within a UMA, resulting in the portfolio seeing lower turnover and trading activity by absorbing holdings from a satellite manager into a direct index.

Direct indexing can have ample benefits for clients. But when it's not implemented in a UMA, a lot of those benefits could fall short. Keeping everything in one place can create better outcomes for clients while saving advisors from administration headaches.

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