Just Invest

Direct Indexing

An Essential Part of Your Model Portfolio for the Mass Affluent

New technology makes it easier than ever for financial advisors to offer direct indexing to their clients. Now that commissions have dropped to zero, it's also a strategic way for advisors to offer more personalized service to a wider range of investors.

Direct indexing—tracking the performance of an index by buying a sample of individual stocks instead of an ETF or mutual fund—has been around for years. However, because of the trading costs and manual labor involved, advisors reserved this service for high-net-worth clients.

That's all changed now.

One of the fastest-growing segments of the financial market—the mass affluent—demand personalization and tax benefits that direct indexing offers.

Today's portfolio management platforms, especially when combined with asset management expertise, allow advisors to offer affluent clients the benefits of direct indexing with low fees and low hassle. With the right tools, you can create tax efficient investment strategies for this growing market. Plus, you can tailor investments to match their ESG values.

Here's how you can become part of the growing trend of customized, tax-optimized portfolios for the next generation of investors.

Who Are the Mass Affluent?

Defined as individuals with $250,000 to $1 million in liquid assets, the mass affluent comprises about 76 million individuals and $18 trillion in assets globally with about 4 million people rising to affluent status each year[1].

Mass affluent investors not only want more tax-efficient strategies, they demand personalization and have an interest in ESG. According to a report from Calvert Research and "Investment News," about 25% of mass affluent investors and 31% of ultra-high-net worth investors have a high interest in ESG[2]. The ability to customize portfolios suits clients that want to manage tax exposure as well as implement ESG strategies.

The tax efficiency and customization benefits of direct indexing make it an attractive strategy for affluent and high-net-worth investors. But it can be a complex process that is best left to financial advisors.

ESG also requires industry expertise. According to the Calvert Research report, 42% of investors surveyed prefer to pursue ESG strategies through an advisor. Thanks to the following industry developments, advisors can now offer the benefits of direct indexing with an ESG strategy to a wider client base.

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$0 Commissions

In October 2019, Charles Schwab eliminated online trading commissions for U.S. stocks, ETFs and options. Fidelity, TD Ameritrade, and other leading institutions soon followed suit.

With trading costs reduced to zero, per-share commissions are no longer an issue. Before $0 commissions, the price per trade would have made direct indexing impractical for many accounts.

Advances in Technology

Digital investing platforms take some of the complexity out of direct indexing. These platforms make it easier for financial advisors to replicate an ETF by eliminating most of the manual labor involved in replacing individual stocks. Advances such as cloud computing and data analytics, combined with access to fractional shares, mean faster rebalancing; however, direct indexing still requires expert judgment and oversight.

Consumer Demand

Mass affluent Millennials and Gen X'ers take a more active role in their investments than previous generations. These investors may research financial information online, but ultimately seek advice from a financial expert3.

Younger generations also increasingly lean toward ESG investing. According to a Morgan Stanley Institute for Sustainable Investing report, millennial investors are twice as likely than previous generations to invest in companies that target social or environmental goals. They also want more choices and customization: 90% of millennials want 401(k)s with sustainable options, while 80% of the general population would more readily adopt ESG investing if they could tailor the impact[4]. This data signals a growing need for ESG-savvy advisors who can offer custom portfolios.

What About Performance?

Investors may not have to sacrifice performance for sustainability. Morningstar evaluated 56 unique ESG-screened indexes and found they had outperformed their mainstream equivalents since inception. These indexes also tend to favor companies with strong balance sheets and lower volatility than mainstream competitors[5]. ESG considerations not only benefit the environment, they also relate to strong businesses with long-term growth potential.

Why Direct Indexing Matters to the Mass Affluent

Direct Indexing is the process of purchasing individual equities in an attempt to replicate an index's performance. Instead of owning a group of securities, such as a mutual fund or an ETF, the investor essentially owns the index.

Direct indexing allows you to buy and sell individual stocks rather than an entire basket of stocks.

How it works: You and your client decide on a few hundred or so stocks. One of those stocks takes a dip by $3,000. You can sell the stock at a $3,000 loss and buy a comparable stock in its place. That $3,000 loss may offset a future capital gain.

By harvesting those losses, they become a tax asset. While the end performance result may resemble that of a mutual fund or ETF, investors will likely get an additional tax benefit.

"There is no way to predict the market," says Forrest Bell, president of Bell Investment Advisors in Oakland, California. "But we can use direct indexing to harvest losses in market swings. That is one of the ways we aim to add value for our clients."

How Affluent Clients Benefit

Absent direct indexing, the mass affluent generally choose from cookie-cutter options: mutual funds and ETFs. If your client opposes any of the securities in an ETF, they have to either live with it or choose another fund. With the right direct indexing solution, you can replace those securities with others that align with the client's financial goals and values.

Direct indexing's customization advantage also allows you to create dedicated ESG portfolios. Clients can invest only in companies that use clean technology and prioritize diversity in their business practices if they choose. By personalizing investments for your client, you develop a more personal relationship.

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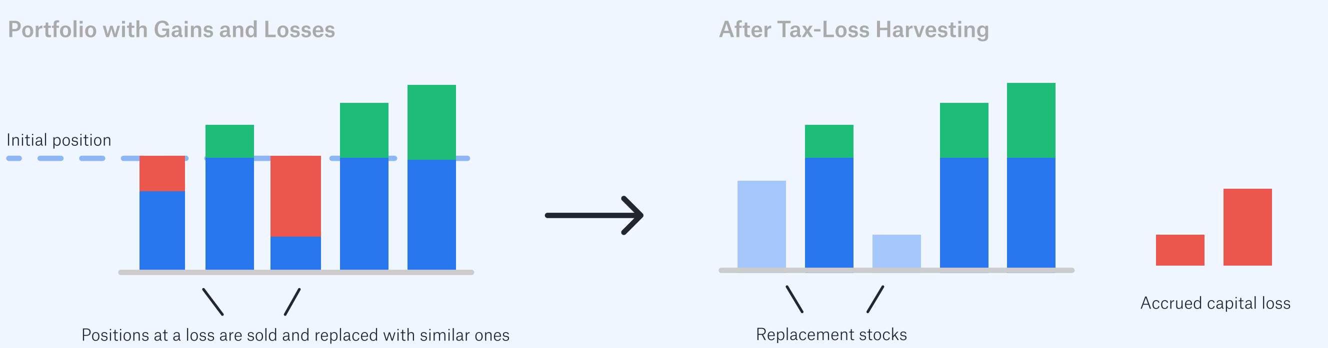
"We're now in an era where an investor knows exactly what they want," explains Lauren Sercu from Sepio Capital. "As more of our clients ask for impact investing solutions, we have looked at direct indexing as a part of our custom impact portfolios, which helps us maintain similar risk-adjusted return expectations as our traditional portfolios."

Tax-Loss Harvesting, At a Glance



Tax Loss Harvesting: Not Just for the Wealthy Anymore

Tax loss harvesting is a key benefit of direct indexing. When buying and selling individual stocks, you may harvest tax losses. This allows for more control over gains and losses through the year, optimizing your tax outcome.

Tax Loss Harvesting Benefits

- **Tax deferral.** Capital losses may be used to offset capital gains realized in other transactions—even from selling real estate. If there are losses left over at the end of the year, you may offset up to $3,000 of ordinary income. Any remaining losses can be carried forward.

- **Push capital gains into a lower tax rate.** The IRS often taxes short-term capital gains at the income tax rate. If you harvest losses to offset those gains, the corresponding future gain could be considered long-term capital gain, which will be taxed at a lower rate.

- **Tax deferral.** Harvested losses may allow you to defer gains far into the future. In the case of charitable donations and bequests to heirs, gains can avoid taxation completely.

Navigating the Wash Sale Rule

When you sell a security at a loss and purchase the same or a “substantially identical” security 30 days before or after the sale date, you create a wash sale violation. In this case, your wash is disallowed and added to the cost basis of the purchased security. To avoid the violation while keeping the full portfolio in the market, purchase a similar, but not identical, security.

Why It Matters for the Mass Affluent

Who wouldn’t want to deduct an additional $3,000 from their tax bill? For the high-net-worth investor, this is pennies. To the mass affluent, it makes a difference on the amount of tax owed.

Tax loss harvesting also helps build a portfolio over the long term. Investment firm First Quadrant conducted a simulation of 500 assets over 25 years. Using loss harvesting added about 27% to the median portfolio compared to passive action. After liquidation, net of deferred taxes, the benefit equals about 14%. The benefits to the affluent client’s portfolio helps them worry less about retirement[6].

How to Introduce Direct Indexing and Tax loss Harvesting to Your Clients

Harvesting tax losses manually is too time consuming and complicated even for the savviest financial advisors. Software can eliminate much of this hard work and allows investors to offer direct indexing and tax loss harvesting as premium services to more clients.

But is it worth the effort to offer premium services to the mass affluent? We think so. The ability to make your client accounts more tax efficient, realize long-term gains, plus customize client portfolios to fit their ESG values, helps build loyalty among your existing clients and attract new ones.

When researching portfolio management platforms geared toward mass affluent clients and higher, look for the following features:

- Low account minimums.
- Customized direct indexing.
- Automatic risk-optimized rebalancing.
- Tax loss harvesting for individual securities.
- Socially Responsible Investing (SRI) screens.
- Analytics that allow you to show clients ESG impact and performance.
- Advanced simulation technology to generate prospective portfolios.

Just Invest, an asset management solution for financial advisers, applies daily tax loss harvesting and watches for wash sales. It also makes recommendations for new securities that keep portfolios in balance—all so you don't have to.

"We designed our software to not only apply daily tax loss harvesting, but to watch for wash sales and to make recommendations for new securities that keep portfolios in balance," says Alan Cummings, PhD, Chief Research Officer for Just Invest. "Our technology allows investors to deliver up to two percent in tax alpha per year."

How Just Invest Helps Advisors Grow Their Client Base

To provide value to all your clients without spending hundreds of hours staring at spreadsheets, choose an asset management solution that does the work for you.

Just Invest offers customized direct indexing for investors across all account types down to $250k minimums. With Just Invest's hyper-personalized recommendations, you'll spend less time analyzing your clients' securities and more time helping those clients plan for the future.

Just Invest gives you the following:

- **Granular ESG.** Align clients' investments and values using the UN's Sustainable Development Goals, impact tilts and SRI screens.
- **Daily Tax Alpha.** Help clients lower their tax bill with daily tax loss harvesting, asset location implementation and tax-efficient transactions.
- **Quantifiable Results.** Keep your clients engaged in their finances. Detailed account reports highlight tax savings, ESG impact and portfolio performance.
- **Branded Solutions.** Set your firm apart with white-label customizations based on your investment philosophy.

Just Invest's Kaleidoscope software provides the direct indexing muscle for your advisory firm. It rebalances direct indexes regularly to take advantage of tax loss harvesting.

With Just Invest's Panorama tax management platform, you can optimize tax savings across multiple accounts.

After a full day meeting with investors, you can go home early and let Just Invest do the work. Set your target allocations and Just Invest's optimization engine will calculate trades, correct for allocation drift and harvest tax losses.

Final Thoughts

With commissions lowered to zero, financial advisors can offer direct indexing to a broader client base. Give your clients what they want—a custom, risk-balanced portfolio that performs well—through an intuitive easy-to-use platform.

To find out how Just Invest can work for you, request a demo.

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