Planning Insights

Beyond ETFs:

How Direct Indexing Can Enhance After-Tax Returns

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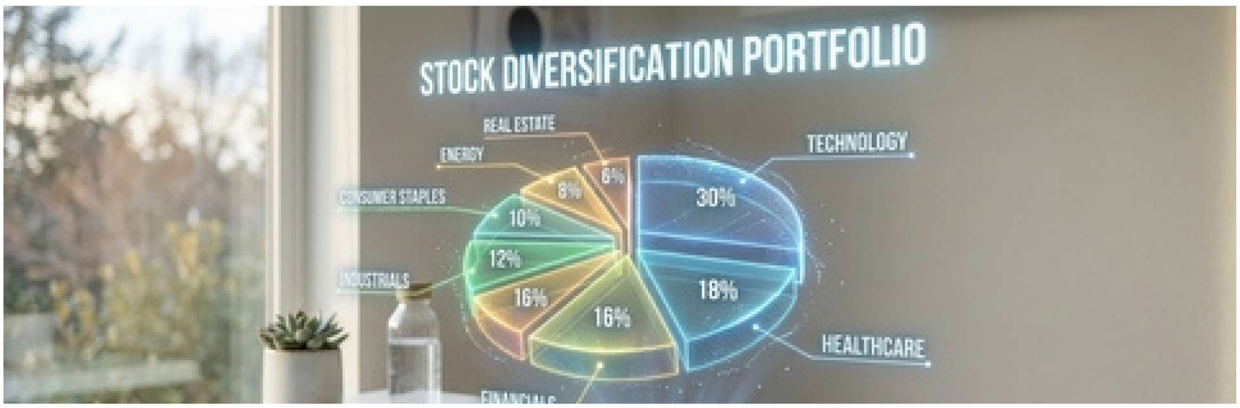

Direct indexing offers investors a more personalized approach to broad market exposure while creating opportunities to potentially improve after-tax returns.

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Over the last several years, direct indexing has emerged as one of the fastest-growing innovations in wealth management. While index mutual funds and ETFs remain excellent investment vehicles, direct indexing offers investors a more personalized approach to achieving broad market exposure while potentially improving after-tax returns.
At its core, direct indexing seeks to replicate the performance of a broad market benchmark—such as the S&P 500—by owning many of the individual stocks within the index through a Separately Managed Account (SMA). Rather than purchasing a single ETF that holds all 500 companies, investors directly own the underlying securities themselves. This ownership structure creates opportunities that traditional index funds simply cannot offer.

How Direct Indexing Works

A direct indexing portfolio is designed to closely track a benchmark index, such as the S&P 500. Portfolio managers use sophisticated optimization software to build a portfolio that mirrors the characteristics of the target index while maintaining similar sector, style, and risk exposures.

For example, instead of purchasing shares of an S&P 500 ETF, a direct indexing SMA may own hundreds of the individual companies that make up the index. The goal is to deliver returns that closely resemble the benchmark while taking advantage of the tax-loss harvesting benefits that this strategy offers.

The Tax-Loss Harvesting Advantage

The primary benefit of direct indexing is tax-loss harvesting.

Even in years when the overall market produces strong returns, many individual stocks experience temporary declines. A traditional ETF investor cannot access these individual losses because they own shares of the fund rather than the underlying securities. Direct indexing changes that dynamic.

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When individual stocks within a direct indexing portfolio decline in value, managers can sell those positions to realize losses and simultaneously purchase similar replacement securities. This helps maintain the portfolio's market exposure while generating realized tax losses that may be used to:

- Offset current or future capital gains
- Reduce taxes resulting from other investment sales
- Offset up to $3,000 in “other income” if capital losses exceed capital gains
- Carry unused losses forward to future tax years

What's particularly interesting is that tax-loss harvesting opportunities can exist even during strong bull markets. Research cited by several direct indexing providers shows that while the S&P 500 may generate positive returns overall, a significant percentage of individual stocks within the index can still experience meaningful declines during the year, creating opportunities to harvest losses without materially changing the portfolio's market exposure.

The result is the potential for improved after-tax returns—an outcome that can be especially valuable for high-income investors in taxable accounts.

Beyond Taxes: Personalization and Customization

Another compelling feature of direct indexing is customization.

Because investors own the individual stocks directly, portfolios can be tailored to reflect personal preferences, existing holdings, or specific investment objectives. Examples include:

- Excluding companies or industries that conflict with personal values
- Reducing exposure to concentrated stock positions
- Avoiding employer stock already held elsewhere
- Tilting toward certain investment factors or themes
- Incorporating ESG or socially responsible investing preferences

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This level of personalization is difficult—or often impossible—to achieve with a traditional index fund.

For example, an executive with a large position in a technology company may not want additional exposure to that same stock through an index fund. A direct indexing SMA can exclude or reduce that position while maintaining exposure to the broader market.

Is Direct Indexing Right for Everyone?

While direct indexing offers meaningful benefits, it is not a universal solution.

The strategy generally works best for investors who:

- Have substantial taxable investment assets that can be dedicated to a direct indexing account
- Are in higher tax brackets
- Expect to realize capital gains over time
- Have sufficient liquidity to continue to fund and maintain the account
- Have a long-term investment horizon, allowing tax-loss harvesting opportunities to accumulate over multiple market cycles

For many investors, traditional ETFs remain an excellent choice. However, for those with significant taxable assets, direct indexing can provide a powerful combination of broad market exposure, tax efficiency, and personalization. Investors who can commit capital for the long term and can add to the investment over time, are often best positioned to benefit, as the value of tax-loss harvesting tends to compound over time through the accumulation and strategic use of realized losses.

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MAM Comments: Direct indexing represents an evolution of traditional indexing. By directly owning the stocks that comprise an index through a separately managed account, investors can seek to capture market returns while unlocking opportunities for tax-loss harvesting. For investors with sizable taxable portfolios, particularly those with a long-term investment horizon and sufficient liquidity to fund a dedicated account, the ability to improve after-tax outcomes may ultimately be more valuable than simply focusing on pre-tax investment returns. The benefits of tax-loss harvesting are often realized over many years, making direct indexing most effective when viewed as a long-term tax-management strategy rather than a short-term performance tool.

Have Questions About Direct Indexing?

Please contact our office if you would like to learn more.

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