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Direct Indexing: ESG Collides with Tax Avoidance

Direct indexing is one of the hottest trends in the investment industry. These strategies are rapidly growing as managers rush to offer clients customized index portfolios with enhanced tax-loss harvesting. In 2021 alone, BlackRock, Vanguard, and Morgan Stanley acquired firms specializing in direct indexing to compete in this growing field.

Currently, there is over $360 billion in direct indexing strategies and the projected 5-year growth rate of these strategies is 12.4%, according to Cerulli Associates[1]. Given these projections, assets in direct indexing strategies could easily top $1 trillion within the next 10 years.

Direct indexing creates both an opportunity and a moral dilemma for ESG and impact investors. On the one hand, it allows investors a customized way to integrate their ESG beliefs and personal values into their portfolios. On the other hand, direct indexing incorporates tax-loss harvesting logic that reduces the amount of revenue the government can use to help society.

In this paper, we explore this tension and offer a solution on how to solve it.

Background

Direct indexing allows an investor to purchase the underlying securities (or a subset) of a benchmark or index rather than invest in a passive ETF or mutual fund. By holding individual securities directly, an investor can customize his portfolio and reap the benefits of tax-loss harvesting he may not get otherwise. With advanced portfolio construction and tax management tools, the direct indexing

[1] Cerulli Associates (August 2021). Improving Client Experience: Customizing with Direct Indexing [White paper].

managers create a custom, tax managed index strategy while minimizing tracking error to the underlying index.[2]

For years large institutions and wealthy investors have used direct indexing to customize their portfolios and help with tax management. These strategies first appeared in the early 1990s with the growth of quantitative investing.

Further advances in technology, zero commission trades, and fractional share stock investing, along with increasing customer demand, have made direct indexing a more attractive and accessible option to a broad investor base.

The Appeal of Direct Investing

Customization and tax-loss harvesting are the two main benefits of direct indexing. Moreover, these benefits increase with rising demand for values-based investing as well as looming increases in tax rates.

On the customization front, investors are increasingly interested in incorporating ESG and values-based preferences into their portfolios. Over 80% of individual investors are interested in incorporating ESG into their investments and tailoring their investments to their specific interests[3]. Additionally, some investors tilt their portfolios toward different equity factors like value, momentum, and ESG.

Tax-loss harvesting allows an investor to trade off gains and losses directly, creating a tax “alpha.” Investors can sell some investments at a loss to offset gains realized by selling other stocks or other assets at a profit. A security with a loss is sold and replaced with a similar asset to maintain the portfolio’s target risk and return profile.

The precise value of the tax alpha is a function of various factors, including an investor’s individual tax circumstances, investment strategy, and time horizon. Recent studies calculate tax alphas from tax loss-harvesting between 0.85 to 2.26%[4]. For our examples, we assume a tax alpha of 1.5%.

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[2] Realized tracking error level will vary based on several inputs including: the target alpha for tax loss-harvesting, index selection, customization decisions, and skill of the asset manager.

[3] Morgan Stanley, Institute for Sustainable Investing, “Sustainable Signals: Individual Investor Interest Driven by Impact, Conviction, and Choice”, 2019

[4] Goldberg, Hand, and Cai. “Tax-Managed Factor Strategies.” *Financial Analysts Journal*, Second Quarter 2019. Chaudhuri, Burnham, and Lo. “An Empirical Evaluation of Tax-Loss Harvesting Alpha.” March 5, 2019.

The Conflict Between ESG and Tax-Loss Harvesting

In theory, there should be alignment between socially conscious investors and taxes. Both share a similar purpose – to help society. Many of the government's spending initiatives align with the values of ESG investors, who favor companies with responsible environmental and social business practices. Taxes help the government provide social services and make public investments. Tax revenue is critical to providing for society and making key investments in education, infrastructure, the environment, security, the social safety net, and other important areas not covered through market economics.

However, this alignment starts to erode when 1) doing well for society limits financial returns and wealth creation or 2) investors believe that the government does not allocate its tax revenue in a productive way.

Both factors are important and legitimate reasons to overlook this conflict. On the tax management side, it is an age-old practice and a central part of wealth management. Part of managers' fiduciary duty is to avoid unnecessary expenses that limit investment returns. One can argue a manager is not properly serving a taxable client if the manager does not offer tax-loss harvesting on standard index products. In terms of the value of taxes paid, given society's diverse views over the allocation of government spending and the quality of its outcome, it is natural for even the most socially conscious investors to seek to control and use their wealth rather than hand it to the government.

Despite investors' natural desire to avoid taxes, the amount they are "harvesting" is significant and on track to increase dramatically. We estimate that up to $4.1 B is harvested each year, and this number is expected to rise to over $11 billion within the next 10 years.

Year	Assets in Direct Indexing Strategies (in billions)	Annual Taxes Avoided (in billions)
2021	**$360.0**	**$4.1**
2025	**$574.6**	**$6.5**
2030	**$1,031.9**	**$11.6**

*****Assumes 75% of assets in direct indexing is taxable, tax alpha is 1.5%, annual growth rate of 12.4% for direct indexing assets

A Solution – A Tax Offset

Our goal is not to abolish tax management strategies or ask investors to pay more in taxes. It is to encourage investors to use their extra wealth to help society and to have asset managers partner with us in this effort.

For a solution to the practice of tax avoidance, we look to the rapidly growing practice of carbon offsets. The goal of carbon offsets is to reduce emissions of carbon dioxide or other greenhouse gases to compensate for emissions made elsewhere. Companies, governments, and individuals are increasingly investing in carbon reduction projects to reduce the negative impact of their climate footprint. The market for carbon offsets or "credits" could be worth upwards of $50 billion in 2030, according to the Taskforce of Scaling Voluntary Carbon Markets.[5]

Following the idea of offsetting harm in one area with positive impact in another, there is an opportunity for investors to calculate, realize, and donate their tax alpha each year – either directly to charity or through a charitable giving fund or foundation.

A tax "offset" allows socially responsible investors to reap the benefits of tax-loss harvesting while making a direct and positive impact on society. This approach has the added benefit of creating additional tax savings from the donation of the funds.

Power of Using Tax Alpha for Social and Personal Impact

Direct donations can have a significant impact on important social issues like hunger and land preservation. For example, an investor with a $100,000 account that realizes a tax alpha of 1.5% could use his extra $1,500 to plant 1,500 trees or provide 15,000 meals, according to the US Forest Service and Feeding America[6]. An investor with a $10 million account could provide 1,500,000 meals a year, reducing or even eliminating food insecurity in a community.

Annual Impact Opportunity for Tax-Loss Harvesting Dollars

	$100k Account	$10 M Account
Value of Tax Alpha	$1,500	$150,000
Trees Planted	1,500	150,000
Meals Provided	15,000	1,500,000

[5] The Taskforce on Scaling Voluntary Carbon Markets (TSVCM), sponsored by the Institute of International Finance (IIF) with knowledge support from McKinsey, estimates that demand for carbon credits could increase by a factor of 15 or more by 2030 and by a factor of up to 100 by 2050. Overall, the market for carbon credits could be worth upwards of $50 billion in 2030.

[6] Feeding America's website. https://www.feedingamerica.com/ways-to-give. US Forest Service's Plant-a-Tree Program.

Additionally, giving to charity can also benefit an investor's health and heart by lowering blood pressure and stress levels and increasing personal satisfaction and happiness, according to the Cleveland Clinic[7].

Conclusion

Investment management practices, even the most socially ambitious ones, will not always be pure in their pursuit of social good. The combination of tax-loss harvesting and socially responsible practices in the same portfolio is one example of this conflict. While it is unrealistic for investors to radically change their investment approach or to create perfect harmony between the quest for financial returns and impact, there is an opportunity for investors to rethink how they best deploy the wealth they have accumulated through tax avoidance strategies.

We advocate for calculating the amount of taxes "saved" each year and donating this money to charity – either directly or through a charitable giving fund. Giving money away creates an immediate positive effect on society and can transform the heart of the person giving it away. Asset managers and RIAs can be leaders in facilitating this conversation and helping mobilize clients towards impact solutions that go well beyond customized screening and ESG portfolio tilts.

[7] "Why Giving is Good for Your Health", Cleveland Clinic's website, October 28, 2020.