Considering the Alternatives

Evaluating alternative research providers is a new challenge for many firms

BY NANCY OPIELA

When a firm hires new analysts, it typically spends much time and effort evaluating candidates. Presumably, the decision to outsource research to a team of analysts would have an even greater impact on a firm's process and performance than the decision to hire an individual. Yet many financial services firms are often less thorough in their approach to hiring alternative research firms.

A lack of experience in hiring research firms may be one factor. Alternative research providers have become an increasingly popular option in recent years, and some forecasts are calling for double-digit growth in the next few years. Thus, many investment managers are beginning to wrestle with the challenge of evaluating an alternative provider for the first time. Fortunately, according to experts, a few fundamental principles can make the process more effective and manageable.

The Evaluation Process

The main problem is that standard, one-size-fits-all criteria for judging quality and value simply do not exist. "You might define quality information as independent data points that provide insight, but what is relevant, actionable, and alpha producing for one investment manager is going be irrelevant, inactionable, and non-alpha-producing for another one," says John Scott, managing director of the Institutional Investment Advisory Group at New York City–based Commerce Asset Management.

Any firm that wants to add an alternative information provider should begin by determining whether the potential new information source will be mission critical. "From sector analysis to forensic accounting and expert networks, there's a vast amount of information out there that's really interesting, but it's essential to determine whether it's relevant to your firm," Scott explains. "Many vendors want to feed you whatever they are producing and hope that even if the information isn't relevant, it might be interesting enough to stick. However, ideally, they should be defining how what they produce supports your firm's competitive edge."

In fact, Merrill Lynch took this approach when it was identifying information providers to include in Merrill Open Minds, a service that now makes available seven alternative research products and services as a complement to the firm's fundamental research and analysis. "Our clients don't have time to evaluate 200 to 300 alternative research providers, so we've done the vetting for them with the commitment to find the best-of-breed providers who offer specialized expertise relevant to our clients' investment processes," says Michael Bird, who is Merrill Lynch's managing director of global commission management and also oversees the Merrill Open Minds program. "Potential research providers are put through a lengthy vetting process, including internal presentations, and we also engage an outside vendor to complete a detailed audit."

KEY POINTS

- The decision to hire an alternative research firm deserves at least as much scrutiny as the decision to hire a new analyst.
- Starting with fundamental principles can make the evaluation process more effective and manageable.
- In addition to determining the purpose of the research to be provided, firms should evaluate such factors as a prospective provider's business model, scalability, quality of information, breadth of platform, and whether the information is proprietary.

The next step is to separate real value from marketing hype. Scott advocates analyzing a firm's business model to evaluate its sustainability. "The vast majority of these alternative research providers generate less than $20 million in annual revenue and might have 50 to 60 people working for them," he says. "A firm that has that kind of revenue-to-employee ratio cannot scale. You can't drive $200 million in revenue with 600 employees."

In addition, a firm's business model should be sustainable on its own—even in the absence of the founder. If an alternative research provider depends primarily on a few principals or has a high annual rate of employee turnover, the long-term viability of the firm is questionable. Often, the principals themselves may have a short-term horizon. "I believe many alternative research firms are positioning themselves for an exit strategy," says Scott. "And working to be acquired by a

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larger firm is very different from positioning yourself as a high-quality, mission-critical provider of information."

Another key consideration is scalability. According to Will Greene, a research analyst at Integrity Research (a New York City firm that vets information sources for a range of financial services clients), scalability is a "reflection of how well a research firm can take on new clients and apply existing methodologies to new companies and geographic regions."

To assess scalability, Integrity Research looks at the size of a firm's operation (e.g., number of staff) and seeks to measure the efficiency of its internal processes. "Bigger is not necessarily better," says Greene. "Rather, success is a function of the quality of the people and internal processes. To that end, in addition to reading the biographical sketches on the firms' websites, we conduct detailed background checks on the principals."

Although performance has always been a mainstay of evaluating traditional research, it takes a backseat in the alternative arena. "The metrics with which the buy side measures value have changed," explains Stanton Green, president and CEO of OTR Global and chairman of the Investorside Research Association, a not-for-profit trade association of investment research providers.

In the past, the buy side evaluated research providers on the basis of how many of their stock calls were correct. Today, the questions have changed. Research providers are asked about the quality of their information, the breadth of their platform, and whether (or to what degree) their information is proprietary.

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Will Greene agrees that distribution is increasingly a differentiating factor. "Hedge funds want the most exclusive information possible," he says. "Often, we look at a firm's revenue stream and ask whether the value of their insights is diluted by the fact that their analysis is being published all over the place."

Compliance is another important consideration in evaluating an alternative research firm. A recent survey conducted by Integrity Research found that nearly half of compliance professionals at hedge funds and mutual funds are worried that their use of expert networks might lead to compliance problems for their firms. "Buy-side firms want to make sure they are working with firms that are obtaining information in legal and ethical ways," explains Greene. "They fear that expert networks might leak material, nonpublic information or that payments made by these expert networks to company employees might be seen as encouraging them to breach their fiduciary duty to their employers." To make sure that research providers' processes conform to the letter of the law, Integrity Research analyzes providers' policies on information gathering.

Checking references also can yield valuable information. To gauge whether a research firm has been able to deliver insightful research and high-quality data in an efficient and professional manner, Integrity Research typically asks for references. This information can provide qualitative insights on the strengths and weaknesses of the firm in question and also can enable quantitative ratings for such categories as quality of analysis to turnaround time. Using such data, Integrity can rank research providers according to a variety of metrics and measure whether firms are widely respected by their users.

Expanding Horizons

The US$1.5 billion alternative research industry is forecasted to continue its growth of 15–20 percent a year. Additionally, according to a 2007 study of U.S. equity investors by Greenwich Associates, 39 percent of buy-side analysts expect to increase their use of alternative research in the next year.

Stanton Green has already seen evidence of that trend. Four years ago, independent research firms (which Green defines as traditional sell-side research but done by an analyst who has left a traditional Wall Street firm) accounted for 80 percent of attendance at Investorside Research Association's annual conference, with only 20 percent coming from alternative research firms. "This year, that ratio was turned on its head," says Green. "We had 80 percent alternative research firms and 20 percent independent research firms."

Moreover, the buy-side has embraced alternative research at a time when the definition of "alternative research" is expanding. "Clients are interested not only in alternative sources for proprietary data and information but consulting services and various tools, such as web scrapers," says Greene. "They often ask us to fill in what they don't know. They'll share their research process, the information sources they currently use, and what they value, and ask, in terms of sources and methods, 'What can we incorporate to make better decisions?'"

Nancy Opiela also writes for the Journal of Financial Planning *and* Focus, *Fidelity's magazine.*

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