

Where Do We Go From Here: Direct Indexing and ETFs



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The emergence of direct indexing has the potential to reshape how advisors implement their client portfolios, but what is the trajectory of direct indices and how will advisors choose between them and ETFs? Perhaps the history of ETFs can offer some guidance.

ETFs first appeared in 1993 with the launch of SPY, the SPDR S&P 500 sponsored by State Street Global Advisors. The initial focus of ETFs was to provide a tax efficient vehicle that could track broad market indices while being both liquid and cost effective. In the 2000s ETFs began to gain traction with institutional investors as the use case expanded to include active and thematic versions. In 2024, ETFs attracted over \$1 trillion in inflows and now represent over \$10 trillion in assets¹ and roughly 30% in daily trading volume.²

Comparatively speaking, direct indexing is in its early innings. While the first version of direct indexing emerged in the 1990s, it focused on institutional investors and ultra-high-net-worth individuals through large, separately managed accounts. It wasn't until recently that it began to gain traction. Advances in fractional share trading, automation, and advisor platforms in the early 2020's opened the door to direct indexing "2.0" and marked the start of the democratization of direct indexing. In the past three years, the dollars invested in direct indexing have roughly doubled to an estimated \$860 billion in assets at year end 2024.³

The debate between direct indexing and ETFs in some ways mirrors the broader active versus passive debate. While investors often express preferences, the two approaches are not mutually exclusive but rather complementary. ETFs are flexible and are well-suited for gaining broad passive market exposure and for more sophisticated

investment solutions, including buffered ETFs, defined volatility strategies, and other products that rely on derivatives or leverage—tools that can be difficult for advisors to implement efficiently at smaller scales. Additionally, they can provide efficient access to strategies that are harder to replicate in a direct indexing environment. The PIMCO Total Return ETF (ticker: BOND) is a good example as it holds over 7,000 securities. The challenge with ETFs is they are not customizable and are tax efficient to a point. Direct indexing possesses the following benefits:

1. Tax management: direct indexing provides the ability to perform tax-loss harvesting at the stock level, enhancing potential tax savings and improving after-tax returns for clients.

2. Clarity in portfolio construction: Investors can exclude certain stocks or sectors to deal with legacy portfolio constraints, or to implement a particular investment point of view that may not be found in an off-the-shelf product.

In the ETF world, there can be material differences in how managers choose to implement the same theme. Consider the following cybersecurity related ETFs:

- The Global X Cybersecurity ETF (ticker: BUG) has about 87% of its weight invested in cybersecurity software revenue streams. Based on Syntax's FIS industry classification system, just 4% of the weight in the portfolio is tied to revenue streams unrelated to cybersecurity.

- The Amplify Cybersecurity ETF (ticker: HACK) has roughly 63% of its weight in cybersecurity software revenue, while 30% of its weight is in non-cybersecurity related product lines.

These differences are largely driven by differences in focus on pure-play companies and conglomerates and do not inherently make one ETF superior to the other. However, this example illustrates that managers can define market segments and themes in multiple ways. With a direct index, the advisor, working with their client, can define the characteristics of their desired holdings, removing the potential ambiguity around what you really own.

3. Flexibility in implementation: Using the Syntax Direct platform, for example, you can select predefined diversified benchmarks and themes or create your own index. You can combine themes, exclude certain securities, and tilt the index to factors and fundamentals such as value, growth, low leverage and high dividends.

4. Transparency: The underlying securities are held directly in the client's name. This provides clear visibility into individual holdings, making it easier for advisors to monitor, report on, and manage a client's portfolio with precision and accountability.

There is plenty of room for direct indexing to co-exist with ETFs, consider the following examples an advisor can mix and match within a core-satellite approach where advisors build a foundation of broad, low-cost, long-term investments and complement it with more targeted exposures. Keep reading after the content section of the newsletter for more of our thoughts on where directing indexing goes from here.

Within a core-satellite framework, the core typically consists of diversified holdings that provide market-wide exposure, while the satellite positions are designed to enhance or personalize the portfolio, incorporating sector-specific strategies, niche asset classes like REITs, emerging markets, or themes. Here are a few illustrative examples:

Example 1: An individual works for a large Silicon Valley firm and receives compensation in the form of salary, shares, and options. She is concerned about the concentration risk associated with her career, compensation at work, and investment portfolio all being closely linked to the technology sector. Her advisor recommends holding a core position in a direct index that holds the S&P 500 but excludes the technology sector. To provide some exposure to innovation outside the information technology sector, the advisor suggests satellite positions in two ETFs with one focused on biotechnology, and the other on power solutions for the energy market.

Example 2: A family has created a significant portion of their wealth from owning multi-family properties. They know and understand real estate but want to avoid creating additional exposure to residential properties. Their advisor suggests holding a core position in a Russell 3000 ETF to provide exposure to the broad US stock market and using a direct index as a satellite position that invests in REITs excluding residential property, such as warehouses, office buildings, data centers, and healthcare.

From our perspective it is not a question of direct indexing or ETFs, but how best can an advisor use these tools to meet the needs of their clients and business.

When we think about the future of direct indexing and ETFs, we view the investing landscape through two distinct lenses: taxable assets and retirement assets. When managing taxable assets, the goal is to maximize after-tax returns, which plays to the strengths of direct indexing. We believe over time, direct indexing should become the core holding(s) in individual portfolios based on its clear tax management advantages today and the potential future enhancement of incorporating short positions into portfolios to increase tax loss harvesting opportunities.

Retirement assets, on the other hand, grow tax deferred or exempt. We believe the role of direct indexing and ETFs will be influenced by advisor preferences and how they construct portfolios. A top-down approach lends itself to ETFs where the advisor selects an option to fill each targeted asset allocation bucket (e.g., domestic large cap, international developed, core fixed income). Whereas in a bottoms-up approach where the advisor identifies the desired market or beta exposures, and uses a direct index (or combination of direct indices) to build a portfolio provides precision and transparency.

1. The evolution of exchange traded funds - Invesco QQQ ETF | Invesco US
2. A Brief History of Exchange-Traded Funds
3. After ending 2024 with \$865B, direct indexing has more room to grow - InvestmentNews