NEUBERGER BERMAN

AN ACTIVE LOOK AT CUSTOM SMAS

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Direct indexing has brought customization to the investment world at large as several asset managers recently made headlines by acquiring independently owned shops that invest directly in the underlying stocks of market indices rather than in ETFs or mutual funds. McKinsey reports that assets under management in direct indexing have tripled over the last three years to $215 billion, and could double by 2025.[1]

Why do asset managers see potential in serving clients through direct indexing SMAs?

By leveraging technology, providers can customize portfolios based on an individual client's investment needs, allowing advisors to look beyond generic vehicles such as ETFs and mutual funds to account for the client's liability stream, risk profile and charitable gifting in ways not contemplated a few years ago.

Consider that for taxable clients, taxes are the largest expense—not trading costs, custody, or management fees. One of the biggest advantages of an SMA is the ability to pass-through losses directly to the client to apply against capital gain liabilities—which is not available with mutual funds or ETFs. For clients seeking index exposures, this tax-management benefit can potentially result in 1-2% additional after-tax alpha.[2]

The question we find ourselves asking is, why limit this level of customization to only passive index exposure?

Broadening the scope from direct indexing to what we call direct investing, advisors and clients may benefit from applying the same customization to active, hedged or client-designed strategies alongside their core allocation.

When investing in an active management strategy, consider the following:

- The primary vehicle available to investors are mutual funds, which can be relatively tax-inefficient.
- Looking across the Morningstar U.S. Equity Large Blend category, taxes paid (pre-tax return minus after-tax return) are around 3.2% over the last 10 years, on average; the amount is similar for U.S. Equity Small Blend.[3]
- As a result, an investor seeing a 10% annualized pre-tax return may receive only 7% after-tax.
- With tax-efficient SMAs, this tax drag on pre-tax capital can be reduced, or potentially eliminated, given the ability to harvest losses.

This after-tax benefit is just one feature of custom SMAs, clients can also create completion portfolios, add factor tilts and incorporate ESG values into their investments.

Advisors also greatly benefit, as taking advantage of a direct investing platform offers streamlined operations from digital client account opening to reporting after-tax performance, all leveraging cloud-based architecture. This frees up more capacity for an advisor to focus on meaningful client engagement.

We are still in the early innings of direct investing, but we believe investors are better served by advisors being able to align their investment, liability, and risk objectives through customized SMAs.

[1]Source: "Direct Indexing Assets to Double by 2025: McKinsey," FundFire, Oct 6, 2021. [2]Tax Alpha is defined as net after-tax excess returns minus net pre-tax excess returns. Excess returns are portfolio returns minus benchmark returns.

[3]Source: Morningstar.

Fund Category Definitions:

Large Blend: Large-blend portfolios are fairly representative of the overall U.S. stock market in size, growth rates, and price. Stocks in the top 70% of the capitalization of the U.S. equity market are defined as large cap. The blend style is assigned to portfolios where neither growth nor value characteristics predominate. These portfolios tend to invest across the spectrum of U.S. industries, and owing to their broad exposure, the portfolios' returns are often similar to those of the S&P 500 Index.
Small Blend: Small-blend portfolios favor U.S. firms at the smaller end of the market-capitalization range. Some aim to own an array of value and growth stocks while others employ a discipline that leads to holdings with valuations and growth rates close to the small-cap averages. Stocks in the bottom 10% of the capitalization of the U.S. equity market are defined as small cap. The blend style is assigned to portfolios where neither growth nor value characteristics predominate.