Investment Insight
Direct Indexing vs. ETFs: Myth Busting

The history of direct indexing has mostly been defined as a niche offering available to a select few.

In recent years, that narrative has shifted.

Improvements in technology — software advancements plus the ability to trade fractional shares — and the move to zero trading fees have been the primary catalysts.

Direct indexing can now serve a population of investors that is growing faster than ever.

But growth also brings questions, and many of those questions seem to be coming from zealots of exchange-traded funds (ETFs) — the fund structure that many perceive direct indexing to be competing against.

ETFs were one of the greatest financial inventions ever. Low-cost, broad market exposure to virtually every investable asset class, available to anyone with a brokerage account and an internet connection. That’s a big hurdle to clear for any new financial product.

The past decades’ growth in ETF assets properly reflects the value that they have delivered to investors. ETF assets have grown faster than social media and online shopping.

Exhibit 1

Technology Adoption Growth Rates
Since 2009: compound annual growth rates

<table>
<thead>
<tr>
<th>Category</th>
<th>Growth Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Smartphones</td>
<td>24.3%</td>
</tr>
<tr>
<td>ETF AUM</td>
<td>18.0%</td>
</tr>
<tr>
<td>Social media</td>
<td>13.0%</td>
</tr>
<tr>
<td>U.S. e-commerce retail sales</td>
<td>11.8%</td>
</tr>
<tr>
<td>Industrial robots</td>
<td>10.9%</td>
</tr>
</tbody>
</table>

Source: Morningstar
Clearly, ETFs have been a force for good. Because of that, new product entrants are forced to clear a high bar and go through a difficult interview process of sorts.

Due diligence is important, and something Morningstar—a direct indexing provider—welcomes.

One of the questions we regularly receive is:

*Does direct indexing just turn into a more expensive index fund (ETF) as a client’s portfolio matures?*

Variations of this question exist, but the line of questioning often compares direct indexing versus ETFs.

First, it might be necessary to step back to compare and contrast them.

**Direct Indexing versus ETFs**

ETFs have tremendous benefits, many of which we already outlined. Isolating direct indexing, there are generally two key advantages it tends to possess versus ETFs and index mutual funds:

1) **Tax-Loss Harvesting:** being able to pick and choose when to sell underlying holdings.
2) **Personalization:** ability to create personalized portfolios that reflect the needs, values, views, and goals of investors.

A simple framework for evaluating these structures looks like this:

### Exhibit 2

<table>
<thead>
<tr>
<th>Attribute</th>
<th>Index Mutual Fund</th>
<th>Index ETF</th>
<th>Direct Indexing (SMA)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tracks an Index</td>
<td>✔</td>
<td>✔</td>
<td>✔</td>
</tr>
<tr>
<td>Ownership of underlying securities</td>
<td>❌</td>
<td>❌</td>
<td>✔</td>
</tr>
<tr>
<td>Portfolio Personalization</td>
<td>❌</td>
<td>❌</td>
<td>✔</td>
</tr>
<tr>
<td>Tax-loss Harvesting at individual tax-lot level</td>
<td>❌</td>
<td>❌</td>
<td>✔</td>
</tr>
<tr>
<td>Low Investment Minimums</td>
<td>✔</td>
<td>✔</td>
<td>❌</td>
</tr>
</tbody>
</table>

Source: Morningstar

In short, it’s not necessarily positives and negatives, rather specific client situations where one product might be better suited than the other.

**Answering the Question: Does Direct Indexing Turn into an Expensive ETF?**

The answer to this question is not cut and dry. At one logical extreme, consider the case of a hypothetical “buy-and-hold investor” who never sells. This would be a hypothetical client who funds a direct indexing portfolio and then simply does nothing.
If we assume the market trends upward over time — the case historically — then years of selling high-cost tax lots from the portfolio to harvest losses could potentially create a situation where the portfolio is mostly comprised of stocks with large, embedded gains.

In this case, realized losses may be hard to come by, and the investor may feel like they are in a more expensive version of an ETF.

Hypotheticals can be a funny exercise, however, and this line of reasoning misses the mark in at least two ways.

1) The hypothetical buy-and-hold investor has likely benefited from their direct indexing portfolio during this period. Direct indexing aims to keep money that otherwise would have been paid out in taxes invested in a portfolio and earning market returns. Investors could potentially earn as much as 1% in tax alpha per year through tax-loss harvesting. Even in strong bull market environments, tax-alpha can still be economically meaningful.

2) A hypothetical buy-and-hold investor who has no other transaction activity is extremely rare. It is far more common to work with clients whose goals, objectives, and needs evolve—impacting their financial plan. One example would be expenses—weddings, houses, college educations—that require withdrawals from a portfolio. Many clients are also looking to diversify a concentrated portfolio, replace an underperforming manager, or sell company stock for tax-related purposes.

The common fabric: While advisors and their clients are well served by ETFs in many instances, direct indexing can be a helpful resource for those who desire personalization beyond what is offered by an ETF or index fund provider.

**Not Direct Indexing versus ETFs, It's Direct Indexing And ETFs**

Direct indexing doesn’t have to be a solution for an entire portfolio. Many clients utilizing direct indexing have ETFs elsewhere in their portfolio — sometimes even inside a direct indexing account.

There are attributes of ETFs — ease of transacting, costs, minimums — that can’t be perfectly replicated by direct indexing. And there are attributes of direct indexing — harvesting losses, personalization — that will make it more desirable than ETFs for certain client situations.

Direct indexing likely won’t dilute the use case of ETFs, rather it might just steal a bit of its thunder.

The future has plenty of room for both. 

**Disclosures**

The tax information provided is for informational purposes only and should not be considered tax or financial planning advice. Please consult a tax and/or financial professional for advice specific to your individual circumstance.

All investments involve risk, including the loss of principal. There can be no assurance that any financial strategy will be successful. Customers should seriously consider if an investment is suitable for them by referencing their own financial position.
investment objectives, and risk profile before making any investment decision. Morningstar Investment Management does not guarantee that the results of their advice, recommendations or objectives of a strategy will be achieved.

©2023 Morningstar Investment Management LLC. All rights reserved. The Morningstar name and logo are registered marks of Morningstar, Inc. Morningstar Investment Services LLC is a registered investment adviser and subsidiary of Morningstar Investment Management LLC. Morningstar Investment Management LLC is a registered investment adviser and subsidiary of Morningstar, Inc.

Opinions expressed are as of the current date, such opinions are subject to change without notice. Morningstar Investment Management shall not be responsible for any trading decisions, damages, or other losses resulting from, or related to, the information, data, analyses, or opinions or their use. This commentary is for informational purposes only. The information, data, analyses, and opinions presented herein do not constitute investment advice, are provided solely for informational purposes and therefore are not an offer to buy or sell a security. Please note that references to specific securities or other investment options within this piece should not be considered an offer (as defined by the U.S. Securities and Exchange Act of 1934) to purchase or sell that specific investment. Performance data shown represents past performance. Past performance does not guarantee future results.

All investments involve risk, including the loss of principal. There can be no assurance that any financial strategy will be successful. Morningstar Investment Management does not guarantee that the results of their advice, recommendations, or objectives of a strategy will be achieved. Diversification is an investment method used to help manage risk, it does not ensure a profit or protect against a loss.

This commentary contains certain forward-looking statements. We use words such as “expects,” “anticipates,” “believes,” “estimates,” “forecasts,” and similar expressions to identify forward-looking statements. Such forward-looking statements involve known and unknown risks, uncertainties, and other factors that may cause the actual results to differ materially and/or substantially from any future results, performance, or achievements expressed or implied by those projected in the forward-looking statements for any reason. Past performance does not guarantee future results.

Morningstar® Managed Portfolios™ are offered by the entities within Morningstar’s Investment Management group, which includes subsidiaries of Morningstar, Inc. that are authorized in the appropriate jurisdiction to provide consulting or advisory services in North America, Europe, Asia, Australia, and Africa. In the United States, Morningstar Managed Portfolios are offered by Morningstar Investment Services LLC or Morningstar Investment Management LLC, both registered investment advisers, as part of various advisory services offered on a discretionary or non-discretionary basis. Portfolio construction and ongoing monitoring and maintenance of the portfolios within the program are provided on Morningstar Investment Services behalf by Morningstar Investment Management LLC. Morningstar Managed Portfolios offered by Morningstar Investment Services LLC or Morningstar Investment Management LLC are intended for citizens or legal residents of the United States or its territories and can only be offered by a registered investment adviser or investment adviser representative.

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 obligation 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 indexes 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.

Investment research is produced and issued by subsidiaries of Morningstar, Inc. including, but not limited to, Morningstar Research Services LLC, registered with the U.S. Securities and Exchange Commission.

**About Morningstar’s Investment Management Group**

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.

**For More Information**

Phone:  +1-877-626-3227
Email: ManagedPortfolios.US@morningstar.com
Online: www.mp.morningstar.com

© 2023 Morningstar Investment Management LLC. All rights reserved. The Morningstar name and logo are registered marks of Morningstar, Inc. Morningstar Investment Services LLC is a registered investment adviser and subsidiary of Morningstar Investment Management LLC. Portfolio construction and ongoing monitoring and maintenance of the model portfolios discussed herein are provided on Morningstar Investment Services’ behalf by Morningstar Investment Management LLC.