DIRECT INDEXING: EXPLAINED

Many investment concepts, tools, and strategies are cloaked in vague complexity, allowing some money managers an air of sophistication. Instead, we believe in cutting through the confusion by educating investors – empowering them to truly understand how these tools work, the benefits they provide, and the risks they may carry. With this knowledge, investors can make smarter, well-informed financial decisions. One such strategy is Direct Indexing, a powerful yet often misunderstood approach that has been gaining in popularity. In this piece, we will break down Direct Indexing, explore how it works, and reveal its potential to add significant value to your portfolio.

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What is Direct Indexing?

Direct Indexing is an innovative subset of investment strategies that aim to replicate the performance of a selected index, such as the S&P 500. Emerging in the 1990's as a solution for high-net worth individuals, direct indexing offers greater flexibility compared to traditional pooled investment vehicles, such as mutual funds and ETFs.

> Instead of owning a single holding like a mutual fund that invests in the S&P 500, Direct Indexing involves directly owning the individual stocks that make up the S&P 500. This distinction brings key benefits, including customization and tax efficiency.

As technology has advanced, the methods of Direct Indexing have evolved as well.

Direct Indexing began with its original and most straightforward method called **index replication** which involved buying every security in an index - think buying all 500 stocks in the S&P 500. While this perfectly replicates the desired performance, there are some obvious drawbacks such as requiring significant starting capital, frequent rebalancing to maintain the proper weightings, and higher trading costs.

The modern solution to these challenges is **optimized sampling** which uses statistical techniques to allow investors to purchase a representative subset of securities that closely mirrors an index's returns, risk profile, and characteristics. Rather than buying all 500 stocks in the S&P 500, an investor could purchase 100 stocks that should perform similarly to the index, reducing the drawbacks of index replication. Given its widespread use today, we will discuss this version of Direct Indexing moving forward.

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Benefits of Direct Indexing

Diversification, Customization and Exclusions:

Direct Indexing enables investors to capture the diversification benefits of a mutual fund or ETF, with the added flexibility of customizing their portfolio. Investors can overweight specific sectors and factors or exclude companies that don't align with their values. For instance, investors who have moral objections to alcohol or tobacco companies can easily avoid them, a flexibility not available when purchasing a pooled vehicle. This is especially valuable for corporate executives who must avoid certain companies or market areas to comply with employer guidelines.

Advantageous Tax Management:

In a mutual fund or ETF, the entire holding is treated as a single investment for tax purposes, accumulating capital gains as the value of the index rises. Upon selling any portion of that investment, a proportional share of those gains is realized and added to the investors tax bill. Direct Indexing, however, offers a superior approach by allowing the investor to own the individual stocks within the index, enabling sophisticated tax strategies that may enhance after-tax, long-term returns.

This approach to tax management unlocked by Direct Indexing is called **tax-loss harvesting**, where investors sell securities that have declined in value to capture the tax losses. These losses can offset gains from other parts of the portfolio or be carried forward to future tax years, boosting after-tax returns over time.

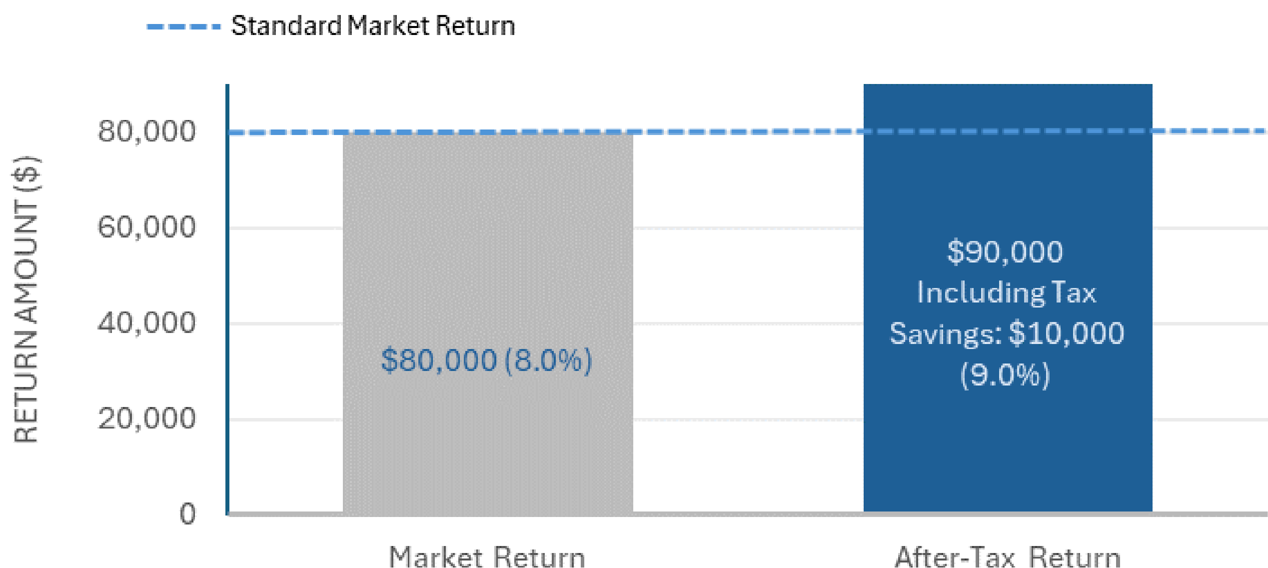
For Example, consider Sarah, who invests $1,000,000 into a Direct Indexing strategy replicating the S&P 500. During the first year, while the overall index return is positive at 8%, certain stocks in her portfolio decline significantly. Sarah's portfolio manager identifies 30 such stocks with combined taxable losses of $50,000 and decides to sell them. By realizing these losses, Sarah can offset $50,000 from her other investments that have generated outsized taxable gains.

Taking taxes into play: Assuming a combined federal and state capital gains tax rate of 20%, this results in $10,000 in tax savings (20% of $50,000), effectively reducing Sarah's tax liability and boosting her after-tax returns. Over time, consistent tax-loss harvesting can compound these benefits and significantly enhance long-term portfolio performance compared to a traditional index fund.

Concentrated and High-Gain Position Management:

Many investors, particularly those receiving equity compensation, find themselves burdened by large stocks positions with significant embedded gains. Due to the potential tax costs associated with selling these positions, they often become an oversized portion of their portfolio and expose the investor to excessive risk. Direct Indexing helps mitigate this risk by combining the previously discussed benefits of diversification and tax efficiency.

Leveraging the statistical methods behind optimized sampling, investors can combine concentrated positions with new capital to form a **completion portfolio**, which is designed to diversify risk from that single holding. For instance, if an investor holds a large position in Apple but wants exposure to the broader S&P 500, statistical techniques can construct a portfolio that emphasizes other sectors or factors outside of technology—such as consumer staples or value—diversifying the overall risk tied to Apple while still mimicking the index's performance.



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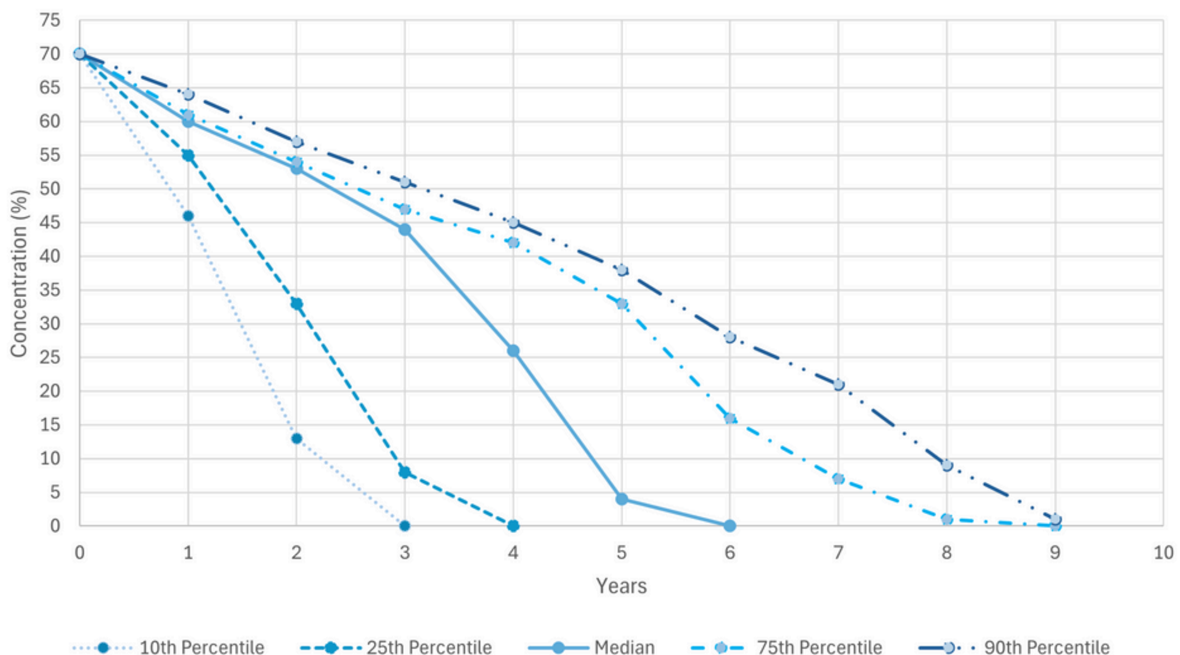
In addition to immediate diversification, tax-loss harvesting can facilitate a gradual reduction in these positions with lower tax consequences. As losses are harvested from other securities in the portfolio, they can be applied to offset gains from the concentrated position, allowing for the tax-efficient sale of the asset.

Take the below example:

Sarah finished her career at Apple and owns $250,000 worth of Apple stock given as equity compensation. Over the past two years, the stock has grown by 50%, making up a large part of her portfolio. To diversify, she contributes her Apple stock and $100,000 in cash to a Direct Indexing strategy.

By setting a tax budget of $500 per year, Sarah can use tax-loss harvesting to reduce her Apple position from 70% of her portfolio to 25% in four years. Over that time, she will pay only $2,000 in taxes—less than 1% of the original value of her Apple holdings, providing a clear example of managing risk while maintaining tax efficiency.



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Drawbacks of Direct Indexing

While Direct Indexing offers numerous benefits, there are also potential drawbacks.

Initial Capital Requirements:

Direct indexing typically requires a larger initial investment compared to pooled investment vehicles like mutual funds or ETFs. This is because replicating an index requires holding a large number of individual securities.

Operational Complexity:

Managing a Direct Indexing strategy involves tasks like rebalancing, tax-loss harvesting, and monitoring holdings for deviation from the index. These tasks can be time-consuming and require sophisticated tools. While tax-loss harvesting is a key advantage, it adds complexity, necessitating careful tracking of lots, wash-sale rules, and tax implications. Fortunately, tools addressing these challenges have emerged, making the product more accessible and cost-effective for retail investors.

Tracking Error:

Tracking error quantifies how much a portfolio's return may differ from the underlying index it tracks. Optimized sampling, though effective, introduces the possibility of tracking error, where a portfolio's return deviates slightly from the index it aims to replicate. While often marginal, it remains a risk.

Behavioral Challenges:

Some investors may struggle with the psychological challenges of managing a large number of individual securities, which can fluctuate significantly in value. This volatility may lead to impulsive decisions that undermine the strategy's effectiveness.

Over the past 30 years, Direct Indexing has evolved from a niche solution for high-net-worth individuals into a more accessible, sophisticated investment strategy. As it continues to grow in popularity among retail investors, it's essential to understand its uses, benefits, and limitations to determine whether it aligns with your financial goals.

To learn more about this strategy and how Direct Indexing might fit your needs, contact a Waterloo Capital financial professional here.

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KEY TERMS

Direct Indexing: Investment strategy that, through different methods of achievement, attempt to replicate as closely as possible the performance of a selected index

S&P 500 Index: A market-capitalization-weighted index of 500 leading publicly traded companies in the U.S.

Index Replication: Direct indexing method implemented by buying every security within a selected index in its proportional weighting

Optimized Sampling: Direct indexing method implanted by using statistical techniques to select and invest in a subset of an index that closely matches its overall performance and characteristics

Pooled Investment Vehicles: Investment funds, such as mutual funds or exchange traded funds, in which investors purchase one holding that represents a stake in a collection of securities

Tax-Loss Harvesting: The practice of intentionally selling positions and/or tax lots that have fallen in value since initially purchased to generate capital losses

Completion Portfolio: A method of complementing a concentrated position with carefully selected diversifying positions to ultimately lower the divergence from a selected benchmark

Tracking Error: Figure representing how much a portfolio’s return may diverge from the underlying index it follows

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