Frequently Asked Questions

First Trust

What is direct indexing?

Direct indexing seeks to closely track the performance of a market index while realizing tax losses to increase after-tax returns.

How does direct indexing work?

The Direct Indexing process starts by selecting the benchmark an investor seeks to track. Exposures to that benchmark can be customized to align with account-specific needs as well as personal values. The portfolio optimization process divides the index into a series of factor exposures and builds a sample subset of securities that still closely represents the exposure of the full index. The result is a customized portfolio of individual securities that investors own via a separately managed account ("SMA"). The tax-optimized portfolio uses continuous tax-loss harvesting to seek to increase after-tax returns.

What is tax-loss harvesting?

Tax-loss harvesting is selling securities to realize capital losses and replacing them with similar securities. The realized capital losses can offset capital gains, reduce taxes paid, and enhance after-tax returns.

What is tax alpha?

Tax alpha is the value created through tax-loss harvesting techniques and is a measure of the after-tax excess return an investor achieves compared to the pre-tax excess return vs. their selected benchmark.

What are tax-efficient transitions of appreciated securities?

Investors in taxable accounts need to consider potential tax liabilities when transitioning appreciated securities with unrealized capital gains. Selling the securities may trigger undesirable tax consequences. However, a direct index SMA can be funded in-kind without creating a taxable event. The tax-aware portfolio optimization process can be used to achieve a tax-efficient portfolio transition and potentially minimize, delay or avoid net taxes.

What is transition alpha?

Transition alpha is the excess return attributable to tax savings versus liquidation of the appreciated security.

What kinds of personalization and customization are available with direct indexing?

Whether prioritizing traditional factors, risk management strategies, or values-based investing, our direct indexing platform provides a menu of 70 levels of customization.

How is direct indexing different from a pooled investment vehicle such as an ETF or mutual fund?

Although exchange-traded funds ("ETFs") and mutual funds can deliver broad market exposure, direct indexing does so with a key difference: a portfolio can be tailored to an investor's specific needs and incorporate tax-loss harvesting strategies. Direct indexing portfolios can also be funded with either cash or an existing portfolio of securities (in-kind), including appreciated stock, which may create tax advantages beyond what ETFs and mutual funds may offer.

This summary is not intended to be tax or legal advice. This summary cannot be used by any taxpayer for the purpose of avoiding tax penalties that may be imposed on the taxpayer. This summary is being used to support the promotion or marketing of the transactions herein. The taxpayer should consult an independent tax advisor.

Investors or financial professionals should consult with a tax professional regarding the potential application of loss deferral regimes, such as wash sales and straddles, to these securities and potential transactions along with other securities and transactions in the broader portfolio.

The information presented is not intended to constitute an investment recommendation for, or advice to, any specific person. By providing this information, First Trust is not undertaking to give advice in any fiduciary capacity within the meaning of ERISA, the Internal Revenue Code or any other regulatory framework. Financial professionals are responsible for evaluating investment risks independently and for exercising independent judgment in determining whether investments are appropriate for their clients.

The strategy was previously managed by First Trust Direct Indexing ("FTDI"). Effective October 31, 2024, FTDI merged into First Trust Advisors L.P. ("FTA"). All business activities, including portfolio management and business records are now performed under FTA.

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