

# TAX-EFFICIENT INVESTING THROUGH DIRECT INDEXING

## *Direct Indexing*



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Driven by advances in technology and increases in investor demand, direct indexing has become one of the fastest-growing investment segments. In fact, Cerulli Associates projects direct indexing assets will top \$800 billion by 2026,<sup>1</sup> outpacing the growth of exchange-traded funds (ETFs), mutual funds and separately managed accounts (SMAs).

While direct indexing is known as a way to customize portfolios for investors, tax management typically is the No. 1 reason investors turn to direct indexing, according to a March 2023 Morningstar report.<sup>2</sup>

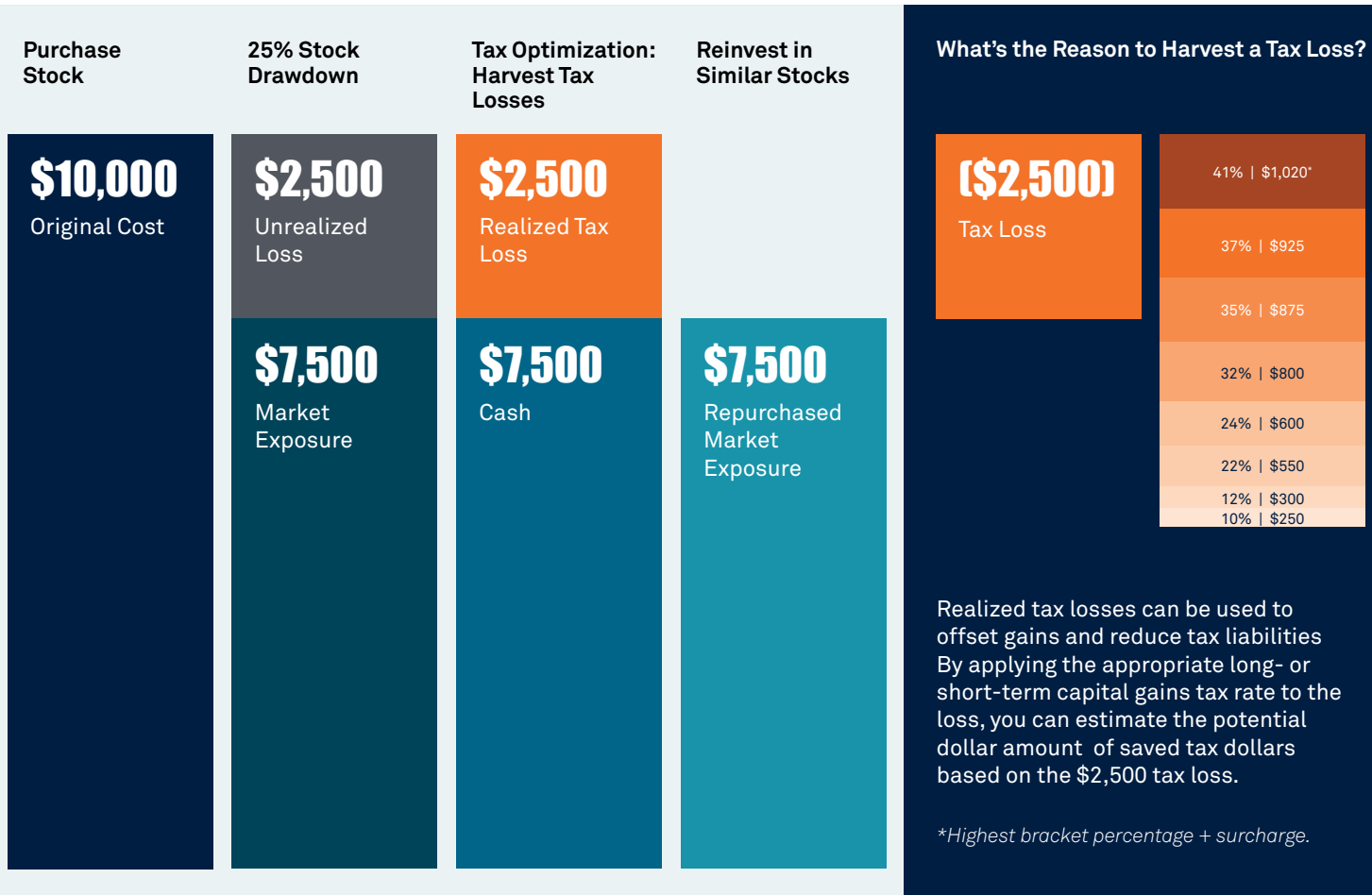
## HOW DIRECT INDEXING HELPS INVESTORS MANAGE TAXES

In short, direct indexing works by using technology and sophisticated algorithms that seek to replicate the performance of a specific index. Managers can use that same technology for tax optimization in an investor's portfolio. Studies have shown that direct indexing portfolios may generate an average 1.08% of additional return (tax alpha) per year thanks to tax management.<sup>3</sup>

Here's how. Direct indexing allows managers to use sophisticated technology to enact a process called "tax-loss harvesting."<sup>4</sup> This process is designed to sell investments that have declined in value to reduce capital gains taxes owed from selling profitable investments. By realizing capital losses, investors potentially can lower their overall tax liability. The same technology is also designed to help financial advisors manage the realized capital gains in their clients' portfolios with an overall annual capital gains budget.

Keep in mind that these portfolios have a mandate to track an index, so whatever stocks are sold for tax harvesting are typically replaced in the portfolio from an overall risk perspective. Because of wash sale rules, a portfolio manager can't simply sell a stock and immediately rebuy it.

However, the technology and algorithms typically allow portfolio managers to find similar securities to help maintain the overall risk profile and characteristics of the benchmark. It helps that the benchmarks generally contain hundreds of securities.



In the scenario<sup>5</sup> above, the portfolio manager identifies and sells a stock with an unrealized loss of \$2,500 to reduce the investor's tax liability. The portfolio manager then reinvests in similar stocks to continue to track the index. To calculate the potential amount saved for the investor, multiply the \$2,500 loss by the appropriate capital gains tax rate.

The customization component of direct indexing can also help align a portfolio to an investor's specific tax situation. For example, some direct indexing programs, like the one offered by

Mellon and Pershing X, incorporate a Tax Transition Scenario Planner tool<sup>6</sup> as part of the overall client experience. This tool examines a list of client holdings and provides several scenarios for a tax transition—each with a different capital gain and tracking error<sup>7</sup> impact. With this integrated tool, an advisor can run this analysis on their own without involving the portfolio managers of the direct indexing strategy. The advisor can then discuss the potential costs, benefits and tax impact of each scenario with their clients prior to converting into a direct indexing portfolio.

## ***Power & Precision***

*Designed to provide advisors with customized solutions at scale to deliver tax-efficient, customized beta exposure to their clients*

## **THE BNY MELLON DIFFERENCE**

The experience and technology of the provider can help enhance a direct indexing solution. Early entrants in the direct indexing space were more focused on the investment side than the technology side. Now, there are FinTech players that are heavy on the technology side and less experienced on the investment side. The combination of Mellon's deep investment expertise and the technological know-how of Pershing X and its Wove platform is designed to provide advisors with customized solutions at scale to deliver tax-efficient, customized beta exposure to their clients.

BNY Mellon Precision Direct Indexing<sup>SM</sup> is designed to leverage [Mellon's](#) 40 years of index management expertise and Pershing X's technology to provide advisors and clients with institutional-quality, personalized index solutions.<sup>8</sup> The solution is fully integrated into the Wove platform, making it easier for advisors to offer the benefits of direct indexing to a wider range of investors.

Contact your relationship manager to find out more about BNY Mellon and Mellon's indexing capabilities.

<sup>1</sup>The Case for Direct Indexing: Differentiation in a Competitive Marketplace, Cerulli Associates, December 2022.

<sup>2</sup>The Direct Indexing Landscape, Morningstar, March 2023.

<sup>3</sup>Tax alpha is the potential value generated by tax optimized solution based on the difference of excess pre-tax return and after-tax return. Estimates of tax alpha vary greatly across market conditions, but average to 1.08%, annualized over the period of study (1926 to 2018). Refer to the study: *An Empirical Evaluation of Tax-Loss-Harvesting Alpha*, Chaudhuri et al Financial Analysts Journal (2020).

<sup>4</sup>There's no guarantee that a particular investor will realize significant tax benefits from harvesting gains or losses. Investment strategies that seek to employ tax management may be unable to fully realize strategic gains or harvest losses due to various factors. Market conditions and/or client account holdings may limit the ability to generate tax losses. Tax-loss harvesting involves the risks that the new investment could perform worse than the original investment and that transaction costs could offset the tax benefit. Also, a tax-managed strategy may cause a client portfolio to hold a security in order to achieve more favorable tax treatment or to sell a security in order to create tax losses. The ability to minimize tax consequences for a specific account may decrease as gains have the potential to accumulate over a period of time. Investors in lower tax brackets generally will not derive the same level of potential tax benefits from tax-managed strategies than those in higher tax brackets. Tax considerations, while important, are just one factor to consider before making any investment decision. Tax-managed investing and tax transitioning do not equate to comprehensive tax advice, are limited in scope and not designed to eliminate taxes in an account. Investors should contact their own tax advisor or financial professional for more detailed information on tax issues as they relate to an investor's specific situation.

<sup>5</sup>For illustrative purposes only. Does not reflect actual results. The scenario is not intended to constitute legal, tax, investment or financial advice, and the scenario is not intended to be a full and exhaustive explanation of the law in any area or all of the tax investment or financial options available. The scenario may not be applicable to or appropriate for every investor and should be used only after consultation with professionals who have reviewed their specific situation.

<sup>6</sup>The Tax Transition Scenario Planner tool is accessible in Pershing X's Wove platform. Clients must be appropriately contracted to use the Wove platform and all the associated services and tools including Tax Transition Scenario Planner tool.

<sup>7</sup>Tracking error, also referred to as "active risk," indicates how closely a portfolio's returns have followed the benchmark's returns. A higher tracking error suggests the portfolio has deviated more from the benchmark while a lower tracking error suggests the portfolio is more similar to the benchmark.

<sup>8</sup>As of October 2023, the only target index available is the S&P 500® Index

## DISCLOSURE

**All investments involve risk, including the possible loss of principal. Certain investments have specific or unique risks. No investment strategy or risk management technique can guarantee returns or eliminate risk in any market environment. Past performance is no indication of future performance. Diversification does not ensure a profit or protect against a decline in a down market.**

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# BNY MELLON PRECISION DIRECT INDEXING<sup>SM</sup>

*The Nexus of Precision & Performance*

Leveraging Mellon's investment management expertise and the power of Pershing X's technology, we are proud to provide advisors and clients with institutional-quality, personalized index solutions.

*Precision by Mellon. Powered by Pershing X.*

## MELLON

*Institutional-Quality Indexing*

With 40 years of indexing experience, Mellon is a global leader in index investment management. Their deep understanding of markets powers the precision required to navigate rebalances and build solutions that meet clients' unique needs.

[www.mellon.com](http://www.mellon.com)



## PERSHING X

*FinTech Innovation*

Pershing X is building an interconnected suite of financial applications that will work together, so you can spend more time focusing on helping your clients thrive.

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