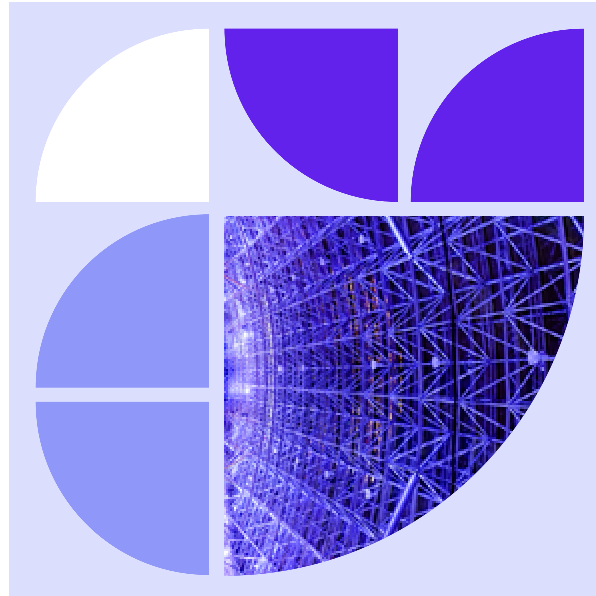
Direct Indexing: Unlocking SMArt Possibilities



Index investing has boomed over the past decade, adding $10.6 trillion of net assets from 2011 to 2021.[1] While exchange-traded funds (ETFs) and mutual funds are largely responsible for the popularity boost, a compelling and more personalized form of index investing is well positioned to continue this evolution of wealth management: **direct indexing**.

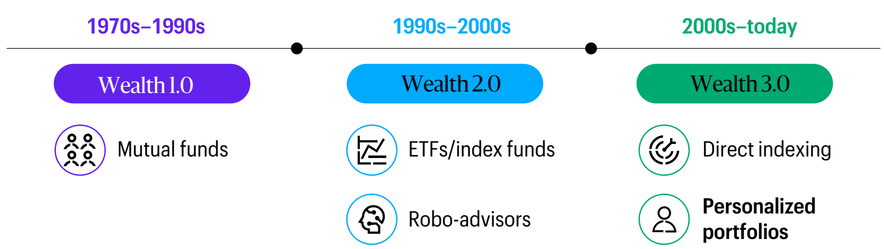
Direct indexing is hardly a novelty, but it's been reserved for select firms and high-net-worth clients historically. Thanks to advancements in trading technology and lower fees, direct indexing has become a viable and more accessible strategy for advisors and their clients.

What is direct indexing?

In its purest form, direct indexing is the process of replicating an index's performance through owning its underlying securities individually. For example, an investor could attempt to track the S&P 500 Index by purchasing a S&P 500 direct index separately managed account (SMA). The portfolio would typically hold a representative sample of securities in the index, optimized to mimic its risk and return characteristics. The portfolio is rebalanced and reconstituted periodically in alignment with the index.

Unlike mutual funds and ETFs, direct indexing offers its investors direct ownership of the securities in the portfolio. This provides them with several key advantages, including greater control, flexibility, and personalization of portfolio holdings that may be customized to align with their individual goals. Also, because the investor directly owns the underlying securities, it allows for enhanced, proactive, and ongoing tax management capabilities.

WEALTH MANAGEMENT IS EVOLVING



For illustrative purposes only.

1. Investment Company Institute, 2022 Fact Book

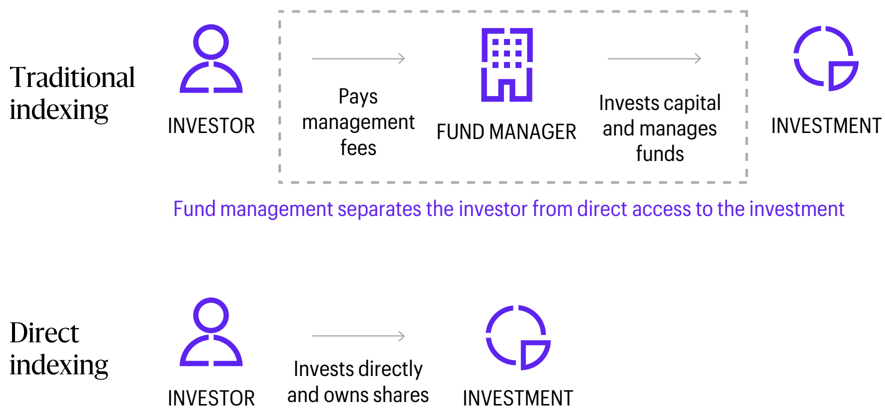
Why is direct indexing more viable now?

Before the rise of online brokerage platforms, direct indexing wasn't feasible for most clients. Manually constructing a portfolio to mirror an index of hundreds of securities used to be an expensive, time-consuming undertaking—not to mention the ongoing maintenance efforts required to rebalance and reconstitute the portfolio.

Today, direct indexing as a whole is a far more realistic strategy thanks to enhanced technology, reduced trading fees, streamlined trading platforms, and accessible products, which collectively lowered the barrier to entry. Moreover, it aligns with the budding theme of personalized financial services. A Cerulli survey found that customization is currently the most prevalent (and integral) phase in the portfolio construction process for advisors[2] as more clients push for tailored portfolios and investment strategies that cater to their needs, goals, and values.

So, it's no surprise that direct indexing has flourished—a trend that's expected to continue in the coming years. By 2026, direct indexing assets are projected to increase by $363 billion, which represents a **compound annual growth rate of 12.3%,**[3] besting ETFs, separate accounts, and mutual funds.

DIRECT OWNERSHIP



Direct indexing provides direct access to individual securities that may comprise an index. By directly owning the securities, the investor can benefit from the added flexibility that has historically been more accessible to the ultra-wealthy, institutions, and fund managers.

For illustrative purposes only.

2. Cerulli, US Broker/Dealer Marketplace 2022

3. Cerulli, The Case of Direct Indexing, Differentiation in a Competitive Marketplace 2022

Why use direct indexing?

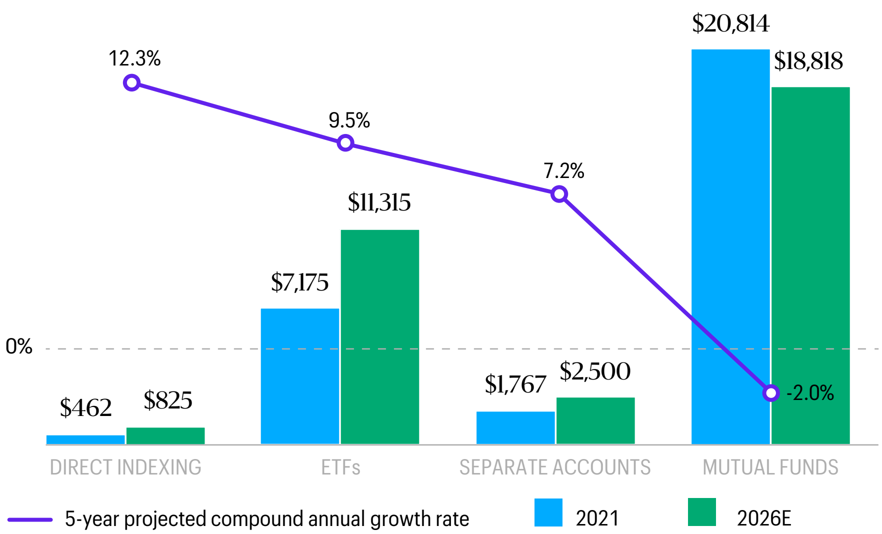
TAX ALPHA

Returns are difficult to predict. Risk, such as volatility, is somewhat easier to predict but is still reliant on estimates and models. Tax alpha, on the other hand, is relatively more transparent. Because investors have direct ownership of the portfolio securities, there are countless chances to exploit volatility and generate tax alpha throughout the life of a portfolio, especially compared with traditional funds.

Investors may do this by taking advantage of unsystematic risk and isolated stock movements. Unsystematic risk refers to risks that are not shared with the broader market—they are attributed to individual securities. Therefore, while a portfolio's value can increase, its underlying positions may have losses that present opportunities for tax-loss harvesting.

Advisors are particularly attracted to the tax management capabilities of direct indexing—86% of advisors viewed ongoing tax optimization as a significant opportunity.[4] It's quite appealing to clients, too; Allspring research found that most new and prospective direct indexing accounts (approximately 80%) prefer an S&P 500 tax-loss-harvesting strategy.

PROJECTED GROWTH OF INVESTMENT VEHICLE, 2021–2026E ($BILLIONS)



Sources: Cerulli Associates, JP Morgan, and Morningstar Direct

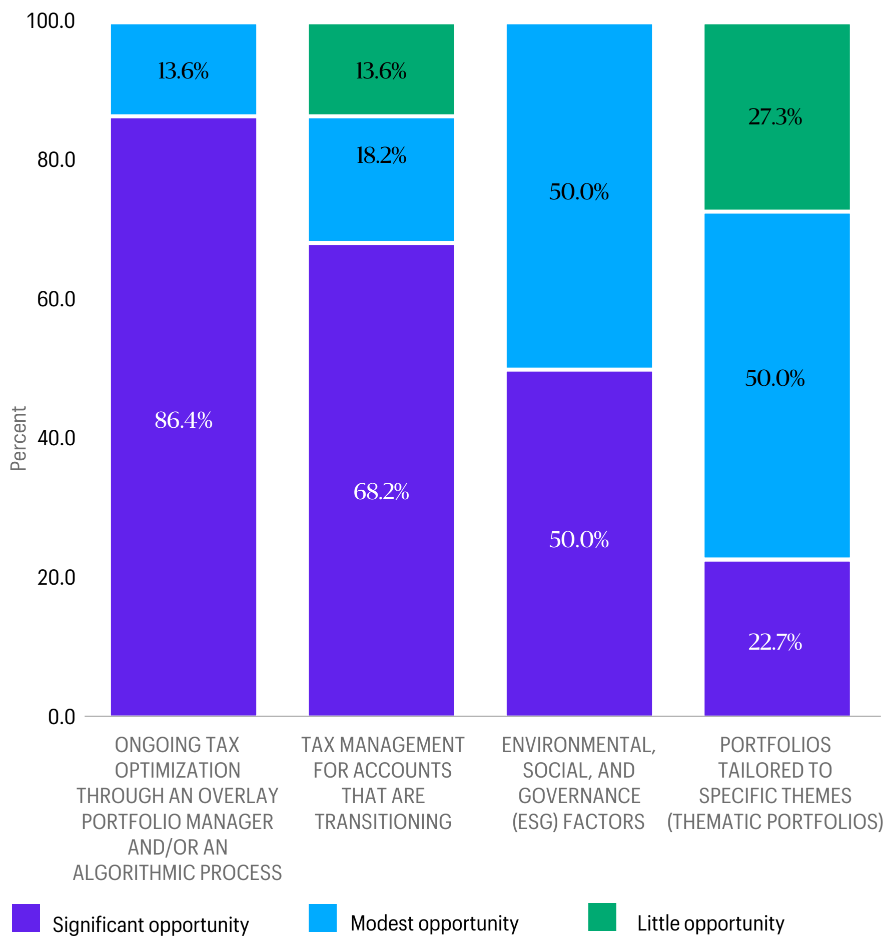
4. Cerulli, US Managed Accounts 2022 Report

CUSTOMIZATION

Clients are increasingly seeking hyper-personalized financial services, and advisors are taking action. Approximately 61% of advisors indicate they are using or considering direct indexing.[5] Since the process involves buying individual securities, portfolios can be tailored to client preferences. For example, a client may already hold a large portion of shares in their employer, a Fortune 500 company. By excluding these shares from their direct indexing portfolio, the client's portfolio becomes more diversified and concentration risk is reduced.

Clients also gain the power to screen for unwanted stocks according to their values and beliefs. For instance, Allspring's **SMArt Large Core 500 ESG-Screened** direct indexing option, one of Allspring's direct indexing options, removes companies from the S&P 500 Index based on participation in activities with negative environmental and social consequences.

ASSET MANAGERS: PERCEIVED VALUE FOR DIRECT INDEXING, 2022



Source: Cerulli Associates. *Analyst note: Respondents were asked, "Please select the opportunity that you feel each type of direct indexing presents."*

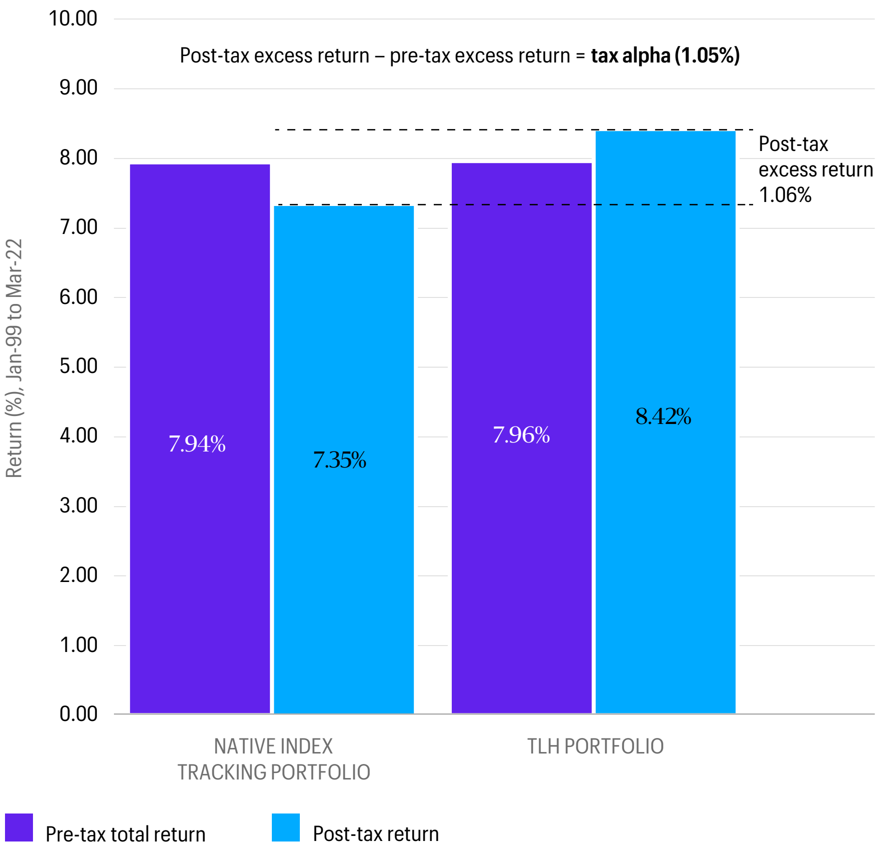
5. "Uncovering the product preferences of today's advisors," Broadridge Financial Services, September 2021

PORTFOLIO TRANSITIONS

Transitioning a portfolio to a different strategy can trigger adverse tax consequences for clients, as existing positions often contain a combination of unrealized gains and losses. Direct indexing adds a layer of flexibility here, as clients are not required to liquidate all holdings—allowing for more effective tax management.

A tax-aware direct indexing strategy can be employed to minimize tax liabilities during the transition, while any harvested losses could offset current or future gains. As a result, deferred unrealized gains can compound over time and potentially increase long-term wealth generation.

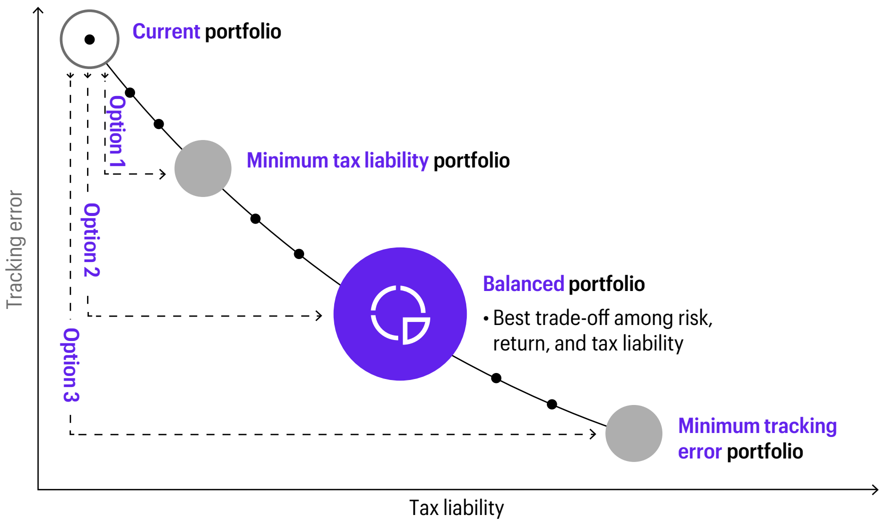
A HYPOTHETICAL TAX-LOSS HARVESTING (TLH) PORTFOLIO HAS SIGNIFICANTLY HIGHER POST-TAX RETURNS THAN A NATIVE INDEX TRACKING PORTFOLIO (1999–2022)



TLH portfolio is hypothetical, does not represent actual decision-making, and may not reflect the impact material economic and market factors might have had on Morningstar's decision-making process. Future performance or returns can differ significantly from the back-tested performance shown.

Source: Morningstar, "Sizing up the Tax Benefits of Direct Indexing"

Additionally, direct indexing strategies can cater to individual client wants, needs, and goals. For instance, a client can choose to minimize tracking error (more closely mirroring the index) or tax liability (prioritizing tax-loss harvesting)—or something in between.



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To facilitate this process, Allspring provides transition analysis with a range of options that examine the tax and tracking error considerations of moving a legacy portfolio to a customized direct indexing solution in a risk-aware and tax-efficient manner.

Direct indexing with Remi

Allspring's Remi platform can help advisors create value for clients with tailor-made, tax-optimized direct indexing. Remi is our intelligent SMA ecosystem that delivers customized portfolios with full-life-cycle tax management.

Unlocking smart outcomes

For further information

We want to help clients build for successful outcomes, defend portfolios against uncertainty, and create long-term financial well-being. To learn more, investment professionals can contact us:

Remi by Allspring

866-701-2585

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