Investment Insight
How are advisors using Morningstar Direct Indexing?

Direct indexing was a sleepy corner of the market a few years ago. Today, it’s projected to grow faster than any other product category in the investment industry.

Exhibit 1: Projected Growth Rates by Product Category

Direct Indexing AUM are projected to grow 12.4% annually in the five-year period from 2021 to 2026.1

61% of advisors across wire houses, broker dealers, and RIAs indicate they are using or considering direct indexing.2

Direct indexing refers to a separately managed account (SMA) that tracks an index, or a blend of indexes, while holding the individual stocks that comprise the index. Said differently, mutual funds and ETFs are wrappers that sit between investors and the stocks they own. Direct indexing removes that wrapper and allows investors to hold the individual stocks that sit inside the index.

Direct ownership of individual securities in portfolios gives investors unique opportunities for tax efficiency and personalization that may not be possible with ETFs and mutual funds. Through the Morningstar Wealth Platform, advisors can create personalized portfolios that reflect their clients’ needs, values, and goals. And it can be done at scale; powered by Morningstar Indexes, Equity Research, and Sustainalytics.

Morningstar launched its direct indexing product roughly a year ago. Collaborating with advisors in that time, we’ve seen the benefits of truly personal and scalable customization, and we believe it will play a key role in the future of investing.
How are advisors using Morningstar Direct Indexing?

Given that direct indexing is a new offering most financial advisors are getting familiar with, one of the most common questions we get is: “How are people actually using direct indexing?”

Broadly speaking, Morningstar Direct Indexing helps advisors manage their clients’ core equity allocation, while seeking to benefit from potential tax savings and customizing their portfolios to match their preferences.

To date, approximately 64% of Morningstar Direct Indexing accounts are allocated to our core beta equity offering. The other 36% of accounts are expressing a thematic view inside of their equity allocation, primarily focused on sustainability.

**Exhibit 2: Morningstar Direct Indexing Accounts by Strategy Type**

![Diagram showing thematic and core beta allocations with percentages and specific examples]

Source: Morningstar Direct Indexing Internal Data.

While we do have an international portfolio, nearly 100% of client accounts are allocated to U.S. stocks across the market cap spectrum. Broad U.S. large-cap exposure—primarily from U.S. Target Market and U.S. Sustainability Dividend—makes up approximately 70% of the assets invested in Morningstar Direct Indexing.

But personalization goes far beyond individual strategies. Advisors also take advantage of tax-efficient transition and concentrated stock management tools, as well as a range of environmental, social, and governance (ESG) exclusions. Put simply, everyone uses direct indexing a bit differently. The graphic below dives into the details.
Customization

Customization is not a feature that has seen mass adoption yet. With 17% of Morningstar’s total accounts implementing some form of customization, this function is still gaining ground. General trends across the industry—using public statements—show that most direct indexing offerings are seeing similar customization trends, in the range of 10%-20% of total accounts.

Of the accounts with customizations, the majority are implementing “exposure-based” customization, which comes from excluding specific securities or screening out parts of the index. The rest of accounts are implementing “tax-focused” customization, which means the account is utilizing a tax-transition plan.

Source: Morningstar Direct Indexing Internal Data.
This is the data and learnings observed so far, but it’s still early days. So, we’re not drawing any conclusions. In fact, we expect these figures to change significantly over time, as more advisors engage with the platform, and we roll out a larger menu of customization options.

Building a Solution Bigger than the Sum of Its Parts

While we pride ourselves on the technology and features that Morningstar Direct Indexing offers, arguably, the true value is enabling advisors to help solve problems for clients. The past year has taught us that while clients’ needs are personal, certain problems often overlap.

For example, managing around concentrated stock positions, and attempting to transition them into a diversified portfolio is a common problem. We believe direct indexing can play a role in these types of problems and create better client outcomes.

As a platform provider, we are striving to identify common investor challenges and create a direct indexing solution that can help solve them. Collaborating with advisors, attempting to understand client needs, and feeding them back into the platform strengthens both the platform and our partnerships.

We are hopeful that this process will continue to drive the growth of Morningstar’s Direct Indexing in the years to come.

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Fixed-income securities are influenced by interest-rate sensitivity and credit risk. They have varying levels of sensitivity to changes in interest rates, but in general, the price of a fixed-income security tends to fall when interest rates rise and vice versa. The value of a fixed-income security with a longer duration or maturity is typically impacted more by a change in interest rates than one with a shorter duration or maturity.

U.S. Government securities are issued by the United States Treasury and backed by the full faith and credit of the U.S. Government. U.S. government agency securities are indirect obligations of the U.S. government and are issued by federal agencies and government-sponsored entities. They have different levels of credit support and therefore different degrees of credit risk.

Portfolios that invest in lower-rated debt securities, commonly referred to as “junk bonds,” involve additional risks because of the lower credit quality of the securities in the portfolio. The investor should be aware of the possible higher level of volatility and increased risk of default.

A debt security refers to money borrowed that must be repaid that has a fixed amount, a maturity date(s), and usually a specific rate of interest. Some debt securities are discounted in the original purchase price. Examples of debt securities are Treasury bills, bonds, and commercial paper. The borrower pays interest for the use of the money and pays the principal amount on a specified date.

The indexes noted are unmanaged and cannot be directly invested in. Individual index performance is provided as a reference only. Since index and/or composition levels may change over time, actual return and risk characteristics may be higher or lower than those presented. Although index performance data is gathered from reliable sources, Morningstar Investment Management cannot guarantee its accuracy, completeness, or reliability.

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Your investment goals matter to us. Our mission is to empower investor success by building investment portfolios selected by your financial advisor. Our world-class investment strategies draw on our core capabilities in research, asset allocation, investment selection and portfolio construction. Our investment professionals are located around the world, which provides both a global point of view and local market expertise.

Based on a proprietary valuation-driven asset-allocation process, our strategies offer investors a range of multi-asset, risk- and outcome-based strategies designed to help meet a variety of goals. Also, our separately managed accounts offer concentrated portfolios of our portfolio managers’ best ideas. We put more than 35 years of investment experience to work in every portfolio we manage to offer you a better investing experience, because your journey matters.

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