



CERULLI
ASSOCIATES



WHITE PAPER

Improving Client Experience: Customizing with Direct Indexing

August 2021

An Idea That's 30 Years New

We have witnessed in recent years the impressive growth in assets in custom passive separately managed accounts (SMAs). More and more investors and their advisors are recognizing the value—the tax advantages, the flexibility, the ability to tailor to client mandates—these SMAs offer. As a result, M&A activity has bolstered asset management firms' offerings in this category—so much so that these solutions have drawn a new label: direct indexing. While the name may be new, the value and appeal of this approach is not. In fact, it's one Parametric pioneered in the early 1990s.

In light of direct indexing's growth, now is a good time to explore this space and create a better understanding of what direct indexing is, what it isn't, and how advisors are using it to improve outcomes for investors and, in turn, for their own practices. Parametric is pleased to sponsor Cerulli's first-of-its-kind study of direct indexing's lexicon, benefits, market adoption, and growth drivers. We hope you find this report useful and enlightening.



Brian Langstraat, CEO
Parametric

Methodology

In 2nd Quarter of 2021, Cerulli Associates was engaged by Parametric Portfolio Associates LLC (Parametric), a registered investment advisor, to publish a whitepaper on the current state and future of direct indexing. For original research, Cerulli conducted 35 executive interviews with various industry participants, including financial advisors managing a minimum of \$250 million in assets under management. Of these advisors, 12 were introduced to Cerulli by Parametric as users of their solution. The whitepaper also draws from Cerulli's industry-leading databases, including their financial advisor survey (over 1,500 responses annually), managed accounts surveys (over 90% of industry assets reporting quarterly), retail investor survey (over 7,000 affluent investors annually), and wealth management market sizings (widely recognized as the industry's most reliable).

Defining Direct Indexing

KEY POINTS

Leading direct indexing solutions are customized separately managed accounts (SMAs) that provide investors direct ownership of individual securities in an index-like solution. The primary objective is beta exposure that can be customized and improve outcomes by leveraging tax efficiencies, ESG, factor tilts, and thematic investing. Unlike mutual funds or ETFs, direct indexing provides individual portfolios with greater control to harvest gains and losses at the individual security level, while staying in risk and tracking error bands.

Direct indexing allows investors to directly own all or a customized assortment of the individual securities in an index, without purchasing a fund. Unlike mutual funds or ETFs, direct indexing provides individual portfolios with greater control to harvest gains and losses throughout the year on the individual security level. It provides this flexibility without significant drifting from the client's risk tolerance and desired tracking error or needing to sell an entire fund to tax-loss harvest.

At the core of direct indexing, the leaders in the space are offering customized separately managed accounts (SMAs)

for passive mandates for their affluent and HNW clients. The primary objective is beta exposure that can be customized and improve outcomes by leveraging tax efficiencies, ESG, factor tilts, and thematic investing.

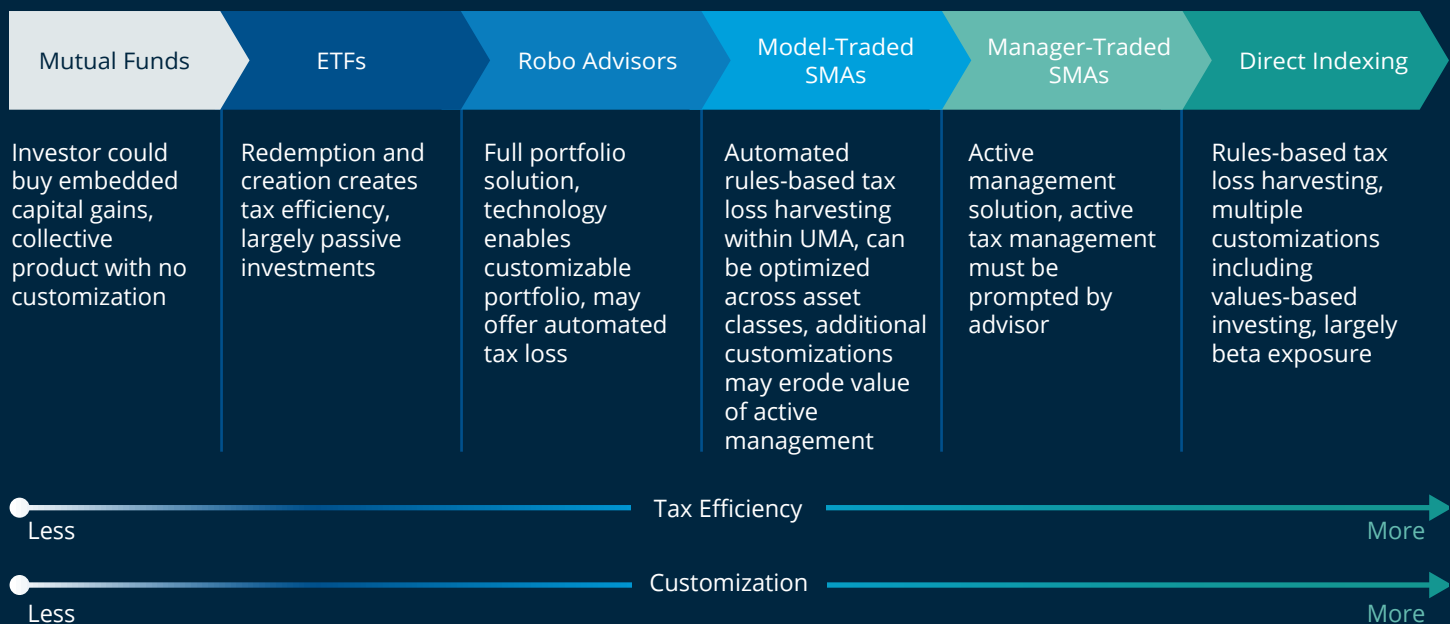
The concept of customizing beta exposure is not new. Major asset managers have been doing this for institutions for years. The applications are wide-ranging, but direct indexing is not a fit for every client or situation. Although advisors primarily employ the solution as a core position, rarely is it a full portfolio solution. There are relatively high minimums, which puts



Clients don't understand the compounding impact of taxes to a portfolio and long-term returns, but they all do know that they don't like paying taxes."

—RIA

Tax Management and Customization Features of Retail Asset Management Solutions, 2021

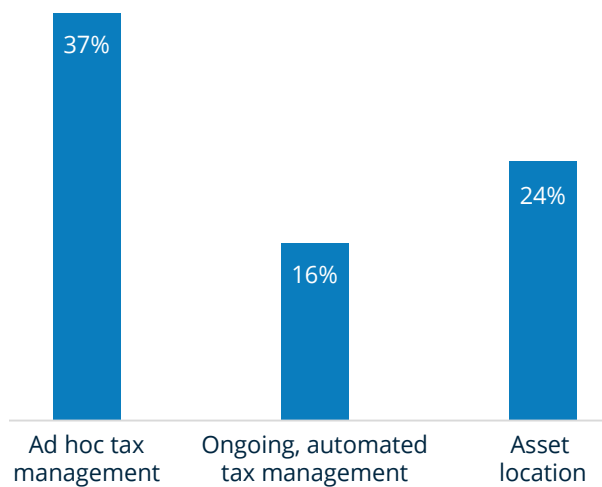


Analyst Note: Categories are ranked by potential for tax efficiency and customization and not their current use.

most candidates in wealthier asset tiers and higher marginal tax rate. Although less affluent clients could benefit from the tax optimization and environmental, social, and governance (ESG) features, the cost-benefit analysis of tax efficiency can be less compelling because the majority of their assets are commonly held in nontaxable accounts.

A true direct indexing solution is best applied against a passive exposure as a starting point. Actively managed SMAs have migrated into the retail channels. The value proposition of retail separately managed accounts (SMAs) is similar to direct indexing—by owning the underlying securities, clients can invest in a more tax-efficient manner than mutual funds, where they might be subject to embedded capital gains. Retail SMAs offer the potential for automated tax-loss harvesting, but just 16% of advisors are taking advantage of this. Active SMAs are intended to seek Alpha—tax loss harvesting may erode the portfolio manager's intellectual capital.

Proportion of Retail SMA Assets Subject to Tax Management Strategies, 2020



Sources: Cerulli Associates

Maturation of Wealth Management

KEY POINTS

The wealth management industry continues to mature from a sales- and transaction-based legacy to a focus on financial planning, outcomes, and investor goals. This has been accelerated by the commoditization of investments, growth of new competitors, and access to information. Wealth managers experienced in financial planning must continue to differentiate their service models as new entrants can reach scale and compete faster.

Although the decades-long trend of practices migrating to the hybrid and independent registered investment advisor (RIA) channels has fueled the growth of the fiduciary model, across all intermediary channels, nearly half of the industry's total wealth management assets are now managed under a fiduciary standard. This is up nearly 20 percentage points since 2009 and equates to \$11.3 trillion in client assets. This trend has shifted the way practices run their businesses, including how they deliver services, construct financial plans, charge fees, and consume investment products.

As portfolio construction, analytics, and trading tools become accessible directly to investors, several services and products that were once mainstays for financial advisors are being commoditized. Technology, combined with the growth of ETFs, continues to threaten the profit margins of any practice trying

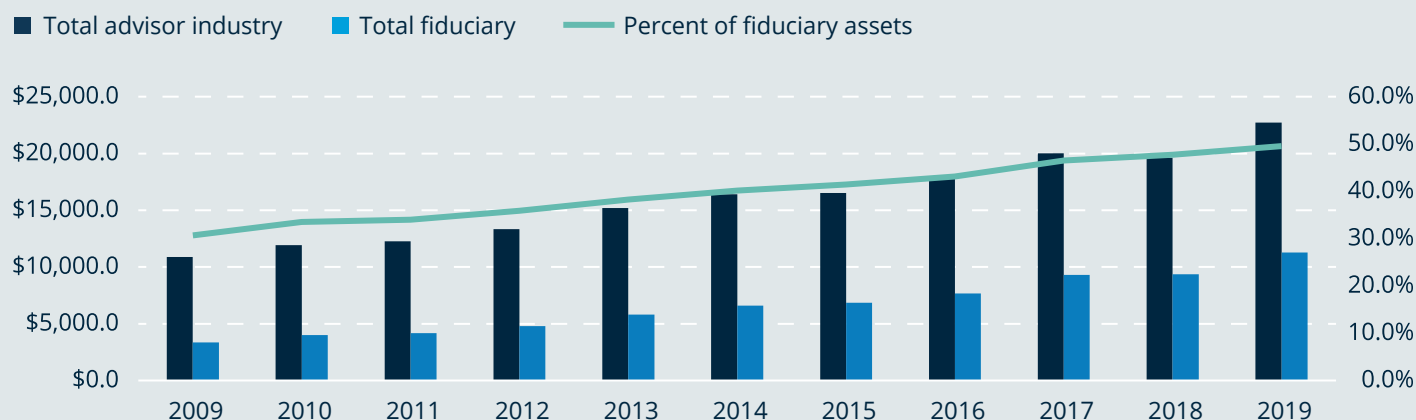


Ten years ago, when we went fee-only and introduced some hourly fees, we sat down with our clients. To this day, I'm disturbed with the number of clients that didn't realize how they were actually paying us to manage their entire life savings. Is that a reflection of us or them?"

—Wirehouse Advisor



Fiduciary Asset Sizing, 2009-2019



Sources: Cerulli Associates, Meridian IQ, Investment Company Institute, Insured Retirement Institute, VARDS, Strategic Insight/SIMFUND, Investment News, Judy Diamond, Department of Labor, PLANSPONSOR, S&P Capital IQ MMD, Financial Planning, Financial Advisor Magazine, Investment Advisor Magazine, and Cerulli Associates, in partnership with the Investment Management Consultants Association, WealthManagement.com, the Financial Planning Association, and OnWallStreet.

Analyst Note: Analysis assumed 20% of turnkey asset manager provider (TAMP) assets were held with RIAs, these assets were removed to prevent double counting. Additionally, assets held by direct providers were removed. Cerulli implemented a methodology change in 2019, resulting in an adjustment to historical headcount and AUM figures for the insurance B/D and national and regional B/D channels.

to scale its businesses via search and selection and transactional trading. Flows to passive products accelerated coming out of 2020's downturn and flows to global equity and fixed-income ETFs have continued to accelerate. In total, advisors now report 16% of assets being allocated to ETFs, which is anticipated to increase to 19% by 2022. Active asset management fees will be further compressed as ETFs grow and the buying power of scalable intermediaries only increases.

Investor fee awareness is also on the rise. In 2020, 45% of investors either didn't know what they were paying their advisors or thought their services were free, which is down from 64% in 2011. However, it's undeniable that the large advertising spend of direct providers, such as Fidelity or Schwab, has impacted investors, who are increasingly questioning the costs and perceived value of advice among "traditional" wealth managers.

Awareness Leads to Planning

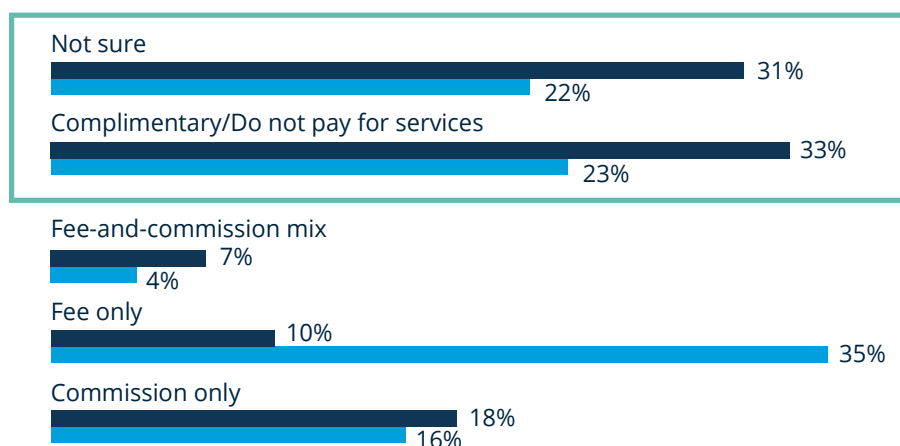
KEY POINTS

Despite fee compression felt by home offices and asset managers, the majority of practices have not reduced their advisory fees. Instead, many are expanding their services to better differentiate. This has led to an industry shifting from investment returns to investor outcomes.

How long can wealth managers stand out and differentiate their offerings based on their planning capabilities as fast-followers and as technology continues to permeate the marketplace? Advisors have to contemplate whether they can incorporate additional planning services effectively at the same fee levels or whether they are best off strategically outsourcing aspects of their businesses.

Investor-Reported Fee Structure, 2011-2020

■ 2011 ■ 2020



Sources: Phoenix Marketing International, Cerulli Associates

Practice Type Comparison, 2019

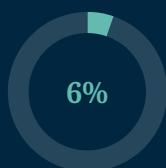
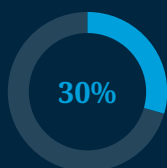
Financial Planner

Full range of planning services, including income, tax, and insurance

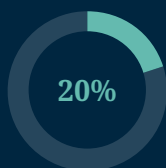
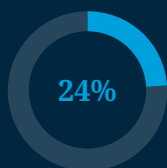
Wealth Manager

Complete range of planning services; emphasis on complex estate, charitable giving, and business planning

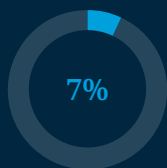
Percent of Industry Practices



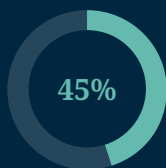
Percent of Industry Assets



% of Practices with Core HNW Focus (i.e., >\$5M)

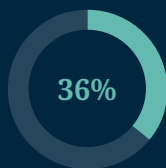
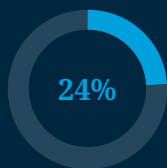


66% have a core market of >\$500K



71% have a core market of >\$2M

% of Practices with Dedicated Financial Planning Specialist or Paraplanner



AUM per Practice

\$172.1

\$774.6

Number of advanced planning services offered

1 2 3 4

1 2 3 4 5

Sources: Cerulli Associates, Meridian IQ, Investment Company Institute, Insured Retirement Institute, VARDS, Strategic Insight/SIMFUND, Investment News, Judy Diamond, Department of Labor, PLANSPONSOR, S&P Capital IQ MMD, Financial Planning, Financial Advisor Magazine, Investment Advisor Magazine, and Cerulli Associates, in partnership with the Investments & Wealth Institute, WealthManagement.com, and the Financial Planning Association® (FPA®)



Tax harvesting is fundamental. The problem is, the greater the wealth, the more complex strategies...How do we balance building the most protection, while making it not so complex that it overwhelms them? It can't come off as an up-sell. Plus, it's hard to scale this across all clients and time it perfectly."

—Wirehouse Advisor

If key portfolio construction tasks are outsourced, practices will not stray from their convictions or forfeit their ability to manage tax implications and customize portfolios. Customizing portfolios due to concentrated or legacy holdings, demands for sustainable investing, and charitable aspirations is a prerequisite when working with high-net-worth (HNW) families.

To keep a competitive edge, practices should look to round out their services in scalable but customizable ways, which can be somewhat counterintuitive. For example, practices working upmarket will have direct relationships with their clients' outside tax professionals, but the mere concept of taxes can be problematic for advisors. Yet advisors have the best view into a household's entire financial picture and potential tax implications in real-time, even when compared to their accountants. Many sophisticated advisors are using the tax-optimization and customization features of direct indexing as a way to create demonstrable value for their clients and improve outcomes.

Financial Planning Clients, 2020 vs. 2022E

■ 2020 ■ Planned for 2022

Comprehensive ongoing planning advice



Targeted planning to address a specific client need



No financial planning services



Sources: Cerulli Associates, in partnership with the Investments & Wealth Institute and the Financial Planning Association® (FPA®)

Applications for Direct Indexing

KEY POINTS

Direct indexing's most quantifiable value is tax optimization and the resultant tax savings. Leading advisors view the tax optimization as a unique and tangible value they can deliver to their clients. However, the solution offers additional customizations to clients, such as responsible investing, flexible onboarding, and tax-optimized charitable giving.

Core to the definition of direct indexing in the previous section are the automated tax advantages, which have the opportunity to create tax savings for clients. However, direct indexing empowers multiple other customizations, such as matching an investor's personal values or empowering their charitable giving.

Managed Account Sponsors' Assessment of the Opportunities for Direct Index Customization, 2021

Analyst Note: Sponsors were asked to stack rank opportunities for direct indexing on a scale of 1 to 6. Sponsors' top-ranked attributes are shown as Major Opportunities while Moderate Opportunities represent their second- and third-ranked choices.

■ Major Opportunity ■ Moderate Opportunity

Ongoing tax optimization (through an overlay portfolio manager and/or an algorithmic process)



Tax management for accounts that are transitioning



Environmental, social and governance (ESG) factors



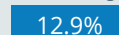
Factor investing (Tilting portfolio toward momentum, value, low volatility, or income)



Thematic Portfolios (Portfolios tailored to specific investment themes)



Excluding industry sectors



Source: Cerulli Associates

Tax Optimization

The concept of tax-loss harvesting is not new to most advisors. Many of the advisors with whom Cerulli spoke described a process of going through their clients' holdings at year end to identify potential tax losses. However, this can be at best an inefficient process as it forces the advisor to find these positions manually. Furthermore, it presumes that specific holdings are down in 4th quarter, when the process occurs. It excludes temporary losses that might occur earlier in the year. There is no better example of this than the market downturn in 2Q 2020, when the U.S. shut down due to COVID-19, only to see the capital markets reach a record high by year end. The technology of an established direct indexer could have taken advantage of this opportunity to create tax losses.

The heaviest users of direct indexing view the tax optimization capabilities as core to their value proposition. Because, as noted earlier, access to investment products and, therefore, to investment returns is no longer a differentiator, the tax savings generated by direct indexing are a way for these advisors to generate quantifiable value for their clients. Direct indexing potentially generates tax savings that can mitigate some of the impact of market drops for investors. One advisor on a >\$1 billion wirehouse team said, "Many practices are looking to say, 'This is my solution, my model.' This is not stocks long, it's a different model." For this advisory team, direct indexing was a differentiator as other advisors did not offer it.



This is a long-term wealth enhancement. It's going to be passed down generations. We start to look like an endowment because our duration is rather large. It's a core portfolio, tax-loss harvesting is the focus. Satellite [investments] is where we try and add alpha."

—Advisor at a Multi-Family Office

However, the potential tax advantages can be challenging for investors to understand, particularly as most think in terms of investment performance. This can be a challenge even for clients who are sophisticated investors. One multi-family office advisor stated, “We have three families who are investment professionals, the other 30 are widget makers. None fully understand. What we can show them through reporting, we can show the source of the gains they've earned. The investment implications are still going to be lost on them.” This confusion is compounded because tax savings from harvesting can potentially mitigate losses for clients in a down market.

Long-term users of direct indexing did acknowledge that the tax benefits of direct indexing declined over time. Because losses from poorly performing stocks had already been harvested, there were fewer opportunities to create losses the longer the portfolio was held. These advisors, however, were all long-term users of direct indexing and remained very positive about the value of the product. There are ways to work around a potentially locked up portfolio. For example, the client can add cash to refresh the portfolio while donating highly appreciated securities. Likewise, the client still may value the personalized value screens associated with their account.

ESG and Values-Based Investing

Beyond tax optimization, the ability for investors to match their investments to their personal values is another potential benefit of direct indexing. For wealth management advisors, the values discussion is a natural extension of their client profiling process. Many described the values discussion with their clients as a natural part of their client conversations. One advisor at a >\$1 billion RIA said, “Typically, the client is going to discuss their opinions, life goals...what's important to them...family, faith, environment. We listen to them and pay attention...They light up when we talk about it (ESG)—they don't know it is an option.” For investors who did not know that value alignment was an option, this is another example of how advisors can personalize portfolios and deliver tangible non-investment-return value.

Values-based investing is most commonly associated with investing in an environmentally aware fashion. The consideration of environmental factors is increasingly moving into the mainstream. One interviewee cited the increasing availability of data from organizations such as the United Nations Principles for Responsible Investing (UNPRI) to help measure the true impact of environmentally aware investing.

In fact, 44% of affluent investors preferred to invest in companies that have a “positive social or environmental impact.”

There remains a misconception that responsible investing is only about the environment. Responsible investing can be applied to a wide variety of issues. Multiple Parametric employees referenced developing a screen for a client to exclude companies that were involved in human trafficking. The neutrality to client value raises the potential application of applying screens to a portfolio that take into account a client's specific religious values, such as Baptist or Muslim.

Interestingly, the ability to match investment portfolios with social values opens up applications for mission-driven institutions. Endowments, foundations, and other long-term investing pools can ensure that their investments reflect their mission and values. As one direct indexing executive said, “This all helps reduce headline risk for organizations with social risk around their investment philosophy.” One of the key values that direct indexers provide, however, is that the portfolio still tracks certain characteristics, even as securities are being excluded.



“We have an investment policy statement for each client—and we address ESG in this. Client can decide how far they want to go with ESG, or to not go at all. Only a couple have ignored it totally.”

—Independent Advisor Focused on the UNHW Market

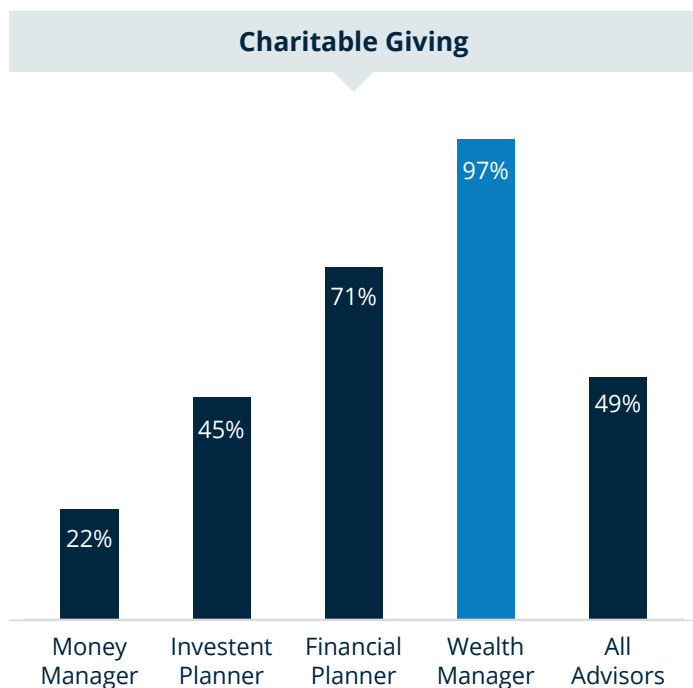


Charitable Giving

Another potential customization is matching a client's values with tax optimization in order to drive their charitable giving. Again, one must view this application as part of a holistic wealth management and another opportunity for wealth management advisors to deliver client value. Nearly all wealth managers (97%) offer charitable planning. Rather than harvesting losses from stocks that have declined in value, the advisor and investor can find ways to donate highly appreciated securities. They might be donated directly to a specific charity. More likely, they are donated to a donor-advised fund, where the investor might be able to direct funds to multiple charities.

The holistically minded advisor tracks a client's charitable intentions as part of their overall financial plan. One multi-family office advisor described a year-end process of looking for appreciated securities as part of a year-end planning process: "Every year we look through [direct indexing] portfolios to find appreciated stock for this...especially since the bull run we've had." Leading direct indexing solutions can automate and optimize this process to take advantage of mid-year market fluctuations.

Advanced Planning Services Databank, 2020



Sources: Cerulli Associates, in partnership with the Investments & Wealth Institute and the Financial Planning Association® (FPA®)

Other Customizations

Another tax-efficient feature of direct indexing prevails when financial advisors onboard a new client. Affluent clients likely already have individual securities holdings. These holdings could be owned as part of an existing separate account position, the client could have generated their wealth through equity compensation at a publicly traded company, or they may have inherited a long-term holding with a low cost basis from their family. Whether the client is seeking to diversify a concentrated position or transition from another asset manager, the various functions of direct indexing can help them do so. As noted above, they can plan to donate shares to fund charitable means. Or the investor and advisor can work with their direct indexing provider to design a plan to slowly exit a highly appreciated or concentrated equity position.



“[Clients] come in with portfolios which are under performing, and we didn’t want to just sell the portfolio out, so [our Direct Index provider] brings this in and builds the index exposure. It saves the client from the taxes.”

—Independent Advisor Focused
on the UHNW Market

Another key customization is that of industry exclusions. If a client has significant holdings in their employer's stock, they can exclude this industry from being included in portfolios. Even if they just work in a specific industry, it may make sense to diversify their household balance sheet by underweighting the industry. Direct indexers also offer the ability to custom benchmark to give clients specific exposures. Finally, direct indexers can help advisors tilt the portfolios to express a specific investment view. Examples of this could include a tilt toward value stocks, different capitalizations (e.g., small cap vs. large cap), or blending indices.

The Future for Direct Indexing

KEY POINTS

Direct indexing is a solution used by a focused group of advisors for their largest clients. Even a modest increase in adoption among this segment can drive assets higher. However, the increasing influence of technology, low-cost trading, and new market entrants could serve to bring this solution downmarket.

Direct indexing is not a new concept. Originally introduced nearly 30 years ago for family offices, the technology-driven solutions have come downmarket over the past two decades. Asset minimums remain wide-ranging across providers, with AUM market leader, Parametric, settling at \$250,000. As a result, direct index assets claimed nearly one-fifth of the industry's total retail separate account assets in 2020. And, as observed in the leaderboard, combined, the top-two providers control a dominating 46% of total AUM.

Despite its advantages, direct indexing remains a niche product totaling a little over \$300 billion in assets and used by a small group of advisors for high-net-worth and ultra-high-net-worth clients. Cerulli projects direct indexing to grow at an annualized rate of over 12% over the next five years, faster than traditional financial products, such as mutual funds, ETFs, and separate accounts. Cerulli believes growth in the short term will continue to come from high-end advisors broadening their use of the solution.

2020 and 2021 have seen a renewed interest in direct indexing from the industry. Morgan Stanley bought asset manager Eaton Vance, which counted Parametric, the sponsor of this paper, among its investment affiliates. BlackRock, one of the industry's largest asset managers, bought Aperio. In addition, major wealth management platforms, such as Fidelity, Schwab, and Vanguard, began offering this service. Providers of direct indexing welcome the new competition as a positive for the industry as it would continue to raise awareness of the benefits.

Top Providers of Direct Index SMAs, 1Q 2021 (\$ millions)

Firm	1Q 2021 AUM
Morgan Stanley (Parametric Portfolio Associates)	\$120,005.0
BlackRock (Aperio Group)	\$44,996.4
Fidelity Investments	\$24,000.0
Columbia Threadneedle	\$6,249.0
Natixis Investment Managers (Active Index Advisors)	\$4,736.3
Envestnet	\$3,408.8
JP Morgan (55ip & OpenInvest) ¹	\$1,400.0
O'Shaughnessy Asset Management, LLC	\$1,227.1
Vanguard (JustInvest) ¹	\$752.0
Ethic ¹	\$672.0
SmartX ¹	\$171.0
Russell ¹	\$50.0
Other Industry Assets ²	\$155,000.0
Total	\$362,667.5



“Our direct indexing partner’s reporting allows us to use real-life examples. We can show clients the actual sources of realized losses and how that impacts the capital gains benefit.”

—RIA

Direct index separately managed accounts represents a **\$362 billion market**

Source: Cerulli Associates
Analyst Note: Assets are limited to retail U.S. clients. Figures do not include institutional assets, global (multinational) accounts, or bank trust accounts.

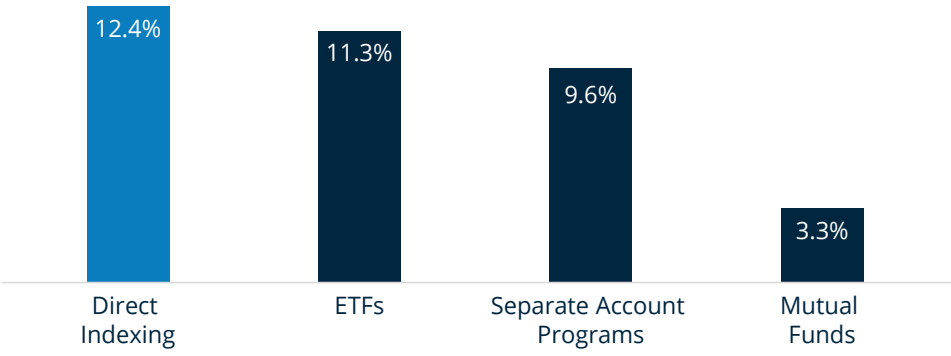
¹ Cerulli Estimate

² Other Industry Assets includes two sizable firms that have asked Cerulli not to reveal their direct indexing assets.

Ultimately, many advisors Cerulli spoke with felt that direct indexing could benefit from better quantification of its value. However, this is no small task given the inherent personalization of the tool. However, case studies of other advisors' success have always been one of the best ways to drive broader adoption of a new product or service. Cerulli believes that direct indexing providers should create some sort of standardized measurement that could quantify the value of their product.

Thus, for advisors to use direct indexing, they must be comfortable with passive investing. However, a strong belief in the value of active management can be an obstacle to use of direct indexing for advisors and investors. There exists a segment of advisors and investors who remain dedicated to active management. An independent advisor focused on ultra-high-net-worth clients said, "We do this [direct indexing] when we have stock concentration, but we try and exit this when we can because you can't beat the index. We don't see the tax value outweighing the cost of direct indexing... I do believe in value of customization

Projected 5-Year Growth Rates by Product



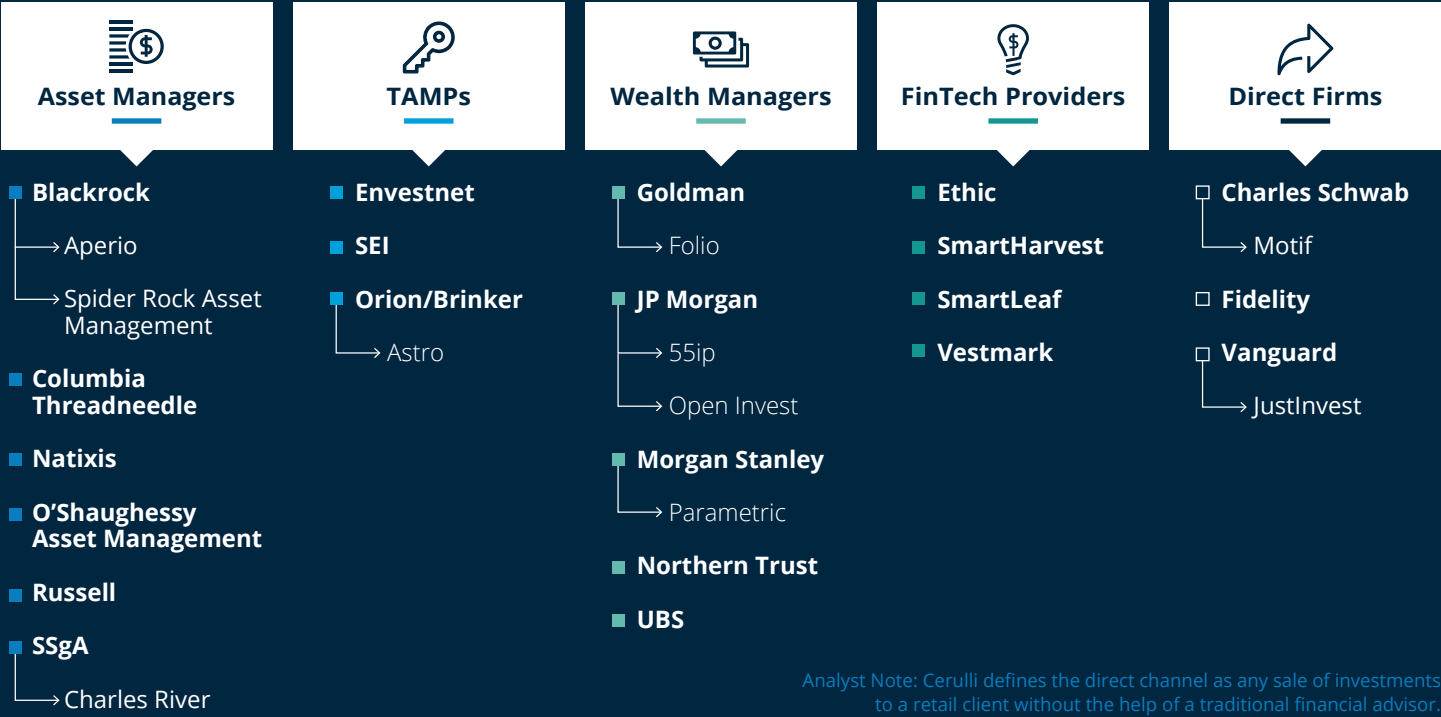
Sources: Cerulli Associates

but the fee on top of my fee, it's hard to rationalize. We are looking to create alpha—they are looking to harvest losses and keep up with the index." While this advisor is a believer in direct indexing, they view it as a transitory tool while they moved toward actively management investments.

Finally, for direct indexing to continue to move into the mainstream of wealth management, there must be acknowledgement that despite being technology driven, there must be a human aspect. Successful providers will balance the needs of scale and

personalization to make onboarding and support systems seamless in order to improve investors' outcomes. As direct indexing grows, the most experienced providers will be best equipped from the perspective of supporting personnel and tools, tracking, reporting, and resolution across tens of thousands of accounts. It is key to remember that the largest providers' roots are in servicing family offices, even if they have come downmarket since, meaning they are accustomed to onboarding and supporting advisors' most valuable relationships with high-touch models.

Direct Index Ecosystem



Analyst Note: Cerulli defines the direct channel as any sale of investments to a retail client without the help of a traditional financial advisor.

Fixed Income

To date, direct indexing has primarily been used as a portfolio core, often used as a large-cap domestic holding. This aligns with the adoption of passive investing, which first took hold in U.S. large-cap stocks, a challenging asset class for active managers to add value. A lesser-known customization of direct indexing is the ability to utilize less common indices or design a custom solution by combining multiple indices to create a custom exposure. This would allow an investor to potentially apply the benefits of direct indexing to mid-cap, small-cap stocks, and global equities.

The final non-large-cap domestic equity application of direct indexing is in fixed-income securities. Similar to global equities, investors are growing comfortable using passive exposures to fulfill the high-quality fixed-income portion of their portfolio. This trend is accelerating coming out 2Q 2020's downturn as fixed-income ETFs proved their ability to withstand a liquidity crunch in the market.

The application of direct indexing to fixed income differs slightly from equities. Much like equities, investors can directly own a customized assortment of individual bonds that can replicate the risk/return characteristics of a corporate bond index. A number of asset managers, including Parametric, BlackRock and Nuveen, are offering laddered fixed income SMAs to advisors

and investors that allow them to customize portfolio characteristics.

For corporate bond portfolios, indices can be tracked, but due to the fragmentation and lot size in the municipal market, it's more difficult to track an index with small accounts. However, like equity direct indexing, fixed income direct indexing does follow a highly customizable, rules-based approach to investing. The investor and their advisor can work to build a rules-based, equal-weighted laddered portfolio that is customized for credit quality and maturity range. Although most laddered portfolios are constructed with different securities, they can be built with very similar maturity, quality, risk and return characteristics. This results in each portfolio behaving very similar to each other and potentially capturing the market beta of that asset class across the targeted maturity range.

Compared to actively managed bond portfolios, laddered portfolios allow for more predictable return outcomes with interest rate changes. Since there is no market timing of interest rates, yield curve or credit changes, investors can achieve more consistent exposure to the market. The predictability of bond pricing allows providers to accurately project the potential tax savings in higher interest rate scenarios. The tax benefits, and potential performance returns, from municipal and corporate

ladders can also be estimated using interactive online calculators provided by the major providers.

Tax loss harvesting, a key feature of direct indexing with equities, is of particular benefit for municipal bonds. When rates rise, lower book yields can be sold at a loss lowering an investor's tax bill. In turn, proceeds can be reinvested in higher yields and allowed to mature. This allows for a "subsidization" of the loss and, since the bonds mature, the investor may avoid paying a tax on gains in the future. This is a compelling benefit and is unique to the municipal bond market. However, with corporate bonds the advantages may be more muted as the investor only benefits from the present value of the tax loss benefit but that is off set by the tax on the higher future income.

Another emerging application of direct indexing for fixed income is in the application of ESG and other socially responsible factors. While values alignment is important, ESG proponents argue that more sustainable companies and municipalities should be more attractive investments going forward. This thesis applies to evaluating the credit quality of a corporation or municipality as well. Organizations that take environmental and other factors into account are less likely to default on their debt.



Moving Downmarket?

At first glance, there appears to be limited utility to using direct indexing for less affluent clients. Direct indexing has largely been a tool successfully used by high-end advisors working with high-net-worth clients. For less affluent investors, more of their wealth is held in tax-qualified retirement accounts, such as individual retirement accounts (IRAs) and 401(k)s, meaning they would not benefit from tax optimization.

The counter argument is that less wealthy investors can benefit from even modest tax savings that can add more money to their pockets. The ability to bring direct indexing downmarket is further fueled by technological developments in the wealth management industry, such as fractional shares and low-cost trading. These developments should theoretically lessen the friction associated with offering direct indexing downmarket.

In research interviews, most participants acknowledged that applying direct indexing to smaller portfolios would mean less customization in order to scale the product. In addition, most felt that a downmarket solution would need to be fulfilled with ETFs. One research participant described a portfolio using sector ETFs that could be tax-loss harvested.

Because the primary users of direct indexing are often advisors with a holistic wealth management service model, the ability to offer a low-end solution could be a way for them to work with potential inheritors of family wealth. Because these advisors often view direct indexing as a differentiator, it provides an opportunity to introduce these next-generation investors to their service mode.



Conclusion

Cerulli is optimistic about the future of Direct Indexing. In 2020 and 2021, Cerulli has observed broad market interest in advisors seeking ways to improve client outcomes through customized solutions, including Direct Indexing. Acquisitions in the space are trending, as witnessed by BlackRock acquiring Aperio, Morgan Stanley acquiring Eaton Vance (Parametric's parent company), and Charles Schwab acquiring Motif.

As the wealth management industry continues to shift to a focus on planning and objectives, the customization features of Direct Indexing allow providers to strike the balance between customizing portfolios to an investor's objectives while maintaining a predictability of returns. The volume of scale players acquiring these capabilities makes it inevitable that technology-driven, highly customizable solutions will come down market despite the debatable tax benefits for less-affluent investors. In addition, the growing advisor and investor acceptance of aligning their investment portfolios with their social values will drive demand for customization. Ultimately, the evolution of the wealth management landscape aligns with the value proposition of Direct Indexing, creating a positive outlook for the solution.



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