MORNINGSTAR®

Direct Indexing & SMAs: Maximizing Tax Efficiency

Tax management isn't just for stock indexes anymore.

Morningstar
October 2024

Jason Kephart, CFA
Director, Multi-Asset Ratings
+1 312 384-3781
jason.kephart@morningstar.com

Bridget B. Hughes, CFA
Director, Parent Research
+1 312 696-6231
bridget.hughes@morningstar.com

Zachary Evens
Manager Research Analyst
+1 312 244-7310
zachary.evens@morningstar.com

Andy Kunzweiler, CFA
Portfolio Manager - Direct Indexing
+1 312 244-7332
andy.kunzweiler@morningstar.com

Important Disclosure
The conduct of Morningstar's analysts is governed by Code of Ethics/Code of Conduct Policy, Personal Security Trading Policy (or an equivalent of), and Investment Research Policy. For information regarding conflicts of interest, please visit: http://global.morningstar.com/equitydisclosures

Tax Management Is Everywhere

Investors' aversion to paying taxes is as strong as ever, and asset managers are expanding their toolkits to provide more solutions in separately managed accounts. SMAs have one big advantage over tax-managed mutual funds and exchange-traded funds, which are structurally more tax-efficient than mutual funds. In an SMA, the investor owns the underlying securities directly, so the tax management can be customized for the individual, something that's not possible with a fund.

Assets in tax-managed SMAs have soared to more than USD 500 billion as of June 30, 2024, according to a Morningstar survey of leading providers. That's a 67% increase from the end of 2022. Direct indexing is the most popular option by far, but firms have turned their focus on other building blocks of an investor's portfolio like active equities and fixed income to expand the toolkit to minimize capital gains taxes across a broader spectrum. And as more financial advisors turn to model portfolios, there are options to help ease the tax burden of transitioning a portfolio and managing taxes on an ongoing basis. The increased popularity of unified managed accounts presents even more opportunities for holistic tax management of entire portfolios that include direct indexing, active strategies, ETFs, and private investments.

In this paper, we'll build upon Morningstar's initial Direct Indexing Landscape from 2023 to look at the continued growth of direct indexing and the expansion of tax-management services.

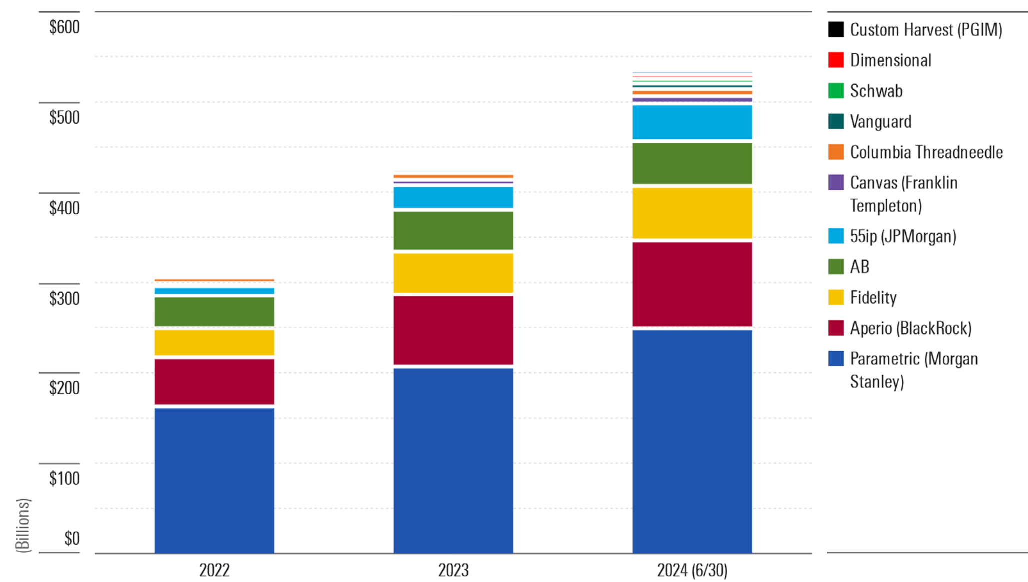
Key Takeaways

- Direct indexing and other tax-managed strategies' assets have grown to USD 500 billion as of June 30, 2024, up 67% from the end of 2022, according to a Morningstar survey of leading firms.
- Morgan Stanley's Parametric continues to be the largest provider, with more than USD 245 billion in tax-managed assets.
- Direct indexing is by far the most popular form of tax management, but other investments like model portfolios, fixed-income, and active stock separately managed accounts are additional options expected to grow quickly.
- The expansion of unified managed accounts, a single account that houses multiple investment strategies, may offer more opportunities for managing the taxes of investors' entire portfolios.

Tax-Managed Assets and Options Continue to Grow

Investors are increasingly turning to asset managers to help minimize their tax bills through personalized investments, like direct indexing. At the end of June 2024, more than USD 500 billion was invested in tax-managed separately managed accounts, up from USD 300 billion at the end of 2022, for a growth rate of 66%, according to a Morningstar survey of leading firms. For comparison, mutual funds that market themselves as tax-managed grew at a much slower pace. They held about USD 73 billion, up from USD 60 billion, over the same period. Most of the tax-managed SMA assets are in direct indexing, but other strategies like active equity, fixed-income, and ETF model portfolios are also starting to attract tax-conscious investors.

Exhibit 1 Assets Under Management See High Growth



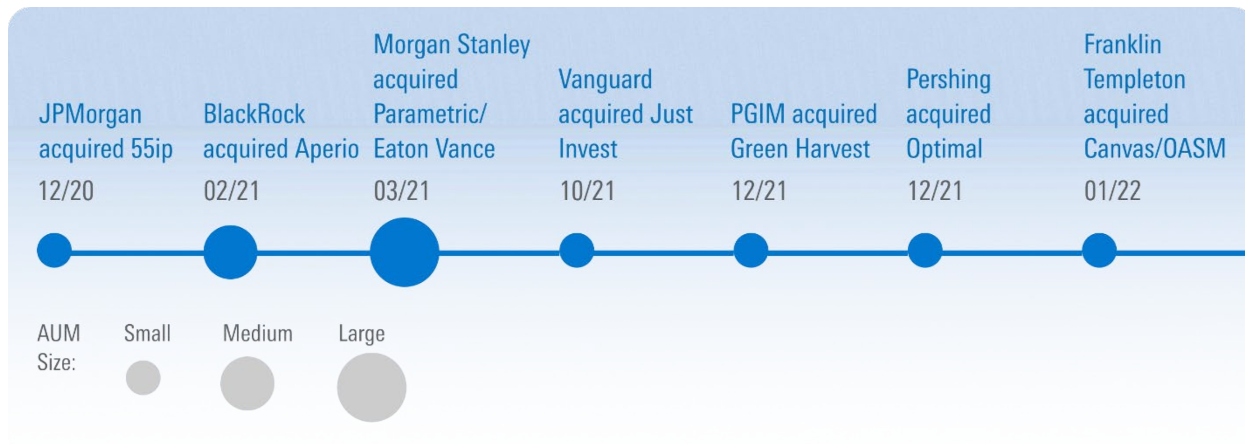
Source: Morningstar Survey. Data as of June 30, 2024.

Parametric, the firm that pioneered direct indexing in the early 1990s, remains atop the leaderboard, with USD 247 billion in assets. Its assets are primarily all in direct-indexing strategies, but in August, Parametric announced a new option to tax-manage active strategies from Capital Group (the parent company of American Funds). Other firms are expected to make their strategies available in the future.

Direct indexing is by far the most common form of tax management across the firms Morningstar surveyed, and don't expect that to change in the near term. There are some notable exceptions, though. JPMorgan's 55ip, which saw tax-managed assets grow to USD 42 billion from USD 10 billion over the period, has most of its tax-managed assets focused on model portfolios. AB (formerly AllianceBernstein) has invested heavily in technology advancements to improve its tax-loss harvesting capabilities for its municipal-bond separately managed accounts. Those tax-managed tax-free income SMAs make up the bulk of its tax-management assets.

AB's build-it-yourself route to building its tax-management capabilities is unique. Among the firms seeing the biggest growth in tax-managed assets, many have used acquisitions to speed up their entry into tax management. In June 2024, wealth management firm AssetMark announced it was acquiring USD 12 billion worth of assets from the Morningstar Wealth Turnkey Asset Management Platform, including its direct-indexing assets.

Exhibit 2 The Direct-Indexing Arms Race



Source: Morningstar Direct, Author's Calculations. Data as Dec. 31, 2023.

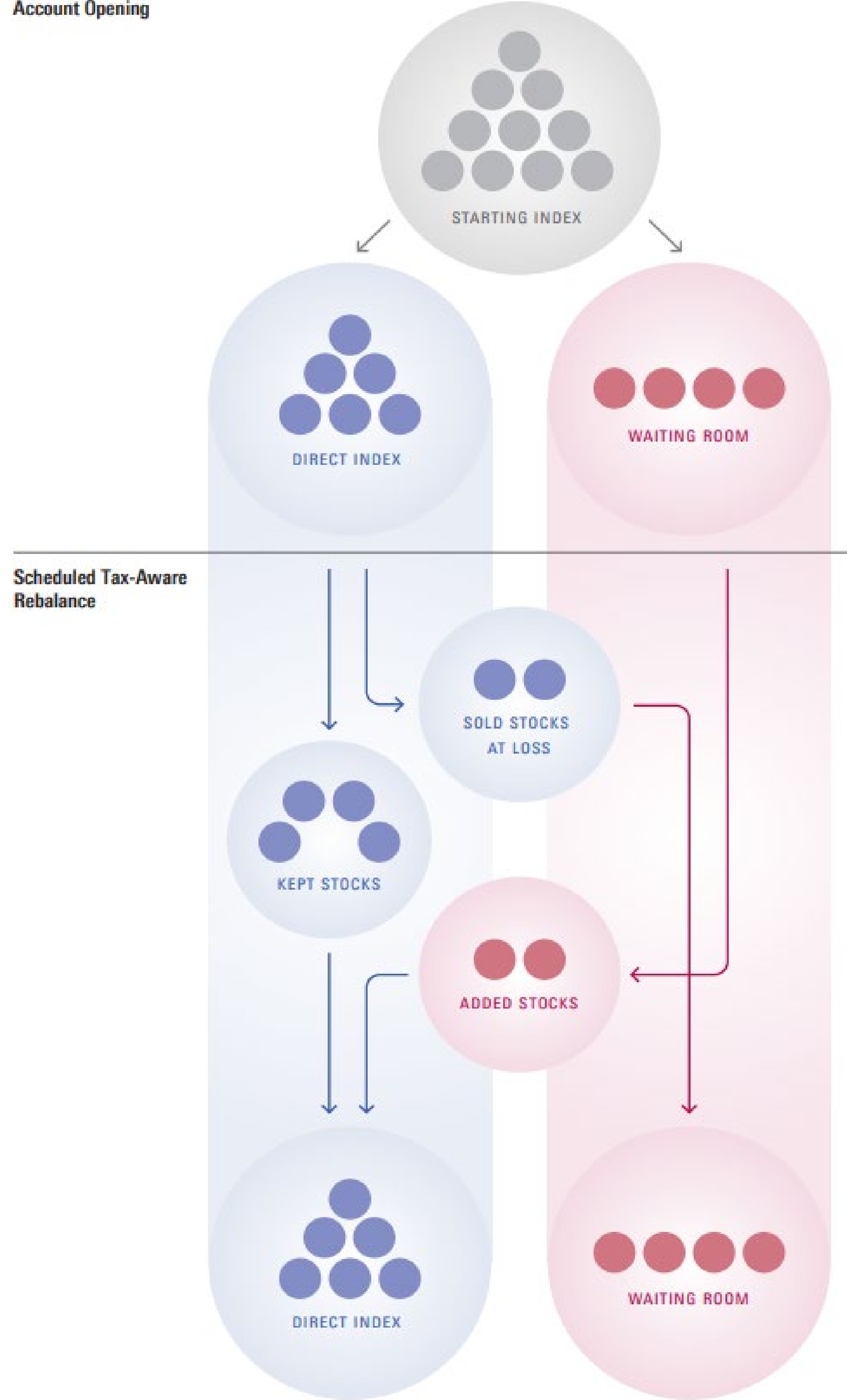
Direct Indexing Revisited

Direct indexing is a tool that high-net-worth investors have made use of for decades, but in recent years, it has become more widely available as innovations like fractional shares and advancements in trading technology have made it easier for asset managers to implement at scale.

The biggest driver of direct index adoption is the tax-management component. Investing directly in the underlying stocks of an index through a separately managed account instead of a mutual fund or ETF tracking the same benchmark allows for individually tailored tax management.

Direct-indexing providers will typically invest in a subset of stocks in the chosen index and sell those that have lost money since they were purchased to lock in the losses. They'll replace those stocks with the leftover stocks in the index that have similar characteristics to stay fully invested. They can rebuy the stocks that were sold after 30 days to comply with the wash-sale rule that prevents people from taking advantage of tax-loss harvesting by buying something substantially similar immediately after locking in losses. Exhibit 3 shows how direct indexing could work in practice.

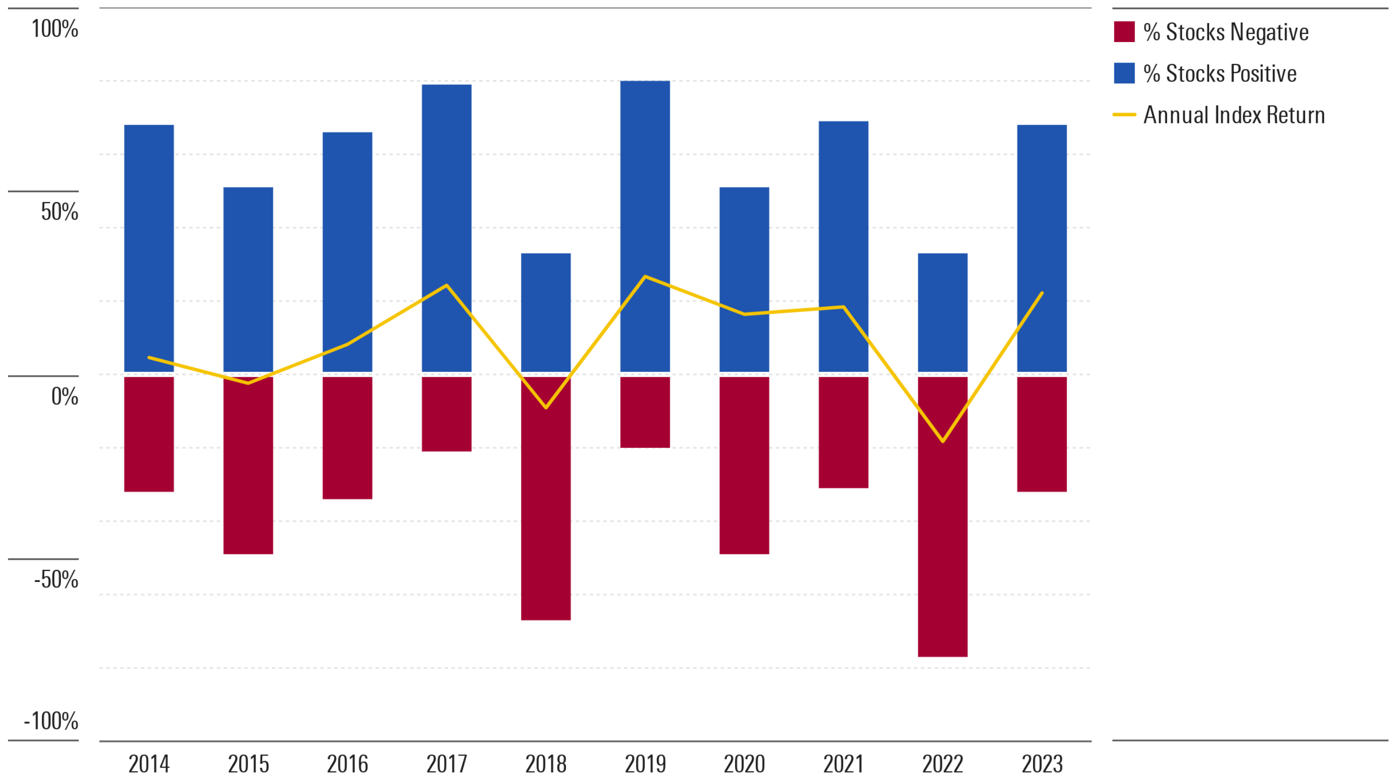
Exhibit 3 Direct Indexing in Practice



Source: Author's illustration.

The process is repeated as often as daily. There are more opportunities to harvest losses in years like 2022, when most stocks lost money, but even in years like 2023, when the MSCI ACWI gained 22%, about a third of stocks in the index had a negative return for the year.

Exhibit 4 There Are Always Losses Somewhere



Source: Morningstar Direct, Author's Calculations. Data as Dec. 31, 2023.

The ability to continually harvest losses at the individual stock level to offset future capital gains can boost aftertax returns. Most providers have published studies showing investors can expect to add an additional 1 to 2 percentage points of return annually through tax-loss-harvesting methodologies. Investors can use realized losses to offset an unlimited amount of capital gains and can carry those losses forward indefinitely—it's not a use-it-or-lose-it situation. For example, if an investor decided to cash out a position with USD 1 million of embedded capital gains to pay for a new house and they had accumulated USD 1.5 million in realized losses through years of tax-loss harvesting, they could offset the full USD 1 million of gains and still have USD 500,000 of losses as a tax "asset" to reduce future capital gains.

Investors can also use up to USD 3,000 of realized losses to reduce their taxable income each year. For high-net-worth investors in the top tax bracket, it is probably better to save the losses for offsetting gains though.

Direct Indexing's Final Form: An Expensive ETF?

There's an old phrase that astutely notes that you cannot squeeze blood from a turnip. It's used to refer to situations where you can't get something, usually money, because there's nothing to give. For direct indexers, there is a chance that, over the long term, the portfolio runs out of losses to harvest. Tax-management providers call this process "ossification."

Portfolios funded with cash, for example, are usually aggressively traded during the first one to five years following inception to realize losses while the cost basis is high. After these first few years, however, loss-harvesting opportunities begin to wane. At this point in a portfolio's lifecycle, direct-indexing providers shift their focus from pure tax-loss harvesting (or "tax alpha") to more of a balanced approach between index tracking on the one hand and tax efficiency on the other.

Exhibit 5 Direct Indexing Accounts Can Run Out of Losses over Time

Source: Author's illustration.

Direct indexing is a strategy that flourishes in volatile, oscillating markets, but the fact of the matter is that tax-loss harvesting by design involves selling individual tax lots with the highest cost basis and avoids selling lower-basis tax lots. After years of successfully realizing losses in a portfolio, what remains is a basket of highly appreciated, low-basis securities. This leaves many advisors wondering whether their clients have become locked into an "expensive ETF."

There are, however, various approaches investors can take to counteract this phenomenon:

- Contribute cash to a portfolio: Securities can be purchased at current market prices with additional cash added to a portfolio, which serves to raise the overall cost basis. This is the easiest way to kick-start tax-loss harvesting.
- Charitable donations: Charitably inclined investors can gift highly appreciated securities out of a portfolio, thereby avoiding having to sell them in the future. Replenishing the portfolio with cash after the securities have been transferred out can supercharge the process.
- Employ leverage: Long-short strategies (130/30, for example) are gaining interest among investors because of the possibility of greater tax-loss harvesting opportunities offered by the short extension of a portfolio. The idea is straightforward—the leveraged portion of the portfolio gives investors more opportunities to harvest losses in dollar terms, and the short portion of the portfolio should be negatively correlated to the long portion (meaning that something should always be declining in price). In addition, losses realized in short positions are taxed at an investor's highest marginal tax rate, making them very valuable. In practice, however, there are significant considerations to be made before implementing this approach. Employing leverage (if it's even allowed at an investor's custodian) can be very costly, to the point that it outweighs the additional tax savings achieved. At the same time, risk management is critical with this approach. Remember that the potential for loss on a security that has been shorted is unlimited.

The Expanding Toolkit

Direct indexing isn't going to lose its spot as the most popular tax-management option anytime soon, but providers are busy working on ways to expand their capabilities to include actively managed equity strategies, fixed-income, and model portfolios. In this section, we'll discuss how firms are approaching managing taxes for these other strategies and the potential benefits and drawbacks.

Active Equities

Tax management has typically been a niche or specialty for a few active stock-pickers, but the biggest direct-indexing provider aims to make it more mainstream. Parametric announced in August it was extending its tax overlay to active managers, and other tax-management providers like PGIM offer the services on their platforms. It's only a matter of time until others follow suit.

One key difference for tax management of an active strategy is how the tax losses are used. With direct indexing, the tax losses are typically used to offset capital gains from other strategies in the portfolio. The tax losses in an active strategy are first used to offset any capital gains the managers may incur from selling their winning picks. Still, the tax management isn't as simple as it is with indexes.

For direct-indexing strategies, tax-loss harvesting is straightforward because there's no preference for one stock over another if the overall portfolio has similar sector and factor exposures to the index. But for actively managed stock portfolios, investors are paying the managers to pick the best stocks in their universe. That creates a tension between harvesting losses and preserving the manager's best ideas.

There are a couple of ways to tackle this problem. For example, if the manager owns a 10% position in Microsoft and it's down 5% from when they bought it, the tax manager could sell it to lock in those gains and replace it with a technology sector ETF like iShares US Technology. However, if the ETF has a positive return over the next 30 days, the portfolio manager can't buy Microsoft because of the wash-sale rule, and there may not be a way to sell the ETF to buy back the stock without realizing capital gains. This could dilute the manager's stock picks.

Parametric's new option seeks to avoid that risk by taking a different approach. The active managers for whom it manages taxes will provide a list of substitute stocks to swap in as replacements. In the example above, that could mean replacing Microsoft by swapping in a tech stock like Broadcom (if that is on the manager's list of next-best picks). This approach would work best with managers that have broadly diversified portfolios instead of those that are more concentrated.

Fixed-Income

Stocks aren't the only asset class where tax management can be added to an SMA. Investors using tax management for bond SMAs should damp their expectations for how much tax alpha they can expect from these portfolios though. On average, tax-management providers we surveyed expect about half as much tax alpha opportunity from taxable-bond SMAs as they do equity SMAs.

There may be long stretches when there are few opportunities to harvest losses in bond SMAs. Bonds of the same credit quality and duration tend to move in tandem outside of idiosyncratic credit downgrades or defaults. This is even more so for municipal bonds that distribute tax-free income. That means tax-loss harvesting opportunities in bonds may be heavily dependent on when interest-rate and/or credit risk is out of favor.

From 2021 through 2023, the US Federal Reserve's rapid hiking of interest rates did present some tax-loss opportunities. In periods of rising interest rates, bond prices go down, and vice versa. In 2022, for example, the US 10 Year Treasury yield rose to 3.88%, from 1.63% at the start of the year, and the Bloomberg US Aggregate Bond Index lost 13%. For most of the last half century, though, interest rates have generally been falling instead of rising. The Federal Reserve cut interest rates for the first time since 2020 in September 2024 and expects more cuts in the future. That could mean fewer tax-harvesting opportunities because of falling interest rates going forward.

Credit risk tends to correlate with stock market risk, so when there are large stock market selloffs, like in 2008 and 2020, bonds with a higher probability of default tend to get punished as investors seek safer havens.

But between such shock periods, bonds can be very sleepy, except for the occasional credit downgrade or default. That makes a bond a great diversification tool but a limited tax-management opportunity.

Model Portfolios

Advisors' adoption of model portfolios is growing at a similarly blistering pace. Assets tracking model portfolios offered by asset managers grew by 50% to USD 450 billion over the two years ended June 30, 2024, according to the Morningstar Model Portfolio Landscape. If the home-office models of large wirehouses and broker/dealers are included, assets jump into the trillions.

Model portfolios are investment blueprints from asset managers or investment strategists. Most models can serve as the core of an investor's portfolio and hold both stocks and bonds. Using a model instead of homebrewing their own portfolios allows advisors to spend more time on holistic financial planning and courting new clients.

Taxes are one of the biggest hurdles advisors face when moving clients to a model portfolio from other investments. Those clients are likely to have a decent amount of capital gains embedded in their existing portfolios and probably don't want to pay big tax bills to move to models, even if they're likely better long-term investments. Firms like JPMorgan's 55ip have focused on using technology to make the transition between portfolios smoother by letting the advisor see potential tax hits and tailor how fast the client moves between portfolios. Like with direct indexing, it uses periods of market volatility to sell at a loss and then purchase the new funds. The exhibit below shows how a potential transition might look.

Exhibit 6 A Tax-Aware Transition Between Portfolios

Starting	%	Transition	%	Target	%
SOXX	60	SOXX	40	SOXX	0
BOXX	40	BOXX	30	BOXX	0
		TCAF	10	TCAF	40
		JPIE	5	JPIE	20
		BINC	5	BINC	20

Source: Author's Imagination.

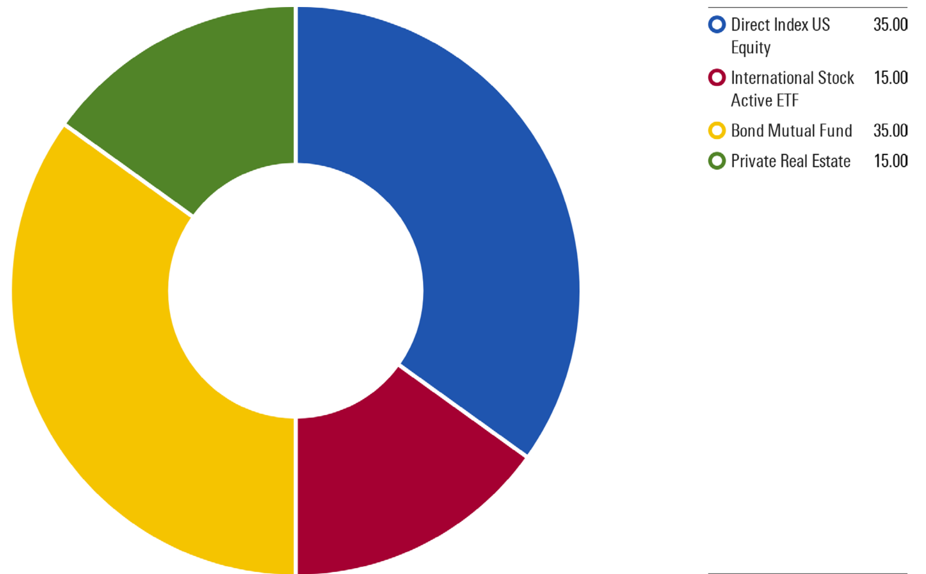
Once the transition is complete, ongoing tax management looks like other asset classes. The biggest difference is instead of swapping stocks or bonds, the model swaps ETFs for other ETFs, typically from an approved list of replacements. To avoid triggering the wash-sale rule, ETFs can't have more than 70% overlap of underlying investments.

Since a model portfolio is going to have fewer individual positions than strategies that invest directly in stocks and bonds and since diversified ETFs don't have as much return dispersion, there may be fewer tax-loss harvesting opportunities for model portfolios over the long term.

One Account to Rule Them All?

Model portfolios typically invest in ETFs and mutual funds. Going forward, increased adoption of unified managed accounts, which can include ETFs, mutual funds, SMAs, private investments, and individual securities, may be the next frontier for tax-management strategies.

Exhibit 7 A Hypothetical Unified Managed Account Portfolio



Source: Author's Imagination.

With UMAs, the tax-management possibilities are much broader in scope since it can encompass the entire portfolio, which may include things like direct indexing or other tax-managed SMAs as underlying components. It's a sort of nesting doll of tax management.

Use of UMAs has been growing, but there's still a lot of room for further adoption as more investment platforms make the option available. At the end of 2023, there was approximately USD 2.6 trillion in UMAs, according to Cerulli Associates, and the research firm expects assets to grow to USD 4.6 trillion by the end of 2027.

About Morningstar Manager Research

Morningstar Manager Research provides independent, fundamental analysis on managed investment strategies. Morningstar views are expressed in the form of Morningstar Medalist Ratings, which are derived through research of three key pillars—People, Process, and Parent. The Morningstar Medalist Rating is the summary expression of Morningstar's forward-looking analysis of investment strategies as offered via specific vehicles using a rating scale of Gold, Silver, Bronze, Neutral, and Negative. A global research team issues detailed research reports on strategies that span vehicle, asset class, and geography.

Medalist Ratings are not statements of fact, nor are they credit or risk ratings, and should not be used as the sole basis for investment decisions. A Medalist Rating is not intended to be nor is a guarantee of future performance.

About Morningstar Manager Research Services

Morningstar Manager Research Services combines the firm's fund research reports, ratings, software, tools, and proprietary data with access to Morningstar's manager research analysts. It complements internal due-diligence functions for institutions such as banks, wealth managers, insurers, sovereign wealth funds, pensions, endowments, and foundations. Morningstar's manager research analysts are employed by various wholly owned subsidiaries of Morningstar, Inc. including but not limited to Morningstar Research Services LLC (USA), Morningstar UK Ltd, and Morningstar Australasia Pty Ltd.

For More Information

For current Morningstar clients, please reach out to your respective Client Success Manager for more information on how you can best leverage this research within your firm.

For all others, please reach out to our business development team at dtainsidesales@morningstar.com to learn more about Morningstar's various offerings and more details about how you can leverage this research.

22 West Washington Street
Chicago, IL 60602 USA

©2024 Morningstar. All Rights Reserved. Unless otherwise provided in a separate agreement, you may use this report only in the country in which its original distributor is based. 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; and are not warranted to be correct, complete, or accurate. The opinions expressed are as of the date written and are subject to change without notice. Except as otherwise required by law, Morningstar 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. The information contained herein is the proprietary property of Morningstar and may not be reproduced, in whole or in part, or used in any manner, without the prior written consent of Morningstar. To license the research, call +1 312 696-6869.