

# Solving the Problem of Mass Customization in SMA Portfolios



There have been a number of articles written recently which speculate that while ETFs will continue to grow as a group, there is a looming offering that is bound to disrupt the ETF industry.

That monster hiding under the bed? It's advisors using technology platforms to build their own custom direct indexing solutions.

While current thought leadership on this topic is going in the right direction, it is on the wrong path<sup>1</sup>. Direct indexing is only half the story.

## Finding a Solution for the Problem of Mass Customization

The media is missing that this is not solely a "Direct Indexing" story; it is a story about the ability to create custom SMA portfolios in an efficient and scalable way. Put another way, the story is in finding a solution for the "Mass Customization" problem that everyone is striving to solve.

While custom direct indexing strategies will take assets from some ETFs, in order to provide the "Mass" in Mass Customization ETFs will continue to play a necessary role in some portfolios. Without ETFs, there is not an efficient way to gain certain exposures in a pure SMA wrapper for accounts below specific thresholds.

The good news is that advisors do not need to wait for technology to catch up to the promise; there are solutions in the marketplace today that can accomplish

mass customization at various levels of sophistication. In fact, Orion has developed the ASTRO platform specifically to address this problem<sup>2</sup>.

Setting up a custom SMA portfolio in ASTRO involves four basic steps:

- Define your set of target exposures
- Set your broad constraints
- Input Client-specific considerations
- Select your security universe

Once these four steps have been completed by an advisor, ASTRO completes the rest of the portfolio construction.

The platform will construct a portfolio with the goal of minimizing the tracking against target exposure(s) while meeting all of the constraints and considerations that have been set within the system.

Advisors do not have to worry about equivalences for security restrictions or for the purpose of tax loss harvesting, because ASTRO handles all of it.

## How ASTRO Constructs Custom SMA Portfolios

Let's review an example of how the four steps previously identified would work in action.

- **Define Your Set of Target Exposures**

Broad Domestic exposure that captures Large-, Mid- and Small-cap securities.

- **Set Your Broad Constraints**

Target a 2% tracking error with a maximum security weight of 5% and own a maximum of 200 securities.

- **Input Client-Specific Considerations**

Client A works at Microsoft and doesn't want to own Microsoft (MSFT). Client B works at Deloitte and is not allowed to own a list of 200 securities. Client C doesn't want to own any company that deals with Tobacco or Alcohol. All three clients expect to pay 37% Short-Term Tax rate and 20% Long-Term Tax Rate.

- **Select Your Security Universe**

Assign a broad list of US Equities to the model, alternatively a suite of ETFs could be used instead. You can even get creative by using individual equities and a curated suite of ETFs.

Once all of the information is entered into ASTRO, you can construct portfolios for all three clients at the same without individually and manually addressing each of their specific considerations<sup>3</sup>.

ASTRO not only handles all of each client's security-related constraints, but it also does it all in a tax-efficient manner. All the details around security selection, capital gains restrictions, and portfolio construction are handled without any further advisor intervention<sup>4</sup>.

While "Direct Indexing" is part of this story, it is much more than a single use case.

There now exists a platform that allows firms to create custom solutions to meet their clients' varied demands in an efficient and scalable manner.

**Ready to see what ASTRO can do for your clients?** Click here to attend a webinar and see how you can customize portfolios at scale.

<sup>1</sup> *An issue of mine is the lack of a common definition for "Direct Indexing". A number of firms say they provide Direct Indexing while their offerings differ significantly.*

<sup>2</sup> *Yes, I may be partially biased since I lead this effort here at Orion. While I tend to think ours is the best, there are other platforms that can do similar things.*

<sup>3</sup> *Technically, ASTRO is leveraging a sophisticated optimization engine to independently optimize each account.*

<sup>4</sup> *It's important to remember that there is a tradeoff between the number and level of restrictions and the expected tracking error.*