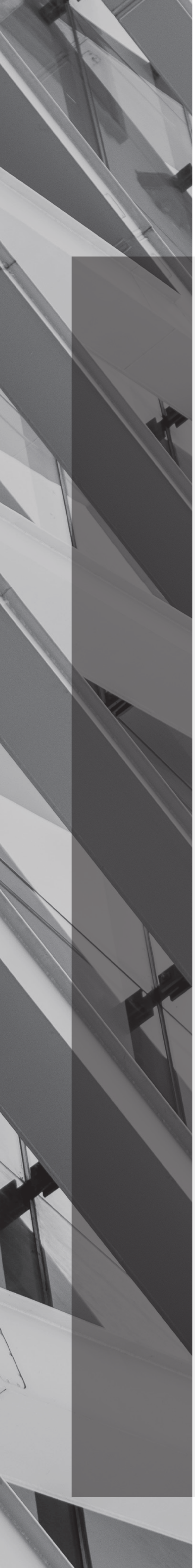
# Alternative Data = Better Investment Strategies, But Not Without Concerns

September 2019

Lowenstein Sandler



# EXECUTIVE SUMMARY

## The lion's share of hedge funds are using alternative data for detailed industry analyses—but not without concerns about data cost and quality.

Eighty-two percent of hedge funds are using alternative data in some capacity, according to a survey by national law firm Lowenstein Sandler LLP. Survey respondents also expect their budgets for alternative data to increase this year, most by 11 to 25 percent. And 55 percent of hedge funds surveyed are already spending $100,000 to $1 million each year on alternative data coming from a wide range of sources.

**82%**

**The percentage of hedge funds who say they are using alternative data.**

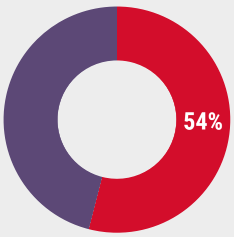
The survey of C-level executives, data scientists, equity analysts, portfolio managers, and legal/compliance officers, released in September 2019, queried fund managers to assess the use of alternative data within funds. The survey grouped funds by size—less than $500 million, $500 million to $5 billion, and more than $5 billion—to learn how funds' data use varies in terms of where they get it, what their concerns are, and what the future looks like.

With more than four out of five funds already using alternative data, survey respondents are showing greater interest in using newer sources, such as biometric data and web scraping. Though respondents predicted that using these sources would increase in the coming year, new laws and regulations surrounding biometrics, geolocation, and other privacy concerns are wild cards, and they could change the trajectory of data sourcing.

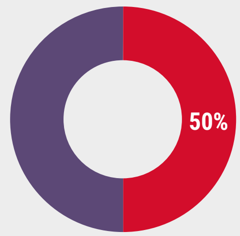
No matter the source, the ubiquity of funds using alternative data to make better predictions for investments has the potential to transform the industry. This comes at an important moment as fund managers are seeking a competitive advantage in a

market that has taken a downturn. More hedge funds were closed than established in the fourth quarter of 2018, and just 561 hedge funds were created last year, the lowest number since 2000, according to a Hedge Fund Research report. In the first quarter of 2019, 136 total hedge funds were launched, an increase over the 111 in the last quarter of 2018, according to HFR, but still there were more liquidations than launches.

As funds seek to prove their worth to investors, survey respondents' use of alternative data tracks with current industry trends. Seventy-five percent of respondents say one of their purposes for using alternative data is to generate greater insights into a particular sector, industry, or issues. Also, 68 percent of respondents said providing additional support for findings or assumptions in fundamental research is one of their reasons for using alternative data.




**54% indicate the cost and time associated with vetting vendors and the quality, integrity, and reliability of the data they sell was the top concern.**




**50% state that the ability to extract and distinguish relevant data from a large volume of data for decision-making was the second greatest concern.**

But even as the use of alternative data grows within the industry, fund managers have concerns.

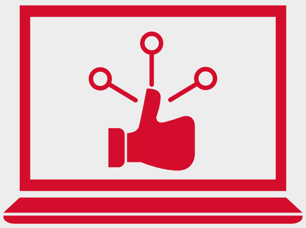
When gathering, purchasing, and using alternative data, the top concern among survey respondents was the cost and time associated with vetting vendors, and the quality, integrity, and reliability of the data they sell (54 percent). Respondents were also concerned about the ability to extract and distinguish relevant data from a large volume of data for decision-making (50 percent).

Concerns also vary by fund size. Large funds are most concerned with data breaches and security issues, while at least 50 percent of small fund respondents had four concerns: unsophisticated existing models, shortage of staff, data security issues, and an increased compliance burden. However, no matter the size, all funds need to ensure that their data comes from a legitimate source and provides them with information they can turn around and actually use to help the business.

"Having a wealth of data is great, but only if you really believe it is going to improve your ability to forecast and capture market inefficiencies or risk premia," Ray Iwanowski, Managing Principal and Co-Founder, Secor Asset Management LP, told *Bloomberg*. "Available information is not synonymous with useful information."

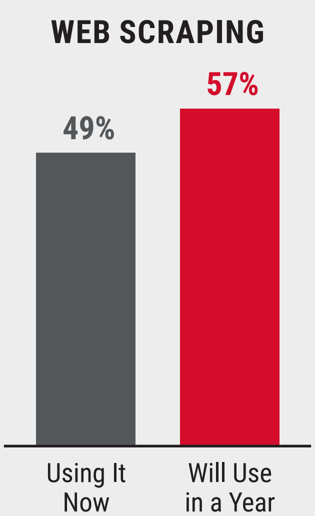
# KEY FINDINGS

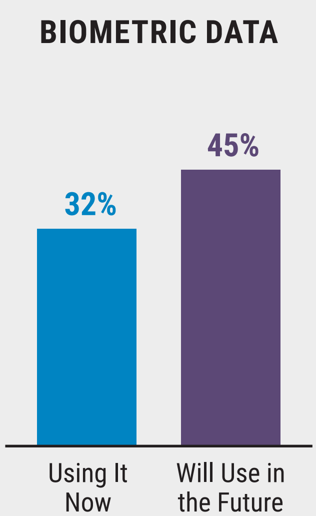
- Respondents were asked what data sources they currently use and what they expect to use in the next 12 months. The most popular alternative data source now and in the next six to 12 months is consumer transaction data, followed by data gathered through social media and cloud platforms—though of the top three sources, only social media is expected to grow as a source.

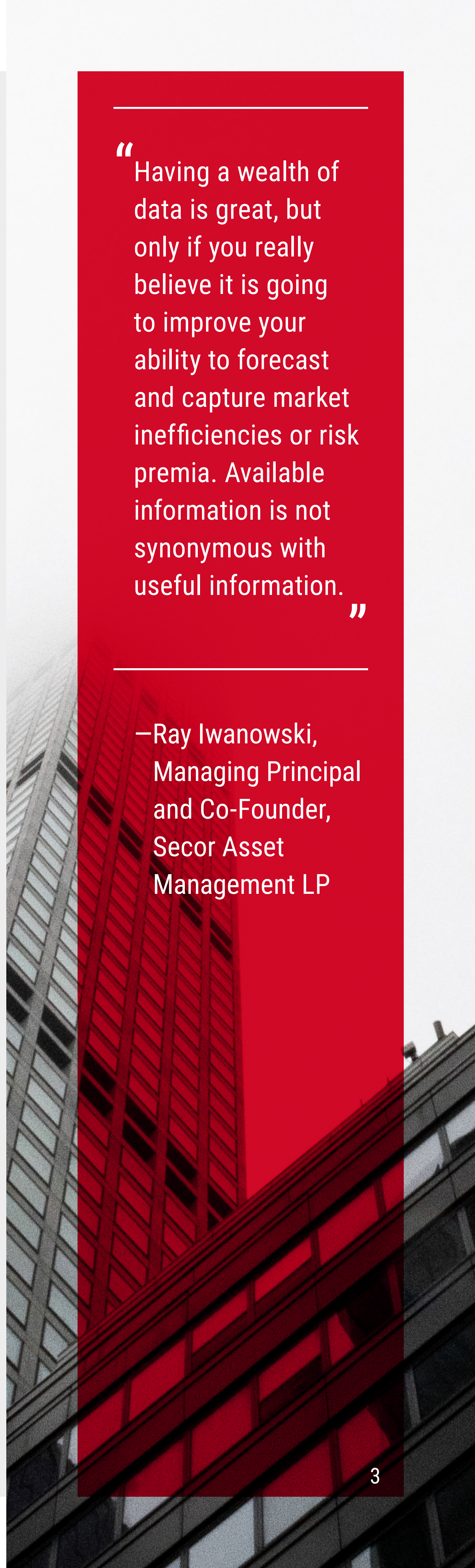


**Of the top three sources for alternative data, only social media is expected to increase.**

- Despite the consistency in the top three spots, respondents predicted that there will be some significant shifts when it comes to data sourcing over the next 12 months. Currently, 49 percent of respondents use web scraping, while 57 percent expect to use it as a source in a year. Similarly, regarding biometric data, 32 percent use it now and 45 percent expect to use it in the future.



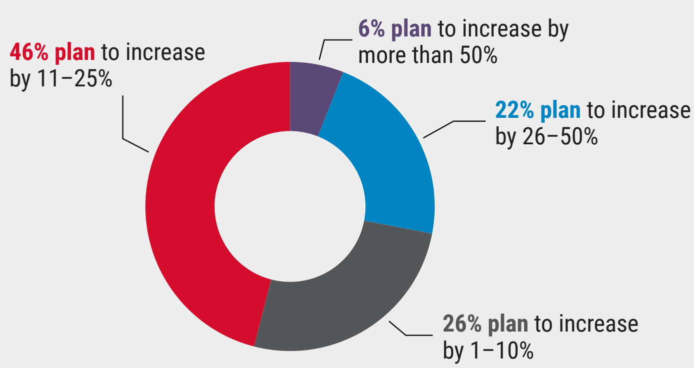



> "Having a wealth of data is great, but only if you really believe it is going to improve your ability to forecast and capture market inefficiencies or risk premia. Available information is not synonymous with useful information."
>
> —Ray Iwanowski, Managing Principal and Co-Founder, Secor Asset Management LP

- Ninety-eight percent of respondents who use alternative data do so in combination with fundamental analysis to make investment decisions. This is not surprising, as funds are clearly using alternative data to support fundamental data analysis, and not entirely replacing it.

**98%** **of respondents use alternative data in combination with fundamental analysis.**

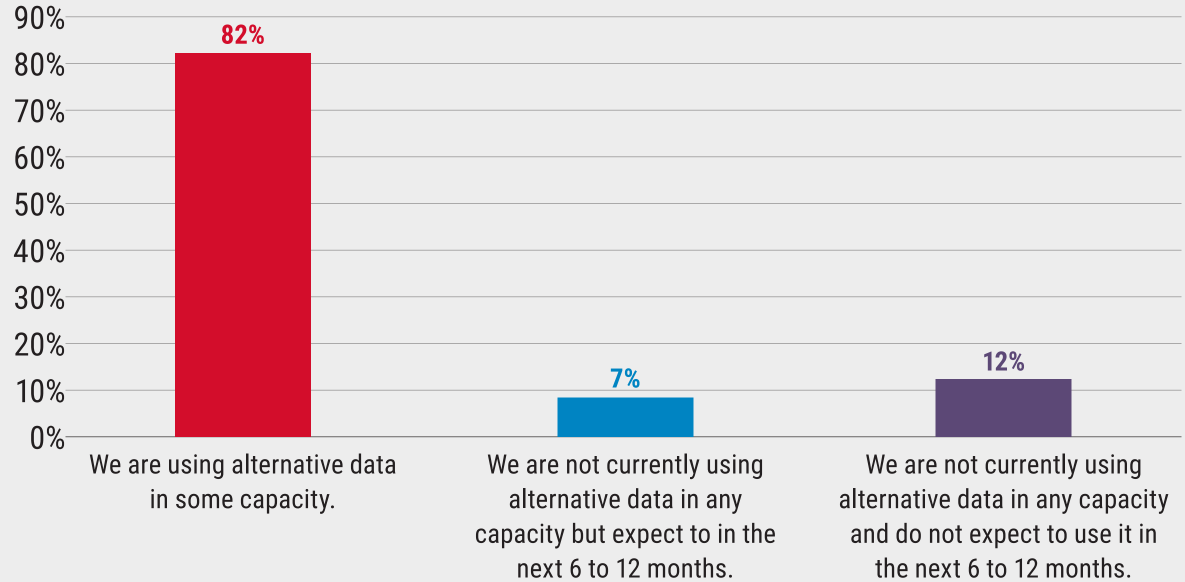
- A vast majority of respondents (81 percent) said their organization plans to increase its budget for alternative data. Of those who plan to increase spend, 26 percent plan to increase by one to 10 percent, 46 percent plan to increase by 11 to 25 percent, 22 percent plan to increase by 26 to 50 percent, and six percent plan to increase by more than 50 percent.



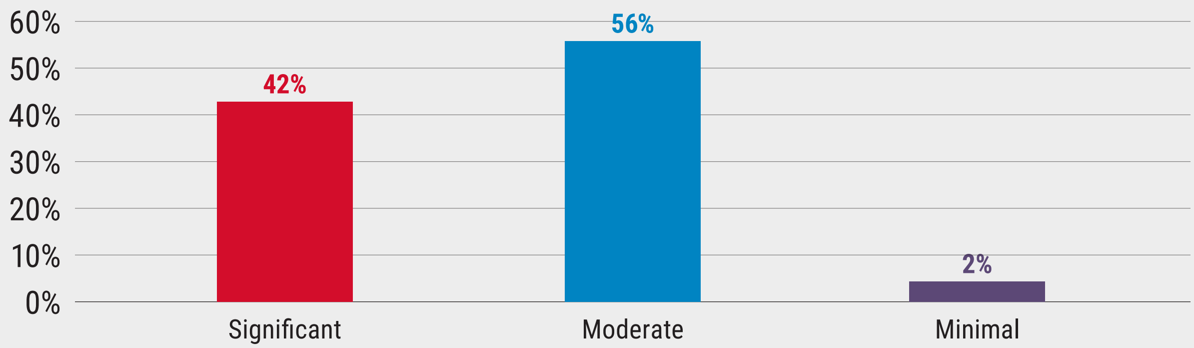

- The top reason respondents use alternative data varies by company size. The primary use for funds with less than $500 million in assets is to understand competitive markets. For $500 million to $5 billion funds, the top use was to generate greater insights into a particular sector, industry, or issues. Respondents at large funds worth more than $5 billion said the top use was to develop unique investment strategies.

# HOW HEAVY IS DATA USE AMONG HEDGE FUNDS, AND WHERE IS THE DATA COMING FROM?

## Which of the following describes your firm's current level of alternative data use?




## How extensive is your use of alternative data?



Most respondents (82 percent) across firms of all sizes are using alternative data in some capacity. The news that hedge funds are using this data is not new—in fact, it's been widely reported. What stands out is that it's happening for almost every type of fund, and even those that aren't using it are thinking about using it. Seven percent of respondents said they are not currently using alternative data in any capacity but expect to use it in the next six to 12 months.

**42%** **of respondents said their use of alternative data was significant.**

When asked about the extent of alternative data use, 42 percent of respondents said it was significant, 56 percent said it was moderate, and only two percent said it was minimal. In a 2017 report, Deloitte cited hedge funds as having been "in the foreground of alternative data innovation," trying to get an edge on the competition. Deloitte noted that firms that don't update their investment processes in the next five years "could face strategic risks, and might very well be outmaneuvered by competitors that effectively incorporate alternative data into their securities valuation and trading signal processes."

Two years later, most funds clearly have received Deloitte's memo. But a significant issue in the evolution of alternative data is determining its source. Not surprisingly, the oldest form of alternative data—consumer transactions—is currently the top category. But while 78 percent of respondents said consumer transaction data was one of their alternative data sources, just 72 percent said they expected it to be one of their sources in the next 12 months. This is not to say that such sources are becoming less valuable but, rather, that other sources are quickly emerging.

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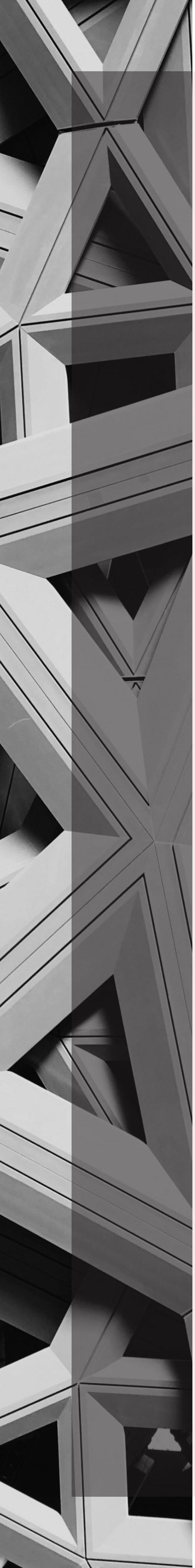
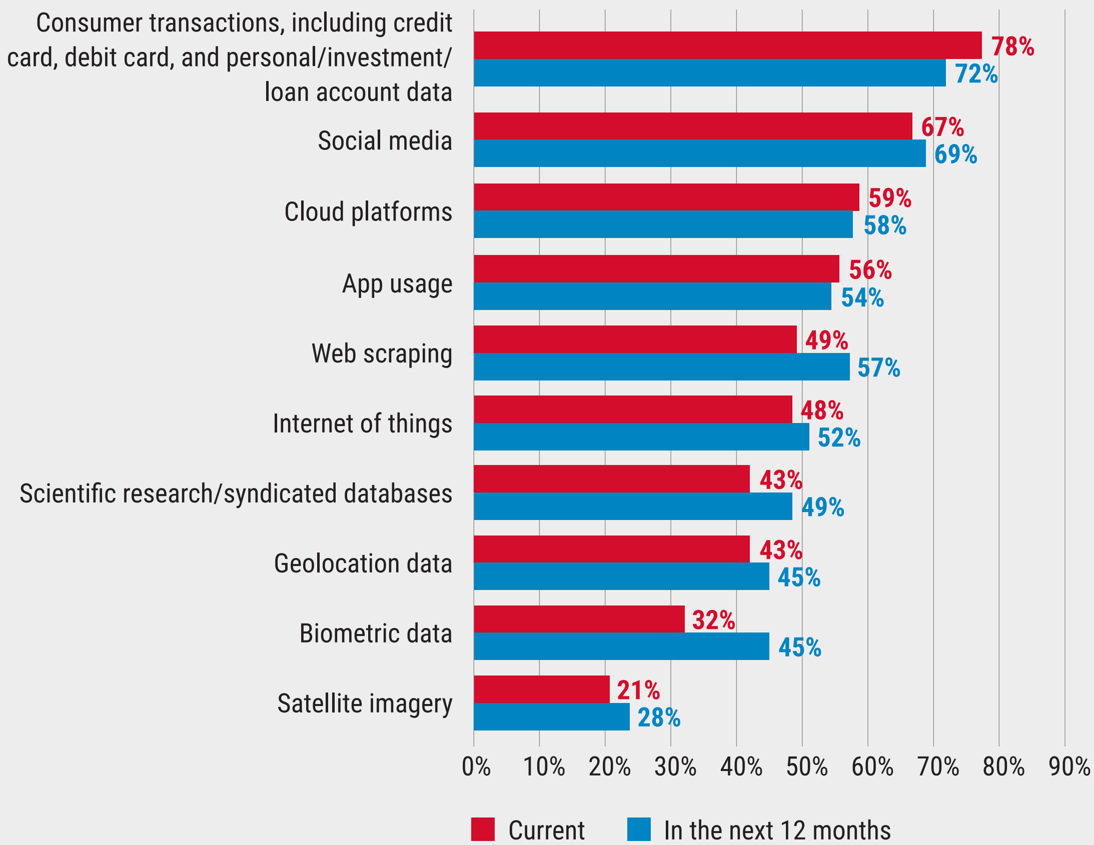
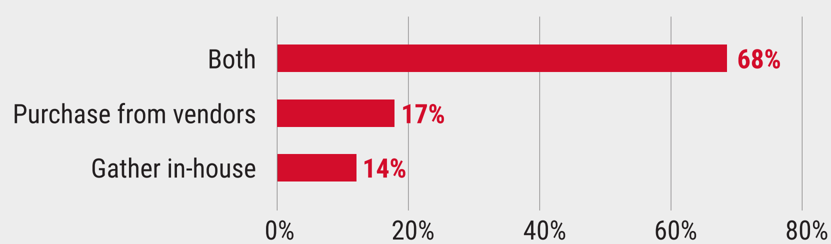


## What are your sources of alternative data?

(Select all that apply.)




## Does your firm gather alternative data in-house or purchase from vendors?



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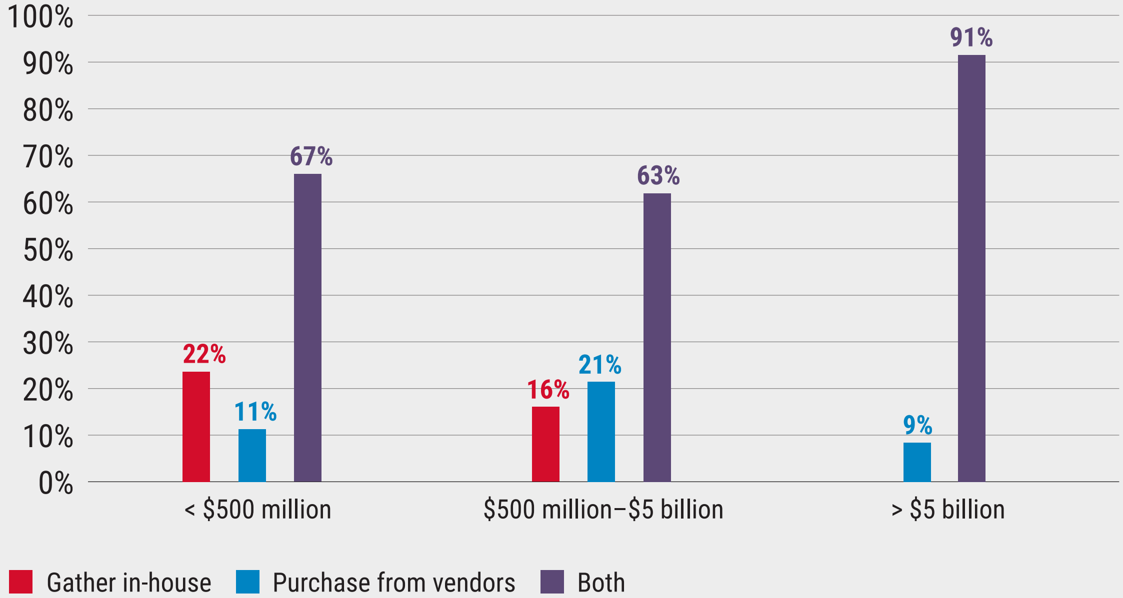



According to the respondents, web scraping and biometric data are among the most promising new sources. Currently, 49 percent of respondents use web scraping, and 57 percent expect to use it as a source in the next 12 months. Thirty-two percent use biometric data now and 45 percent expect to use it going forward.

Still, there are potential regulatory changes—at the state, national, and international levels—that could impact access to data, therefore protecting consumer privacy. Acts like the Geolocation Privacy and Surveillance Act and the American Data Dissemination Act could make certain data more difficult to obtain in the future. There are also multiple state laws popping up to protect consumer data, such as the California Consumer Privacy Act and the Colorado Protections for Consumer Data Privacy Act.

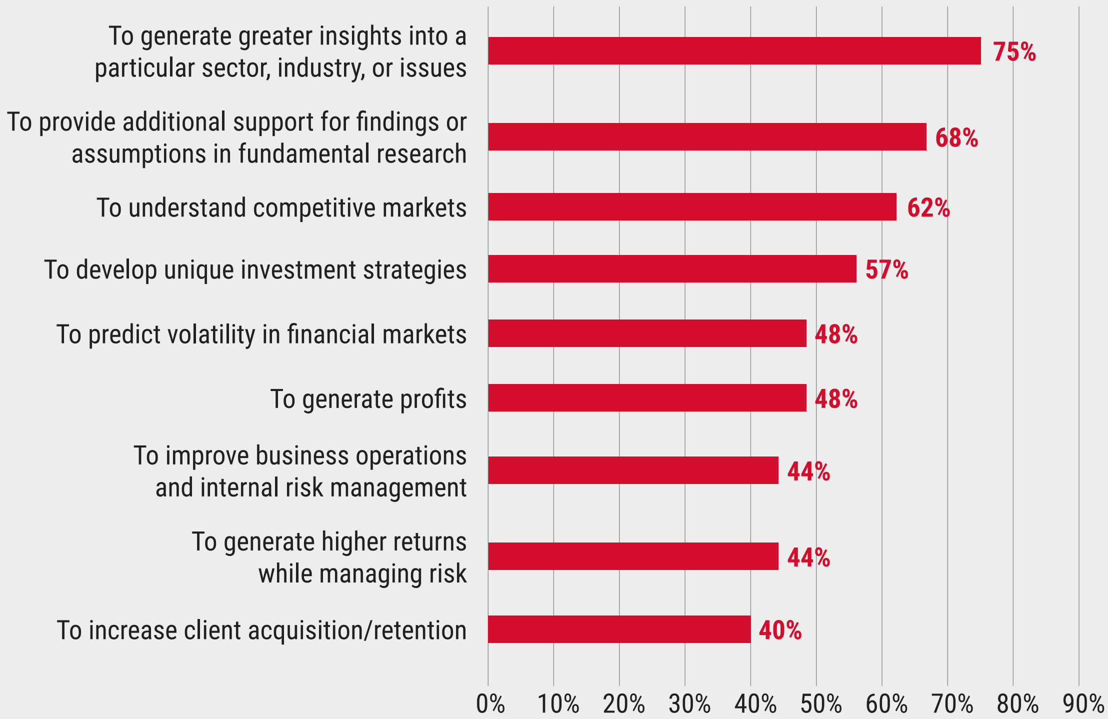
Respondents also expect to use social media, the "internet of things," scientific research/syndicated databases (e.g., Euromonitor Passport), geolocation data, and satellite imagery in the next 12 months.

Where are funds getting all this data? Most respondents said they are using both in-house data gathering and purchasing from vendors. Only 17 percent of respondents purchase solely from vendors, and only 14 percent gather solely in-house.

# WHY ARE HEDGE FUNDS USING ALTERNATIVE DATA—AND WHAT ARE THEIR CONCERNS?

## For which of the following purposes do you use alternative data?

(Select all that apply.)



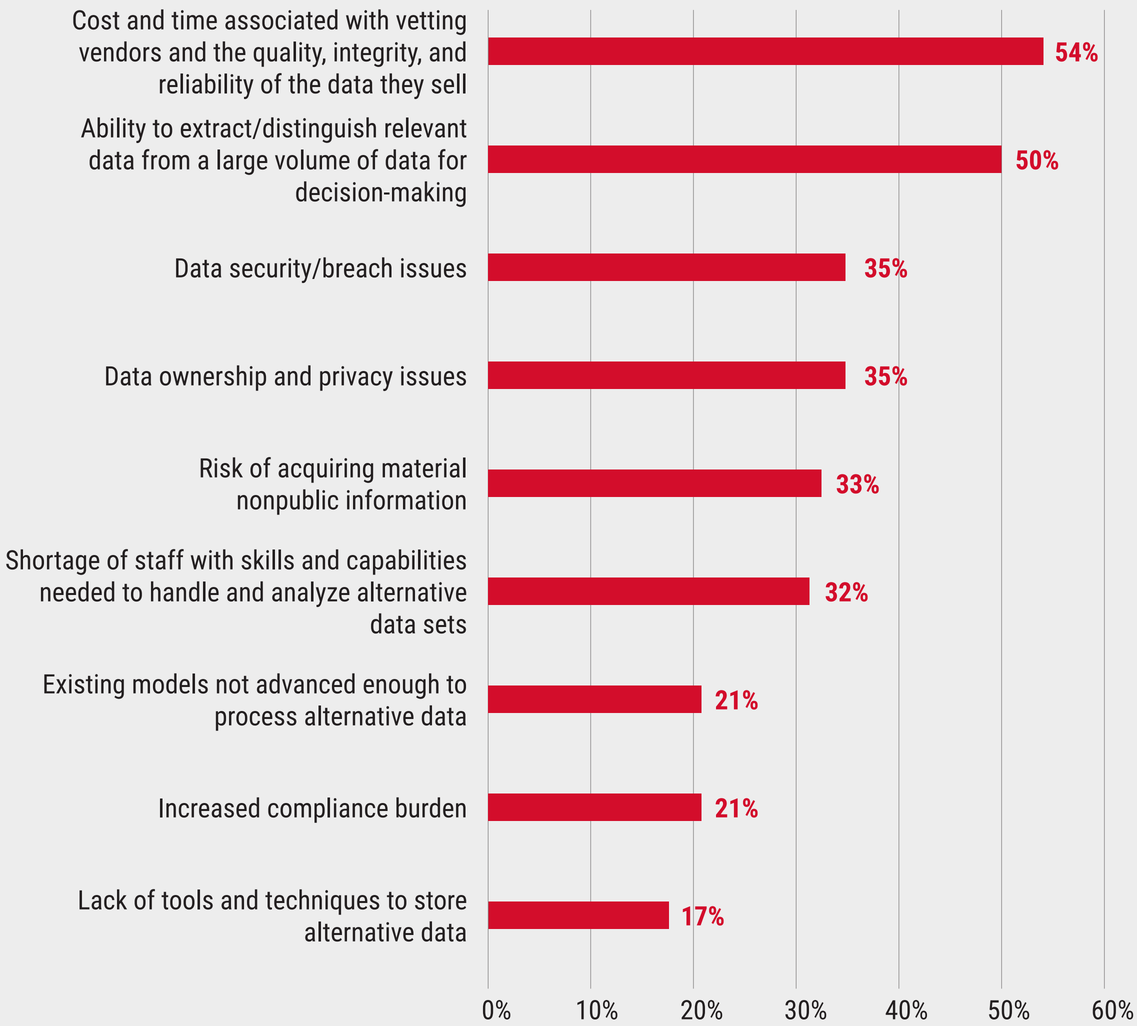

When asked about what drives the use of alternative data, 75 percent of respondents selected generating greater insights into a particular sector, industry, or issues. Well over half of the respondents (68 percent) also said they use alternative data to provide additional support for findings or assumptions in fundamental research.

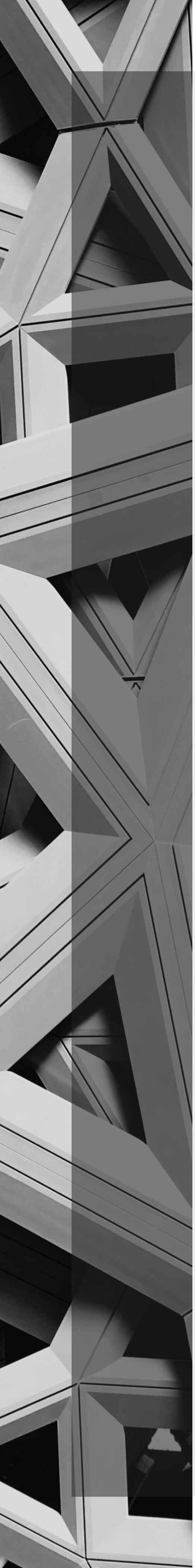
"The data is often obscure, meaning that it is not readily available to the public, and must be specifically sought out by hedge funds intending to gain more information about, say, a company or a commodity," according to *International Banker*. "Indeed, it is this obscure nature of alternative data that makes it high value, and hedge funds are only too willing to pay a premium for its acquisition."

These will likely always be the reasons funds look to alternative data.

"Every company is now a data company," said Abraham Thomas, Chief Data Officer at Quandl. "There's no transaction that doesn't leave a trace."

## Which of the following are your major concerns when gathering/purchasing and using alternative data?





Still, using data effectively is far from simple. Even though most funds are using alternative data, there are concerns, especially when it comes to cost, data quality, and vendor reliability.

When respondents were asked what their major concerns were when gathering, purchasing, and using alternative data, 54 percent said the cost and time associated with vetting vendors and the quality, integrity, and reliability of the data they sell were issues. Respondents (50 percent) are also concerned with the ability to extract/distinguish relevant data from a large volume of data for decision-making.

But funds of different sizes have slightly differing concerns, although it is worth noting that rising problems related to data privacy can affect organizations of all sizes. Smaller funds (with less than $500 million under management) tend to have a wider range of equal concerns, ranging from issues such as existing models are not advanced enough to process alternative data, shortage of staff with the skills and capabilities needed to handle and analyze alternative data sets, data security/breach issues, and an increased compliance burden. It is not surprising that smaller funds with less experience would have a wider range of concerns than do their larger counterparts with more resources.

Mid-sized funds (with between $500 million and $5 billion under management) were most concerned about the ability to extract/distinguish relevant data from a large volume of data for decision-making, along with the cost and time associated with vetting vendors.

**71%**

**of large funds said data security and breaches were a concern.**

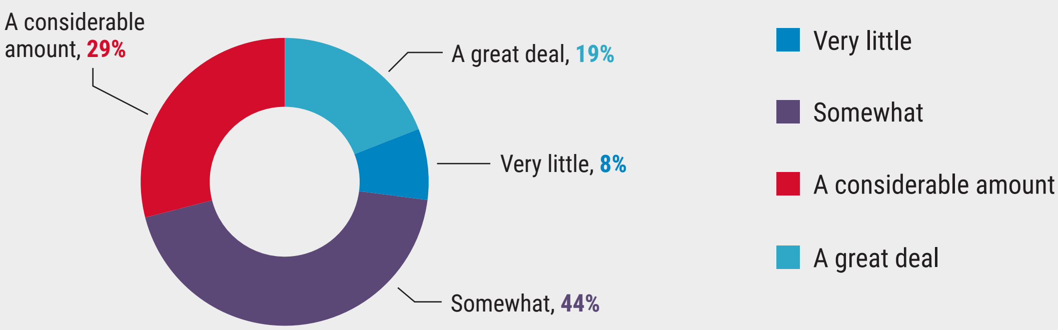
Large funds (with more than $5 billion under management) were most concerned about keeping their data safe. They are less likely to be worried about price and more likely to be more advanced when it comes to data-gathering processes.

As funds grow, concerns change. It makes sense that smaller funds would have a wider range of concerns as they begin to create their data strategies. Mid-sized funds, which have yet to amass large amounts of data, are most concerned with working through the data they have while finding out what is relevant to them. More sophisticated larger funds, likely with data strategies and systems in place, are most concerned with making sure their data is protected.

One common concern among all sizes is the shortage of staff with the skills and capabilities needed to handle and analyze data sets. This is not a skills gap, as there are plenty of employable people able to fill these roles. But funds often lack the resources to manage the volume of their data. As funds continue to increase budgets, effective staffing will become an important part of this process.

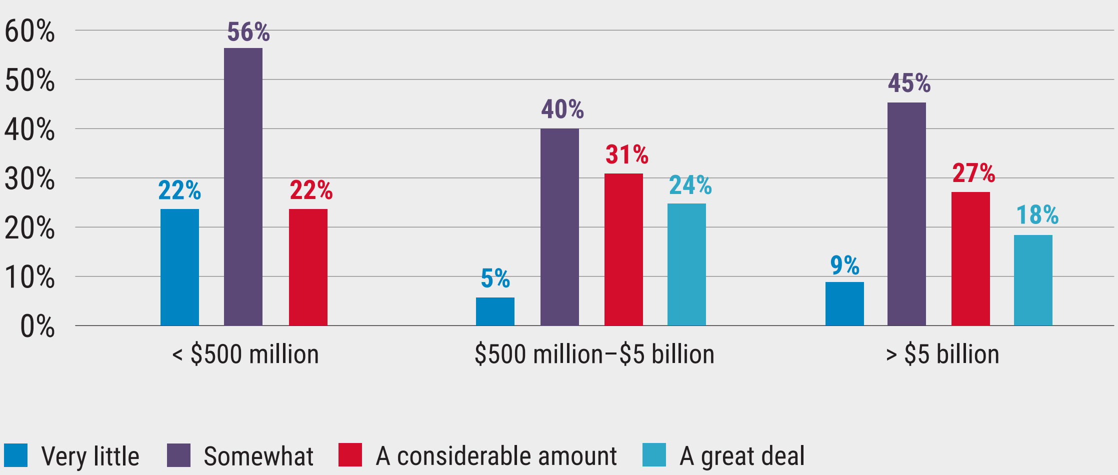
# Please indicate the extent to which your organization's data strategy could be improved through better monitoring and by quantifying risks associated with the use of alternative data.

## CUMULATIVE RESPONSES




And funds seem to know their processes need to be improved. When asked to indicate the extent to which their organization's data strategy could be improved through better monitoring and by quantifying risks, 44 percent felt it could be improved at least somewhat. Many respondents took it a step further, saying their strategy could be improved a considerable amount (29 percent) or a great deal (19 percent). Only eight percent think their strategy could be improved very little. No respondents said they felt their programs had no need for improvement. A further breakdown of respondents by fund size can be seen below.

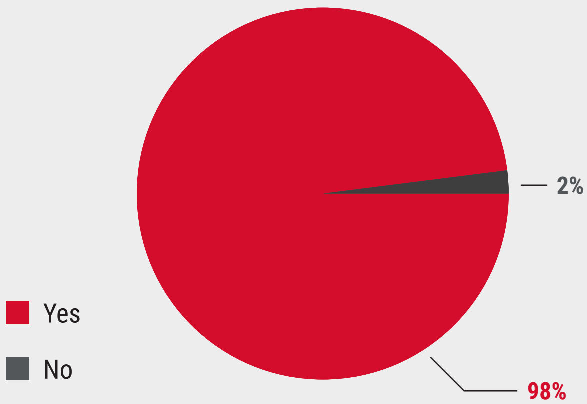
## BREAKDOWN OF RESPONDENTS BY FUND SIZE



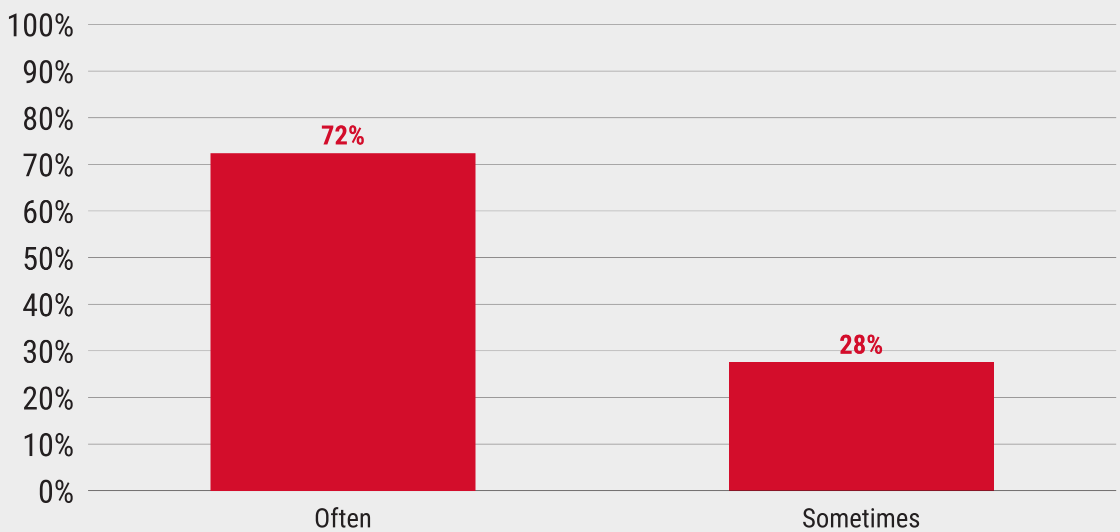
# HOW WILL THE USE OF DATA EVOLVE FOR THE HEDGE FUND INDUSTRY?

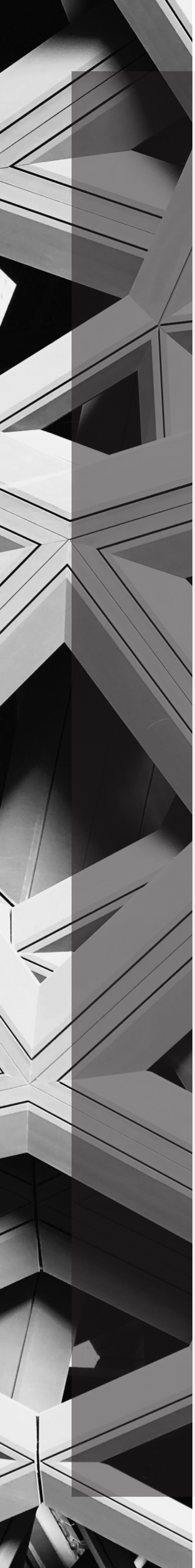
## Do you use alternative data in combination with fundamental analysis to make investment decisions?

**USE OF ALTERNATIVE DATA + FUNDAMENTAL DATA**




## How often do you use both data types together?



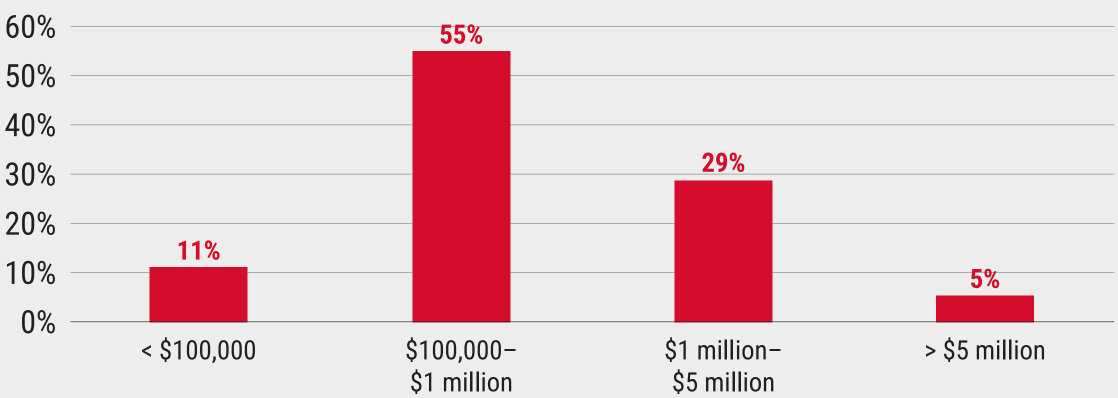


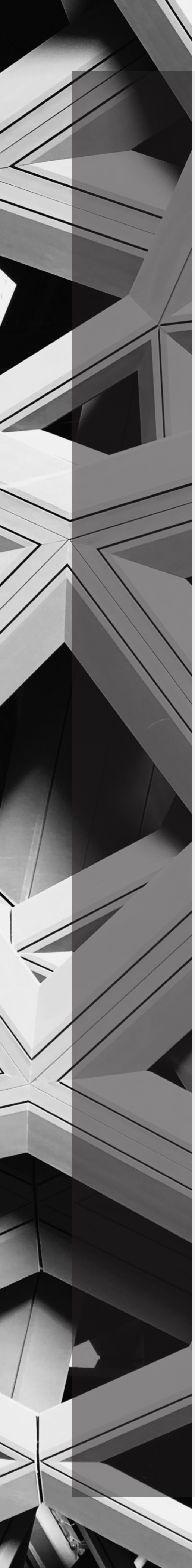
Although alternative data can provide funds with vital information, it cannot be used in a silo. Nearly all respondents (98 percent) said their fund uses alternative data in combination with fundamental analysis to make investment decisions. Seventy-two percent of respondents said they often use these two types of data together. Clearly, funds are using alternative data to support (but not entirely replace) fundamental data analysis. Will this change in an ever-evolving investment research landscape—which Mahesh Narayan, Global Head of Portfolio Management and Research at Thomson Reuters, said will look "very different" in the next several years?

"Investors will likely need to obtain more data and information to feed new AI and machine learning technology they invest in, including alternative data to identify new ways of finding alpha," Narayan said in his organization's "Future of Investment Research" survey, conducted last year with Greenwich Associates. "We expect active portfolio managers will also be looking less to the sell-side for their research, with a greater reliance on internal research and vendors to supply the information and tools they need."

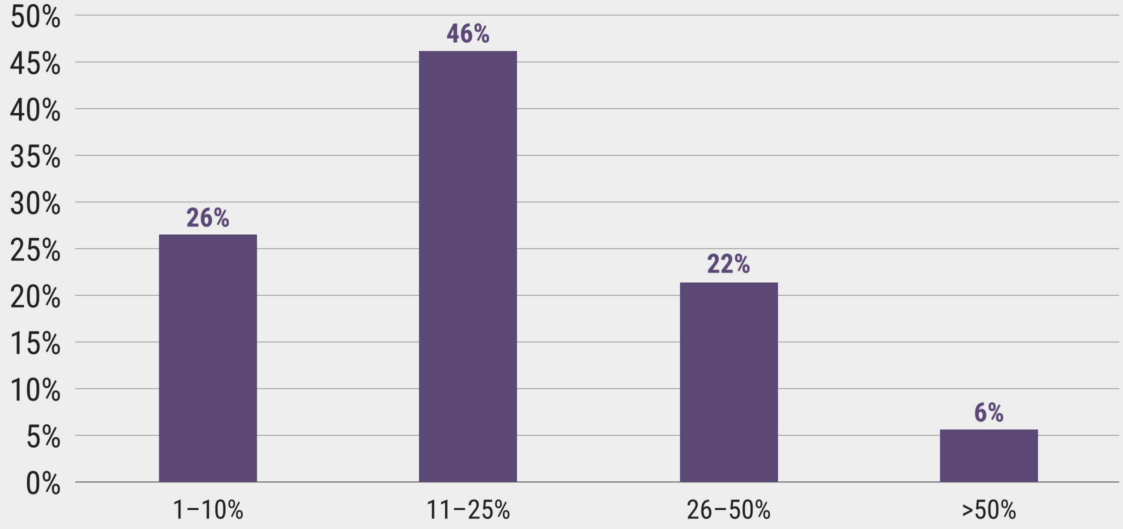
One thing funds seem to know that will change in the coming year is how much they plan to spend on data.

## What is your average annual spend on alternative data?

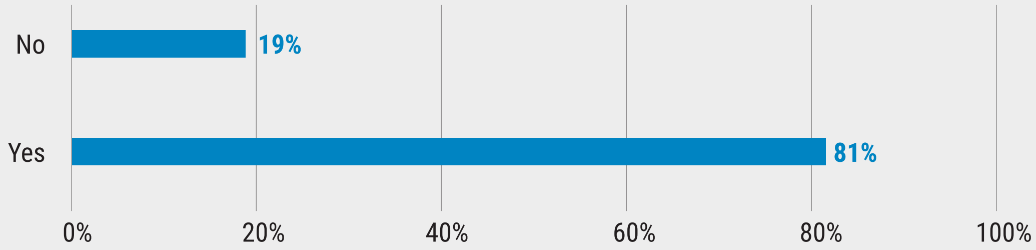




## By what percentage does your organization plan to increase its budget?




## In 2019, does your organization plan to increase its budget for alternative data?



Currently, slightly more than half of funds (55 percent) spend $100,000 to $1 million per year on alternative data. Twenty-nine percent of respondents said their fund spent $1 million to $5 million per year. But those numbers are expected to increase, potentially quite dramatically.

**55%** **of funds spend $100,000 to $1 million per year on alternative data.**

Most respondents (81 percent) said that in 2019, their organization plans to increase its budget for alternative data. Of that group, 46 percent said that they plan to increase their budget by 11 to 25 percent. Twenty-six percent plan to increase by one to 10 percent, 22 percent said they plan to increase by 26 to 50 percent, and six percent said they planned to increase by over 50 percent.

If funds plan to continue to invest in alternative data, it will be vital for them to have a solid strategy, an effective process to evaluate their sources, and the correct staffing. The talent is out there, and having the right levels of staffing will be important as regulatory agencies continue to closely watch alternative data use in the coming years. That staffing is also critical for managing ever-present security and data privacy issues.

Most respondents (81 percent) said that in 2019, their organization plans to increase its budget for alternative data. Of that group, 46 percent said that they plan to increase their budget by 11–25 percent. Twenty-six percent plan to increase by 1–10 percent, 22 percent said they plan to increase by 26–50 percent, and 6 percent said they planned to increase by over 50 percent.

# REPORT METHODOLOGY

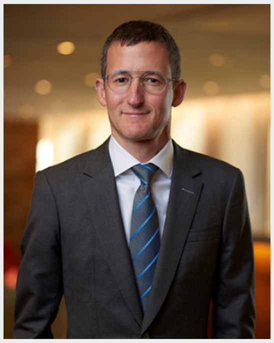
In early 2019, 76 respondents completed Lowenstein Sandler's Alternative Data = Better Investment Strategies, But Not Without Concerns survey via an online survey tool. The results were tabulated, analyzed, and released in September 2019.

The demographics were comprehensive: 39 percent of respondents were portfolio managers, while other respondent titles included C-level executive (23 percent), equity analyst (16 percent), data scientist (11 percent), legal/compliance officer (11 percent), and other (one percent).

With respect to company size, more than half (55 percent) of respondents came from organizations with more than 50 employees, while 12 percent came from companies with less than 10 employees, and 33 percent came from companies with 10–50 employees.

Most respondents (62 percent) came from medium-sized funds ranging from $500 million to $5 billion. Seventeen percent of respondents came from funds of less than $500 million, and 21 percent came from funds greater than $5 billion.

# ABOUT THE AUTHOR




**PETER D. GREENE**
Vice Chair, Investment Management Group
Lowenstein Sandler LLP
**T:** +1 646.414.6908
**M:** +1 917.596.3586
pgreene@lowenstein.com
Biography


Peter represents top-50 hedge fund managers as well as well-pedigreed managers launching their first funds. He also advises clients on the formation and structuring of funds and management companies, compliance and regulatory matters, and executive and employee compensation (on both the manager and employee sides). Peter has significant experience in counseling clients on insider trading determinations, including with respect to the purchase, analysis, and use of alternative/big data. Having served as the General Counsel and Chief Operating Officer of a buy-side investment firm earlier in his career, he has a unique understanding of clients' goals and the nature of their interactions with investors, regulators, auditors, administrators, employees, and outside counsel. Peter is recognized as one of America's Leading Lawyers for Business by *Chambers USA* for his work in the areas of investment funds and hedge funds.

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Lowenstein Sandler's Investment Management group is one of the leading practices of its kind in the United States. With more than 100 of our 300+ lawyers dedicated to serving funds and investor clients worldwide from our headquarters in New York City and offices across the nation, we are a force in the industry.

Representing many of the nation's largest and best-known asset managers, institutional investors, broker-dealers, commodity pool operators, and commodity trading advisors, the Investment Management team provides the full spectrum of legal services to hedge funds, private equity funds, distressed debt funds, credit funds, venture capital funds, real estate funds, fund of funds, and other pooled investment vehicles, as well as to investment advisers and others in the investment community.

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