Vanguard Personalized Indexing

A practitioner's guide for financial advisors

Personalized indexing, also known as direct indexing, has grown in popularity as traditional barriers have been eroded by trading cost reduction, fractional share capabilities, and modern software. These developments have increased both client demand and the availability of personalized indexing across the industry.

So how should we think about personalized indexing in terms of overall portfolio construction, and when might clients benefit from using it instead of a mutual fund or exchange-traded fund (ETF)? In this practitioner's guide to personalized indexing, we'll answer these questions and provide guiding principles and examples you can use as you consider how Vanguard Personalized Indexing might fit into your practice and your client portfolio construction.

Under the hood

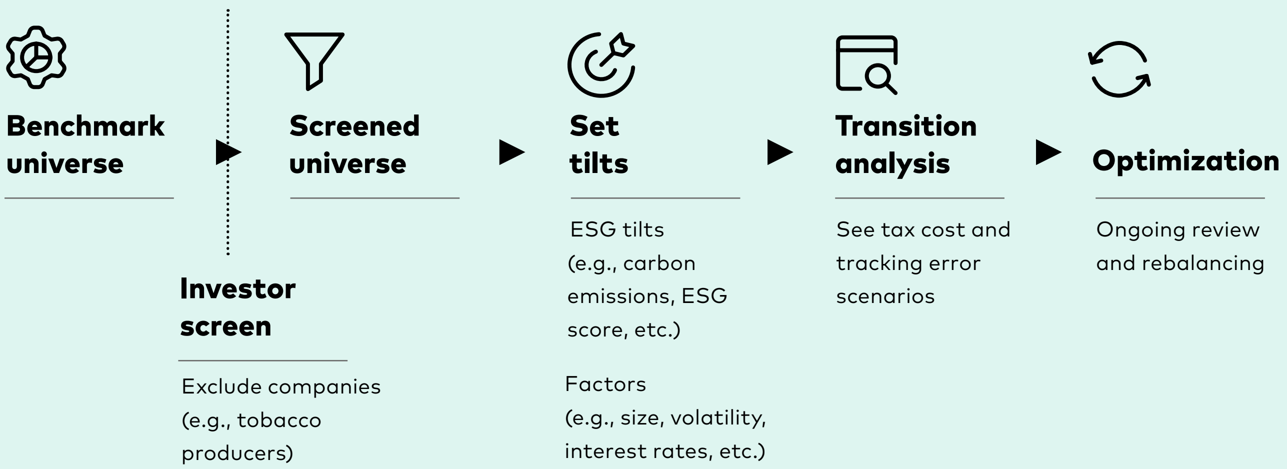
Vanguard Personalized Indexing is a technology-driven investment solution that you can use to offer clients custom portfolios at scale. Because the end client owns shares of the underlying securities in a personalized indexing portfolio (rather than shares of a pooled vehicle, like a mutual fund or ETF), there are additional opportunities to customize their holdings and potentially capture tax alpha.

How does personalized indexing work?

A personalized-indexing portfolio is a separately managed account (SMA) based on an index. With Vanguard Personalized Indexing, you'll first select a traditional market-cap-weighted index (e.g., CRSP US Total Market Index) as the personalized indexing portfolio's starting universe before specifying your client's criteria for customization, which can vary from tilts (e.g., ESG preferences, factor/style tilts) to excluding individual securities or sectors (see figure).

Once you and your client have designed the custom strategy, optimization will run behind the scenes to determine the portfolio of stocks your clients should own. Generally, personalized indexing portfolios comprise a few hundred securities, though the exact number your client holds will depend on the traditional index of choice and the number of requirements imposed.

From this point forward, the optimizer will work to track the custom strategy closely while reflecting the client's criteria (e.g., tax-loss harvesting, factor/ESG tilts). As a result of this approach and the active decisions embedded in the custom strategy, the personalized indexing portfolio will typically run a moderate tracking error against the traditional benchmark. Depending on the decisions you made regarding the screens, tilts, and other portfolio considerations, there will be intended tracking error.



Note: Personalized indexing is available for domestic and international equities across the market-cap spectrum. The coverage of international equity markets may be limited in some cases because non-U.S. personalized indexing equity exposure is constructed using American Depositary Receipts (ADRs), which may have limited availability. As you discuss your client's equity sub-asset allocation, you'll want to consider if personalized indexing provides sufficient exposure to targeted markets.

Use cases for Vanguard Personalized Indexing

As a technology-based platform for investing, personalized indexing can play a variety of roles. You'll use Vanguard Personalized Indexing to tap into one of the following use cases:

Tax-loss harvesting (TLH)
Owning individual securities allows your client to benefit from individual security tax-loss harvesting. By gaining exposure to the stock market through a portfolio of individual securities rather than a fund or ETF, your client will have more opportunities to receive a tax benefit from the sale of securities at a loss in exchange for tracking error in the portfolio (assuming they are in a position to benefit from TLH). Generally, high/ultra-high-net-worth individuals benefit most from TLH as discussed in greater detail in a later section.

Expressing environmental, social, and governance (ESG) preferences
Your client can express their values through custom exclusionary criteria (e.g., carbon emissions, weapons, pesticides), positive impact tilts (e.g., overweighting companies with a higher percentage of women in leadership), or a unique combination of screens and tilts. This customization allows clients to invest according to their values and preferences, which may not have been possible through off-the-shelf funds.

Completion/transition portfolios
You can build a target portfolio around your client's legacy positions (i.e., locked/concentrated positions or restrictions they have on owning certain securities). Additionally, you can transition these positions over time to minimize the tax obligation while enabling the portfolio to achieve the desired investment exposures.

Factor investing
Should you or your client have conviction in a factor strategy, you can build this tilt into the portfolio while also incorporating the TLH and ESG benefits articulated above. For example, you and your client may believe there is a long-term benefit to increasing exposure to certain market-cap and growth characteristics of companies. Vanguard Personalized Indexing supports over- or underweighting to traditional investment factors at your discretion.

Factor investing is complex. Different factor methodologies result in different portfolios with varying levels of factor purity, tracking error, etc. It is especially important to understand the complexities of factor investing and the underlying methodology used, and compare the use of personalized indexing to off-the-shelf factor products to see which best meets your clients' needs.

Fit for your clients

As a customizable solution, personalized indexing portfolios will vary greatly by investor based on their specific goals and constraints. Here are principles to follow as you consider using Vanguard Personalized Indexing in your client's portfolio.

When to use personalized indexing versus mutual funds and ETFs

Below, we highlight the trade-offs of personalized indexing and share some illustrative scenarios. We also compare ETFs, mutual funds, and personalized indexing based on a single like-for-like choice (e.g., comparing three vehicles providing exposure to the same universe such as U.S. large-cap stocks).

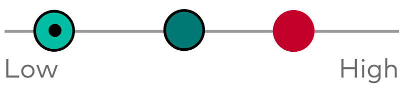
Personalized indexing vs. mutual funds and ETFs*

Active mutual funds and ETFs | Index mutual funds and ETFs | Personalized Indexing

Customization

Personalized indexing allows for a high level of customization as different ESG screens (exclusionary and inclusionary), factor tilts, and exclusions (security or sector-level) can be applied to your index of choice. You can customize the personalized indexing portfolio as much as you want. Some portfolios might look almost exactly like the index but incorporate TLH, while others might have really meaningful differences because they excluded whole sectors or applied many ESG screens. Mutual funds and ETFs cannot be personalized in the same manner, though there are a wide variety of prepackaged options, and the mix of funds can be customized client-by-client.

Potential to minimize tax impact

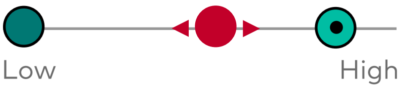


There are two factors to consider: the ability to tax-loss harvest and the tax efficiency of the vehicle itself. In terms of tax-loss harvesting, personalized indexing allows an investor to harvest losses at the security level, unlike mutual funds or ETFs. As a result, losses can be captured even in years the index has gained in value, which can be used to offset gains and then up to $3,000 of taxable income. Losses can be carried forward to future years.

While mutual funds and ETFs can be used for TLH and may or may not regularly distribute taxable income in the form of capital gains distributions, TLH is limited as funds/ETFs cannot distribute net losses to investors. Remember that TLH is more effective when there is regular routine cash flow and for high-net-worth investors in higher tax brackets and who may have realized gains from other types of investments (e.g., real estate, private equity, hedge funds).

For investors who simply want a tax-efficient vehicle to use for a buy-and-hold strategy, a general rule of thumb is that index funds tend to be more tax efficient than active funds, while ETFs tend to be more tax efficient than standalone mutual funds. (Vanguard's ETF share class structure allows our mutual funds with ETF share classes to benefit from the same tax-efficient mechanisms.)

Tracking error



The tracking error of a personalized indexing portfolio will vary based on the extent to which it is customized and TLH is applied. The more customized a portfolio, the more it deviates from the broad-based, market-cap-weighted benchmark, and the greater the tracking error will be. It will be higher than an index mutual fund or ETF, which aims to minimize tracking error. It may or may not be higher than an active mutual fund or ETF, depending on the extent to which the personalized indexing portfolio is customized and how much active risk the manager aims to take on in its strategy.

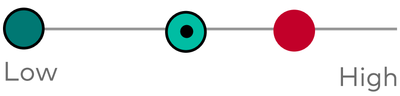
As a reminder, tracking error is simply a measure of active risk, or how much the portfolio is expected to deviate from the benchmark, including both underperformance and outperformance relative to the index, and therefore should not be used as an indication of expected alpha.

For investors who simply want a tax-efficient vehicle to use for a buy-and-hold strategy, a general rule of thumb is that index funds tend to be more tax efficient than active funds, while ETFs tend to be more tax efficient than standalone mutual funds. (Vanguard's ETF share class structure allows our mutual funds with ETF share classes to benefit from the same tax-efficient mechanisms.)

Cost

Personalized indexing is typically more expensive than index funds. Active funds are generally more expensive than personalized indexing. The industry average expense ratio for active funds is around 60 bps with some expense ratios exceeding 100 bps.

Complexity



Personalized indexing can be as complex as you decide to make it. For example, if you just track the index and do TLH, there isn't nearly as much to understand as if you were adding in a variety of factor tilts. Personalized indexing requires education for both you and your client around different customization levers and their impacts on the portfolio. But unlike an active fund, personalized indexing offers additional transparency in that you understand what active decisions are being made (rather than it being up to the discretion of an active manager).

Additionally, owning individual securities through personalized indexing comes with greater logistical complexities, such as lengthy statements. Although mutual funds and ETFs, as prepackaged, pooled products, do require due diligence, the strategy is predetermined.

*The relative positioning in these graphics is an approximation based on Vanguard's knowledge and experience.

Personalized indexing and overall tracking error

Clients will use personalized indexing for a variety of goals, and as a result, each personalized indexing portfolio will result in a different level of tracking error. While there is no one-size-fits all answer for what acceptable tracking error is within a client's personalized indexing portfolio, consider these key questions:

Is the overall portfolio risk appropriate for the client?
Whether or not the tracking error of the personalized indexing sleeve is acceptable will depend on the impact it has on the overall portfolio (e.g., a small, highly customized personalized indexing sleeve may have a high tracking error, but the overall portfolio may have a relatively modest tracking error) and if that overall portfolio risk level is in line with the client's risk tolerance.

Is the tracking error intended?
As stated above, any time you personalize, your client's portfolio will deviate from the originally selected index universe. For example, if a client selects the CRSP US Total Market Index with a value factor tilt or the CRSP US Total Market Index with no fossil fuel stocks, the resulting customized strategy will have tracking error relative to the broad-based index.

If the client believes taking on this additional risk for their customization is worth it, then the tracking error is intended, and likely appropriate. If, however, there is unintended tracking error stemming from the inability to replicate the index due to insufficient cash flow/assets, then the risk is not balanced by any reward and may not be worth it.

Case studies

Many of the previous considerations are trade-offs, and whether Vanguard Personalized Indexing makes more sense than a mutual fund or ETF will depend on your client's goals and risk tolerance. Here are a few case studies to help illustrate the situations in which personalized indexing makes sense.

Desire for personalization beyond that of an off-the-shelf solution

The cost and complexity of personalized indexing must be weighed against the value your client gains from customization. This can be difficult to measure as the benefits of personalization are typically non-pecuniary (i.e., the utility your client derives from seeing their preferences reflected in the portfolio is outside the realm of pure investment alpha), but the following example might be used to think through the decision.

Values-based investing client

Consider for a moment your ESG-focused clients, the ones who care very much about seeing their personal values reflected in their investments. Often, you can find an off-the-shelf mutual fund or ETF that meets their needs, but occasionally, some clients—let's call one Andrew for the purposes of this example—have very specific criteria for personalization.

In this situation, your best bet for building a portfolio that meets Andrew's specific needs (excluding any companies that test on animals and emphasizing companies with good board diversity) will likely be personalized indexing.

To confirm whether personalized indexing is appropriate, you'll want to make sure that Andrew is comfortable with the additional considerations that come with the solution, specifically, a slight fee premium over an index ESG fund, added complexity that comes with owning individual securities, and additional tracking error. Said another way, personalized indexing will be appropriate for Andrew if the non-pecuniary value he derives from customization and values expression outweighs the additional cost of personalized indexing.

Desire for personalization beyond that of an off-the-shelf solution

Specific factor combination client

Consider now your clients who use factors as part of their investment strategy. These could be clients who are well versed in the alpha potential of factor premia, or they could be clients who you believe could benefit from factor tilts in their portfolio, based on their goals and your investment strategy as their advisor. Given the complexity of factor investing, choosing an off-the-shelf ETF product designed to provide factor exposure is generally the best option.

Occasionally, though, there will be a client for whom this solution may not be appropriate. This client—let's call her Emily for the purposes of this example—may have other customization needs that prohibit the use of a prepackaged fund or ETF, or she may want to use a combination of factors or may want to apply those factors to an investment universe that doesn't already exist as a prepackaged product. In either of these situations, personalized indexing may be a good solution for Emily.

To confirm that it is, you'll once again need to be sure that the tradeoffs—additional cost, additional complexity, the potential for additional tracking error—do not outweigh the benefits. In this example, Emily will likely receive both non-pecuniary (i.e., satisfaction of being able to customize) and pecuniary (i.e., potential for added alpha above that of an index fund) value from personalized indexing. As mentioned above, an additional consideration, for both you as the advisor and Emily, is the complexity that comes with factor investing, especially if multiple factors are involved.

Opportunity to benefit from TLH in personalized indexing above and beyond the tax efficiency of an ETF

For many investors, especially lower-net-worth ones, the tax efficiency of personalized indexing will not outweigh the additional cost and complexity. That said, for high-net-worth clients with significant capital gains, the TLH benefit of Vanguard Personalized Indexing—which can be done at the security level and across all market environments—can make a meaningful difference. Leveraging personalized indexing, certain investors can roughly double the amount of harvested losses they generate (personalized indexing investors can harvest about 11% of the account balance as losses in a given year, whereas the loss harvests by commingled fund investors are about 6%).*

High-net-worth client

As you think about your clients, consider those that are particularly tax sensitive. For some clients, simply minimizing taxes by investing in a tax-efficient vehicle like an ETF will be sufficient. For others, usually those who have regular capital gains arising from assets held outside their taxable equity account, TLH is more appropriate as it can be used to offset gains and lighten the tax burden. Within that group of clients, there will be a few—let's call one Greg for the purposes of this example—who will benefit meaningfully from security-level TLH. Vanguard Personalized Indexing allows for daily security-level TLH and works best when the following conditions apply:

- The client has large enough capital gains regularly arising from assets held outside of their taxable equity account (e.g., realized capital gains are on the order of at least 3% to 4% of taxable equity holdings per year).
- They have a meaningful share of wealth invested in their taxable equity account (e.g., at least 20% to 30% of all financial wealth is in taxable equities).
- Greg meets both of these conditions. In this situation, personalized indexing can provide him with additional tax savings on a regular basis and a significant improvement in TLH alpha, with the alpha more than doubling from 53 bps with commingled vehicles to 116 bps with personalized indexing as shown in Vanguard's TLH white paper.*
- As always, make sure the benefits of personalized indexing (additional tax alpha) outweigh the considerations (increased tracking error, additional cost, additional complexity). Also, keep in mind that tax alpha is variable and greater when the following conditions occur:
  - —Volatile market environment.
  - —Large difference between the harvesting tax rate and the liquidation rate.
  - —Regular contributions to the account.
  - —Regular capital gains arising from sources outside of the taxable equity account that is used for TLH.
  - —As a result, if Greg were a one-time, lump sum investor in his personalized indexing portfolio, the TLH opportunities in his personalized indexing portfolio may decrease substantially.

* Kevin Khang, Thomas Paradise, and Joel M. Dickson, 2020. Tax-loss harvesting: A portfolio and wealth planning perspective. Valley Forge, Pa.: The Vanguard Group.

Large existing positions/positions with large embedded capital gains

As stated in the use-case section, Vanguard Personalized Indexing provides the flexibility to both complete around, and transition from, large existing positions.

Legacy position client

Consider your new clients (or existing clients who bring over new assets). Often, they arrive with an existing portfolio. To transition their assets out of the existing positions and into the portfolio you think is most appropriate, you need to sell securities, generally resulting in a taxable event.

For some clients, especially those who are more tax sensitive, this can be challenging. Alternatively, other clients are not allowed to sell out of a position, or they may have an outsized position in another portfolio that they need to work around (e.g., ESOP holding of employer stock, unvested restricted stock position from executive compensation package).

For the purposes of this example, let's examine Gabby, to whom both situations apply. Gabby, a tax-sensitive executive at Amazon, cannot sell her existing company shareholdings due to vesting requirements and restrictions on insider selling, and would like to transition the rest of her portfolio to your recommendations. In this situation, personalized indexing will likely be able to serve two roles for Gabby:

- Using personalized indexing as a transition portfolio will allow you to offset the gains generated by selling some of Gabby's existing positions with losses generated from the personalized indexing portfolio that you are slowly transitioning her into, lessening the tax burden.

- Because she cannot sell her Amazon stock, personalized indexing allows you to transition her into a portfolio that is completed around Amazon (e.g., CRSP US Total Market Index with Amazon excluded individually or as part of a broader sector).

In this scenario, you can lessen Gabby's overexposure to an unsellable legacy position, getting her closer in line to her target allocation.

Multiple use-case clients

This category includes clients who fall into two or more of the above use cases, where the combined benefits outweigh the total cost and complexity, and overall portfolio tracking-error is still appropriate.

Keep in mind

To determine if Vanguard Personalized Indexing is right for your client, consider the following checklist:

- Does your client have specific exposure needs (ESG or other) that can't be met by pooled products?
- Will the potential tax alpha outweigh the extra cost? To assess this, consider if your client fits the financial profile. Key factors include regular cap gains, large equity allocation as a percentage of net worth, regular cash flows, etc.
- Does your client have a large existing position that they cannot sell out of due to restrictions or tax impact and must complete around or slowly transition out of?
- Does your client have the ability to sustain tracking error relative to the starting investment universe?

Harness the power of Vanguard Personalized Indexing

Want more information about this technology-based approach for customizing your clients' investment portfolios to reflect their unique values, financial objectives, and tax-loss-harvesting needs?

Connect with us today at 800-997-2798.

FASPRGDE 062022