CLEARPOINT

DANIEL MEGES, CHIEF ECONOMIST & HEAD OF PUBLIC EQUITY, SENIOR MANAGING DIRECTOR

BENEFITS TO DIRECT INDEXING—TAXES, CUSTOMIZATION, AND EFFICIENCY

BY DANIEL MEGES, CHIEF ECONOMIST & HEAD OF PUBLIC EQUITY, SENIOR MANAGING DIRECTOR

What is direct indexing and how can it improve client outcomes? That is the topic we will explore in this month's *ClearPoint*.

Clearstead is increasingly utilizing direct indexing solutions with private wealth clients who have significant assets in taxable accounts. The reason for the use of direct indexing solutions is multifaceted, but ultimately, as fiduciaries, our analysis has shown that these solutions have historically provided favorable after-tax returns for these clients' taxable accounts, as well as the ability to better customize and personalize their US equity exposure consistent with their personal values, liquidity needs, and risk tolerances.

So, what are direct indexes and how do they work? Direct indexes allow a client to replicate the returns of any number of well-known indices in a more tax-efficient manner than owning a mutual fund or even an exchange traded fund (ETF). The most common example would be to have a direct index that mirrors the returns of the S&P 500 Index. The direct index approximates the S&P 500 by buying a subset of the full index—either 70, 150, or 300 individual stocks that are weighted in a portfolio so that it closely tracks the overall performance of the underlying index.

CLEARSTEAD CONTINUES TO BOLSTER TEAM WITH NEW TALENT

We are pleased to announce that we have added talent to the Research & Investment Management and Private Client teams:

Patrick Spittler
Senior Portfolio Manager

Abby Kirk
Associate Portfolio Manager

Alex Enasel
Planning Associate, Tax

Emma Traggiai
Planning Associate

Tom Spear
Planning Associate

Dawn Hein
Client Service Associate

Amy Taylor
Administrative Assistant, Tax

These changes underscore the firm's commitment to building its investment consulting practice, promoting the next generation of leadership, and maintaining a rigorous investment process.

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The top holdings of the direct index will most likely track the weights of the largest names in the index but omit many of the smallest names in the index that generally have little overall impact on longer-run returns. The advantages to this approach are numerous.

First, by owning a sub-set of the individual constituents of the index, the portfolio will approximate the return stream, but not be forced to buy, trade, and rebalance as it would if it owned the entire 500 names that comprise the S&P 500. Conversely, an S&P 500 index mutual fund will own close to all, if not all, of the index and be forced to buy and sell prompted by investors regularly entering and leaving the mutual fund. Contrast that with a personalized, direct index where you are the only investor. Therefore, direct indexing often works to minimize trading costs and overtrading.

Second, direct indexing allows for more tax efficiency for clients' whose returns are subject to capital gains taxes and dividend income is subject to ordinary income taxes. This is because direct indexes are historically better compared to both mutual funds and ETFs in their ability to offset some of these tax liabilities. Mutual funds, in general, are some of the least efficient vehicles for taxable accounts. By owning all the components of the index, as discussed, they may be forced to overtrade to fully replicate the underlying index as well as manage investor redemptions. Additionally, it does not necessarily matter when you buy a mutual fund, as every investor is liable for the embedded gains within the fund from earlier periods. It is not uncommon that the sale of securities within the mutual fund portfolio creates capital gains for all investors, even for those who may have invested after the gains were achieved and who may have an unrealized loss on the overall mutual fund investment. In mutual funds, you can face tax liabilities without having experienced the gains.

Realizing the tax-inefficiencies of mutual funds, Morningstar Investment Research created a metric—the Tax Cost Ratio—to measure the tax impact of mutual funds on investor's net (post-tax) return. The Morningstar Tax Cost Ratio measures how much a mutual fund's annualized return is reduced by the taxes investors pay on stock dividends (or bond coupon payments for fixed income funds), and on any realized capital gains to their shareholders. The 3-year Tax Cost Ratio averages the negative tax impact over the past three years, which helps smooth the impact of any one year where unusual fund flows or index volatility may have impacted the tax score. The table below shows some of the largest S&P 500 mutual funds or other popular US large cap equity indices and the negative tax impact created by the mutual fund structure. The table indicates that, on average, investors in these mutual funds are likely to experience about -50 basis points less than the headline returns of these funds annually due to their tax liability associated with taxable distributions.

Mutual Fund	Ticker	Management Fee	Morningstar 3-Year Tax Ratio
Vanguard 500 Index (Admiral)	VFIAX	4 basis points	37 basis points
Fidelity 500 Index	FXAIX	2 basis points	54 basis points
Schwab S&P 500 Index	SWPPX	2 basis points	49 basis points
Vanguard Total Stock Market Index (Admiral)	VTSAX	4 basis points	37 basis points
Schwab Total Stock Market Index	SWTSX	3 basis points	59 basis points
iShares S&P 500 Index Investor	BSPIX	10 basis points	58 basis points

Source: Morningstar 3/31/2024.

These tax inefficiencies are not present in direct indices—as well as in ETFs—but direct indexes have other tax efficient characteristics that distinguish them from ETFs. For instance, by owning individual names outright, it allows one to tax-loss harvest individual positions throughout the calendar year as some portions of the S&P 500 inevitably experience intra-year drawdowns. This is important as it can provide some tax-loss offsets for ordinary dividend income as it naturally arises throughout a calendar year.

In addition to being more tax efficient than mutual funds, direct indexes are more tax efficient than ETFs because they are better at tax loss harvesting, gains deferral, and (in the case where you have legacy holdings of appreciated individual securities) tax-sensitive transition. For instance, if you sell an ETF, you are effectively selling every share of the underlying index in proportion to its weight in the index. But with a direct index, you can selectively avoid selling the top gainers and thus continue to defer any potential capital gains. For most clients, deferring long-term capital gains is even more powerful than tax-loss harvesting individual positions in terms of the long-run compounding of their portfolios.

While many firms offer direct indexing solutions, Clearstead conducted an exhaustive search in 2022-2023—evaluating over 15 separate providers—to arrive at the decision to partner with Smartleaf. Smartleaf was founded in 1999 as a software company primarily focused on tax-efficient rebalancing and model management. Over 10 years ago they began to offer direct indexes to independent advisors, and today, Smartleaf tax efficient algorithms manage over $60 billion in assets in a variety of direct indexing solutions, as well as providing tax-efficient overlay that can optimize rebalancing and tax-loss harvesting around one's entire portfolio. Clearstead chose to partner with Smartleaf due to its core-competency in tax-efficient trading and index management, its ability to optimize rebalancing and tax-loss harvesting around a full portfolio, and its ability to be easily customized or personalized to a client's values and preferences.

To get the tax benefits of tax-loss harvesting, IRS rules require that you not repurchase the security you sold within 30 days (you also cannot have purchased extra shares in the 30 days before the sale). Smartleaf's tax-efficient trading and model management algorithms obeys these rules. When Smartleaf harvests losses, they reinvest the proceeds of the sale into similar securities to keep one's portfolio on track with its underlying index. After the 30-day wash-sale period is over, they will look to move your position back to the original investment, as appropriate.

The ultimate benefit to Clearstead's clients from direct indexing is in the improvement of post-tax annualized returns. In fact, a 2020 CFA Institute study found that, on average, direct indexing—when constrained by the current IRS wash-rule—generated about 0.85% of tax alpha per year when a modern tax-loss algorithm was applied to historic data from 1926 to 2018.[1]

Since Clearstead has begun implementing the Smatleaf direct-index solution into client portfolios over the last nine months it appears that the results are consistent with the findings of the CFA Institute study. Most of Clearstead's clients have experienced returns in line with the S&P 500 during Q1-2024 and have benefitted from the types of tax-alpha (better-post tax returns than if they were invested in a mutual fund or ETF) due to tax loss harvesting and deferring short gains to long-term gains, as described earlier.

While tax-loss harvesting may seem to be the engine of Smartleaf's positive tax alpha, much of the positive tax alpha, in fact, derives from deferring gains from short-term (often tax at 40%) to long-term gains (typically taxed at 20%). Some gains may be deferred for numerous periods when Smartleaf's algorithms hold on to an overweight appreciated position to defer, reduce, or avoid taxes. Smartleaf tries to counterbalance this risk by underweighting similar securities to leave the overall risk characteristics of the portfolio in-line with the underlying index.

In addition to positive tax alpha, Smartleaf allows for the easy customization of their direct index solutions. This can be as simple as basic environmental, social, and governance (ESG) type screens that remove select names from the personalized index—like companies that derive most of their revenue from fossil fuels—or screens associated with faith-based groups like the US Conference of Catholic Bishops' investment guidelines. In fact, direct indexes can also be employed by institutional clients, not for tax considerations as most endowments or foundations do not face taxes on gains or dividends, but to cost effectively tailor a baseline index to their institutional philosophy. For instance, an endowment for a faith-based school could utilize a direct index with select screens to reflect the values of its faith. Further personalization for individual clients can be the exclusion of specific stock—perhaps the client is an executive in the company and therefore must pre-screen his sales through a board or a compliance office—or even the provision to never sell a specific security. All these options to personalize the direct index solution can be easily configured by Clearstead via Smartleaf's onboarding website.

Direct indexing is a powerful tool to minimize our clients' tax burden and ultimately deliver optimal after-tax returns that can compound indefinitely. Clearstead clients can fund their personalized direct index with either cash or in-kind with a pre-existing portfolio of individual stocks. The process of onboarding a client custodied at either Fidelity or Schwab can be accomplished in a few days and Smartleaf—unlike most others in the direct indexing space—can optimize after-tax returns around a full portfolio that includes mutual funds or ETFs in addition to the direct index. Clearstead also negotiated an advantageous fee arrangement for all clients at Smartleaf and, as the relationship with Smartleaf grows, Clearstead will have the opportunity to lower fees further to our clients utilizing direct index solutions.

Source:

(1) "Empirical Evaluation of Tax-Loss Harvesting Alpha" S.E. Chaudhuri, T.C. Burnham, and A.W. Lo, CFA Institute/SSRN, January 26, 2020.

MARKET BENCHMARK RETURNS

June 30, 2024		1M	3M	12M	YTD
US Large Cap	S&P 500 Index	3.6%	4.3%	24.6%	15.3%
US Small Cap	Russell 2000 Index	-0.9%	-3.3%	10.1%	1.7%
Developed Intl	MSCI EAFE (Net)	-1.6%	-0.4%	11.5%	5.3%
Emerging Intl	MSCI Emerging Markets (Net)	3.9%	5.0%	12.5%	7.5%
Real Estate	FTSE NAREIT All REITs Index	2.2%	-0.9%	5.7%	-2.2%
Core Fixed	Blmbg. U.S. Aggregate Index	0.9%	0.1%	2.6%	-0.7%
Short Fixed	Blmbg. 1-3 Year Gov/Credit index	0.6%	1.0%	4.9%	1.4%
Long Fixed	Blmbg. U.S. Long Government/Credit	1.1%	-1.7%	-1.6%	-4.1%
Corp Debt	Blmbg. U.S. Credit Index	0.7%	0.0%	4.4%	-0.5%

Source: Bloomberg

The performance data shown represents past performance. Past performance is not an indicator of future results. Current performance data may be lower or higher than the performance data presented.