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## Investment Insights

# Direct Indexing and Personalization at Scale—How Tech Provides the Way Forward

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### Key Takeaways

1. Direct indexing and personalization used to be available only to ultra-high-net-worth investors, but technical advances and more widespread computing power are rapidly bringing those offerings to smaller investors.
2. Personalization at scale, fueled by more powerful technology, means being able to effortlessly combine specific exposure with tax management while aligning values and other filters. And it can all happen on one platform.
3. An advisor needs a provider with expertise and a deep understanding of what the inputs for a given platform are as well as how all of that is communicated to the client. It's difficult to find a low-cost automated solution in any one place. But as the tech improves, the search will only get easier.

*Morningstar Investment Management has brought together thought leaders from our Investment Management team, Sustainalytics, and Morningstar Indexes to present the Evolution of Personalization. This series explores hyperpersonalization, direct indexing, and how those quickly developing areas are changing the way advisors address client concerns and the desire for more personalized investing:*

- Evolution of Personalization 1: The Investors of the Future Are Coming—and Maybe Sooner Than You Think

Author William Gibson is famous for saying that the future is already here—it's just not evenly distributed. That was the case for direct indexing and personalization for some time, when only investors in the ultra-high-net-worth bracket enjoyed access to such a solution. However, with the advent of more widespread computing power in the realm of portfolio optimization and risk modeling, the digitization and meta-analysis of client information and data collection, and other tech developments, personalization is working its way to a broader array of investors and becoming available to those below the highest of the high. The distribution is beginning to even out—and will continue to do so.

What's the key driver of that tech-centric spread? Computing power. It is far more advanced than it was 20 years ago. Advisors have more tools and apps available that allow them to understand clients' needs, risk tolerance, financial goals, and behavior at an individual level over time to produce better insights and recommendations. Meanwhile, portfolio-construction tools, trading systems, and analytical reporting designed to manage hundreds and thousands of investors' accounts have enabled advisors to scale their practices more than ever before.

It's important to remember, of course, that direct indexing itself isn't new. But the marriage of technology and investing, which allows a broader group of investors to enjoy access to personalization, is a recent development—and a critical one at that. And while there are plenty of investment shops that still see tech as supporting investment, the forward-thinking ones recognize that direct indexing puts the two on an equal footing.

**A robust Direct Indexing platform can offer:**

- The ability to create, manage and trade your clients' unique and tailored portfolios at scale and tax-efficiently. The all-in approach of traditional pooled investment vehicles such as mutual funds, while perfectly appropriate for many investing needs and goals, makes it hard to account for a client's personal preferences or values as well as their financial situation, which may entail scenarios such as concentrated-stock-risk exposures or significant capital-gain tax implications. Your tech stack should support the volume of custom portfolios via automated and intelligent workflows and connectivity with tax and client data sources.
- Technology-enhanced client experiences to foster deeper advisor-investor relationships. Digitally enabled, data-driven workflows accelerate action and reduce the opportunity for human error inherent in manual processes, whether it involves collection of client data and preferences, portfolio tax-aware trading and rebalancing, or ongoing reporting focused on what matters most to clients.
- Transparency and deeper connection between clients and their money. Real-time visibility into the securities your clients own and informative illustrations as to how they align with causes clients care about—can set the stage for powerful narratives apart from standard portfolio reporting and forge stronger relationships between clients and their money.
- Enabling cost-effective personalized portfolio management at lower investment minimums. While not isolated to direct indexing portfolios, zero-dollar stock trading commissions and fractional share trading (i.e., the ability to buy and sell fractions of a stock) where available have made managed accounts more accessible.

**Tax efficiencies and personalization**

Personalization at scale, fueled by more powerful technology, means being able to effortlessly combine specific exposure with tax management while aligning values and other filters. And it can all happen on one platform.

TurboTax was able to seize the opportunity to vastly improve what was a cumbersome, confusing paper-based tax preparation process by creating an intuitive, streamlined electronic tax-filing experience. In the same way, technology advancements mean it's much easier to grasp the essential details of capital-gains implications and the best ways to minimize tax impact. After all, for many investors, taxes can often hinder performance to a greater degree than fees and other assorted costs. There are always tax tradeoffs in terms of higher risk, higher return, and how closely an investor wants to adhere to their

values versus how much they need to invest to achieve a particular set of goals. Advanced tech allows advisors to understand and manage them.

**Direct Indexing unlocks more opportunities to generate higher after-tax returns, or “tax alpha,” with active tax management techniques such as:**

- Tax-loss harvesting without triggering wash-sales—aimed at reducing tax risk without sacrificing market exposure by selling securities at a loss and replacing them with others
- Tax-efficient transitions and gains-realization deferral—sophisticated systems aid not only advisors in constructing and investors in selecting a portfolio that represents their preferences, but they also help determine how to thoughtfully transition an existing account over time to align more with the proposed customized portfolio, all the while balancing tracking-error and capital-gains realization
- Tax-aware rebalancing—helps with identifying tax lots to trade based on investor goals and cash-flow requirements

**Direct indexing and the values-based investor**

Values-based investing—in particular, environmental, social, and governance (ESG) investing—is also an increasingly important area for clients. On the ESG front, it’s understood that advisors can create stickier assets with clients who consider it to be important,<sup>1</sup> but until now there hasn’t been an easy way to integrate that with a portfolio. Advisors were previously left searching for funds to add. Now they can fold a client’s individualized values into it.

On that front, it’s critical to have high-quality ESG data sources that can help power your personalized portfolio building, analytics, and client-reporting needs. Some investors may not want to put their money into such areas as defense contractors or guns, fossil fuels, casinos, genetically modified organisms (GMOs), or companies with poor environmental and labor-relations track records. Once again, many advisors may not think their clients want such capabilities, but at the time this article was published, plenty of investors and companies have walked away from Russia in the wake of their invasion of Ukraine. Thus, values-based investing can loom surprisingly large when the going gets tough.

**Cost vs value considerations: caveat emptor**

Overall, the advent of technology does, as stated, create a landscape where advisors are able to offer valuable personalization to a wider swath of investors. However, it’s worth noting that it remains a bit of a buyer-beware situation. Advisors need to examine what’s included in the cost of a solution—but they also must consider what isn’t.

For example, does the direct indexing solutions provider cover any licensing costs associated with index replication usage or ESG data needs? The same goes for understanding if your direct indexing solutions provider has connectivity to tax-aware rebalancing and account-management systems, whether the

portfolio optimizer includes values-preferences and risk-tolerance inputs, and the degree to which trading costs are factored in. “Caveat emptor” remains very much in play.

### **In conclusion**

At the end of the day, an advisor needs a provider with expertise and a deep understanding of what the inputs for a given platform are as well as how all of that is communicated to the client. It’s difficult to find a low-cost automated solution in any one place. But there’s no doubt that as the tech improves, the search will only get easier.

And as it does become easier to find the right direct-indexing provider, advisors will be better able to prepare for tomorrow’s clients, bolstering loyalty to their practices and future-proofing their businesses. ■■

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<sup>1</sup>“Why ESG funds have seen stickier assets and outperformance in covid-19 crash,” ESG Clarity—April 7, 2020

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