



Next on the horizon: direct indexing

Direct indexing: the next product to meet evolving investor expectations

Driven by lower costs and increased client demand, direct indexing has seen significant growth in assets under management (AUM) in the United States, increasing from approximately \$100 billion in 2015 to approximately \$350 billion USD in 2020. The adoption has been driven by new ecosystem players within the United States lowering the barriers of entry for advisors interested in offering direct indexed portfolios to investors.

In Canada, direct indexing provides a new opportunity for wealth managers to offset fee erosion and provide clients a differentiated offering. The recent move to zero commission fees and the rising interest in fractional shares trading provide the necessary economic conditions and building blocks for direct indexing. In the absence of a scaled ecosystem player in Canada that can enable direct indexing, the first incumbent

player to market with the offering will benefit from a significant first-mover advantage. This will provide them the ability to offer a differentiated product suite, and provide greater efficiencies for their advisor base to personalize client offerings.

Lower costs are driving the adoption of direct indexing

Advanced technology, low trading fees, and the rise of fractional shares have lowered the high costs traditionally associated with direct indexing. Direct indexing enables wealth managers to purchase the underlying stocks of an index for their clients instead of purchasing the mutual fund or ETF, to optimize taxes and customize portfolios to enable risk and factor exposure. These lower costs have made separately managed accounts (SMAs), which are used to house such strategies and were once limited to ultra-high-net-worth clients, accessible to a broader set of client segments.¹

An example of this shift is Dimensional Fund Advisors, which lowered its minimum investment requirement for SMAs from \$20 million to \$500,000 USD in 2021.² Even more recently, Fidelity has developed a retail-focused direct indexing product, called Fidelity Managed FidFolios, with a \$5,000 USD minimum investment—one of the lowest entry points on the market. The offering is currently in pilot (as of January 2022) and is expected to be available to all investors in the coming months.³

Investor interest is shifting to more customized portfolios

The surge in direct indexing has also been driven by millennials seeking personalized portfolios, often with a focus on environmental, social, and governance (ESG) considerations. In 2020, \$27.4 billion USD flowed into ESG-related US exchange-traded funded (ETFs).⁴

US-domiciled ESG assets totalled over \$17 trillion that same year, accounting for one-third of the total US AUM.⁵ In Canada, responsible investments that incorporate ESG factors made up 61.8% of professionally managed assets and represented \$3.2 trillion CAD AUM at the start of 2020.⁶

Capability enablement through acquisition for greater accessibility

In response to this growth, leading US wealth and asset managers have been busy over the last 18 months acquiring direct indexing capabilities. Morgan Stanley acquired Eaton Vance, thereby gaining access to Parametric, which manages \$300 billion of direct indexing portfolios. Blackrock purchased Aperio, increasing its SMA AUM by 30% to \$160 billion.

Vanguard added Just Invest, whose offerings include a direct indexing platform called Kaleidoscope, to its stable. And Charles Schwab bought the technology of Motif to accelerate the development of its thematic and direct indexing technology.



Direct indexing enables greater control and customization, and tax optimization

Direct indexing platforms create the potential for advisors to implement their own investment strategies at the individual stock level, rather than relying on packaged funds and ETFs. These highly personalized investment solutions create a level of stickiness between the advisor and client that can be difficult to replicate elsewhere. Direct indexing allows investors to track the performance of an index by buying

a sample of its member stocks instead of buying an ETF or a mutual fund. By owning the individual stocks rather than a bundled product, investors benefit from greater control over and customization of their portfolio—in other words, they can build portfolios that reflect their personal values and preferences while benefiting from tax optimization.

Let's break this down:

Tax optimization	Incorporating ESG factors	Bespoke risk and factor exposure
<p>Direct indexing allows investors to hold the underlying securities of an index, matching the performance, while taking advantage of tax-loss harvesting opportunities. This is done by selling the individual securities that declined and created losses at tax time to offset capital gains made by the individual securities whose value increased. The investment outcomes for clients are material, with annual improvements in after-tax returns estimated at between 1 and 3%.⁷</p> <p>This contrasts with traditional ETFs, which are internally effective at minimizing capital gains distributions (especially compared to mutual funds) but cannot necessarily generate pass-through losses on the underlying holdings in the ETF. For example, if the S&P 500 in the aggregate is up for the year, but 150 of the individual stocks in the index are down, the ETF may not generate any capital gains distributions, but the investor would have no means of harvesting the 150 stocks that were at a loss.</p>	<p>Advisors can use direct indexing to apply ESG modules to an index—the S&P 500, for example—to align with the performance of the index while also adhering to a client's values and ESG goals. With the factors that determine whether an ETF meets ESG criteria starting to come into question, the ability to provide a product whose ESG factors are customized and transparent presents a significant opportunity for under-served investors.⁸</p>	<p>Direct indexing can help tailor an investor's portfolio based on their risk tolerance. For example, if an investor is risk-averse and wants a portfolio with lower volatility, an advisor can apply sophisticated risk models and analytics to the index and integrate a minimum volatility index to help manage the client's desired risk.⁹</p> <p>Similarly, direct indexing allows investors to customize their portfolio based on other factors and thematic preferences; for example, they can adjust their exposures to specific sectors if they become over- or underweight in them. In this case, the use of direct indexing is less about client preferences and more about ensuring client portfolios are diversified and less subject to concentration risk.</p>

Significant growth expected over the next five years

Direct indexing is primed to grow at an annualized rate of 12.4% in the United States over the next four years, according to recent surveys by Cerulli, outpacing the expected growth rate for traditional products such as mutual funds, ETFs, and separate account

programs, which are projected to grow 3.3%, 11.3%, and 9.6%, respectively, over the same period.¹⁰ Similarly, Morgan Stanley estimates that direct indexing will grow to \$1.5 trillion AUM by 2025.¹¹

Potential growth opportunity for Canadian wealth managers

As the interest in direct indexing continues to grow, Canadian wealth managers can capitalize on the trend to:

- Position themselves as market leaders by being one of the first to make direct indexing accessible to Canadian clients
- Increase their market share and attract new clients
- Address growing client demand for ESG-related products and services
- Enable other offerings, such as portfolio mirroring, for self-directed investing clients (this uses algorithms to allow investors to mirror thematic portfolios, such as ESG, that are created and managed by both investment managers and other investors, and can foster a sense of community)
- Offset potential investments in underlying capabilities for direct indexing (e.g., fractional shares) that can drive adjacent revenue for the financial institution and value to the client
- Increase stickiness between the advisor and client that can be difficult to replicate elsewhere

Conclusion

Direct indexing is continuing to gain traction amongst wealth management clients in the United States, becoming an important revenue source for firms. Canadian institutions would benefit from exploring how incorporating direct indexing within their product suite could position them for continued success against an ever-changing wealth industry landscape.



Endnotes

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Let's talk

Peyman Pardis

Wealth Transformation Leader
ppardis@deloitte.ca
647-403-2190

Contributors

Kendra Thompson

Partner
National Wealth Management
& Advice Leader

Sandeep Mukherjee

Director, Consulting

Ferishta Sahebzada

Senior Consultant, Consulting

Shaun Goffenberg

Consultant, Consulting

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