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## Direct Indexing: It's All About Customization

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*Direct indexing:* It's a term many in the investment community seem to have latched on to. And I'll admit, it neatly and efficiently gets at what high-net-worth investors increasingly seek: ETF-like market exposure with access to the underlying securities in the portfolio. Yet while use of the term continues to grow, it undersells many of the benefits and the true potential of this exciting area of investing.

Is there a better term? I prefer *custom separately managed accounts*. Granted, it doesn't quite roll off the tongue in the same way, but it contains a key word that's often missing from the direct indexing conversation: custom. After all, why stop at simply mimicking an index's holdings when investors have the opportunity to do so much more: manage taxes, blend benchmarks, introduce factor tilts, express their ESG views, and so on. These accounts don't simply offer market exposure; they also add real value in multiple dimensions.

So while I and others in the industry still use *direct indexing* as a shorthand way to talk about custom SMAs—why tilt at windmills?—I believe custom SMAs offer a good deal more than direct indexing. And the tremendous growth of these types of accounts over the past several years tells us that the era of the custom SMA is here.

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## Direct indexing, like index investing, continues to reshape conversations about investing.

### The benefits of customization

The crux of direct indexing is customization—it's everything. No two custom SMAs need be alike when there's the ability for tax-loss harvesting on individual securities to achieve higher after-tax performance; to tailor ESG criteria to each client's principles; and to tilt a portfolio to factors such as value or momentum.

Many investors can benefit from it. And advisors who offer it get to create something that builds a foundational connection with their clients.

### But direct indexing isn't for everyone

The value of customization can vary depending on an investor's specific profile, but the ideal candidate is an investor who, among other things:

- Funds a portfolio with securities
- Is in a higher tax bracket
- Has a long-term investment focus
- Has convictions about ESG or responsible investing

Those whose profiles don't align with customization might not see much value in direct indexing—especially after considering the product from a cost perspective. That's right, customization does have costs. Relative to commingled vehicles such as ETFs, custom SMAs have higher fees, greater tracking error, and added operational complexity.

Many investors who don't naturally benefit from customization—at least beyond its costs—should continue to get their market exposure through funds and ETFs. But it's important to add that funds, ETFs, and custom SMAs aren't mutually exclusive. All have important roles in the investment ecosystem.

### What does direct indexing's rise mean for financial advisors?

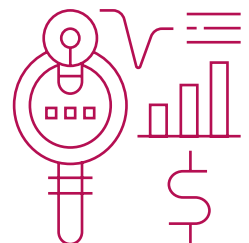
Just as index investing has changed the way financial advisors serve their clients, the rise of direct indexing is also changing the way financial advice is given. Advisors who in the past counted on their ability to pick stocks—or their ability to select managers to pick stocks—to fully offset the fees and taxes their clients pay have had to adjust their approach.

Finding the right mix of active and passive solutions for clients is now paramount. Clients want portfolios that combine both approaches, with a keen eye for the risk, fees, taxes, and performance that each approach, and a combination of both, can offer. It's no longer enough for advisors to hang their hats on producing alpha. They can't promise it, and over the long run most will find it elusive.

Instead advisors are increasingly growing their businesses by acknowledging that investing is changing; making room in their practice for transparent, low-cost, rules-based products; and redefining their value proposition to their clients.

Advisors can capture additional benefits beyond commingled funds by offering their clients custom direct indexing solutions built around tax management, responsible investing, and long-term exposures beyond cap-weighted indexes, such as factor investing. (And let's not forget that successful advisors are also building financial plans, putting together the right asset allocations, reporting on performance, and considering clients' estate-planning needs and charitable-gifting inclinations.)

Direct indexing, like index investing, continues to reshape conversations about investing. It's helping advisors think realistically and holistically about what's best for their clients.



## Customized SMAs: A high bar

New direct indexing providers tend to underestimate the challenges created by customization and focus exclusively on the technology by way of algorithms, portfolio construction, and user interfaces. But that's only part of the story, since providers need a full cast of distribution, marketing, client consultation, implementation, and service to deliver and defend the promise of customization. This is a high bar.

That's why the majority of market share tends to go to providers with established technology and intellectual property, a track record of success, and teams of people with the experience to deliver with ease.

## How to choose a custom SMA provider

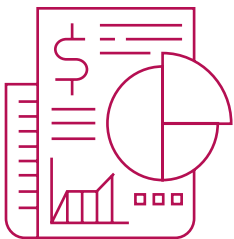
Many in the investing community criticize SMAs as overpromising and underdelivering on customization—the primary reasons these accounts exist. The critics note that while all SMAs offer investors ownership of individual securities, in most accounts customization is suppressed in favor of a cookie-cutter approach to portfolio construction.

As new custom SMA providers pop up in response to growing demand, it's important to remember that not all providers are created equal. When done right, a truly custom SMA can combine the benefits of consistent broad market exposure with by-account personalization, flexibility, and security-level transparency.

Does the provider you're evaluating have what it takes to deliver on the full potential of an SMA? Here are factors to consider during the vetting process.

### Does the SMA provider have the right expertise?

It's critical to assess a provider's expertise and request proof points of their capabilities. Consider the sophistication level of their service teams and whether they're not only well versed in investment strategy but also able to deliver the high level of consultative service custom SMAs require. From understanding client needs before constructing a portfolio to post-implementation reporting, client service is key.



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### Can the SMA provider scale?

A customized SMA manager must have a scalable and efficient investment platform to handle a growing number of individual accounts. You also want to ensure a provider's technology can support portfolio management and reporting. Internal technology developed to address an SMA can inherently deliver more functionality than off-the-shelf solutions, providing confidence in the implementation of your customized exposures. Ensure your SMA manager's technology delivers reporting that produces clear insights into your clients' unique circumstances.

### What types of exposures can they capture?

Ask about the provider's ability to deliver individualized exposures beyond traditional cap-weighted indexes. Are they flexible enough to offer global exposures? What about factors—not just standard ones like value and momentum but blends of different factor strategies? And what about different asset types, such as options or fixed income?

Beyond customized market exposure, many investors will seek to incorporate customized responsible investing features. To ensure a manager has the resources to customize an SMA that can be aligned with your clients' values, consider the SMA provider's range of socially responsible offerings, the team focused on responsible investing research and implementation, their proxy-voting policies, and how shareholder engagement is incorporated into their offerings.

## More and more investors are resisting one-size-fits-all portfolio solutions.

### Is the provider accessible?

Beyond access to a dedicated client service team, ask whether investment professionals are available for in-depth conversations. Portfolio managers, investment strategists, and researchers should be accessible and able to partner with the client service team to deliver tailored solutions to advisors and their clients.

With increasingly sophisticated clients and advisors, it's worth kicking the tires on an SMA provider's research capabilities. They should have a research team that can quickly respond to your clients' unique requests.

Also find out if the research team generates new ideas in tax-managed investing, for example, or regularly gathers new data to make the case for socially responsible investing. Do they have teams dedicated to testing hypotheses, busting myths, and diving deeply into the issues that really matter to investors—or should matter, if only they were aware of them?

### How closely does the SMA provider focus on tax management?

For many high-net-worth investors, taxes can represent a larger drag on returns than fees or trading costs. As a result, taxes often have a major impact on the long-term growth of a portfolio. That's why your SMA provider should take a rigorous approach to tax management.

Find out how long they've been tax-managing their clients' portfolios. It's one thing to say you do it, but it's quite another to have deep experience and expertise in this hard-to-get-right field.

Ask whether the provider can fund accounts in cash and transition in-kind securities. Funding an SMA with preexisting securities and then tax-efficiently transitioning to an index-like portfolio is a major benefit over ETFs. Ideally the SMA provider will help fund the account in a manner that avoids unintended gains and aligns trades with your clients' tax and risk sensitivity.

Finally, spend time understanding the provider's approach to harvesting tax losses—especially if a client has multiple SMAs. Gauge whether the manager can coordinate tax management across all portfolios to ensure that losses realized in one account aren't washed out by trading in another account.

### The bottom line

Just as investors and advisors for decades have been increasingly compelled by indexing's overwhelming logic, now direct indexing is also reshaping conversations about investing. It's making advisors think holistically about what's best for their clients. At the same time, more and more investors are pressing their advisors for greater customization and resisting one-size-fits-all portfolio solutions.

Advisors should think hard about both the benefits and costs of direct indexing for each of their clients. Because the last thing an advisor should do is put them in a portfolio they're unsuited for or that fails to properly deliver the benefits of direct indexing.

Successfully managing an SMA isn't easy. Too often investors default to a commingled fund or accept an SMA offering with little room for customization. It's worth the time it takes to find a provider that can continuously monitor your clients' portfolios, systematically harvest for tax losses, allow customization to express your clients' values, and target common or bespoke market segments. In other words, you're looking for a provider that delivers market exposures with much, much more. Isn't that what your most valued clients deserve?





## Brian Langstraat, CFA, Chief Executive Officer

Brian is responsible for Parametric's firmwide strategy and organizational development. Since joining Parametric in 1990, Brian has held positions in portfolio management, product development, portfolio administration, marketing, and client service. In 2014 he was elected to the Eaton Vance Corp. board of directors. He has a BA in economics and sociology from the University of Washington.



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