



OCTOBER 2025 CLIENT QUESTION OF THE MONTH:

DIRECT INDEXING

Francesca Lanza
Associate Portfolio Manager

321 Columbus Avenue, 3rd Floor
Boston, MA 02116

www.winthropwealth.com

Our Client Question of the Month explains what direct indexing is, how tax-loss harvesting works, and what we believe are the key benefits and drawbacks of the strategy. It is a tool in our investment toolbox, used in certain circumstances when appropriate.

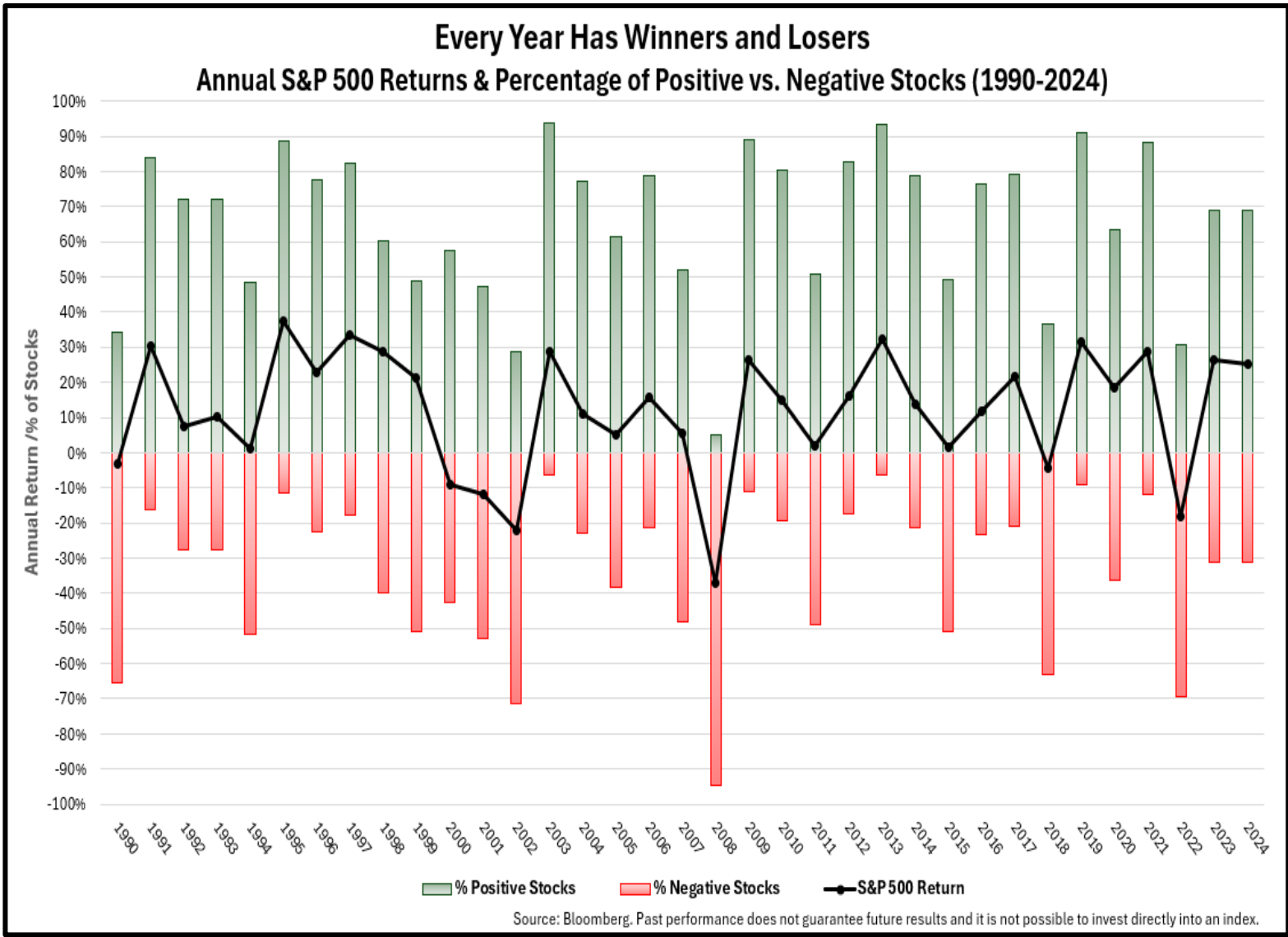
What is Direct Indexing?

Direct indexing is an investment strategy where investors directly own hundreds of individual stocks that make up an index, such as the S&P 500. This approach aims to closely track the index’s performance while creating opportunities for customization and tax management.

A key advantage of direct indexing is its ability to capitalize on the variation in individual stock returns to capture tax losses, since the underlying stocks in an index do not all perform the same. Every year, some stocks finish positive while others finish negative, regardless of the index’s overall return.

For example, in 2008, the S&P 500 fell sharply, yet a handful of companies still posted gains. In 2024, the index delivered strong double-digit returns, but nearly one-third of stocks declined. This variability in returns creates opportunities to harvest losses to offset gains elsewhere in the portfolio or for future use, improving after-tax returns even in strong markets.

The chart below illustrates how positive and negative percentages of S&P 500 component stocks appear in every calendar year from 1990 through 2024, as well as the corresponding S&P 500 index returns over the past 35 years. Direct indexing leverages individual stock performance variations and seeks to deliver index-like exposure while providing personalized tax and investment benefits.



How Tax-Loss Harvesting Works

The process is designed to systematically identify and realize investment losses while keeping the portfolio exposures similar to the underlying index through the use of technology. Please see our client question on [tax-loss harvesting](#).

- 1. Portfolio Setup:** The account is funded with cash or existing securities to align with a chosen index that fits within the investor's investment objective.
- 2. Ongoing Oversight:** Portfolios are monitored daily for opportunities such as loss harvesting, rebalancing, and cash deployment.
- 3. Rebalancing & Harvesting:** Securities with losses are sold and replaced with similar securities to maintain index exposure. This approach seeks to generate "tax alpha" – the additional after-tax return from reducing taxable gains, which can help maintain long-term wealth.

Who Should Consider Direct Indexing?

Direct indexing may be suitable for tax conscience investors that hold cash or concentrated stock looking to diversify individual security risk. It may also appeal to investors seeking greater customization. However, investors should be aware that such strategies often have account investment minimums and associated management fees which may vary depending on the provider (sub-advisor). *No strategy assures success or prevents against loss. Diversification does not protect against market risk.*

At Winthrop Wealth, we may consider this type of strategy under certain circumstances as part of our Total Net Worth Approach. We would carefully evaluate the potential risks and benefits of direct indexing within the context of a client's comprehensive financial picture. If deemed suitable by your financial advisor, we would implement this strategy alongside the core investment portfolio and overall investment strategy, serving as a complement rather than a replacement.

Why Consider Direct Indexing?

Direct indexing allows investors to customize their portfolios, seek to manage taxes more efficiently, and maintain control over individual holdings, all while maintaining broad market exposure. While these benefits are compelling, it's important to also consider potential trade-offs. Here's what a direct indexing strategy ideally seeks to provide:

- 1. Tax Efficiency**
 - Capture tax-loss opportunities even in strong markets.
 - Offset gains to reduce tax liability and mitigate "tax drag" – the reduction in investment returns resulting from taxes on dividends, interest, and capital gains, which can negatively impact long-term growth.
 - Greater flexibility in managing capital gains compared to ETFs or mutual funds.
- 2. Customization**
 - Manage concentrated stock positions or integrate new cash.
 - Apply factor tilts (e.g., growth vs. value) or customized stocks screens; *note these may reduce diversification and impact index tracking.*
- 3. Personalized Diversification**
 - Maintain broad market exposure (e.g., S&P 500 or Russell 3000) while tailoring holdings to individual objectives.
- 4. Transparency & Control**
 - See exactly which stocks you own.
 - Benefit from flexible trading and rebalancing to match personal goals.
 - Review performance reports that compare pre- vs post-tax returns to demonstrate the strategy's financial benefit.

Considerations and Limitations

Before implementing a direct indexing strategy, it's important to understand some key limitations and trade-offs, and note that no strategy assures success:

- **Front-loaded Tax-Loss Opportunities** – Tax-loss opportunities are typically front-loaded, meaning more losses are generated in the first year than in subsequent years. Over time, especially in upward trending markets, the amount of available losses may become depleted unless new cash or securities are added to the portfolio.
- **Tracking Error** – Another key consideration is “tracking error”, which is the standard deviation of a portfolio’s relative return compared to its underlying benchmark. For example, excluding any fees, if the benchmark returned 8%, a portfolio with 1% tracking error would typically fall in the 7%–9% return range about two-thirds of the time, though outcomes may vary based on actual holdings.
- **Higher Fees and Complexity** – Direct indexing strategies generally carry higher fees than traditional index ETFs due to greater customization and ongoing management. For example, we access this strategy through a sub-manager, which introduces additional costs.
- **Portfolio Complexity** – This strategy consists of owning many individual securities, which may result in a portfolio that appears more complex than investing in a single index fund.

Conclusion

Direct indexing combines the potential benefits of index tracking with tax efficiency and customization. By harvesting losses at the individual stock level while maintaining broad market exposure, it offers a tax-aware, tailored approach to portfolio management – even in upward markets.

However, investors should also consider the key trade-offs: tax-loss opportunities may diminish over time if no new cash or securities are added to the portfolio, tracking error will impact returns, and fees are typically higher than traditional index ETFs.

At Winthrop Wealth, we view direct indexing as one of many tools available to support our clients’ long-term goals. When thoughtfully integrated into our Total Net Worth Approach, it can complement the core portfolio and help create a more personalized investment strategy. We invite you to speak with your advisor to consider whether direct indexing is the right fit for your broader investment plan.

At Winthrop Wealth, we follow a [Total Net Worth Approach](#) to wealth management that combines both comprehensive financial planning and investment management. The financial plan helps define cash flow needs, seeks to optimize account structures, considers tax mitigation strategies, and determines the appropriate asset allocation based on the client’s willingness and ability to take risk. Based on the output of the financial plan, our investment management process designs a well-diversified portfolio constructed with a long-term methodology based on prudent risk management, asset allocation, and security selection. *For clients who receive both financial planning and investment advisory services under agreement. No strategy assures success or protects against loss. Investing involves risk, including loss of principle.*

Disclosures

Content in this material is for general information only and not intended to provide specific advice or recommendations for any individual.

All indexes mentioned are unmanaged indexes which cannot be invested into directly. Unmanaged index returns do not reflect fees, expenses, or sales charges. Index performance is not indicative of the performance of any investment. Past performance is no guarantee of future results.

The Standard & Poor's 500 Index is a capitalization weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The Russell 3000 Index is an unmanaged index that measures the performance of the 3,000 largest U.S. companies, representing approximately 98% of the investable U.S. equity market.

No strategy assures success. All investing involves risk including loss of principal.

Diversification does not protect against market risk. All investing involves risk which you should be prepared to bear.