Using outsourcing for strategic competitiveness in small and medium-sized firms

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Abstract

Purpose – The purpose of this paper is to develop an outsourcing matrix and explains how outsourcing can be used to facilitate strategic innovation.

Design/methodology/approach – The methodology used in this study is of an explanatory case study. This paper uses secondary data as well as primary data from several interviews with executives, entrepreneurs and industry experts. The combination of the two sources of data ensures a certain level of convergence and completeness in the analysis presented.

Findings – The approach suggested in this paper offers small and medium-sized firms an opportunity to innovate strategically (i.e. creation of newer services and products) and potentially level the playing field with larger rivals.

Originality/value – This paper offers practicing managers a framework for using outsourcing as a means to compete effectively. Importantly, compared to the outsourcing literature's traditional focus on large firms, this paper is one of the few which takes the perspective of the small or medium sized firm. Additionally, this paper serves as a foundation for theory building and future research on the usage of outsourcing by such firms to enhance strategic competitiveness.

Keywords Outsourcing, Small to medium-sized enterprises, Strategic management, Competitive strategy

Paper type Conceptual paper

Introduction

Outsourcing of activities which started largely in the manufacturing sector to secure lower cost supplies is also growing widely throughout the service sector. Its growing importance has made it a major concern for industry, government and the public at large. The consequences of outsourcing in today's business landscape cannot be ignored. The global outsourcing market is estimated at $386 billion and is estimated to be growing at a rate of 25 percent (Tagliabue, 2007). It is estimated that almost 80 percent of *Fortune* 500 firms are involved in some form of outsourcing already and continue to be involved in more outsourcing work. This pattern in outsourcing is also reflected in Europe where the offshore practices of European firms are predicted to grow about 30-40 percent during the years 2003-2008 (Kshetri, 2007). The growth of newer communication and computing technologies which facilitate outsourcing in the service sector, coupled with globalization, seem to be driving this growth in outsourcing services.

While many firms have used outsourcing effectively to achieve important cost saving, additional potential to exploit outsourcing still exists. While cost reduction is

The author is grateful to Mr Chris Anderson, Dr Ivan Abel and several professionals from the securities industry who helped him formulate several ideas in this paper.

Competitiveness Review: An International Business Journal
Vol. 18 No. 4, 2008
pp. 322-332

1059-5422
DOI 10.1108/10595420810920806

important, one time cost reduction does not offer sustained competitive advantage for firms only till rivals catch up. For instance, about 97 percent of companies report cost reduction to be a big motivation in a survey of companies involved in outsourcing conducted by Lewin and Peeters (2006). A much lower percentage of companies cited strategy to be the factor driving their outsourcing decision. This paper seeks to contribute to managerial practice by showing that outsourcing of certain activities within the core of the company can potentially lead to strategic innovation.

In particular, one untapped arena is where outsourcing can be effectively exploited by small and medium-sized firms to enhance their competitive advantage through strategic innovation. Based on an outsourcing matrix, this paper explains how outsourcing can facilitate strategic innovation, apart from the traditional roles played by outsourcing, namely enhancing operational efficiency and flexibility. In particular, this approach gives small and medium-sized firms an option to become more creative in strategy innovation (i.e. creation of newer services and products), potentially leveling the playing field with larger rivals. Using the financial services industry as a context for illustration, this paper presents various options of outsourcing based on the outsourcing matrix and suggests steps a company should take to achieve strategic innovation. This paper is structured into six sections inclusive of this introductory section. The second section presents the methodological approach used in this paper, and the third contain outlines the conceptual overview of the matrix. In the following section, the outsourcing matrix is presented and elucidated using a case study. This section also presents suggestions as to how the matrix may be implemented for strategic innovation. The final two sections present the managerial implications of this paper and conclude with suggestions for future research.

Methodological approach

The methodological approach followed in this study is of an explanatory case study (Yin, 1993, 2003). This approach tries to understand the casual structure of the specific phenomenon to provide a basis of new theory generation or new understanding of the event studied. This approach is in contrast to explorative and descriptive case studies common in the literature, where the motivation is to develop a grounded theory. According to Yin, in an exploratory case study the goal is "analytic generalization." This approach fits well with the goals for this paper, as it allows for us to build upon and understand the typology presented. Therefore, we present the conceptual underpinnings of the typology, follow it with the background of the industry and integrate the case study in illustrating the model's logic. For this case study, we use secondary as well as primary data from several interviews with the founders of the firm and industry experts to present the underlying logic of the matrix. The combination of the two sources of data ensured a certain level of convergence and completeness in our explanations. However, considering the strategic importance of this topic to the firm as well as the political sensitivity of this topic, it should be noted the interviews were offered under strict conditions of anonymity and confidentially. In fact, one of the interviewees let it be known that any breach in the agreement would lead to prompt legal action by his firm. Hence, all names or any identifying information is deliberately obscured.

Conceptual overview

In management literature, outsourcing has been defined as moving activities that had previously been performed within the organization externally (Parkhe, 2007). In this paper, we use the term outsourcing in instances of the outsourcing activity done locally (within a country's borders) and in other countries. We make this point to clarify to the reader that even though in the popular press there is a tendency to use offshoring and outsourcing interchangeably, it should be noted that offshoring can also be done within the company;, i.e. captive outsourcing (UNCTAD, 2004). Traditionally, in strategy literature, the outsourcing decision was viewed within the transaction cost framework (Grant, 2008). Under this framework, the focus was on optimizing the costs/risks given the tradeoffs between conducting the activity internally or externally. This perspective usually applies to firms who outsource activities which were deemed non-core (i.e. non-critical), such as payroll maintenance. While not challenging the importance and usefulness of this transaction cost view, it brings in firm resources to show how a firm can expand the concept of outsourcing by further differentiating its core activities into supplementary and complementary activities. By doing so, firms are able to transform themselves by redefining their business strategies. In the literature, others have referred to such changes as third generation outsourcing (Brown and Wilson, 2005) or transformational outsourcing (Linder, 2004). While the suggestions presented in this paper are applicable to small and large-sized firms, it is more critical for smaller firms, as they do not have the choice of captive offshoring. In this type of offshoring, large corporations can internalize some of the benefits of outsourcing through the establishment of foreign affiliates. For instance, firms like IBM have restructured themselves as a globally integrated enterprise. In such cases, firms locate operations and functions anywhere in the world – based on the right cost, the right skills and the right business environment, integrating those operations horizontally (Palmisano, 2006). Considering the fact that larger firms have capitalized on the information revolution, wherein the flow of information has expanded the scope of tradable services (Blinder, 2006), small and medium-sized firms need to "rethink" more effective ways to compete (Ali, 2006).

Outsourcing matrix

The goal of this matrix is to allow firms to link outsourcing decisions with strategic planning rather than using them just as a means of cost reduction. Understanding this link is critical, as one of the major reasons for failure of outsourcing projects is the failure to clarify the strategic objectives of the onset of the project (Robinson and Kalakota, 2005). While the process of outsourcing involves moving internal activities externally, the outcomes achieved by a firm through outsourcing vary, based on the particular activity outsourced. To explain the varied outcomes and the implications for competitive advantage, this paper presents an outsourcing matrix (Figure 1). The following paragraphs discuss each of the three outcomes (Cell A: efficiency, Cell B: synergy and legitimacy, and Cell C: core-enhancing) of outsourcing. The fourth cell (shaded in grey) will not be discussed, as this option represents strategic suicide for a firm.

The vertical axis of the matrix represents the generic role played by outsourcing based on similar articulation on information strategy literature (Elango, 2000). When outsourcing leads to replacement of one or more of the value activities currently done by the firm internally, we call this role supplementary. Examples of such activities

		Strategic Importance	
		Non-Core	Core
Outsourcing Role	Supplementary	Cell 1 Efficiency (*e.g., Record-Keeping, Web-Site Maintenance*)	
	Complementary	Cell 2 Synergy & Legitimacy (*e.g., Joint Marketing, Financial Reporting*)	Cell 3 Core-Enhancing (*e.g., Research*)

Figure 1.
Outsourcing matri

include tasks such as building maintenance, payroll processing and payments, web site maintenance, etc. to external parties. In a situation where outsourcing leads to supporting a value activity within a firm, causing it to be done more effectively, we call this role complementary. Examples of such roles could include accounting or marketing activities. For instance, the usage of professional accounting firms or advertising firms is the norm in many firms. In these cases, while the services of these external firms are used, it does not mean that these activities are eliminated within the firm. Typically, what we see happening is that some activities where the firm does not have expertise (i.e. expert knowledge) are done outside and some activities are carried inside where the firm is more effective in accomplishing the task.

The horizontal axis of the matrix represents degree of strategic importance of a particular value activity. Here, we split activities into two groups: core and non-core activities. Core activities refer to value activities which fall within the core-competence of a firm and non-core activities refer to activities outside it. Core competence is the collective learning in an organization and refers to the ability to integrate diverse streams of knowledge (Barney and Hesterly, 2008). Further differentiation of core vs non-core activities are presented in subsequent sections. Within the two axes presented, the outsourcing matrix consists of four cells, three of which offer viable outsourcing options. Each of these three cells offers specific options for firms to pursue, and these roles will be expanded with examples from the case study from the financial services sector following a presentation of the context of the industry studied.

Contextual background

The examples used in this paper are based on a medium-sized investment firm called Boutique Asset Management (BAM) in the financial services industry. This firm operates in the Portfolio Management (NAICS code: 52392) segment of this industry. In this industry, the prime source of revenue for firms is fees or commissions received for managing the assets of others. The activities of firms in this industry include management of mutual funds, pension funds, portfolio funds, and investment trusts. It is estimated that this industry employs around 200,000 individuals, has a combined revenue of \$84 billion and industry gross product of \$44.5 billion, and grew about 7.7 percent in 2005 (IBISWorld, 2006). It is estimated there are 7,977 mutual funds holding around \$8905 billion worth of assets (US Census Bureau, 2007). In this industry, about 62 percent of firms have outsourcing arrangements and about 31 percent say they will be increasing their outsourcing in the next two years (Maxey, 2007). Estimates of the services outsourcing by the financial services industry is about \$40 billion.

BAM was started in 1997 by two friends Sammie Bjiorshein (hence forth referred to as Sam) and Raja Tamil (henceforth referred to Raj). They initially met in a required financial modeling class as they were working on their PhDs in Economics and Business, respectively, at the City University of New York. Raj, who had extensive background and contacts in financial markets, felt there existed a market for mutual fund firms whose stock picking strategy was based on econometric models infused with neural networks. He was also very impressed by Sam's capabilities in advanced mathematical models incorporating complexity theory by virtue of skills he had developed earlier while getting his PhD in Mathematics. The usage of complexity theory with neural networks allowed Sam's models to infuse technical and fundamental modeling concepts seamlessly. So, he broached the idea to Sam that starting a firm could make them rich. To his surprise, Sam jumped at the offer. Both of them dropped out of the PhD program to start BAM. Within eight months, they completed the regulatory requirements along with the certification exams required to operate in this industry and secured seed capital. BAM was born in the basement of a multistory building near Wall Street, with two state-of-the-art computers and Raj's wife as part-time secretary without pay. The initial startup capital of \$130,000 was raised with contributions from family members, while investments (i.e. assets) were secured from wealthy friends and contacts in the industry.

After going through initial start-up pains, BAM prospered due to its ability to produce consistently high returns for its initial investors. BAM quickly become a favorite among investors who sought this type of stock-picking methodology. BAM's reputation for consistency improved significantly in a short time, as its returns were not even affected by the 2000 and 2003 market meltdowns. The consistency and market-leading performance of BAM led to a short article in one of the country's largest newspapers, wherein BAM was noted for being the "best" in its niche. Soon thereafter, investors were pouring money into BAM. However, this also invited new competition in its product segment.

By late 2006, there were about 20 direct competitors and an equal number of indirect competitors (ETFs) compared to only one or two during its initial days in 1997. Moreover, some of the newer competitors were broad financial conglomerates with interests in banking and insurance. Raj and Sam felt the pressure to reduce management fees (the prime source of revenue) as well as a demand for additional services (e.g. web-based access). On the cost side, they found their expenses continuing to increase. Over the last nine years, they had added about 46 members to their firm. Additionally, the salaries for good business graduates in New York City had gone up by 80 percent during the same time period. While BAM was doing well by most industry metrics, the risks of competing with larger conglomerates worried both partners. BAM was already one of the pioneers in using outsourcing, having begun as early as 1996, which allowed it to keep its costs low. Both partners felt there was a need for them to plan for the reinvigoration of the firm. Raj came across an article titled

"Global sourcing" by Forbath and Brooks (2007). This article claimed the next wave of outsourcing would lead to "non-financial" benefits like faster time-to-market, ancillary revenue streams, and process improvement. This convinced Sam and Raj that maybe there were other options in outsourcing which would allow them to chart a better future for their firm. Given this situation, they hired a former PhD colleague (who was also a professor) to conduct strategic analysis and offer suggestions for BAM on outsourcing options.

Outsourcing matrix applied

In this sub-section, we apply the outsourcing matrix to BAM to show potential options of outsourcing and its varied outcomes.

Cell 1. This cell represents non core-activities wherein the external service provider supplements (i.e. replaces) a value activity that is done internally. The activities in the cell do not represent the core of the firm and, coupled with ability of a firm to achieve cost savings along with reduced administrative burden, makes their outsourcing a logical choice for most firms. Examples of this type of outsourced activity include record-keeping, data warehousing, development of web pages, etc. The prime driver of this type of outsourcing is efficiency. BAM, as mentioned earlier, had outsourced these activities, because Raj and Sam felt these activities consumed too much time and attention. They felt it was more cost-effective to secure services from outside firms rather than keep them internally.

Cell 2. This cell represents non core-activities wherein the external service provider complements a value activity within a firm. In these activities, firms do not have the scale, legitimacy, or synergy to get the task done internally. Therefore, firms use outside providers to complement their services. Examples of this type of outsourced activity include marketing, computer infrastructure maintenance and auditing services. The driver of this type of outsourcing is synergy and legitimacy. For instance, to promote its products, a firm needs a distribution network. BAM, being a smaller firm, did not have the scale to run its own distribution network. Therefore, it had secured the services of a large financial service firm to market its products along with several firms on a fee/commission basis.

As is the case with many firms, BAM had already exploited the options (efficiency and synergy and legitimacy) provided by Cells 1 and 2. These two cells represent traditional outsourcing space and have been well exploited by firms for several decades. The exploitation of these two cells is also referred to as the first and second wave of outsourcing (Brown and Wilson, 2005). However, a key limitation of these two cells is that once similar cost reductions are achieved by rivals, they do not offer any strategic advantage. Therefore, the key focus of this paper is Cell 3, wherein firms seek to enhance their strategic core by outsourcing to generate strategic innovations.

Cell 3. This cell represents core-activities of the firm which can be complemented by outsourcing. Conventional logic on outsourcing dictates that value activities within this cell should be conducted within the company, as these activities are of strategic importance. While this paper concurs with the notion that the core competence of an organization should be protected, we believe some fine tuning of this notion will allow greater benefits to small and medium-sized organizations.

To illustrate this point, in the case of BAM, its core competence (*raison d'etre*) is the ability to pick the "right" stocks based on specific requirements of its portfolio models and customer mix. Therefore, BAM should not outsource this activity (i.e. strategic suicide). However, what BAM can do is look for activities outside its core which will enable it to pick stocks. For instance, to sustain this core competence, BAM needs a continuous stream of stock market research to be conducted on firms both within and outside its portfolio. Such research costs are estimated to comprise about 30-40 percent of operating costs in this industry. If BAM can outsource its research activities more efficiently and effectively than its current operations, it will enhance its core, allowing for strategy innovation. Obviously, BAM, through outsourcing, gains cost parity with larger rivals who may be conducting such activities internally. Therefore, outsourcing may allow BAM to tap specialized knowledge and processing capabilities at a reasonable cost which might not have been possible before.

As mentioned earlier, such options are critical for small and medium-sized firms. This is because when large firms face twin pressures to reduce costs and conduct these activities internally, they typically internationalize operations through captive offshoring, as they have the resources to buy out local firms or set up greenfield operations on their own. For instance, according to the *Wall Street Journal* (Kelly, 2007), Merrill Lynch & Co. has taken minority stake in the research firm Copal Partners to create "deal books" for corporate mergers and acquisitions. For firms such as BAM, choosing to offshore operations internally is usually not viable in terms of scale and costs. Moreover, smaller firms do not have the resources or capabilities to set up ventures in foreign countries, unlike large firms. Therefore, this matrix offers small and medium-sized firms new options with outsourcing of Cell 3 activities to enhance their strategic innovation.

Exploiting strategic innovation

In this sub-section, we explain how Cell 3 activities can be used for enhancing strategic innovations. Let us assume that BAM uses outsourcing firms for stock and market research activities. Through these firms, BAM can contract CAs in India (equivalent of CPAs in the USA) with about five to ten years' experience to conduct financial analysis. Currently, the cost for such services in Indian outsourcing markets is between $20,000 and $30,000 (inclusive of benefits and other costs). For comparison, this is about $20,000 to 30,000 lower than the starter compensation package an average business undergraduate would receive in the USA. Hiring CPAs in the USA with comparable experience could cost three times as much as outsourcing. While there have been increases in hiring costs for such professionals in India and elsewhere, it should be noted they are typically in offshoring hubs such as Bangalore or Moscow (Farrell, 2006). It is estimated that more than 90 percent of such people are located in less well-known cities like Coimbatore in India or Zlin in the Czech Republic. Therefore, this option not only allows for operational cost reductions (even relative to lesser qualified talent secured locally), but also provides for a significant upgrade in BAM's capabilities. For instance, BAM can use the Indian CAs to conduct scenario-forecasting on tax policies based on accounting principles. While these services are available in the USA, for BAM the fees and costs are unviable, forcing senior management to make judgment calls based on heuristics. By outsourcing Cell 3, BAM has access to new research at about 50 percent of the current costs (Kentouris, 2005) endowed with greater skills, allowing for BAM to innovate strategically by finding new competitive positions against rivals.

Porter (1996) suggests new competitive positions (need, access, and variety based) can help firms draw new customers into the market or draw customers from rivals. The various strategic options BAM could consider include:

- offering additional personalized services which were previously unviable for its "medium network" clients (i.e. need-based position);
- reducing its entry point for its clients from, say, $1 million to a much lower figure (i.e. access-based position); and
- increasing its scope of operations, for instance, BAM may have kept itself out of BRIC countries due to the high cost of information collection in these emerging markets.

However, lower operational costs and newer capabilities will allow it to add a market segment which was not possible before (i.e. variety-based position). Without outsourcing these activities, BAM's strategic options were limited to broad segments which were not too specialized, in which larger firms operate. The key notion being advanced here is that outsourcing Cell 3 activities allows BAM to avail itself of cutting-edge services at a low cost, thereby creating an arsenal of new options for strategic innovation.

Therefore, Cell 3 allows BAM to exploit capabilities outside the organization to leverage its own ability to offer newer services and products, improve quality, speed and responsiveness and achieve operational scale previously impossible. In this approach BAM, rather than being boxed in a corner by newer rivals, can compete by offering newer services and products which are hard for rivals to replicate. At the least, it creates a level playing field. While the earlier example focused on research activities to explicate the benefits of Cell 3 outsourcing, other activities for BAM to consider for outsourcing include fund accounting and management reports, statutory accounting and compliance audits, investor reporting and investor relations.

Managerial implications

This section of the paper offers suggestions for managers implementing core-enhancing outsourcing. First, while Cell 3 represents an opportunity for strategic innovation, differentiating value activities of the core suitable for outsourcing is critical. Any wrong choice in identifying the elements to outsource will result in a diminished strategic position for the firm. In order to differentiate core activities that can be outsourced, firms may want to question if the knowledge required to complete the outsourced task is explicit or implicit (Polanyi, 1967; Szulanski, 2003). Explicit knowledge is knowledge about a particular concept or phenomenon which is explainable, whereas implicit knowledge is tacit and cannot be explained, usually characterized by understanding of insights and acquired through experience. Explicit knowledge is conducive to transfer from one person to another through formal languages, manuals, blueprints, etc. and therefore can be outsourced. Moreover, since the underlying principles are usually well-understood, the firm is unlikely to face any additional strategic threat through outsourcing. Implicit knowledge, on the other hand, is embedded knowledge within the firm and involves factors which cannot and should not be articulated, as this can result in strategic risk for the firm.

Again, using BAM as an example, let us apply this concept of explicit and implicit knowledge. Assume that BAM has several proprietary stock selection models for stock screening and selection. BAM would be faced with minimal competitive risk if it outsourced and asked CAs from India to review financial reports of firms around the world and to generate input information for its stock selection model or generate reports. There are several reasons for this. First, this is a case of explicit knowledge wherein most individuals with financial analysis training would be aware of such models. Training a few more individuals does not pose an additional strategic threat. Moreover, information generated through outsourcing by itself is not proprietary, as it is based on information which can be acquired by others. However, in the case of implicit knowledge the reverse will hold true. Therefore, BAM should not outsource the running or refinement of its proprietary stock selection models, nor share any insight into the specifics of its outsourcing model, such as weighting criteria of input parameters. In fact BAM should make efforts to "wall-off" (Hamel *et al.*, 1989) such knowledge, by building institutional barriers between personnel, records and processes within BAM and outsourcing firms.

Second, while there are many risks to outsourcing, activities in Cell 3 have relatively higher risks compared to those in Cells 1 and 2. Therefore, firms may need to be careful to avoid these pitfalls. First, if a firm outsources part of its core activities, specific guarantees need to be sought that information collected will not shared with (i.e. resold to) others. Therefore, apart from careful screening of vendors, specific safeguards should be negotiated and protected through legal means. For instance, BAM should demand that outsourcing work be carried out in a facility that is not shared and that information generated by employees in the facility is secured. Second, monitoring the quality of the outsourcing supplier is much more difficult in activities related to Cell 3. For instance, non-systemic errors in research reports cannot be identified easily and the consequences of such errors are significantly high. Therefore, firms need to be careful to identify supplier firms who have good reputations. Additionally, firms should also use an in-house employee to institute random quality control checks. Despite these risks, small and medium-sized firms may find it worthwhile to exploit this opportunity of outsourcing, not as a means for cost reduction alone, but also as a means for enhancing their core competencies, thereby serving as a tool of strategic innovation.

Third, managers of core-enhancing outsourcing need to careful not to create a "hollow corporation." Firms should not completely lose in-house capabilities of core related activities. For instance, BAM should always retain some capability in research however effective the outsourced partner is in providing research services. This will allow BAM an exit strategy (Lorber, 2007) to rebuild such operations in-house if needed.

Fourth, managers should not forget that core-enhancing outsourcing is more costly in terms of managerial time and commitment relative and requires different approaches compared to the options presented in Cells 1 and 2. For instance, each of the five costs of outsourcing (Kelly and Jude, 2005): cost of knowledge transfer; cost of contracting; cost of communications; cost of quality; and cost of change will be higher for Cell 3.

Finally, managers need to recognize that a collaborative approach is needed with core enhancing outsourcing to get its full benefits. Firms need to find partners who have higher operation and ethical standards, reputation, trust, and competence, as an agnostic attitude does not work for Cell 3 initiatives. Failure of managers to adapt to this requirement increase the possibility of firms failing in Cell 3 outsourcing despite successful experience in Cells 1 and 2 outsourcing previously. Therefore, firms need to make realistic commitment of resources and refinement of strategies to ensure the plans of such outsourcing are achieved.

Conclusion

In this section, we conclude by offering suggestions for future research. This paper's primary goal was to develop an outsourcing matrix to illustrate how outsourcing can be used by small and medium-sized firms to gain competitive advantage. To this extent, a typology was presented and supported through the explanatory case study. We believe this paper offers practicing managers of medium and small businesses a tool for using outsourcing as a means to compete effectively with large firms. Additionally, compared to the outsourcing literature's traditional focus on large firms, this paper is one of the few which posits the perspective of the small or medium sized firm.

While we hope this paper serves as a foundation for future work and theory building on this topic, we believe this paper suffers from the inherent limitations due to the case study methodology employed. Therefore, we also offer two fruitful avenues for researchers working on this topic. The choice for the case study was made considering the newness in the execution of the particular option of outsourcing suggested in this paper. Therefore, replication of the matrix at a later date using broader samples may offer needed refinements to the model presented. Second, in order to implement core-enhancing outsourcing strategies, we believe much work is needed on the topic of services outsourcing risk management. Our review of the literature found that, while academic work on this nascent topic of outsourcing is emerging, work on implementing risk management programs (Whitmore, 2006) during outsourcing in service firms seems to be rather scarce. This topic needs attention, as the typical contractual risk mitigating mechanisms commonly used in outsourcing (Mclvor, 2005) may not work in a knowledge-based transaction. In this regard, we hope this paper serves as a foundation for future scholars working on implementing outsourcing strategies.

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