Institutional Insights

The unique value of custom SMAs in wealth management: Direct indexing and beyond

Understanding the impact of the next great innovation in advisory solutions

INSIDE

KEY TAKEAWAYS

- **A race to meet rising expectations:** Advisors face stiff competition in the race to meet rising investor expectations, putting a premium on scale and differentiation. The rise of direct indexing has shone a spotlight on the potential for customized separately managed accounts (custom SMAs) to help in this effort.
- **Quantitative capabilities drive unique value:** The automation and scale offered through these solutions has the potential to significantly impact this race by enabling advisors to efficiently deliver highly personalized portfolios with potential for after-tax outperformance.
- **Impending enhancements to elevate this value:** This potential is fueling an evolution of custom SMA products. Forthcoming enhancements will enable deeper personalization and extend the automation and optimization capabilities of direct indexing to more traditional active strategies.
- **Prioritizing work towards developing an offering:** Advisors and firm leaders should consider starting the necessary groundwork to be able to offer custom SMAs. Understand them, how current and forthcoming products may differ, and how they could fit into and enhance your practice.

Fidelity INVESTMENTS

Rising investor expectations

We've seen a rise in investor expectations of advisors in recent years. Beyond access to securities markets, today's investors want help with holistic planning, and they want that plan to go beyond purely financial outcomes. They want access to the latest innovations in investment products (e.g., crypto) and niche services (e.g., healthcare planning), and they want all of this packaged up within a convenient and pleasant experience. How can advisors keep up? Further, how can advisors differentiate their offering in an increasingly crowded market, and how can they do so efficiently enough to fuel their growth and expand their offering to underserved segments of the market?

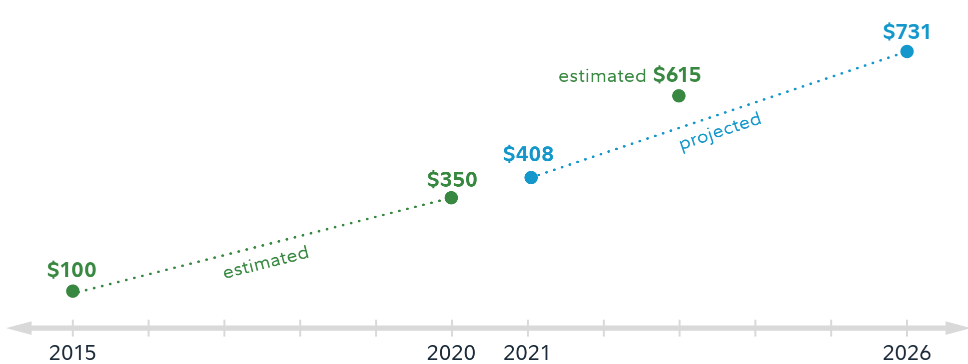
These are substantial challenges, and there isn't a single, simple solution. Instead, there are many different solutions, available or emerging, that each have the potential to incrementally improve an advisor's ability to differentiate at scale in this market. Within this paper, we explore one such solution: customizable separately managed accounts (custom SMAs).

A solution to meet them

Among the most popular topics around investment trends, direct indexing is having a moment. Some market watchers have even named it one the hottest trends to watch this year, alongside crypto, sustainable investing, and the rise of retail investors.[1]

With assets invested in these products rising ~350% between 2015 and 2020[2], and Cerulli projecting that rising demand and lower pricing will fuel another nearly 2X rise between 2021 and 2026[3] (Exhibit 1), the buzz shouldn't be surprising. And since then, actual growth has outpaced the projection, with more than $615 billion in assets by the end of 2023.[4]

EXHIBIT 1: Estimated and Projected Growth of Direct Indexing ($ Billions)



Estimated 2015 and 2020 data points sourced from Deloitte; Projected 2021 and 2026 data points sourced from Cerulli Associates. Estimated 2023 data point sourced from Cerulli Associates.

For illustrative purposes only.

However, it's not simply the buzz of an exciting new trend that's driving interest, growth, and expectations around direct indexing. It's a combination of:

1. Utility and the potential to meet these rising investor expectations head-on

2. Availability, as advances in computing power and the erosion of trading commissions have allowed providers to extend their offerings down-market.

This potential has also piqued the interest of several large asset managers that are positioning themselves to enter this market, either through acquisitions of fintechs or boutique firms, or through the development of their own new solutions.[5]

> These solutions are evolving simply into scalable custom SMAs

Definition and distinction

The rising interest in this solution may be clear, but what exactly is direct indexing, and how does it relate to SMAs? If you're not sure, you're in good company! In a recent survey, we found that only about one in four advisors are "very" or "extremely" familiar with direct indexing. As you might expect, familiarity seems to open the door to usage, with one in four advisors reporting that they include direct indexing investments in client portfolios. Further, we found that the more familiar an advisor is with this solution, the more likely they are to offer it.[6] Some clarity could go a long way.

Direct indexing is a technology-enabled investment strategy that aims to deliver beta exposure and tax alpha. To execute this strategy, an investor in a separately managed account holds a basket of securities selected to provide similar market and risk exposures to a benchmark index, while allowing the investor to accept additional tracking error to customize the portfolio and execute tax management strategies.

This may sound like a passive investment, but don't let the name or focus on beta fool you! Adding layers of tax management and personalization to these portfolios introduces elements of active management and sources of alpha. Further, as providers are starting to offer the ability to apply these capabilities beyond the beta and tax alpha foundations of direct indexing, it's clear that these solutions are evolving simply into scalable custom SMAs.

Understanding the unique value of custom SMAs

Custom SMAs derive their unique value from several key features: 1.) Tax management, 2.) Potential to personalize, and 3.) Automated analysis and systematic execution. A closer look at these features illuminates the unique value that custom SMAs can offer investors and their advisors.

> Tax Loss Harvesting through a custom SMA may generate 100 bps or more of tax alpha per year

Feature #1: Tax management

By investing in securities directly, rather than through a commingled fund like a mutual fund or an ETF, custom SMAs can offer a broad array of tax management capabilities, from transition and withdrawal management to deferral of capital gains. However, the most prominent of these capabilities is tax loss harvesting. Tax loss harvesting generally entails:

1. Selling individual positions or tax lots when there's an unrealized tax loss, and
2. Using the proceeds to buy similar securities or otherwise work to mitigate tracking error and the overall risk of the portfolio.

By executing these types of trades frequently, across the portfolio, and around wash sale restrictions, investors can lock-in tax losses throughout the year that could be used to offset taxable gains—and/or ordinary income—all while continuing to track a benchmark index.

Some may question why an investor would pay more for a custom SMA when index funds generally have low expenses and receive favorable tax treatment as a result of their low turnover and income. However, this line of thinking appears to underestimate the value of the tax management techniques at hand. Executives interviewed by Cerulli expect direct indexing through custom SMAs to produce an average tax alpha of 100 bps per year[3],and an academic analysis published in Financial Analysts Journal came to a similar conclusion.[7] While the custom SMA market is still growing and evolving, available solutions have generally been priced between active and passive funds. The utility of these kinds of estimates may be limited when the specific costs and returns of real-life solutions vary, but they at least provide a valuable frame of reference for the potential of custom SMAs to deliver tax alpha in excess of the cost premium over index funds.

For advisors working to differentiate from their competitors, the potential to generate 100 bps or more of after-tax outperformance—while maintaining an exposure that's comparable to an index fund—has genuine appeal at a time when any kind of outperformance can be hard to come by. Further, with Cerulli reporting that only 53% of managed accounts receive any tax treatment, and only 16% are subject to the ongoing and systematic tax optimization that is indicative of direct indexing[8], advisors offering this capability should have a distinct advantage in competing for new business.

Feature #2: Potential to personalize

The ability to tailor a professionally managed portfolio of securities to the needs and preferences of an individual investor is the central value proposition of an SMA. In practice, though, the customization capabilities offered to most retail SMA investors have been fairly limited. Truly personalized portfolios have been reserved for high-net-worth investors with sufficient assets and scale to cover the expense.

Now, though, as the cost of execution has declined and custom SMAs have shifted down-market, average retail investors can have professionally managed and personalized portfolios of their own. Initially, this meant that investors or advisors could exclude specific securities, individually, or based on attributes such as industry, country, or sector. More recently, capabilities and interests in more broad-based exclusions have risen to prominence. These include exclusions based on sustainable investing criteria as well as other purpose-driven and/or personal investor preferences.

There's plenty written right now about the importance of personalization, and not just in wealth management. McKinsey recently wrote that, across US industries, personalization matters more than ever. They found that:

71% of consumers **expect** personalization

76% are **frustrated** when they don't get it

76% are more likely to **consider buying** from brands that personalize

78% are more likely to **recommend** those brands

They also found that personalization in any US industry could generate a significant lift in revenue, with top performers in personalization seeing the greatest benefits.[9]

This holds true in wealth management too. A study from The CFA Institute found that 82% of investors with advisors were interested in personalized products, and 62% were willing to pay more for customization. The personalized product that was most interesting to respondents? Direct indexing through custom SMAs.[10]

The ability to offer clients truly custom investment management—including execution of complex strategies and reflection of investors' personal values and preferences—could be a game-changer. *Take a moment to consider how valuable a custom SMA offering could be to your own clients and practice.*

The CFA Institute:

4 in 5 investors are interested in personalized products

Feature #3: Automated analysis and systematic execution

The benefits of these tax management and personalization capabilities have long been recognized, but their cost—along with historically higher investment minimums—have limited their appeal beyond wealthy investors with significant tax burdens. However, the latest wave of custom SMAs doesn't have this problem, as advancements in computing power, the expansion of quantitative investment capabilities, and the collapse of equity trading commissions have lowered the cost of execution and enabled firms to offer an institutional-quality solution in custom SMAs at a significantly lower investment minimum and price point.

While this technology-driven approach has made custom SMAs more affordable and accessible, it has also elevated this solution, offering advisors a powerful tool to develop and execute sophisticated strategies. Providers have infused these solutions with quantitative investment techniques and expertise to develop their own rules-based optimization engines that use algorithms to analyze positions across many portfolios at once, and against a wide range of potential criteria. These engines identify potential opportunities to facilitate tax loss harvesting—or otherwise enhance those portfolios—and they enable portfolio managers to efficiently and systematically evaluate and execute the appropriate trades. Improvements in processing power have also allowed providers to develop deep data sets from which they can harvest insights and build out systematic processes. All of this makes tax loss harvesting feasible at a trading frequency high enough to provide meaningful benefits to investors, and it enables advisors to customize each client's portfolio at scale.

For advisors working to scale their practice and enhance the value that they deliver to their clients, plugging into an SMA platform could provide significant leverage by allowing them to spend more time working with clients—helping them to make plans and decisions—rather than spending that time managing the execution of those plans.

> Advancements in computing power, the expansion of quantitative investment capabilities, and the collapse of equity trading commissions have lowered the cost of execution and enabled firms to offer an institutional-quality solution.

It is important to understand that the value of tax-loss harvesting for any particular client can only be determined by fully examining a client's investment and tax decisions for the life of the account and the client. Clients and potential clients should speak with their tax advisors for more information about how a tax-loss harvesting approach could provide value under their specific circumstances.

Considering what's next

Given how quickly this market is evolving and eliciting new product iterations, it's timely to look out a bit and consider where its headed.

With the introduction of elements of active management to custom SMAs, it seemed only a matter of time before we saw these capabilities developed for direct indexing being applied beyond the realm of beta and tax alpha, in pursuit of pre-tax alpha and more traditional active strategies. Some providers are indeed making that leap. This means that, within custom SMAs, advisors will soon be able to develop truly personalized strategies—in pursuit of alpha, beta, tax alpha, or a combination thereof—and they'll be able to optimize and execute these strategies at scale. Further, depending on their provider, advisors may be able to access consulting services, best practices, and/or resources around how to operationalize custom SMAs and incorporate this powerful investment strategy into their practice.

> Advisors will soon be able to develop truly personalized strategies—in pursuit alpha, beta, tax alpha, or a combination thereof—and they'll be able to optimize and execute these strategies at scale.

Additionally, while initial customization capabilities offered through these mass market SMAs have primarily relied on a directed and exclusionary approach, providers are developing deeper capabilities that allow portfolios to be more fully personalized to the investment, tax, and/or personal beliefs or preferences of the investor and/or advisor. This includes the ability to establish overlays and tilts that can be layered over portfolios—based on sustainable investing considerations, investment factors, or any number of other criteria—as well as the ability to establish custom benchmarks and track performance against that benchmark, along with the underlying indices.

The evolving technology and systematic approach that enable this investment capability also have the potential to continue to enhance the utility of custom SMAs. As this solution matures, what would it mean to have these kinds of quantitative investment capabilities available within every firm? How would that change wealth management? How might that impact grow as data continues to proliferate and computers become more powerful? And, how does integrating this kind of solution into a firm's technology ecosystem, practices, and user experience elevate the value of this solution and the firm that uses it? The potential is clear.

Making a plan and starting the work

The potential medium- to long-term value of custom SMAs is impressive. While wealth managers don't need to have a custom SMA solution tomorrow, firms and advisors alike should consider prioritizing steps in that direction. The ultimate decision to offer a custom SMA solution may fall to firm leaders, but advisors have a role to play as well in becoming familiar with this solution and advocating for their preferred approach. The rise of custom SMAs is a high stakes opportunity for all involved. *Let's make a plan, and get to work!* Here are some priorities to consider:

1. **Invest the time and energy it takes to understand custom SMAs:** What they are, what they provide, and what they could become. This is the first step toward developing a substantial offering, but it's also important to recognize that even if you're not yet offering custom SMAs, you are likely already competing against advisors who are.

2. **Consider how these solutions could fit within your practice.** Who among your clients might be a fit for this solution? How could adding it to your product shelf support or enhance your value proposition? What support would you or others at your firm need to begin offering this solution? How could it integrate into your technology, portfolio construction and management processes, and overall practice?

3. **Begin exploring providers and solutions,** but keep in mind that the capability and provider landscape is rapidly changing and will look quite different six months or a year from now. In addition, differences between specific approaches have the potential to deliver meaningfully different results and experiences. With that in mind, scan the market to understand what's possible today, as well as how that may change in the months and years ahead. Then, begin building out your list of requirements and preferences with an eye towards tax management features, depth and breadth of personalization parameters, and the overall strength and quality of the provider's technology and quantitative investment capabilities.

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For additional information, please contact your Fidelity relationship manager.

For investment professional use.

Endnotes

[1] 4 Hot Investing Trends to Watch for in 2022, Kiplinger.com, December 2021.

[2] Next on the horizon: direct indexing, Deloitte, June 2022.

[3] The Cerulli Report—U.S. Managed Accounts 2021, Cerulli Associates.

[4] The Cerulli Report—U.S. Managed Accounts 2024, Cerulli Associates.

[5] The rise of direct indexing, FinancialPlanning.com, March 2022.

[6] Advisor Insights Study, 2022, Fidelity Institutional. The study was an online blind survey (Fidelity not identified) and was fielded during the period August 3 through September 6, 2022. Participants included 1,359 advisors who work with individual and/or small business investors, and are licensed and credentialed. Advisor firm types included a mix of RIAs, national brokerage firms (commonly referred to as wirehouses), other broker-dealers, with findings weighted to reflect marketplace headcount by channel, as reported by Cerulli. The study was conducted by an independent firm not affiliated with Fidelity Investments.

[7] Shomesh E. Chaudhuri, Terence C. Burnham & Andrew W. Lo (2020) An Empirical Evaluation of Tax-Loss-Harvesting Alpha, Financial Analysts Journal, 76:3, 99-108, DOI: 10.1080/0015198X.2020.1760064.

[8] Direct indexing and the Unfulfilled Promise of Tax Efficient SMAs, Cerulli Associates, Q1 2021.

[9] Excerpted from "The value of getting personalization right—or wrong—is multiplying", November 2021, McKinsey & Company, www.mckinsey.com. Copyright © 2022 McKinsey & Company. All rights reserved. Reprinted by permission.

[10] Enhancing Investors' Trust: 2022 CFA Institute Investor Trust Study.

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