WEALTHCARE
financial guidance for life

Wealthcare Direct Indexing

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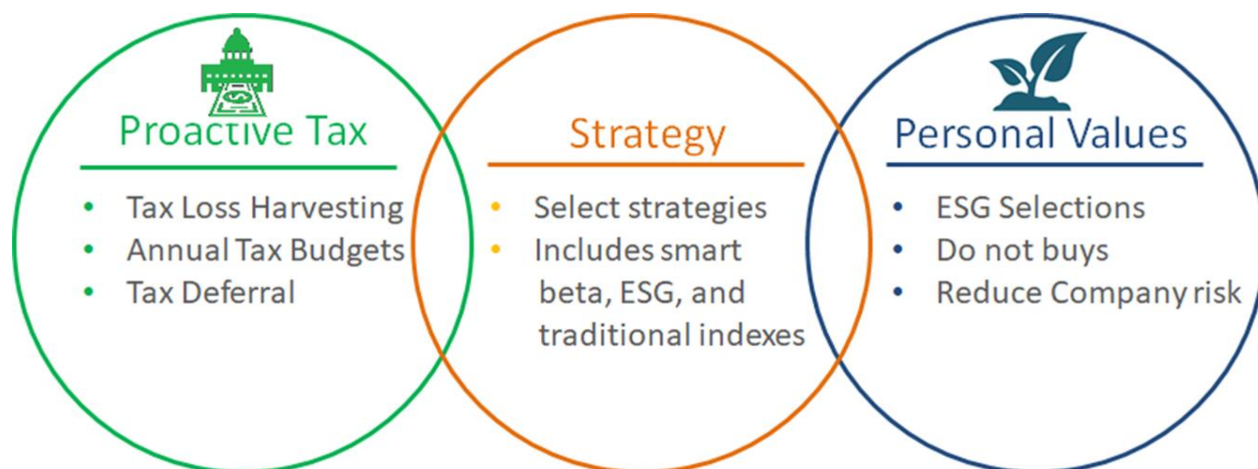
What is Direct Indexing

- A separate managed account that allows investors to take charge of their passive mandates allowing improved customization.
- Investors can select from a wide range of benchmarks and then tailor their exposure to incorporate their unique objectives.

> Michael Kitces : "Indexing 2.0 represents the potential for a total disruption of the existing index fund and ETF industry, by the re-creation of all existing tax-efficient index funds *in an even more tax-efficient manner!"*

The Value of Wealthcare Direct Indexing



Investment Process

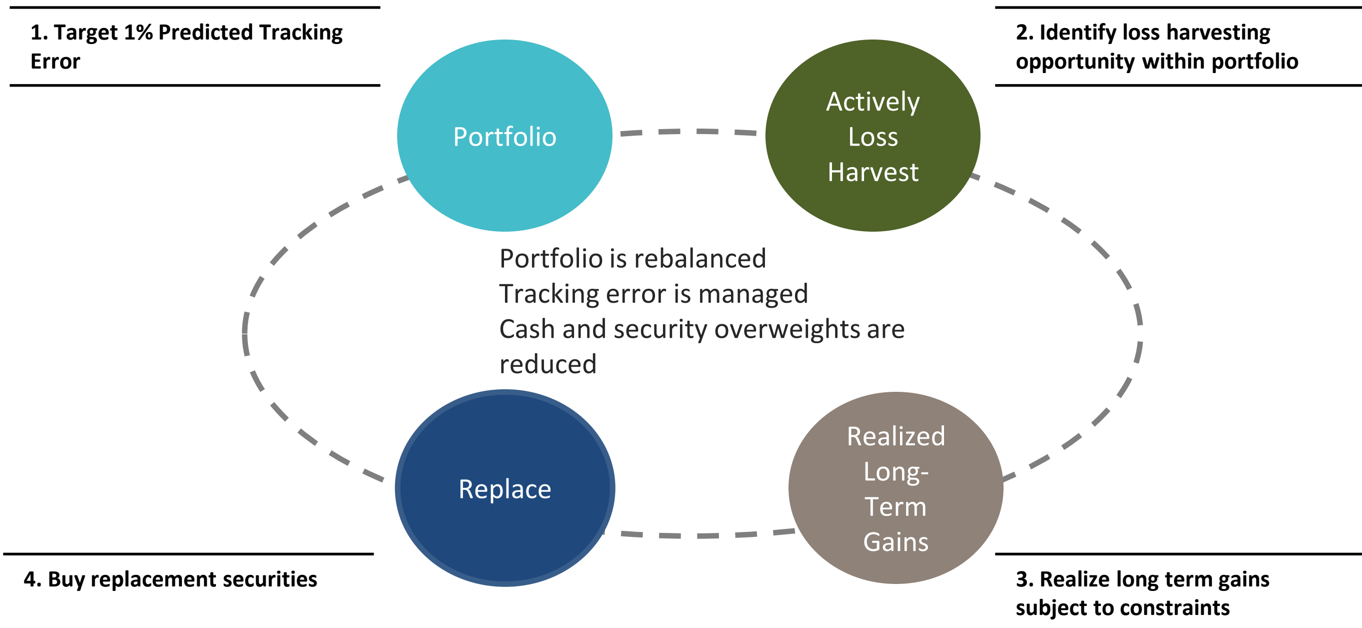
- You select a benchmark strategy. Examples include:

  S&P 500;
  Russell 3000;
  Dividend Strategy;
  MSCI KLD 400 Social

- Choose to apply tax management for taxable portfolios;
- You can restrict individual securities;
- You can apply exclusionary ESG screens

- Tracking error and risk are monitored continuously using multi-factor risk models;
- Tax management strategies and holding period management are applied where appropriate.

Wealthcare Rebalancing Process



Tax Management

Several academic studies[1, 2] have estimated that taxes historically erode 1%–2% of a client's investment returns. Mutual funds have come under increased scrutiny due to their embedded capital gains exposure and their capital gains distributions which are not initiated by the underlying investor. As a result of the creation and redemption process of exchange traded funds (ETFs), ETF have been more tax efficient than mutual funds.

	Direct Indexing	ETFs	Mutual Funds
Tax loss harvest on individual securities	☑	☒	☒
Custom Indexes and ESG Criteria	☑	☒	☒
Distribute Losses	☑	☒	☒
Avoids Uncontrolled Gain Gains	☑	☒	☒
Avoids embedded capital gains	☑	☒	☒
Low minimum account	▤	☑	☑

Tax Efficiency of Separate Account Managements (SAMs): However, both ETFs and mutual funds by nature are unable to distribute losses on an individual stock level. As such, separate account management has the ability to be more tax efficient. Wealthcare's strategies for separately managed accounts (SMAs) are designed to generate predictable tax alpha by integrating tax-loss harvesting (TLH) strategies with equity index-tracking portfolios. Depending on the client's tax situation, research has shown loss harvesting can improve annual active return by 1.7%–2.2% (before any fee differential and without liquidation) over a 10-year period versus a comparable index fund or exchange-traded fund (ETF).*

PROCESS
▪ Identify loss harvesting opportunities
▪ Sell tax lots with unrealized losses
▪ Reinvest proceeds in new securities
▪ Monitor tracking error
▪ Avoid wash sales
▪ Manage holding period
▪ Defer realization of capital gains

POTENTIAL RESULTS
▪ After-tax return is potentially 1-2% higher per year than pre tax return
▪ Realized losses in the portfolio may be used to offset gains from other investments.

Wealthcare will continuously monitor and rebalance portfolios to recognize tax losses from securities that have declined. Realized tax losses can then offset taxable capital gains generated by other assets.

1 Lipper Analytics 2010 Tax Study.2 Peterson, J.D., P.A. Pietranico, M.W. Riepe and F. Xu, "Explaining After-Tax Mutual Fund Performance." Financial Analysts Journal, Vol. 58, No. 1 (January/February 2002).
2 Longmeier, G. and G. Wotherspoon, "The Value of Tax Efficient Investments: An Analysis of After-Tax Mutual Fund and Index Returns." Journal of Wealth Management, Fall 2006.

Market Conditions that Favor Tax Loss Harvesting Strategies

Factor	Performance Effect
Volatility	The greater the volatility, the more opportunities to tax loss harvest
Market Returns	A low return enviornment is more favorable to generating tax alpha compared to robust equity returns.
Spread	The greater the spread between long term capital gains and ordinary income, the greater the tax alpha opportunities.

Client Suitability

The Big Winners from Tax Loss Harvesting	
High Income Earner	Ability to deduct maximum $3,000 losses against ordinary income benefits those in higher brackets.
Steady Saver	Regular deposits create multiple price points, which offer continuous harvesting opportunities.
Philanthropist	To the extent that the appreciated securities are donated to charity or passed down to heirs, the tax can be avoided entirely
Clients Who Benefit the Least	
Scattered Portfolio	Direct Indexing is carefully calibrated to manage wash sales across all assets managed by Wealthcare, including IRA assets. However, the algorithms cannot take into account information that is not available.
Imminent Liquidator	For those who expect a significant imminent withdrawal of capital, tax loss harvesting will not yield optimal results.

Key Tax Considerations Before You Invest

U.S. tax law limitations	U.S. tax law may prohibit you from taking all realized losses into account in the current year. U.S. tax law limits recognition of investment losses depending on an investor's particular circumstances including investments outside the portfolio and the total amount of losses and gains recognized during the year.
Performance	The loss harvesting process may cause the strategy to underperform compared to the benchmark. Because Wealthcare intends to manage the portfolio with certain U.S. tax considerations, the strategy may be prohibited from making certain investments during the year which could have an adverse effect on performance.
Wash sales with accounts held away	There is the risk that wash sales could be generated if purchases and/or sales of securities occur in another account held by the same client.
Tax law may change	There is the risk that tax laws could change which could make the strategy more or less advantageous.
Ability to harvest losses may decrease over time	There is the risk that over time the ability to harvest losses decreases considerably – a situation sometimes referred to as "gain locked".
Net gains may be realized	There is the risk that Wealthcare may realize net gains in an effort to control portfolio risk.
Gains may not be fully offset by losses*	Gains recognized may not be fully offset by losses. The strategy could increase your tax liability if you do not have adequate losses to offset the gains recognized

Strategy Selection

Direct Indexing is a process that seeks to replicate the performance and risk profile of an index by purchasing its underlying securities.

Traditional Passive Strategies: With Wealthcare Direct you can choose to select a traditional market capitalization index such as the S&P 500 Index. Many traditional indexes weigh member companies (or "constituents") according to market capitalization, which is calculated by multiplying a company's share price by the number of shares outstanding. This is known as market-cap weighting, which is frequently an indicator of company size.

Rules-based Strategies / Smart Beta: By contrast, a smart beta approach assesses and weights companies by other characteristics that have nothing to do with market capitalization. Many smart beta strategies choose their member companies based on factors, or investment characteristics that may help drive returns. Some examples of commonly used factors include:

Popular Rules Based Strategies through Direct Indexing	
Quality	Stocks are selected and weighted based on their return on equity (which measures profitability).
Value	Stocks are selected and weighted according to their price-to-book ratio, which is a means of valuing a company.
Low Volatility	Stocks are selected and weighted according to their historical volatility, with the less volatile stocks getting larger weights.
Dividend Yield	Stocks are selected and weighted according to their dividend yield, which measures the dividend distribution.

Wealthcare Direct Indexing: Wealthcare's Direct Indexing enables you to replicate ETF strategies in separately managed accounts to provide the cost savings of indexing combined with tax efficiency. We construct a portfolio reflecting each client's preferred trade-off between an index and tax alpha.

Portfolios that Reflect Personal Values

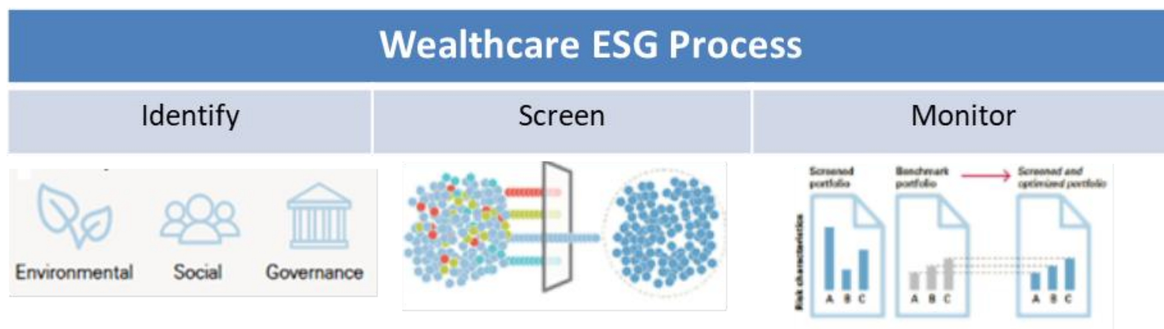
Investors throughout the world are increasingly interested in environmental, social, and governance (ESG) issues.

We believe that specific forms of ESG investing can be prudent for investors with particular preferences, beliefs, resources, and circumstances. As with any other form of investing, investors must establish their goals and weigh the potential benefits of the various approaches against any relevant risks and costs to give themselves the best chance of achieving their desired outcome.

Will screening help or harm investment performance?

One of the most frequently asked questions is whether an investor can "do good and do well" when screening portfolios. In other words, is there a financial benefit or sacrifice when removing companies from an opportunity set because of certain corporate practices? There is currently no industry consensus on this answer, and a commonly cited meta study has shown mixed results (Friede, Busch, and Bassen, 2015). In general, investors should understand that performance may be materially different from conventional investment options (indexed or active) over various time periods and that cost and diversification are key considerations.

Mutual Funds and ETFs with separate accounts may provide an effective vehicle to implement ones views, however can be blunt. Given the higher degree of control in separate account management, screens can be customized to identify and implement individual personal values.



Once the goals have been determined and the range of potential options identified and reviewed, the next step is to decide what to do based on the investor's customized decision-making criteria. This should include an assessment of direct or indirect implications of each option they are considering. The potential trade-offs of ESG-related actions will differ by investor and sometimes will require significant judgment, particularly if the investor has values preferences, such as humanitarian, political, or religious.

Disclosures

All investments carry a degree of risk of loss of principal and there is no assurance that an investment will provide positive performance over any period of time.

Investors should consider the investment objectives, risk, charges and expenses of an investment carefully before investing. A rise/fall in the interest rates can have a significant impact on bond prices and the NAV (net asset value) of a fund. Funds that invest in bonds can lose their value as interest rates rise and an investor can lose principal. High yield bonds (lower rated or junk bonds) experience higher volatility and increased credit risk when compared to other fixed income investments.

Past performance is not necessarily indicative of future returns and the value of an investment may decrease as well as increase, an investor may not receive the amount initially invested, and income, if any, may fluctuate. The value of an investment may be affected by a variety of factors, including economic and political developments, interest rates and foreign exchange rates, as well as issuer-specific events. Returns do not reflect the deduction of advisory fees, brokerage fees or any other expenses that the accounts would have or actually paid.

Small-Mid Cap stocks may be subject to a higher degree of risk than more established companies' securities. The liquidity of the small-cap market may adversely affect the value of these investments so that shares, when redeemed, may be worth more or less than their original cost.

International stocks may be subject to a higher degree of risk than stocks of established domestic companies because of currency fluctuations, political instability and other uncertainties. Shares when redeemed may be worth more or less than their original cost.

Exchanged Traded Funds (ETFs) are designed to track an assigned index or strategy. ETFs are structured so that the shareholder owns an portfolio of securities. There is no guarantee that an investor in an ETF will earn the return of the target index. ETF fees, bid/offer spreads, deviations from net asset value and tracking risk to the target portfolio can reduce the return earned by the investor.

Exchanged Traded Notes (ETNs) are designed to track an assigned index or strategy. ETNs are structured so that the issuer guarantees the return of the target index less fees. There is no guarantee that an investor in an ETN will earn the return of the target index less fees. ETN bid/offer spreads, deviations from net asset value and default risk of the issuer can reduce the return earned by the investor.

Please note that programs providing tax aware investment management should not replace your consultation with a professional advisor regarding your tax situation. Municipal bond income may be subject to state income tax if issued by a state other than your domicile state, and may be subject to the Alternative Minimum Tax. This information should not be construed as specific tax or investment advice. A prospective client should review their investment objectives, risk tolerance, tax situation, and liquidity needs before choosing an investment.

Investors should note that there are frequently material differences between hypothetical, back-tested or simulated performance results and actual results subsequently achieved by any investment strategy. Unlike an actual performance record based on trading actual client portfolios, simulated results are achieved by means of the retroactive application of a back-tested model itself designed with the benefit of hindsight. Simulated performance does not necessarily reflect the impact that material economic or market factors might have on an adviser's decision making process if the adviser were actually managing a client's portfolio. The back-testing of performance differs from actual account performance because the investment strategy may be adjusted at any time, for any reason and can continue to be changed until desired or better performance results are achieved. No representation is made that any index or account will or is likely to achieve profits or losses similar to those shown. Alternative modeling techniques or assumptions might produce significantly different results and prove to be more appropriate. Past hypothetical, back-test or simulated results are neither indicators nor guarantees of future returns.