

Replacing the Difficulty of Stock Picking: An Ode to Direct Indexing



The financial world is buzzing with stories on how stock picking has become increasingly more difficult. Whether this challenge is the result of broad market cycles, the growth of ETFs, or the addition of more quant-based strategies, stock selection continues to have massive implications for investors' financial health.

But what if you could offer a tax-managed stock strategy to your clients without having to worry about stock selection? In 2018, Orion created ASTRO, a portfolio optimization and risk modeling tool, to give advisors an opportunity to do just that.

ASTRO sees the world differently than most tools. Instead of viewing a portfolio as a collection of securities, it views it as a collection of risk factors. This subtle but powerful difference enables advisors to build stock-based SMA strategies for their clients. Let's see how.

Direct Indexing: ASTRO in Motion

You may be familiar with the term 'direct indexing,' or replicating the performance of an index by purchasing the underlying shares. Let's assume that you'd like to replicate the risk and return profile of the S&P 500; however, instead of owning all 504 securities, you want to replicate the index with only 100 securities.

First, ASTRO will decompose the S&P 500 into a series of factor exposures based on the underlying securities. Some examples of these factors include Beta, Market Capitalization, EPS growth rates, and Relative Strength¹.

Then, ASTRO will look at the factor exposures of the securities currently held within the client's portfolio—taking into account any unrealized gains or losses associated with each position. The optimization engine will build a portfolio of stocks from the S&P 500 and the client's account to replicate (as close as possible) the factor exposure of the S&P 500—given the constraint that it can only use 100 securities. ASTRO will tell you how close it expects the portfolio to track the S&P 500 by providing you with Tracking Error and R-Squared² statistics.

Let's take the above example one step further. Now, you'd like to replicate your favorite mutual fund manager's strategy—allowing your client to hold individual securities while accounting for tax sensitivity and a similar risk/return profile as that fund. ASTRO will decompose the fund's factor exposures and then build a portfolio of individual equities that gives the client a similar factor exposure as that fund.

Conclusion

Historically, stock-based SMA strategies have only been available to large institutional firms—and at an expensive price point. With ASTRO, RIAs can cost-effectively enhance their client offerings with direct indexing—without having to sweat over stock selection.

To learn more about how ASTRO can help you implement direct indexing strategies for your clients, sign up for one of our upcoming ASTRO demos.

1. *For a complete list of actual factors, please reach out to the ASTRO team astro@orionadvisor.com*
2. *Tracking Error indicates how closely a portfolio follows the index to which it is benchmarked. For example, a tracking error of 1% means that a portfolio's return should be within 1% of the index's return 2 out of 3 years. R-Squared measures how closely each change in price of the portfolio is correlated to the index. An R-Squared of 1 means they are perfectly correlated.*