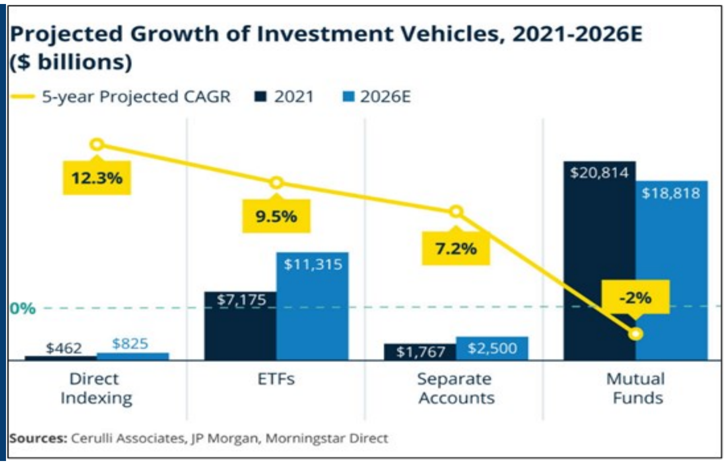
October 2, 2023

Market Musings

A newsletter brought to you by Victoria Capital Management, Inc.

VOL. 6, ISSUE 10

According to Cerulli Associates, direct indexing will grow to more than $800 billion in assets by 2026, outpacing the growth rates of other investment vehicles. As market events impact transactions, the selling of those stocks that are experiencing increasing unrealized losses could be substantial.



Is Direct Indexing Another Name for Portfolio Insurance?

When we first heard about Direct Indexing it sounded like a clever idea. Managing individual stocks in taxable portfolios that mirrored an index and then selling those securities that had unrealized losses to provide taxable investors with a tax deduction seemed to make sense. The idea relied on the fact that individual securities change price much faster than an index and investors could take advantage of short-term price swings. Over the past few years, this concept has ballooned with many firms advertising the benefits of this tax-advantaged investment strategy. However, the success of this scheme could trigger risks for the stock market in general.

In the 1980s a similar strategy gained popularity with the institutional investment community -- portfolio insurance. The idea was that market declines would trigger partial sales of securities in institutional accounts so that the portfolio would have an increasing cash position that would buffer the portfolio from market declines. This idea made so much sense to institutional investors that it received widespread acceptance. Unfortunately, when the market began to decline in October of 1987, portfolio insurance kicked in across multiple institutional portfolios and the stock market crashed on Monday, October 19th declining by 23% that day! The problem was that the stock market could not absorb the massive automatic program selling of securities and snowballed into a disaster as trading on the New York Stock Exchange effectively stopped. The Federal Reserve had to reverse the panic by lending money to market makers so that they could buy stocks.

Direct Indexing poses a similar risk. As more firms convince their clients to engage in this investment strategy, stocks with unrealized losses will be sold because they have fallen in price to create a capital loss which is advantageous for taxable investors. Then these stocks fall further and are sold by other investors who have a loss. The process weighs on weak stocks while minimizing sales of strong stocks. As the overall market declines, more stocks will be sold to recognize the loss – another snowball effect. To avoid another “Black Monday,” the government should eliminate the deduction of capital losses from securities but, to offset the loss of that deduction, the government should lower the capital gains tax to 10%. The result would be no run on the market and increased tax collections from having only to pay a 10% tax on capital gains while the absence of tax write-offs would benefit tax revenues.

“Actions speak louder than words.”

Melancholy State of Provence, 1736

Market Commentary

September lived up to its reputation of being the worst month for domestic stocks with small caps being particularly hard hit – declining by 6.0%! Mid-cap stocks were also down for the month by 5.3%. Investors who sought safety in large caps fared better with a decline of only 4.8%. Foreign stock markets also suffered declines with Pan Asia down 2.3%, Europe down 1.5%, and Emerging Markets down by almost 3%. Fixed-income securities across the globe declined as well while domestic yields rose to levels not seen since 2007. The U.S. dollar continued its ascent, mostly relative to the Japanese yen which continued to weaken during the month. We are heading into the last three months of the year that generally have a positive bias. Let’s hope this proves the case this year.

In the US Federal Reserve’s latest Summary of Economic Projections, forecasts for 2023 Real GDP growth in the US surged from 1% up to 2.1%. After four quarters in a row of lowering GDP forecasts, the Fed has now raised forecasts for two straight quarters.