Vanguard

Thoughts on direct indexing

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Brian Bruce: Another thing that I see that's potentially very important and big in this field is the idea of direct or custom indexing, and I was curious what the three of you thought about that.

Jim Rowley: I don't like the name because I don't think it has anything to do with indexing, if I can throw that out there. Right, and if I thought about, first of all, you know, to us, it's a portfolio management solution. It's not an investing strategy. It's not an investment theme or exposure. No more than like a mutual fund is not a strategy. So, but it's a portfolio management solution; and if I thought of what might be the three benefits that investors would choose such a portfolio management solution, I can think of tax-loss harvesting. I can think of embedding. We talked about ESG preferences.

ESG gets really difficult at an aggregated fund level because how do I know, Brian, my ESG preferences are the same as Ben's and yours and Craig's. And we might not all like the same fund, but a customized separate account, we would all be able to maybe implement all our preferable ways to attach what we want with ESG, and maybe the third one being more specific factor tilts, which again goes back to the earlier discussion of we might have different definitions of a specific factor, and multiple factors, I should say, in how we implement it.

And I think what I find ironic with the three things I just mentioned; Ben talked about ESG. It's explicitly active. I think we'd all agree tax-loss harvesting is an active strategy. And I think factors, you can label it as in the passive construct, but factor investing is an active strategy. And yet we have this name, direct indexing; but as I see it, the three benefits that you would adopt or wish to be involved in direct indexing, it's for the purposes of active management.

Ben Johnson: Yes, I don't know if anyone remembers the old *Saturday Night Live* skit "Coffee Talk" where Mike Myers played Linda Richman, but I always lead into the direct indexing conversation with, "Direct indexing is neither direct nor indexing, discuss," and I would agree wholeheartedly with Jim in that regard.

There inevitably are certain benefits with respect to tax, I think, portfolio completion for certain clients that might have a concentrated stake in say employer stock or a portfolio of individual stocks that they came to by way of inheritance, what have you. You can diversify at the margin and incrementally draw down positions in those securities in a tax-efficient way.

I think fundamentally what you're talking about though with direct indexing is its software. It's a software that's overlayed a separately managed account. It creates a dialogue between the client and the portfolio in the way that you don't have a dialogue with an indexed product.

So, you have to be mindful of what the potential costs, direct costs, and opportunity costs might be. Whenever you're talking about an active construct, be it ESG factors, direct indexing, the opportunity cost, what you might not get by just not owning the broad market are inherently unknowable.

So, you've just got to be aware of what the tradeoffs are that are involved as an investor. But I think in certain circumstances, it, I think, can very much have benefits for certain clients, especially those in scenarios like I've described. You might be in a higher tax bracket. You might have a big slug of stock that you need to kind of build a completion portfolio around. And indeed, if you look at some of the largest providers of these services, that's how a large portion of those accounts are ultimately funded.

END OF RECORDING

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