



# CASE STUDY: TRANSITIONING EQUITY PORTFOLIOS EFFICIENTLY

## CLIENT CHALLENGE — Help Clients Switch Investment Strategies While Minimizing Tax Consequences.



### CLIENT PROFILE

Consider this strategy for clients who are :

- Seeking to replace individual stock holdings or an existing separately managed account (SMA) with another strategy.
- Looking for a simple cost- and tax-efficient transition.

For clients who own underperforming actively managed SMAs or a portfolio of stocks they no longer wish to manage themselves, it could make sense to switch to an index or quantitative strategy.

Liquidating the holdings and reinvesting in an exchange-traded fund (ETF) is one option. However, this could result in a significant tax bill — especially if the securities have appreciated. Furthermore, some securities would likely be included in both the original portfolio and the new strategy. Selling and then rebuying the same securities would incur unnecessary taxes and transaction costs.

**So, how can you help your clients transition their portfolios tax-, cost- and risk-efficiently?**

### **SOLUTION: CONSIDER NORTHERN TRUST ASSET MANAGEMENT (NTAM) DIRECT INDEXING FOR A TAX-SMART TRANSITION PLAN**

Since direct indexing accounts can be funded in-kind with individual stocks and ETFs, securities can be transferred without being sold or converted to cash. This allows NTAM portfolio managers to add value by deferring capital gains and transferring assets between accounts more tax- and cost-efficiently.

Direct indexing also offers the potential for enhanced risk management as managers seek to track the chosen index more closely than the original account likely would. Furthermore, in cases where the client holds individual stocks, our managers will implement risk parameters around the holdings.

## THE NTAM TRANSITION PLAN PROCESS

Portfolio transition analyses can be run for both existing clients and prospects. For current clients, we access and analyze the existing tax lots. For prospects, you can upload the account's tax lots directly into the NTAM Direct Indexing Portal. The process works like this:

1

### Input tax lots.

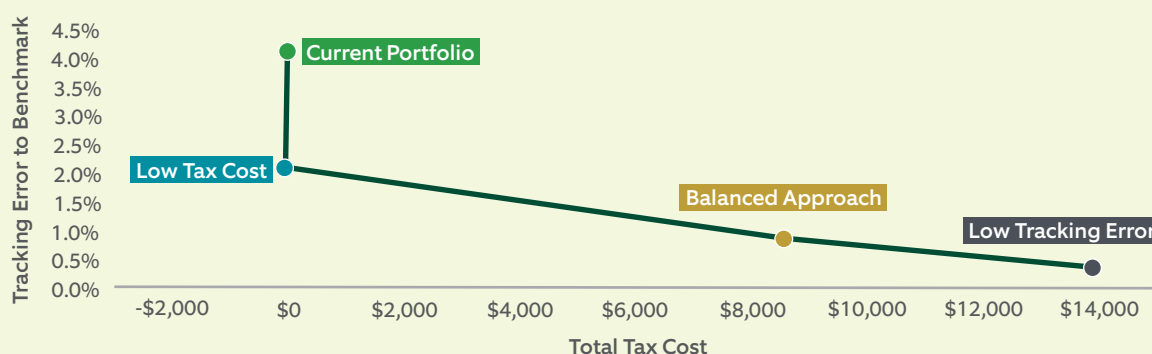
Once the tax lots are identified or uploaded, you can set the parameters for the transition.



2

### Receive a detailed report showing trade-offs between tracking error and tax costs.

NTAM can customize the portfolio to fit a broad range of investment and tax objectives. Total tax costs tend to increase as the portfolio is aligned more closely with the benchmark.



3

### Choose one of three transition options for managing taxes and risk:

1. Lower tax cost, higher tracking error
2. Balance between taxes and risk
3. Lower tracking error, higher tax cost

Low Tax  
Cost

Balanced  
Approach

Low Tracking  
Error

With NTAM Direct Indexing, portfolio transitions can accommodate client-specific customization requests, such as exclusions, tilts or ESG considerations. As described above, advisors receive a detailed analysis that shows the implications of each option, including the tax cost (based on the client's current tax rates), portfolio characteristics and risk parameters.

With this analysis, you can thoroughly understand tax and risk consequences before making a transition recommendation. Finally, when exported to a PDF, the transition analysis becomes an effective visual aid to facilitate client discussions.



## CLIENT AND ADVISOR BENEFITS

Transitioning a portfolio via NTAM Direct Indexing enables your client to save on capital gains taxes while incorporating customization parameters and managing risk. Furthermore, with just a few inputs, the portfolio management team can begin to analyze different scenarios and build an optimized portfolio, enabling you to efficiently add value to your client relationships.

After the transition, your client's direct indexing portfolio can continue to deliver tax alpha through loss harvesting in the future. Alternatively, the account can be designed to lower tracking error over time by using any losses in the account to offset gains from other potentially outsized positions.

## GOOD to KNOW:

The tax savings achieved by transitioning accounts using this process is considered **tax alpha**. This represents the taxes saved from not having to liquidate the entire account.

Be aware:

Post-transition tax alphas will be lower than those for accounts funded with cash.

## POTENTIAL CONSIDERATIONS FOR DIRECT INDEXING ACCOUNTS

The ability to generate losses may be lower than expected, especially in markets that are rising significantly. Furthermore, the continuing benefits may not be fully realized in flat or falling markets because reinvested tax savings could potentially be low or negative.

## 3 KEY TAKEAWAYS

1

Transitioning to a direct indexing account creates an opportunity to defer taxable gains.

2

Transitioning an existing portfolio allows the client to save on capital gains taxes compared to completely liquidating the account.

3

**Client outcome:** Direct indexing helps clients achieve their portfolio transition goals, along with the opportunity for account customization and enhanced risk control.

## QUESTIONS?

**Learn how cutting-edge technology can help solve investing challenges.**

Find out about NTAM's direct indexing capabilities by contacting your NTAM sales professional (or by emailing [ntam\\_direct\\_indexing\\_sales@ntrs.com](mailto:ntam_direct_indexing_sales@ntrs.com)).

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