ARRO | FINANCIAL COMMUNICATIONS

BLACKWATER Search & Advisory

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DIRECT INDEXING: THE NEXT BIG THING?

Direct indexing is a new trend in the investment industry that is looking to give investors more flexibility in their investments at a lower cost. In this report, we investigate what direct indexing really is, and what it is not. **We** then assess the potential for disruption on the asset management industry in the US and in Europe. Finally, we look at whether direct indexing is worth the hype for different investors' profiles.

1. What is Direct Indexing?

Direct Indexing (DI) has recently become a hot topic in the investment industry.

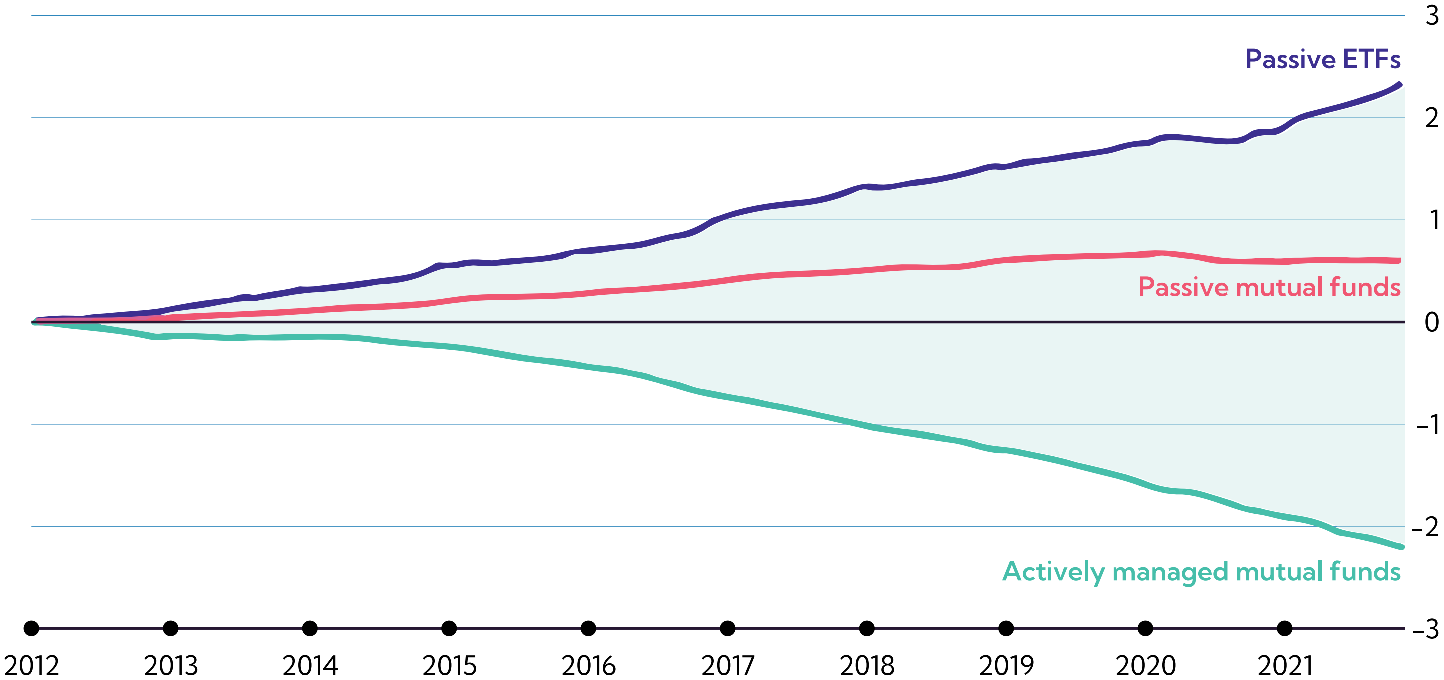
SURFING ON THE PASSIVE WAVE

Passive investing has seduced investors all over the world in the past decade. The poor returns and high fees of active managers have led them to continually lose assets to the profit of index-based products like passive mutual funds and ETFs.

While the move towards passive started with traditional cap-weighted equity indices, investors quickly demanded more specialized products that the industry happily created. **Aware that one size does not fit all, ETF providers launched sector, factor, thematic and ESG funds to accommodate investors' need for more customized solutions.**

"Often presented as the latest evolution of passive investing, **direct indexing aims to make commingled investments look outdated** by allowing investors to buy (and modify) an index outside of the traditional fund wrapper."

Cumulative net flows ($Tn) from US active to passive funds, 2012-2022



Source: Investment Company Institute, FT

DIRECT INDEXING REMOVES THE WRAPPER

Direct indexing keeps the passive investing philosophy, but gets rid of the fund wrapper, taking down the last barrier to the full customization of investments to investors' needs. It brings a new spin on an investment approach that has been around for decades, but traditionally reserved to institutional investors: Separately Managed Accounts (SMAs).

A few key developments have allowed to democratize SMAs' approach to retail investors. First, trading conditions have improved, and investors of all size can now trade at lower costs with zero commission on equities, while fractional share trading allows them to trade stocks regardless of the share price. Then, software tools have also improved, facilitating portfolio customization and tax monitoring, hereby allowing advisers to extend sophisticated strategies to a broader audience.

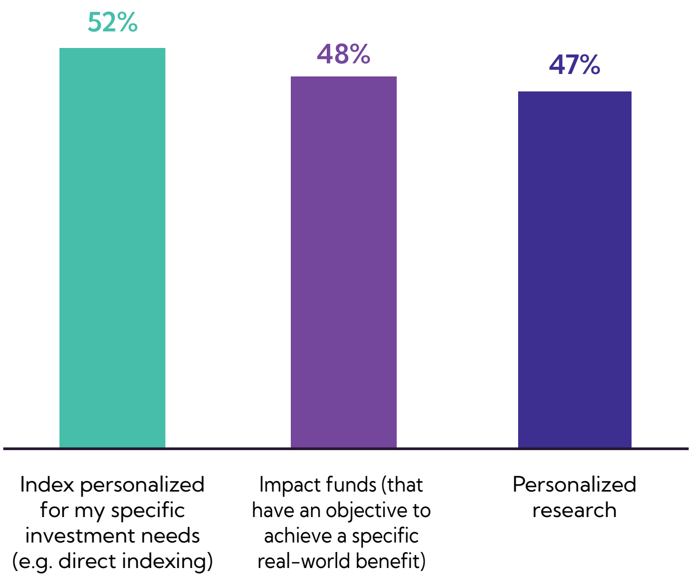
Three key trends have removed barriers for Direct Indexing

- Better technology (new software tools for easy customization and tax monitoring)
- Lower cost (no commissions on equities)
- Improved accessibility (fractional share trading)

DIRECT INDEXING, AKA SELF-INDEXING, CUSTOM INDEXING, PERSONALIZED INDEXING...

Most retail investors are interested in indices personalized for their specific investment needs , and direct indexing looks to answer exactly his need.

Retail investor interest in personalized products



Source: CFA Institute Survey 2022.

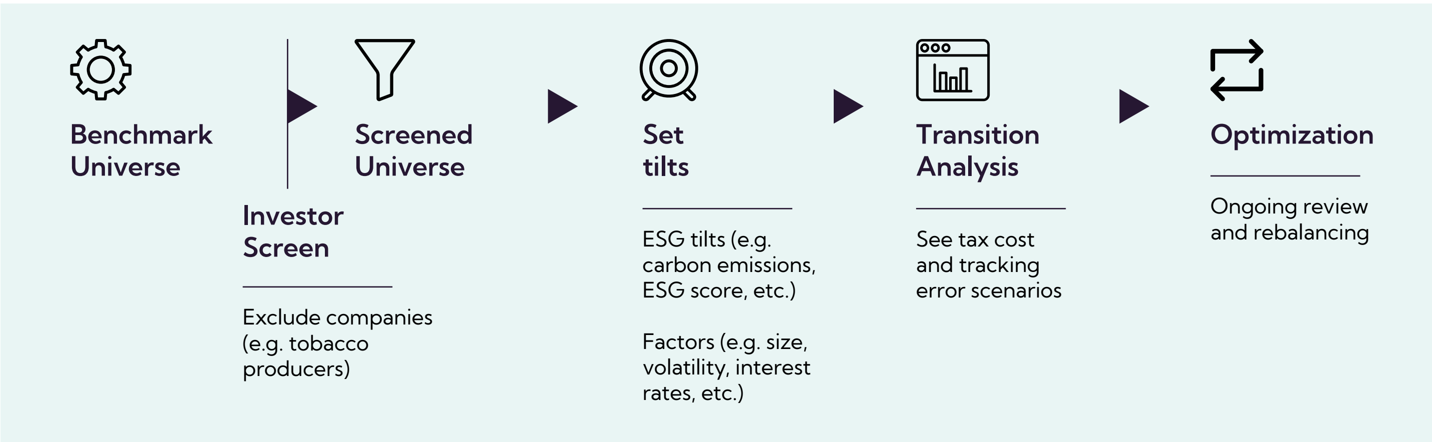
> "As a result, the biggest direct indexing providers have opted to use alternative wording such as self-indexing, custom indexing, or even personalized indexing."

'CUSTOM' IS WHERE THE 'INDEXING' STOPS

In a typical direct indexing process, investors would start from a traditional market-cap-weighted equity index - meaning bigger market-cap companies get a higher allocation. Then they could modify the weights or even remove certain stocks altogether from their portfolio, based on the consideration of criteria that matter to them like sustainability or investment factors like momentum, value, or low volatility. Finally, the portfolio would be frequently reviewed on a daily, monthly, or quarterly basis for opportunities to harvest tax losses – more on that later in the report.

"Direct indexing investors use an index as a starting base to build their custom portfolio. That is where the 'indexing' stops in 'direct indexing."

A typical Direct Indexing process



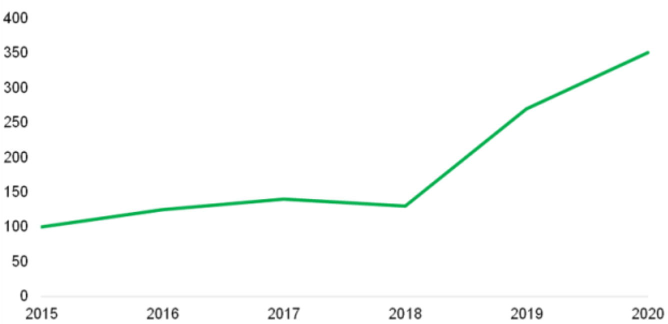
Source: Vanguard

THE DIRECT INDEXING GOLD RUSH

Despite making headlines recently, direct indexing is nothing new. In the US, the first entrant to the market goes back to the 1990's. Still the recent surge in interest has attracted many to the game, from large asset managers to robo-advisers, custodians, white-label platforms, and even index providers.

"Most of the growth in assets happened from 2019 to today, as the largest investment companies have begun a race to snatch the most successful direct indexing platforms. "

Direct Indexing assets under management



Source: Cerulli

Most of the available data points on the industry's assets and growth have been produced in a report funded directly by Parametric, the pioneer of direct indexing itself, but the series of expensive acquisitions by the biggest asset managers seem to confirm that the market is expected to grow,

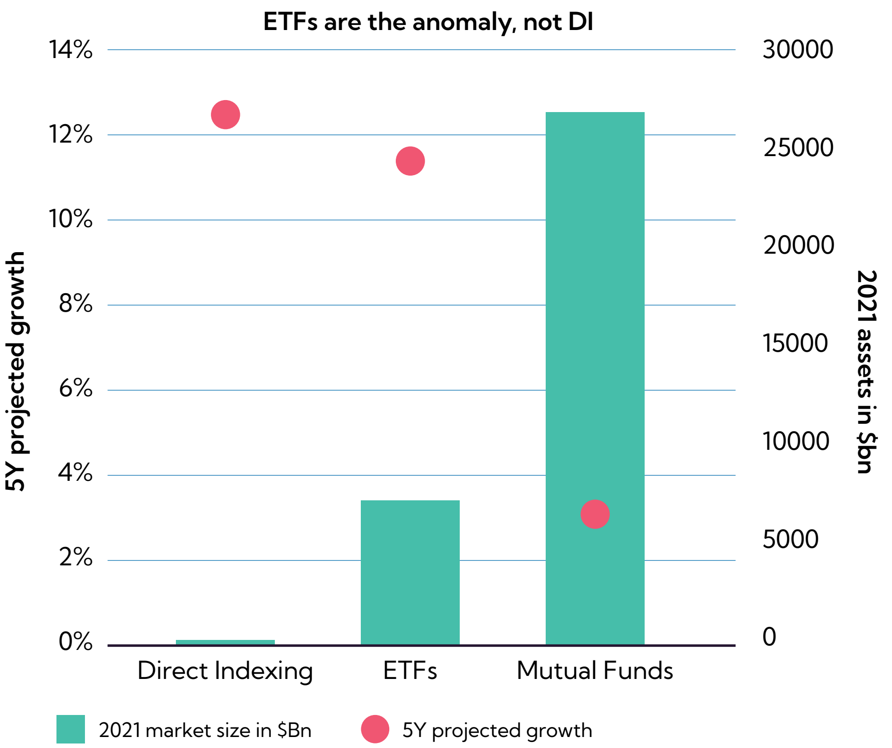
Direct Indexing assets under management

Source: BWS

The report states that in 2021 direct indexing represented approximately $350 billion in the US. It also postulates that the rate of growth of direct indexing over the next five years – estimated at 12.4% – will outpace that of other products like ETFs and mutual funds. While such findings make good headlines, there is nothing surprising there. **ETF and mutual funds are huge and more mature markets that completely dwarf direct indexing so it is expected that they would grow at a slower rate.**

On the opposite, the real surprise in these numbers is how dynamic the ETF growth remains. At twenty times the assets of direct indexing, ETFs are just slightly lagging the growth predictions by a percent (11.3%), while mutual funds are far behind at 3%. This points to ETFs being the 'anomaly' here, not DI.

Assets vs projected growth



> Even at this superior rate of growth, direct indexing would not reach $1Tn in assets before 2030 – and it would still be a fraction of the money invested in ETFs and funds.

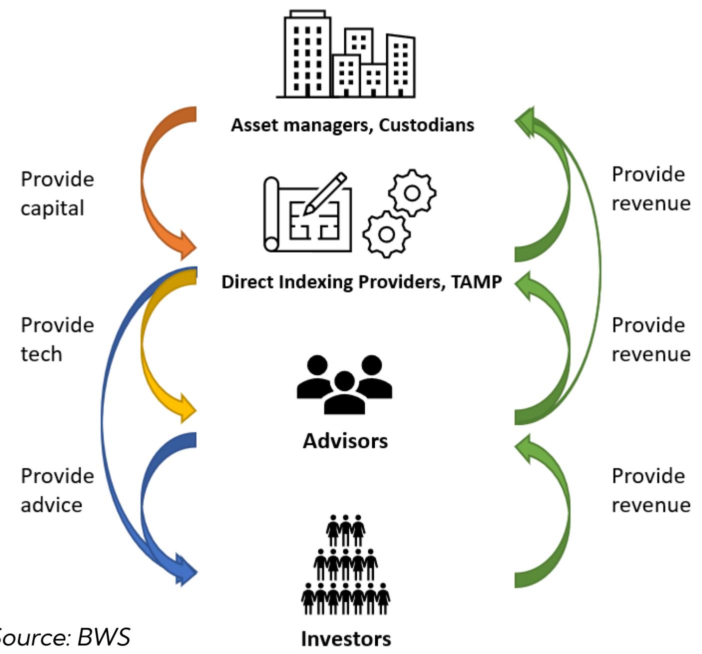
Source: Cerulli, BWS

2. Is Direct Indexing going to disrupt the market?

Direct indexing might make the fund wrapper disappear, but not the fund managers.

We look at the level of threat or opportunity that direct indexing represents for each participant in the value chain.

Participants in the Direct Indexing value chain



Source: BWS

ASSET MANAGERS – IF YOU CANNOT COMPETE WITH IT, BUY IT

In theory, direct indexing represents a threat to asset managers as it aims to replace investment products like funds and ETFs in investors' portfolios. **While the small size of the direct indexing market makes the threat appear limited so far, it looks like asset managers are taking it seriously as they bought the biggest direct indexing providers and positioned themselves to reap their revenue.**

After the acquisition, some asset managers chose to integrate the new tech seamlessly to their existing brand for a welcome refresh. Others let the direct indexing platforms grow under their separate brand but share the revenue. Lastly, a few asset managers have only acquired minority positions in direct indexing providers that have therefore remained independent.

- Morgan Stanley, BlackRock, Vanguard, JPMorgan Chase, Goldman Sachs, Franklin Templeton...

CUSTODIANS – UPSELLING TO THEIR ADVISERS' NETWORK

Custodians have also entered the direct indexing market. They have the most **synergies with the approach as they already are serving large networks of investment advisers.** Upgrading their offer to integrate more automated customization and tax-loss-harvesting is a natural evolution for those firms.

Charles Schwab, BNY Mellon's Pershing...

TURNKEY ASSET MANAGEMENT PLATFORMS – SELLING ADVISERS THE BACK-OFFICE MAGIC TRICK

Another type of participant in the direct indexing market, Turnkey Asset Management Platforms (TAMP), offer white-label technology for investment advisers. **As the direct indexing market grows, so does the competition** between investment advisers and this creates a very favourable environment for TAMP to sell their product.

SEI, Envestnet Wealth, SmartX, Gamma Investing...

INVESTMENT ADVISERS – COMPETITION TO APPEAL TO TECH SAVVY INVESTORS

Investment advisers are the last link in the direct indexing chain and face the end investors directly. The competition is growing amongst advisers as technology becomes more efficient and helps democratize customized solutions at a mass scale. While some advisers belong to a network and can rely on a well-known brand and existing set of tools, others are independent and could benefit from using direct indexing software to increase investors' trust.

Technology is forever more important in investing. The 2022 CFA Institute Investor Trust Study found that most retail investors believe access to the latest technology tools to manage their investments will be more important than access to a human being in the next three years. Still the flexibility allowed by the direct indexing technology creates room for advisers to add value by working with investors and help them tailor their portfolios to their needs.

Technology is forever more important in investing.

Yet most advisers are still unfamiliar with direct indexing. **A Cerulli and Parametric report from end of 2021 found that more than 50% of advisers do not know what direct indexing is, and just 12% of them are currently using the strategy.** This might be the result of the complexity that direct indexing creates for advisers, who might be better off recommending simpler ETFs portfolios to their clients and avoiding the risk of underperformance altogether.

ROBO-ADVISERS – DEVELOP CUSTOMIZATION TO WIN MORE CLIENTS

In the same vein, robo-advisers can benefit from the technology of direct indexing to offer more customization options for investors while still maintaining the mass scale and low costs that made them popular options in the first place.

Like other direct indexing providers, large popular robo-advisers have been the target of acquisitions by investment banks looking to renew their offering and smarten up their technology to appeal to the younger investors crowd.

Wealthfront, Fidelity Fidfolios...

INDEX PROVIDERS – PROVIDE CUSTOM BENCHMARKS AND RELEVANT METRICS (ESG, FACTOR...)

A little counter-intuitively maybe, the rise of direct indexing can represent an opportunity for index providers. Even though direct indexing portfolios are heavily personalized, indices remain at the heart of the investment process. Investors' custom portfolios will require individual benchmarks. This creates room for index platforms to add value by creating robust and scalable indices to supp ort investors at a global scale.

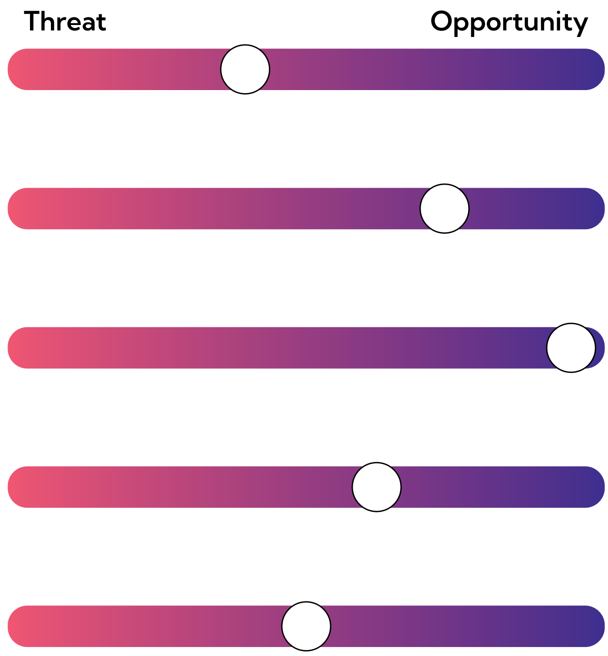
Even though direct indexing portfolios are heavily personalized, indices remain at the heart of the investment process.

Still, the minimal impact of the starting universe in the final portfolio means that index brands will matter less in custom indexing strategies than in ETFs for example.

Together with a need to cut costs to be able to compete with ETFs, the growth of direct indexing market might benefit new challenger index providers at the expense of more established brands. They could be a good option for direct indexing providers who would otherwise use internally generated universes.

- MSCI, FTSE Russell, Morningstar...

DI projected impact on the market: low probability to disrupt



Asset Managers (fund & ETF providers)
As the market for DI is relatively small and not expected to take over ETF and mutual funds, the threat is minimal. Acquisitions even help some AM realize a revenue opportunity.

Custodians
DI represents a large opportunity for custodians as they can build on already established business with RIAs.

DI platforms (TAMP)
DI is an obvious opportunity for white-label asset management platforms as it provides them with another use-case for their clients.

Advisors
While advisors that do not offer DI might lose some clients or fail to appeal to new ones, DI is mostly an opportunity for RIAs to appeal to younger tech savvy clients and establish business early on.

Index providers
DI uses indices at the base of the investment process only so it does not provide much opportunity for index providers to make deals outside of providing a few base universes.

Source: BWS

DIRECT INDEXING, AN ETF KILLER OR REBRAND FOR SMAS?

Direct indexing is the new, shiny version of the traditional Separately Managed Account (SMA) which have historically been limited to institutional investors as well as ultra and high-net-worth individuals since customization was complex and expensive.

Today direct indexing is more than just a marketing gimmick as it truly brings an upgrade to SMAs with lower fees and better technology.

Yet it is not exactly an ETF killer either, as ETFs remain an attractive solution for cost-focused retail investors with small investment amounts.

ETFs offer cheap and instant diversification across a wide range of exposures with low trading costs even for smaller investors. Not everyone needs or wants the degree of customization that direct indexing offers, and the variety of funds already existing on the market is more than enough to craft interesting portfolios that can reflect the values and interests of most investors.

On top of costs considerations, the current direct indexing offer is much less diversified than that of ETFs in terms of asset classes available. Most direct indexing providers focus exclusively on stocks, as bonds remain more challenging to hold for individual investors as they trade less, and in larger lot sizes. For now, real estate and commodities are out of the conversation entirely.

DIRECT INDEXING IS MOSTLY A US PHENOMENON

Today direct indexing is mostly a US phenomenon. There is no official direct indexing solution marketed in Europe so far. The closest alternatives are a few robo-advisers offering investors the option to exclude certain stocks from their portfolio.

Fewer than one in five European ETF firms say they expect to develop a direct indexing proposition, according to a survey by Cerulli. This does not mean that the approach is never going to cross the ocean, but we can expect that the growth in direct indexing will continue to come from US investors for the coming years.

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Europe is a more complex, fragmented market which makes it more difficult to penetrate. For example, the tax consideration is not as clear for European investors. Their portfolios likely contain more countries, so direct ownership of stocks can create a more complex tax situation.

If there is a way for direct indexing to reach European investors, it would most likely be through ESG investing.

Sustainability is a predominant investment trend in Europe. ESG ETFs have received almost half of all the flows in 2021, showing how important the topic is to investors.

3. Is it worth the hype for investors?

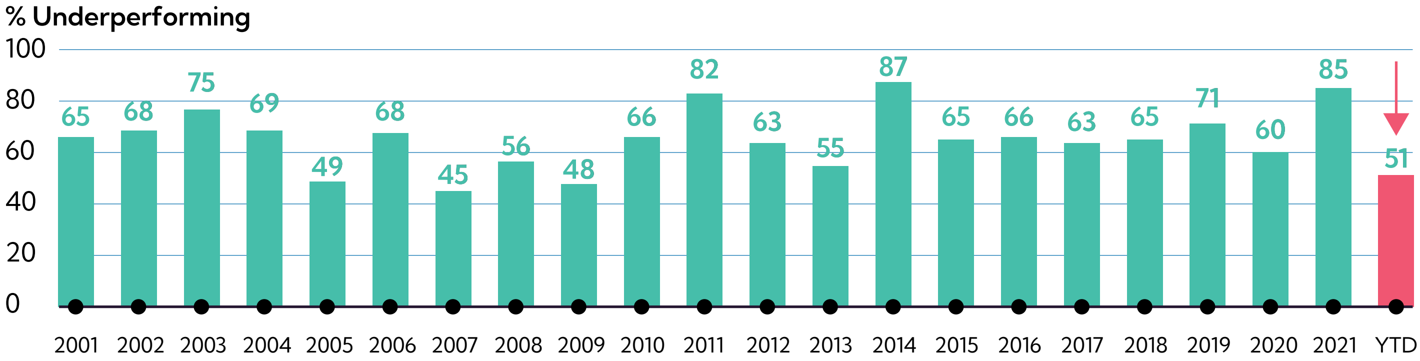
The two main arguments put forward by direct indexing providers are the potential for customization and tax optimization. We analyse each point separately.

CUSTOMIZATION IS ACTIVE INVESTING

If there is one thing to take away from this report, it is that direct indexing is everything but a passive strategy. Customization is active investing.

This creates the risk of underperforming market indices or investors' benchmarks. **Active investing returns have not been brilliant** and have been one of the main reasons behind the move towards passive investing in the past decade.

Percentage of Large-Cap US Equity Funds underperforming the S&P 500 each year



Source: S&P Dow Jones Indices LLC. Data as of June 30,2022.

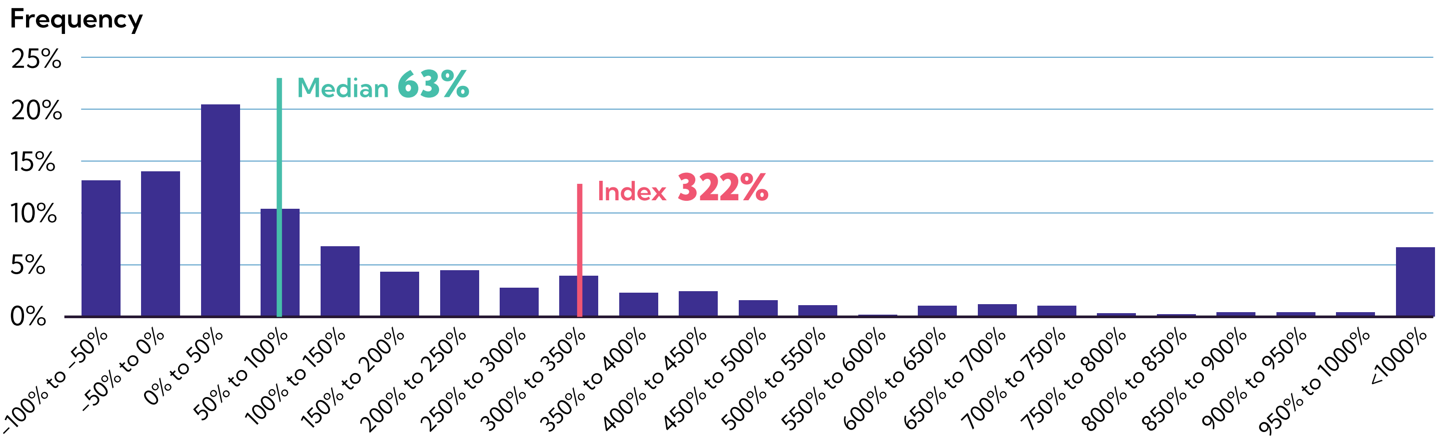
IT IS NOT ALWAYS WISE TO TWEAK AN INDEX

As direct indexing democratizes access to complex strategies, it will eventually reach some investors that might not have financial education and might make naïve bets on which stocks to exclude. Offering this flexibility without sufficient questioning of the reasoning behind might turn out to be detrimental to the long-term investment performance. This can contrast with the advisers' pledge to providing investor education and thorough investment advisory services to the ultimate benefit of the investor.

It is exceedingly difficult to select stocks and the resulting portfolio is likely to underperform the broad market as returns are not evenly distributed amongst stocks.

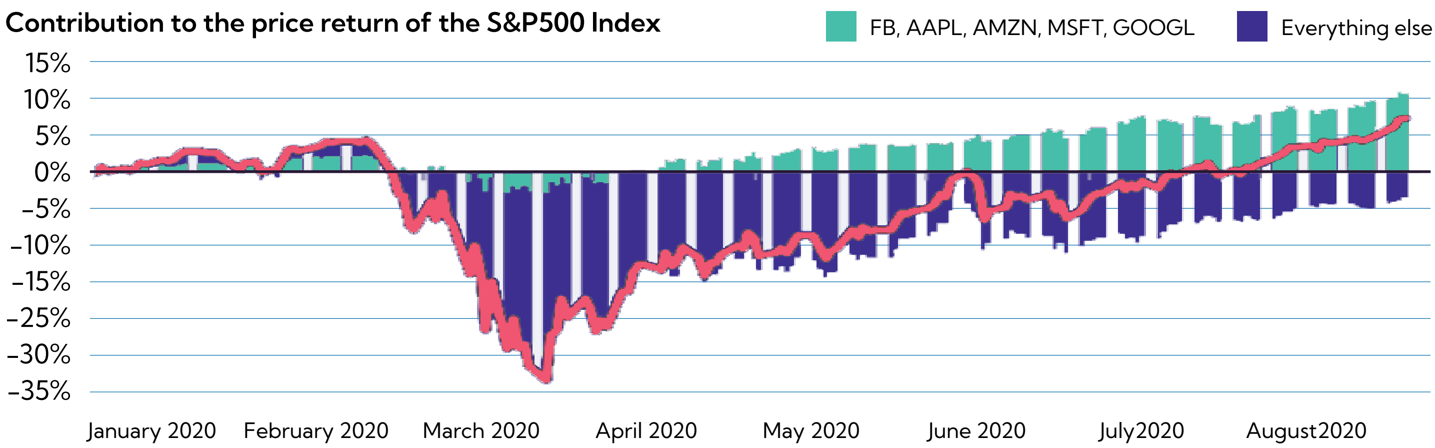
In a report published last year, SPDJI found that only 22% of the stocks in the S&P 500 outperformed the index itself from 2000 to 2020. **Often as pictured the stocks driving the gains in those indices are the big names that investors could exclude.**

Most S&P 500 constituents underperform the index, 2000–2020



Source: S&P Dow Jones Indices LLC, FactSet. Data from 2000 to 2020.

The largest five stocks drove S&P 500 performance, 2020



Source: S&P Dow Jones Indices LLC

A LIMIT TO REFLECTING INVESTORS' VALUES: THE CONFUSION AROUND METRICS

The desire to invest more sustainably, or according to investment factors will eventually have to be translated into concrete metrics to be applied to clients' portfolios. Concretely direct indexing providers must define some sets of metrics that their clients will be able to choose from.

This is not an easy task as there is a lot of confusion around ESG metrics. **The investment industry has still not come to an agreement on which metrics make more sense and the field is still wildly divided.** A flurry of metrics exists, sometimes contradicting each other.

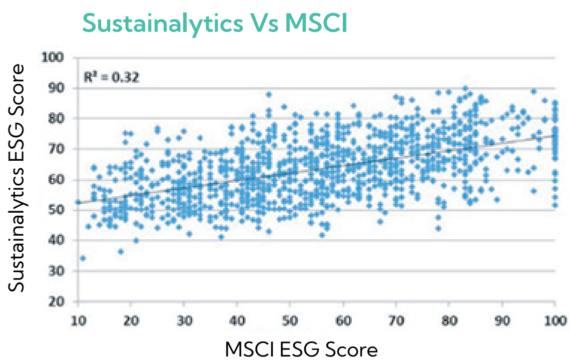
The same can be argued about investment factors which depending on the technicalities of their definition can result in quite different end portfolios and associated returns.

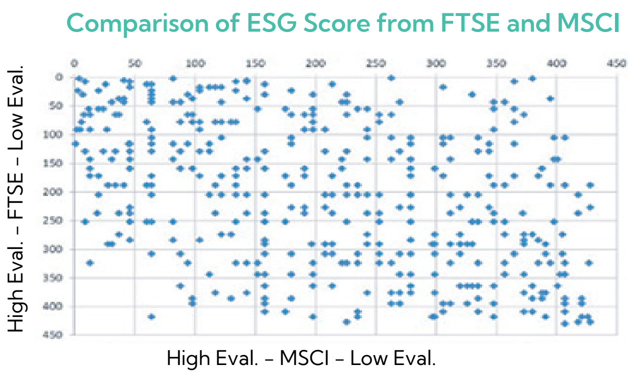
"There is a lot of confusion around ESG metrics. The investment industry has still not come to an agreement on which metrics make more sense and the field is still wildly divided. A flurry of metrics exists, sometimes contradicting each other."

Divergence in ESG ratings across large US companies

Source: Data from MSCI, FTSE Russell and Sustainalytics, computation and analysis by Dimson, Marsh and Staunton

Comparison of ESG scores shows low correlation between providers





Source: CSRHub, S&P 1200 equities

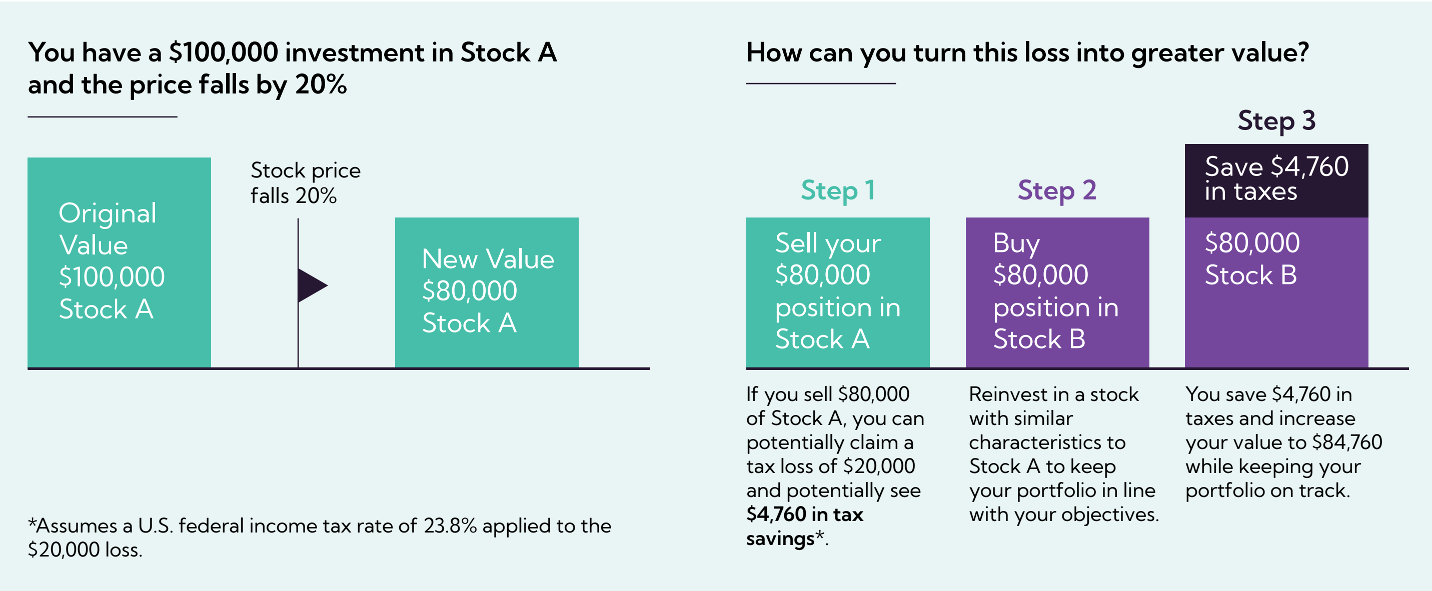
AFTER-TAX RETURN IS WHAT TRULY MATTERS TO TAXABLE INVESTORS

Only after-tax performance matters to investors, and this is often forgotten in the investment world. Both asset managers and index providers do not really need to be thoughtful about taxes, as they sell their products to the industry directly or to many investors with vastly different tax profiles.

Most of the time, the responsibility falls upon financial advisers and wealth managers. Investors around the world usually have access to a few regulated solutions for tax optimization, like tax deductible investments or tax deferred accounts (sometimes even partly tax free).

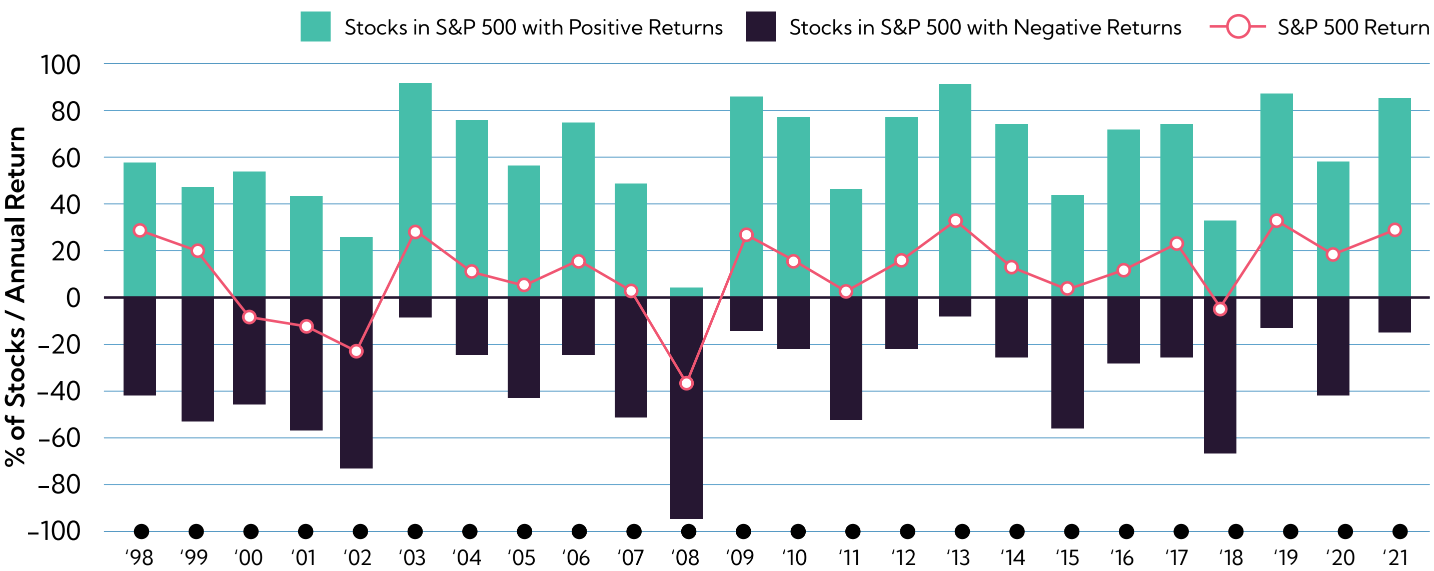
Another way to optimize taxes is Tax Loss Harvesting (TLH). **Markets are volatile and there are almost always some stocks that decline in price in any investment universe, creating opportunities to harvest losses.** By selling the stocks at a loss, investors can partly defer taxes on their gains. This generates money to reinvest in their portfolio instead of paying it out in taxes today.

Tax-Loss Harvesting how it works



Source: JPMorgan

S&P 500 Index returns, 1998 to 2021, Every year had stocks with negative returns



Source: BlackRock (Aperio)

Still TLH is no free lunch and there are many risks associated with the practice. For example, **investors risk selling losing stocks at the worst time like a stock market crash**. Those are the stocks that would rally the most during the subsequent recovery. Also, the replacement stocks might have slightly distinct characteristics as no two companies are the same. This means that they will not act as a perfect proxy and will create bias in the portfolio's risk profile and factor exposure, potentially creating a drag on the portfolio's performance or adding volatility.

"TLH is no free lunch and there are many risks associated."

A LOOK AT DIRECT INDEXING INVESTORS: IS IT RIGHT FOR YOU?

With some direct indexing offers start with as low as $1 initial investment, the approach is being sold as the go-to solution for all types of investors. Still direct indexing is not necessarily the best option for everyone.

There are a few questions that can help you find out whether direct indexing is the right approach for you. Amongst the most important ones, **investors should weigh the potential tax benefits from TLH against the extra cost and complexity.**

"Direct indexing is not necessarily the best option for everyone."

TLH is not a free lunch and high net worth individuals (HNWI) will benefit most from the practice. Most of the solutions available today in the US are requiring high minimum investment amounts for this reason.

It is also healthy to consider whether investors' specific investing preferences (in ESG or factors for example) can be met by existing products like ETFs or mutual funds, before suggesting an individualized approach like direct indexing. The market for specialized ETFs and ESG funds is expanding rapidly so gap in the offer might be only temporary and might not justify investing directly.

Identifying relevant alternatives that would satisfy investors' preferences is not an easy task, as information is often scattered across providers' websites and not always directly comparable from one product to another. Thankfully, platforms like Trackinsight or Morningstar can help investors save time and be more efficient in their research.

Lastly, **investors must not underestimate the risk of sustaining a different performance versus that of standard benchmarks like investors' starting universes.** Depending on the degree of customization, direct indexing investors will need to possess a high-risk tolerance to go through potentially significant return discrepancies at the worst times.

HIGH-NET WORTH INDIVIDUALS: TAX OPTIMIZATION IS PREVALENT

High-net worth individuals will benefit the most from implementing tax-optimized strategies because their tax burden is higher than average.

However, **DI is not automatically the best option for all HNWI.** Sometimes simply minimizing taxes by investing in a tax-efficient vehicle like an ETF can be enough. It is important to consider the gains realized by lightening the tax burden considering the increased tracking error, additional cost and complexity of the approach.

PORTFOLIO COMPLETION INVESTORS: CUSTOMIZATION IS PREVALENT

Some investors might hold large positions in a specific stock. They might have direct exposure to the stock as a result of employee compensation, or skilful past stock picking, or even just a gift. They might as well have indirect exposure to the stock, for example by working for a certain company or industry.

The idea behind the investing logic here is the same: **carefully craft a portfolio around the existing position so that their overall portfolio is not as overweight in the concentrated position or industry.** This way they are limiting the risk associated with their high exposure to the legacy stock or their professional industry, and their overall wealth will be more resilient in case of a decline in the stock or industry.

PROFILES THAT ARE LESS A MATCH FOR DIRECT INDEXING: ESG AND FACTOR INVESTORS

Outside of high-net-worth investors and those who hold large stock positions, direct indexing is often presented as an ideal solution for investors with preferences for values-based investing (ESG) or factor-based investing. However, **we consider that the existing alternatives in ETFs and mutual funds should satisfy most of investors' demands, and the offer keeps growing every day.**

Conclusion

Direct indexing is a trend to monitor but not an immediate threat to the industry as its benefits remains restricted to specific investors profiles.

Direct indexing is the asset management industry's attempt at breaking away from the ever-more-powerful index providers, regaining both some control and a portion of the fees. It is mostly constricted to the US so far, and the most successful providers have already been bought by large asset managers.

Still, it is a step backward for most investors as it combines all the issues of direct investing and none of the benefits of index investing. While some degree of personalization serves a better alignment of interests between firms and clients, giving mass retail investors full autonomy with their investment decisions might prove detrimental to their long-term returns, failing the industry pledge of working in the ultimate benefit of investors. All in all, direct indexing is an interesting but niche service right now most beneficial to specific high-net-worth US investors. **Will** it remain so? Only time will tell.

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