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Preparing for the Next Evolution in Passive Investing: Direct Indexing

Industry Adoption Insights

Ready for Next

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WHAT IS DIRECT INDEXING?

Direct indexing is a niche investing strategy that has been around for over 30 years, but is just starting to pick up steam among investors. In simple terms, direct indexing (DI) allows an investor to hold a portfolio of individual stocks through a separately managed account (SMA) that mirrors a specific index, rather than buying shares in a traditional exchange-traded fund (ETF) or mutual fund that tracks the same index. This approach offers several advantages to investors over traditional index investing, including greater tax efficiency and the ability to customize the portfolio to the investor's specific needs or values. Historically, however, implementation has been a challenge due to the technical complexity and scale required.

I. INTRODUCTION

Direct indexing* is increasingly becoming a must-have offering for wealth and asset managers servicing taxable accounts.

To gain a better understanding of this niche but fast-growing market, Broadridge conducted a survey of 1,060 North American wealth and asset management firms, including both executives and advisors.

This paper highlights key insights around:

1. Why direct indexing is an important trend for the investment industry
2. How wealth and asset management firms see direct indexing impacting their business
3. Recommendations for investment firms and advisors to prepare for direct indexing

Direct indexing represents the next step in the evolution of the managed assets landscape. Similar to how mutual funds have ceded ground to exchange-traded funds (ETFs) over the last 20 years, we expect to see a similar migration to direct index accounts (see Exhibit 1).

Low trading fees, fractional shares, and advancements in portfolio management technology are now making direct indexing more accessible and easier to implement, with investment minimums starting in the low thousands of dollars (e.g., $2,000 at Altruist, $5,000 at Fidelity) (see Exhibit 2). As this trend continues, direct indexing will be a key category to watch for the investment industry.

Exhibit 1
An evolution of managed assets:

Fund Supermarkets
- Convenient
- One-stop shop

Exchange-Traded Fund
- Lower cost
- Tax advantaged

Separately Managed Accounts
- Customized
- Tax optimized

Robo and Direct Index
- Lower cost
- One-stop shop
- Tax optimized
- Lower investment requirements

Source: Aite-Novarica Group

Exhibit 2
Select market offerings showing distribution audience, investment minimum and fees charged, based on available public data.

BUILT FOR INDIVIDUALS	Investment Minimum	Fees
Schwab	$100,000	0.40%
Fidelity	$5,000	0.40%
Wealthfront	$100,000	0.25%

BUILT FOR ADVISORS	Investment Minimum	Fees
Altruist	$2,000	0.12-0.18%
Franklin Templeton (Canvas)	$250,000	0.35%
BlackRock (Aperio)	$1 million	0.35-0.50%
JPM (55ip)	$250,000	0.23%
Vanguard	$250,000	0.2%
Morgan Stanley (Parametric)	$250,000	N/A

*See definition on previous page

As of Q2 2022, assets in direct (also known as custom or personalized) indexing stood at about $458 billion, according to Cerulli Associates. Cerulli projects that assets in direct index SMAs will rise at a compound annual growth rate (CAGR) of 12.4% through the end of 2026 to more than $800 billion, outpacing ETFs (11.3% CAGR), other separate accounts (9.6% CAGR) and mutual funds (3.3% CAGR).[1]

Direct indexing is therefore becoming a key consideration for the wealth and asset management industry. As a result, the past two years have seen a wave of acquisitions, with many of the largest financial firms entering into the space.

In 2021, Morgan Stanley Investment Management acquired one of the pioneers in direct indexing, Parametric, through its purchase of Eaton Vance. Other notable acquisitions have included BlackRock's acquisition of Aperio, J.P. Morgan Asset Management's acquisition of fintech provider 55ip, Vanguard's acquisition of Just Invest, Franklin Templeton's acquisition of O'Shaughnessy Asset Management, BNY Mellon | Pershing's acquisition of Optimal Investment Management and First Trust Capital Partners' purchase of Veriti Management (see Exhibit 3).[2] Despite the heightened level of activity, direct indexing is still in its infancy, representing a small portion of global assets under management.

Exhibit 3

Major players are betting on custom (CI) and direct (DI) indexing. A list of recent acquisitions in the industry:

TECHNOLOGY ONLY

2022	VERITI	→	First Trust Capital Partners
2021	OPTIMAL ASSET MANAGEMENT	→	PershingX / BNY MELLON
2020	motif	→	charles SCHWAB
	Folio Financial	→	Goldman Sachs
	55ip	→	JPMorgan Chase & Co.

TECH OFFERING + SUB-ADVISOR PLATFORM

2021	GreenHarvest ASSET MANAGEMENT	→	PGIM
2020	CANVAS.	→	FRANKLIN TEMPLETON [1]
	Just Invest	→	Vanguard
	OpenInvest	→	JPMorgan Chase & Co.
2020	PARAMETRIC	→	Morgan Stanley [2]
	aperio	→	BlackRock
2018	Adhesion wealth	→	Vestmark

II. DIRECT INDEXING SUMMARY INSIGHTS

We contacted 1,060 executives and advisors at wealth and asset management firms across North America.

Of those, **47%** were knowledgeable enough about direct indexing to complete our survey (500 participants).

- According to a separate Broadridge Financial Advisor Survey[3] from September 2022, only **44% of advisors are "familiar"** with direct indexing and just **16% are currently deploying it** in client accounts.
- Recent Cerulli surveys have shown that only **14% of financial advisors recommend direct indexing** to their clients, despite **63% of financial advisors serving clients with a core market of more than $500,000 in investable assets**, and 14% targeting a core market of more than $5 million.[5]

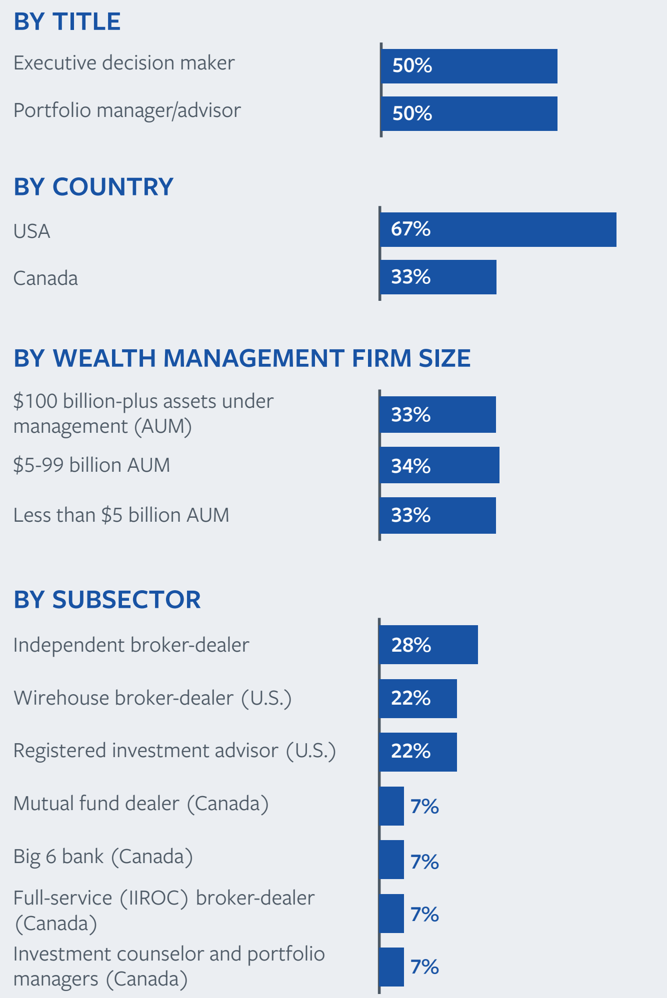
See Exhibit 4 for a full breakdown of respondents.

INSIGHT #1: IT IS STILL EARLY, BUT THE BIGGEST FIRMS ARE MOVING QUICKLY

While adoption is growing, firms that are familiar with direct indexing are moving quickly **(93% currently offer or are planning to offer).** Meanwhile, **84% of large-firm respondents already have a solution in the market.** (See below).

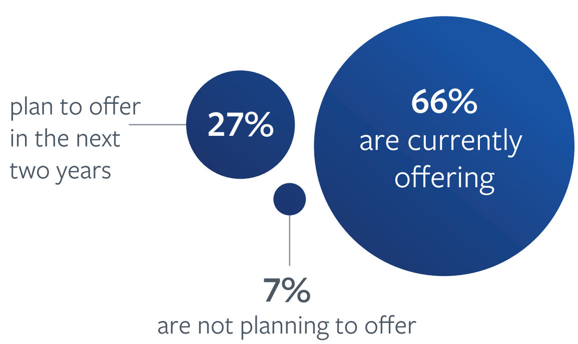
Exhibit 4

A breakdown of the 500 survey participants and their backgrounds:



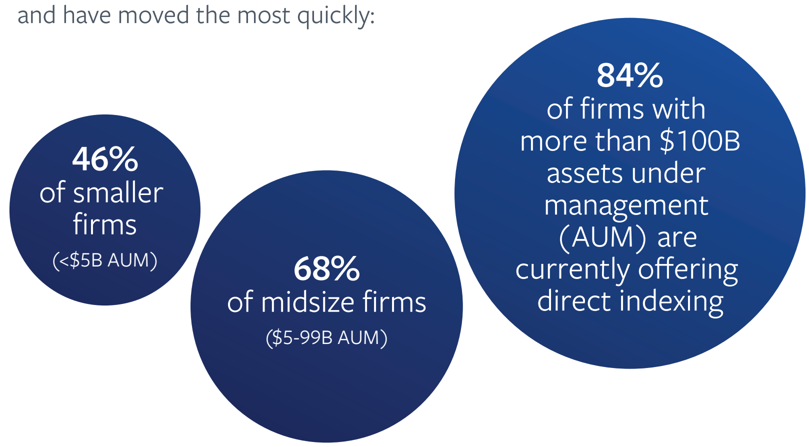
Firms Offering Plans

Of the 47% who were knowledgeable enough about direct indexing to complete our survey:



Currently Offering Direct Indexing – AUM Disparity

Larger firms are more likely to be embracing these products and have moved the most quickly:



INSIGHT #2: YOUNGER CLIENTS ARE DRIVING DEMAND AND THERE IS GREATER NEED FOR EDUCATION

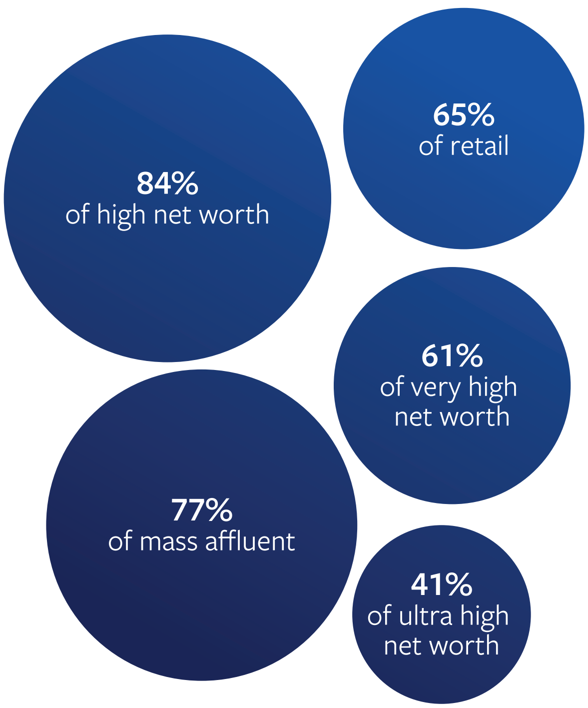
Client interest is **highest among the younger segments, with firms targeting HNW and mass-affluent investors most heavily.** The ability to create more tax-efficient portfolios and customized ESG tilts are the main drivers of client interest, according to the firms we surveyed.

Offering these capabilities is a major value-add for advisors and will be table stakes in gaining the next crop of wealthy investors.

> “We have witnessed a huge rise in client interest in the general market, which we can credit to it being cost efficient and providing interesting customization as opposed to traditional investing approaches.”
>
> **– HEAD OF WEALTH MANAGEMENT FOR A VERY LARGE U.S. REGISTERED INVESTMENT ADVISOR (RIA) FIRM**

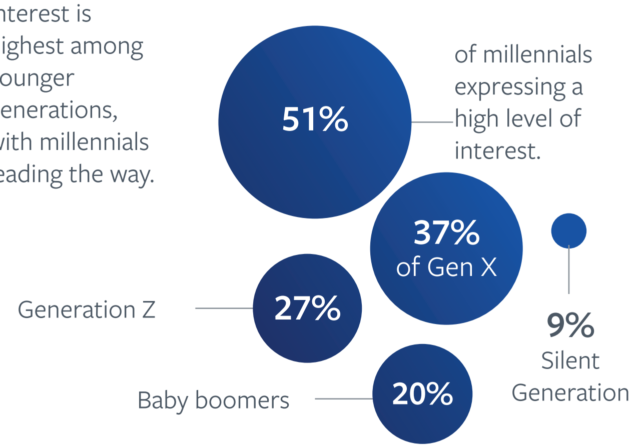
Target Clientele

Our respondents plan to target the following demographics:



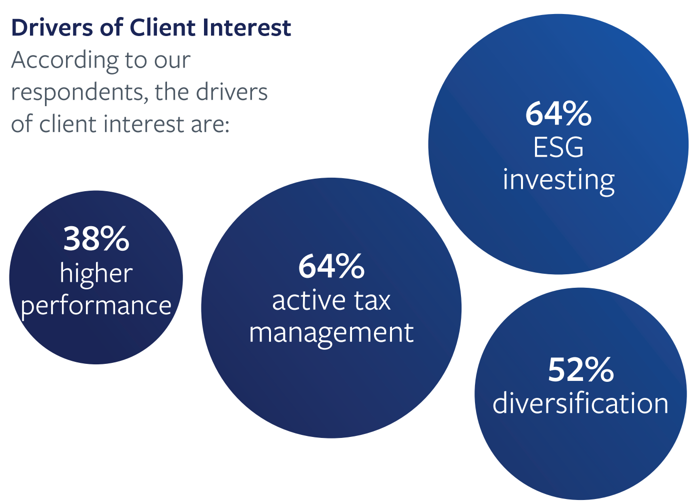
Client Interest by Age

Interest is highest among younger generations, with millennials leading the way.



Drivers of Client Interest

According to our respondents, the drivers of client interest are:



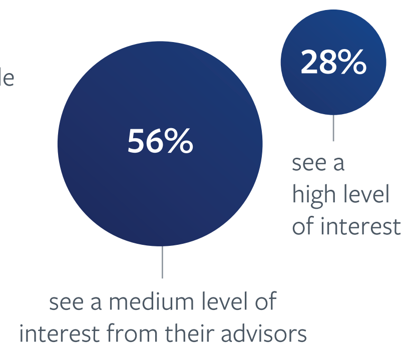
Investor interest

25% of our 500 respondents reported seeing interest from more than 20% of their client base.

82% of our 500 responsdents reported seeing interest from at least 6% of their base.

Advisor Interest

Among respondents with an executive title



INSIGHT #3: DIRECT INDEXING WILL HAVE A SUBSTANTIAL IMPACT ON THE FUND INDUSTRY

For those with an offering or plans to offer direct indexing, they see it as having a substantial impact on the fund industry — **85% of those currently offering or planning to offer direct indexing see moderate to high replacement of ETFs.** ETFs have taken substantial market share from mutual funds over the past 20 years. Direct indexing may be the next evolution, though perhaps not at the same scale. It will ultimately come down to whether the net costs of direct indexing can compete with index fund expense ratios for lower asset levels, and whether advisors and brokers can soothe concerns around the complexity associated with direct indexing.

In 2006, **40% of advisors used ETFs in client portfolios.**[6] **Now that number is over 90%.** In that time, ETF assets have grown at approximately a 20% CAGR, from $300 million to more than $7 trillion.[7] As the technology advances and awareness increases, we could see similar levels of growth in direct indexing. Furthermore, as asset allocation to passive ETFs has grown, so has the political pressure on asset managers due to their outsized economic influence and voting practices. This could be an additional tailwind for direct indexing because it puts ownership control back in the hands of the individual investor. (See Exhibit 5 for comparison.)

Exhibit 5

A comparison of direct indexing vs. passive/active exchange-traded fund (ETF) and mutual fund (MF).

High ● ● ● ● ●
Medium ● ● ●
Low ●

	Direct indexing	Passive ETF/MF	Active ETF/MF
Customizability	● ● ● ● ●	●	●
Tax efficiency	● ● ● ● ●	● ● ●	●
Tracking error	● ● ●	●	● ● ● ● ●
Cost	● ● ● 25-50 basis points	● 5-15 basis points	● ● ● ● ● 50-100 basis points
Complexity	● ● ● ● ●	●	● ● ●

At the Schwab Impact 2022 conference, Walter Bettinger, Schwab CEO, announced that finding the lowest fee possible is now a priority for Schwab. "We have to get that cost down closer to where a regular ETF or an indexed mutual fund might be," Bettinger said. "We're going to disrupt that industry, and it's going to help you serve more clients."

40% of advisors used ETFs in client portfolios in **2006.**

90% of advisors using ETFs in client portfolios, as of **2022.**

In 16 years, ETF assets have grown at approximately a 20% compound annual growth rate, from $300 million to more than $7 trillion.

$458B in direct indexing assets under management today

compound annual growth rate of 12.4%

$800B in direct indexing assets under management expected by 2026

INSIGHT #4: DIRECT INDEXING WILL BE A KEY DIFFERENTIATOR FOR ADVISORS, DESPITE CONCERNS

Advisor disintermediation and loss of revenue are the top concerns among survey participants, but the industry broadly recognizes that this is something that many investors will expect going forward (See Exhibit 6).

The added complexity and increased customizability may make the advisor's role even more important.

As a counter to advisor concerns about disintermediation, a chief investment officer at a Canadian independent broker-dealer said the following: "It gives financial advisors more presentation flexibility rather than forcing them to invest in existing fund structures." The flexibility around portfolio customization that direct indexing allows may make the advisor role all the more important.

Repondents Planned Minimum Investment Level for Direct Index Solution

Minimum investment levels continue to decline, but the product remains out of reach for retail investors.

36% $50-149K

36% $150-249K

Top Reason for Not Offering Direct Indexing: Too Expensive

61% of non-offering respondents.

Exhibit 6

The top reasons for and against offering direct indexing, along with the challenges and risks.

Source: Broadridge

INSIGHT #5: A NUMBER OF FIRMS ARE PLANNING TO BUILD IN HOUSE, BUT THEY MAY BE UNDERESTIMATING THE RESOURCES REQUIRED

Creating a direct indexing offering comes with technical and operational challenges that some firms may find themselves unprepared for. Some considerations:

- On the technical side, **direct indexing requires intense levels of data management** (firms must track the individual tax lot of all securities in the SMA). They also need **automated portfolio management tools** for tax optimization, tracking error management, rebalancing, and customized portfolio construction.

- It is **doubtful that we will see many more acquisitions in the space with so many independent providers already acquired and many of the biggest players having already made their move.** Firms that do not currently have an in-house tool, particularly smaller firms, will likely look to technology partners and/or large asset managers like BlackRock and Vanguard to provide this capability to clients.

- Operationally, direct indexing can create challenges that do not exist with traditional SMAs. **The need for a "house" or "balancing" account to support ownership of full shares across the strategy is the start.** Then the firm must decide how these accounts impact trading, processing of corporate actions, asset transfers, and proxy voting. Firms must also review the impact to other back-office functions such as reconciliation.

HOW FIRMS ARE OFFERING THE CAPABILITY

Larger firms are looking to internal technological capabilities to offer direct indexing, while smaller firms are looking to partners. **Very few (only 5% of respondents) are offering the capability manually** (e.g., without the aid of portfolio management automation technology).

The largest wealth and asset managers ($100 billion or more AUM) are primarily leveraging internal capabilities to offer direct indexing today **(69% of the currently offering group)**, or are building toward an in-house solution **(54% of the planning group)**.

Smaller firms (less than $5 billion AUM) are either currently leveraging **(42%)** or looking to leverage **(57%)** outside partners.

Midsize firms ($5-99 billion AUM) are somewhere in between, with roughly half **(52%)** currently offering the capability internally or planning to build in-house **(50%).**

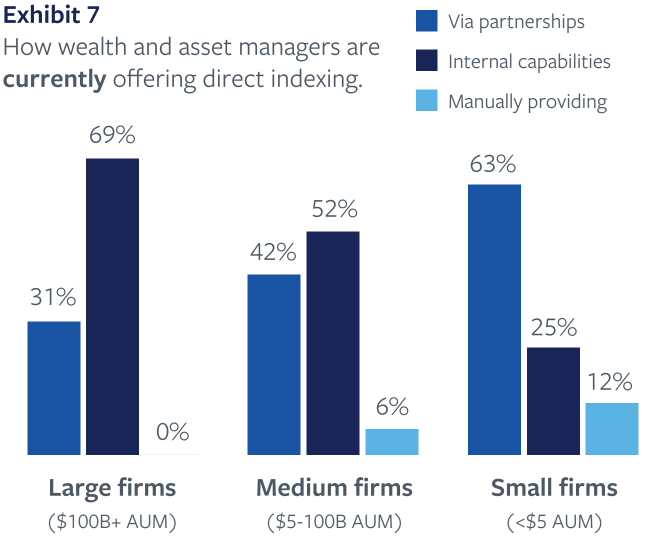
Surprisingly, **30%** of midsize firms with plans to offer direct indexing were looking toward acquisitions (vs. 17% for large firms and 5% for smaller firms). (See Exhibit 7.)

- The method in which firms are offering/planning to offer direct indexing is consistent across AUMs, with most integrating it into existing services (**60% of respondents)**, as opposed to creating a separate line of business (à la "Schwab Personalized Indexing") **(33%)** or using a sub-advisor platform **(6%)**.

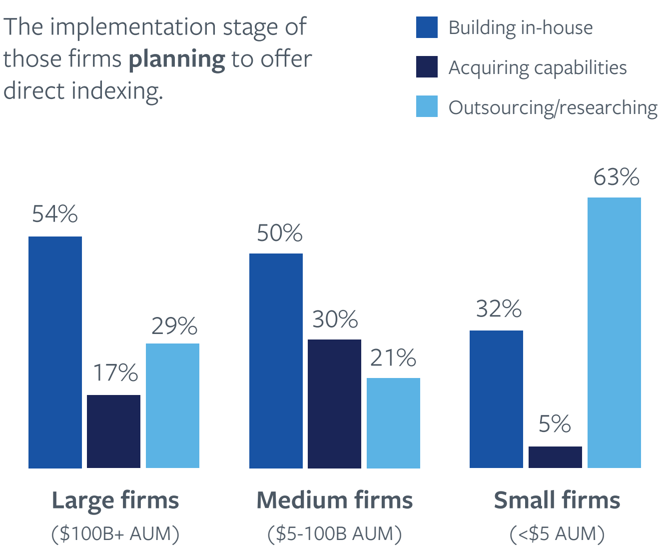
- In terms of revenue generation, most firms plan to offer DI at competitive rates — **55% will charge 25-50 basis points (bps)** and **25% will charge 0-24 bps.** This is greater than the fees typically associated with a passive ETF, but below the average fees of an active fund. Given the potential for added tax benefits, those fees may pay for themselves.

Exhibit 7

How wealth and asset managers are **currently** offering direct indexing.



The implementation stage of those firms **planning** to offer direct indexing.



Source: Broadridge

WHAT THEY SAID

"IT services partners will play an important role in ensuring safe investment in the indexing market as it rapidly grows," said a financial advisor at a large independent Canadian broker-dealer.

"Traditional firms are now largely looking into finding partners who can provide direct indexing services," an advisor at a small U.S. RIA concurred.

"There is still a lack of market understanding for the product and it requires deep- dive research," said the chief information officer of a U.S. wirehouse.

"Firms will have to acquire technology to place themselves in a favorable position to offer these assets," said the chief investment officer at a Canadian Big Six bank.

Added a financial advisor at a U.S. wirehouse, "Firms will need to realize that they must acquire the necessary technology to position themselves in this service offering."

"Partnership with fintech firms to capitalize on the opportunity is essential," said the head of wealth management at a Canadian Big Six bank.

III. PREPARING YOUR FIRM FOR DIRECT INDEXING

Developing a direct indexing offering presents substantial challenges, technically and otherwise. As firms contemplate adding direct indexing to their suite of solutions, they should consider the following key questions:

1) Why should my firm offer direct indexing?

Direct indexing is migrating from a tool solely for the UHNW to add tax efficiency, to a mass-market product that further democratizes investing and promotes investor control.

Younger clients and the mass-affluent/HNW segments are where our survey respondents are currently seeing the most client demand. Beyond just the ability to provide greater customization around ESG and other strategies, advisors may also be able to generate better returns. Using a back- test on a client's portfolio, the value of such portfolio tilts and active tax management can be quantified.

Broadridge can help firms run these simulations and develop a proof point for advisors to aid in making a decision about the value that direct indexing can bring to their practice.

2) How should my firm develop a direct indexing offering?

Direct indexing requires additional technological, operational, and investment capabilities. Firms looking to offer direct indexing will have three options to address these needs: build, buy, or outsource. For most firms, the first two options will be out of the question — too time-consuming and too costly. This leaves outsourcing. Some of the largest asset managers and index providers, like BlackRock and Vanguard, now offer advisor-driven direct index solutions.

There are also newer entrants, like BKLN and Ethic, that offer sub-advisory platforms. And finally, there are pure direct index technology-as-a-service players, like Rowboat and Alpima, that embed the technical capability into an advisor's existing stack through APIs. These solutions are offered at varying fee levels, investment minimums and levels of customization, as well as with varying degrees of complexity around implementation.

Broadridge can help firms narrow the universe of options and address operational challenges by running cost-benefit analyses and aiding in the development of a target operating model that delivers maximum value to the firm, its advisors and its clients.

3) How can direct indexing create value for the client, firm, and advisor?

How an advisor or portfolio manager monetizes direct indexing will depend on its ability to improve client outcomes. Knowing your clients' goals and account situations (i.e., taxable vs. non-taxable) will be critical in determining the value of an offering and its impact on revenue for the firm and advisor. Fee-only fiduciaries that charge basis points on AUM may see direct indexing purely as a retention tool. Firms that collect commissions from fund investments may see their fees at risk, while at the same time increasing their overall cost base.

Broadridge can help firms plan for these costs and come up with new ways to monetize the value being delivered to clients. Fee structures may be as simple as an incremental fee on assets in the SMA, or as creative as a fee on realized outperformance through tax efficiency versus an index.

IV. CONCLUSION

Direct indexing is a trend that all wealth and asset managers should be evaluating and preparing for. Our survey findings and recent market events confirm that many of the largest wealth and asset managers have already solidified their plans to offer direct index SMAs, and yet roughly 50% of firms remain unfamiliar with the concept. To avoid being left behind, firms of all sizes should start evaluating and preparing now, before it's too late.

Broadridge can help wealth and asset managers stay competitive as the investment industry evolves towards a new frontier in the form of direct indexing, consulting on key strategic questions, including: (1) why direct indexing is something your firm should (or shouldn't) offer; (2) how your firm can develop a differentiated product offering; and (3) how direct indexing can create value for the client, firm, and advisor.

As your firm thinks through its strategy, contact Broadridge for consulting advice and sophisticated analysis to help create win-win-win outcomes for firms, advisors and investors.

V. ENDNOTES

1 Cerulli: Advisory Solutions Quarterly (Q2 2022).
2 Fund Fire: Direct Indexing Set to Continue Fast Growth in Advisor Channels.
3 https://www.broadridge.com/press-release/2022/financial-advisors-demand-diversification
4 Parametric: The Advisor Perspective on Direct Indexing (March 2022).
5 https://www.yahoo.com/now/cerulli-associates-projects-direct-indexing-120100450.html
6 https://www.cnbc.com/2017/10/10/exchange-traded-funds-are-the-go-to-investment-for-advisors.html
7 https://www.cnbc.com/2023/01/23/the-first-etf-is-30-years-old-this-week-it-launched-a-revolution-in-low-cost-investing.html

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