

# The Power of Direct Indexing Within a UMA

Direct Indexing has become a bit of a buzzword in the financial press. It sounds interesting, but do you really understand the power and potential applications of Directing Indexing for your clients? Why could Direct Indexing be a viable option for your clients?



While the decision to use a Direct Index is important, where you choose to house the solution is just as important. Most advisors nowadays use Direct Indexes as a standalone separate account (SMA). Worse yet, some use software to generate trade ideas for the advisor. In fact, according to the 2022 Cerulli Direct Indexing leaderboard, less than 2% of those \$208B in assets reported are held within a Unified Managed Account (UMA). Yet shockingly, it is within the UMA structure where the true power of Direct Indexing is unlocked. The intent of this paper is to provide advisors with an actionable blueprint on how to harness the power of the Direct Index and exploit the UMA structure to make it your highly differentiated competitive advantage.

### Let's Start with the What, then get to the Why of Direct Indexing?

Index investing has been popular for a number of years. The intent of index investing, also known as passive investments, has been to achieve a 'market return.' For highly efficient asset classes – such as Large Cap, fund managers rarely beat the benchmark. In fact, last year, according to Morningstar, only 26% of fund managers beat their benchmark. So, if excess returns are very difficult to get through active investing, why pay extra for it? This has traditionally been implemented via index mutual funds or ETFs that track an index like the S&P 500.

Direct Indexing involves owning all or a representative amount of the securities in an index directly versus through a mutual fund or an ETF. Direct Indexing offers your clients more control over their portfolio while still receiving the benefits of tracking an index. A study done by industry expert Cerulli Associates in August of 2021 showed that the projected five-year growth rate of accounts using direct indexing at 12.4%. This exceeds growth rates for ETFs (11.3%), SMA programs (9.4%) and mutual funds (3.3%).

Innovations in digital investing platforms fueled by technology have made Direct Indexing a more accessible and practical solution for investors seeking more customization in their portfolio. Direct Indexing opens new avenues in investing for your clients. It also offers a wealth of opportunities for those advisors who can master how they construct Direct Indexes for their clients. Perhaps of equal or greater importance is how Direct Indexing is offered.

> 2%

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#### Cerulli Associates in August of 2021





## The Problems Direct Indexing Solves When Used in a UMA

### 1. Tax Management

One of the main benefits of Direct Indexing is the tax planning flexibility. Tax alpha represents actual client savings we've seen with clients here at Adhesion who utilize our ongoing tax harvesting program. It is defined as the percentage improvement in returns from reduced tax liabilities. A recent study showed that advisor clients using this approach via Direct Indexing achieved a 21% improvement in their tax alpha versus those not using a Direct Indexing approach on our platform. For example, one of the most often mentioned tax strategies is tax-loss harvesting. The rules regarding the use of tax losses on your client's taxes are very clear. If they violate the wash-sale rule, deducting those tax losses is negated.

One of the easiest ways to trigger the wash-sale rule is to have client assets spread over a number of different taxable investments. It is easy to inadvertently purchase a security that was sold at a loss within the 60-day time frame and trigger the wash sale rule.

A UMA can help solve this issue as it is designed to house investments of various types all in one account. This arrangement allows advisors and clients to hold investments of all kinds in one place, making monitoring all activity much easier. The likelihood of an inadvertent violation of the wash sale is much less likely when all investment assets are held in a single UMA.

### 2. Core Satellite Allocations

An additional benefit of using Directing Indexing within a UMA is the core satellite asset allocations. It generally refers to building a core of indexed investments and adding satellite allocations to active managers, specific industries, sectors, or

# 21%

improvement in their tax alpha versus those not using a Direct Indexing approach on our platform.

asset classes to tilt the portfolio in a direction directly aligned with the client's goals. A UMA allows the entire allocation to be managed on a single platform to facilitate rebalancing, asset allocation changes, cash management and allocating new investments.

### 3. Cost Savings

In this era of advisor fee compression, the lower product costs of Direct Indexing allow you to demonstrate value to clients and prospects in terms of how your investment approach will lower their overall cost of investing. Direct Index fees are significantly lower than actively managed portfolios, so using Direct Indexes as the primary investment vehicle or combined in a core satellite allocation can significantly reduce the asset management expenses of a portfolio.

An additional cost saving benefit of a UMA platform is having access to hundreds of manager relationships versus reaching agreements individually with each manager outside of a UMA. Fees are typically lower for managers within a UMA. This can remove pressure on you to lower your advisory fees, thus helping protect your bottom line.



#### 4. Investment Personalization

A Direct Index can be aligned with the client's situation, whether this involves a factor tilt, focusing on SRI/ESG issues, or aligned to compensate for a concentrated stock position held elsewhere. As every advisor knows, each client is unique and has a different situation. Unfortunately, index mutual funds and ETFs are generally all the same to the extent that they don't allow for any level of personalization.

Direct indexing inside a UMA offers a potentially excellent solution for clients who can benefit from an indexing approach but whose situation lends itself to more personalization. This personalization could be in the form of a client wanting to tailor their indexing towards ESG or SRI by including or excluding certain holdings in their customized Direct Index.

#### 5. Handling of Concentrated Stock Positions

Investment personalization also works well for clients with concentrated positions elsewhere in their portfolio. The Direct Index can be customized to reduce or eliminate that holding from inclusion in the index. Personalization can also adjust the level of holdings in the sector of the concentrated position. For example, if the concentrated position is in a major tech stock, the index can be personalized around that holding.

If you have clients where concentrated positions are more the norm rather than the exception, touting your ability and willingness to design customized Direct Indexes to meet their portfolio needs can be a way to appeal to these clients' needs.

#### 6. Additional Revenue Stream

Advisors can develop their own series of Direct Indexes tailored to different client objectives. They can white label their indexes and layer an advisor fee on them for clients. The fee would be a part of their overall advisory fee structure.

Adhesion Wealth Advisor Solutions regularly partners with advisors to help them build and maintain custom Direct Indexes on the Adhesion platform. If presented compellingly, this experience can be a difference maker for existing and prospective clients and can provide a new revenue stream from the advisory fees from the customized indexes.

#### 7. Breakaway Legacy Assets

When leaving a firm and bringing client assets to your new firm, clients often may have long-time holdings with a low basis. As a result, many firms force clients to sell these positions and start from scratch on their platform. This can trigger hefty capital gains taxes for these clients. Adhesion can absorb low basis holdings for breakaways and their clients by building a Direct Index within our UMA. The portfolio will likely see lower turnover and trading activity by absorbing holdings from a satellite manager into a Direct Index.

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## Summary

Direct Indexing is here as a mainstream investment option for HNW clients. Your competitors will likely be offering Direct Indexing. You should be too, but you should be offering a better version of direct indexing. Adhesion's UMA is a highly differentiated solution.

Using a UMA in conjunction with Direct Indexing offers a comprehensive and potentially beneficial solution. Not only can you provide Direct Indexing, but you can also do this in conjunction with managing all of their assets in one place. This promotes tax-efficiency and makes asset allocation decisions easier.

While we've discussed UMAs and Direct Indexing in the context of taxable accounts, there are applications for IRAs and other tax-advantaged accounts as well.



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Give us a call to learn more about Direct Indexing and UMAs, and how a partnership with Adhesion can potentially benefit your clients and your advisory practice in this competitive environment.

Call 888-295-8351, email [sales@adhesionwealth.com](mailto:sales@adhesionwealth.com), or visit [www.adhesionwealth.com](http://www.adhesionwealth.com).



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