



The Case for Direct Indexing

Differentiation in a Competitive Marketplace

December 2022

Raise your benchmark

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. It's making advisors think holistically about what's best for each of 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. The last thing an advisor should do is put a client in a portfolio they're unsuited for or that fails to properly deliver the benefits of direct indexing.

Successfully managing a custom 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 partner with a provider that can continuously monitor your clients' portfolios, systematically harvest tax losses, allow customization to express your clients' values, and target common or bespoke market segments. In other words, a provider that can make passive investing personal. Isn't that what your most valued clients deserve?

A handwritten signature in dark ink, reading "Thomas Lee". The signature is fluid and cursive, with the first name "Thomas" and last name "Lee" clearly distinguishable.

Tom Lee, CIO
Parametric

Methodology

In 1Q 2022, Cerulli Associates was engaged by Parametric Portfolio Associates LLC (Parametric), a registered investment advisor, to publish a white paper focused on real-life use cases of direct indexing strategies based on insights from financial advisors. The white paper also addresses the current state and future of direct indexing. For original research, Cerulli conducted a series of executive interviews with various industry participants, including financial advisors managing a minimum of \$250 million in assets under management. Of these advisors, eight were introduced to Cerulli by Parametric as users of their solution. The white paper 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 (nearly 10,000 affluent investors annually), and wealth management market sizings (widely recognized as the industry's most reliable).

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Summary

- 2021 and 2022 saw numerous asset and wealth managers acquire technology-driven companies that allow for scalable customization of portfolios and tax management of investments.
- As advisors universally adopt fee-based models and financial planning, the line between business models is blurring, making differentiation challenging. Many wealth managers are looking to the tax management and customization features of direct indexing to create a favorable client experience.
- As new entrants begin to offer direct indexing and other customized separate account products, market awareness of these products will only increase through heightened education. Cerulli expects direct indexing to grow at an annualized rate of 12.3%, faster than mutual funds and ETFs. However, the wide range of new entrants means advisors must understand different providers' capabilities around reporting, flexibility, and trading.

Overview of the Direct Indexing Landscape

Competition continues to intensify in the wealth management industry as investors exercise more control over their portfolios and providers are challenged to differentiate their financial planning and fee-based business models. This has continued to amplify industry interest in direct indexing and, more broadly, mass customization of client portfolios, powered by advanced technology.

Three-quarters of managed account sponsors say that direct index separately managed accounts are the top product they are looking to add to their platforms from outside asset managers this year.

Differentiation is increasingly challenging for financial advisors and wealth management firms. Most advisors, regardless of firm or channel, have transitioned to fee-based financial planning built upon a holistic financial plan, making being a “fiduciary” less of an outlier and more the norm. Adding the ability to customize portfolios, either for taxes, personal beliefs and values, or a unique financial goal (e.g., selling a business or unwinding a concentrated stock position), gives advisors a way to create a unique client experience to potentially stand out from their peers.

Driven by this demand, asset managers continue to develop their ability to offer customized portfolios to advisors and their clients. This has been driven in part via mergers and acquisitions (M&A). Following on the heels of BlackRock’s acquisition of Aperio and Franklin Templeton’s acquisition of O’Shaughnessy, in the first half of 2022, First Trust acquired Veriti Management to gain access to its direct indexing platform, and RIA consolidator Hightower made an

investment in a \$2.7 billion direct-index-focused firm. Despite significant M&A, the direct indexing market is still dominated by legacy early entrants, such as Parametric, which is the largest provider of direct index SMAs, and Aperio. However, it must be noted that these two firms were acquired by Morgan Stanley and BlackRock, respectively. Cerulli anticipates that this demand and interest will lead to a surge in assets, with direct indexing assets growing at a five-year compound annual growth rate (CAGR) of 12.3%, and closing 2026 with \$825 billion in total assets. This growth is expected to exceed that of ETFs, mutual funds, and the overall separate account market.

Direct index providers are also taking steps to develop their offerings further to better integrate with the needs of their distribution partners. Providers in general are touting the benefits of mass customization and pushing to make customized portfolios available to a greater swath of clients and advisors. Direct index managers are taking steps to offer their strategies in fractional shares. Fractionalization is also a key priority for broker/dealer firms, with Morgan Stanley announcing fractionalization capabilities within its unified managed account (UMA) becoming available in 4Q 2022. Providers are also taking steps to build out asset classes offered in their direct index strategies, moving from large-cap domestic equities to international, small cap, and, in some cases, fixed income. Better integration with the overlay portfolio manager within a UMA program is another key development that managers are striving toward in order to provide the investor with a more holistic experience.

Managed Account Sponsors: Attractiveness of Investment Products or Solutions, 2022

Direct index separate accounts

75.0%

ESG investment solutions

62.5%

Model-delivered separate accounts

46.9%

Income solutions

40.6%

Strategic asset allocation model portfolios

31.3%

Manager-traded separate accounts

25.0%

Active ETFs

25.0%

Less liquid alternatives (private equity)

25.0%

Tactical asset allocation model portfolios

12.5%

Passive ETFs

3.1%

Liquid alternatives in '40-Act structure

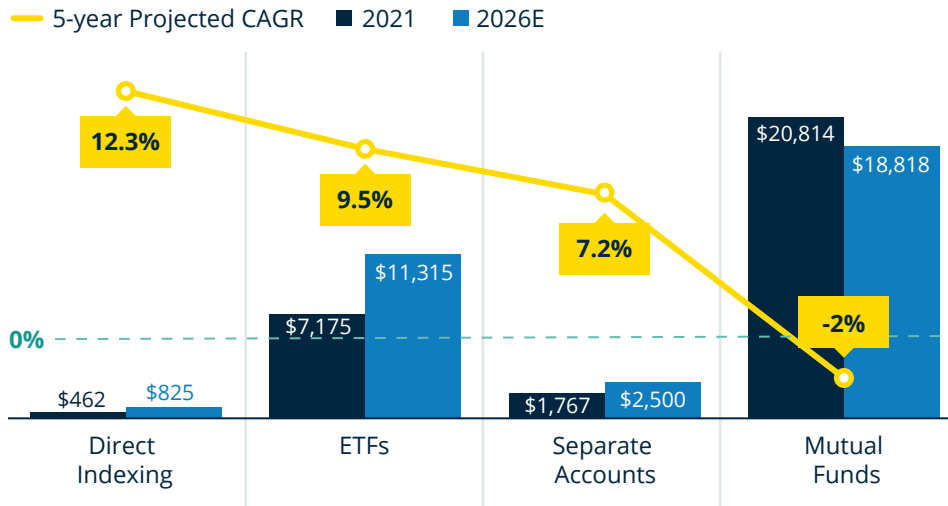
3.1%

Interval funds

3.1%

Source: Cerulli Associates | **Analyst Note:** Participants were asked, “What investment products or solutions are you most interested in adding to your platform from outside asset managers?” No participant selected closed end funds, UITs, CITs, or MLPs.

Projected Growth of Investment Vehicles, 2021-2026E (\$ billions)



Sources: Cerulli Associates, JP Morgan, Morningstar Direct

Considerations When Evaluating a Direct Indexing Provider

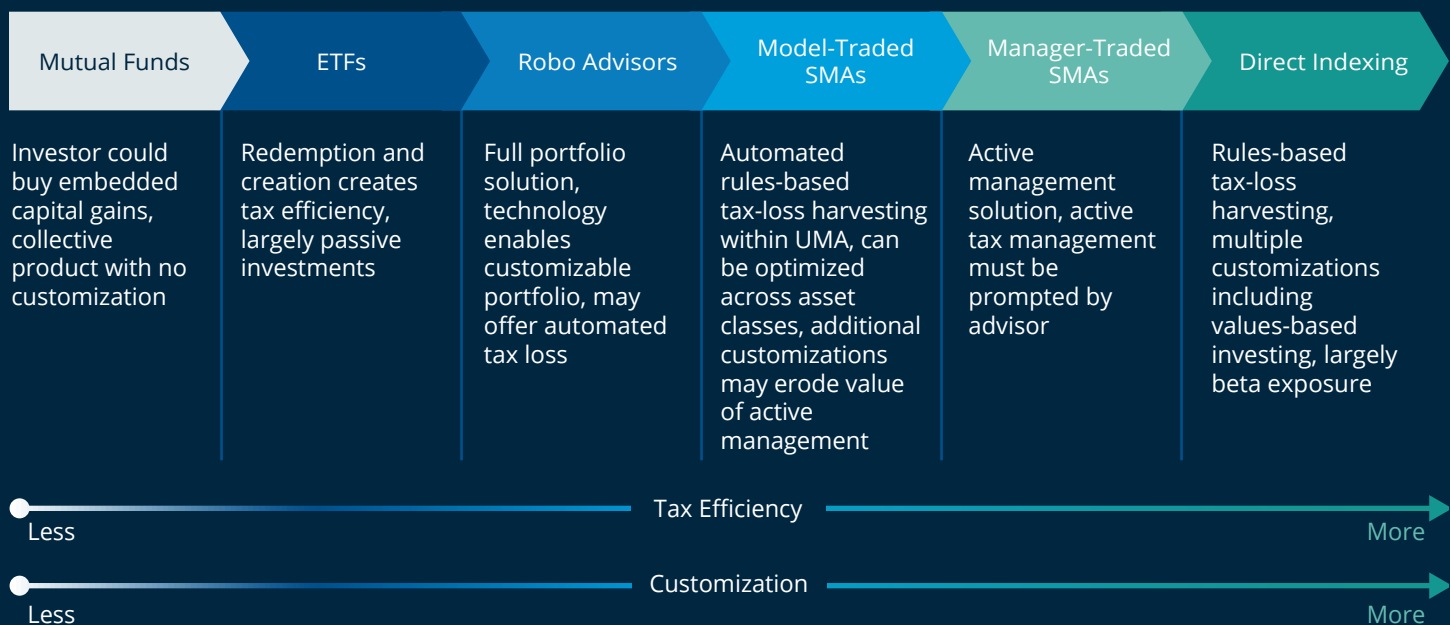
As more firms step into mass customization, it becomes incumbent on advisors to understand and compare the capabilities of potential providers. First, advisors must understand their direct indexer's methodology for tax-loss harvesting and the frequency with which trades are being evaluated. This

is exemplified by what occurred in April 2020, when capital markets suffered a severe downturn at the start of the pandemic, creating a major tax-loss harvesting opportunity before markets rebounded for an extremely strong year. Leading direct indexers are monitoring portfolios daily, allowing the investor to benefit in volatile markets. Second, the advisor must evaluate their direct indexer's technology offerings. This in

part encompasses the advisor interface and their ability to customize and then monitor portfolios. However, a leading technology offering should also support client reporting, so that an advisor can easily explain to their clients how they benefit from direct indexing. While the need for reporting largely applies to tax savings now, it is likely that investors will look for reporting on environmental, social, and governance (ESG) portfolios to understand the impact of their choices.

The most headline-grabbing development, however, has been the move downmarket by some providers. In a similar white paper released in 2021, Cerulli predicted direct indexing would come downmarket, powered by low-cost trading and fractional shares. In early 2022, Fidelity announced plans to offer a \$5,000 account minimum direct indexing solution, allowing retail investors to customize on several pre-selected factors and screens. Several weeks later, Altruist, a platform provider for financial advisors that brands itself as "The Shopify for RIAs," announced plans for a \$2,000 minimum direct index account. Both of these strategies are made possible by increased capabilities in fractional share trading.

Tax Management and Customization Features of Retail Asset Management Solutions



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

Despite the splashy nature of these headlines and the excitement garnered by bringing a solution that was once only available to the highest of high-net-worth clients to market for nearly any investor, Cerulli does not believe ultra-low-minimum direct index solutions are the ripest fruit for product expansion in the short term. Most of these investors hold the majority of their wealth in tax-deferred retirement accounts, such as IRAs or 401(k)s, and therefore the addressable market is modest. Rather, the biggest growth will come from financial advisors servicing mass-affluent and high-net-worth clients who have not yet been introduced to direct indexing.

Providers should not turn a blind eye to downmarket customization solutions. The increased influence of technology has allowed providers to scale customized solutions in other industries. Likewise, the industry sits at the precipice of a major wealth transfer from Baby Boomers to the next generation. Many industry providers are taking steps to capture these currently low-balance accounts before they inherit wealth from their parents.

Cerulli believes the flood of new providers will increase both awareness and adoption of direct indexing among financial advisors. Recent Cerulli surveys have shown that only 14% of financial advisors are aware of, and recommend, direct indexing solutions to their clients. This is despite 63% of financial advisors serving clients with a core market of more than \$500,000 in investable assets, and 14% targeting a core market of more than \$5 million.

It is these higher-balance clients who can best take advantage of the tax and personalization options. Simply put, many financial advisors with clients who are best suited for direct indexing are not using these strategies in their practices. As direct indexing becomes more mainstream, that 14% figure is poised to rise substantially in coming years. As such, Cerulli expects that assets will grow at an annualized rate of

Financial Planning Clients, 2021 vs. 2023E

■ 2021 ■ Planned for 2023

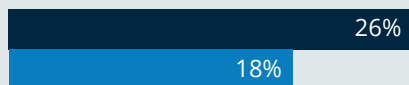
Comprehensive ongoing planning advice



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®)

12.3% over the next 5 years, faster than mutual funds and ETFs.

This scarcity of use among financial advisors has allowed those who do implement direct indexing in their practice to use it as a differentiator. In fact, one advisor Cerulli interviewed was somewhat dismayed by the growing awareness of direct indexing among his peers. This advisor stated, "I am disappointed this is starting to become mainstream, because I think that using direct indexing right now helps me stand out from my peers." Advisors looking to



I am disappointed this is starting to become mainstream, because I think that using direct indexing right now helps me stand out from my peers."

- Wirehouse Advisor



use it as such should begin to implement it now to remain ahead of the curve.

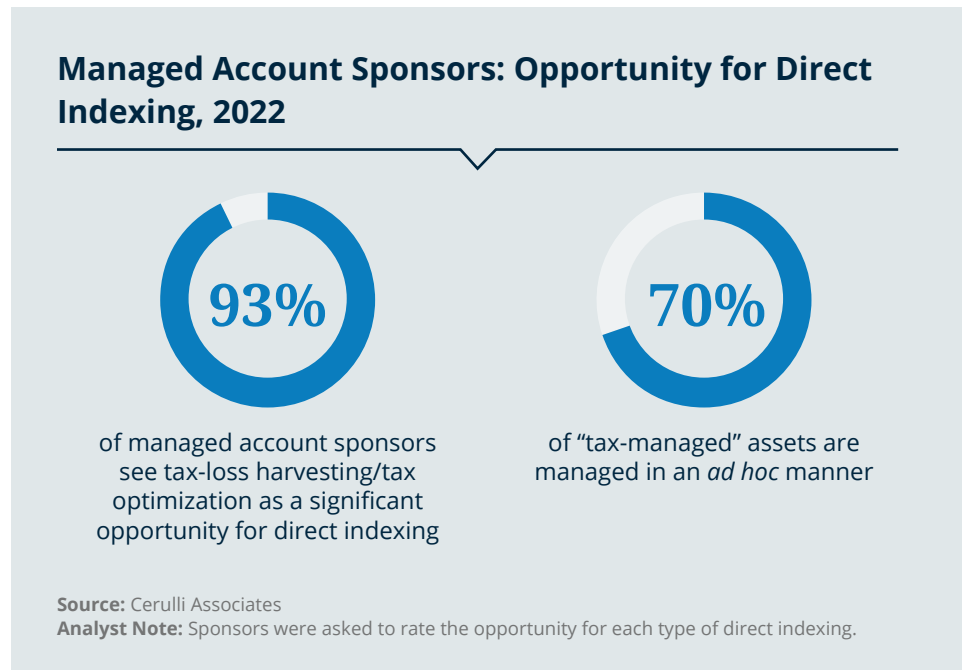
As direct indexing moves along the product adoption curve, managers must transition from product awareness to implementation of their offerings. Some providers have already begun this process, increasing the volume of education around how to implement their offerings in their practice, and what segment of clients they should consider for direct indexing strategies.

In this white paper, Cerulli presents a series of case studies, looking at how financial advisors have tangibly implemented direct indexing in their practice, and used it to generate improved outcomes for their clients.

This white paper is designed to make it easier for financial advisors to identify situations where they should be thinking about direct indexing in their practice, and scenarios where it can most benefit their clients. As one RIA advisor, formerly a head of product for a large wirehouse before leaving to build his own advice business, tells Cerulli, "Direct indexing has proven to be viable. The key is operationally figuring how to make it easy for advisors to use."

- A tax-loss harvesting process that pairs algorithmic techniques with human decision making allows investors to capitalize on loss-harvesting opportunities throughout the year, rather than just at year-end. A tax-loss harvesting process that pairs algorithmic techniques with human decision making can harvest losses in a volatile market.
- Advisors who use direct indexing in client portfolios will often pair this strategy with high-conviction, concentrated managers.
- High-net-worth investors nearly universally value managing taxes in their investments, which in many cases can improve outcomes and lead to referrals.

When speaking with advisors about the benefits of direct indexing, a common refrain arises—the quantifiable benefits of systematic tax management. Tax optimization and tax-loss harvesting are the top current use cases for managed account sponsors for advisors who are using direct indexing in their practices.



In fact, nearly all managed account sponsors surveyed by Cerulli in 2022 agree that tax-loss harvesting is the top opportunity to apply direct index separately managed accounts.

Moving from *ad hoc* tax management to an algorithmic, systematized model

through a direct indexing portfolio can create tangible value for clients that they are able to easily identify come tax season. Already, most investors, especially affluent households, are intensely focused on taxes. Recent Cerulli research indicates 68% of investors feel an account that

Households with Advisor Interaction: Desired Account Features by Investable Assets, 1Q 2022

Desirable Feature	Household Investable Assets						All Respondents
	\$100K-\$250K	\$250K-\$500K	\$500K-\$1m	\$1m-\$2m	\$2m-\$5m	>\$5m	
My account is personalized to my situation and designed specifically around my financial goals	64%	73%	80%	74%	78%	85%	75%
Regular updates on my account that helps me understand progress toward my personal financial goals (e.g., saving for retirement)	63%	75%	78%	72%	72%	77%	74%
Access to a financial advisor to help develop a plan for achieving my goals	59%	73%	74%	71%	69%	92%	72%
Regular updates on my account that help me understand how my investments are performing against investment benchmarks (e.g., S&P 500, Dow Jones Index)	67%	68%	69%	70%	70%	92%	69%
The account minimizes my tax bill by using tax-efficient investments strategies	64%	66%	70%	63%	74%	100%	68%
Ability to view all my accounts through one online login at any time	69%	67%	66%	64%	62%	69%	66%
A low-cost online-only investing account	45%	37%	33%	33%	36%	15%	35%



I got into the industry as a tax planner and preparer. I have a huge appreciation for the need to have efficiency for taxes in client portfolios.”

- RIA Advisor



minimizes taxes is the most desirable feature of said account, and this percentage rises to 100% for high-net-worth investors.

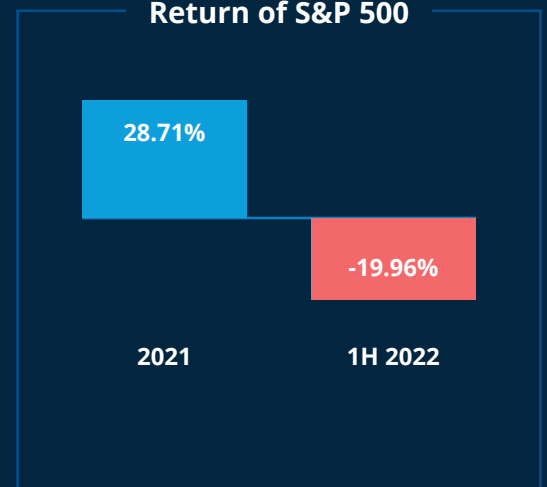
As one RIA advisor tells Cerulli, “Taxes are top-of-mind with my clients right now. We are trying to take advantage of market conditions, and direct indexing allows us to do that.” Another RIA relates, “It’s not what you’re going to make, it’s about what you’re going to keep, and clients understand that.” As one direct indexing product expert relates, “Taxes are measured in percent, while fees are measured in basis points.” In other words, while direct indexing might be more expensive than other passive solutions, the incremental cost is more than made up for by the tax savings generated through tax-loss harvesting.

Advisors looking to take advantage of the benefits of tax-loss harvesting need not wait for a sustained downmarket. Several higher-end direct indexing providers offer a hybrid algorithmic approach with portfolio manager oversight that continuously monitors accounts, allowing for loss harvesting throughout the year. Advisors implementing a direct loss-harvesting strategy were often able to harvest losses in the vastly different market environments of 2021 (S&P 500 return up 28.71%) and the first half of 2022 (S&P 500 return down 19.96%). The crucial aspect of the human-intermediated algorithmic overlay is that the portfolio is constantly monitored, ready to pounce on opportunities that an advisor managing in an *ad hoc* manner would likely miss. For instance, an advisor who only gathers losses at the end of the year likely missed out on the opportunity to gather losses in March and April of 2020, when the market declined during the onset of the COVID-19 pandemic. However, the nimbleness of harvesting losses must also be balanced against not overtrading the portfolio so that investors can experience their desired risk and return characteristics.

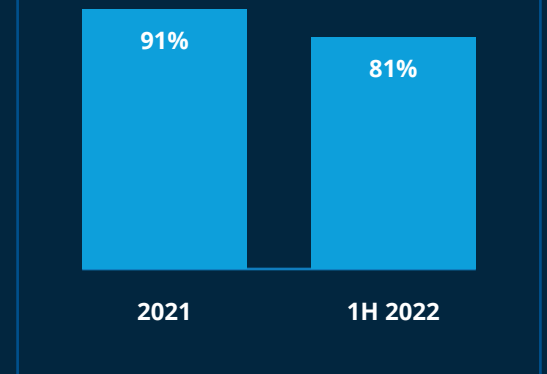
Despite vastly different market performance in 2021 and the first half of 2022, significant drawdown opportunities and chances to harvest losses were present in both market environments.

Performance of Large-Cap Stocks, 2021 vs. 1H 2022

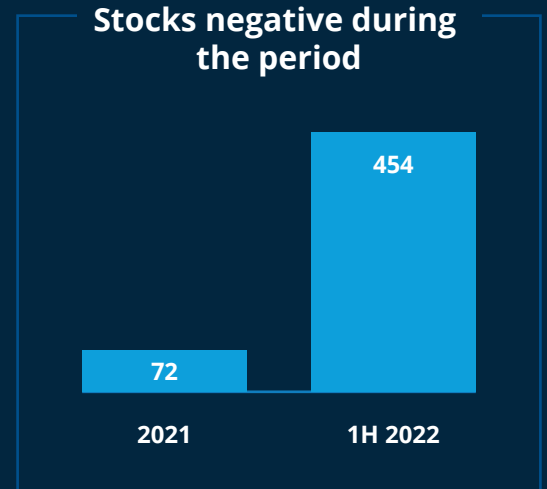
Return of S&P 500



% of stocks with max drawdown of 10% at some point



Stocks negative during the period



Sources: Parametric Portfolio Associates and Cerulli Associates

CASE STUDY:

Core-Satellite Portfolio Construction

Using direct indexing and tax-loss harvesting for core positions allows advisors to select high-conviction managers to round out client portfolios

Practice Profile:

- Wirehouse advisor
- \$300 million AUM
- Serves 100 households
- Sole practitioner, specializing in executives from Midwestern tech hub

One wirehouse advisor with whom Cerulli spoke has had substantial success in their practice by using direct indexing and tax-loss harvesting as the core of client portfolios, while actively managing satellite sleeves on a discretionary basis. This allows the practice and its clients to maintain exposure to the market and generate losses in the portfolio to offset gains in other areas. It also adds efficiency by empowering the practice to focus its due diligence and portfolio construction efforts elsewhere in the portfolio.

The advisor describes their strategy: "I would frame it as a core-satellite model. The core is going to be a direct indexing strategy with the understanding that we are going to try and mirror the S&P 500 or another index. We can choose the index and tilt based on the client and the need. We will then diversify around this core equity position. I have not found a client that has heard of direct indexing, but, for the most part, my prospects are in mutual funds and ETFs, and it is an easy conversation to talk about the relative inefficiency of those vehicles."

This advisor related a story of a client who hired his practice after transitioning away from another advisor who used a portfolio of mostly ETFs and mutual funds. The client also owned a business and had real estate holdings that generated substantial gains elsewhere in the portfolio.

In the advisor's own words: "This [implementation] was amazing for him. We were able to give him market exposure tax-efficiently, but also generate losses that he could use to offset gains elsewhere in the portfolio... I find that a lot of high-net-worth individuals really have no idea how tax-efficient, or inefficient, their portfolios are. I find many large accounts that have mutual funds in taxable accounts."

By implementing direct indexing strategies in their portfolios, advisors can add efficiency and improve outcomes for their clients. Implementing a tax-conscious approach to investing is good business and will remain crucial for successful advisors going forward—with many of the savviest advisors already doing so.



I find that a lot of high-net-worth individuals really have no idea how tax-efficient, or inefficient, their portfolios are."

- Wirehouse Advisor

Trimming Highly Appreciated Stock Positions

- Highly appreciated equity securities offer advisors very few options to unwind positions in a nimble or tax-efficient manner.
- The flexible nature of direct indexing offers advisors and investors multiple tactics to unwind highly appreciated securities, such as tax-loss harvesting, planned charitable giving, and tax-efficient withdrawal techniques.
- The unwinding of a highly appreciated security can often be fraught with emotional issues for end-investors as it may be an inherited position from a family member or equity in a company they helped build.

Concentrated equity positions are often one of the thorniest problems facing a financial advisor working with more affluent clients. These positions often have been accumulated over numerous years and can expose the investor to undue risk due to the high proportion of assets tied up in a single security or industry. These positions, as they have often been accumulated over a career or have been bequeathed years ago from a family member or trust, also tend to come with a low-cost basis, making them

particularly difficult to unwind without incurring a substantial tax implication. There are also behavioral finance obstacles for advisors to overcome: investors may be emotionally attached to these holdings, attaching some sentimental value to them because that stock may have been given by a grandparent in a will, or it may be from a company for which the investor worked over a matter of decades.

Additionally complicating matters is the fact that many advisors inherit these positions when they begin the relationship with their clients, making one of their first tasks unwinding a large, complicated, and highly tax-inefficient holding. Direct indexing can help advisors navigate these challenges and assist with making these concentrated positions far less unwieldy.

Using direct indexing to unwind a concentrated position is in some ways like a perpetual motion device. An advisor working with a client who has a highly concentrated position can set up a direct index account in order to begin harvesting losses. Those losses



When you're liquidating a concentrated position, you can offset some of that tax bill. And then...you continue to roll that into the portfolio. And as you roll that into the portfolio, you're generating even more losses and getting broad-based exposure."

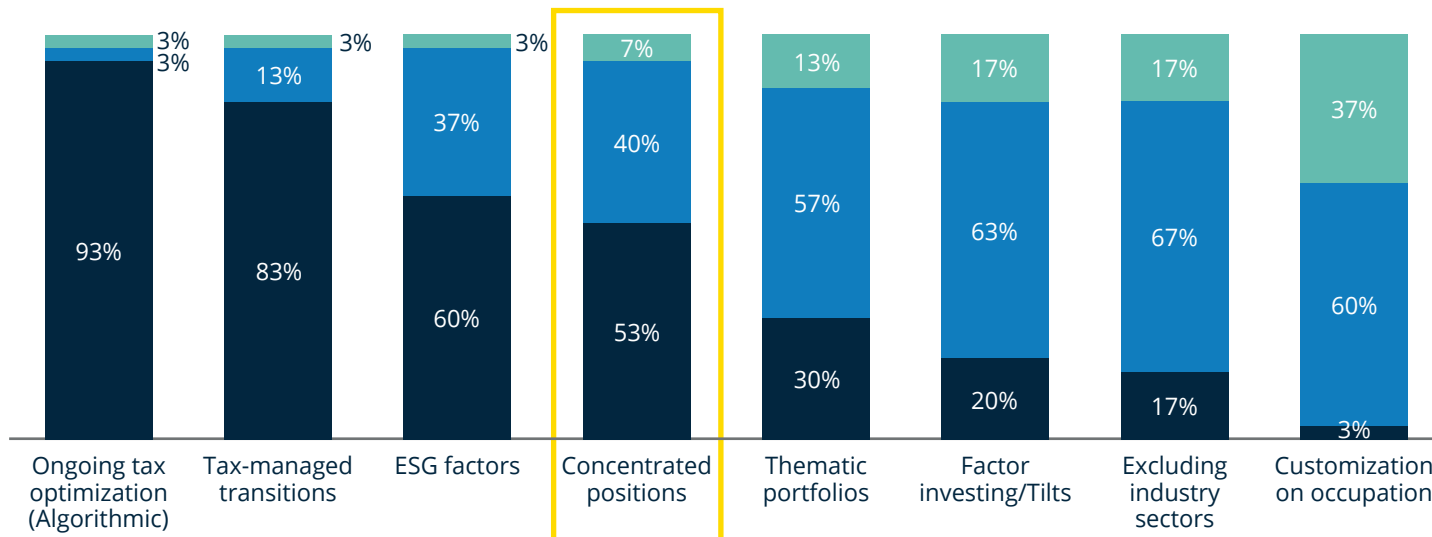


can be used to offset gains in the sale of some of the concentrated equity position, with those proceeds being reinvested in the diversified, direct index portfolio. This investment comes at a higher cost basis, in turn priming the portfolio to generate more losses and begin the cycle anew.

One product expert at a direct index provider describes the process as follows: "The direct index strategy can also be coupled with a planned giving strategy, using a donor-advised fund or charitable giving to gift appreciated stock and realize additional tax savings."

Managed Account Sponsors: Opportunity for Direct Indexing, 2022

■ Significant opportunity ■ Modest opportunity ■ Little opportunity



CASE STUDY

Exiting Concentrated GameStop Position Scores Points

Enhancing client outcomes through direct index solutions led to multiple referral opportunities across family, friends.

Practice Profile:

- Wirehouse advisor
- \$300 million AUM
- Sole practitioner, specializes in technology executives
- Serves 75-100 households

Direct indexing can be beneficial even if the client approaches the advisor after already selling out of a highly appreciated position. One advisor who Cerulli interviewed successfully used

a direct indexing strategy to unwind a concentrated position in GameStop. The advisor told Cerulli, “I was introduced to the son of a client that was a very active trader who is an engineer at a big tech company. He started with a \$50,000 investment and made \$23 million trading GameStop.” This investor had clearly accumulated a significant capital gain.

The advisor continued, “I was not introduced to him until after he had sold out of the position. This was January 2021, and he had a \$20 million gain on the books...his father introduced us. He was very skeptical of financial advisors.”

The advisor worked with a direct index provider over the course of the year to do whatever possible to minimize the taxable gain, generating losses while diversifying exposure. The advisor worked with the client to select the indices to which they wanted exposure, while also highlighting the loss-harvesting capabilities.

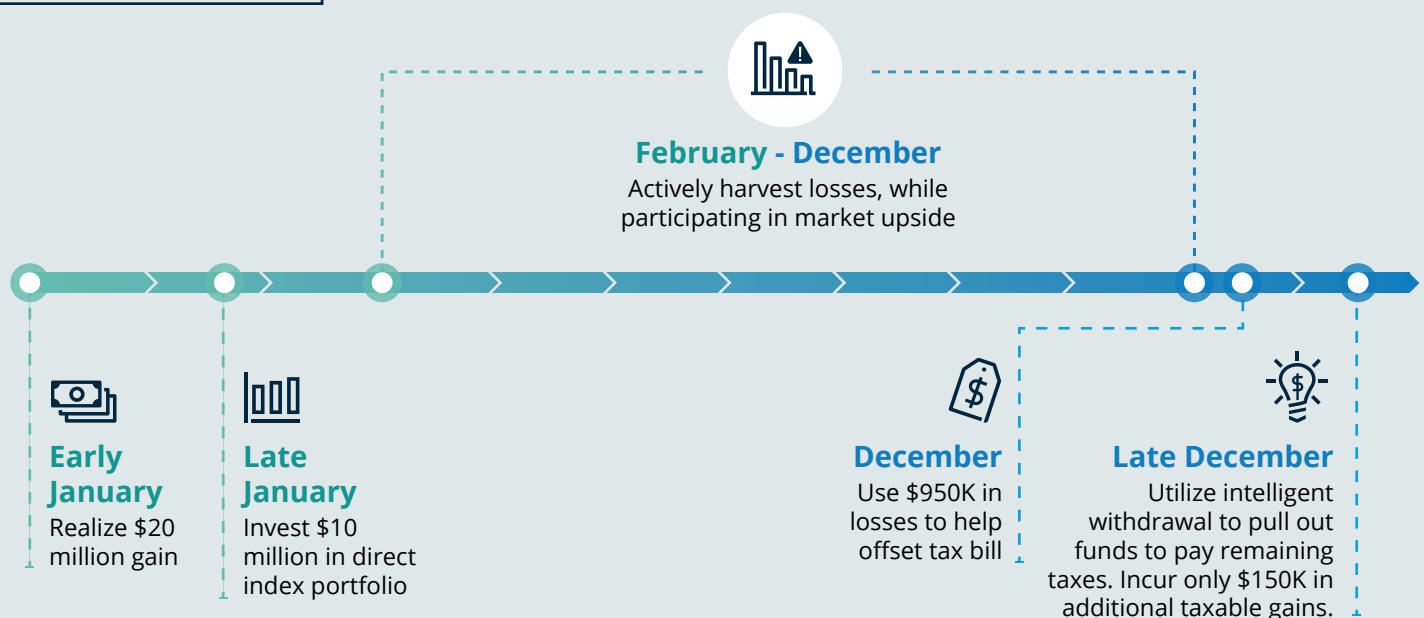
The advisor went on to describe the results, “We leveraged direct indexing

combined with a donor-advised fund, combined with an opportunity zone fund...he participated in market upside in 2021—tracking error plus or minus one percent to the indices we chose—and we generated something in the neighborhood of \$950,000 in losses off a \$10 million original investment.”

The advisor and client took it a step further, using the direct indexing provider’s intelligent withdrawal system to remove funds from the direct index portfolio to pay taxes at the end of the year on the gains that could not be written off. The advisor noted that the intelligent withdrawal system only generated \$150,000 in taxable gains to foot that tax bill, in a year when many equity indices were up in excess of 20%.

As the advisor concluded, “This is a 40-year-old client that I now have as a client for life. I think he’s given me four or five referrals.” Advisors who are able to solve unique problems for their clients and work around vexing issues are the ones who grow and retain their business.

2021 Timeline



Planned Charitable Giving

- Incorporating ongoing charitable giving as part of a client's financial plan can contribute to a favorable client experience and potential point of differentiation for advisors. Less than half of advisors provide this service today.
- Charitable giving presents another opportunity to help their clients invest tax-efficiently. Donating individual securities to a charity provides the investor and advisor a way to manage highly appreciated stock.
- Replacing highly appreciated securities that are donated with new cash resets the cost basis of these securities, creating new potential tax-loss harvesting opportunities in the future.

One of the less discussed uses for direct indexing is planned charitable giving. This can be applied to charitable giving as a one-time event or over multiple years. Today, just less than half (47%) of advisors offer charitable giving advice to their clients. However, only 7% of affluent investors report that their advisors assist them with charitable giving, meaning many investors do not look to their advisor and wealth management firm for help with this part of their financial life.

One of the primary benefits of direct indexing is tax savings generated by

harvesting losses. But arguably just as important are the customization features associated with direct indexing and the ability to modify a client's portfolio to support a client's financial goals and values. This ability for modification is similar to the application of environmental, social, and governance (ESG) principles to client portfolios and the alignment of investments with their personal values.

There are multiple ways in which direct indexing can be used to support planned charitable giving. Most importantly, an advisor must commit to learning about their clients' charitable preferences and plans as part of their profiling and discovery process. Once an advisor has determined a client's charitable giving plans and intentions, the first and simplest step is to identify highly appreciated stock in the direct indexing portfolio and gift these securities either to a donor-advised fund or directly to the charity. This runs counter to tax-loss harvesting where declining stocks are used to capture tax losses. Rather, in this case, the investor identifies highly appreciated securities so that they do not realize the associated tax gain, instead achieving the tax savings from charitable giving. In turn, the investor can use cash they would have donated to replenish the portfolio.

A second similar application is the use of charitable giving to trim concentrated stock positions. Many investors hold highly appreciated securities with a low cost basis. In many cases, these are legacy holdings, potentially inherited from a relative. Or it may be an investor who has created wealth in part by receiving company stock while working for a publicly traded company. The advisor then works with the client to donate the low-cost-basis stock to a donor-advised fund or their charity of choice. The client then replenishes the portfolio with cash, which purchases new securities.

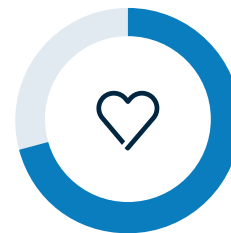


I think they light up when we talk about it—they don't know it is an option."

- RIA Advisor



Charitable Giving Advice Can Unlock the HNW Market



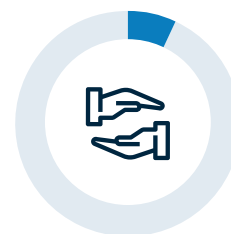
71%

of HNW-focused firms offer charitable giving as a primary service



47%

of all financial advisors (focused on all levels of wealth) provide charitable giving



7%

of affluent investors (over \$100,000 in investable assets) report that their financial provider assists them with charitable giving

Source: Cerulli Associates, 2021

CASE STUDY

Helping First-Generation Wealth Creators Fulfill Their Charitable Plans

Donating highly appreciated securities is a highly tax-efficient way to fund planned charitable giving

Practice Profile:

- Independent RIA
 - \$1.5 billion AUM
 - Specialized in advising technology executives who are often first-generation wealth creators
 - Serves approximately 500 clients
-

For one \$1 billion-plus RIA firm in the Pacific Northwest, planned charitable giving is viewed as a natural element of understanding its clients' goals and values. The firm's clients are often executives at technology firms that have created their wealth, rather than inheriting it. Its average client has about \$3 million in assets, but ranges from \$500,000 to as high as \$100 million. Having been the beneficiaries of company stock, clients often hold highly appreciated, concentrated positions in their employer's stock.

This firm uncovers its clients' objectives and values through ongoing conversations. Over time, advisors come to understand what is important to the client, whether it is their family, faith, or the environment. The conversations are often organic and free-flowing in nature, rather than a checklist that advisors walk through with the client. As one advisor put it, "A good advisor figures out what

their preferences are. Most clients might not know. The client wants your advice. That's why they hire you."

As part of this process, the firm works with clients to determine what role charitable giving plays in their financial plan. Given that this firm's clients are often first-generation wealth creators, they often place high value on their values and charitable giving. Each year in the fourth quarter, the firm identifies the "winners," the highly appreciated securities in its clients' portfolios, to fund this goal. The firm donates the highly appreciated securities either to a charity chosen by the client or a donor-advised fund. The client then puts the cash they would have donated into the direct indexing account, replacing the donated securities.

As we have seen, financial advisors are using direct indexing in multiple ways to help their clients reach their financial goals. As noted earlier, advisors and wealth management firms are struggling with differentiation as the industry universally migrates to financial planning and fee-based advice. The flexibility of direct indexing allows advisors to create unique client experiences. Direct indexing is a small segment of the wealth management industry today, largely being used for tax-sensitive high-net-worth clients. However, the influx of providers bringing customized solutions to market will create additional awareness and adoption of this product. Likewise, the low cost of trading and predominance of fractional shares will allow these customized solutions to come down market to less affluent investors. While not every advisor will adopt direct indexing, the push toward mass customized solutions will change investors' expectations for their relationships with their advisors and wealth management providers.

Keeping the Loss-Harvesting Engine Moving

One of the primary objections to direct indexing is that as losses are harvested, over time the portfolio is populated only with highly appreciated securities that are unlikely to be sold at a loss. If advisors and investors donate highly appreciated securities to a charity or donor-advised fund while instead replenishing the portfolio with the cash they might have donated, they can rebuy these securities with a new cost basis, creating opportunity for future loss harvesting.

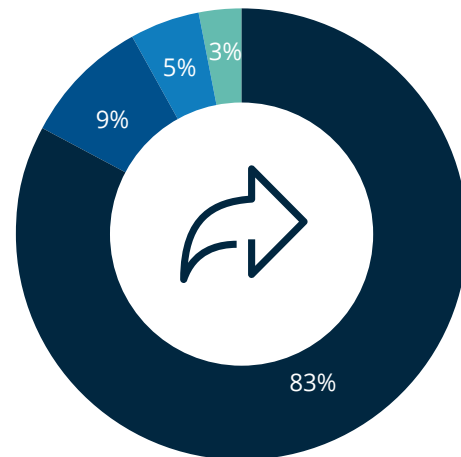
- Aligning investors' portfolios with their values is a way for advisors to create positive client experience beyond investment returns.
- An estimated \$84 trillion will transfer to the next generation of investors. Younger investors and consumers wish to align with brands that reflect their social values.
- Direct indexing offers advisors the flexibility to match ESG factors with their clients' preferences and values.

This ability to customize a portfolio to align with a client's value hierarchy will become important in coming years. Younger consumers and investors increasingly wish to see brands they support demonstrate social responsibility. Cerulli data shows that, while 48% of retail investors prefer to invest in a manner that reflects their personal values, that percentage spikes to 61% of investors ages 40-49, and 75% of investors who are younger than 40. Cerulli projects that \$84.4 trillion in assets will change hands over the next 25 years. Of those assets, Cerulli projects that 83% will move through bequests to heirs. In short, advisors are about to be faced with assets transitioning to clients who are far more likely to be interested in environmental, social, and governance (ESG) investing.

Given its highly customizable nature, direct indexing fits exceedingly well with ESG, allowing for advisors and investors to work with their direct index provider to build portfolios that best match the goals, objectives, beliefs, and values of their clients. The flexibility of direct indexing gives them varying paths to implement ESG investments that are most relevant to their clients. As one RIA advisor relates to Cerulli, ESG is best uncovered as part of normal client profiling conversations. Once that profile is uncovered,

Percent of Total Wealth Transfer by Transfer Method, 2021-2045

- Bequests to heirs
- Bequests to charity
- Inter vivos to charity
- Inter vivos to heirs



Sources: Cerulli Associates, Federal Reserve, U.S. Census Bureau, Internal Revenue Service, Bureau of Labor Statistics, and the Social Security Administration | **Analyst Note:** *Inter vivos* transfers are given at any point while the giving household is alive.

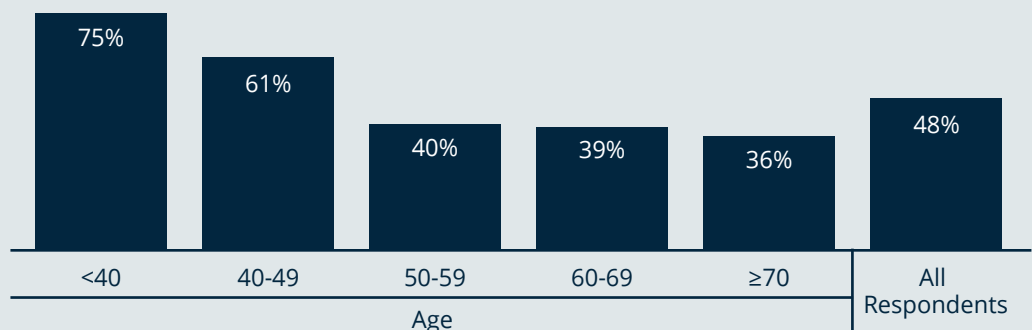
advisors can fully customize to match their clients' values and implement through a direct indexing strategy.

Through this research, Cerulli has uncovered three practices at varying stages in their ESG journeys—yet all have successfully implemented ESG through direct indexing.

Preference for ESG Investing by Age Range, 1Q 2022

Total agreement with the following statement:

"I would rather invest in companies that have a positive social or environmental impact."



CASE STUDY 1

Coastal Practice Using ESG for Specialized Client Acquisition

An MFO serving a limited number of UHNW families leverages direct indexing to customize client engagements, meet demand, and improve outcome

Practice Profile:

- Multi-family office (SEC-registered RIA)
- Serves 16 HNW and UHNW client families
- \$4.2 billion AUM
- ESG central to practice

The first ESG use case Cerulli encountered is a practice located in a coastal city, where nearly all of its client accounts have some manner of ESG overlay. As one of the partners at the firm tells Cerulli, “We generally work with clients that have some level of ESG or other [values-based] filtering.” Direct indexing has allowed them to get far more involved in the process than they would be able to if they relied merely on commingled products. The partner adds, “Direct indexing has allowed us some level of putting our own hands on the scales in terms of overweights and underweights in certain sectors or industries. Having the flexibility and capability is important to us.”

Many of the families that this practice works with are global, often from Europe, where ESG adoption outstrips the progress thus far in the United States. This creates complicated tax scenarios that the firm is able to couple with the ESG overlays through a partnership with direct indexing managers. As another partner relates, “Sometimes it doesn’t make sense to use the tax-loss harvesting feature, [but in that case] we still use direct indexing for the ESG filtering... that’s usually a core piece of our portfolio that’s going to sit in the portfolio for decades.”

The direct indexing strategies offer the ability to not only customize in line with investor preferences, but to also invest in the ESG manner that clients prefer. At this practice, some clients want to exclude certain industries or sectors, while others seek impact investing, or pairing direct indexing with donor-advised funds to advance a certain cause. Even at practices with such substantial ESG adoption, clients have broadly different goals and objectives, and direct indexing gives advisors the flexibility to meet these diverse needs.





CASE STUDY 2

ESG Dabbler Preparing for Values-Based Future

A highly sophisticated multi-family office classifies itself as an ESG dabbler and credits direct indexing as the spur

Practice Profile:

- Multi-family office (SEC-registered RIA)
 - \$7 billion AUM
 - ESG for limited number of clients with the opportunity to expand
 - Serves 86 HNW and UHNW client families
-

At the other end of the spectrum, Cerulli has also encountered practices that are far less advanced in their use but that have had early success with implementing values-based investing through ESG. Another RIA advisor relates their usage to Cerulli: “We’ve had a few clients ask, but as a firm we haven’t had to go as far as building out ESG models for fixed income or equities.”

For those few clients who do want to make ESG a part of their portfolios, this advisor has leveraged Parametric’s Custom Core offering to help construct those portfolios. The advisor states, “[With Custom Core/Direct Indexing], we can focus on promoting the personalization, and the ESG tilts for that customization.” Another advisor relates successfully using the Canvas platform (a direct index offering from O’Shaughnessy Asset Management, which is owned by Franklin Templeton, that allows advisors to customize on multiple pre-set dimensions, including ESG) for their few clients who wish to obtain ESG exposure. The advisor adds, “The ESG overlay on the Canvas platform is pretty popular. We have had a bit of interest in that, but primarily it is more of a one-off case right now.”

These advisors who are currently only dabbling in ESG see the writing on the wall and are prepared for the time when their clients to want to implement ESG to a greater degree in their portfolios. As another “dabbling” advisor relates, “There is a lot in the works. Once we start to see more demand, there is a lot more that we can do from a direct indexing perspective.” Advisors are anticipating the demand and are ready to implement ESG once it begins to materialize.

CASE STUDY 3

Fully Embracing ESG

Direct indexing is integrated into top-down portfolio construction processes of an emerging RIA aggregator that has responsible investing as a core philosophy

Practice Profile:

- RIA aggregator with 28 advisors
 - \$3.5 billion AUM
 - Senior management deemed ESG a core focus several years ago
 - Serves 480 HNW and affluent client families
-

The final use case that emerged in Cerulli's conversations with advisory practices about ESG and direct indexing involves a chief investment officer at an RIA aggregator. The CIO makes investment and product decisions that filter down to the firm's 28 advisors and 480 clients. Several years ago, senior management of the RIA decided to make ESG investing a much greater part of the firm's business model. As this CIO states, "When I joined five years ago, one of the mandates I had from our founder was to do more in the ESG space."

In this case, the customization aspects of a direct index offering are appealing as the core of ESG portfolios, where advisors can then go out and add additional thematic elements in satellite sleeves. They describe their investment strategy thusly: "The investment solution that we have for ESG includes direct indexing as the core, around the edge we have funds that follow a certain theme for the total portfolio...Our clients get to choose what they want to have, and then we're able to put together a portfolio that makes sense."

As discussed in other use cases, the ability to mold a direct index solution to a client's unique goals and objectives is more appealing than a mass-market commingled offering. As the CIO tells Cerulli, "We didn't want to go out and find a whole bunch of ETFs...it was very important to us to be able to control the integrity of the portfolio." A direct index portfolio gives the advisor and their clients faith that the strategy is being managed exactly in line with their goals and objectives and gives them the flexibility to continuously alter and change the strategy.



We have an ESG-plus-impact solution that utilizes direct indexing as the core. It is still tax-managed, and we have full control over what goes in the core."

- RIA Advisor



Customized Fixed-Income Ladders

- Customized laddered bond SMAs allow advisors and their clients to customize portfolios across multiple dimensions, unlike traditional equity direct indexing, which seeks to deliver characteristics similar to an index.
- The expected direction of bond prices in rising or falling rate environments offers advisors and investors unusually predictable outcomes.
- Advisors and investors using an external manager to build bond ladders benefit from the manager's pricing power and credit quality research.

Fixed Income within the Construct of Direct Indexing

Fixed-income direct indexing is different than direct indexing within an equity portfolio, though it can deliver similar benefits. Fixed-income direct indexing involves equally weighting securities across a specified range, often referred to as "laddering," that the investor and financial advisor are able to choose to best meet their portfolio needs and objectives. A client more comfortable with interest rate risk can select a five- to 15-year bond ladder, while a more rate-sensitive client replacing a large cash position may choose a one- to five-year laddered portfolio. When bonds roll off the ladder at the low end of the portfolio, the proceeds are reinvested at the long end, allowing for steady, predictable returns and income streams.

It is important to note that the tax-loss harvesting aspect of these bond ladders is fundamentally different than that of their equity counterparts. An equity-loss harvesting strategy may involve selling a certain piece of the portfolio at a loss, waiting 31 days, and buying a similar security, all while working to remain within beta guidelines while realizing tax losses. For corporate and municipal bond ladders, if interest rates

were to rise, bond prices fall. A laddered strategy allows them to sell the bond and write off the loss due to the rise in interest rates and reinvest in a higher yielding bond. If those new bonds are then held to maturity, there would never be a capital gain payment. One product expert calls this a "government-subsidized loss." Though different from equity direct indexing, the tax benefits are still substantial.

Areas where an advisor can customize a laddered portfolio:



Maturity Ranges



Credit Quality



State Preferences



ESG Factors

Benefits

The benefits of a laddered fixed-income portfolio are numerous for financial advisors. Not only are the losses in effect subsidized for a municipal portfolio, but the laddered nature of the portfolio also



There are all sorts of different customization components to get the client tailored exposure that they want in a rules-based fashion. The client knows these are the exposures, and the outcome is somewhat predictable. That is something we can deliver."

- Head of Fixed Income
at a Direct Index Manager



lends itself to more dependable return outcomes. The state preference offered in municipal portfolios allows for clients to lower or manage their in-state tax bill, and the overall coupling of market beta with customization allows advisors to tailor fixed-income exposures in a way that a pooled vehicle does not. As one product expert tells Cerulli, "There are many degrees of customization that all advisors can use, but it comes down to broad categories (maturity, credit quality, state preference) that are easy for them to define."

Compared to a commingled product, such as a mutual fund or ETF, the ability to tax-loss harvest specific bonds grants the advisor and their client significant flexibility to realize tax losses while staying within their desired portfolio characteristics (e.g., credit quality, maturity). Likewise, relative to the advisor buying individual bonds, going through a professional manager allows them better pricing and the benefits of the manager's credit quality research.

CASE STUDY

Making \$50 Million in Cash Work for the Client

A fixed-income direct index strategy allowed the practice to meet the objectives of a mid-sized business owner, without forfeiting transparency, control, or liquidity

Practice Profile:

- Multi-family office (SEC-registered RIA)
- \$2 billion AUM
- Practice works with business owners in financial services
- Serves 75 HNW and UHNW client families

Cerulli spoke to one advisor who has used laddered investing in their practice for several years, relating a use case where they worked with a client who ran a mid-sized business. The business had a corporate cash account with approximately \$50 million, and with the low interest rates of the last few years, was earning essentially nothing.

This advisor worked with the direct indexing manager to build a zero- to three-year municipal laddered account for a large chunk of the corporate cash account, approximately \$40 million. This portfolio was built from

variable-rate notes and short-term municipal securities, with the objective of generating excess return over a bank account, while maintaining liquidity for the client’s business needs and objectives. The client was also intensely focused on credit quality; as the advisor relates, “We worked with a direct indexing provider on a very specific mandate, we wanted them to monitor the credit quality and make sure there were no specific events there.”

The provider was able to easily collaborate with the practice to successfully build and implement the solution. The advisor noted how they are able to communicate through their Bloomberg terminal with the portfolio managers at the direct indexing provider trading the account, staying abreast of the implementation and execution of the strategy.

A laddered bond strategy allows advisors to be as hands on, or hands off, as they would like with a client’s fixed-income exposures. One advisor who implemented a laddered fixed-income portfolio says, “Other than a credit event, we want you [the DI provider] to do basically nothing. We’re asking to use your institutional research and pricing to purchase bonds at better prices than we can internally. Then construct a portfolio in a cost-efficient way.” Other advisors may want their DI provider to actively trade and take advantage of market inefficiencies. Both strategies can be implemented by the right partner firm, and advisors can tailor these choices for different clients with different needs.

Corporate Cash Account Before and After Use of Customized Bond Ladder

	Corporate Cash Account		Laddered Bond Solution
Credit Quality	N/A	>	AA or better
Maturity	Cash	>	0-3 years
State Preference	N/A	>	Georgia preferred
Yield	<0.5%	>	2%-3%

Source: Cerulli Associates

What is the Index?

It is important to note that while this is called “direct indexing,” the goal of a fixed-income DI strategy is not to mirror an index. In fact, it is generally impossible to mirror a bond index like the Bloomberg Aggregate or Bloomberg Municipal Bond index. Rather, these strategies try to create a customized ladder based on a variety of qualities that gives investors passive exposure to bond markets while creating consistent investment objectives. Advisors using direct indexing for equities are using the strategies to mirror the index and create an additional benefit through customization. Fixed-income direct indexing strategies are trying to mirror characteristics determined by the investor and the advisor, rather than buying bonds to replicate an index.



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