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Getting Started With Direct Indexing

What is direct indexing, and how does it work?

- Direct indexing strategies aim to deliver the pretax returns of an equity index, like the S&P 500, similar to a passive exchange-traded fund (ETF).
- Investment managers implement direct indexing strategies through separately managed accounts (SMAs). The direct ownership of underlying stocks that make up the index allows for security-level purchases and sales.

What are the benefits of direct indexing strategies?

- Tax-loss harvesting
- Customization to feature or avoid certain exposures, such as sectors, factors, themes or environmental, social and governance (ESG) metrics
- Thoughtful portfolio onboarding, including existing holdings, and tax-optimized charitable giving through appreciated securities

How do direct indexing strategies compare to other passive and active strategies?

The darker green shading below indicates a relatively more favorable feature among the various implementation strategies.

Implementation Strategy	ETF, Index-Tracking	ETF, Factor Investing	Direct Indexing, SMAs	Active, SMAs	Active, Commingled
Fund With	Cash	Cash	Existing positions (stocks, ETFs)	Stocks, assuming overlap with manager holdings	Cash
Objective	Index replication	Factor tilts	Tax-loss harvesting; factor or ESG tilts	Security selection; factor tilts; (potential;) tax-loss harvesting	Security selection; factor tilts
Expense Ratio	Lowest	Low	Lowest to low	Low	Highest
Allowable Customization	None	Beyond initial exposure selection, none	Yes, including factor or ESG tilts, sensitivity to existing holdings, and tax-loss harvesting	Beyond initial exposure selection, typically limited to negative screening	Beyond initial exposure selection, none
Tax-Loss Harvesting	Limited to entity level	Limited to entity level	Yes, effective to the single-security level	Yes, but more limited than direct indexing	Limited to entity level
Tracking Error	Lowest	Medium	Low	Highest	Highest
Liquidity	T+1	T+1	T+1	T+1	T+1

Source: Morgan Stanley Wealth Management Portfolio Analytics

How do direct indexing strategies enhance a portfolio's overall tax efficiency?

- Ownership of the underlying securities can unlock opportunities to harvest capital losses at the single-security level.
- Tax-loss harvesting involves selling investments in your portfolio at a loss—and using those losses to offset your realized or potential future gains.
- Direct indexing may provide similar pretax returns to a passive ETF, but deliver intermediate realized capital losses, or (positive) "tax alpha."

What are the customization benefits of direct indexing?

- Index selection: Investors can select an appropriate reference index, typically driven by the strategy's place in an overall asset allocation. For example, the S&P 500 for large cap US stocks, or the MSCI EAFE for international stocks.
- Exposure tilting: Investors can identify exposure tilts to feature or avoid. Examples: featuring companies with favorable environmental characteristics or avoiding companies with high levels of carbon emissions.

How does direct indexing compare to ETFs and mutual funds?

Passive index-tracking ETFs:

- In both historical and forward-looking testing, direct indexing strategies delivered greater after-tax returns, implying tax alpha, and achieved those marks with a high probability of success.

Active investment strategies, such as mutual funds:

- Direct indexing strategies achieved favorable hypothetical, historical post-tax returns relative to the Morningstar investment strategies universe for major US equity categories.
- In forward-looking testing, direct indexing strategies tended to outperform with higher income levels—due to higher tax rates and more favorable tax-loss harvesting opportunities—and shorter investment horizons.
- Lower volatility levels appeared to extend the time horizon of effectiveness for tax-loss harvesting.
- Index price returns did not have a clear impact on direct indexing's probabilities of success, which points to its likely usefulness in a variety of market environments.

This paper references information in a special report, *Direct Indexing: Opportunities for Customization and Potential Tax Alpha*, published October 11, 2022 by Wealth Management Chief Investment Officer Lisa Shalett and team. For more information on direct indexing, please reach out to your Financial Advisor.

For index, indicator and survey definitions referenced in this report please visit the following: https://www.morganstanley.com/wealth-investmentsolutions/wmir-definitions

Glossary

Alpha is the excess return of an investment relative to the return of a benchmark index.

Expense ratio a measure of what it costs an investment company to operate an exchange-traded fund or mutual fund.

Tracking error is a divergence between the price behavior of a position or a portfolio and the price behavior of a benchmark.

Volatility This is a statistical measure of the dispersion of returns for a given security or market index. Volatility can either be measured by using the standard deviation or variance between returns from that same security or market index. Commonly, the higher the volatility, the riskier the security.

Risk Considerations

Hypothetical Performance

General: Hypothetical performance should not be considered a guarantee of future performance or a guarantee of achieving overall financial objectives. Asset allocation and diversification do not assure a profit or protect against loss in declining financial markets.

Hypothetical performance results have inherent limitations. The performance shown here is simulated performance based on benchmark indices, not investment results from an actual portfolio or actual trading. There can be large differences between hypothetical and actual performance results achieved by a particular asset allocation.

Despite the limitations of hypothetical performance, these hypothetical performance results may allow clients and Financial Advisors to obtain a sense of the risk / return trade-off of different asset allocation constructs.

Indices used to calculate performance: The hypothetical performance results in this report are calculated using the returns of benchmark indices for the asset classes, and not the returns of securities, fund or other investment products.

Indices are unmanaged. They do not reflect any management, custody, transaction or other expenses, and generally assume reinvestment of dividends, accrued income and capital gains. Past performance of indices does not guarantee future results. Investors cannot invest directly in an index.

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. Therefore, the historical returns of an index will not be the same as the historical returns of a particular investment a client selects.

Investing in the market entails the risk of market volatility. The value of all types of securities may increase or decrease over varying time periods.

This analysis does not purport to recommend or implement an investment strategy. Financial forecasts, rates of return, risk, inflation, and other assumptions may be used as the basis for illustrations in this analysis. They should not be considered a guarantee of future performance or a guarantee of achieving overall financial objectives. No analysis has the ability to accurately predict the future, eliminate risk or guarantee investment results. As investment returns, inflation, taxes, and other economic conditions vary from the assumptions used in this analysis, your actual results will vary (perhaps significantly) from those presented in this analysis.

The assumed return rates in this analysis are not reflective of any specific investment and do not include any fees or expenses that may be incurred by investing in specific products. The actual returns of a specific investment may be more or less than the returns used in this analysis. The return assumptions are based on hypothetical rates of return of securities indices, which serve as proxies for the asset classes. Moreover, different forecasts may choose different indices as a proxy for the same asset class, thus influencing the return of the asset class.

Direct indexing may only be appropriate for people who have a considerable amount to invest in a taxable account and want a level of customization they couldn't otherwise obtain through a portfolio of funds or individual securities. If you invest in a tax-deferred account, such as a 401(k) or IRA, the tax-harvesting benefits of direct indexing may provide no additional benefit to you. There is no guarantee that you will maximize value by tax-loss selling; holding onto slumping stock may have resulted in value greater than that obtained through tax-loss harvesting via direct indexing. In addition you will incur asset-based fees and expenses in a direct indexing account that may be higher than those for other investments, as well as transaction costs arising from customization and frequent rebalancing.

International securities may carry additional risks, including foreign economic, political, monetary and/or legal factors, changing currency exchange rates, foreign taxes and differences in financial and accounting standards. International investing may not be for everyone. These risks may be magnified in **emerging markets** and **frontier markets**.

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.

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

An investment in an **exchange-traded fund or mutual 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.

Please consider the investment objectives, risks, charges and expenses of the fund(s) carefully before investing. The prospectus contains this and other information about the fund(s). To obtain a prospectus, contact your financial advisor. Please read the prospectus carefully before investing.

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