The Future of Investing – Direct Indexing

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The active versus passive debate is a common one in the world of investing. Active managers, those trying to use skill (and a little luck) to beat the market, want to convince investors that it is still possible to beat the broad market. However, the most recent SPIVA report (December 2018) showed that 82.14% of the large cap funds in the US failed to beat the S&P 500 after fees. The underperformance of active management (broadly speaking) is one of the main contributors to the rise of ETFs. Relative tax advantages and lower fees (compared to actively managed mutual funds) can also be cited as contributing factors.

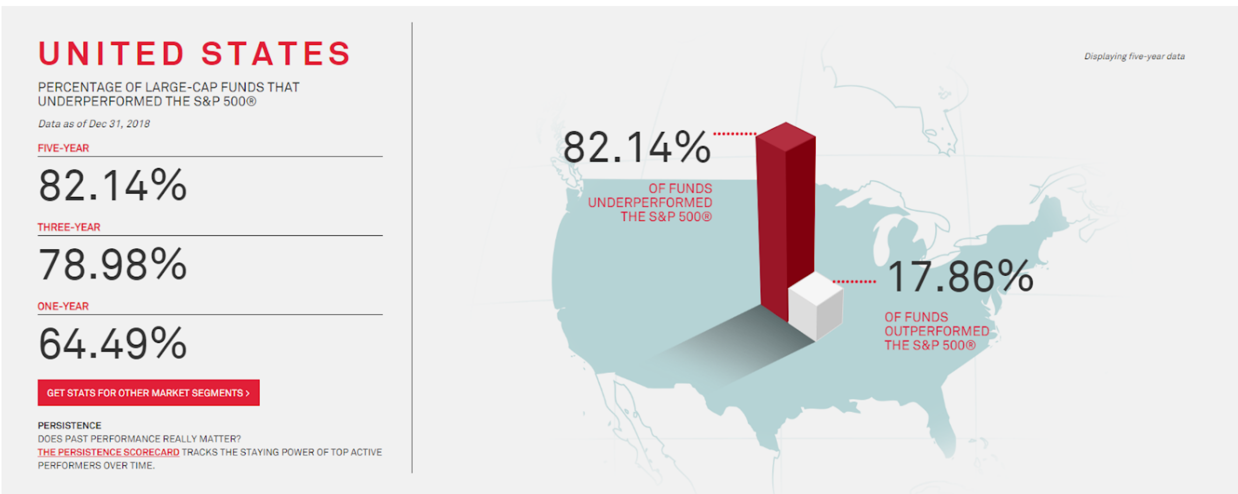

Figure 1: Percentage of Large-Cap Funds that Underperformed the S&P 500[1]

According to the Investment Company Institute's statistics[2], $3.77 Trillion dollars have been invested into ETFs as of March 2019. Actively managed mutual funds have been the clear victim. According to Morningstar[3], 66% of actively managed mutual funds were in outflow over the previous 12 months ending in September of 2018. It appears that investors are casting their ballots regarding the active versus passive election.

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[1] "SPIVA Statistics & Reports." SPIVA, S&P Dow Jones Indices LLC, 31 Dec. 2018, us.spindices.com/spiva/#/reports.
[2] "ETF Assets and Net Issuance March 2019." Investment Company Institute, Investment Company Institute, 29 Apr. 2019, www.ici.org/research/stats/etf/etfs_03_19.
[3] Kinnel, Russel. "What Trends in Actively Managed Fund Flows Reveal." Morningstar.com, Morningstar Research Services, LLC, 18 Dec. 2018, www.morningstar.com/blog/2018/12/13/active-managed-flows.html.

I do not believe in passive investing. Before you label me a lunatic, let me provide some clarity. I believe that investing is either systematic or discretionary. All investing requires some sort of action. Even if I buy a stock and hold it my entire lifetime, I took action in the beginning. Active managers as we know them today are really discretionary managers in most cases. In other words, they choose to invest (or not to invest) in securities based on their opinion of the outlook for that particular investment. I am not a big believer in discretionary strategies. The main reason is that they are largely absent of rules-based discipline.

Indexing, or passive investing as it is known today, is systematic. I am a huge fan of systematic strategies. In Chapter 12 of his book Thinking Fast and Slow[4], Daniel Khaneman showed the effectiveness of using simple rules for making decisions. In an index, the rules for asset allocation, security selection, and rebalancing are all defined and followed with discipline. Up until recently, indexes were fairly simple—following market capitalization and style rules. Now, indexes are multifactor, multi asset, and alternatively weighted. They are still rules-based, but they are quantitatively more advanced than the more primitive indexes. This is why I am so excited about the future of investing.

In my opinion, direct indexing is one of the most exciting innovations in the history of investment management. This process simply consists of buying all the constituents of an index in a separate account (without a fund intermediary like an ETF). Having been around for a while now, direct indexing has historically been reserved for larger account sizes because of trading costs. It is now more accessible than ever before, with fractional shares, asset-based pricing, and new index innovations making direct indexing possible for even smaller accounts.

Investing directly in the underlying securities has a few advantages that are going to support rapid growth. The first is the potential tax benefits. In an ETF, you own the basket and the taxable transaction is usually realized upon the liquidation of the ETF itself. Direct indexing allows more control over the tax situation of the investor because the investor owns the underlying holdings. Therefore, he or she can use tax loss harvesting to potentially increase after tax returns. As noted by the PMC Quantitative Research Group[5], "realizing capital losses through active tax management usually results in a lower tax basis for the stocks in the

[4] "The Science of Availability." Thinking, Fast and Slow, by Daniel Kahneman, Farrar, Straus and Giroux, 2011, pp. 129–136.
[5] "Capital Sigma: The Return on Advice." Envestnet, Inc., Envestnet | PMC Quantitative Research Group, 2018, www.envestnet.com/essentialadvisor.

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portfolio, and a lower basis generally implies higher capital gains taxes once stocks are liquidated. Deferring taxes makes more dollars available in the portfolio to earn a return (15).” Furthermore, if an investor has a liquidity need, instead of selling the entire ETF or fund, he or she can selectively liquidate stocks with losses to defer tax. We have included a figure below that illustrates the potential value that proper tax management can have on portfolios versus those that are not actively tax managed:

Figure 2: “External Tax Alpha”: Cumulative returns for tax-managed and benchmark portfolios.[6]

The second advantage to direct indexing is customization. If an investor were to buy an ETF, they would not have the ability to customize the underlying portfolio. By owning the index constituents, an investor can select or exclude securities based on personal preferences and their unique objectives and constraints. Investors can select for ESG criteria, sector preference, and even factor weightings. These customizations are critical for arriving at a more client centric investment experience. No longer will the bias be toward institutional benchmarks that are often vastly irrelevant to a retail client’s financial goals. Now, investors can really pick an index that is built around them.

Direct indexing also has benefits that are behavioral in nature. Optically it is very challenging for some clients to buy one ETF in their portfolio, so investors often have several ETFs with overlap among the underlying

[6] “Capital Sigma: The Return on Advice.” Envestnet, Inc., Envestnet | PMC Quantitative Research Group, 2018, www.envestnet.com/essentialadvisor.

holdings. This is done to appease and pacify client behavior; however, it is unnecessarily redundant. In my work as an OCIO for financial advisors, I have seen portfolios with two or three different S&P 500 ETFs. They own the same underlying holdings, but because of the optics associated with owning only one ETF in a larger account, the advisor "diversified" without "diversifying". With direct indexing, an investor can invest in one index for their exposure to the broad market. This is more behaviorally palatable than buying one ETF because of the multiple holdings in the account. Furthermore, if customized for the client, direct indexing can also satisfy the natural aversion to ambiguity of a client by incorporating names that the client readily recognizes.

The fourth advantage of direct indexing is really a general benefit with systematic strategies: discipline. This is available whether investing in ETFs or directly in the indexing. Behaviorally, without automating rules for investing, it requires immense fortitude to follow a strategy. In my opinion, academically supported, time-tested, rules-based approach can lead to impressive investment results if followed with discipline, and the only way to do this (or at least to guarantee adherence) is to automate the process. Direct indexing, like ETF investing, keeps an investor disciplined. I believe this the most important factor of any investment strategy.

Out of the benefits mentioned throughout this paper, I think that customization is the most profound innovation that has emerged with direct indexing. By equipping advisors with better tools to create portfolios specific to the objectives of their clients, I think there is substantial opportunity for advisors to create adaptable, behaviorally palatable portfolios that will put the client's best interest at the forefront of his or her investment approach. Finally investing is coming around to making the client the actual benchmark.

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