

WHITEPAPER

Direct Indexing

Delivering Personalization at Scale to Differentiate
Your Firm and Stave Off the Robots

Table of Contents



03	Introduction
03	Industry Trends
05	Direct Indexing Technology and Service Evolution
06	Case Study: Forme Financial
07	Conclusion
08	About Orion Advisor Tech

Introduction

Technology advances continue to alter just about every aspect of wealth management, most notably bringing down costs for traditional investment services. So much so that investing has largely become commoditized.

The bread and butter of advisory offerings featuring asset allocation, model portfolios, product selection and ongoing rebalancing are now being provided by digital platforms and discount brokers for “free.” As a result, historical financial advisor investing value propositions are being forced to change and compel firms to rethink the investment management services they are providing.

In order to remain sustainable in this new environment, advisors are now looking for new and alternative ways to add value back into their investment management services and better differentiate their offering by providing more bespoke, personalized and customized portfolios.

One powerful approach is through “Direct Indexing.” Direct indexing enables firms to customize and personalize portfolios by holding the underlying securities of a portfolio, instead of in the form of packaged and pooled products, in order to mimic a separate account structure to track an index or adhere to a model portfolio to accommodate for constraints and opportunities in that portfolio, such as tax loss harvesting, concentrated position management, and ESG mandates.

While the concept of “**direct indexing**” has been around for quite some time, it has typically been limited to large portfolios due to the time, complexity and costs involved; and therefore, has experienced relatively small adoption industry-wide.

However, with dramatic innovations in trading and rebalancing technology, new service models, fractional share availability, combined with the elimination of trading commissions —direct indexing is now affordable and applicable to portfolios of all sizes.

Accordingly, this white paper will highlight the industry and technology evolution driving this movement, provide lessons from top advisors on how they are leveraging direct indexing technology and services to bring scale to their operations so they can continue to grow, differentiate their firms, better serve their client relationships, and ultimately stave off the robots.

Industry Trends

For years, technology has been the driving force in bringing down the costs for investment management services. Combined with more transparency driven by regulatory requirements and a bruising competitive environment brought on by digital players along with robo advisors, most industry experts agree that traditional investment management is being, or has been, commoditized.

As an example, global assets under management have increased by 11% to \$103 trillion last year, yet increases in revenue of 1% and profitability of 2% have not kept pace¹. Furthermore, robo advisory assets have increased to \$3 trillion from zero, just a decade or so ago to now being predicted to eclipse \$16 trillion by 2024².

In order to reverse this commoditized trend, many industry experts agree that the focus now is on “hyper personalization.” Hyper personalization is the use of advanced technology to deliver a more custom experience for clients and now tops the digital agenda for most wealth management firms. According to a 2021 survey by software firm Objectway³, companies said they intend to use this approach for portfolio construction, new product design, financial planning customization, risk profiling, and reporting.

¹ <https://www.infosys.com/iki/perspectives/the-tech-driving-asset.html>

² <https://www2.deloitte.com/content/dam/Deloitte/de/Documents/financial-services/Deloitte-Robo-safe.pdf>

³ <https://www.objectway.com/the-future-of-wealth-management-is-hyper-personalised/?lang=en>

A great example of this personalization movement driven by technology is to provide more tailored portfolios through the use of direct indexing. Direct indexing brings the ability to efficiently deploy tax loss harvesting, accommodate a large legacy position or manage to an ESG mandate without changing the risk profile of the portfolio.

For example, portfolio managers can replicate the risk/return profile of the S&P 500 index with roughly 30-40 different stocks vs. holding all 500 of them. From there, powerful rebalancing and trading technology using innovative algorithms can provide alerts to tax loss harvesting opportunities, or put in place constraints to not purchase stocks of companies that are part of an index or model portfolio for ESG reasons, as well as for concentrated position management to minimize capital gains taxes on low-cost basis holdings⁴.

So much so, that just for the tax-loss harvesting opportunities alone, advisors and portfolio managers can now deliver a significant “tax alpha” that can more than make up for their additional fees for actively managing the portfolio.

Direct indexing is growing and is becoming a major driver of industry opportunities. According to recent research from Cerulli Associates,⁵ there are now more than \$362 billion in custom direct indexed separately managed

accounts, which are projected to grow at 12% per year, creating a significant opportunity.

Additionally, only 12% of advisors are currently using direct indexing strategies, which also creates another strong opportunity for advisors to differentiate themselves from the vast majority of advisors who aren't.

The direct indexing research from Cerulli shows that the primary reason for leveraging direct indexing is for tax management and tax loss harvesting, however, with the rise of ESG investing, direct indexing is also being deployed to personalize portfolios in order to align with a client's values.

As a result of this growth and opportunities to deploy personalization at scale through direct indexing, the asset management industry is taking note by making massive investments in direct indexing technology as they see the opportunity to enhance their service offering and provide better customization tools for advisors and their clients. Additionally, the availability of advanced direct indexing technology is also driving costs down, enabling direct indexing to be offered at lower and lower minimums.

Direct indexing provides a powerful differentiator for advisors in positioning their firms and service offering, particularly as clients are demanding more personalized services. Direct indexing also provides advisors with demonstrable evidence of the work they are doing for their clients, showing the tax savings they are creating, which often more than justifies their typical 1% fees. On top of that, advisors are able to message that they are providing alpha through more personalized services and aligning their investments with their values through ESG approaches — all of which create stickier client relationships, as well as provide a new marketing message for their firms to attract and retain the best clients.

⁴ <https://www.thinkadvisor.com/2021/08/24/how-direct-indexing-can-save-the-investment-management-industry/>

⁵ Cerulli Associates: *The Advisor Perspective on Direct Indexing – March 2022*; <https://www.cerulli.com/knowledge/white-paper-improving-client-experience-customizing-with-direct-indexing>

Direct Indexing Technology and Service Evolution

While the concept and approach for direct indexing has been around for decades, it has not been widely adopted due to its historic costs and complexities, making it only workable for large portfolios. However, all of that is now changing rapidly. For example, trading costs in the form of commissions had been a barrier to deploying direct indexing strategies, however, with the elimination of trading commissions broadly throughout the industry the past few years, that cost issue has gone away.

Other barriers to adoption have been the lack of technology solutions that are available to advisors to be able to work directly with clients in developing the portfolios they want in order to minimize capital gains taxes, align their values with their investments in the form of ESG and to leverage tax loss harvesting opportunities to create significant savings. Now, with the advent of powerful, advisor-facing technology tools, advisors can personalize portfolios and broaden the use cases for direct indexing beyond traditional equity indexes such as the S&P 500, but to also apply them to model portfolios, or active strategies that don't include tax management. They can simply target an exposure they want to manage within that portfolio or strategy and customize it directly to the clients' objectives.

This approach creates an enhanced client experience that becomes a communication tool, a story book if you will, in how the advisor and client jointly develop the best, most

customized portfolio for that individual client. Recent experience has shown, however, that just providing direct indexing trading and rebalancing technology on its own to advisors has not led to widescale adoption as it still requires time, resources, expertise, and operational efficiencies that not all firms possess. At the same time, traditional direct indexing service models of providing a clients' portfolio to an asset manager for review and recommendations takes time as the advisor must then analyze those recommendations to ensure alignment with their overall investment strategies for that client. Once that back and forth is complete, only then can the asset manager begin implementation. As a result, this traditional service model creates a disconnected experience, higher costs, and lack of scalability, which again has led to low adoption.

What is emerging, however, is a new technology + service model that is a hybrid of providing the front-end direct indexing technology to advisors in an easy-to-use and understandable interface for initial analysis and recommendations. Combining that technology experience with a service model provided by direct indexing experts behind the scenes to implement the trades and rebalancing, corporate action management, and ongoing associated operational requirements better leverages advisors, creating a win-win result.

This technology-enabled service model — **tech + service** — provides a best-in-class experience and includes the guard rails, bumpers, and fiduciary responsibilities needed for compliance. Ultimately, creating a “hybrid” managed account which provides a superior solution: advisors and clients receive the best of both worlds.

Advisors are able to work with clients in a technology experience to identify their objectives for tax management, ESG, and other requirements to personalize the portfolio; and then digitally provide these instructions for implementation to the service provider. This frees up the advisor from those ongoing, back office operational requirements and brings scale to their direct indexing efforts.

Particularly when working with a new client who has an existing portfolio transferring in that is already invested and needs to be adjusted and rebalanced for the new strategy, this hybrid approach enables the service team to slowly unwind positions in a tax sensitive manner over time, and not trigger capital gains taxes resulting from broadly selling low-cost basis securities. Similarly, tax management overlays can be put in place on top of existing strategies clients want to keep in place.

This streamlined model is further enhanced by working within a [wealth platform that also has complimentary components](#) such as risk profiling, financial planning, reporting, CRM and more, resulting in advisors being empowered with a full suite of integrated tools and better data to deliver on their service promises and finally scale personalized delivery.

Case Study – Forme Financial

Forme Financial is a very unique advisory firm in many ways, most notably that it is a de-novo startup RIA founded by some of the most experienced, skilled and knowledgeable financial professionals in the industry. The team backing Forme is a literal “who’s who” of wealth management executives, including CEO John Clendenning, former CEO of Charles Schwab Bank and CPO Jack Chung, the former executive who led the development of Apple Pay. Forme opened up shop in Q1 of 2022, and has already experienced significant growth and success.

A key aspect of Forme’s success is its niche-business strategy to focus the practice on working with professional verticals, with its first foray starting with physicians. “We are creating a tech-driven experience that provides purpose-built advice that mirrors the lifecycles of high-earning professionals,” said Bill Martin, CIO of Forme Financial.

As part of Forme’s comprehensive service offering, Forme places a key aspect on tax management to optimize client investment returns, focusing on delivering a significant “tax alpha” through the use of Direct Indexing. “For liquid market segments, such as large cap equities, it is very difficult for advisors and managers to create alpha consistently over time,” Martin says. “However, by using a direct indexing approach, we are able to deliver significant out-performance by capturing tax savings in a meaningful way.”

Particularly for clients transitioning in to the firm with an existing portfolio, direct indexing can provide many tax-related benefits by transitioning the portfolio to Forme’s strategies over time, leveraging technology to provide scale, accuracy and efficiencies. “We see many other advisors selling out portfolios to move clients into their models, triggering significant capital gains, particularly after the last decade or so of significant market growth, which lead to client management issues once they see their tax bills,” Martin notes. “Alternatively, by using direct indexing approaches, we can efficiently manage those tax issues, while mimicking the indexes and models we deploy so that oftentimes we deliver zero tax transition costs through our direct indexing process.”

When it comes to syncing up clients’ values with their investments, Martin notes that he is able to use direct indexing approaches to personalize portfolios with an ESG lens. “Direct indexing allows for easy customization, even for SRI strategies, with the result that clients truly feel that you have listened to them and that you can deliver a truly unique portfolio, customized to that specific client.”

In order to create a modern firm that can scale with their growth, while still providing a high-touch experience, Forme is leveraging the latest technologies. “When we were designing the firm, we looked at a number of different partners to help us realize our vision,” Martin says. “A key requirement for us was having a connected experience so that our direct indexing capabilities are integrated into our portfolio accounting and reporting systems, as well as to our custodians; and Orion provides that right out of the gate. Orion is providing a cohesive experience for our clients, advisors and back-office staff, which is truly invaluable.”



Key tools that Martin is leveraging from Orion's direct indexing technology are the Tax Transition proposal tool as well as the Tax Savings report.

“

The Tax Transition report is critical for client acquisition as we can show them directly how we will transition the portfolio and how we manage the tax implications, providing them with confidence and peace of mind so that they quickly convert to becoming clients. Additionally, the Tax Savings report provides compelling and quantifiable evidence of the benefits we are delivering, which more than justifies our fees.

Bill Martin,
CIO, Forme Financial

”

Going forward, Martin believes that direct indexing is the future of investing. “All you have to do is look at the dozens of acquisitions of direct indexing technologies the big asset managers are making to know that this is so much more than a trend,” he says. “Everyone wants to get closer to the client to better control and manage the relationship and there is no better way to do that than personalizing portfolios through direct indexing.”

Conclusion

Technology evolution in wealth management will continue to shape and change how advisors work with their clients, providing both a challenge and an opportunity. As noted above, traditional portfolio management can often be done more efficiently and cost-effectively by technology solutions through robo advisors and digital platforms. However, what the industry has also seen over these past few years is that demand for human advice remains strong and those same technology enhancements are now better enabling advisors to deliver on their unique value propositions in a more efficient and scalable way.

Most notably, direct indexing further powers that personal touch as advisors can visibly demonstrate how they are implementing their clients' wishes for sustainable investing, providing significant tax savings, all while customizing portfolios to help clients meet their goals and objectives. Personalizing portfolios at scale will be the next way advisors continue to stay one step ahead of the robots and remain paramount in their clients' lives, while also enjoying all the benefits of a more efficient and growing business.

About Orion Advisor Tech

Orion is a premier provider of the tech-enabled fiduciary process that transforms the advisor-client relationship by enabling financial advisors to Prospect, Plan, Invest, and Achieve within a single, connected, technology-driven experience. Combined, our brand entities, Orion Advisor Tech, Orion Portfolio Solutions, Orion Risk Intelligence, Orion Compliance, Brinker Capital Investments, Redtail Technology, and TownSquare Capital create a complete offering that empowers firms to attract new clients seamlessly; connect goals more meaningfully to investment strategies and outcomes, and ultimately track progress toward each investor's unique definition of financial success. With the addition of Redtail and TownSquare, the combined platform services more than \$3 trillion in assets under administration and \$62 billion of wealth management platform assets. Prior to closing on Redtail and TownSquare, Orion served 4.7 million technology accounts and supported more than 2,300 independent advisory firms with \$1.9 trillion in assets under administration and \$60 billion of wealth management platform assets (as of March 31, 2022), making Orion the platform of choice for all growth-focused advisory firms looking to strengthen their client relationships, gain a competitive edge in a crowded marketplace, and build strong, profitable businesses.



Learn more at orionadvisor.tech.com

402-496-3513