

Direct Indexing: The Next ETFs?

Everybody wants to make a lot of money, hold onto as much of it as possible, invest it wisely to grow it, and pass a lot of it on to their descendants. Kiyosaki wasn't the first one to express these sentiments: they are, essentially, the goals of almost every investor. For a long time, mutual funds were a key to pursuing those goals. Then came exchange-traded funds (ETFs), which entered the scene in the early 1990s and grew significantly, reaching nearly **\$14 trillion** in assets under management by the end of 2024. ETFs and index funds have often been favored over mutual funds, based on low costs, transparency, and diversification, but what really helped ETFs gain popularity was their potential for tax efficiency. Now, **direct indexing (DI)—buying individual stocks to match an index instead of (or along with) an index fund or ETF—may be the next continued evolutionary leap in tax-efficient investing.** Here, we present a primer on this underutilized strategy and explain what it may offer that other vehicles do not.

"It's not how much money you make, but how much money you keep, how hard it works for you, and how many generations you keep it for."

—Robert Kiyosaki, from the 1997 book, "Rich Dad, Poor Dad," which sold more than 40 million copies worldwide and spent nearly six years on The New York Times best-seller list.

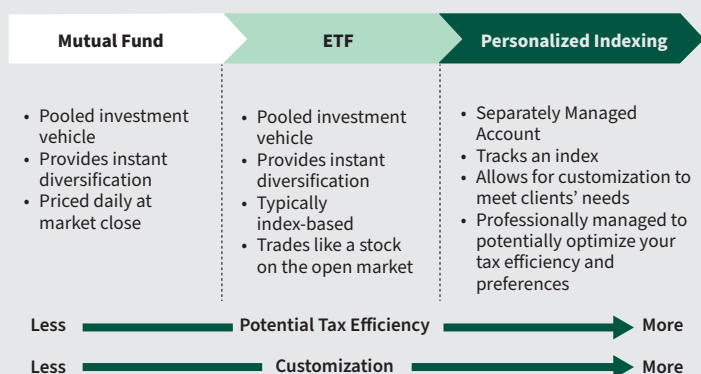
asset managers have been doing it for decades, but the high costs and complexity of managing a DI portfolio limited the strategy to high-net-worth individuals. Now, it's cost-effective and scalable for most investors, thanks to important technological advances. Today, automated portfolio optimization tools can help make tax-efficient investing more accessible through tax-loss harvesting.

What Is Tax-Loss Harvesting (TLH)?

Every dollar paid in taxes is one that can't be invested to earn more money and won't compound over time. In the simplest terms, TLH is the timely selling of securities at a loss to offset the amount of capital gains tax owed from selling profitable assets. The IRS's "wash sale" rule prohibits a taxpayer from claiming such a loss if they buy the same or a "substantially identical" security within 30 days. But that can be avoided by buying stocks that perform similarly to the sold asset, thereby continuing to track the underlying index. Like DI, TLH has been a tool for the wealthy for decades but restricted to them because it required costly time and effort from tax advisors or managers, often at the end of the month or year. With today's technology, it can be done at any time, almost instantaneously, meaning most investors may be able to use TLH to offset capital gains, potentially equating to substantial tax savings depending on individual circumstances.

TLH can be applied whether markets are going up—as they have for more than a decade—or when they pull back, even for a long period of time, as they can do. In bull markets, DI investors capture gains, but also have the opportunity to benefit, tax-wise, from stocks and areas of the market that fail to keep up with the

Evolution of Index Investing



Source: "Improving Client Experience: Customizing with Direct Indexing", Cerulli Associates White Paper, August 2021, page 3.

One of DI's potential advantages is that it can help reduce capital gains taxes, which may allow investors to keep more of their money and potentially enhance long-term outcomes through reinvestment. DI can also help with a critically important skill for long-term investing success: It can help investors manage their emotions.

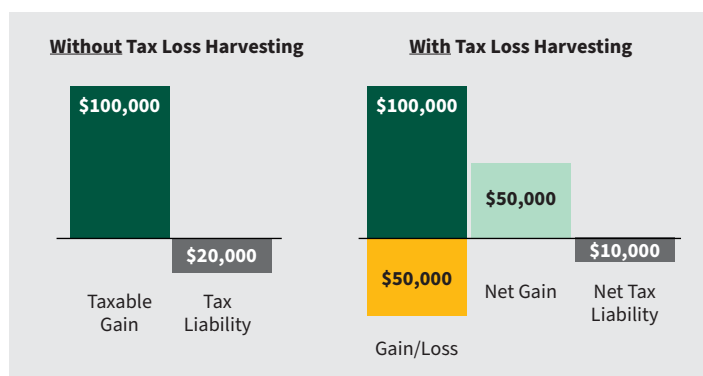
WHAT IS DIRECT INDEXING, AND WHAT DOES IT OFFER?

DI involves buying individual stocks to mimic an index instead of (or along with) an index fund or ETF. It's not a new concept. Sophisticated

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rally (also known as a loss in your portfolio). In down markets, investors capture losses that can be used to reduce taxes and improve after-tax returns. Opportunities abound, as on average, 93% of stocks in the S&P 500® have experienced a drawdown at some point during the year, which may present opportunities for tax-loss harvesting. Those losses can be carried into future years, so the investor could use them down the road, when markets rebound. They can also be used to offset gains from other areas, such as a real estate sale, a business sale, and more.

In the hypothetical example below, an investor sold an asset and realized \$100,000 in long-term capital gains. The tax liability would be \$20,000, assuming a 20% long-term capital gains rate. Now, assume the same investor sold another asset, this time realizing a capital loss of \$50,000. Using TLH, this loss could be used to offset the capital gains, thereby reducing the tax liability by \$10,000.



WHAT ELSE CAN DIRECT INDEXING DO?

Customization

Every investor, and every portfolio, is different. DI provides a higher level of control, allowing for more opportunities to align a portfolio with what matters most to an investor. The alignment can be with the investor's risk preference, financial goals, and values. Some may have a high concentration in their employers' stock or own a business that tends to mirror a certain sector or area of the market. DI may help avoid redundant or risk-compounding holdings by eliminating the overexposed areas from one's personal "index." Some investors may be bullish on certain sectors and bearish on others. They can adjust their portfolio to match their preferences. DI also allows the combination of multiple benchmarks, or custom ones. It can even be used to enable factor tilts or active overlays for investors who want more than market-cap-weighted exposure. You can also use these DI strategies in tax-deferred accounts, and

although the tax savings don't apply, your ability to choose and manage to a "personalized index" is applicable.

This customization can provide an "IKEA effect", the increased sense of value that comes from having contributed to a product's creation, which can make investors less likely to abandon their strategy.

Purpose-Driven Investing

Values, faith, or beliefs can be of great importance to many investors. With DI, they can prioritize what matters to them by choosing stocks that meet their specific ethical or moral guidelines. Standard investment vehicles often lack the flexibility to meet specific value-based metrics. An investor can say, "I don't want to own any oil companies." And the advisor can say, "Yes, we'll manage that portfolio for you. We'll still address tax-loss harvesting, but it's now your own "index", matched up to what's important to you." This way, DI can foster an emotional connection to the tailored portfolio. The endowment effect, which shows that simply owning a product positively impacts its perceived value, can influence investors' behavior by increasing the likelihood that they will stick to their strategy. The naming of accounts can have a similar effect: Research from the 2008 financial crisis showed that traditionally named accounts saw a 50% liquidation rate while goal-based named accounts saw a 5% liquidation rate².

HOW CAN DIRECT INDEXING HELP MANAGE EMOTIONS?

At NewSquare Capital, one of our recurring, evergreen themes is that investors' inherent human biases and emotions can drive poor decisions that can work against achieving investment goals. Managing those emotions is, in our opinion, a key to successful investing. We believe DI offers "skin in the game" in a way that can help connect an investor to their portfolio, which may help reduce the feeling that one should sell during bear markets, or up their risk levels when markets surge higher. To us, it goes beyond that, because it may help tether the client to the advisor, so they're more likely to be on the same page.

We recently read a piece from Orion Behavioral Finance/Orion Portfolio Solutions, a technology services firm serving wealth managers, about the [behavioral effects of DI](#). "Unlike traditional index funds, which are faceless baskets of stocks and bonds," Orion said, "direct indexing ... gives investors something tangible to identify with. That sense of ownership can serve as a gateway to deeper financial conversations—about risk management, college savings, estate planning, small business strategies, and tax optimization."

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Anything, in our minds, that fosters that kind of communication is a good thing—because those talks can help investors stay focused and clear-headed, with a long-term perspective. We'd love to have a conversation about how direct indexing can help you.

The bottom line of DI is that if you have current or future capital gains, DI can give you similar index-like returns (with index-like risk) and, in addition, the potential for improved outcomes from tax savings. Using sophisticated technology, DI may provide benefits that are not typically available in traditional vehicles like ETFs and Mutual Funds.

Market Review

The S&P 500® Index advanced sharply in the third quarter of 2025, finishing with a double-digit year-to-date gain, bolstered by the U.S. Federal Reserve's (Fed's) September interest-rate cut, expectations for more easing, stronger-than-expected corporate earnings, and continued enthusiasm around artificial intelligence (AI). The communication services, information technology, and consumer discretionary sectors accounted for more than half of the index's quarterly gains, as the AI theme powered the market higher.

That said, the equity rally broadened as smaller-capitalization and value names outperformed their large-cap and growth counterparts. Small-caps tend to benefit from lower interest rates and rate-cutting cycles, and with the market pricing in two more cuts before the end of the year, the Fed's move helped push the Russell 2000® Index to all-time highs.

Since the "Liberation Day" pullback in April, the S&P 500® was up approximately 33%, while the Cboe Volatility Index, or VIX, which spiked to 45.31 on April 4 before falling dramatically, was range-bound during the third quarter, rarely piercing 20 and often dipping below 16. Meanwhile, S&P 500®-valuations closed the quarter at nearly 23 times forward earnings estimates, near a five-year high, and well above the 10-year average of 18.7 times.

The Fed reduced the federal funds rate by a quarter point in September as concerns around rising unemployment seemed to outweigh inflation worries. U.S. stocks broadly outperformed other developed markets during the quarter, but failed to keep pace with emerging market stocks, which were boosted by a weaker U.S. dollar and investors' efforts to diversify away from U.S. stocks amid historically high valuation premiums as well as trade and tariff uncertainty. Third-quarter estimates for corporate earnings rose during the period, though some observers worried that rising

expectations could make it difficult for companies to beat forecasts.

U.S. bond markets broadly posted positive returns, with the Bloomberg U.S. Aggregate Bond Index finishing the quarter with a 2% return, up 6% in the first nine months of 2025. Lower-quality sectors such as high-yield bonds generally outperformed, and U.S. Treasury (UST) yields fell across the curve amid concerns about potentially accelerating inflation and a softening job market, with major dips following recent jobs reports. The 10-year UST yield briefly dipped below 4% in September, a five-month low, after the Fed's rate reduction. It had neared 4.5% in mid-July. The market was pricing in two more quarter-point cuts in 2025 and a full percentage point of cuts over the next 12 months.

Commodities markets broadly advanced during the period, led higher by the continuing surge of gold prices, which repeatedly notched all-time highs. Copper prices—viewed as an indicator of global economic health—declined modestly during the quarter. They spiked in July when President Donald Trump proposed a 50% tariff on raw copper, but fell quickly when the proposal was revised to apply to certain copper-based products instead. Still, copper prices were significantly higher on a year-to-date basis, driven by demand for AI data centers and rising defense spending around the world. Oil prices also ended the quarter lower amid fears of a supply glut toward the end of 2025.

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¹Source: SEI Wealth Network, 2008. Shefrin, Hersh, and Meir Statman. "Behavior Portfolio Theory", Journal of Financial and Quantitative Analysis, 2000.

Indexes referenced:

The S&P 500® index is widely regarded as the best single gauge of large-cap US equities. The Index includes 500 leading companies and covers approximately 80% of available market capitalization.

The Russell 2000® Index measures the performance of the small-cap segment of the U.S. equity universe. The Russell 2000® Index is a subset of the Russell 3000® Index representing approximately 10% of the total market capitalization of that index.

The CBOE Volatility Index (VIX), also known as the Fear Index, measures expected market volatility using a portfolio of options on the S&P 500®.

The Bloomberg Barclays US Aggregate Bond Index is a broad-based flagship benchmark that measures the investment-grade, US dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related corporate securities, mortgage-backed securities, (MBS) (agency fixed-rate pass-throughs), asset-backed securities (ABS), and commercial mortgage-backed securities (CMBS) (agency and non-agency).

Additional statistical data sourced from: Bloomberg Finance, LPL Research, Morningstar, and NewSquare Capital, LLC.

Diversification does not guarantee a profit or protect against loss in a declining market.

Benefits of TLH depend on individual tax circumstances. Investors should consult a tax advisor before implementing such a strategy.

As with any investment strategy, DI may not be suitable for all investors and does not eliminate investment risk. Investors should consult with a financial professional to determine whether such strategies align with their goals and circumstances.

Value-based investing may limit diversification and could affect portfolio performance. Investors should consider these factors when evaluating such strategies.

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