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An LSEG Business

The Direct Indexing opportunity 2022

Survey Report

Contents

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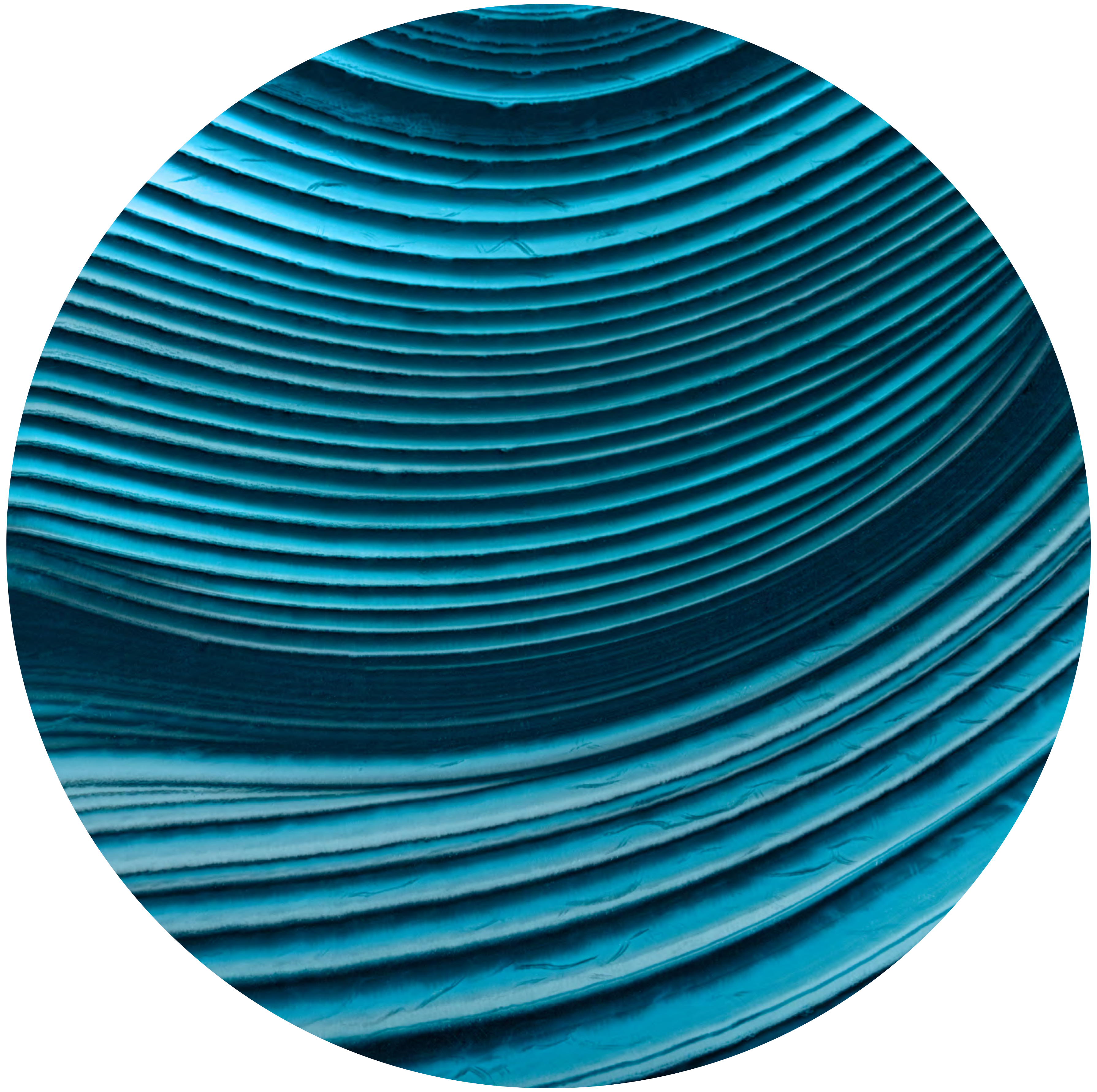


Executive summary

Five years ago, hardly anyone in the financial services industry – outside of a small group of specialized, mostly tax-focused firms – had awareness of direct indexing (DI). Fast forward to 2022, and there is broad industry agreement that DI is expected to be a key growth driver in the industry – especially for wealth firms. It's no surprise that the industry finds broad agreement that direct indexing is undergoing significant growth, and that this growth is expected to accelerate over the next three to five years.

A total of 21 individuals participated in an online survey conducted by Aite-Novarica Group from March to June 2022. Survey participants spanned the wealth industry, including wealth management firms, asset management firms, investment platform providers, and digital/robo advice providers. Given the size of the sample, the data in this report is considered to be a directional indication of conditions in the market. Of the firms surveyed, 81% have high interest in offering direct indexing solutions to advisors and 76% ranked direct indexing as a top priority over the next 12 months. The majority (90%) believe direct indexing will allow their advisors to better demonstrate value to clients by delivering personalized solutions such as tax-loss harvesting, efficient management of concentrated positions and portfolio customization, especially related to ESG preferences – all the top drivers of demand.

The survey results indicate that firms may be underestimating what puts the 'index' in direct indexing. The foundation of direct indexing involves the timely capture, calculation and maintenance of accurate, investment-grade index data. Only 10% of surveyed firms ranked custom indexes or performance benchmarking as top obstacles to implementing and scaling a direct indexing solution. Almost half (48%) indicated they would rather build these capabilities in-house than purchase them from a third party.

Ranking the direct indexing opportunity

Out of the firms surveyed, 76% have a high interest in offering direct indexing through advisors, which is critical over the next 12 to 24 months. Beyond the top benefits of tax management and customization, nearly 70% of firms interviewed look at financial advisors as the primary opportunity for distributing direct indexing solutions and as the best positioned to help clients navigate their investment. All advisor channels rank high, but registered investment advisors (RIAs) are the top target market among 90% of firms surveyed.

81%
of firms ranked DI as a top priority over the next 12 to 24 months

76%
of firms have a high interest in offering DI solutions to advisors

Top benefits
include tax management and customization

52%
of firms ranked ESG as a medium benefit and rising

90%
of firms ranked RIAs as the top opportunity for DI adoption/distribution

Nearly half
of firms see fractional share trading as a top obstacle

67%
of firms believe net new assets will be the primary source of DIA assets followed by SMAs and brokerage assets

38%
of firms believe DI fees will drop to between 20 and 29 bps in five years and one-third of firms believe fees will drop to between 10 and 19 bps

One-third
of firms believe the DI market will see material growth in the next 12 to 24 month

67%
of firms believe the role of advisors will be critical for client adoption of DI

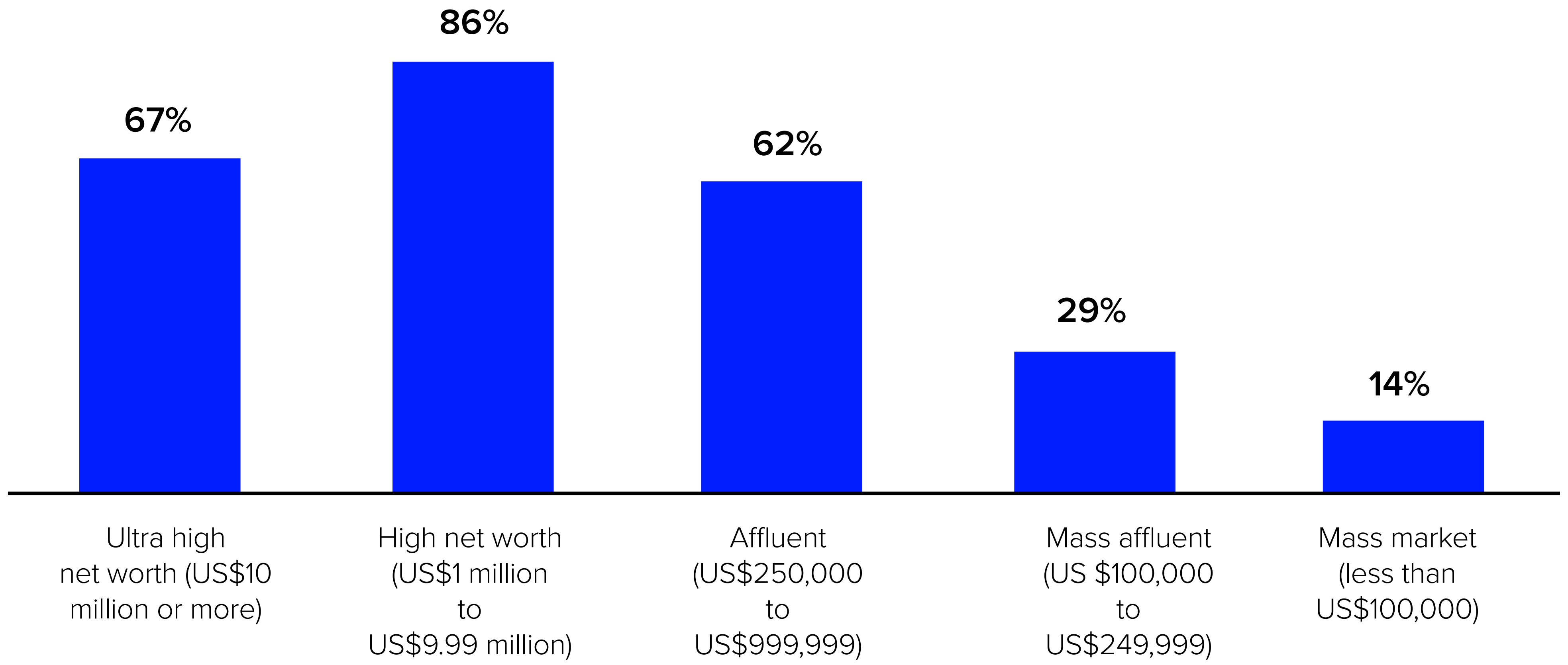
Over half
of firms believe DI fees will allow them to better demonstrate value to clients

Source: Aite-Novarica Group – June 2022

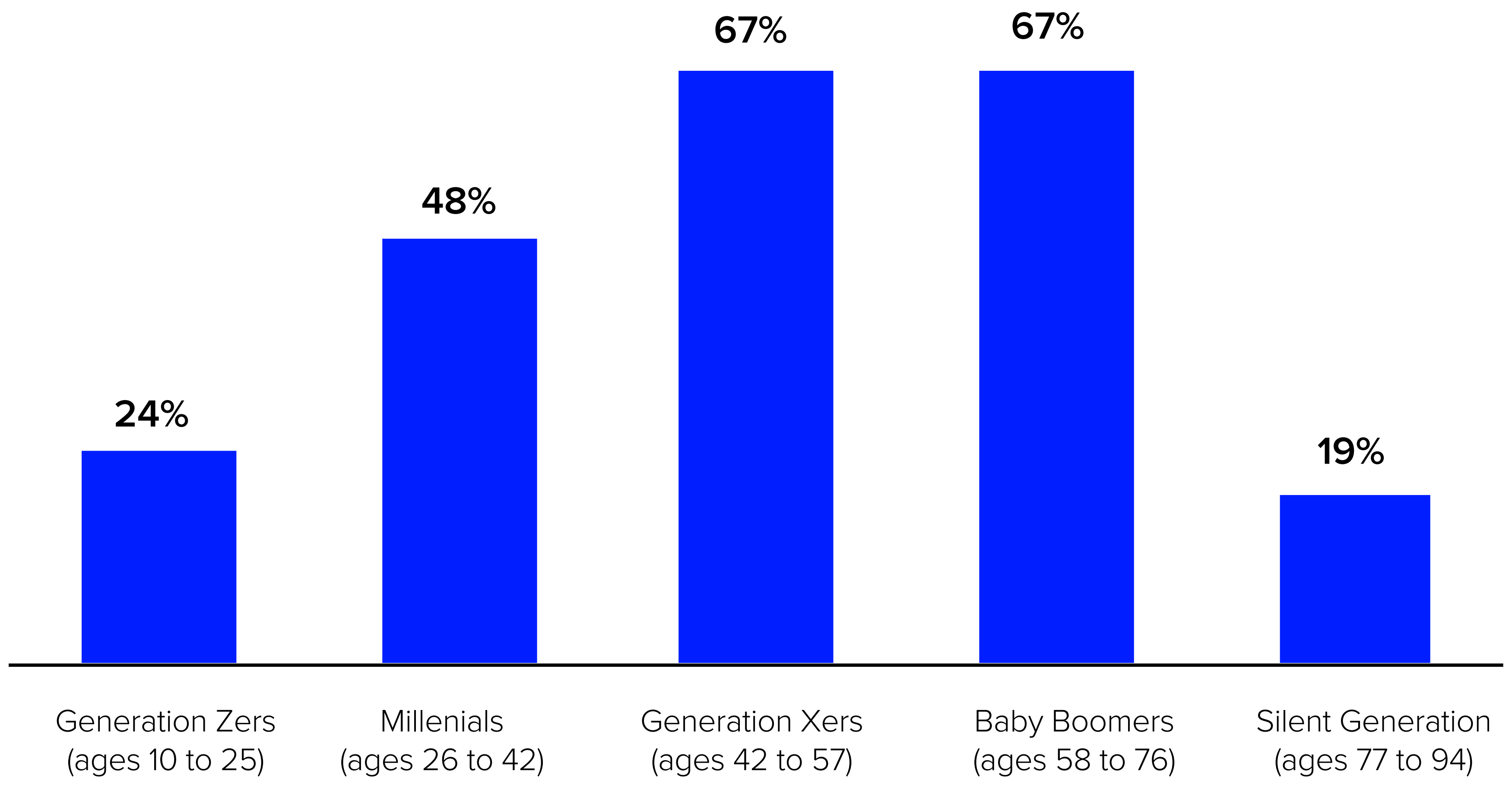
Figure 1. Level of direct indexing opportunity by client affluence

Direct indexing targets clients across wealth and age tiers. Advancements in technology and brokerage offerings will allow direct indexing to be accessible to a broader range of clients across a wider span of investable assets. Nonetheless, most firms are still focused on more affluent clients, where the benefit of tax management has a more material impact.

Please rate the level of opportunity the following segments of client affluence provide for the distribution of direct indexing solutions (n=21)



Please rate the level of opportunity the following segments of client generations provide for the distribution of direct indexing solutions (n=21)



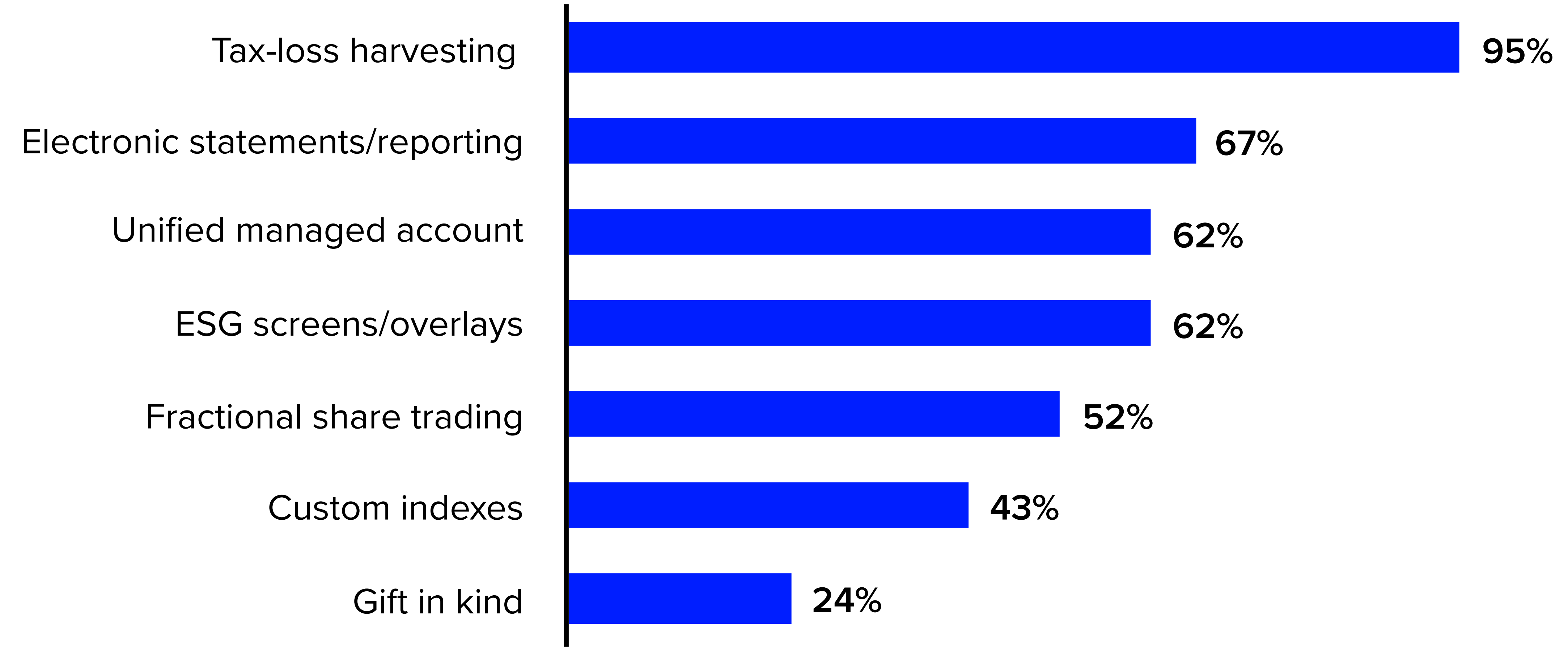
Source: Aite-Novarica Group – June 2022

Figure 2.
Direct indexing capabilities

Firms surveyed rated capabilities that are most important in managing and delivering direct indexing. When asked, respondents stated tax-loss harvesting as by far the most important capability when implementing a direct indexing strategy.

As direct indexing proliferates through the financial services industry, there are a few capabilities that are emerging as key to delivering a comprehensive solution. Tax-loss harvesting was highly ranked among firms looking to provide direct indexing to clients and financial advisors. The ability to provide electronic statements and performance reports, along with environmental, social and governance (ESG), and unified management account (UMA) capabilities, also ranks high. It would be a safe assumption that these four items should be considered table stakes when implementing a direct indexing solution.

How important is it to have the following capabilities for managing and delivering direct indexing solutions? (n=21)



Source: Aite-Novarica Group – June 2022

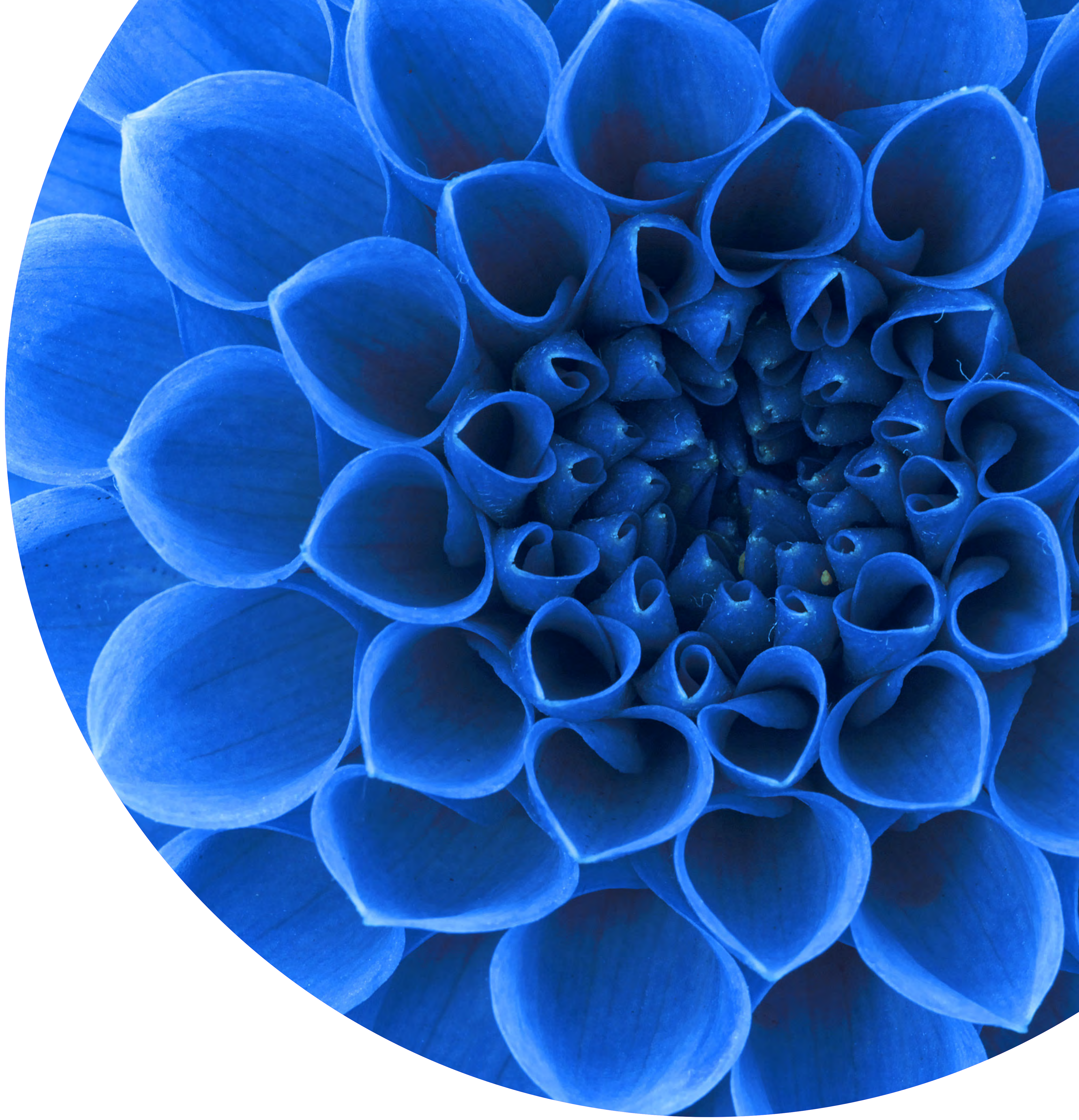


Figure 3.
Obstacles for implementing capabilities

Nearly half (48%) of respondents ranked fractional share trading as a major obstacle, followed by having a UMA and tax-loss harvesting.

While tax-loss harvesting is ranked highly as a key capability, only 38% of firms stated that it is an obstacle. ESG screens and overlays are also not seen as tremendous obstacles. These findings are important, as they indicate that the industry, as least from a capabilities perspective, is not being greatly hindered by a lack of technology or platform functionality.

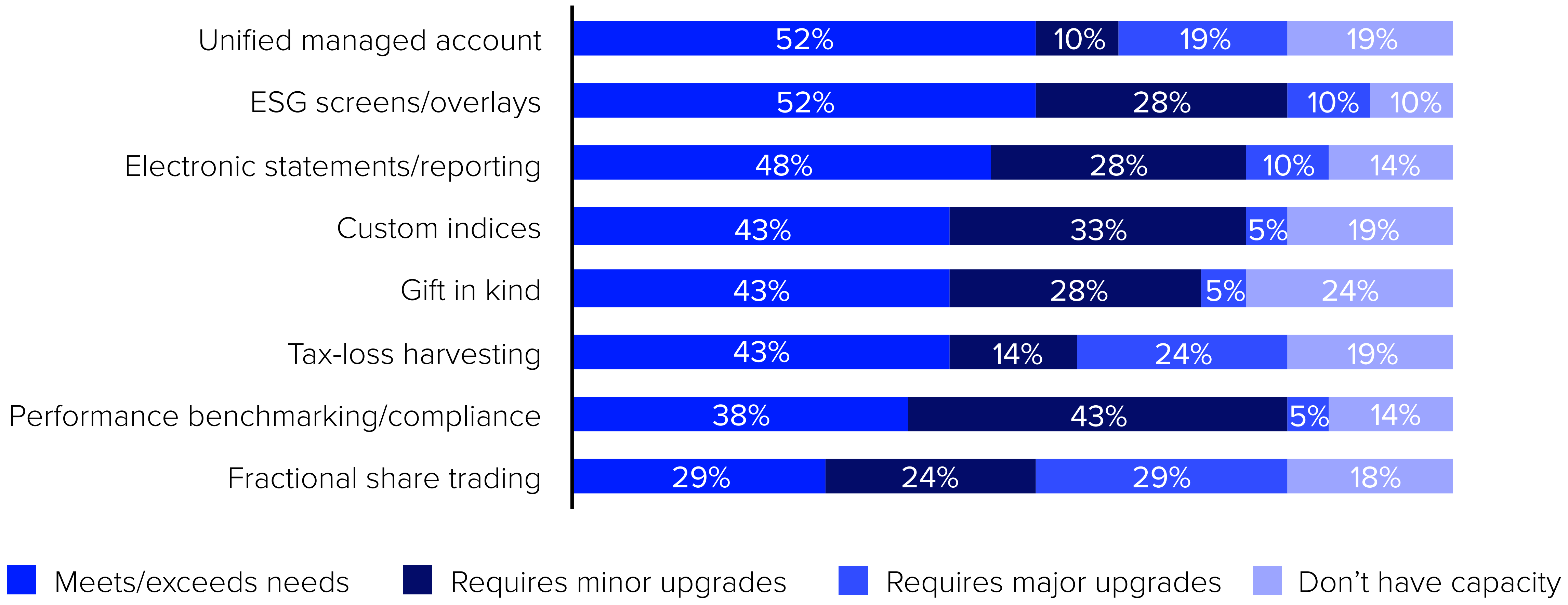
Major obstacles		Medium obstacles	
Fractional share trading	48%	Performance benchmarking/compliance	62%
Unified managed accounts	38%	Custom indexes	48%
Tax-loss harvesting	38%	ESG screens/overlays	43%

Source: Aite-Novarica Group – June 2022

Figure 4.
Current effectiveness of direct indexing capabilities

ESG screens/overlays and unified managed account capabilities ranked as the top two direct indexing capabilities meeting the needs of organizations surveyed, both at 52%.

Please rate how effectively the following direct indexing capabilities are meeting the needs of your organization (n=21)



Source: Aite-Novarica Group – June 2022

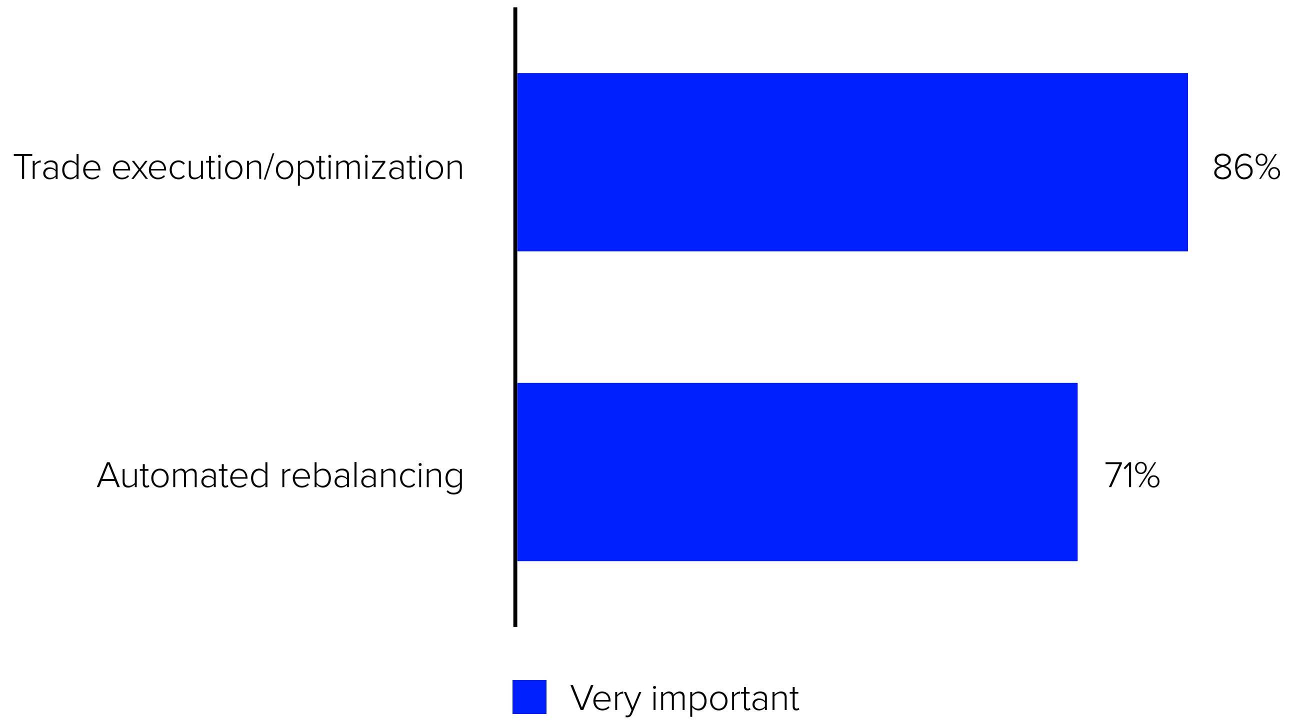
Figure 5. Importance of trading and rebalancing

Trade execution and optimization were rated as very important capabilities by 86% of firms surveyed, and automated rebalancing by 71%. Trade execution and optimization are essential for delivering direct indexing.

Trading and optimization are significant obstacles among 43% of firms surveyed, while automation is less of a major obstacle at 14%.

While expanding asset classes and index options for the direct indexing market provides greater choice for advisors and investors, it can exacerbate trading and rebalancing challenges. This is especially true for small-cap fixed income, where the inventory of firms and securities that comprise these indexes can be restrictive, underscoring the need to assure firms have access to the most robust trading platform and rebalancing tools.

How important is it to have the following capabilities for managing and delivering direct indexing solutions?

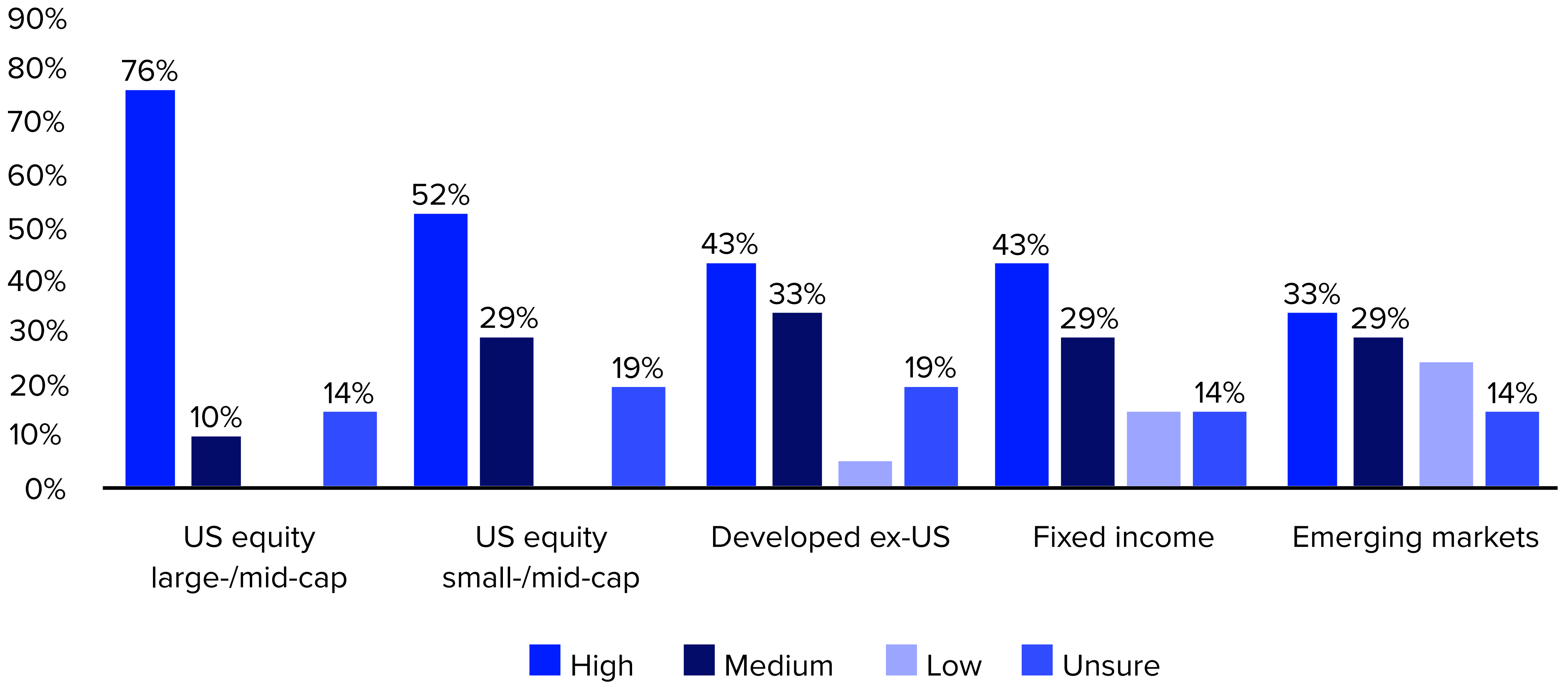


Source: Aite-Novarica Group – June 2022

Figure 6. Outlook for adding direct indexing solutions by asset class within the next five years

The direct indexing market will continue to grow and expand. Most direct indexing solutions target US equity large-cap. However, 52% of firms surveyed have a high likelihood of launching a US equity small-cap solution and 43% likelihood of launching a non-US index or fixed income solution.

What is the outlook for adding direct indexing solutions for the following asset classes/investments vehicles in the next five years? (n=21)



Source: Aite-Novarica Group – June 2022

Survey methodology

A total of 21 individuals participated in an online survey conducted by Aite-Novarica Group from March to June 2022. Participants in the research are at wealth management firms, asset management firms, investment platform providers, and one from a digital/robo or hybrid advice provider. Given the size of the sample, the data in this report is considered to be a directional indication of conditions in the market.

About Aite-Novarica Group

Aite-Novarica Group is an advisory firm providing mission-critical insights on technology, regulations, strategy and operations to hundreds of banks, insurers, payments providers, investment firms, and technology and service providers.

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