PARAMETRIC

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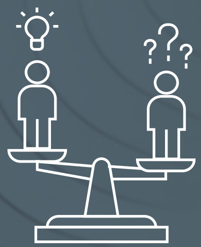
The Advisor Perspective on Direct Indexing

The investment industry has witnessed impressive growth in custom passive separately managed accounts (SMAs) as more investors and their advisors recognize their value. As a result, M&A activity has bolstered major financial firms' offerings in this category. These increasingly popular custom passive SMAs, with their many benefits, from active tax management to client-directed responsible investing frameworks, have attracted a new name: *direct indexing*.

Parametric has offered custom passive SMAs for more than 30 years. But with so much buzz around direct indexing in more recent years, we wanted to deepen our understanding of current growth and future opportunities in the direct indexing space. That's why we partnered with Cerulli Associates to survey a targeted list of advisors serving high-net-worth (HNW) investors. They've offered us a comprehensive picture of who uses direct indexing, how it benefits their clients, and where they can unlock the potential for an even more enhanced investor experience.

Methodology

Cerulli Associates surveyed 200 advisors across four channel segments: independent and hybrid registered investment advisors (RIAs), wirehouses, national and regional broker-dealers, and independent broker-dealers. These advisors manage an average of $250 million in assets and have been in their positions for an average of 20.7 years.



More than 50% of advisors remain unfamiliar with direct indexing.

Who uses direct indexing?

With the amount of M&A activity related to direct indexing taking place just in the past two years, significant change has come to the competitive landscape. The time is now for advisors to learn about direct indexing and adopt it for their practice. According to the Cerulli survey, more than 50% of advisors still remain unfamiliar with the strategy and its positive impacts for their clients.

Among the 12% of advisors who currently use direct indexing for their clients, broker-dealers are bigger users of SMAs by roughly three times more than RIAs, thanks in large part to increased availability of direct indexing platforms in their segment. It's worth noting that direct indexing allocations rise with assets under management (AUM). Among advisors managing $500 million or more, 19.2% of those assets are allocated to SMAs versus 13.7% to exchange-traded funds (ETFs), which are more popular among advisors managing less than $500 million.

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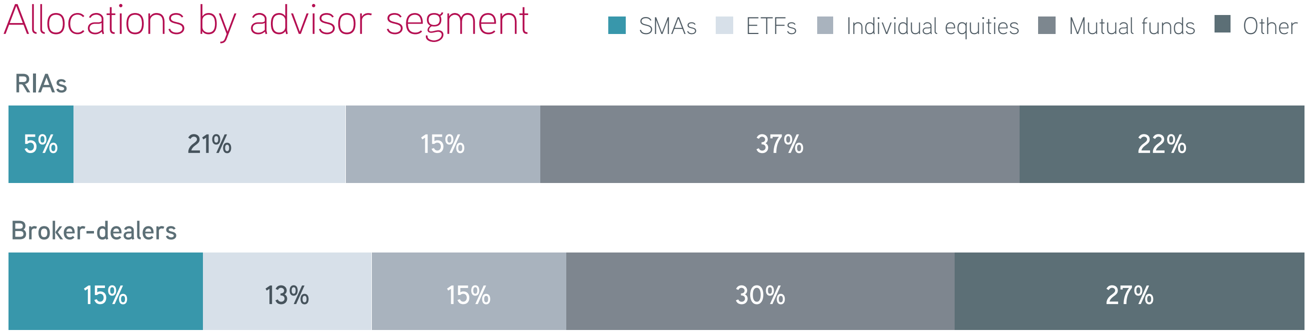
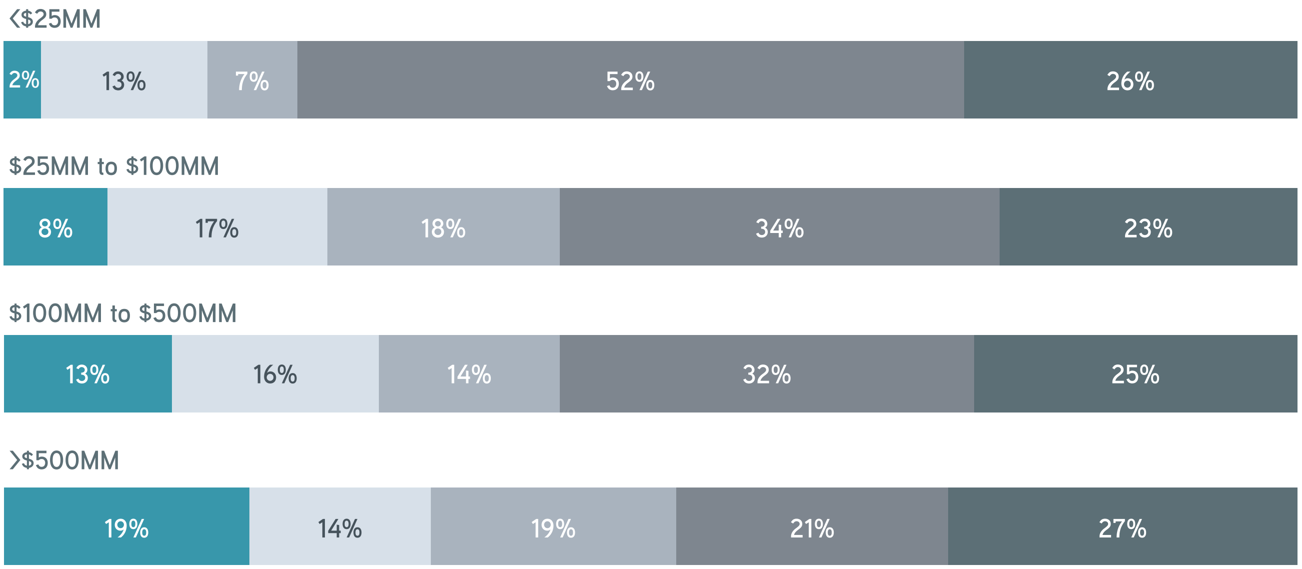
Allocations by advisor segment



Allocations by advisor AUM



Source: Cerulli Associates, 11/30/2021. For illustrative purposes only. Not a recommendation to buy or sell any security.

Among advisors who avoid direct indexing entirely, the majority claim they're satisfied with the solutions they currently recommend to clients. Advisors with established books of business are less inclined to make drastic changes to their offerings, preferring to project the confidence that comes with product familiarity. This, combined with a primary focus on risk management, suggests that many advisors prefer to stick to their established investment methodology—not an unreasonable attitude given the volatility of the COVID-19 pandemic years.

SMA allocations **rise** with assets under management.

Top reasons advisors don’t use direct indexing

59%
Satisfied with current solution

26%
Practice already customizes portfolios

21%
Clients understand other products better

17%
Too expensive

17%
Too many trade communications

16%
Too many holdings

Source: Cerulli Associates, 11/30/2021. For illustrative purposes only.

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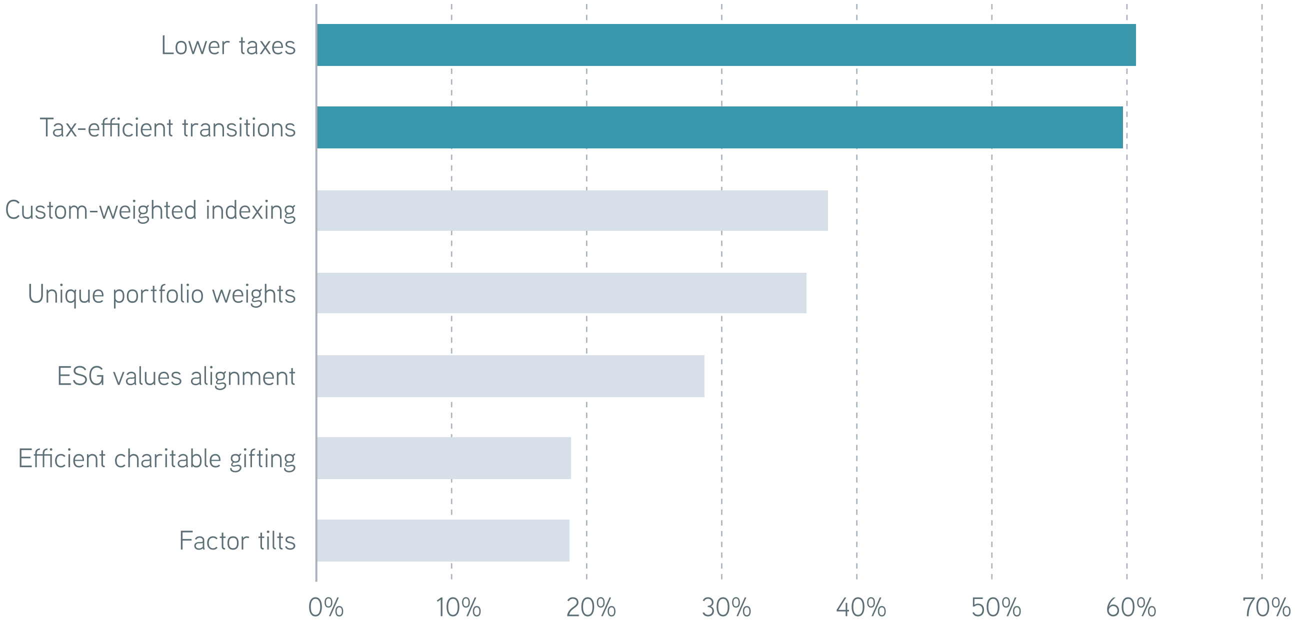
What's the appeal of direct indexing?

It comes as no surprise that advisors cite lower taxes as the main reason to embrace direct indexing. Besides the potential for smaller tax bills overall, individual security ownership can improve tax efficiency for investors transitioning between managers, making charitable contributions, and managing or unwinding concentrated positions. Accordingly, tax management is the top direct indexing customization that advisors implement. Coming in second is customized exposures: the ability for investors to apply custom weights to their underlying benchmarks. This makes direct indexing a viable choice for tax-exempt investors like institutions, especially those who are operating under ESG mandates and may wish to overweight or underweight securities depending on their mandate's criteria.

Most valued benefits of direct indexing



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More than half of advisors **wait for their clients** to broach the subject of responsible investing.

We were more surprised to learn that advisors are hesitant to discuss values alignment with individual investors. More than half wait for their clients to broach the subject, which may be a reason advisors claim low demand for responsible-investing solutions. About one-third of advisors view responsible investing as politically motivated and don't want clients to think they share those motivations. However, these views may change in the near future; advisors report that clients who are interested in environmental, social, and governance (ESG) investing skew younger and are only just beginning to build their capital.

Factors preventing advisors from adopting responsible investing

41%
Lack of investor demand

34%
Perception of politicization

32%
Perception of underperformance

28%
Unclear boundaries

28%
Doesn't fit into client policy statements

19%
Increased screening

Source: Cerulli Associates, 11/30/2021. For illustrative purposes only.

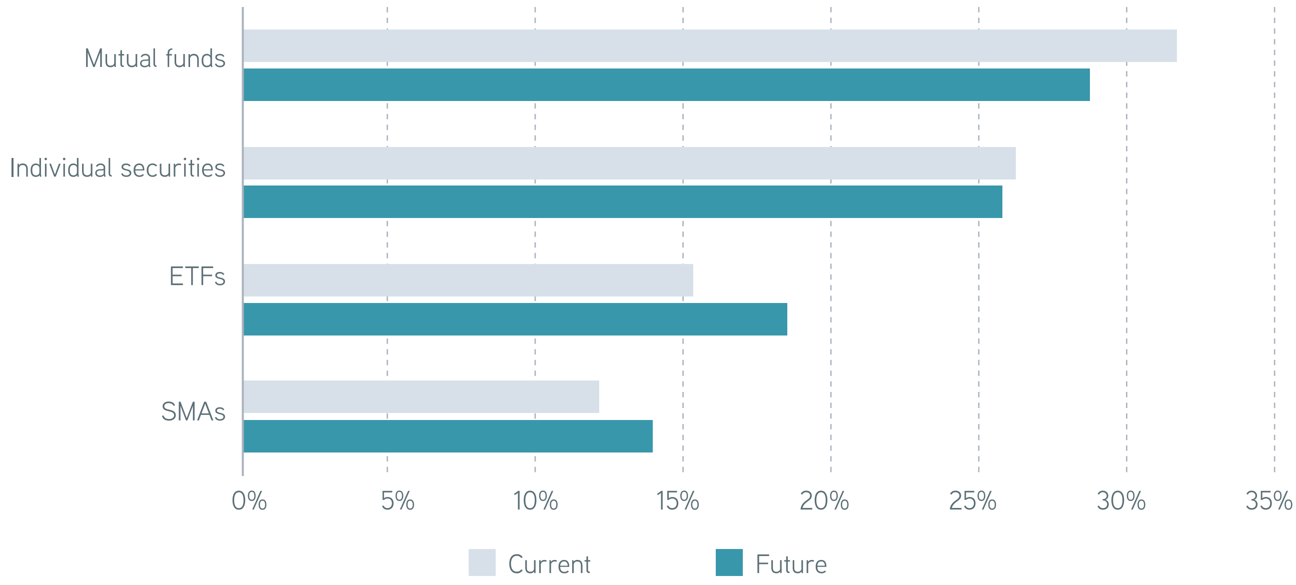
Advisors are **more willing than ever** to put client assets into passively managed vehicles.

What can direct indexing offer for advisors?

Direct indexing is nothing novel at Parametric. We've been recommending tax-managed custom SMAs to investors and advisors since 1992. But the very concept is proving new elsewhere in the industry, requiring many advisors to rethink their value propositions. To us, this is a good thing—more room for better client outcomes, advisor adoption, and category growth.

We see this growth potential as well in allocations to passive products. Mutual funds currently dominate advisor allocations, largely due to their long history in the market. But advisors are planning to pull back on mutual funds and individual securities. Across all channels and AUM bands, they're more willing than ever to put client assets into passively managed vehicles. Nearly one-third of advisors say they're allocating 26% to 50% of their AUM to passive products.

Current client asset distribution vs. expected distribution over the next two years



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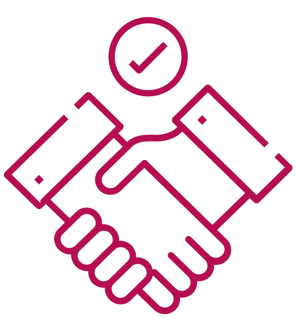
So why should advisors take the time to explore direct indexing? Consider the following:

- **Active tax management.** Filing time isn't the only time to look for opportunities to harvest tax losses. Year-round active tax management allows clients to capitalize on these opportunities on a strategic, security-specific basis—and to avoid big tax penalties for necessary investment decisions, such as transitioning portfolios and managing unrealized gains.
- **Customization.** Many passive investors look to the simplest broad-market index ETFs as a one-and-done core allocation. But cap-weighted indexes display ever-growing overweights to certain sectors, whose downturns can be a significant drag on the investor's entire portfolio. Turning to equal-weighted indexes, meanwhile, can reduce upside potential when those sectors are booming. A custom-weighted index can lower sector and concentration risk while giving investors the freedom to add or remove securities at will, without waiting for index providers to decide for them.
- **Choice in responsible investing.** Advisors shouldn't worry about how they'll look if they broach the subject of ESG. What matters is how the client defines responsible investing: their own ethics, their own objections, and their own preferences. Whether they'd rather screen out disagreeable securities or engage in the hope of changing the business's practices, direct indexing ensures they don't have to wait for responsible investing standards from on high.



The bottom line

Direct indexing gives advisors new ways to add value for their clients in a progressively more passive market. Parametric was among the first firms in direct indexing, but we're no longer alone. We've seen some of the biggest names in investing add or enhance custom passive SMA capabilities in recent months. By building partnerships with direct indexing providers, advisors can make their partnerships with investors stronger than ever.

Contact us

For more information regarding direct indexing, please contact your Parametric representative.

parametricportfolio.com

Learn more about what Parametric's direct indexing capabilities can do for your clients.

About

Parametric Portfolio Associates® LLC ("Parametric"), headquartered in Seattle, is registered as an investment advisor with the US Securities and Exchange Commission under the Investment Advisers Act of 1940. Parametric is a leading global asset management firm, providing investment strategies and customized exposure management directly to institutional investors and indirectly to individual investors through financial intermediaries. Parametric offers a variety of rules-based investment strategies, including alpha-seeking equity, fixed income, alternative, and options strategies. Parametric also offers implementation services, including customized equity, traditional overlay, and centralized portfolio management. Parametric is part of Morgan Stanley Investment Management, the asset management division of Morgan Stanley, and offers these capabilities through offices located in Seattle, Boston, Minneapolis, New York City, and Westport, Connecticut.

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There is no assurance that a separately managed account (SMA) will achieve its investment objective. SMAs are subject to market risk, which is the possibility that the market values of the securities in an account will decline and that the value of the securities may therefore be less than what you paid for them. Market values can change daily due to economic and other events (such as natural disasters, health crises, terrorism, conflicts, and social unrest) that affect markets, countries, companies, or governments. It is difficult to predict the timing, duration, and potential adverse effects (such as portfolio liquidity) of events. Accordingly, you can lose money investing in an SMA.

Investment strategies that seek to enhance after-tax performance may be unable to fully realize strategic gains or harvest losses due to various factors. Market conditions may limit the ability to generate tax losses. 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. Also, a tax-managed strategy may cause a client portfolio to hold a security in order to achieve more favorable tax treatment or to sell a security in order to create tax losses. Prospective investors should consult with a tax or legal advisor before making any investment decision.

An environmental, social, and governance (ESG) or responsible investing strategy limits the types and number of investment opportunities available to the investor. As a result, the investor's portfolio may underperform other investment strategies that do not have an ESG focus. The ESG investment strategy may result in investments in securities or industry sectors that underperform the market as a whole or underperform other strategies which apply ESG standards. An issuer's ESG performance or the investment advisor's assessment of such performance may change over time, which could cause the investor to temporarily hold securities that do not comply with the investor's responsible investment criteria. In evaluating an investment, the investment advisor is dependent upon information and data that may be incomplete, inaccurate or unavailable, which could adversely affect the analysis of the ESG factors relevant to a particular investment. Successful application of the investor's responsible investment strategy will depend on the investment advisor's skill in properly identifying and analyzing material ESG issues.

Parametric is located at 800 Fifth Avenue, Suite 2800, Seattle, WA 98104. For more information regarding Parametric, or to request a copy of Parametric's Form ADV or a list of composites, contact us at 206 694 5500 or visit www.parametricportfolio.com.

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