NORTHERN TRUST
ASSET MANAGEMENT

DIRECT INDEXING INSIGHTS

THE IMMEDIATE AND CONTINUED BENEFITS OF DIRECT INDEXING

THE BENEFITS OF DIRECT INDEXING DO NOT DISAPPEAR WHEN LOSS HARVESTING OPPORTUNITIES DIMINISH

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EXECUTIVE SUMMARY

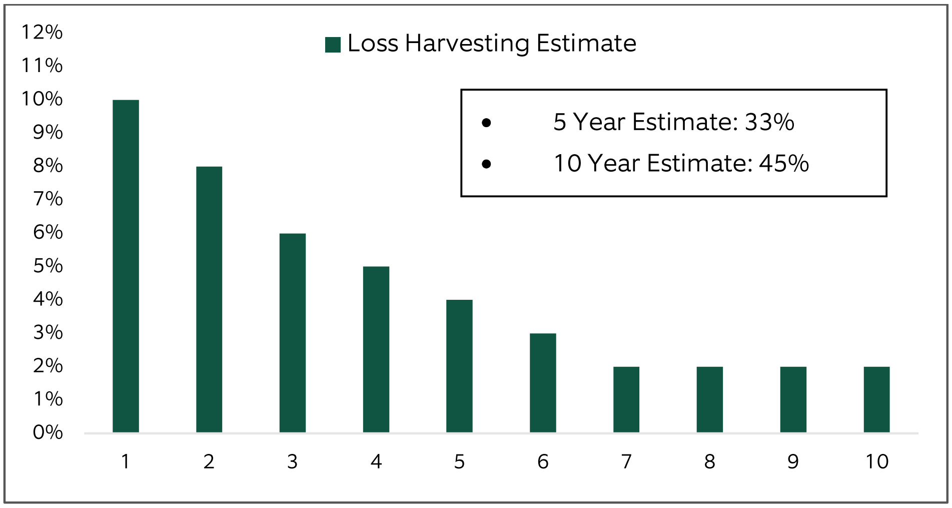
Direct Indexing has been increasing in popularity and is now considered table stakes in order to stay competitive within the high-net-worth client segment of the intermediary channel. The benefits are clear when loss harvesting is conducted and losses are used to offset gains from other investments, especially early on in the account's lifespan. This process reduces tax outflows. However, the benefits of a direct indexing strategy do not end there. They continue on as those tax savings stay invested and compound over the years. This paper discusses and quantifies the continuing benefits of direct indexing strategies.

REVIEWING THE EARLY BENEFITS OF TAX LOSS HARVESTING

Most direct indexing strategies offer two main advantages. The first is the ability to customize the account in line with the client's preferences (e.g., not holding a stock to which the client is exposed elsewhere, or ESG considerations), which we will discuss in another paper. Here, we will focus on another important benefit – tax management. To review, by owning the individual stocks in an index (or typically a subset), a savvy manager can take advantage of the equity market's natural volatility by selling individual names as they fall below their cost basis. This cannot be done in a fund as the fund will have only one holding that will either increase or decrease in value. However, within the index, there are almost always stocks that are down no matter what the overall equity index is returning. Direct indexing managers will replace the stocks that have been sold at a loss with a similar (but not the same, given the IRS wash sale rules) basket of stocks so that the account can continue to track the index with a typically small tracking error (relative risk of the account versus the index).

The capital losses generated by the direct indexing manager can then be used to offset capital gains from other investments on the client's IRS schedule D, thus saving money that otherwise would have been taxable. (Losses not used in the current tax year can be carried forward indefinitely.) This can be very valuable, especially for clients in a high tax bracket, high tax state and/or clients with significant short-term capital gains outside the direct indexing (DI) account.

Exhibit 1:
Loss Harvesting Estimate as a Percent of Initial Value by Year Since Inception



Source: Northern Trust Estimates. Assumes returns of 7%. Higher returns might result in lower loss harvesting, lower returns might result in higher loss harvesting. Past performance is not indicative of future results. Important Information" on the last pages for notes on hypothetical projections.

Exhibit 1 shows Northern Trust Asset Management's (NTAM) estimates of the amount of losses that can be expected to be generated from an all-cash funded Separately Managed Account (SMA) that regularly harvests losses. At NTAM, we seek to harvest losses on a monthly cadence (again outside the wash sale period) in order to capture losses when they are available and reinvest dividend income. Assuming a reasonable market return of 7% and typical volatility, we can see loss generation starts out very strong and tends to decline over time. In the later years, the losses are mostly derived from reinvesting dividends and cash from corporate actions. Note that in year one, all losses will be short-term and new losses from dividends and cash will also be short-term. It is also possible that some long-term holdings might turn into losses due to volatility spikes, down markets or idiosyncratic stock situations.

THE CONTINUING BENEFITS FROM COMPOUNDING

We've seen that the immediate benefits from loss harvesting diminish over time but don't disappear completely. We now turn to the continuing benefits realized from the compounding of taxes saved. An example might help. Let's assume that in a typical account we were able to generate 10% in capital losses in the first year. So, for a $1 million account, that represents $100,000 in realized short-term losses that can offset $100,000 in realized capital gains, thus resulting in no immediate tax bill for those gains. This can potentially create a near-term tax savings of anywhere from $40,000 to more than $50,000 (40% to more than 50%) for high-net-worth clients, depending on the client's state of taxation and the nature of the outside gains.

Those tax savings can potentially remain invested and generate a market return. This is where the continuing benefits come into play. By keeping that money invested, those savings will compound over time. The longer this deferral of gains can be kept going, the better for the client's after-tax wealth.

One other important fact to mention is that as losses are harvested from a DI account, the cost basis of the account is decreased. This is due to the fact that because stocks are sold at a loss, new replacement purchases are incepted at the lower amount, thus lowering the overall cost basis of the account.

Gain Deferral

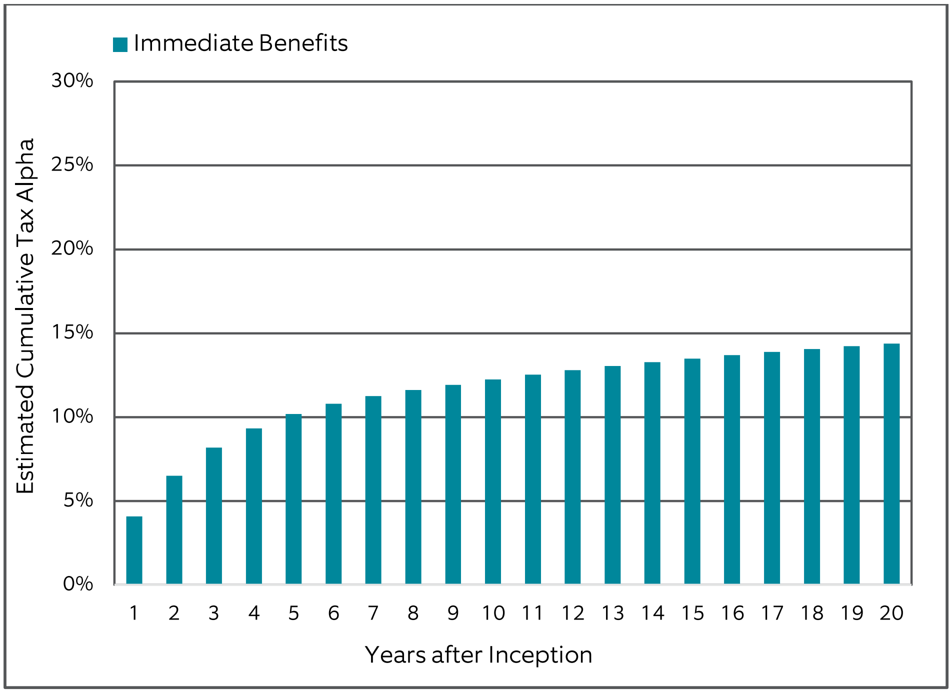
Deferred gains that can be held until death result in a step up in cost basis that can eliminate the built-up gain for beneficiaries. In addition, low-cost shares can be donated to charity, providing the same advantage.

THE POTENTIAL VALUE OF CONTINUING BENEFITS

Now let's look at a hypothetical direct indexing account funded with $1 million in cash and tracking the S&P 500 Index with a low tracking error. We also assume an S&P 500 return of 7%, in line with Northern Trust's latest capital market forecast. Exhibit 2a and 2b present the estimated hypothetical cumulative tax alpha of loss harvesting over a 20-year period. We assume that losses can be harvested in the second 10-year period at around 2% of the original balance, similar to the later years of the 10-year periods from Exhibit 1. For simplicity, we also assume maximum federal tax rates of 40.8% for short-term capital gains and 23.8% for long-term capital gains and no cash inflows. Tax alpha is defined as the amount of losses generated multiplied by the associated tax rate (short- or long-term) divided by the market value of the account.

As you can see in Exhibit 2a below, the cumulative tax alpha from the immediate benefits tend to level off over time at a steady rate. After-tax benefits start out high as the hypothetical account starts with cash and decline over time as the account ages and fewer stocks are at a loss and fewer gains are deferred. This is generally referred to as ossification. In later years, the account will continue to be rebalanced at a similar frequency no matter its age. This includes reinvesting dividends that accumulate and any cash from corporate actions as well as harvesting available losses. However, loss generation clearly will slow down.

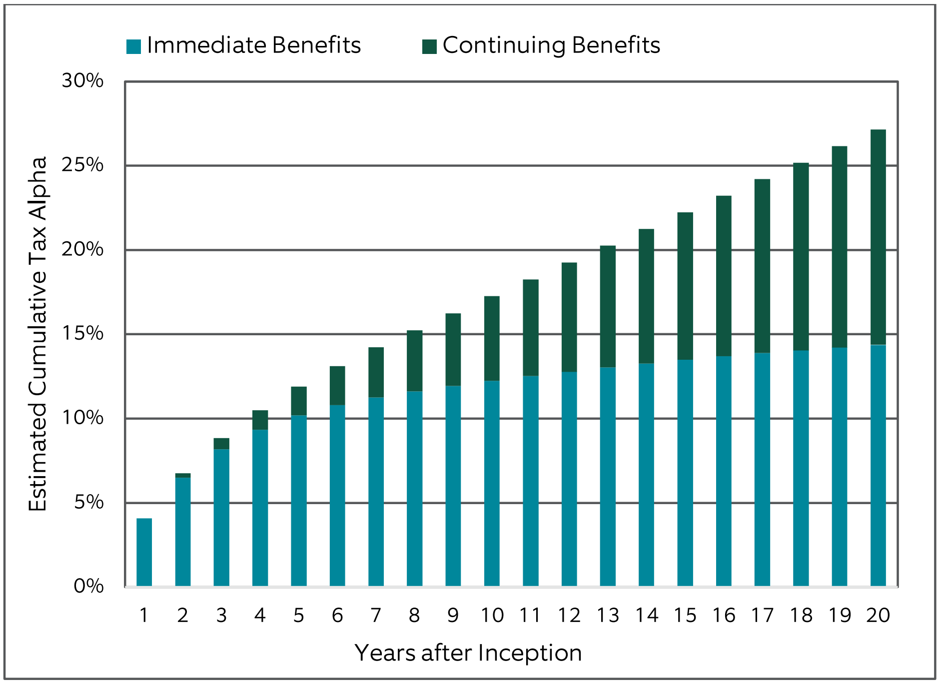
Exhibit 2a: Immediate Benefits of Tax Loss Harvesting



Source: Northern Trust Asset Management. Assumes loss harvesting rates outlined in exhibit 1. Assumes 7% Return on the S&P 500 Index. It is not possible to invest directly in any index. Index performance returns do not reflect any management fees, transaction costs or expenses. Past performance is not indicative of future results. Important Information" on the last pages for notes on hypothetical projections.

If we add the continuing benefits to the graph (in green), you can see that the total tax alpha, including the compounding of the tax savings invested in the portfolio, continues to grow. This is modeled by assuming that any tax savings are invested in the DI account as a proxy for other investments. Here we can see the benefits of that compounding of the tax savings.

Exhibit 2b: Immediate and Continuing Benefits of Tax Loss Harvesting



Source: Northern Trust Asset Management. Assumes loss harvesting rates outlined in exhibit 1. Assumes 7% Return on the S&P 500 Index. It is not possible to invest directly in any index. Index performance returns do not reflect any management fees, transaction costs or expenses. Past performance is not indicative of future results. Important Information" on the last pages for notes on hypothetical projections.

The benefits of tax savings compounding become a larger component of the annual tax alpha than the immediate tax savings once the loss harvesting activity slows down, prolonging the benefits. As mentioned, the longer these tax savings can be deferred, the higher after-tax wealth that can be created. Holding the direct indexing account until death and passing onto heirs will potentially result in the highest benefit given the DI account will experience at step up in cost basis, thus allowing the beneficiary to sell the portfolio tax-free if desired assuming no further appreciation.

VALUE AFTER FEES

Next, we look to answer the question of: If we factor in investment management fees for a direct indexer versus simply investing in an index ETF (which can be both inexpensive and tax efficient) does the benefit remain?

If we assume the fee for DI is 25 bps (0.25%) and the fee for an equivalent index ETF is 5 bps (0.05%), we can say the fee differential is 20 bps (0.20%). Expected total annualized tax alpha typically ranges from 1% to 2% depending on the state in which the client resides, the inception date, cash flows, and the market environment. Even at the lower end of this range the answer to the question posed is yes. Note that we have ignored dividends for this analysis as we assume that dividends and taxes on dividends are similar, whether in an ETF or SMA wrapper.

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.

ADDITIONAL STRATEGIES FOR SEASONED ACCOUNTS

It is not uncommon for clients to take additional steps in order to "rejuvenate" the loss harvesting opportunities in direct indexing accounts. Here are a few of the most common practices:

- Add cash to the account
    - Depositing cash into the account will create fresh tax lots that can be turned into future losses. Note that during the first year, losses generated from the fresh cash will be short-term.

- Gifting securities from the account
    - Appreciated direct index portfolios are an ideal source for charitable gifting. Of course, the gift is tax deductible as is gifting cash. However, by gifting low-cost basis securities, the investor removes the tax liability from the account as well. It's best to replenish the DI account with cash that otherwise would have gone to charity, which would have the impact described in section above.

See our paper *The Benefits of Tax Management for Appreciated Portfolios* for more detailed information on these strategies.

CONCLUSION

Direct indexing strategies in separately managed accounts have become very popular with advisors and clients because of the flexibility and benefits they provide, especially the benefits of tax management. There is a misperception in the industry that DI portfolios lose their value after losses slow down. As we have seen from our analysis, this is not the case. Gain deferral is a critical component of tax loss harvesting strategies including direct indexing. Deferring gains created in these portfolios, after taking advantage of the immediate benefits of offsetting gains from other investments, takes advantage of the power of compounding to potentially increase long-term after-tax wealth.

MODEL ASSUMPTIONS:

- Return of 7% for the S&P 500
- Tax impacts were calculated using the highest marginal individual tax rates in the U.S.; 23.8% long-term, 40.8% short-term.
- Short-term and long-term losses are credited at the corresponding tax rates.
- Tax alpha is calculated as after-tax excess return – pre-tax excess return.
- Pre-tax excess return is assumed to be zero.

To learn more about our Direct Indexing capabilities and advisor workstation, contact your NTAM sales professional or send an email to us at: **ntam_direct_indexing_sales@ntrs.com**

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