Direct Indexing and the Unfulfilled Promise of Tax Efficient SMAs

For decades, the financial services industry has touted the customization of managed accounts, yet only partially delivered on that claim. Direct indexing may change that.

Key Points

- Firms distributing managed accounts have long promoted the ability of these products to be customized for individual client attributes such as taxes. But so far, only half (53%) of managed accounts receive tax treatment.
- Owing to new developments in financial services, direct index SMAs offer firms the opportunity
to expand the use of tax optimization to create customized portfolios for clients.

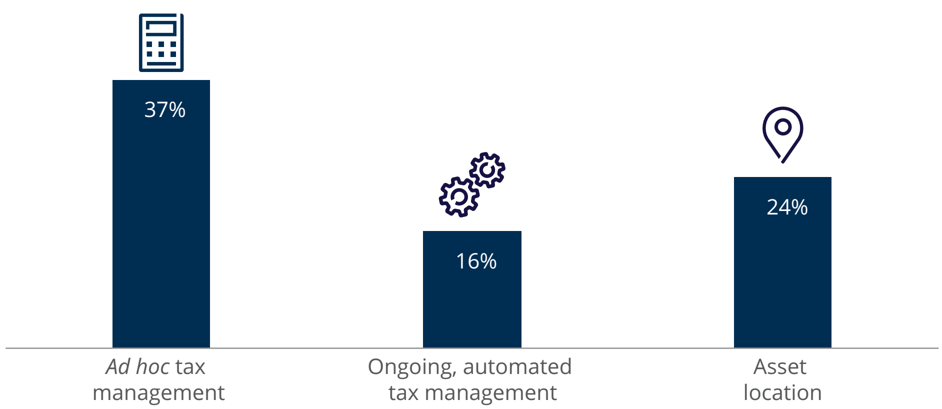
Tax Optimization

Ever since James Lockwood and his colleagues invented managed accounts in the 1970s, one of the main selling points for this product has been the ability to customize the portfolios for taxes and—what was then termed—socially responsible investing. One of the reasons the Securities and Exchange Commission allowed separately managed accounts (SMAs) to continue as unregistered securities (as opposed to mutual funds) under Rule 3a-4 is because they are customizable.

Yet, almost five decades later, a significant proportion of managed accounts remain outside the scope of tax customization. Only 53% receive tax treatment, with only 16% subject to ongoing, systematic tax optimization, leaving the balance (37%) benefiting from tax optimization on an ad hoc basis. Nearly half (47%) receive no tax treatment at all, and only 24% benefit from tax location strategies. At a time when overlay management of taxes is readily available, this low proportion (16%) represents a failure to realize the long-articulated benefits of managed accounts.

Proportion of Retail SMA Assets Subject to Tax Management Strategies, 2020

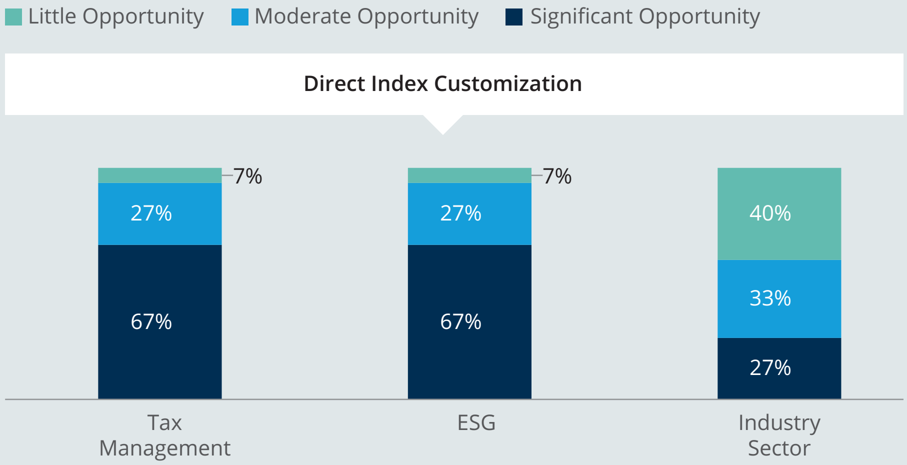
Source: Cerulli Associates

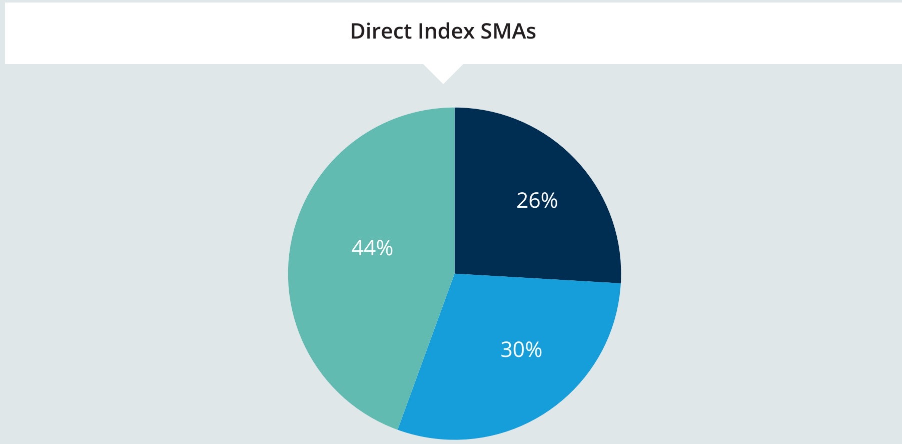


> When asked to identify the types of opportunities direct indexing presents, two-thirds (67%) of asset management firms identify managing for both taxes and environmental, social, and governance (ESG) factors.

Asset Managers' Assessment of the Opportunity , 2020

Source: Cerulli Associates | Analyst Note: Asset managers were given the opportunity to identify other possibilities. "Thematic portfolios" and "Factor tilts" were mentioned.





Enter Direct Indexing

Several developments have created the opportunity to expand tax optimization to a broader set of clients, hopefully allowing the industry to deliver on the promise of tax customization through direct indexing. The disappearance of brokerage commissions eliminates the trading fees resulting from the high turnover of personalized indices. In addition, the growing use of fractional shares allows lower balance accounts to hold the large number of securities necessary to track an index. The ever-increasing sophistication of algorithmic portfolio construction techniques is making it easier to manage direct index portfolios. A senior leader at a fintech firm that supports the managed accounts industry tells Cerulli, "The collapse in trading fees has made a difference. Direct indexing used to be for someone with an account worth at least a half a million bucks. Now you can do it all at scale."

One-quarter (26%) of executives at asset management firms believe direct index SMAs present a significant opportunity, and while this cohort represents a minority of asset managers, it consists of some of the largest firms, such as Franklin Templeton, J.P. Morgan, Natixis, and Fidelity Investments, which collectively manage a broad swath of industry assets. When asked to identify the types of opportunities direct indexing presents, two-thirds (67%) of asset management firms identify managing for both taxes and environmental, social, and governance (ESG) factors.

Automating Personalization

Direct index SMAs require a certain degree of high-touch interaction between advisors and clients. Advisors need to work with clients to assess the trade-off between generating tax alpha or observing ESG rules against the deviation from the index inevitably caused by the cumulative effect of adding several tax and ESG constraints.

Tax transition is also a major constraint that needs to be discussed between the advisor and the client. Few clients transfer all-cash portfolios to advisors. Most bring securities with embedded gains and many hold concentrated positions. Transitioning assets requires a conversation about trade-offs: advisors need to discuss the tax implications with clients to determine whether they are more concerned with tracking error or with negative tax consequences.

Direct Indexing a Fintech Solution

All this interaction between advisors and clients discussing trade-offs can only happen at scale if there is some dashboard that the advisor can use to help the client perform what-if scenarios, especially in discussing ESG constraints.

To perform this trade-off analysis and communicate the results to an asset manager in a scalable way requires a technological interface between the advisor and the asset manager. To offer a successful personalized index, asset managers need to build a console that allows the advisor to construct portfolios in consultation with their clients and communicate this information to the portfolio manager. In other words, asset managers need a fintech solution. A senior product executive at an asset manager tells Cerulli, “All the work that Parametric is doing through Eaton Vance putting customized tilts so you manage the portfolio even better [for the client] and deliver it through a fancy front end... To do this, the industry has to move to tech-enabled solutions.”

Managed accounts have long been touted for their ability to be customized for the unique circumstances of each investor, particularly their tax situation. Yet decades after the emergence of this product, the industry should do more to create a personalized investment experience through managed accounts. The growing availability of fintech solutions that can support mass customization may help the financial services industry better deliver these benefits.

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About the Author

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Tom has over 20 years of experience in the financial services industry. Prior to joining Cerulli, Tom was an Investment Product Manager at Fidelity's Global Asset Allocation Division, where he played a leadership role in the ongoing development of Fidelity Personalized Portfolios, Fidelity's Unified Managed Account (UMA) for retail customers. He also led the investment managers in creating the Breckenridge Municipal Portfolio, Fidelity's first separate account for consumers managed by a third party. Before working on the retail side of Fidelity, Tom built and led the team that developed Fidelity's Separate Account Network for registered investment advisors (RIAs), and his group partnered with a third party wrap sponsor to create Managed Account Resources, a UMA platform for RIAs.

Tom began his career in high tech, working in sales, business development, and product management at a number of software firms, including Lotus Development Corporation.

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