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# Advisers should brace for the relentless case for direct indexing



Despite lukewarm adoption by financial advisers, the financial services industry is committed to leveraging this crucial channel to get direct indexing in front of more investors.

December 2, 2022 *By Jeff Benjamin*



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Don't be fooled by the slow adoption rate of direct indexing by financial advisers and their clients, because the financial services industry is **determined to convince the financial planning industry** that direct indexing can benefit just about every investor.

Speaking earlier this week as part of an **InvestmentNews webcast**, Dana D'Auria, co-chief investment officer and group president at Envestnet Solutions, warned that the large institutions are buying up direct indexing platforms and that the marketplace will soon be flooded with access to the technologies that enable **extreme portfolio customization**.

"These things feed on themselves, and the 'why now' question has to do with the ability to do this," she said. "The feedback loop of all the big players buying up direct indexing units means they need to make a return on investment, so they're putting the sales muscle behind it."

Beyond just bracing for more and **better pitches for direct indexing**, D'Auria said advisers would be wise to realize sooner rather than later that direct indexing represents the next key value-added service.

"If you're not bringing it to the client, somebody else will," she said.

Cerulli Associates estimates that about 12% of advisers are currently using direct indexing platforms to customize client portfolios, but they predict that the growth of direct indexing will outpace that of mutual funds, ETFs and separately managed accounts over the next five years.



It's that kind of bullish outlook, despite lackluster enthusiasm from advisers, that has firms like Envestnet and Charles Schwab Asset Management jumping into the space.

"Direct indexing is an evolutionary step forward in index investing; it is simply a newish way for investors with taxable accounts to potentially have better after-tax returns," said D.J. Tierney, a director at Schwab, who also participated in the webcast.

Schwab's platform currently only applies to taxable accounts, which underscores the tax-management benefits that are a hallmark of direct indexing, but not the only benefit.

"Tax management is the single biggest reason you do direct indexing," D'Auria said. "But it is also relevant outside of taxable accounts, and the first example would be sustainable investing."

Technological advances in the quantitative strategy have made direct indexing more widely available and, as in so many other areas of financial services, the increased competition is making access more affordable.

Key to continued adoption is getting financial advisers on board, and low fees alone might not be enough to sway some.

Webcast panelist Kashif Ahmed, president of American Private Wealth, described directing indexing as a solution in search of a problem, and said he's not seeing an interest from clients.

"The obvious benefit is the hyper-personalization, and advisers will need to drive this," he said. "But the concern is advisers like to go to clients and say this is a new thing. There may be an aspect of FOMO here, and I would caution advisers that this isn't right for everybody."

But at the other end of the spectrum there's Chris Chen, chief executive of Insight Financial Strategists, who also participated in the webcast and described himself as "ready to jump in with both feet."

"I think the ESG application can work across accounts, whether qualified or not," Chen said. "And the tax implication I think is enormous."

At this point, most direct indexing platforms set minimums at around \$100,000 and tend to focus on the tax-management advantages, but Tierney said the future is wide open.

He compares direct indexing today to the early days of exchange-traded funds, which owe much of their success to wide adoption by financial advisers.

"The drivers of direct indexing include the low-cost scale of cloud computing and commission-free trading," he said.

In terms of potential, Tierney cites the launch of the first ETF in 1992 and the fact that 10 years later, there were still only five ETF providers. But over the next 10 years, more than 80 providers entered the ETF space.

"That's where we are with direct indexing now," he said. "It's been around for over two decades but now the gloves are coming off, fees are coming down, and account minimums are coming down. If you're an adviser, the time to get into direct indexing is now. You don't want to look back at this and realize you had accounts that could have benefited."

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