SOLACTIVE
German Index Engineering

Direct Indexing: The Unwrapping of ETFs

Blog
February 2019
Research, Solactive AG

Takeaways from the Sunshine State

Meeting all our friends from the industry at the *Inside ETFs* conference was a great experience, and we are already looking forward to attending the next one.

One of the hot subjects warming the debate this year is clearly the fee-pressure on pure beta ETFs. The 'Race to Zero and beyond', a topic which we covered in our blog last September, was ubiquitous at this year's gathering of the ETF community.

Nonetheless, there was another prominent on- and off-stage debate; *the rise of 'Direct Indexing', its advantages, and its potential disruption*. This concept is a form of investment that is said to make traditional ETFs obsolete and potentially reshape investing the same way that ETFs themselves disrupted the markets a few years back. But what does Direct Indexing actually mean?

Video Killed the Radio Star

Apologize to Dave and Matt for blatantly stealing their on-stage example at *Inside ETFs*, but I believe it is the most fitting: The way we produce and consume music continuously evolved from paraffin wax rolls to vinyl, tape, and digital recording. Now, according to the IFPI Global Music Report 2018, streaming digital music outperformed physical sales.

What is the point that we want to make here? The commodity 'music' remained the same, but its wrapper changed. It underwent many transformations in order to 1) enhance the quality, 2) improve the accessibility, and 3) reduce the costs.

Making the analogy with the financial markets, the industry progressed from actively trading single stocks at high commissions to actively managed baskets of stocks in mutual funds. Then once again, the wrapper was transformed into passively managed index funds that are cheaply and easily accessible, mainly ETFs or Index Funds. Like with the aforementioned example of music, the delivery format changed, *and it is highly unlikely that the innovation and disruption will stop here!*

The ETF – A Wrapper with Handy Features

Many features of ETFs make them a great investment vehicle. They give investors broad access to the markets, they create various economic exposures, they reduce costs by means of economies of scale. Additionally, in cases of index tracking, ETFs are generally significantly cheaper than their actively managed siblings, as the strategy management has been outsourced to a specialized index provider. Potentially, the long-term returns end up being higher after costs. I´ll leave this last hypothesis to a separate debate. Nevertheless, these ideal and seamless-experience vehicles are not perfect in all aspects. Here are some reasons:

1. Before seeing the light, ETFs incur *Set Up Costs* paid in the approval process to exchanges, custodians, and legal experts way before the start of operations without having any guarantees for profitability.
2. ETFs bear a long *Time-to-Market*. As they are defined by the regulation, – and each market has established its own regulatory framework – launching an ETF takes possibly several months. Not to mention that rolling out the same product in various markets means to repeat the filing process and re-incur the costs several times.
3. *Tax Efficiency*: Independently from the size of the underlying basket, most of the jurisdictions are treating the 1 share of ETF as 1 single underlying; this implies that investors will be taxed according to the realized performance of the ETF trade. Some managers on the market are offering an alpha by optimizing on taxes. In fact, some jurisdictions do have tax benefits; tax-loss harvesting is common in the US. With several dozens $ bn. of assets under management, Parametric Portfolio Associates is a leader in this field.
4. Sophisticated investors would like to tailor their portfolios' exposures according to their own investment appetite. Yet, they are forced to take an ETF as an *Imposed Benchmark*, since the provider offers no ability to customize.

Direct Indexing as Solution?

Put in simple terms Direct Indexing is a replication of an Index – the same way an ETF does – only without a fund wrapper around it. Is this possible? Theoretically, the answer is yes. Advancements in technology are key to achieve that:

1. *Tracking Error*: Typically, indices have a lot of constituents. Compared to ordinary investors, ETF managers have generally better capabilities to execute large amounts of trades and hold resources to track and adjust the portfolio according to corporate action events. Now, with the democratization of trading by the electronic trading brokerage firms, it is possible to overcome the above barrier by developing algorithmic execution engines smart enough to ensure the best prices for the investor.
2. A simple way to overcome ETFs significant *Time-To-Market* and increased costs associated with the *Fund Structuring* is to develop the concept of Separately Managed Accounts in the US or deposit-based solutions in Europe. Certain regulators allow the outsourcing of personal trading accounts to external asset managers. Naturally, a human asset manager would not be able to handle all the volumes. A robo-AM is an intuitive option to do so.
3. *Cost Killing*: The main costs associated with trading activities are the fees paid to the exchange which maintains in return a continuous, transparent and open auction. In theory, this service can be replaced by a public open ledger in which members can trade according to the set of rules programmed in Smart Contracts and audited by the blockchain technology. This infrastructure bears the disruptive potential to reduce costs in settlement and custody significantly. Taking

into account factors like the development costs of Smart Contracts, maintenance, and backups of the ledger, or incentives for few qualified players, the costs might end up as high as the current fees paid to exchanges.

4. Current mega-capitalization companies such as Alphabet Inc. or Amazon.com have a stock price in the order of USD 1'000. For a small investor with USD 10'000 to invest, it will be tricky to buy a portfolio with the top 100 US large capitalization companies. Similarly, when replicating the US large capitalization index, it will be complicated to buy 0.000501 shares of Viacom for every one dollar invested. Companies such as Californian *Optimal Asset Management* offer a platform which gives investors access to tailored solutions and includes a booking process for *Fractional Shares* - allowing investors to buy small portions of stocks rather than full pieces.
5. Direct Indexing allows investors to endlessly customize indices and their asset allocation. Hypothetically, an investor could forge his own index, for example, one that tracks the US Large Cap market except for stocks that, randomly chosen, start with the letters F, A, N, and G – you might get the point.

New Possibilities in the box

Similarly, to the music example given above, the basic idea of democratization of investment through passive investing will not change. The wrapper, in this case, the ETF, might eventually be altered in the course of time. Since Direct Indexing is still in its infancy, established ETF providers should embrace this trend by joining forces with disruptive players, rather than battling it. Will this trend be the end of ETFs?

I do not think so by any means. Will it have the potential of becoming the next revolution of passive strategies? It certainly has. Game on.

Timo Pfeiffer

Head of Research & Business Development
Solactive AG

Disclaimer

SOLACTIVE
German Index Engineering

Solactive AG does not offer any explicit or implicit guarantee or assurance either with regard to the results of using an Index and/or the concepts presented in this paper or in any other respect. There is no obligation for Solactive AG - irrespective of possible obligations to issuers - to advise third parties, including investors and/or financial intermediaries, of any errors in an Index. This publication by Solactive AG is no recommendation for capital investment and does not contain any assurance or opinion of Solactive AG regarding a possible investment in a financial instrument based on any Index or the Index concept contained herein. The information in this document does not constitute tax, legal or investment advice and is not intended as a recommendation for buying or selling securities. The information and opinions contained in this document have been obtained from public sources believed to be reliable, but no representation or warranty, express or implied, is made that such information is accurate or complete and it should not be relied upon as such. Solactive AG and all other companies mentioned in this document will not be responsible for the consequences of reliance upon any opinion or statement contained herein or for any omission.

Contact

Solactive AG
German Index Engineering
Guiollettstr. 54
60325 Frankfurt am Main
Germany

Tel.: +49 (0) 69 719 160 00
Fax: +49 (0) 69 719 160 25
Email: info@solactive.com
Website: www.solactive.com

© Solactive AG

Timo Pfeiffer
Head of Research & Business Development
Tel.: +49 (0) 69 719 160 320
Email: timo.pfeiffer@solactive.com

Phil Wiedbrauck
Public Relations & Social Media
Tel.: +49 (0) 69 719 160 311
Email: phil.wiedbrauck@solactive.com

Fabian Colin
Head of Sales
Tel.: +49 (0) 69 719 160 220
Email: fabian.colin@solactive.com