

The Best Brokers For Saving On Capital Gains Taxes

Wealthfront beats out Fidelity, Schwab and Vanguard when it comes to direct indexing and tax loss harvesting.

WILLIAM BALDWIN, SENIOR CONTRIBUTOR

July 26, 2025 • Daily Cover

You make money in the market but tell the IRS you're losing money. Yes, this works—for a while.

Direct indexing with loss harvesting looks like a bonanza, for both providers and customers. Is it? Short answer: Yes, but.

Yes, you can do nicely with this scheme, more than covering the fees charged. The two buts: (1) Before getting in, think about what's going to happen on the way out. Below I will present a cautionary tale about the resulting mess. (2) Take any vendor's projection of tax savings with a grain of salt.

Providers evidently see gold here. In recent years Vanguard, BlackRock, JP Morgan Chase and Morgan, Stanley have bought their way into the business. Wealthfront, a Palo Alto, California robo-adviser, has made a great success democratizing automated loss harvesting and aims to go public in the near future. Frec, a newer San Francisco firm and something of a Wealthfront knock-off, has shaken up the business with an insanely low-cost offering.

Direct indexing means owning the S&P 500 or another index not via a fund but via individual stock positions. Instead of putting \$100,000 into the Vanguard S&P 500 exchange-traded fund you buy 42.4 shares of Nvidia, 13.7 shares of Microsoft, 0.33 shares of Westinghouse Air

Brake Technologies and so on. Or rather, a computer does the buying.

Periodically the computer plucks out losers to sell for a capital loss, replacing them temporarily with substitute stocks that behave similarly (Merck for Pfizer, perhaps). After 30 days have passed, the original position can be restored without creating a loss-killing wash sale. You sit on the winners for as long as you can.

We are, of course, talking about money in taxable accounts. There is no point to direct indexing inside an IRA or 401(k).

A direct indexing account typically has between 200 and 400 stocks. You don't need more than that to do a decent job of tracking an index with 500 stocks in it.

Parametric Portfolio Associates was a pioneer in this business, originally offering the tax dodge to wealthy clients paying for custom portfolio management. Its direct-indexing skills (and the large footprint of Morgan Stanley, which picked up the company when it acquired Eaton Vance) explain Parametric's \$400 billion of assets under management.

The prevalence of fractional shares and the automation of financial advice mean that little people can now get in on the action, with as little \$5,000.

What kind of capital losses do you get? That will depend on the direction and the volatility of the market. Over a decade, Wealthfront reports, capital

losses have averaged 2.6% to 3.3% per year for its clients, but there is a great deal of year-to-year variation.

People who put money in at the beginning of 2022 got a gusher of losses in the ensuing crash, but then they would have been better off waiting for a year and doing without the tax goodie. Remember that your aim with loss harvesting is not to have losses. It's to have gains but report losses.

Suppose you have a plump capital loss to put onto your tax return. How much good does that do you? This is a function of your tax bracket and your other investing activity.

Capital losses can absorb any amount of capital gains and, beyond that, can be written off against up to \$3,000 a year of ordinary income like salaries. Unused losses can be carried forward indefinitely but expire with the taxpayer's death.

It is reasonable to expect that the tax benefits will, in the early years of a direct indexing account, more than pay for the fees, which are usually in the range of 0.1% to 0.4% a year. But at some point, perhaps after five years of a mostly bullish market, or later if stocks go sideways, you will have nothing but gain positions. Note that someone who bought in 2015 would not have derived much tax benefit from the crash of 2022 because even at its low point that year

the market was twice as high as in 2015.

This matter of loss exhaustion brings me to the first caveat about fancified indexing. What are you planning to do when it's time to move on?

To illustrate, I will cite the case of a Forbes reader that I will identify as Mr. X. X signed up for a separately managed account with a financial advisor who was using direct-indexing software. Recently, with most of the potential losses captured, he quit the advisor and deposited the stock at a discount broker. He asked me: Now what should I do?

X is sitting on an interesting pile of shares. He owns Nvidia at a \$12 entry point, and should let that position ride. So, too, with gains in Taiwan Semiconductor, Broadcom and Microsoft. But he's got 140 positions that are now underwater or showing small gains. It would be nice to declutter.

Some of these clunkers will be easy to dispose of. Pepsico, Nike, Pfizer—no problem. But what about PT Bank Raykat or Airports of Thailand? These American Depositary Receipts trade over the counter, which is to say, not on Nasdaq or the New York Stock Exchange. On Yahoo Finance I recently saw the airport ADR with an average daily trading volume of 993 shares and a frightful bid/ask spread of \$9.52 to \$12.

X could sell all the cats and dogs, but would probably get hosed on the OTC shares. Apart from their sometimes larcenous bid/ask spreads, unlisted shares may not qualify for commission-free trading.

Another problem: Odd lots (less than 100 shares), of which X has more than 400, are sometimes hard to trade. This junkpile cries out for all-or-none orders (you don't want a trade to turn an odd lot into an odder one). But combining that restriction with a price limit increases the chance that an order simply won't be executed.

X did walk away with a fat loss carryforward, which may come in handy some day, but is likely to spend many hours cleaning up.

Here's someone commenting anonymously online on direct indexing: "I made a big mistake doing it in a Wealthfront account and when I wanted to consolidate holdings with another firm, I had to manually sell 195 securities. Stick

to broad index ETFs!"

I don't entirely agree with that sentiment. Direct indexing makes sense if you have plans for the end game and if you stick to large U.S. companies. I'll go this far with the Wealthfront critic: You should get your small-stock and foreign exposures via ETFs.

Now let's look at the second caveat, which is to understand the value of a capital loss. Wealthfront says that, over the past decade, it has captured \$3.5 billion of losses for its customers, 91% of them short-term. (These figures include earlier versions of tax-wise automated investing as well as the more recent direct indexing product.) The losses, it declares, have saved people an estimated \$1 billion in taxes.

Fine print: The estimate assumes that all of the short-term losses went to use, immediately, against short-term gains. This is unrealistic.

Someone with a \$100,000 account generating \$3,000 of capital losses, and with no capital gains to report, can indeed use the \$3,000 against ordinary (that is, high-taxed) income. But someone with a \$1 million account generating \$30,000 of capital losses is unlikely to be using all that against high-bracket income. It would require having at least \$27,000 of short-term capital gains. People do not have short-term capital gains unless they engage in foolish behavior, such as investing in a hedge fund.

Rational investors do, however, have long-term gains to report. They get them from employer stock, sales of homes, all-cash takeovers and unwanted capital gain distributions from mutual funds.

Realistic assumptions for big-ticket investors: You will be using most of your capital losses, whether short or long, to absorb long-term gains. You may find yourself using a loss long after you harvested it.

The top rate on long gains is 23.8% plus whatever your state grabs. Conclusion: Losses are valuable but not as valuable as advertised.

Now here are some product reviews.

Wealthfront

This one is my favorite. It offers a direct-indexed S&P 500 account at a bargain-basement 0.09% annual fee, with a \$5,000 minimum.

Frec

In a price war with Wealthfront, this outfit has the same 0.09% fee for the S&P 500 direct deal, with a \$20,000 minimum. It gets a runner-up status because it's newer and smaller. It oversees \$350 million to Wealthfront's \$80 billion.

Frec has some interesting variations on the theme, including a Sharia-compliant index portfolio at 0.35%.

Fidelity

Its direct-indexing product uses 250 or so stocks to mimic the Fidelity Large-Cap Index (similar but not identical to the S&P 500). The annual fee is 0.4%, with a \$5,000 minimum. When the harvesting wears out you can transfer the collection of stocks to a no-fee brokerage account.

Forty basis points is a lot. But using this service could make sense if you have other money at Fidelity, which oversees (in custody or management) \$15 trillion. It has a powerful brokerage platform and the oldest and biggest broker-affiliated donor-advised charity fund. Exit plan: Offload your long-term winners onto the charity, which will take them, fractional shares included, with a few mouse clicks.

Schwab

Charles Schwab has a 0.4% direct indexing product (minimum, \$100,000) and a charity fund similar to Fidelity's.

Vanguard

This firm invented retail-level indexing and is known for its low costs. Four years ago it spent an undisclosed sum of money (your money, if you are a Vanguard customer; it's a mutual corporation) to acquire direct indexer Just Invest Systems.

So, what's on offer? I can't find an answer on the Vanguard website, which has only a vague description of direct indexing aimed at financial advisors. The company did not respond to a press inquiry.

A few weeks ago former shareholders of Just Invest sued Vanguard, claiming they were double-crossed on a performance payout. Could be a while before we see a competitive offering from the indexing king.