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# Direct Indexing – A new tool for investors

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Exchange Traded Funds have proven their usefulness to investors and market participants. Over the last few years, the number of listings and assets under management for ETFs have skyrocketed to USD 10 trillion as of Dec. 21, which underlines their wide acceptance.. However, are ETFs checking all the boxes of requirements for all investors? Certainly not and hence, other innovations have evolved in the market. One such innovation is – Direct Indexing (DI).

In recent times, DI is making news. Although not a new concept, it has started to gain popularity due to evolving circumstances. This insight is a deep dive into the concept and trends of DI, its advantages and limitations to gauge its suitability for investors. It also highlights how DI providers can gain a competitive advantage in the market.

## What is Direct Indexing:

While there is no widely accepted or formal definition, DI can be explained as a strategy that tries to replicate an index performance, to the extent possible, by directly investing in index constituent stocks and by customizing the underlying portfolio based on the requirements of an investor.

Let us take an example of a physical ETF that tracks S&P 500 index. The ETF to replicate these indices would hold all 500 companies of the index in a similar proportion of their weight in the index. During the review, the ETF manager would rebalance the holdings to align the portfolio as per the new weights. If there are any additions and deletions in the constituents, the ETF manager would replicate them. Also, if there are corporate actions in the index constituents, suitable adjustments are made. The ETF manager would offer units of ETF to investors and not the actual shares of the S&P 500 constituents. As a result, the investor is not concerned with any of the above activities. Investors in return would be charged a fee by the ETF manager to manage the ETF.

With DI, all those tasks would be handled by the investor or the investor's advisor. The investor would hold the shares of the companies instead of units of ETF. This approach enables the investor to customize their portfolio and use it tactfully for tax harvesting. The ability to customize, execute tax management and directly own the shares makes DI an appealing option.

## Industry Trend:

As per a report published by Oliver Wyman / Morgan Stanley, the popularity of the DI is rising. DI products are expected to grow from ~$350BN AUM in 2020 to ~$1.5TN by 2025 by taking the share from mutual funds and ETFs. Asset managers are understandably, rushing to gain early movers' advantage by listing DI as one of their offerings. FinTech companies are playing a key role in enabling and popularizing the concept. These companies have developed user-friendly platforms.

Fractional trading has lowered the minimum investment requirements when creating portfolios. If an index constituent with a 10% weight is trading at USD 5000 per share, the minimum portfolio size cannot be less than USD 50K. But with fractional trading, this is not a constraint. Fractional trading permits a smaller portfolio size.

In the last couple of years, many major asset managers have acquired fintech companies that enable them

| Acquirer | Direct Indexing Firm / Target |
|---|---|
| **Morgan Stanley** | Eaton Vance along with its direct indexing subsidiary, Parametric |
| **BlackRock** | Aperio |
| **JPMorgan** | OpenInvest |
| **Vanguard** | JustInvest |
| **Franklin Templeton** | O'Shaughnessy AM along with Canvas, its direct indexing platform |
| **Morningstar** | Moorgate Benchmarks |

## Advantages of Direct Indexing to Investors:

Besides significantly lowering the entry barrier for investors, DI offers many other advantages:

- Customization
- Direct Ownership
- Tax-loss harvesting

**Customization:** ETFs do not allow customization at an investor level. DI allows an investor to have a portfolio in line with an index. but with the option of the alteration as required.

**Direct Ownership:** DI means holding shares of index constituents by investors. Direct holdings allow investors to participate in investor meetings of the companies and exercise voting rights. In the case of an ETF or any other mutual fund, the fund manager gets to vote, which may or may not represent the actual view of all investors of the fund.

The dividend would get directly credited into investor's accounts, giving them the choice to reinvest or not.

**Tax-loss Harvesting:** Direct ownership and customization both enable tax-loss harvesting.
In simple terms, tax-loss harvesting means offsetting taxable profits made in one investment against losses in other investments. This helps to lower the tax burden, making tax-loss harvesting one of the major perks of DI.

## Challenges:

DI offers more flexibility to investors compared to other investment products, but it does not come for free. Here are some challenges:

- Knowledge / Expertise cost
- Platform and Data Fees
- Higher Tracking Error

**Knowledge / Expertise Cost:** DI is not a one-time process. To track the desired index, the investor needs to understand how the index is constructed, when does it rebalance, how corporate actions are treated. to keep the portfolio in line with the index. In short, to enjoy benefits from DI, the investor needs the right expertise or hire an advisor.

**Platform and data fees:** To keep the portfolio aligned with an index, the investor needs access to index data such as index composition, corporate action data, upcoming in-outs and should be prepared to bear the associated cost.

Technology makes it easier to manage DI. However, the investor must pay technology platform charges to use the facility. CNBC article published in 2019 stated the average fee for passive funds was 0.13%, compared to 30% to 0.40% for DI.

**Higher Transaction Fees:** ETFs/ mutual funds typically have a much larger ticket size and can negotiate bulk deals that reduce the transaction fees. Unfortunately, this is not an available advantage for an individual investor who must pay higher transaction fees.

It's essential to keep in mind, DI is not a silver bullet for all types of investors but is increasingly becoming a very viable option giving ETF and mutual funds a run for their money.

## How can DI providers gain a competitive advantage?

Cost, solutions, and customer services are the three important decision-making factors for the investors when selecting a DI provider. Hence, DI providers must make their services available at lower cost, offer more innovative solutions and maintain good customer support services. Any asset management firm which plans to enter DI space needs to:

- Offer custom and innovative solutions which involves:
  - Undertaking deep dive research for new financial products.
  - Use of cutting-edge technologies to develop user friendly platforms which offer comprehensive range of functionalities including customization, ESG, tax loss harvesting, performance analytics, and reporting.
- Manage operations required in maintenance of portfolios – such as rebalance, corporate action tracking, and adjustments etc.
- To support clients across globe, - there's a need to have multiple teams in place covering different time zones to better assist with customer queries.

## Summary:

In the plethora of investment products currently available to investors, DI is a meaningful addition.

DI has started gaining investors' attention due to benefits that it offers while keeping the portfolio passive to a large extent. These benefits along with more tech-savvy investors and user-friendly technology interfaces are the main drivers for the growth of DI.

Evalueserve's risk and quant solutions division works with index industry players and provide domain and technology expertise for development of innovative solutions, design and develop infrastructure for accuracy, speed and scalability, and, on-going operations including reporting, database management, corporate action adjustments, fund accounting, and all aspects of index life-cycle management. For more information, please visit: https://www.evalueserve.com/industry/quantitative-investment-strategies/

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