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Direct Indexing is a Useful Tool, Not an Investment Strategy

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The introduction and widespread promotion of do-it-yourself investment solutions that put control over sophisticated portfolio actions in the hands of investors is ever-present in the world of wealth management. Among the most rapidly growing new products is direct indexing, which, when utilized properly, provides custom solutions by allowing clients to build portfolios to their unique specifications while achieving index-like returns. The capabilities of direct indexing tools can prove substantial, but clients should be mindful of automation tools claiming to provide quick-fix solutions as they have the potential to create harm if not properly implemented and maintained. While direct indexing can be a powerful tool, it doesn't come with a direction manual on how to make the best decisions to meet your goals now and in the future. Put simply, just because a client has the shingles and a hammer doesn't mean they should start climbing the ladder to rebuild their roof. Let's explore some specific watchouts.

TAX LOSS HARVESTING:

Arguably the most commonly touted benefit of direct indexing is its ability to reduce a client's tax burden by building around existing positions and harvesting losses during down markets. While this appears to capture the benefits of active management, the success of any tax strategy comes down to the details. How is the client to know whether selling depressed positions will add value via loss harvesting or harm long-term wealth by selling low? Additionally, how is the client to devise a strategy to work down a low basis concentrated position? While most clients instinctively aim to minimize their tax liabilities, seasoned wealth managers know that too much emphasis on harvesting losses can interfere with making gains. Seasoned portfolio managers know how to devise a tax plan that meets your needs while balancing them against the long-term growth of the portfolio. Likewise, they can make recommendations on when broad-based market pullbacks can represent genuine opportunities to reduce risk in your portfolio via diversification while still hitting tax targets.

RISK TOLERANCE:

Direct indexing, by all accounts, does a sufficient job of diversifying portfolios and reducing the risks posed by overconcentration. However, in an investing landscape where correlations are high to the downside, the importance of matching allocations at the asset class level to long-term goals is difficult to overstate. One way professionals accomplish this is by establishing an investment policy to not only meet long-term return goals, but to maintain acceptable volatility levels during challenging markets. Clients' goals don't fit neatly into prescribed models, so why should asset allocation stop at 60/40? Direct indexing offers little or nothing to arguably the most important investment decision. That decision, which studies suggest account for 70%-90% of returns, is the asset allocation decision.

ACTIVE RISK MANAGEMENT:

As important as asset allocation is, a static plan will never be sufficient to tackle an evolving world. Whether it's an unexpected uptick in inflation, a major financial crisis, an inheritance event or simply growing closer to retirement, an investment strategy and its associated risk tolerance are constantly changing. Last year's strategy is not necessarily appropriate for next year's challenges, and evaluating risk requires sophisticated research and analytics. While direct indexing alone leaves it up to the client to decide when and how to adjust risk in their portfolio, having access to a professional portfolio manager that can revisit the strategy and apply ideas informed by the latest investment research could be an invaluable resource for clients.

HOW CITY NATIONAL ROCHDALE CAN HELP:

Investment portfolios should be constructed to meet client needs dynamically over time. In practice, that means having ongoing, active oversight to make adjustments as personal, economic or market circumstances change. Given the importance of having a portfolio that delivers against objectives, it is unwise to assume a client can best achieve the desired outcomes merely as a result of access to a direct indexing toolkit. That's why at City National Rochdale we provide direct access to seasoned investment professionals to advisors and clients. We see that as a crucial component to helping clients achieve their goals. Our portfolio manager will actively and dynamically adjust client portfolios and serve as a steady hand to help reduce the likelihood of wealth-destroying actions that clients might otherwise make. Direct indexing can imitate some of the value of a seasoned portfolio manager but can't hope to provide the same level of client focus and attention. Ultimately, direct indexing is a powerful new tool, but even the fastest car won't get you where you're going without good directions and regular maintenance.

To learn more, contact your Senior Investment Consultant or Portfolio Manager. You can also visit us at www.cnr.com, or email us at citynationalrochdale@cnr.com.

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