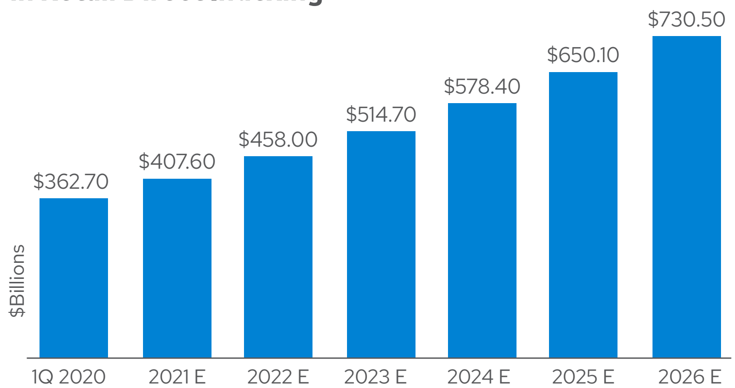
Direct Indexing and Personalized Portfolios

While the term "direct indexing" may have been coined only recently, the strategy underlying it isn't a new approach to investing—in fact, it traces its roots to the introduction of the first index fund 50 years ago—but it has become increasingly popular in recent years.[1] In its purest form, direct indexing involves replicating an index of investments with individual securities instead of purchasing an index fund or ETF. For example, the Dow Jones Industrial Average could be directly indexed through buying the shares of its 30 constituents in proportion to the index's weightings. Direct indexing is accomplished through a separately managed account, and, according to Cerulli Associates, over $730 billion is forecast to be directly indexed by 2026.

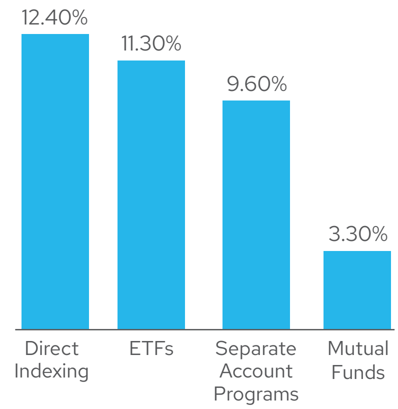
[1] Barron's: https://www.barrons.com/advisor/articles/direct-indexing-benefits-clients-51661805559

Projected Direct Indexing Growth in Retail Direct Indexing



Source: Cerulli Associates.

Projected 5-Year Growth Rates by Product



There's more to this story than simply matching an index, though. Personalized indexing represents a further development of direct indexing that enables customized solutions, particularly for high-net-worth investors. Personalized indexing can incorporate tax-loss harvesting, sustainability goals, factor tilts, and even help manage concentrated stock positions. These additional potential benefits enhance the appeal of direct indexing and its more advanced forms.

This paper will explore the details of direct indexing with a focus on the more personalized aspects of this methodology. Case studies will also be presented to illustrate the benefits of direct indexing for wealth management clients. Finally, Envestnet's direct index offering, branded *Quantitative Portfolios*, will be discussed along with related overlay services.

Features and Potential Benefits of Direct Indexing

For many investors, the features of a direct indexing approach provide desirable benefits in conjunction with a comprehensive financial plan. While direct indexing isn't as simple as buying a mutual fund and will have a higher minimum investment than typical funds, it also offers unique opportunities for investors. Direct indexing can also be used to support charitable and social goals.

Portfolio management fees for direct indexing strategies are typically 50–75% less than actively managed strategies in the same asset class.[2] Even factor-tilted direct indexing strategies, which systematically capture the same factor exposures as active managers and are rightly considered to be "quantitative active" in approach, are often at least 50% less expensive than active strategies.[3] In addition, completely personalized direct indexing portfolios have significantly lower fees than the average active manager.

Potential Benefits of Direct Indexing*

- Low Cost
- Diversification
- Transparency
- Tax Efficiency
- Customization/Personalization

[2] Envestnet; [3] Envestnet

* Direct indexing strategies have the risk of not closely tracking the performance of the underlying index they seek to replicate. While attempting to track an index, passive investments often do not consider a company's profitability, financial health, or growth potential in their investment selection criteria.

- **Low Cost.** Over the past few years, the costs of holding and transacting in individual stocks has dramatically declined. In addition, the portfolio management fee for direct indexing strategies is often less than half that of an actively managed strategy.
- **Diversification.** As a general rule, direct indexing results in well-diversified portfolios, thus offering broad exposure to an asset class. It's not an approach tied to a few large, risky bets. In fact, direct indexing can even help manage preexisting concentrated equity holdings in a portfolio (more on that soon).
- **Transparency.** Mutual funds only reveal holdings on a quarterly basis, but owing to their implementation as separately managed accounts (SMAs) and the resulting ownership of individual securities, direct indexing strategies ensure 24/7 visibility into the portfolio. This is not a "black box" solution—every security is listed with total transparency. One benefit of transparency is that it can help avoid investment overlap across accounts.
- **Tax Efficiency.** Mutual funds and even ETFs can generate unwelcome tax distributions from their internal trading activities, which is particularly problematic for investors in high tax brackets. With direct indexing, all trading can be managed for optimal tax management. Losses can be harvested and gains can be reaped in a structured process to help maximize after-tax returns, all according to the client's specific tax situation.
- **Customization/Personalization.** Direct indexing enables the construction of portfolios that are customizable across a range of characteristics and preferences. Do you have a client whose ideal equity portfolio incorporates a value tilt, excludes tobacco companies, and doesn't add to her exposure in an employer's stock? Direct indexing can accommodate all of those requests.

The features of direct indexing can enable advisors to offer unique, value-added services that go beyond pre-packaged investment products while helping to meet key client needs. In a crowded field, this customization can be a critical aspect of differentiation from competitors. With this idea in mind, let's dig deeper into the implementations of direct indexing. Then, we'll evaluate the tax management and portfolio personalization advantages of direct indexing before reviewing specific case studies.

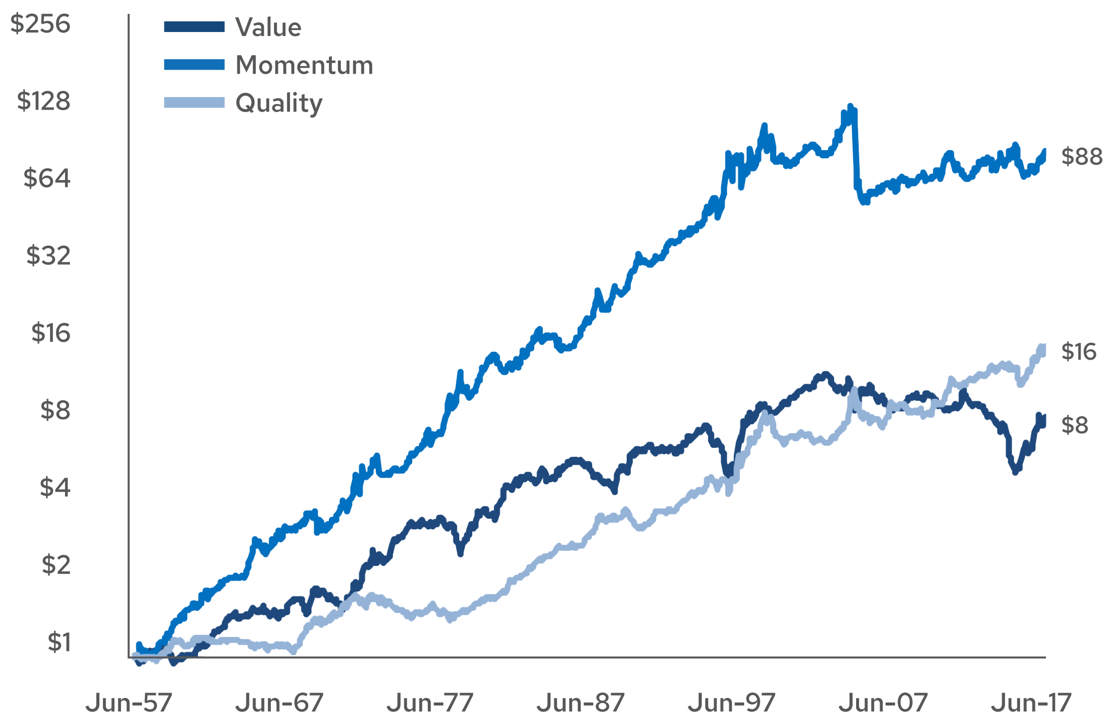
Multifaceted Approaches to Direct Indexing

Direct indexing encompasses an array of approaches and methodologies—this is truly a multifaceted approach to investing. It's important to understand the breadth of strategies under the direct indexing umbrella and how each one can be utilized effectively. The use cases vary widely, so let's review the possibilities.

The standard, and most commonly known, form of direct indexing provides diversified exposure to an asset class. For example, a directly indexed portfolio could fully replicate the securities and weightings of the S&P 100 or it could hold a representative sample of stocks in the NASDAQ Composite. The goal of these direct indexing portfolios isn't to outperform a benchmark; the objective is to provide exposure to the beta of the asset class, as represented by the index being tracked. It's a form of passive management.

Direct indexing can also be utilized in an effort to outperform the benchmark by capturing and highlighting various asset pricing factors. What are factors exactly? Think of factors as sources of return that can be isolated through quantitative analysis. Some of the most well-known investment factors are Value, Momentum, Low Volatility, Quality, and Size. These factors have been found—through decades of academic and industry research—to drive returns that were previously thought to be idiosyncratic, and this research has led to the creation of portfolios that emphasize one or more factors. Direct indexing provides an outstanding route to implement factor-oriented strategies because the portfolio can be tailored as much as desired. For example, the S&P 500's constituents could be evaluated from a factor perspective, and a direct indexing portfolio could be constructed to capture exposure to, or "tilt" toward, the Value and Momentum factors. More complicated factor exposures could be crafted, too.

Performance of Value, Momentum, and Quality Factors
Growth of $1: 6/30/1957 – 10/31/2022



Correlation of Returns*
6/30/1957 – 10/31/2022

	Value	Momentum	Quality
Value	1.00		
Momentum	-0.21	1	
Quality	-0.04	0.28	1

Source: QRG
*Value and Momentum: Kenneth French Data Library; Quality: AQR Data Library.

> “As more sophisticated means of analyzing stock price performance have emerged over the years, ‘factor’ investing increasingly has become a viable and important approach to portfolio management.”
>
> –Brandon Thomas, Co-Founder and CIO, Envestnet | PMC

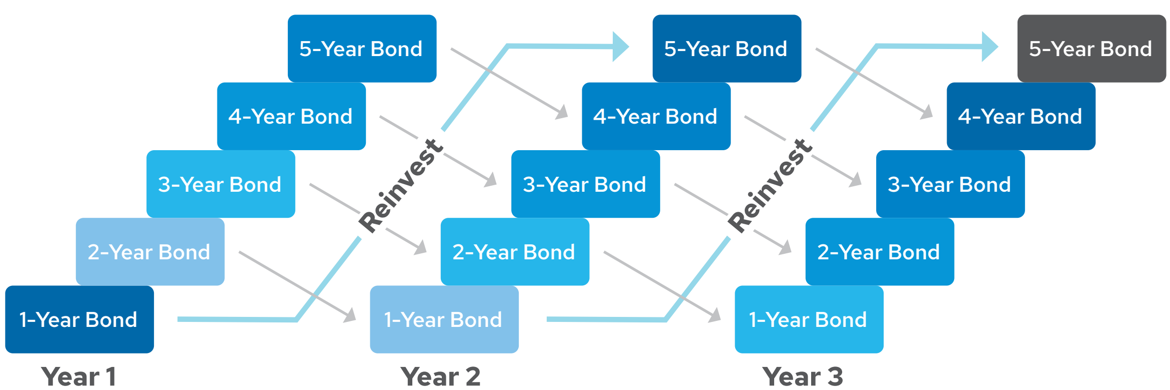
Direct indexing can support sustainability objectives for a portfolio, too. This process can include accommodating religious values and other social preferences by screening out certain securities. Do you have a client who needs a large cap stock portfolio but also wishes to avoid oil-related stocks? Direct indexing can be used to construct this allocation. Maybe you have a client seeking small cap exposure without investing in companies providing abortion services or drugs for religious reasons. Again, direct indexing can incorporate these filters. Younger investors are especially likely to request sustainable solutions, and many philanthropic foundations are built around religious or social missions that preclude certain investments. (A lung cancer foundation probably won’t want to own tobacco company stocks or bonds!) Sustainability goals can be achieved through more than just basic restrictions. Direct indexing also enables portfolios to overweight environment-friendly and socially responsible companies. In this way, you’re not just avoiding certain investments; your clients are leaning into sustainable businesses and elevating their values through conscious efforts.

It’s important to note that direct indexing isn’t limited solely to equities, as bonds are now being incorporated into direct indexing strategies, as well. Corporate and municipal bond ladders can be created to provide income and reduce interest rate sensitivity. By reinvesting proceeds from maturing securities into bonds with longer maturities, the ladder could continue indefinitely. Absolute return bond portfolios also represent an emerging niche in direct indexing. These strategies are less focused on providing stable income like bond ladders and more focused on the potential for higher overall returns.

The sustainability filters referenced above are applicable to fixed income portfolios created through direct indexing, too. Values-oriented investing thus isn’t limited to equity allocations. For investors seeking to align their investments with social, environmental, or faith-based preferences, direct indexing enables effective implementation across asset classes.

Bond Ladder Concepts

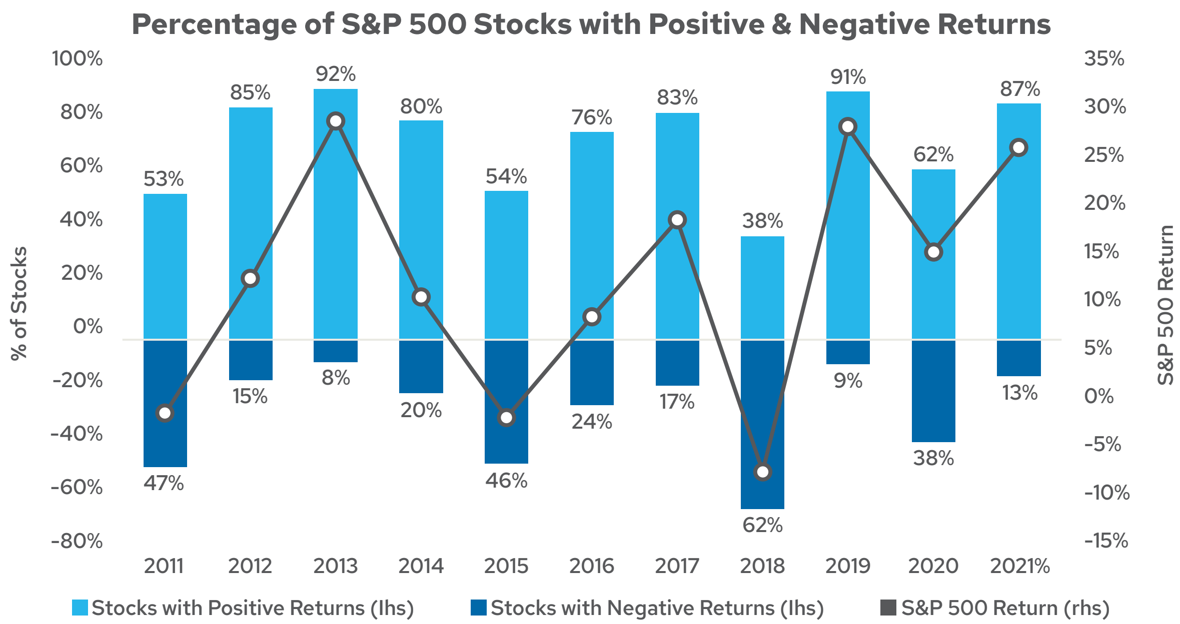
Reinvest Proceeds of Matured Bonds



Tax Optimization Through Direct Indexing

When a new client transitions taxable accounts to an advisor, there's often a significant portfolio restructuring. This reallocation process frequently incurs hefty taxes on accumulated capital gains. With a direct indexing program that manages existing positions in a tax-efficient way, however, the overall tax bill can be reduced.

Direct indexing can help enhance tax optimization far beyond a transition period, too. What is the process of ongoing tax management for a direct indexing portfolio? First, examine this fact: Even when the stock market is performing well, plenty of opportunities may exist for tax-loss harvesting. The chart below illustrates these historical statistics over time. Your clients can potentially benefit from loss harvesting in bear markets and bull markets, making tax management an important financial planning tool every year.

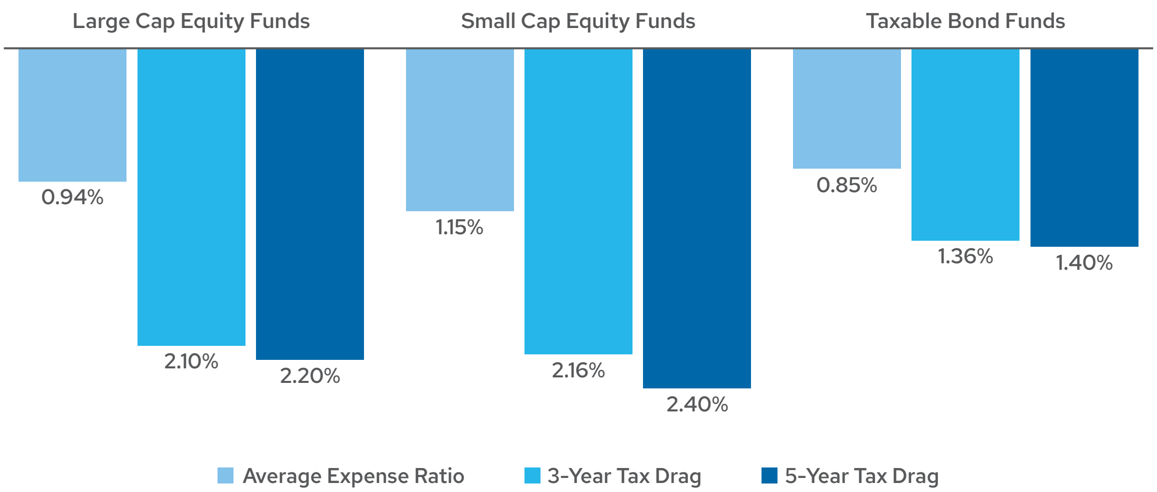


Surviving index constituents. Source: YCharts

From 2011 through 2021, an average of 27% of S&P 500 stocks declined each year.

Actively managed mutual funds, still the bread and butter of many investment portfolios, subject investors to greater tax liabilities than many people realize, thus enhancing the appeal of tax-optimized direct indexing. Just how much of a tax drag can weigh down returns for investors in the highest bracket? Actively managed large-cap mutual funds have sacrificed 2.2% of return, on average, annually due to taxes over the past five years, and active small-cap funds lost 2.4% on average over the same period. Taxable fixed income funds aren't immune to tax drag either; they have sacrificed 1.4% in average annual returns over the last five years (for investors in the highest tax bracket). Taxes, then, often drag down realized fund returns in nonqualified accounts even more than expenses. All else equal, a more tax-efficient investment process can provide better outcomes for your clients than a tax-inefficient strategy. Don't just focus on expense ratios. Focus on realized returns.

Projected Direct Indexing Growth in Retail Direct Indexing



Data on actively managed US mutual funds for Morningstar through 8/31/2022. Tax drag: The Morningstar Tax Cost Ratio measures how much a fund's annualized return is reduced by the taxes investors pay on distributions. Mutual funds regularly distribute stock dividends, bond dividends, and capital gains to their shareholders. Investors then must pay taxes on those distributions during the year they were received.

Does tax optimization materially improve realized investment account returns? According to the research, the answer is unequivocally yes. Up to 100 bps (basis points) of return can be generated through the effective tax management of a portfolio.[4] Over time, the tax savings can really add up, especially for affluent investors in high tax brackets.

$1,661,513.30

That's how much additional money would be earned over 20 years on a $3 million portfolio by increasing after-tax returns from 5% to 6%.[5]

Direct indexing has the potential to grow wealth through tax optimization in a meaningful, consistent manner. Bear markets provide ample opportunities for tax loss harvesting, but the tax management benefits of direct indexing also extend into bull markets, as we saw earlier. Let's now explore the personalized portfolios that can be constructed through direct indexing and how customization can help you to meet your clients' goals.

[4] Envestnet: https://www.envestnetinstitute.com/article/capital-sigma-advisor-advantage

[5] Hypothetical illustration assuming no deposits or withdrawals and steady returns

Customization/Personalization Through Direct Indexing

According to research, 80% of Americans report that tailored solutions are important to them.[6] More specifically, 70% of wealth management clients say that the level of personalized service received affects their decision to retain or leave their current advisor.[7] Personalized investment guidance matters to your clients.

How does direct indexing help you deliver customized advice and portfolios? We've already reviewed how tax-sensitive investors can be better served through direct indexing because it doesn't force them to incur inopportune tax bills. The values and sustainability-based screening that can be integrated into direct indexing was presented previously, as well. However, those are far from the only elements of personalization possible through direct indexing.

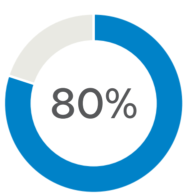
Imagine that you have a client who's a pharmaceutical executive. Her employer is a company in the Russell 1000 index that regularly rewards her with restricted stock. Because your client now has a concentrated position in her employer's shares, she doesn't want additional exposure through a Russell 1000 index fund or large cap mutual fund.

The solution: Direct indexing.

A custom portfolio can be created for your executive client that excludes her employer's stock but also achieves the goal of closely tracking the index. And what if you and your client ultimately decide that she shouldn't be holding other pharmaceutical stocks either? Direct indexing can incorporate an industry restriction, too.

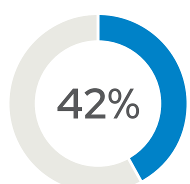
Truly bespoke portfolios can be constructed and managed through direct indexing. What if you want a tax-sensitive, value-oriented international equities allocation that avoids investments in tobacco companies and your client's employer (a Swiss bank)? You can't create that portfolio with packaged investment products. You need something else. You need direct indexing.

Today, we all demand more personalized, tailored solutions



of consumers say it's important to them.

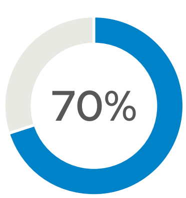
Source: McKinsey



of consumers are annoyed when content isn't personalized

Source: Adobe

And it's important for your business



of wealth management clients see highly personalized service as a factor in deciding whether to stay with their current advisor or switch to another firm.

Source: Envestnet, The Advisor's Playbook for Leading Your Clients Forward, 2020

[6] McKinsey: https://www.mckinsey.com/capabilities/growth-marketing-and-sales/our-insights/personalization-at-scale-first-steps

[7] Envestnet: The Advisor's Playbook for Leading Your Clients Forward

Case Studies

Now that we've explored the essential elements of direct indexing, let's examine two specific case studies from the Envestnet | PMC team. These examples are for illustrative purposes only, but they are based on solutions delivered to real clients. As you read through these cases, look for similarities to clients you've served as well as potential clients who chose other advisors. Consider if, and how, direct indexing may enable you to meet your clients' financial goals while also helping to enable you to attract more clients in the future.

Case Study #1

Portfolio in Transition

Client	Solution
• Tax-averse client transitioning assets to new financial advisor • Client moving from multiple financial institutions to consolidate strategies	• Propose new diversified investment solution • Low cost is a main priority • Determine how much client is willing to pay in taxes for new portfolio and over what time period • Perform a transition analysis

High Net Worth Individual	$2,841,967 .... Value
	$304,952 ...... Unrealized Net G/L

FOR ONE-ON-ONE USE WITH A CLIENT'S FINANCIAL ADVISOR ONLY

Source: Envestnet PMC.

No Tax Management

Scheufler NO TM

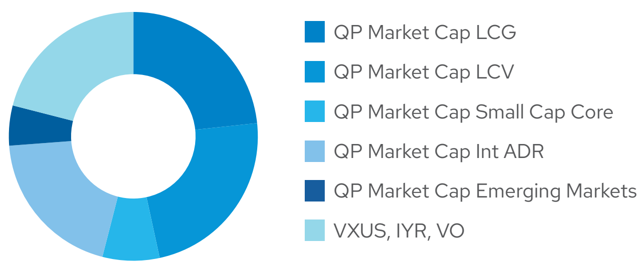
Existing Portfolio Tax Scenario	
Total Portfolio Value	$2,841,967
Unrealized Net Short-Term Gain/Loss	$0
Unrealized Net Long-Term Gain/Loss	$304,952
Realized Short-Term Gain/Loss	$0
Realized Long-Term Gain/Loss	$0

Optional Tax Mandate (As Determined by Client)	
Max Short-Term Gains for 2022	$0
Max Long-Term Gains for 2022	$0
Max Tax Bill for 2022	N/A

Estimated Federal Tax Impact on Portfolio After Transition	
Net Realized Short-Term Gain/Loss	$0
Net Realized Long-Term Gain/Loss	$274,128
Externally Realized Short-Term Gain/Loss	$0
Externally Realized Long-Term Gain/Loss	$0
Estimated Federal Tax Bill**	**$54,826**

Proposed Asset Transition Summary

Manager	Allocation %	T/E
QP Market Cap LCG	23.3%	0.00%
QP Market Cap LCV	23.3%	0.00%
QP Market Cap Small Cap Core	7.4%	0.00%
QP Market Cap Int ADR	19.8%	0.00%
QP Market Cap Emerging Markets	5.2%	0.00%
VXUS, IYR, VO	21.0%	0.00%
Weighted TE:		**0.00%**



This example is hypothetical and for illustrative purposes only.

** 20% tax rate assumed for long-term gains and 39.6% tax rate assumed for short-term gains.

Source: Envestnet PMC.

Tax Management

Scheufler TM

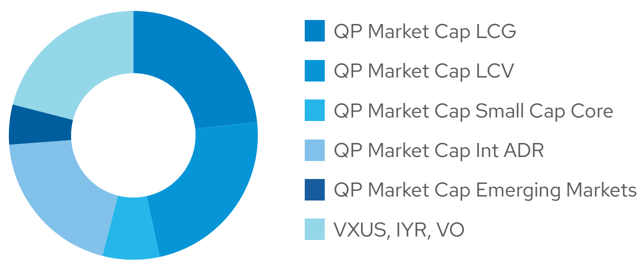
Existing Portfolio Tax Scenario	
Total Portfolio Value	$2,841,967
Unrealized Net Short-Term Gain/Loss	$0
Unrealized Net Long-Term Gain/Loss	$304,952
Realized Short-Term Gain/Loss	$0
Realized Long-Term Gain/Loss	$0

Optional Tax Mandate (As Determined by Client)	
Max Short-Term Gains for 2022	$0
Max Long-Term Gains for 2022	$0
Max Tax Bill for 2022	N/A

Estimated Federal Tax Impact on Portfolio After Transition	
Net Realized Short-Term Gain/Loss	$0
Net Realized Long-Term Gain/Loss	$376
Externally Realized Short-Term Gain/Loss	$0
Externally Realized Long-Term Gain/Loss	$0
Estimated Federal Tax Bill**	**$75**

Proposed Asset Transition Summary

Manager	Allocation %	T/E
QP Market Cap LCG	23.3%	1.48%
QP Market Cap LCV	23.3%	1.47%
QP Market Cap Small Cap Core	7.4%	0.44%
QP Market Cap Int ADR	19.8%	1.26%
QP Market Cap Emerging Markets	5.2%	0.31%
VXUS, IYR, VO	21.0%	0.00%
Weighted TE:		**0.99%**



Over $54,700 in estimated federal tax savings through the use of tax-efficient direct indexing for this client.

This example is hypothetical and for illustrative purposes only.

** 20% tax rate assumed for long-term gains and 39.6% tax rate assumed for short-term gains.

Source: Envestnet PMC.

Case Study #2

Introduce Factor Investing Through Direct Indexing

Background: Income Beneficiary is co-trustee. Clients have been averse to models/SMAs/funds and prefer individual security purchases. They have used SMA managers in the past but eventually directed liquidation.

Trust Account Details

- Current Account Market Value: $51M+
- Current Unrealized Gains: $21M+
- Asset Allocation 100% Individual Equities
- 54 Individual Stocks & 7 Sector ETFs
- $41M in Individual Large Cap Equities
- $10.8M in two S&P 500 Passive ETFs (VOO & IVV)

Full Acount Transition

No Tax Management

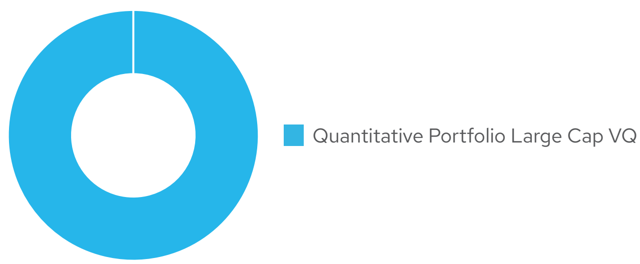
Existing Portfolio Tax Scenario	
Total Portfolio Value	$41,975,335
Unrealized Net Short-Term Gain/Loss	$0
Unrealized Net Long-Term Gain/Loss	$21,205,115
Realized Short-Term Gain/Loss	$0
Realized Long-Term Gain/Loss	$0

Optional Tax Mandate (As Determined by Client)	
Max Short-Term Gains for 2022	$0
Max Long-Term Gains for 2022	$0
Max Tax Bill for 2022	N/A

Estimated Federal Tax Impact on Portfolio After Transition	
Net Realized Short-Term Gain/Loss	$0
Net Realized Long-Term Gain/Loss	$17,435,277
Externally Realized Short-Term Gain/Loss	$0
Externally Realized Long-Term Gain/Loss	$0
Estimated Federal Tax Bill**	**$3,487,055**

Proposed Asset Transition Summary

Manager	Allocation %	T/E
Quantitative Portfolio Large Cap VQ	100%	0.13%
Weighted TE:		**0.13%**



This example is hypothetical and for illustrative purposes only.

** 20% tax rate assumed for long-term gains and 39.6% tax rate assumed for short-term gains.

Source: Envestnet PMC.

Full Account Transition

After talking with the advisor, we understood the background of the client relationship. An analysis was conducted on the entire account as a baseline, knowing the client would be hesitant to have the full account fall under a managed solution.

Potential Benefits:

- Helps to work towards more balanced sector allocations.
- Ability to harvest losses to help avoid short-term gains and provide better flexibility when making changes to account or raising funds for potential distributions.
- Factor-based investing potentially leads to outperformance.
- Combines clients current process of owning individual securities with a passive, low-cost approach.

Source: Envestnet PMC.

Full Acount Transition

With Tax Management

Existing Portfolio Tax Scenario	
Total Portfolio Value	$41,975,335
Unrealized Net Short-Term Gain/Loss	$0
Unrealized Net Long-Term Gain/Loss	$21,205,115
Realized Short-Term Gain/Loss	$0
Realized Long-Term Gain/Loss	$0

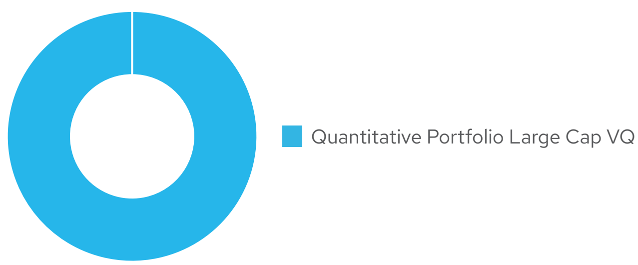
Optional Tax Mandate (As Determined by Client)	
Max Short-Term Gains for 2022	$0
Max Long-Term Gains for 2022	$0
Max Tax Bill for 2022	N/A

Estimated Federal Tax Impact on Portfolio After Transition	
Net Realized Short-Term Gain/Loss	$0
Net Realized Long-Term Gain/Loss	-$8,297
Externally Realized Short-Term Gain/Loss	$0
Externally Realized Long-Term Gain/Loss	$0
Estimated Federal Tax Bill**	

This example is hypothetical and for illustrative purposes only.

Proposed Asset Transition Summary

Manager	Allocation %	T/E
Quantitative Portfolio Large Cap VQ	100%	4.13%
Weighted TE:		**4.13%**



Direct indexing satisfied this client's desire to own individual securities while incorporating factor tilts. A tax-managed transition reduces the estimated federal tax bill by nearly $3.5M.

As you can see, direct indexing can deliver real-world advantages for clients like yours. The potential benefits of direct indexing can be significant, and this approach may satisfy a range of client preferences. Think of direct indexing as a comprehensive blend of possible solutions to many vexing investment problems.

** 20% tax rate assumed for long-term gains and 39.6% tax rate assumed for short-term gains.

Source: Envestnet PMC.

Quantitative Portfolios from Envestnet

Quantitative Portfolios (QPs) are a suite of asset class and thematic investments that blend the benefits of "beta" investing with the portfolio customization of managed accounts. QPs represent Envestnet's direct indexing solution. These four varieties of QPs can help improve after-tax and risk-adjusted results—in a cost-effective manner:

- **Market Series** QPs feature low-cost access to important market segments coupled with opportunities for customization and tax management.
- **Factor-Enhanced** QPs provide the potential for excess returns via increased exposure to well-known asset pricing factors such as Value, Momentum, and Quality.
- **Sustainable** QPs explicitly focus on companies with high sustainability ratings and/or environmental, social, and governance priorities.
- **Fixed Income** QPs designed to provide consistent income in the investment-grade corporate and municipal segments.

QRG Capital Management, Inc., Envestnet's wholly-owned quantitative asset management unit, provides the research framework, portfolio design and construction techniques, and ongoing portfolio management experience that drive the QPs. QRG's suite of QPs help address important investor needs that are often overlooked by "one-size-fits-all" passive investments. Many of our QPs are designed to provide cost-efficient beta exposure, tracking the characteristics and returns of well-known indices. Since the investor owns the underlying securities, they have opportunities for personalization and tax management. For investors who want to potentially outperform the market but lack conviction in active stock picking, the Factor-Enhanced QPs tilt to factor exposures that increase the potential for improved risk-adjusted returns. The portfolios are based on research from QRG as well as academic and industry leaders that suggests a handful of factors remain statistically significant over time.

Regarding Sustainable QPs, note that sustainable investing encompasses a range of approaches that recognize the interconnectedness between environmental health, social equity, and long-term economic performance. These investments are made with the intention to protect and enhance long-term value by addressing environmental, social, and/or governance (ESG) risks or improving environmental and social challenges. For QRG, sustainable investing is inclusive of the following distinct investment approaches:

- ***Values Alignment:*** Minimizing exposure to individual companies or entire industries whose business practices conflict with an investor's personal convictions.
- ***ESG Integration:*** The practice of incorporating environmental, social, and governance information into investment decisions.
- ***Thematic Impact:*** The intent to generate positive, measurable social and environmental impact alongside a financial return.

QRG offers extensive opportunities for portfolio personalization through options to tailor portfolios across each of these sustainable investing approaches.

In combination with Envestnet's Overlay Services offering, each of these series of portfolios can help manage an investor's tax bill and capture "tax-management alpha" via minimizing realization of short-term capital gains and tax-loss harvesting. Envestnet's tax management technology, QRG's risk models, and Envestnet | PMC's Investment Specialists combine to help address investor-specific situations.

Conclusion

Despite the many valuable features of direct indexing, only 14% of advisors are currently using this approach to investing. For advisors, this statistic means that adopting direct indexing as part of your practice can be a key point of differentiation. Not only can direct indexing help you retain existing clients and serve them better, it may also enhance your appeal to potential clients who are seeking “white glove” personalized services. By providing customized portfolios that competitors can’t offer, your firm can stand out in a crowded field. Most importantly, though, you can help address complicated and layered client needs through direct indexing. As the investment industry shifts away from cookie-cutter brokerage services and toward personalized wealth management, direct indexing could become an integral element of the financial advisor’s toolkit. Will you be leading this transition?

Q | R | G

For more information about QRG & Quantitative Portfolios

Visit envestnet.com/qrg or contact the QRG Consulting Team at QRG@envestnet.com

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Direct indexing strategies have the risk of not closely track the performance of the underlying index they seek to replicate. While attempting to track an index, passive investments often do not consider a company's profitability, financial health, or growth potential in their investment selection criteria.

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