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The Direct Indexing Landscape

A look at investors' options and opportunities.

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

Lan Anh Tran
Analyst, Passive Funds Research
+1 312 244-7590
lananh.tran@morningstar.com

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

Contributors
Amy Arnott
Madeline Hume
Mahi Roy
Jasmine Xu

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Executive Summary

Direct indexing isn't a new option for affluent investors, but in recent years interest has surged in it as a useful way to reduce taxes and personalize portfolios. The growth in demand has sparked a wave of acquisitions by some of the largest asset managers as they look to keep up with the latest trend. Advancements in trading technology have also increased its efficiency and led some firms to launch new offerings with lower investment minimums. At the end of 2022, more than $260 billion was following direct indexes, according to a survey of some of the largest providers. Assets should continue to grow at a steady pace. In this paper, we'll cover what is driving investors toward direct indexes, highlight available offerings from some of the largest providers, and offer best practices for evaluating direct index investments.

Key Takeaways

- More than $260 billion is invested in direct indexes as of the end of 2022, according to a survey of some of the largest providers.
- The growing popularity of direct indexing set off a wave of acquisitions by some of the largest asset managers.
- The perceived opportunity for asset managers is so large that Vanguard made its first acquisition ever to jump-start its direct index offerings.
- Tax management is the number-one reason investors turn to direct indexing; personalization is the second-most popular reason.
- Providers estimate between 1% and 2% of additional return per year thanks to tax management, though high-net-worth investors in higher tax brackets get the biggest benefit.
- Direct indexing providers have similar offerings, but individuals will have unique experiences, even with the same service.
- Fees can be high compared with index funds and exchange-traded funds. Starting fees among surveyed providers range from 0.25% for minimum investments of $250,000 and up to 0.40% for firms targeting smaller accounts.
- Investors need to pay close attention to their direct index's tracking error. Even tracking error as small as 2% can vastly change investors' outcomes relative to the index.

The Next Frontier for Personalization

It has never been easier to customize an investment to an individual. Lately, the ability to customize stock portfolios has accelerated because of direct indexing. Simply, direct indexing allows individual investors to pick which index securities they want to track or exclude in a separately managed account. It gets more complicated quickly, though, as this paper will show.

The two biggest drivers of direct index adoption are taxes and personalization, with the former attracting most of the interest. Investing directly in the underlying stocks of an index in lieu of a mutual fund or ETF tracking the same benchmark allows for individually tailored tax management. It also allows investors to exclude certain stocks and industries or emphasize stocks with characteristics like low environmental, social, or governance risk or high exposure to traditional investment factors like value. This paper will cover the pros and cons of these options.

Although direct indexing isn't new (industry asset leader Parametric's offering launched in 1992), several innovations have encouraged its proliferation in recent years. Indeed, increasing computing power and collapsing brokerage costs have lowered the degrees of difficulty and costs of the calculations and trading required for large-scale tax and portfolio customization. This paper will show how important cheaper-than-ever trading costs have been in enabling personalized tax management.

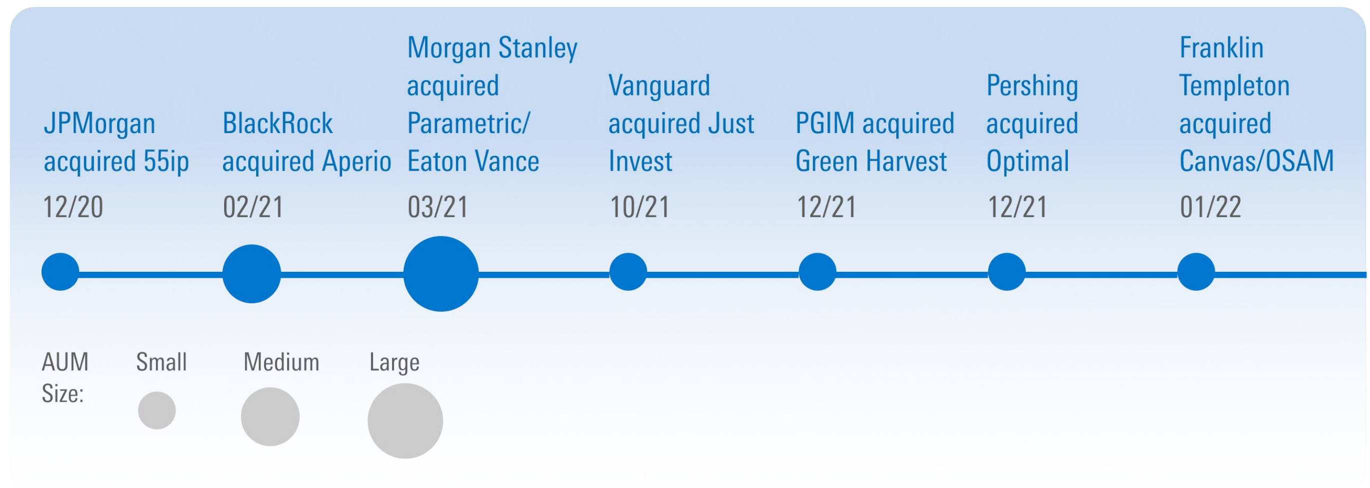
Assets tracking direct indexes topped $260 billion as of 2022, according to a Morningstar survey of some of the largest providers. A spree of big direct-indexing-related acquisitions since 2020 by some of the largest asset managers, including Vanguard's October 2021 purchase of Just Invest, signals the industry's optimism for meaningful future growth. (Morningstar Wealth, a subsidiary of Morningstar, also leaped into the direct indexing market in November 2022. This paper does not assess nor comment on it.)

The Direct Indexing Arms Race

Asset managers have been keen to take part in direct indexing as it has taken off and have tried to move fast. They want to bring services long available to the ultra-rich to a broader range of investors with smaller accounts. To do so, they need access to the technology necessary to personalize and tax-manage investor accounts at scale.

Although many asset managers have invested heavily in technology and investment tools, some major players have opted to buy firms to help them build or procure their direct indexing infrastructure. Exhibit 1 shows the shopping spree that firms have been on since 2020 and the dates each deal closed.

Exhibit 1 A Timeline of Direct Indexing Acquisitions



Source: Morningstar Direct. Data as of Dec. 31, 2022.

JPMorgan was the first, scooping up tax-focused financial technology firm 55ip at the end of 2020. JPMorgan used the service's technology, which had been focused on tax-loss harvesting for model portfolios, to launch its direct indexing offering in 2022.

Morgan Stanley's purchase of Eaton Vance, which closed in March 2021 and included the biggest direct indexer by assets, Parametric Portfolio Associates, kicked off a spree of industry deals. BlackRock announced it was acquiring Aperio, the second-largest direct indexer, in October of that year, and then Vanguard made its first acquisition in its 47-year history. The passive-investing giant obtained little-known Just Invest in October 2021 and turned it into Vanguard Personalized Indexing Management in a transaction that testified not only to direct indexing's momentum but also Vanguard's designs to aggressively grow its advice business.

Other firms are either building their own offerings or forging strategic partnerships. Charles Schwab built its direct indexing service on its brokerage platform in 2022, for example, and both Natixis Investment Managers and Principal Asset Management have cooperated with smaller firms to create their services.

While each of these firms is targeting high-net-worth individuals, in 2022, Fidelity was the first to expand its direct indexing service to smaller investors with as little as $5,000 after the brokerage's move to offer fractional shares of stocks made it possible to assemble a broad enough basket of index stocks to mimic the benchmark's performance.

No One Likes Paying Taxes

Investors mainly opt for direct indexing for tax management, providers have told Morningstar. The ability to continually harvest losses at the individual stock level to offset future capital gains can boost aftertax

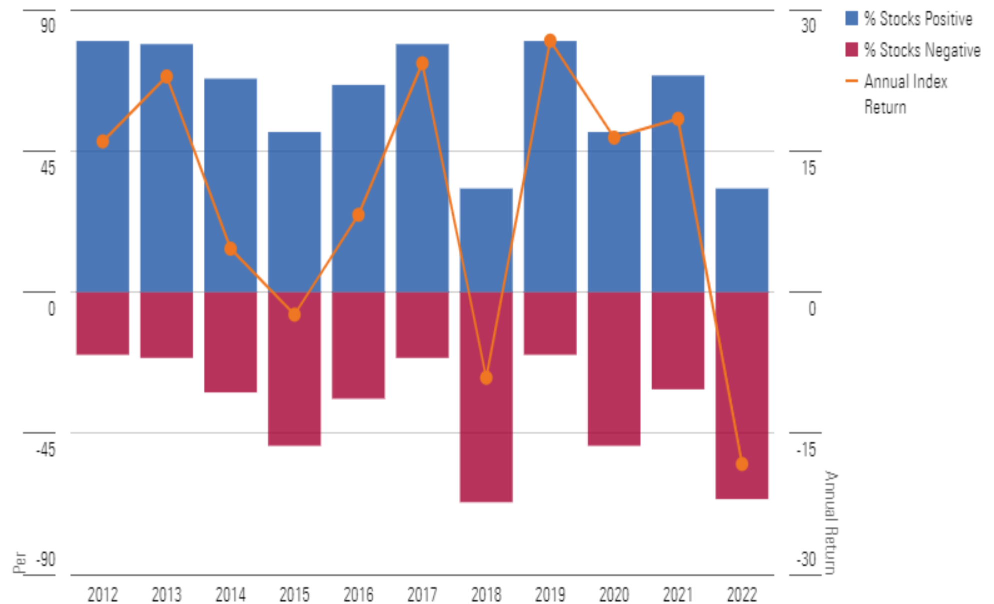
returns. Most providers have published studies showing investors can expect to add an additional 1 to 2 percentage points of return annually through tax-loss-harvesting methodologies.

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 realized $1 million of capital gains in a year and had $1.5 million in realized losses, they can offset the full $1 million of gains and still have $500,000 of losses as a tax "asset" to reduce future capital gains at any future time. Investors can use up to $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.

There Are Always Losses Somewhere

The opportunity to harvest losses depends on the market environment. In bear-market years like 2022, there are plenty of chances to harvest losses. In years like 2013, when broad market indexes rise, some stocks will be down at some point in the year, proving opportunities to stockpile realized losses. To illustrate how the opportunity set can ebb and flow, Exhibit 2 shows the percentage of stocks in the MSCI ACWI Index that had positive and negative returns each year for the last decade and the index's annual return.

Exhibit 2 Even When Stock Markets Are Up, Not Everyone Is a Winner



Source: Morningstar Direct. Author's Calculations. Data as of Dec. 31, 2022.

Regular Contributions Help Keep the Taxman at Bay

One thing direct indexing investors can do to improve their opportunities to harvest losses is to continue to make regular contributions. Large gains can make it hard for investors who make lump-sum investments to harvest gains. Microsoft's MSFT big 2021 gain, for instance, made it a poor candidate for tax-loss harvesting in 2022 for those who started direct indexing the U.S. market in the previous year with lump sums, because the software titan gained more in 2021 than it lost in 2022.

If investors had spread out contributions, however, they would have had the opportunity to lock in some losses throughout 2022 because the Microsoft shares they purchased in the second half of 2021 and early 2022 would have been underwater.

But the longer investors own direct indexes, the more they should expect the tax "alpha" to deteriorate as their holdings have more embedded gains.

Finding the Right Balance Between Taxes and Tracking the Index

Direct indexing providers balance harvesting losses with tracking their benchmark indexes. It's easier said than done and can require frequent trading. Providers must sell stocks for losses and refrain from buying them again for at least 30 days, which could increase tracking error if the cash from the sale just sits there, waiting to be redeployed. To avoid that drag, providers typically reinvest tax-sale proceeds in stocks with similar attributes or characteristics—swapping Coca-Cola KO for PepsiCo PEP, for example. To ensure substitutes are available, direct index accounts usually only hold about half the stocks in their indexes at any given time. For example, a direct index tracking the S&P 500 might only hold about 250 stocks.

Providers use various optimization techniques to make sure those 250 stocks roughly match the same sector, industry, and factor exposures as the target index. The more an investor chooses to customize their portfolio, however, the less efficiently the optimizers will work. Larger performance differences between a direct indexing account and its intended index will ensue.

None of the providers surveyed shared many details of how their tax management works, such as how much of a decline it would take for the algorithm to suggest locking in a loss. That makes it difficult to compare different direct indexing options.

Direct Indexers Struggle to Differentiate Themselves

As more firms rush to offer direct indexing and as tax management and customization get easier, comparing different options resembles comparing different chain restaurant menus. Sure, there are small differences, but the core offerings look alike. Exhibit 3 gives a snapshot of the assets, minimum investments, starting fees for a U.S. large-cap index, and the number of indexes and customization options available at some of the largest direct index providers.

Exhibit 3 The Landscape

Firm	Assets	Min Investment	Starting Fee	Index Options	Customization
Morgan Stanley	$ 160	$ 250,000	0.35%	Extensive	Extensive
BlackRock	$ 55	$ 250,000	0.35%	Extensive	Extensive
Fidelity	$ 32	$5,000/100,000	0.40%	Limited/Extensive	Limited/Extensive
Columbia	$ 6	$ 250,000	0.32%	Extensive	Extensive
Franklin Templeton	$ 4	$ 250,000	0.35%	Extensive	Extensive
Vanguard	$ 3	$ 250,000	0.20%	Extensive	Extensive
Charles Schwab	$ 1	$ 100,000	0.40%	Limited	Limited
J.P. Morgan	$ 1	$ 250,000	0.23%	Limited	Limited

Source: Morningstar Direct. Author's Calculations. Data as of Dec. 31, 2022.

Most fees for U.S. large-cap indexes start in the ballpark of 0.20% to 0.40% and fall as account balances grow. At Schwab, for example, fees fall to 0.35% from 0.40% once an account has more than $2 million. Fees can also be higher for international or more-niche indexes.

For the index and customization options, we considered fewer than five index or customization options to be limited and more than that to be extensive to distinguish between those that have a wide range of options and those that have fewer. Fidelity's direct indexing service for investors at the $5,000 minimum only has three indexes to choose from, for example, but those at the higher $100,000 minimum have a broader menu to select from.

The only two firms that have limited index options and customization options are JPMorgan and Charles Schwab. JPMorgan currently only offers a U.S. large-cap direct indexing option and Schwab offers four indexes covering U.S. large caps, international large caps, ESG, and small caps. Both began offering direct indexes in 2022. Expect them to offer a much broader range of options for both indexes and customization soon. Once the tax and portfolio construction optimization algorithms are in place, swapping one index for another doesn't require much extra work.

Despite the similarities, direct indexing investors have myriad options that let them choose their own unique adventure, even at the same provider.

A Tasting Menu

Exhibit 4 shows a small sample of what investors can pick from at most direct indexing providers.

Exhibit 4 A Sampling of Choices

Base Index	Taxes	Exclusions	ESG	Factors
MSCI ACWI	Standard	Single Stocks	Low-Carbon	Value
S&P 500	Light	Industries	Women's Inclusion	Momentum
MSCI EAFE	Aggressive		Reproductive Rights	Low-Beta
Russell 2000			Catholic Values	Quality
MSCI EM			Racial Justice	Multi-Factor

Source: Morningstar Direct. Author's Calculations. Data as of Dec. 31, 2022.

- Base Index: The first choice is probably the easiest: picking the index. Several firms reported their most popular direct index was the MSCI ACWI, or equivalent, which is a market-cap-weighted global equity index. For investors concerned with tax-loss harvesting, that's a sound choice. The MSCI ACWI, which includes developed- and emerging-markets stocks, has the broadest investment universe—and the more individual securities, the more opportunities to harvest losses. Most firms also offer a standard index range of other common benchmarks, like the Russell 2000 for small-cap exposure or MSCI Emerging Markets.

- Taxes: Direct indexing clients usually expect tax-loss harvesting, but there are limitless ways to decide what kind of loss is worth harvesting. Is it a drop of 1%, 5%, 10%, or more? Direct indexers tend to run their tax-management algorithm daily but can set any threshold for locking in losses. None of the direct indexers surveyed shared their tax-loss-harvesting secret sauce. Some, like BlackRock's Aperio, though, leave the choice to investors. While it may be tempting to collect every penny of losses, that would entail higher turnover that would likely lead to more tracking error and potential trading impact costs.

- Exclusions: These can be done at the individual stock level or at the industry level. At the individual security level, an investor may already have a lot of exposure to a stock in another account, like a Microsoft executive with a lot of stock options. At the industry level, investors can carve out large chunks of the index, which may have a big impact on returns. For example, someone working in the tech sector may want to exclude technology hardware from the S&P 500 because so much of their net worth is highly correlated to that industry already. But that would remove Apple, the largest weight in the S&P 500 as of mid-March 2023. Some industry exclusions, like oil, gas, and consumable fuels, will most likely appeal to investors interested in the next set of options related to ESG investing.

- ESG: It is a common critique of ESG investing that the term can mean pretty much anything. But with direct indexing, investors can focus on the aspects of ESG investing that mean the most to them. For example, someone purely concerned with climate change could only choose to emphasize stocks with low-carbon footprints. Or an investor who cares more about the social aspect of ESG could choose to focus on women's rights and target companies that have better metrics on equal pay.

- Factors: Targeting stocks with specific characteristics, like those with cheaper-than-average price/earnings multiples or less earnings volatility, has been a common investment tactic since academics Eugene Fama and Kenneth French published their three-factor pricing model in 1992. The most common factors, like value, momentum, quality, and size, are on most direct indexer's menus. Investors can also combine factors into customized multifactor overlays that blend, say value and quality. It can even get more granular than that. Some providers, for instance, will let investors pick among valuation methods, such as price/book, price/earnings, or price/sales.

Direct Indexing Isn't Passive Investing

No doubt one of the reasons direct indexing is getting more buzz lately is the continued allure of passive investing. The market share of passive, market-cap-weighted index funds and ETFs had grown to almost 50% as of the end of February 2023, nearly double its market share of a decade earlier.

Passive investing has thrived as active managers have struggled, in aggregate, to outperform common indexes after their much higher fees. Even active managers who have outperformed over specific time periods have struggled to do so consistently. That's made picking a cheap index fund a sound option for most investors.

The customization options in a direct index, including tax management, blur the line between passive and active investing. While some active managers who hew too close to their benchmark have often been referred to as "closet indexers," some direct index accounts could reasonably be thought of as "closet active management" instead of passive investing.

Tale of the Tape: Direct Indexing vs. ETFs

Exhibit 5 highlights the key differences between direct indexing and using an ETF for market-cap-weighted U.S. large-cap exposure.

Exhibit 5 How Direct Indexing Stacks Up With ETFs

Attributes	Direct Index	ETF
Fees	> 0.20%	< 0.05%
Tracking Error	> 0.50%	< 0.05%
Capital Gain Risk	Low	Low
Tax Loss Harvesting	Yes	No
Customization	Yes	No
Easy to Trade	No	Yes

Source: Morningstar Direct. Author's Calculations. Data as of Dec. 31, 2022.

For U.S. large-cap exposure, ETFs are much cheaper and easier to trade. And while they lack the ability to harvest individual security losses, they rarely distribute capital gains to investors and are tax-efficient options. They also reliably track their indexes closely. The results of most U.S. large-cap ETFs, like

Vanguard Total Stock Market VTI or iShares Core S&P 500 IVV, are within a few basis points of their indexes.

Customization and tax management can significantly increase direct index accounts' performance differences with their benchmarks.

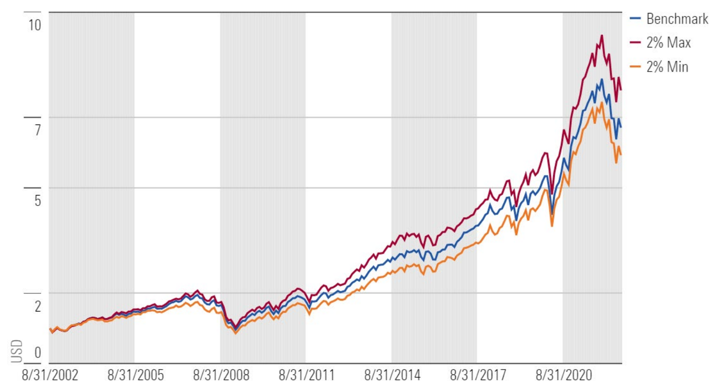
Tracking Tracking Error

Tracking error measures the difference between an investment and its benchmark index. Tracking error indicates the magnitude of the difference but not its direction. A portfolio with high tracking error can be an underperformer or outperformer.

This is an important measurement for direct indexing investors. The more unpredictable performance is compared with the benchmark index, the harder it may be for an investor to stick with during periods when the tracking error isn't favorable. There's also the chance that investors may end up with worse aftertax performance. Most providers estimate about a 1% tracking error.

To illustrate the potential impact of high tracking error, we ran 100 Monte Carlo simulations for a direct index with a 2% tracking error versus the Morningstar U.S. Markets Index over a 20-year period. Exhibit 6 shows the best and worst results of our simulation compared with the index.

Exhibit 6 The Trouble With Tracking Error



Source: Author's Calculations Data as of December 31, 2022.

Source: Morningstar Direct. Author's Calculations. Data as of Dec. 31, 2022.

An investment closely tracking the benchmark would have grown a $100,000 initial investment to $670,000, a 570% cumulative gain. In the investment with 2% tracking, however, results ranged from an ending balance of $770,000, or a 670% return, to a final nest egg of $590,000, or a 490% return. The $180,000 difference between those extremes shows the potential opportunity costs of a high-tracking-error strategy. It is a good example of why investors should be mindful of their tracking error. If it is higher than anticipated, changes to the customization options might be warranted.

Where Does Direct Indexing Go From Here?
The future of direct indexing probably won't look much like the present. Here are some predictions.

The next frontier for most direct indexers is fixed income. Industry pioneer Parametric already offers direct indexed bonds to high-net-worth investors, and it is inevitable that others will follow suit. In theory, direct bond indexes should offer the same benefits as direct equity indexes. Trading fixed income is more complex, however, because bonds are less liquid than stocks; certain bonds in an index may not even be available. It is developing situation, but it doesn't take much to imagine portfolios with separate accounts that combine direct indexes of multiple share classes.

More powerful computers should continue to reduce the costs of direct indexing. That, and increased competition, should push down direct indexing fees and investment minimums. Fidelity's $5,000 minimum may be an outlier today but common five years from now.

As always, the biggest winners of competition among finance or technology companies are often the end users, which in this case are investors. M

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For More Information
Connor Furlan
Connor.Furlan@morningstar.com

22 West Washington Street
Chicago, IL 60602 USA

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