



Direct Indexing: Potential Tax Savings and Flexibility

Direct Indexing: Potential Tax Savings and Flexibility

Alan Guerry

Vice President, Financial Advisor, Portfolio Management Director

June 2024

Introduction

Investors today have a wide array of strategies and tools at their disposal, ranging from traditional mutual funds to exchange-traded funds (ETFs). However, one lesser known but increasingly popular strategy is **direct indexing**. This approach not only seeks to replicate the performance of an index but also offers opportunities for greater *tax efficiency* and *individual customization*.

Let's explore the concept of direct indexing, its potential benefits, and whether it might be the right strategy for you.

What is Direct Indexing and How Does it Work?

Direct indexing is an investment strategy where an investor directly owns the individual stocks within an index, such as the S&P 500, through a separately managed account. Unlike traditional index funds or ETFs that pool investors' money to buy shares of a fund, direct indexing involves purchasing the actual stocks that make up the index. This approach offers greater control over investments, along with unique *tax advantages* and *customization options*.

With direct indexing, an investment manager uses optimization software to select a sample of stocks from the index. This selection aims to closely mirror the index's performance while allowing for more personalized investment choices. The direct ownership of stocks

means investors can make strategic decisions about each individual security, potentially enhancing their overall investment strategy.

Tax Benefits of Direct Indexing

One of the most compelling advantages of direct indexing is **the potential for significant tax benefits**, particularly through a strategy known as [tax-loss harvesting](#).

Tax-loss harvesting involves selling securities that have declined in value to realize losses. These losses can then be used to offset capital gains and potentially reduce your taxable income.

By systematically identifying and selling these underperforming stocks throughout the year, investors can minimize their tax liability in a way that's not possible with traditional mutual funds or ETFs.

For example, if you own a direct indexing portfolio and one of the stocks in the index declines in value, you can sell that stock to "harvest" the loss. This harvested loss can offset *capital gains* from other *appreciated stocks or investments*, **reducing your overall capital gains tax**.

Even if you haven't realized any capital gains in a given year, you can still use up to \$3,000 of realized losses to **offset your ordinary income**ⁱ. Any remaining losses can be carried forward to future years, providing a long-term tax advantage.

Morgan Stanley's research has demonstrated that systematic, year-round tax-loss harvesting can significantly enhance after-tax returns compared to traditional index-tracking fundsⁱⁱ. In both historical and forward-looking simulations, direct indexing strategies with this approach were more likely to deliver **greater after-tax returns** than passive ETFs. This makes direct indexing an appealing choice for investors aiming to enhance their portfolios for tax efficiency.

By taking advantage of tax-loss harvesting, investors can potentially reduce the tax impact on their investment gains and improve their overall returns.

Customizing Investments to Meet Goals and Values

Another major benefit of direct indexing is the ability to **customize** your portfolio to align with your specific financial goals. Unlike index ETFs, which offer a fixed basket of stocks, direct indexing allows investors to tailor their holdings according to their preferences and objectives.

For instance, if you have a **concentrated stock position** in your portfolio, you may be able to diversify around that position with direct indexing. Similarly, if you wish to avoid certain industries or companies, you can exclude those from your portfolio.

Potential Downsides of Direct Indexing

As with most investment strategies, there are limitations to consider before you dive into direct indexing. For example, the strategy may lead to higher management fees than investing in similar ETF strategies, because the level of customization may involve buying and selling securities that can lead to higher transaction costs. However, depending on your individual portfolio, the potential tax savings from harvesting losses may help to offset those costs.

In addition, when owning individual securities, direct indexing typically requires a relatively high minimum investment of \$250,000. As such, if you're interested in direct indexing but have assets held across multiple accounts at different institutions, you may need to consolidate your investments with a single Financial Advisor to realize the full potential of this strategy.

Is Direct Indexing the Right Strategy for You?

Direct indexing can be highly beneficial, particularly for high-net-worth individuals looking for tax-efficient investment strategies. However, it requires a disciplined approach and the guidance of a knowledgeable financial advisor to manage the complexities associated with the strategy.

One advantage I can bring to the table as a Morgan Stanley Financial Advisor is [Tax Management Tools](#), a suite of solutions to help implement a tax saving strategies tailored to your unique needs.

Conclusion

Direct indexing presents a compelling investment strategy for those seeking greater tax efficiency and personalized portfolio management. By leveraging tax-loss harvesting and customizing your investments, you can potentially *enhance your after-tax returns* and *align your portfolio with your financial goals*. Direct indexing can be beneficial, but it typically requires a disciplined approach. Ask your Morgan Stanley Financial Advisor if the strategy may be right for you.

ⁱ [Topic no. 409, Capital gains and losses | Internal Revenue Service \(irs.gov\)](#)

ⁱⁱ <https://www.morganstanley.com/articles/what-is-direct-indexing-benefits>

Our simulations assumed that the investment manager was implementing direct-indexing strategies that involved systematic, year-round tax-loss harvesting and was responsible for determining whether to recognize losses.

Disclosures

Index Definitions:

Russell 3000 Index: Russell 3000 Index measures the performance of the 3,000 largest US companies based on total market capitalization.

S&P 500 Index: The Standard & Poor's (S&P) 500 Index tracks the performance of 500 widely held, large-capitalization US stocks.

Morgan Stanley Smith Barney LLC, its affiliates, Financial Advisors and Private Wealth Advisors do not provide tax or legal advice. Clients should consult their tax advisor for matters involving taxation and tax planning and their attorney for matters involving trust and estate planning and other legal matters.

Direct Indexing may adversely impact account performance. There is no guarantee that Direct indexing will produce the desired tax results. Morgan Stanley offers investment program services through a variety of investment programs, which are opened pursuant to written client agreements. Each program offers investment managers, funds and features that are not available in other programs; conversely, some investment managers, funds or investment strategies may be available in more than one program. Morgan Stanley's investment advisory programs may require a minimum asset level and, depending on a client's specific investment objectives and financial position, may not be appropriate for the client. Please see the applicable program disclosure document for more information, available at www.morganstanley.com/ADV or from your Financial Advisor.

Tax-loss harvesting. IRS rules stipulate that if a security is sold by an investor at a tax loss, the tax loss will not be currently usable if the investor has acquired (or has entered into a contract or option on) the same or substantially identical securities 30 days before or after the sale that generated the loss. This so-called "wash sale" rule is applied with respect to all of the investor's transactions across all accounts.

Equity securities may fluctuate in response to news on companies, industries, market conditions and general economic environment.

An investment in an **exchange-traded fund** involves risks similar to those of investing in a broadly based portfolio of equity securities traded on an exchange in the relevant securities market, such as market fluctuations caused by such factors as economic and political developments, changes in interest rates and perceived trends in stock and bond prices. Investing in an international ETF also involves certain risks and considerations not typically associated with investing in an ETF that invests in the securities of U.S. issues, such as political, currency, economic and market risks. These risks are magnified in countries with emerging markets since these countries may have relatively unstable governments and less established markets and economics. ETFs investing in physical commodities and commodity or currency futures have special tax considerations. Physical commodities may be treated as collectibles subject to a maximum 28% long-term capital gains rates, while futures are marked-to-market and may be subject to a blended 60% long- and 40% short-term capital gains tax rate. Rolling futures positions may create taxable events. For specifics and a greater explanation of

possible risks with ETFs, along with the ETF's investment objectives, charges and expenses, please consult a copy of the ETF's prospectus. Investing in sectors may be more volatile than diversifying across many industries. The investment return and principal value of ETF investments will fluctuate, so an investor's ETF shares (Creation Units), if or when sold, may be worth more or less than the original cost. ETFs are redeemable only in Creation Unit size through an Authorized Participant and are not individually redeemable from an ETF.

Investors should carefully consider the investment objectives and risks as well as charges and expenses of an exchange-traded fund or mutual fund before investing. The prospectus contains this and other important information about the mutual fund. To obtain a prospectus, contact your Financial Advisor or visit the mutual fund company's website. Please read the prospectus carefully before investing.

The returns on a portfolio consisting primarily of **environmental, social, and governance-aware investments (ESG)** may be lower or higher than a portfolio that is more diversified or where decisions are based solely on investment considerations. Because ESG criteria exclude some investments, investors may not be able to take advantage of the same opportunities or market trends as investors that do not use such criteria. The companies identified and investment examples are for illustrative purposes only and should not be deemed a recommendation to purchase, hold or sell any securities or investment products. They are intended to demonstrate the approaches taken by managers who focus on ESG criteria in their investment strategy. There can be no guarantee that a client's account will be managed as described herein. **Rebalancing** does not protect against a loss in declining financial markets. There may be a potential tax implication with a rebalancing strategy. Investors should consult with their tax advisor before implementing such a strategy.

Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns include the reinvestment of all dividends, but do not reflect the payment of transaction costs, advisory fees or expenses that are associated with an investment. Performance of indices may be more or less volatile than any investment product. The risk of loss in value of a specific investment is not the same as the risk of loss in a broad market index.

Strategy May Be Available as a Separately Managed Account or Mutual Fund

Strategies are sometimes available in Morgan Stanley Wealth Management investment advisory programs both in the form of a separately managed account ("SMA") and a mutual fund. These may have different expenses and investment minimums. Your Financial Advisor or Private Wealth Advisor can provide more information on whether any particular strategy is available in more than one form in a particular investment advisory program.

Overlay Managers or Executing Sub-Managers ("managers") in some of Morgan Stanley's Separately Managed Account ("SMA") programs may affect transactions through broker-dealers other than Morgan Stanley or our affiliates. If your manager trades with another firm, you may be assessed costs by the other firm in addition to Morgan Stanley's fees. Those costs will be included in the net price of the security, not separately reported on trade confirmations or account statements. Certain managers have historically directed most, if not all, of their trades to outside firms. Information provided by managers concerning trade execution away from Morgan Stanley is summarized at: www.morganstanley.com/wealth/investmentsolutions/pdfs/adv/sotresponse.pdf. For more information on trading and costs, please refer to the ADV Brochure for your program(s), available at www.morganstanley.com/ADV, or contact your Financial Advisor/Private Wealth Advisor.

Diversification does not guarantee a profit or protect against loss in a declining financial market.