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More and Better: An Introduction to Direct Indexing

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Introduction

Investors today seek more than just market-average returns. They're looking for strategies that deliver after-tax outperformance, align with their financial goals, improve tax efficiency, and reflect their personal values. Direct indexing seeks to meet these needs by offering index-like exposure through custom equity portfolios, enhancing after-tax outcomes and allowing for greater personalization. In other words, direct indexing can deliver on investors' search for more and better.

This paper introduces direct indexing by revisiting its foundational principles of index investing and tax-loss harvesting — two key components of a tax-efficient portfolio. We then present the case that by combining index investing and tax loss harvesting, direct indexing offers the potential for outperformance through "tax alpha," which is the additional return from tax benefits unavailable with traditional index funds or ETFs.

Next, we examine the technological and structural developments that made direct indexing feasible, and assess the size and consistency of tax alpha over time.

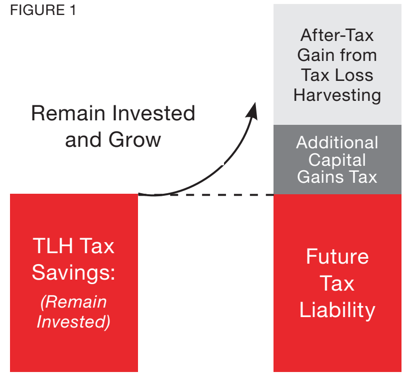
Finally, we explore the customization potential of direct indexing, identify the types of investors who might stand to benefit most, and outline the key risks they should consider.

Long-term, after-tax returns matter most

Taxes matter in investing. They matter because levies on capital gains, dividends, and interest decrease investable balances and commensurately reduce the long-term compounding of a portfolio. For decades, tax-aware investors have delayed realizing capital gains and accelerated realizing capital losses by selling securities that trade below their cost basis.

Gain deferrals and tax-loss harvesting have historically added value to portfolios by minimizing tax outlays and generating returns on those tax savings.

FIGURE 1



Source: Key Wealth

More and better, with direct indexing

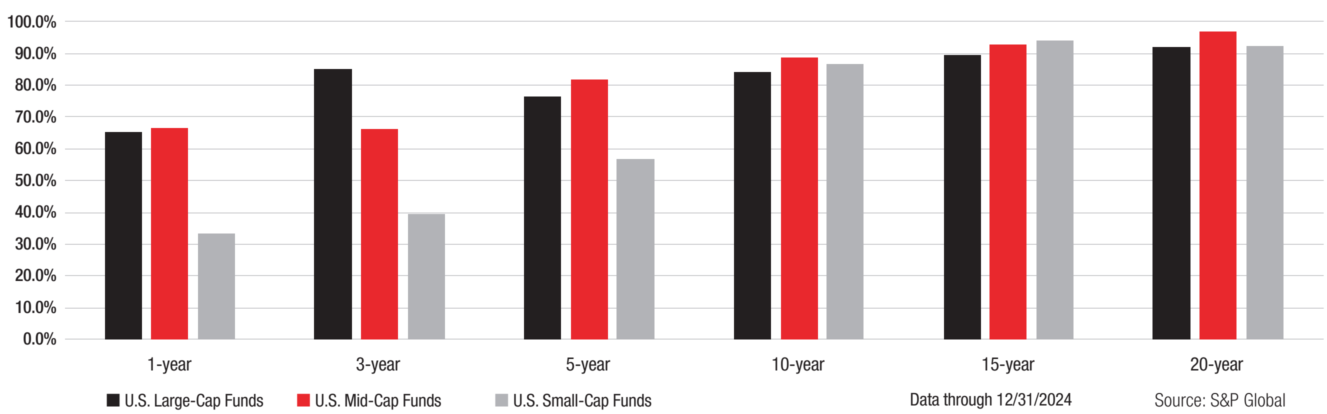
Direct indexing takes tax-aware investing to the next level by incorporating recent changes in market structure, technology, and trading/transactions costs.

To better understand direct indexing, consider two major evolutions in the investment landscape that made it possible:

1. Changes in market structure — passive investing:

According to Morningstar, passive index investing now accounts for over 50% of U.S. equity fund assets — and its share continues to grow. Instead of attempting to exceed market average returns through active stock picking, passive index investors seek to replicate the performance of the overall market by investing in a broad market index. This approach is driven in part by data suggesting that most active strategies underperform their benchmark indexes over time (see chart below). As a result, more investors are choosing to allocate a significant portion of their equity exposure to passive index-based strategies.

FIGURE 2 **Percentage of U.S. Actively Managed Equity Funds Underperforming Their Benchmark Index**



Data through 12/31/2024 Source: S&P Global

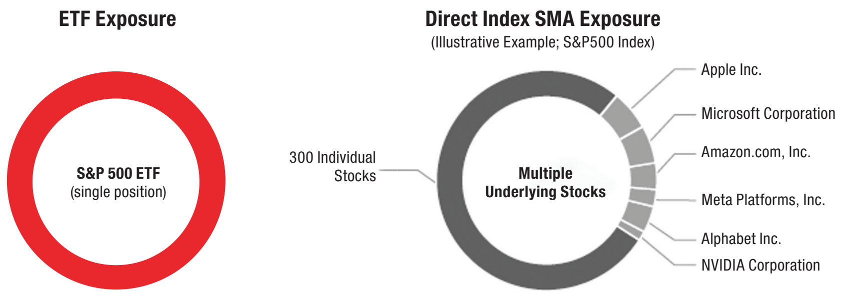
2. Reduction of transaction costs — low/zero trading commissions:

Advancements in technology and the evolution of online discount brokerages and mobile trading apps have significantly reduced the transaction costs of investing. Increasingly, investors can manage a large set of individual securities without the prohibitively high trading costs of the past.

How direct indexing works: A smarter way to index

Enabled by today's substantially lower trading costs, an investor seeking to passively index (e.g., S&P 500 Index) can now directly own a large representative sample of the index's underlying stocks, in a separately managed account (SMA). Historically, this investor might have chosen an index mutual fund or exchange traded fund (ETF), which track the index returns nicely, but with limited ability to tax loss harvest because of the bundled structure of a fund. Direct indexing effectively unbundles the index fund, mimics the exposures, and unlocks substantially higher tax efficiency with the ability to harvest underlying losses of individual stocks.

FIGURE 3



Source: Neuberger Berman, Key Wealth

Consider an example of direct indexing with the S&P 500 Index. In this case, an algorithm portfolio construction tool might construct a diversified portfolio using a sample of roughly 250–300 of the 500 underlying stocks in the index. The aim is to replicate the sector weights, industry weights, market capitalization, dividend yield, and other portfolio characteristics to mirror closely the future returns of the index (tracking error of 1%).[1]

In direct indexing, only a sample of the index holdings are owned, allowing certain stocks to be intentionally left out as reserves. These unowned stocks in reserve can later be used as substitutes to maintain the portfolio's overall exposure while avoiding IRS wash-sale violations. For instance, if the portfolio holds Coca-Cola shares and sells them at a loss, the strategy might swap into Pepsi shares — which were previously held in reserve — to retain similar exposure without triggering wash-sale rules.

Harvested losses in direct indexing can be used to offset taxable gains across an investor's broader portfolio, thereby generating tax alpha — often 1%–2% annualized versus Index ETFs and 3%–5% better than average active funds. In other words, direct indexing delivers more: index-like returns *plus* tax alpha.

FIGURE 4

Evolution of Investment Vehicles

Directly holding stocks in a separately managed account (SMA) can provide investors greater control over their after-tax outcomes

Mutual Funds 1930s–40s	Index ETFs 2000s	Direct Index SMAs Present
Risk of underperforming index returns Capital gains are likely, and uncontrollable	**Target index-matching returns** Capital gains are unlikely, but no ability to pass through losses	**Target index-matching returns** Ability to capture losses on individual tax lots
-2.7% Annual tax cost in Morningstar U.S. Large Cap Blend Category	**0.0%** Annual tax impact	**+1%–2%** Estimated annual tax alpha[2]

Source: Morningstar, Neuberger Berman

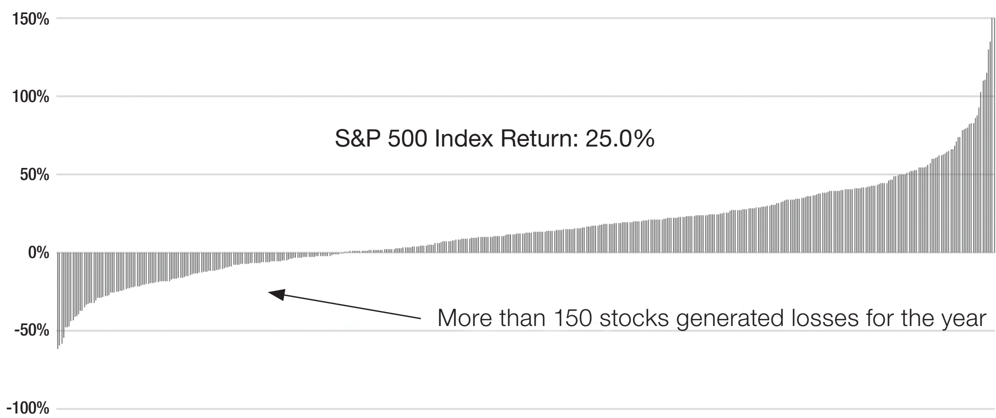
Direct indexing is passive in stock selection and active in tax and risk management.

Some investors view tax alpha as particularly compelling because its reliability requires only that 1) the underlying index contains some stocks that experience losses, and 2) the investor has or expects to have capital gains generated elsewhere in their portfolio to offset those losses. Neither requirement is overly constraining.

It should be noted that direct indexing does not actively seek to invest in loss-making stocks. Instead, it exploits the reality that some stocks decline even in the strongest of markets and tax-loss harvesting those losses can often be used to offset taxable gains generated elsewhere. In 2024, for example, when the S&P 500 Index had strong total returns of +25% for the calendar year, more than 150 stocks declined and finished the year with unrealized losses. Those are the losses that direct indexing looks to harvest. Those are the losses that could not be harvested if the investor held an S&P 500 index mutual fund or ETF.

FIGURE 5

S&P 500 Stock Returns in 2024



Source: S&P Global, FactSet

The stock dispersion of the S&P 500 in 2024 was no anomaly, either. From 2010–2020, an average of 30% of the stocks in the S&P 500 Index declined during any given calendar year. That suggests ordinary stock volatility can be a reliable source of tax losses to harvest. As a result, and for an investor with capital gains generated elsewhere in their portfolio, tax alpha appears far more reliable as compared to pre-tax alpha from actively managed stock selection (revisit Figure 2).

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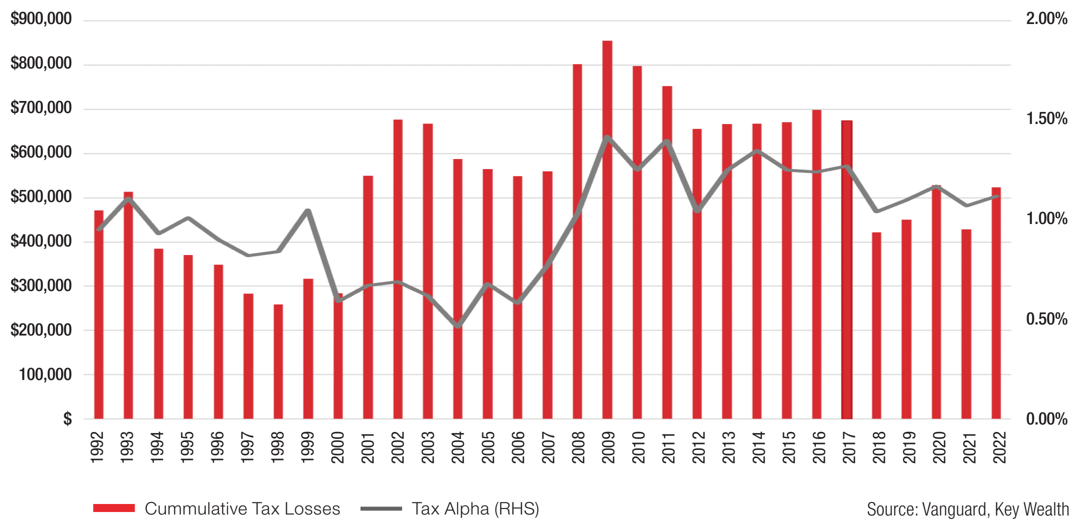
The custom nature of direct indexing means each portfolio follows a unique, path-dependent trajectory. As a result, the tax alpha an investor experiences depends largely on two factors: the timing of the portfolio's inception and whether it was initially funded with cash or in-kind stock transfers. From there, the movement of individual stock prices determines the opportunities for loss harvesting and the resulting tax alpha. Returns seek to closely track the index over time, but the path matters for the tax alpha component.

To provide context, Vanguard conducted a back-test to estimate the range of 10-year aggregate tax losses and tax alpha from a hypothetical $1,000,000 direct indexing portfolio in U.S. large-cap stocks over time. Their results are depicted in Figure 6, with the majority of vintages in the range of $400,000–$700,000 worth of tax losses over 10 years, delivering approximately 1% of annualized tax alpha.

FIGURE 6

Cummulative Losses and Resulting Tax Alpha
($1,000,000 invested; 10-year holding periods)



Source: Vanguard, Key Wealth

An investor in U.S. equities experiencing index-like returns plus 1%–2% annualized tax alpha, over the long term, would put them firmly in the top quartile of after-tax outcomes among the peer-set depicted in Figure 2.

It should be noted that tax alpha from direct indexing typically diminishes over time, as portfolio holdings appreciate above their cost basis. In such cases, harvesting tax losses requires more significant price declines. While the timing of when a portfolio becomes 'seasoned' is path-dependent, tax alpha is often most pronounced in the first six to seven years, particularly in the absence of new cash inflows into the portfolio.

Beyond tax alpha: Customization, suitability, and risks

Direct indexing is highly flexible; it lets investors design portfolios that meet unique needs, including:

Diversification of concentrated positions
Investors holding single-stock or single-industry concentration can diversify around it with an adjusted index-completion portfolio while using harvested losses to reduce the concentration over time.

Optimize estate planning and charitable gifting
Direct ownership of underlying securities allows for flexibility and tax optimization through gifting of shares with low-cost basis.

Values-based or custom exclusions
Investors can exclude specific companies or industries while maintaining otherwise broad index exposure, thereby incorporating personal values or strategic investment views.

Tax alpha and flexible customization are two compelling arguments for direct indexing, but the strategy might not be right for all investors or scenarios. Among those who may experience limited benefits or underwhelming outcomes are:

- Investors without sources of capital gains to offset tax-losses into.
- Investors with ample tax-loss carryover from previous investments.
- Investors who prefer actively managed equity (research-driven active management, mutual funds, ETFs), and who prefer a defined investment thesis of each underlying stock they own.

In contrast, scenarios that may align particularly well to direct indexing solutions include:

- Tax-sensitive investors with substantial capital gains naturally arising elsewhere in their portfolio.
- Business owners anticipating a future sale.
- Tax-sensitive investors in higher tax brackets.
- Investors with highly concentrated, low-basis stock, seeking to diversify exposures.
- Investors with exposure to hedge funds or derivatives, or other generally tax-inefficient investments.
- Investors seeking personalization, to align their portfolios with their values or investment views.

Finally, a few notes on risk. All investing involves the risk of loss of principal. Direct indexing bears additional specific risks that include, but are not limited to:

Underperformance of pre-tax returns
A direct indexed portfolio is constructed by algorithm to risk-match the selected underlying index, targeting to replicate returns with a small tracking error (typically 1%). Because of this tracking error, portfolios may unintentionally outperform or underperform index returns on a pre-tax basis. Index-matching returns are targeted but not guaranteed.

Inability to use full value of tax losses
Tax savings or tax alpha ultimately depend on capital gains generated elsewhere in an investor's portfolio to offset losses into. For more details on tax-related risks in direct indexing, investors should consult with their professional tax advisors.

Adverse changes in tax law or IRS challenge
Tax laws may change. Capital gains tax rates may increase. The IRS may challenge the relevant tax treatment that direct indexing depends on. As always, investors should consult with their professional tax advisors.

For more information, please contact your advisor.

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About the Author

Justin A. Tantalo is an Investment Consultant on Key Family Wealth's investment management team. In this capacity, he guides strategic investment decisions as they relate to asset allocation, portfolio construction, and manager selection for Key's most affluent clients and multi-generational families.

Justin is a CFA Charterholder. He received an M.A. in Economics from the University of Waterloo (Canada) and a B.A. in Economics from the University of Western Ontario (Canada). Justin serves as a faculty member in Finance and Investment Management at The UHNW Institute, a nonprofit think tank aimed at better serving ultra-high-net-worth families.

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1 To interpret a 1% tracking error: Statistically, the portfolio's annual return is expected to be within 1% point of the underlying index's return 68% of the time, and within 2% points of the index return 95% of the time. Tracking error is an estimate.

2 Neuberger Berman; Shomesh E. Chaudhuri, Terence C. Burnham and Andrew W. Lo., 2020, "An Empirical Evaluation of Tax-Loss-Harvesting Alpha.

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