J O U R N A L   A R T I C L E

The Tax Benefits of Direct Indexing: Not a One-Size-Fits-All Formula

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Direct-indexing strategies realize tax benefits by harvesting losses on individual stock positions. Some investors might benefit from this powerful tool for growing after-tax wealth significantly more than others. An important determinant of the tax benefits of direct-indexing strategies is the tax rates applicable to gains from other investments. We argue that high-net-worth investors with allocations to hedge funds and derivatives are the most likely investors to have systematic short-term capital gains and, therefore, derive the highest tax benefits from direct-indexing strategies. We use a long history of U.S. stock returns to estimate the level of tax benefits offered by direct-indexing strategies under different tax rate assumptions. We show that investors, even those without short-term capital gains in their portfolios, can significantly increase the tax benefits of direct indexing by regular capital contributions and charitable giving of appreciated stocks. A character-deferral decomposition of the tax benefits helps explain what drives this result.

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