What Tailor-Made Investing Looks Like

Disruptive Forces in Investing **January 9, 2024**

Anu Rajakumar: In the last decade, capital flows into passive strategies occurred at an unprecedented pace as the investment industry met a need for low-cost instruments to gain broad market exposure. But today's investors are increasingly seeking tailored solutions, designed to meet their own unique needs, whether those are related to taxes, investment returns, income needs, or ESG preferences to name a few. Custom Direct Investing has emerged as a potential major disruption in the investment management industry. But what exactly is Custom Direct Investing, and why could it be a credible threat to other investment vehicles? My name is Anu Rajakumar, and to answer those questions and more, I'm pleased to welcome Jacob Greene, Head Strategist for Neuberger Berman's Custom Direct Investing group.

Jacob, it's great to have you on the show, and especially to kick off the first episode of 2024.

Jacob: Thanks, Anu. Great to be here.

Anu: So, Jacob, Custom Direct Investing has been touted as disruptive and the next major evolution in investment management, but let's take a step back and perhaps you can give some context as to why this is so important, and also why you think it's finding its stride right now.

Jacob: We'll start with the premise that each client has their own goals and objectives. Your goals may be different than my goals, may be different than a large endowment's goals, but each of those need to be met. And so our objective with custom investing is to help investment professionals meet the needs of each one of these investors, whether it's an institution or an individual.

Historically, what's prevented them from doing that is mutual funds and ETFs are the common way that investors access the markets. These are commingled vehicles. So, structurally, they can't make adjustments for each individual client. What we're looking to do is unwrap the investment vehicle, and we're doing that to deliver better value to end investors. The form that that takes is taxable clients can now take control of their after-tax experience. Other benefits--you can transition existing portfolio positions; you don't have to fund with cash. You have a stock concentration; you can build around that. Custom exposures, turning religious beliefs into being incorporated in the investment portfolio. So all of these are unique needs that clients come to us with, and we can help build for them.

Why now? In terms of trends, it's technology has gotten better, which allows us to do this in a scalable manner. Trading costs have come down. So the cost of us trading individual securities and many of them for a client is no longer a big hurdle. And then there's the demand all around us. With the digital age, we now have access to products across our life, and we've come to expect that things could be tailored to our individual needs. Investments are no different. It's just the starting point for being able to get there so that we can deliver tailored solutions.

Anu: Terrific. That's a lot of great background. It sounds like, you know, Custom Direct Investing really means putting the investor back into the driver's seat, taking control, and as you said, unwrapping the investment vehicle to be really customized for individuals. So, as you look at the audiences that are potential targets for Custom Direct Investing, tell us about any observed trends in terms of demand.

Jacob: First is demand is growing significantly. This is still a relatively new space, but it is a big focus of the investment industry. If we think about it from a tax lens, it's going to be clients who are in higher tax brackets, clients who have a lot of capital gains as well. So, they may be private equity investors, they may have a lot of real estate, but they have some type of tax liability that they're looking to match against.

The other thing is with the changing dynamics of transfer of wealth, of engaging more taxable money across families, it helps engage other members of the family that might otherwise be disinterested or may not come to the table that could be meeting them in terms of their values, but some of it is with the wealth transfer taking place, and it's going to be one of the largest we've ever seen, getting ahead of that from a tax perspective, figuring out where the generations want to be invested, how they want to be invested.

And as we look globally, ESG is a big trend. And so you could have European investors approaching this and saying, "I want better ESG scores, but I want ESG incorporated how I define it." Being able to meet that. So it is a broad and quickly growing audience that we're seeing.

Anu: Yeah, absolutely. it's a great point and that transfer of wealth theme is something that, you know, Stephanie Luedke spoke about in great depth in an episode last year, certainly a key theme, as you said, engaging multiple generations of investors and aligning to their own values.

Jacob, you mentioned tax efficiencies. Let's dig into that a little bit. Just walk us through an example of how taxes are considered in these kind of portfolios, just to kind of bring it to life for our listeners.

Jacob: Yeah. First and foremost, tax hasn't been considered in the investment industry. It is an institutional world, and it has been. We're looking to shift that. We think it's important, and we could show the value for clients to see after-tax results. I always equate it to looking at your paycheck. Seeing the gross number is great. You really care about the net number because it's what's hitting your pocket. It's no different with the investment returns.

And especially in the U.S. right now, you have capital gains rates that are very high. You're looking at 30% in some areas on long-term positions. For positions held less than a year, it can be greater than 50%. That means [if] you make $100 in investments, you're only walking away with $50 after-tax. We all look around investment products and-and figure out how to do the best for individuals, this is the biggest drag that they're facing. So what steps can we take?

One, it's unwrapping it, buying individual securities in a separately managed account, or SMA, and then being able to use tools once we hold those positions. Tax loss harvesting is one of the largest. Conceptually, you buy a position, it goes down in value. If you sell that position, you now have a realized loss. That loss can be used against a gain elsewhere to lessen the tax bill that you're paying. That allows you to keep more money invested in the markets.

Same on the other side. Stock goes up. If you sell it, you're paying a tax, so maybe I don't want to sell it. Maybe I want to let that go, so I can *not* pay a larger tax bill this year. Being able to use those pieces in conjunction, and do it on a systematic basis day in, day out, holds real value. We've seen for individual investors, 1% to 2% of annualized benefit after tax. That's versus a passive index. On some of the actively managed portfolios, that can be 3% to 6% annualized.

So as we look at what is important, what do I need to be monitoring? It is these after-tax returns. That's focused in the US. There are other areas that this comes into play as well. You can think about Canada and Australia. These are other tax jurisdictions where clients can tax manage and see some benefit from doing so.

Anu: No, that's great. And to see the kind of proof in the pudding that this really does add critical value to clients is terrific. You know, you mentioned, SMAs, maybe you can just talk a little bit about vehicles that investors may use in this context.

Jacob: Historically, it's been mutual funds and ETFs. Mutual funds were introduced in the 1940s, ETFs making more headway [in the] '90s, 2000s, and becoming the key vehicle. I'll go back to those structural challenges. They are commingled vehicles. Everyone gets the exact same experience. SMAs are the unlocking of that and buying the individual securities in a client or in an institution's name(s) so that they own it. They then have the ability to do what they choose with that and to take into consideration some of their values. So it's taking that step forward.

In terms of tax, that can be meaningful. A mutual fund often will pass through a capital gain regardless of whether you sold anything that year. That means lessening the return for an investor. We've seen across Morningstar groups, that can be a couple percent of tax drag that you're facing. No fault of your own.

On the other side with the separate account, we can go ahead, we can do what I was mentioning, the loss harvesting, the gain deferral. We can add a couple percent of tax alpha. So now you're talking potentially 5% swing in benefit that a client can get. This is extremely meaningful while meeting those other individual benefits. So you have a stock concentration, we can help build around that. You want to fund in kind, you can do that.

We had a client recently approach us here in the U.S., they have Sharia beliefs, and they wanted that translated into their portfolio. The commingled vehicles out there didn't quite meet that, and they were expensive. So we were able to help tailor a portfolio just for them that helps them get the investment exposure they want while taking their values into account. And we're seeing that piece grow a lot in Europe and in other parts of the world as well.

Anu: Yeah, no, thank you very much. Makes sense. You know, as I was thinking about this, Jacob, you know, at Neuberger, we're obviously an active manager. How does Custom Direct Investing complement or kind of live within this world of having some high conviction, active management in a portfolio as well?

Jacob: Yeah. Historically, this has been focused on the passive space. You hear the term direct indexing out there, that's gained a lot of popularity. We've actually looked to expand this into active equity as well because we do think tax management needs to be holistic, needs to be expanded.

And so, what we're doing is taking the same customization and overlaying that on an active equity portfolio. If we think about what an active equity portfolio manager, a stock picker is meant to do, it's "buy low, sell high." That's the goal. The problem is for a taxable payer—that is tax inefficient. It's going to create a drag, and it's going to pull back. So you're not actually getting the full benefit that they offer. We can help protect the pre-tax stock pickers alpha on an after-tax basis. So that's where I mentioned the 3% to 6% tax alpha earlier. And then when you take a core-satellite approach, you have passive and active for the same client. Consider wash sales across those, get consistent customization across those. As you look to fund them with existing securities, being able to split out the securities, fund them in kind so you're not paying the tax bill upfront. So it really is the same conversation. What we're looking to do is break down some of these terms that have been very narrow, and instead just focus on client customization, client tax management, regardless of what the underlying portfolio is.

Anu: Great. You already shared a few comments just showing the difference between these custom direct portfolios versus passive components. Are there any additional pros and cons that investors should be considering as we think about whether they want to make a shift from, again, their commingled passive index fund or their passive ETF into maybe shifting towards something like this?

Jacob: Yeah. So the pros, the tax benefit, the ability to build around risk and monitor something, it's not a free lunch. You do have some type of risk deviation that you get. You give up something on a pre-tax basis. You do that in order to get a better after-tax return, or to get the better custom return. So there is that deviation. The other thing is, as this becomes more talked about, there's a view that this is technology, and it's not just a technology offering. This is [an] investment tool that investment professionals can help deliver. I think about it like getting on an airplane. As airplanes become better, they can do more to fly themselves, but most of us don't want to step on an airplane without seeing a pilot who looks experienced in the cockpit—knowing that for takeoff, for landing, for when you hit turbulence—may be peace of mind.

Anu: Mm-hmm.

Jacob: But it is oversight. It's those risk controls that you have in place. And at the end of the day, this is an investment. This is something that people are using to meet their long-term goals. It's not something to let out of sight there.

Anu: Yeah, it's a great point. As we start to wrap up here, Jacob, I'd love to get your outlook on kind of where you see the space evolving in the future. As you said, these are still, you know, kind of the early days of Custom Direct Investing. I'm curious about what excites you the most.

Jacob: I'm excited for clients to be looking at after-tax returns across the board. It's-it's too meaningful for it to not be happening. Uh, the other thing is, I'm excited for this to go beyond just where we've seen equity exposure. So we've already gone from just passive to passive and active. Now, what can we do in Munis? What can we do in corporate bonds? How can we start to bring all of this together and have clients looking across everything and seeing after-tax results?

Anu: Great. So it sounds like we can expect a more holistic approach to this customization, this tailoring for investors. I'm sure that's something that a lot of folks can get on board with.

Jacob: Definitely.

Anu: All right. So I can't let you go without a bonus question, Jacob. So today we've been speaking a lot about customization. And I wanted to ask you, if you had a blank slate for a day that you could customize however you want, to do whatever Jacob wants to do, how would you spend your customized Jacob Greene Day?

Jacob: Ooh, that's a good question. Uh, don't get many of those. [laughter]. So the day would definitely include record shopping. I'm a big music fan, big record buyer. So I would be going to some of my favorite record stores in New York. Likely going to find

	a good bagel or piece of pizza. Can't miss the good food options we have around here. And then, ending the day with maybe even both a live sporting event and a concert. So get all of those in.
Anu:	Get ‘em back-to-back, why not?
Jacob:	I'm not worried about sleep. Yeah.
Anu:	It's your day. You can do whatever you like.
Jacob:	So, that sounds like a dream day to me.
Anu:	That sounds lovely. Thank you very much for sharing. Jacob, you shared a lot of great context about Custom Direct Investing. You've laid the case for this to be kind of the next evolution of portfolio management. We talked a lot about the ability to customize for investors, and really giving them back control of the underlying securities while, you know, capturing tax savings and efficiencies or personal values. And I think that's a story that will likely resonate with a lot of our listeners. And I think, no doubt, keep you and your team very busy for a long time to come. So, Jacob, thank you once again for coming on the show.
Jacob:	Thanks so much for having me, Anu.
Anu:	And to our listeners, if you've enjoyed what you've heard today on *Disruptive Forces*, you can subscribe to the show via Apple Podcasts, Google Podcast, or Spotify, or you can visit our website, www.nb.com/disruptive forces for previous episodes as well as more information about our firm and offerings.