remi
by Allspring

With Direct Indexing, Optimization Techniques Matter

KEY TAKEAWAYS

+ How direct indexing portfolios are managed can differ significantly by provider.
+ Different approaches to portfolio optimization can have a material impact on portfolio exposures; tracking error; and, eventually, portfolio outcomes.
+ At Allspring, we believe it is important for our direct indexing portfolios to be optimized daily, accounting for both tax-loss opportunities *and* tracking error.

Is your direct indexing portfolio managed to optimize both tax efficiency *and* tracking error?

While tax-loss harvesting itself is a widely accepted strategy of direct indexing, the process by which it is implemented is often unknown. Moreover, traditional methods may inadvertently add undue tracking risk to a portfolio.

Given our experience, we believe there is a better way.

Portfolio optimization: A look under the hood

Some direct indexing providers use what is called a “triggered” approach to tax-loss harvesting within a portfolio. With this approach, the investment portfolio is monitored for specific conditions or “triggers” that would signal an opportunity for tax-loss harvesting, such as last rebalance date, cash balances, and losses available in the tax lot.

However, this approach to monitoring portfolios is not the same as optimizing the portfolio holistically. While the triggered method accounts for tax-loss opportunities, it may overlook the impact of tax-loss harvest trades on tracking error, which can lead to added tracking drift and, in turn, increased portfolio risk.

At Allspring, both taxes *and* tracking error are considered as part of our daily optimization process on our direct indexing portfolios. Our process is built to detect not only available losses, but also whether those losses should be acted on given their relative impact on tracking error and the mandate of the account.

Portfolio optimization comparison

	TRIGGERED	ALLSPRING
Monitored daily	●	●
Optimized daily		●
Evaluates tax-lot information	●	●
Evaluates tracking error information		●

HYPOTHETICAL EXAMPLE:

PORTFOLIO A:

Losses: 15 bps*
Tracking error: 15 bps of **tracking error improvement as selling losses decrease active weights** in portfolio holdings

PORTFOLIO B:

Losses: 20 bps
Tracking error: 5-bp **increase in tracking error as selling losses increase active weights** in portfolio holdings

RESULTS:

A triggered optimization might overlook Portfolio A or prioritize Portfolio B as it is focused on the losses and not whether the optimization also improves the tracking error.

*basis points (bps; 100 bps equal 1.00%)

Tracking error is a critical metric of direct indexing. For investors, there is an expectation that their portfolio will closely mimic the risk and return profile of the index it is tracking. This may vary in degree given the mandates' emphasis on tax efficiency and/or tracking error, but, nevertheless, it is a critical element of the management process.

High tracking error can imply higher risk. It suggests that the portfolio has positions and/or position weightings that significantly differ from its tracking benchmark, potentially leading to unexpected and undesirable portfolio performance results as compared with the benchmark.

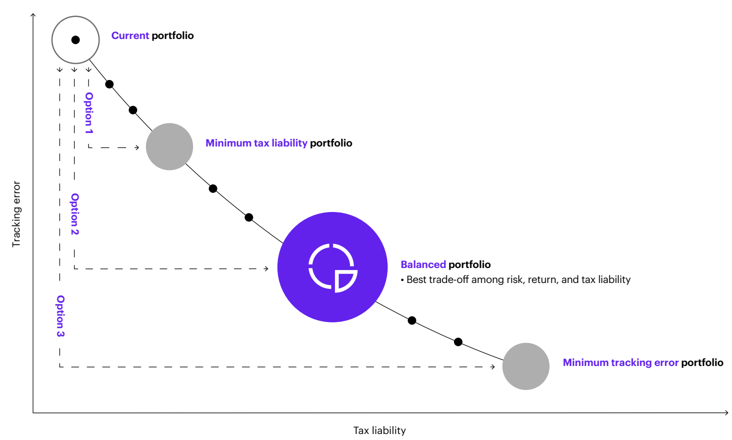
Daily optimization and discretionary implementation

That is why Allspring designed a daily optimization process that accounts for both tax-loss opportunities *and* tracking error. We systematically evaluate tracking error drift and improvement alongside taxes to support better decision-making. While we don't trade portfolios every day, having the requisite insights available on a daily basis helps us make sensible discretionary trading decisions. A more continual, holistic process can result in improved tax efficiency and reduced risk potential, which we believe leads to a better experience for the client.

At Allspring, we recognize that direct indexing strategies should cater to individual client wants, needs, and goals. During the transition period from a legacy portfolio to a new direct indexing portfolio, investors have options for emphasizing distinct levels of tax alpha and tracking error. For instance, a client can choose to minimize tracking error (more closely mirroring the index) or tax liability (prioritizing tax-loss harvesting)—or something in between. This is made possible by our proprietary optimization process, which allows for an enhanced level of specificity—engineered to deliver an elevated and tailored experience for clients.

Of course, portfolio management is more than optimization. Our experienced portfolio management team uses not only the optimization results but also real-world investment acumen to decide when, where, and how to make portfolio adjustments over time.

OPTIMIZE TAX ALPHA AND TRACKING ERROR



Seeking an elevated direct indexing experience for your clients? Meet Remi.

Remi is Allspring's intelligent solution for personalizing SMA portfolios—powered by technology, research, human insights, and systematic tax management. Remi combines Allspring's proven investment expertise with powerful and proprietary technology to deliver truly tailor-made, tax-optimized, and cost-effective fixed income and equity portfolio solutions.

Investors may choose from multiple investment options with Remi, including direct indexing portfolios. If you are interested in enhancing the investing experience for your clients, explore Remi.

Go to allspringglobal.com/remi to learn more.

For further information

We're committed to thoughtful investing, purposeful planning, and the desire to deliver outcomes that expand above and beyond financial gains.

Click or scan the QR code to check out Allspring's insights: