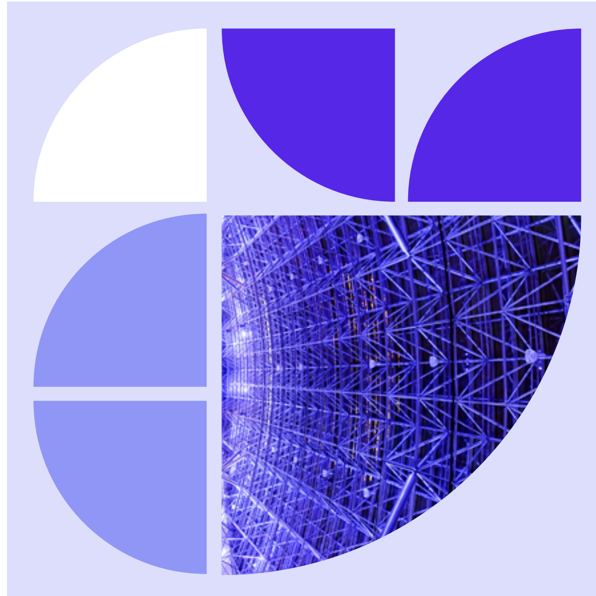
remi
by Allspring

Direct Indexing: Unlocking SMArt Possibilities



Index mutual funds and exchange-traded funds (ETFs) have long been staples of index investing, but direct indexing is emerging as a compelling, more personalized option for investors to help build and manage their portfolios.

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

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 an 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, transparency, and personalization of portfolio holdings that may be customized to align with their individual goals. It also allows for enhanced, proactive, and ongoing tax management.

WEALTH MANAGEMENT IS EVOLVING

1970s–1990s	1990s–2000s	2000s–today
Wealth 1.0	Wealth 2.0	Wealth 3.0
Mutual funds	Index funds	Personalized portfolios
	ETFs	Direct indexing

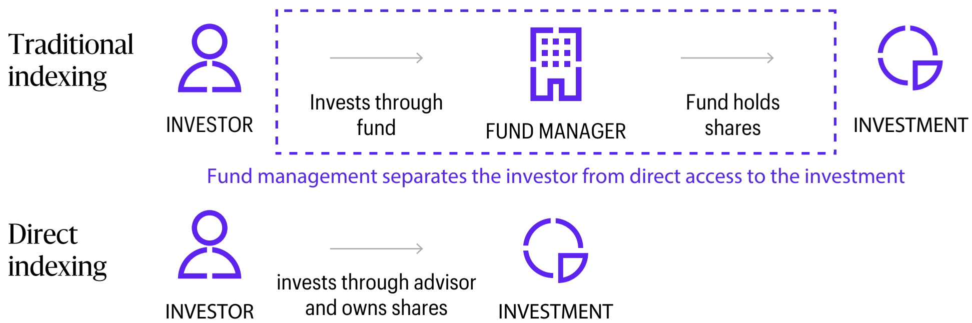
For illustrative purposes only.

Why is direct indexing more viable now?

Before the rise of online brokerage platforms, direct indexing wasn't feasible for most investors. 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 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[1] as more investors seek tailored portfolios and investment strategies that cater to their specific needs, goals, and values. The direct ownership of securities and transparency of the portfolio help to make this possible.

DIRECT OWNERSHIP

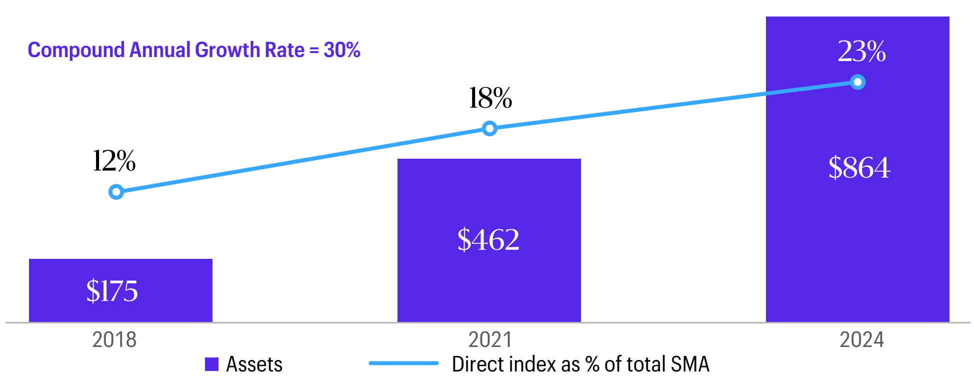


Direct indexing provides direct access to individual securities that may comprise an index. By directly owning the securities, the investor can benefit from the added flexibility that has historically been more accessible to the ultra-wealthy, institutions, and fund managers.

For illustrative purposes only.

Given its investor-friendly capabilities, it's no surprise that direct indexing has flourished—a trend that's expected to continue in the coming years. Thanks to investor demand combined with rapid adoption by advisors and wealth managers, direct indexing is projected to grow to more than $1 trillion in 2026.

GROWTH OF DIRECT INDEXING ($B)



Sources: Cerulli U.S. Product Development 2024, Separate Account Edge Q1'25. Reflects number of direct indexing managers tracked by Cerulli

1. Cerulli U.S. Managed Accounts 2024 Report

Why use direct indexing?

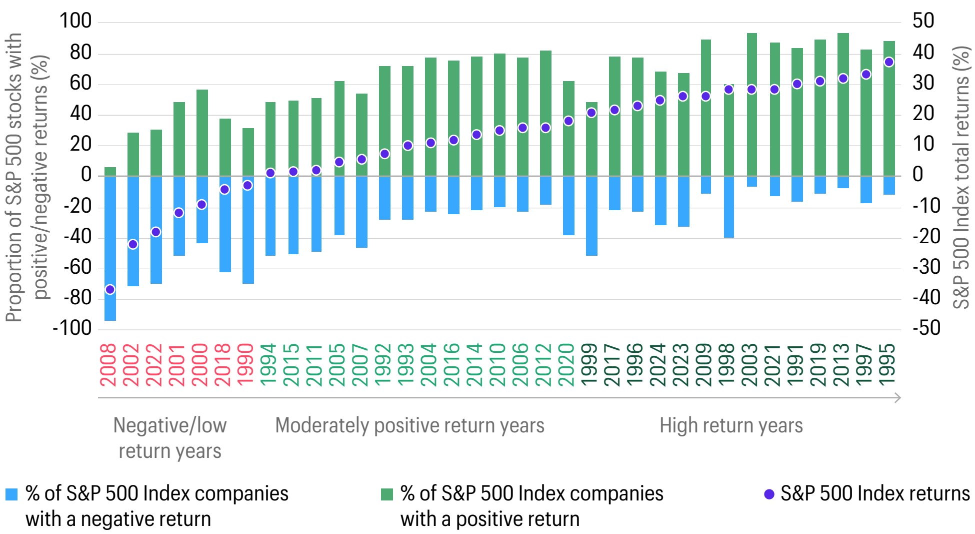
TAX ALPHA

Because investors have direct ownership of the portfolio securities, there may be opportunities 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 isolated stock movements within the portfolio. This is important because while a portfolio's overall value can increase, its underlying positions may have losses that present opportunities for tax-loss harvesting. With direct indexing, investors can take advantage of tax-loss harvesting opportunities at the individual security level, even in up markets.

UP OR DOWN, TAXES ALWAYS MATTER

Investors may **have opportunities to reduce their capital gains tax liability** through tax-loss harvesting. We can see this historically across all types of market environments.



Sources: MSCI and Barra Portfolio Manager. As of 31-Dec-24.

Past performance does not guarantee future results

CUSTOMIZATION

Investors are increasingly seeking hyper-personalized financial services, and advisors are taking action. Approximately 69% of advisors indicate they are either using or considering using direct indexing.[2] Since the process involves buying individual securities, portfolios can be tailored to investor preferences. For example, an investor 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.

THE POWER OF PERSONALIZATION

Investor scenario:

An investor holds a substantial amount of company stock. They are seeking to reduce their concentrated exposure and transition to a diversified stock portfolio, excluding the company stock as a holding.

Goals:

- Reduce single stock concentration risk
- Enhance portfolio diversification
- Increase after-tax returns

Challenge:

- Create a personalized portfolio composition to meet new goals (Example: direct indexing SMA minus company stock)
- Increase the tax efficiency of the portfolio
- Create an effective transition plan

Solution:

- Execute an effective exit and transition plan
- Use a systematic transition process to move to a customized SMA specifically designed to meet the investor's needs
- Fund a personalized, cost-effective, and tax-efficient direct indexing SMA

New portfolio benefits:

Reduced concentration risk

Enhanced and ongoing tax management, creating greater tax alpha potential

Increased portfolio flexibility, customization, and personalization

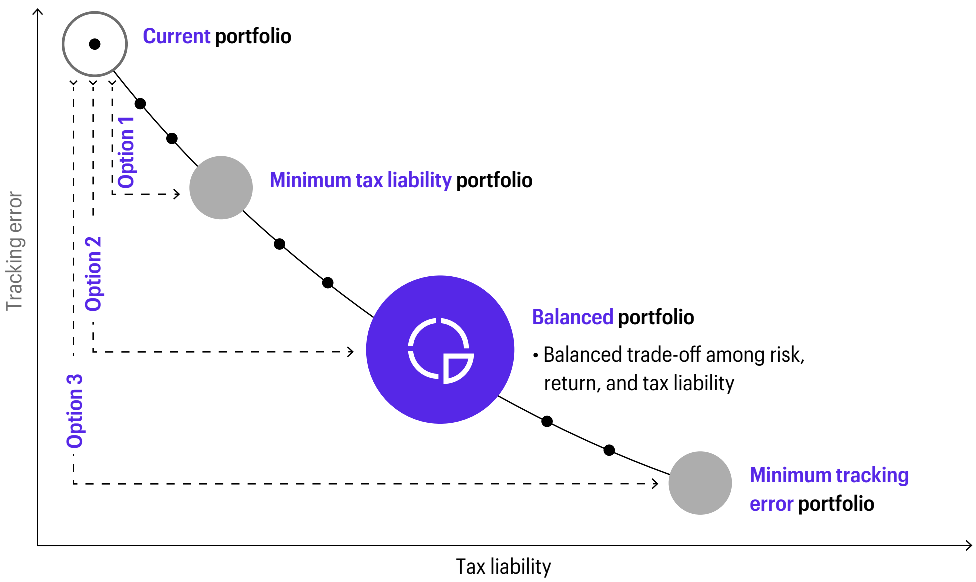
2. RIA Channel and FTSE Russell, 2024.

PORTFOLIO TRANSITIONS

Transitioning a portfolio to a different strategy can trigger adverse tax consequences for investors, as existing positions often contain a combination of unrealized gains and losses. Unlike transitioning from a fund, direct indexing adds a layer of flexibility, as investors 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.

Additionally, direct indexing strategies can cater to priorities of the individual investor. For instance, at Allspring an investor can choose to minimize tracking error (more closely mirroring the index) or tax liability (prioritizing tax-loss harvesting)—or a combination of both.



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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.

For further information

We're committed to thoughtful investing, purposeful planning, and the desire to deliver outcomes that expand above and beyond financial gains.

Click or scan the QR code to check out Allspring's insights:

The Standard & Poor's 500 Index (S&P 500 Index) consists of 500 stocks chosen for market size, liquidity, and industry group representation. It is a market-value-weighted index with each stock's weight in the index proportionate to its market value. You cannot invest directly in an index.

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Diversification does not ensure or guarantee better performance and cannot eliminate the risk of investment losses.

Tracking error measures the extent to which a manager's performance mimics that of a benchmark. The value is the standard deviation of the difference between a fund's performance and a benchmark's performance. Tracking error is based on historical performance and does not represent future results.

Tax alpha refers to the additional value or returns generated in an investment portfolio by incorporating strategies that minimize tax liabilities, such as tax-loss harvesting. Tax alpha is based on historical performance and does not represent future results.

Tax-loss harvesting is the selling of investments at a loss so that losses can be used to offset gains on the sale of other investments—thereby reducing capital gains tax owed. Proceeds from the sale may be used to purchase similar securities to maintain the general composition of the investment portfolio.

Remi is a solution for personalizing separately managed account portfolios, powered by technology, research, and human insights. Remi's portfolio construction engine is backed by our fundamental research team, simplified transitions, and tax management. Remi is a service of Allspring Funds Management, LLC.

There are several investment-related risks associated with tax loss harvesting. There is potential that the tax loss harvesting may:(i) negatively affect the overall performance of an investor's portfolio; and (ii) result in a temporary overweight and/or underweight of certain sectors, securities, and/or cash in an investor's portfolio that influences performance, and Allspring will not consider any other account that the investor may have. 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. Allspring may repurchase securities for an account after the end of the tax loss wash sale period at a price higher or lower than that for which they were sold. Allspring will not attempt to harvest every tax loss that occurs in an account securities sold for the purpose of tax loss may or may not be repurchased by Allspring for the selling account following the 30-day wash sale period. Allspring cannot prevent wash sales that may occur in other accounts besides the account to which the tax loss harvesting was applied. Furthermore, Allspring cannot prevent wash sales that may occur due to investor or financial advisor requests that impact trading in the account.

Investment strategies that seek to enhance after-tax performance may be unable to fully realize strategic gains or harvest losses.