

## **Think. Outsource. Trade - Investment Outsourcing for the Hedge Fund World**

Thanks to globalization for adding another acronym to my already information-overloaded brain. This one is called “IRO” or Investment Research Outsourcing. Over the next five years it is an acronym you will hear again and again. IRO, loosely defined, is the offshoring of front-office work to a 3<sup>rd</sup> party provider. In this article, I will look at the potential of integrating an IRO workstream into the Buy-side and Hedge Fund World.

### **GROWTH OF INVESTMENT RESEARCH OUTSOURCING**

The growth of investment research outsourcing was initially driven by economics. Sell-side Banks no longer had revenue streams to support the free distribution of research and therefore looked for a cheaper way. The answer was tapping into offshore brain pools that could produce high quality White Label research at a lower cost. By some estimates, you can get 3 analysts in India for the same price of 1 analyst in New York or London.

Given today’s bear market, write-offs, and reduced budgets at investment banks, outsourcing of front-office analysis will only continue to grow. Estimates of IRO 2008 growth rate range from 20% to 40%. The growth rate would probably be even larger except for the ability to scale resources.

### **BUY-SIDE MOTIVATION VS SELL-SIDE ECONOMICS**

While the Sell-side is clearly motivated by cost, the Buy-side has a completely different motivation. Most IRO firms tout time, depth of research, and resource scarcity as reasons for Buy-side motivation. While these perceptions are on the right track they don’t fully explain the value that IRO brings, especially around the time dimension. IRO firms state that an IRO workstream frees up higher level traders/analysts to spend more time on investment ideas while passing-off the “grunt” work of detailed research. This may be true but it is only half the picture. The value of IRO is the ability to create a 24\*6 “Follow The Sun” investment process which moves from idea genesis through trade execution at a much quicker pace. In essence, when your research day is ending in New York or London, it is just beginning in India. In a world of clustered investment decisions, the ability to supercharge your investment process is the real-key to the buy-side IRO approach.

### **INTEGRATING AN IRO WORKSTREAM**

Developing an IRO workstream can be as simple as making a call/sending an email or as complex as having an on-site IRO resource serve as a communication gateway to a dedicated external team. In developing the IRO workstream, it is important to first understand your investment process. Then, ask how an external resource can fit for specific time-bounded tasks.

While the Sell-side IRO model grew via a “hand over the wall” approach. The Buy-side model is much more dependent on communication and investment process integration.

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Thus, it is much more vital to define how, when, why, and what. It is also important to think about how your resources will be affected by having external IRO resources.

Most firms start out with a “direct connect” model of having a single dedicated IRO resource connect with 1 to many internal analysts. The IRO team grows organically as they prove their worth. As with any outsourced model, both teams have an implementation period where they “learn to dance with each other”. A side benefit of the IRO workstream is the documentation and formalization of investment workflows.

### **BUY-SIDE SKILLS & IRO MARKET PERSPECTIVES**

IRO firms vary in terms of geography and scale with the largest firms having research centers in India. Most firms have experience in business due diligence, investment research, and valuation. However, beyond these additional bandwidth skills, many firms have niche skills. Some IRO firms have more experience with credit modeling while others offer abilities to perform quantitative modeling, or stress-testing. A few offer complementary services such as business surveys and systems development.

It is estimated that up to 20% of US Institutional Managers utilize IRO firms, with an annual global market size of \$550 Million (\$385M Sell-side & \$185M Buy-side). Given current conditions, this market will continue to grow rapidly. This is the reason scale is perhaps the biggest challenge both for Buy-side clients as well as IRO firms.

### **EVALUATING AN IRO PARTNER**

When looking at IRO partners, it is important to understand that the nature of the buy-side investment process is different from the sell-side roots of the industry. A buy-side IRO workstream includes heterogeneous, time-bounded tasks that involve real-time communication. A resource’s judgement is paramount. Therefore, while past client experiences are helping in identifying domain expertise, the success ultimately rests on the IRO resource. This is why you must see resume of potential resources, interview these resources, and “beta-test” any resources.

Scale is another key evaluation point. With this industry growing rapidly and another growth wave coming from the sell-side, IRO firms have to balance the needs of new and existing clients. This is not so easy in a high-growth environment where the experienced talent-pool is limited and resource scarcity raises expectations of employees. Therefore, HR issues such as training and resource turnover become important factors. The last thing you want to do as an asset manager is to train and re-train IRO resources. Scale also includes issues such as physical infrastructure and ability to protect your intellectual property. Lastly, a manager needs to understand how IRO firms manage the spectrum of client needs. With scale concerns, it may not be good to be a small fish in a big pond.

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Domain expertise specific to your investment strategy is also an important consideration. Firms with domain expertise save learning curve time. IRO firms with domain expertise also will likely have the potential of add-on and swappable resources.

### **SUMMARY**

In today's world of data overload and time-constrained decisions, an IRO workflow managed correctly, can make you a better manager. It is also clear that this IRO is moving beyond additional bandwidth into higher value service offerings. An IRO workflow can serve as a key input to a "Follow the Sun" investment model. Many Growth challenges lay ahead, but an IRO integration can streamline investment decisions.

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