Capital Markets | the way we see it

Revolutionizing the Research Practices of Investment Management Firms

A look at evolving drivers and challenges that are prompting investment management firms to re-think existing research practices

Contents

1. Highlights

Research remains an integral component of the investment management process, playing a key role in overall strategic asset allocation and the portfolio construction process. Historically, different firms such as sell-side firms, buy-side firms, and investment banks have been the primary consumers of investment research and these players are now under tremendous pressure in today's volatile market conditions to manage their research operations efficiently.

After the severe impact of the financial crisis of 2008-09 on the financial services industry, investment management firms began to re-evaluate their research practices—not only to optimize costs, but also to improve overall efficiency in order to deliver better quality research and advice to clients. However, firms looking to overhaul their research practices often face multiple challenges due to heightened regulatory pressure, diminished advisor productivity, and increased client demands.

Firms are now at an inflection point concerning their research practices, and often find themselves needing to balance delivery of in-depth research with cost-efficiency. Cost arbitrage, reduced time to market, generating new investment propositions, and access to high quality talent are the key drivers leading investment management firms to increasingly outsource their investment research services to third-party vendors. The role of external research is steadily increasing due to the strong perceived value delivered by external providers and as firms are gradually realizing the advantages of an outsourced research process. As firms increasingly start to leverage external research partners for their investment research requirements, two key sources models are seen emerging: captive and third-party.

Making a well-informed decision to outsource investment research will be imperative, requiring firms to follow a few guidelines for evaluating a potential outsourcing vendor/ strategic partner. Evaluating and selecting a best-fit strategic partner will require firms to follow a well defined process which includes: identifying research processes to be outsourced; evaluating the HR and domain capabilities of the vendor; negotiating service level agreements; evaluating vendors' intellectual property (IP) and compliance standards; and selecting a sourcing strategy which best aligns with their business goals.

Though most firms still view research as a critical in-house function, they are re-evaluating the economics and overall operations of their research function. Though outsourcing presents multiple benefits for the financial industry, different firms are expected to outsource different processes—leveraging a sourcing model that best aligns with their business strategy.

2. Introduction

Research has always been an integral part of the investment management process for various investment management firms including sell-side firms, buy-side firms, and investment banks. The financial crisis of 2008-09 impacted firms' profitability, which continues to be under pressure in the current volatile economic and market environment. Firms today are looking at ways to manage their operations efficiently in order to manage costs while trying to remain competitive in the market. In addition, in today's highly volatile economic environment, clients expect their firms to demonstrate high investment performance.

- Buy-side firms are seeking strategies that can generate alpha[1] in times of diminishing performance fees[2], shrinking management fees[3], and reducing assets under management.
- Sell-side firms are finding it challenging to maintain their profit levels due to turbulent market conditions and are devising strategies to become more efficient in serving their clients.
- Investment management firms globally are re-thinking how to efficiently manage their investment research practices to become more efficient and client focused.

Exhibit 1: Key Consumers of Investment Research Services

Buy-side Firms	Leverage investment research to provide recommendations exclusively for the benefit of the firm's money managers. *Examples:* venture capital firms, hedge funds, mutual funds, private equity firms, or insurance companies.
Sell-side Firms	Leverage investment research to provide recommendations for retail and the firm's investment banking clients. *Examples:* independent brokerage houses or trading business of an investment bank.
Investment Banks	Mergers & acquisitions and advisory units of investment banks require research to help their clients develop strategies, identify growth areas, reposition their businesses and gain competitive advantage.

Source: Capgemini Analysis, 2012

[1] Alpha is a measure of an investment's performance on a risk-adjusted basis relative to a benchmark index. Alpha takes the price risk of an investment and compares its risk-adjusted performance to a select benchmark index. The excess return on the investment relative to the benchmark index return is the alpha on that investment

[2] Performance fee is a paid to investment managers for generating positive returns on investments or portfolios of clients. The performance fee is generally calculated as a percentage of investment profits, often both realized and unrealized

[3] Management fee is a charge levied by an investment manager for managing an investment fund or a portfolio. The management fee is levied towards compensating the investment managers for their time and expertise. The fee can also include other items such as administrative costs

3. Existing Challenges around Firms' Investment Research Practices

In the wake of the severe impact of the 2008-2009 financial crisis, investment management firms have begun to overhaul their research practices but face multiple challenges in the process.

Challenge #1: Increased Regulatory Pressure

The 2008-09 financial crisis highlighted inherent weaknesses around the way firms manage their investment research function. Regulatory bodies have introduced or are in the process of introducing new legislations which aim at increasing due-diligence, better record keeping, and improving the overall quality of investment research with a key focus on protecting investor benefits.

There are four key areas where regulatory reforms are emerging within the investment research space:

- Identification and disclosure of possible conflicts that may raise questions about the impartiality of their research and recommendations. New guidelines will require firms to ensure that the analysts owning the investment research provides only his personal views and recommendations in the research report which are also validated by the firm's legal and compliance team.
- Supervision of analyst remuneration.
- Monitoring analyst activities.
- Putting a stringent review process in place for all investment research before it gets published externally.

With most of the new regulatory reforms still evolving, firms are likely to be impacted and will have to re-align their existing research practices to be in compliance with the new rules and regulations.

Key Regulatory Reforms and Guidelines Emerging Around Investment Research

Emerging regulations are calling for firms to:

- Identify and disclose possible conflicts around their investment research practices
- Focus on supervision and remuneration of research analysts
- Regularly monitor and restrict research analyst activities
- Provide a stringent review process for research before it is published externally

Challenge #2: Low Productivity of Financial Advisors

Though a typical financial advisor spends around 67% of his time on client facing activities, a substantial portion of an advisor's total productive time, 29%, is spent on operational/ administrative tasks such as carrying out investment research. Out of the 29% productive time spent on operational/ administrative activities, over 8%[4] is expected to be spent by a financial advisor on investment-related research. Minimizing the time spent on investment research will free-up advisors time for delivering better investment advice to their clients.

Firms have an opportunity to help their financial advisors free-up productive time by outsourcing the non-core research activities and also leveraging new technologies to make their research processes more efficient.

Challenge #3: Increasing Client Inquiries

The financial turmoil of 2008-09 caused a crisis of confidence and trust among investors, with investor's now increasingly cautious and demanding more transparent advice from their financial advisors. To illustrate, investor inquiries around their portfolios and investment advice or recommendations are believed to have increased by around 64% in 2009 as compared to that in 2008[5], and the trend is likely to continue as economic and market volatility persists.

Research professionals in investment firms—though not in direct contact with clients—are at the receiving end, burdened with responding to the specific requests that advisors/ investment professionals receive from their clients. This rise in investor inquiries accentuates the need for an effective research management process to support advisors with their investment decisions.

Challenge #4: Scattered Research/Information across the Organization

The other key challenge that research professionals at investment firms face is finding the required data and information, as it is often spread across a wide variety of forms and channels, with access controlled by multiple end users. Research shows that around 86% of research professionals likely require multiple systems for accessing the required information/ research[5]. On average, research professionals at investment firms need to access more than three separate systems to find the required information at any given point making easy access to the right information a critical issue.

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[4] 2009 Global Private Banking and Wealth Management Survey, PwC, 2009

[5] Managing investment research in an era of change, Pensions & Investments, 2010

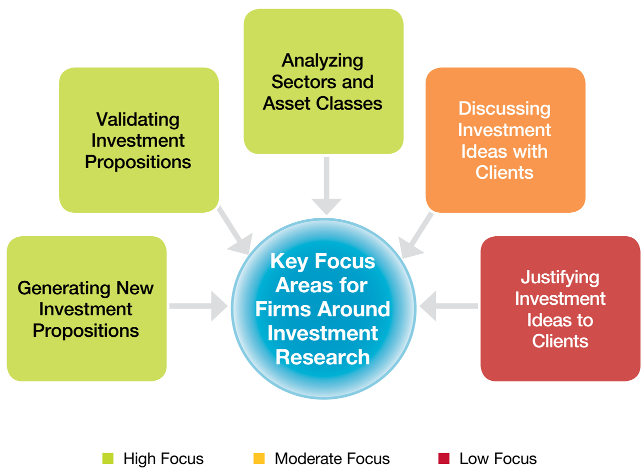
4. How Leading Firms are Identifying and Responding to Challenges

4.1. Themes and Emerging Focus Areas for Investment Research Practices

To overcome the current challenges, investment management firms are indentifying and focusing on areas within their research processes and practices that are most important to them: generating new investment propositions for clients; validating investment ideas; and analyzing industry sectors and asset classes have emerged as the primary focus areas.

Other areas such as leveraging research to justify investment propositions and the discussion of investment ideas with clients have emerged as the next level of priority for global investment management firms.

Exhibit 2: Key Focus Areas for Firms around Investment Research



Source: Capgemini Analysis, 2012

Investment research remains an important element for firms across their investment management value-chain and continues to play an integral role in client portfolio construction and overall asset allocation. However, the changing market and economic conditions have resulted in an evaluation of investment research practices—which many market analysts see as an inflection point around how firms will be managing their research processes in the near future. Firms today are trying to find a fine balance of how to deliver a strong and in-depth research while remaining cost-efficient in this 'new normal.'

4.2. Primary Drivers for Sourcing Investment Research

While it is becoming increasingly difficult for firms to sustain the rising operating costs of their research, delivering insightful and high quality investment research to clients remains imperative. As firms are becoming more and more averse to increasing their research costs, heightened regulatory legislation puts even more responsibilities on firms as they make recommendations to clients. Independence in generating investment ideas and doing away with the sell-side bias[6] has become more important today than ever before.

To overcome these challenges, firms are revolutionizing their existing research practices by adopting multiple approaches for sourcing their investment research. Though investment research outsourcing as a concept is not new, asset management firms who have historically been leveraging sell-side research are gradually realizing the benefits of outsourcing their own investment research function.

Though motivations for outsourcing investment research may be different for different firms, the key drivers remain:

- **Cost Arbitrage:** The most important driver for outsourcing the investment research function has been to bring cost efficiencies to companies during a time of reduced industry profitability. Research shows that outsourcing research processes allows firms to save substantial costs, depending on the type of work and location to which it is outsourced.
- **Access to Quality Talent:** Firms are also increasingly embracing investment research outsourcing due to scarcity of talent in areas such as quantitative and qualitative financial research. A smaller talent pool signifies higher wage costs and other challenges in retaining staff. On the flip side, vendors employ highly-skilled and qualified resources— often with advanced degrees in management, engineering, and finance—that are made available to the firms as per their requirements.
- **Generating New Investment Propositions:** Historically, asset management firms have been questioned for their recommendation bias, as a majority have been using sell-side research, which in turn reduces their competitiveness. However, in today's volatile and competitive environment, firms need new ideas and insightful research for their highly demanding clients. Vendors who specialize in delivering investment research outsourcing services help reduce recommendation bias by delivering independent research.
- **Faster Time to Market:** During the financial crisis, many firms significantly reduced their research coverage to save costs. However, with the economic recovery in 2010, firms started expanding their research coverage (both due to increase in client demand and growth opportunities) by tracking more asset classes and high-growth emerging markets, requiring faster time to market.

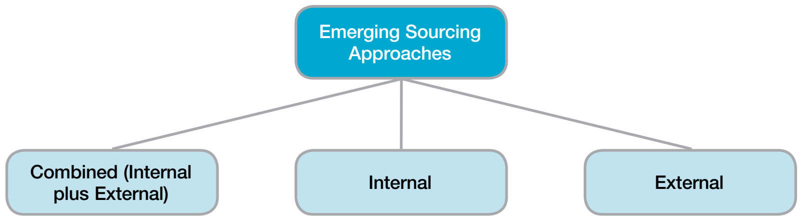
[6] Historically, most of the research coming from sell-side providers is believed to have recommendation bias aimed at generating "churn", i.e. stimulating a turnover of trades on a short-term basis.

- **Compliance with New Regulatory Requirements:** After the 2008-09 financial crisis, new regulatory reforms have been or are being introduced by authorities putting a lot more responsibility on investment management firms. These regulatory changes are putting pressure on firms to demonstrate more independence in generating investment propositions and recommendations.

4.3. Approaches to Managing Investment Research Functions

There are three key approaches around which firms are managing their investment research function. The first is the combined approach, the second is the internal in-house approach, and the third is the external sourcing approach.

Exhibit 3: Three Key Sourcing Approaches Being Adopted by Firms



Source: Capgemini Analysis, 2012

Having a combination of internal and external research—leveraging the best of both worlds—is gradually emerging as the primary approach being adopted by investment management firms. Increasing reliance on the combined approach signifies a shift from a pure in-house/ internal model which has historically been the prominent practice in the industry till now.

Though some firms are still following the exclusive in-house approach, it is increasingly becoming less practical in the face of current market realities and pressures which require firms to generate new ideas, investment strategies, and improve client's asset/ portfolio performance. This shift in approach is a result of the realization that internal teams are unable to cover the entire research spectrum which is required today.

The role of external research providers has been limited to the freely available sell-side research/ resources available to firms in the past. However, post financial crisis the demand for high quality and transparent research has opened up the market for a model that operates fully externally or outsourced.

Key value propositions external research providers can deliver include qualitative/analytics capabilities, independence in decision making, and unbiased recommendations.

4.4. Value Propositions for Using External Research Providers

The role and importance of external research providers is steadily increasing due to its perceived value, and as companies realize the advantages of an outsourced resource process. Three key value propositions that external research providers can deliver to investment management firms are:

- **Qualitative/ Analytics Capabilities:** While high quality quantitative data is easily accessible to the market participants, the same level of qualitative analysis is not existent among sell-side investment research providers. The key challenge is that most sell-side research is not written for private investors—who are more interested in high-level qualitative details and analysis, rather than the large data-sets and facts which are generally provided by most sell-side providers. An external research provider can offer this level of detail.
- **Independence in Decision Making:** Freely available sell-side research, which most investment management firms have been relying on, has been proven to have a recommendation bias. Independence of thought of external research providers is therefore fast emerging as the key selling point for delivering high quality insightful research.
- **Unbiased Recommendations:** Most investment management firms have been relying almost exclusively on the sell-side divisions of investment banks/brokerage firms for their research needs. However, the recent financial crisis of 2008-09 has made them recognize that the bias within the sell-side model does not necessarily operate in best interests of investors. External research providers are more likely to deliver greater value for firms as they are better placed to do independent research and make appropriate unbiased recommendations.

Within external research outsourcing, two key sourcing models are being leveraged by firms: **captive** and **third-party approaches**.

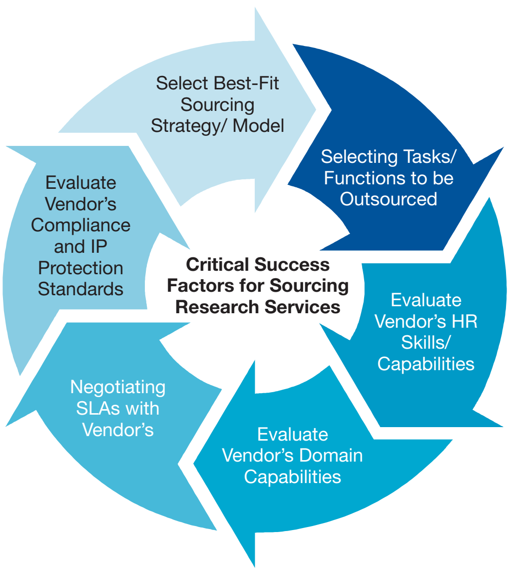
In the **captive approach**, firms have a tendency to keep functions or operations closer to their core activities in-house as it involves protecting intellectual property and sensitive data/ information. Captive centers, which were originally set up in offshore locations to provide low value back office services, today provide support to critical and core business processes such as investment research and high-end analytics. For example, financial institutions such as American Express, Citibank, and HSBC initially started their offshore captive operations for low end data entry and voice processes but have steadily begun leveraging these captives for high-end research and analytics work.

In the case of the **third-party outsourcing approach**, though many banks and investment houses initially opted to take the captive route, many have now undertaken a delivery approach where captive operations and outsourcing services to third-party vendors co-exist. The increasing maturity level, capabilities, and scale of third-party vendors as well as the availability of skilled low cost resources are the key factors driving firms to increasingly outsource critical and high-end research and analytics such as equity research, fixed-income research, and business valuations.

5. Critical Success Factors for Firms Outsourcing Their Investment Research Services

Making the go/no-go decision to outsource investment research services is a highly complex process which requires firms to follow key guidelines for evaluating the potential outsourcing vendor, or captive approach. Evaluating and selecting a best-fit strategic partner requires companies to follow a well defined process which includes the following steps.

Exhibit 4: Critical Success Factors for Sourcing Investment Research Services



Source: Capgemini Analysis, 2012

- **Step 1: Select Tasks/ Functions to Be Outsourced:** Investment firms need to assess the key tasks/ functions they want to outsource which may range from low-end data gathering tasks to highly specialized tasks such as making investment recommendations. Identifying and defining functions to be outsourced will help firms evaluate vendors effectively to ensure they have the requisite skills and experience.
- **Step 2: Evaluate a Vendor's HR Skills and Capabilities:** Outsourcing investment research requires the vendor to have substantial experience in hiring, training, and retaining the highly-skilled workforce imperative for successful delivery of the outsourced research services.

- **Step 3: Evaluate a Vendor's Domain Capabilities:** Evaluating the domain capabilities of an outsourced research vendor requires a lot of effort from the investment firms. However, firms that do not pre-judge a vendor's domain capabilities may have to spend extra time training and inducting the resources, negating the key benefits of outsourcing - cost savings and faster time to market.
- **Step 4: Negotiate Service Level Agreements (SLAs) with Vendors:** It is important for the investment firms to evaluate a vendor's ability to deliver high quality services with specific turnaround times. This will require relevant SLAs and agreed quality controls to be in place.
- **Step 5: Evaluate Compliance and IP Protection Standards:** The most important aspect of the vendor evaluation process is for investment firms to gauge the level of understanding vendors have of regulatory and IP protection standards prevalent in their region/ market. Firms must also confirm that the vendor understands and can implement the nuances of the investment industry's regulatory requirements.
- **Step 6: Select Best-Fit Sourcing Strategy Model:** While deciding whether to in-source (captive model) or outsource to a third-party vendor, firms need to evaluate the key pros and cons of both approaches and align them to their business model and priorities.

While the above steps are expected to help firms in evaluating a best-fit strategic partner, companies deciding on whether to outsource their investment research services will have to design a tailored sourcing roadmap to optimize their research operations.

6. Examples of Emerging Practices

Leading firms have been leveraging third-party research providers to realize cost efficiencies, gain faster time-to-market, and deliver high quality investment research for their clients. Offshore research services are emerging as a low-cost alternative for financial services firms. Some examples are provided below.

A private banking arm of a leading global bank had an internal research team catering to its client research needs, but with a rapidly growing client base, the bank was challenged to keep pace with its research capabilities—especially in the emerging markets such as Asia-Pacific and Latin America.

To improve its research capabilities and achieve faster time to market, the bank partnered with a third-party provider to outsource it research operations offshore. The bank hand-picked the analysts, all vendor employees, and instructed them on the guidelines, procedures, and templates that the bank has been using for carrying and delivering investment research. The key goal was to combine the best of both worlds by leveraging best practices present within the bank and the vendor. After successful integration with the vendor, the bank was able to introduce new high quality research products for their clients at a much faster turnaround time.

A leading global asset manager wanted to reduce their overall time to market for their different products and services which would help them improve their overall profitability. To assess the commercial and overall quality delivered by an outsourced vendor, the firm set up an initial pilot project with one of its products. After successful completion of the pilot, the firm expanded the scope and outsourced multiple products to the vendor. Outsourcing helped the firm free-up more time for its portfolio managers and analysts for idea generation, networking, and stock picking. The firm was also able to introduce new products to its customers by converting broad themes into actionable ideas.

A leading hedge fund in the U.S. wanted a dedicated team of resources to support its analysts by building and maintaining financial models on stocks they cover. The hedge fund selected an outsourcing partner who was required to do a pilot project, familiarizing itself with the firm's templates and processes, and demonstrate its capability by building10 financial models. The pilot was successful and the firm was able to realize increased analyst-to coverage ratio at significantly lower cost.

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