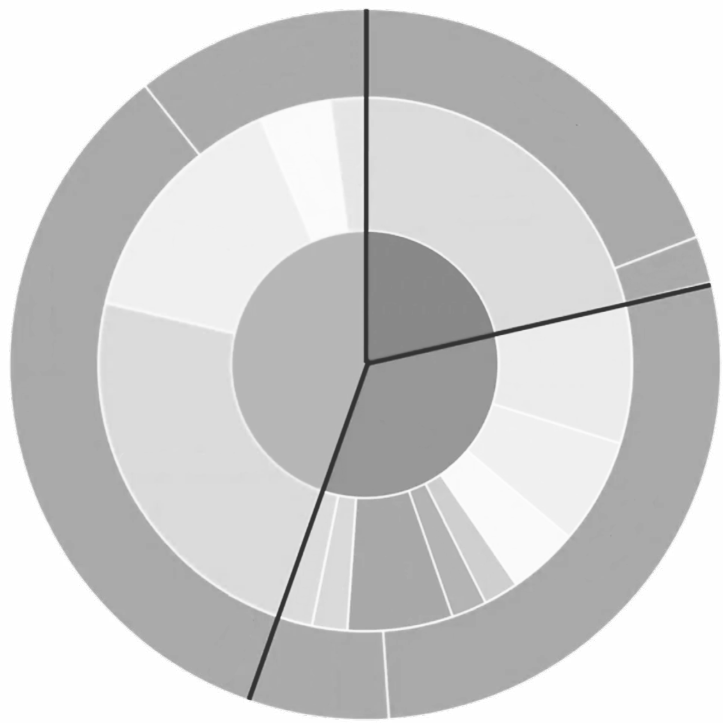
First Ascent Asset Management

UNDERSTANDING DIRECT INDEXING



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UNDERSTANDING DIRECT INDEXING

Direct indexing is a way to create a broadly diversified portfolio of individual stocks that are personalized to meet the needs, values, and preferences of an investor.

Putting Direct Indexing in Context

The starting point is for you and your advisor, working together, to identify your long-term financial goals. Your advisor then develops a portfolio designed to enhance your chances of meeting those goals.

The first step in developing that portfolio is to create an asset allocation strategy. That strategy determines how you will deploy your assets among different "asset classes."

Asset classes are categories of investments. They may be defined broadly, like stocks, bonds, and cash, or more narrowly, like large growth stocks, small value stocks, and emerging markets stocks. Each asset class consists of investments that have similar performance characteristics.

The asset allocation strategy created by your advisor determines how much of your portfolio will be invested in each asset class. By thoughtfully allocating your investments among the asset classes, your advisor can target your return needs, while minimizing portfolio volatility.

There is a volume of research that shows that establishing the right asset allocation strategy is more important to your investment success than individual securities selection. So, it is very important that your portfolio provides the right exposure to the various asset classes.

Asset classes can be represented by indexes. Indexes are baskets or collections of investments that fall within the definition of the asset class. For example, the Russell 2000 Value Index consists of US small value stocks. The S&P 500 Index consists primarily of US large-cap stocks.

There are many mutual funds and exchange traded funds (ETFs) that are managed to track indexes, so investors can gain exposure to the asset classes that they represent. Those funds hold most, if not all, of the securities in an index that represents the asset class.

It is possible to build a well-diversified portfolio by investing in a combination of these index-tracking funds in a manner that is consistent with your asset allocation strategy. But since you do not directly own the underlying securities held by these funds, you have no control over their purchase or sale. This limits your ability to customize your portfolio.

Customization Through Direct Indexing

Direct indexing allows for an additional level of customization. You and your advisor can select one or more indexes that you want your portfolio to track. Then, since you own the individual stocks in the portfolio, you can modify the portfolio to meet your needs, values, and investment preferences.

There are many ways to customize a direct indexing portfolio:

Express Your Values. You can screen out companies or industries that engage in activities you do not wish to support. Or you can overweight your portfolio toward companies or industries that engage in activities you do wish to support.

Express Your Preferences. You can tilt your portfolio toward stocks of companies with specific investment characteristics. For example, you can overweight your portfolio with low volatility stocks, stocks of small emerging companies, or stocks that pay higher dividends.

Reflect Your Personal Situation. You can incorporate existing legacy holdings into your direct indexing portfolio. Or, if you already have significant exposure to a particular stock—your employer's stock, for example—you can limit or eliminate that stock from the portfolio.

Charitable Giving. By donating specific tax lots with the most built-in gain, you can meet your philanthropic goals, while maximizing the tax benefits.

Tax Loss Harvesting. Your portfolio can be managed to capture tax losses that can be used to offset taxable gains, thus potentially lowering your year-end tax bill.

What You Should Know

Direct indexing is different than investing in traditional separately managed accounts, mutual funds, or ETFs. Here are some things you should consider:

Winners and Losers. The focus of direct indexing is not picking winners or avoiding losers. Rather, it is on implementing an asset allocation strategy and customizations that give your portfolio the market exposures and performance characteristics that best fit your goals.

Since the broad market *always* contains winners and losers, your portfolio will too. Over time, some of the winners will become losers and some of the losers will become winners as individual companies, industries, and economic sectors cycle in and out of favor. Historically, however, exposure to the broad markets has produced solid long-term returns for investors.

Cost. Direct indexing portfolios usually have lower expenses than traditional separately managed accounts. But because of the level of personalization required to build and manage direct indexing portfolios, they may cost more than a portfolio built using mutual funds or ETFs.

The difference may not be significant, but each investor should consider whether any additional cost is justified by the benefits of customization and tax management.

Tracking the Index. A direct indexing portfolio will not hold every stock included in the index it is designed to track. Instead, the portfolio manager will use a process called "optimization" to select a representative subset of those stocks intended to mimic the performance of the index.

Since the direct indexing portfolio and the index will not have the same holdings, there will be some difference in their performance. The magnitude of the difference will vary based on account size, the index you are tracking, and the level of customization you choose.

This difference is sometimes called "tracking error." This term is a misnomer since tracking error is neither good, nor bad. But investors should expect greater performance differences between their portfolio and the index it tracks as the level of portfolio customization increases.

An Excellent Solution

Direct indexing is not right for every investor, but it can be an excellent solution for investors with customization and/or tax management needs, who are comfortable with an index-oriented approach to investing.