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TECHNOLOGY

Survey Finds Widespread and Growing Use of Alternative Data

By Vincent Pitaro, *Hedge Fund Law Report*

Two-thirds of hedge funds, nearly half of private equity (PE) firms and two-fifths of venture capital (VC) firms presently use alternative data, and most do so to a significant or moderate extent, according to a recent survey by Lowenstein Sandler. The survey asked 125 alternative investment managers about their current and anticipated uses of alternative data; data sourcing; key concerns; demand for consumer transaction, social media and other categories of data; and its use in responsible investing. This article analyzes the survey results, with commentary from Lowenstein Sandler partner Peter D. Greene.

For more from Greene, see "Key Compliance Considerations for Fund Managers Using Alternative Data" (Jan. 9, 2020). See also our three-part series on the opportunities and risks presented by big data: "Acquisition and Proper Use" (Jan. 11, 2018); "MNPI, Web Scraping and Data Quality" (Jan. 18, 2018); and "Privacy Concerns, Third Parties and Drones" (Jan. 25, 2018).

Methodology and Demographics

Lowenstein Sandler conducted the study in the spring and summer of 2021. The pool of respondents represented a broad cross-section of hedge fund, PE and VC firms. Of the 125 respondents, 43% worked for hedge funds, 32% in PE and 24% in VC, according to the survey report (Report).

More than two-thirds of respondents were either C-level executives (34%) or in legal/compliance (34%). The rest consisted of portfolio managers (15%), equity analysts (11%) and data scientists (6%).

Nearly half of respondents' firms (44%) have from 10 to 50 employees. Nearly as many (41%) have more than 50. Just 15% reported having fewer than 10 employees.

Forty-three percent of respondents reported having up to $500 million in assets under management (AUM). Nearly half have from $500 million to $5 billion in AUM, while the rest (8%) have more than $5 billion in AUM.

Lowenstein Sandler conducted a similar study in 2019. The respondent pool in that study was very similar to this year's pool, according to Greene.

See "Survey Finds Widespread and Increasing Use of Alternative Data by Hedge Funds" (Oct. 17, 2019).

Widespread and Growing Use of Alternative Data

More Than Half of Firms Currently Use Alternative Data

There is "a steadily maturing and sophisticated landscape for alternative data," according to the Report. A majority of respondents (54%), consisting of 67% of hedge fund respondents, 48% of PE respondents and 40% of VC respondents, said that their firms presently use alternative data. Another 34% – including 57% of VC respondents and 35% of PE respondents but just 22% of hedge fund respondents – do not currently use alternative data but plan to begin using it in the next 12 months. Notably, however, the proportion of hedge fund respondents that said they currently use alternative data dropped significantly from 2019, when 82% said they used alternative data.

Most respondents (92%) that use alternative data use it either to a significant (40%) or moderate (52%) extent. Half of hedge fund respondents said they use alternative data to a significant extent, versus just 33% of VC respondents and 26% of PE respondents. The proportion of hedge fund respondents reporting significant use of alternative data is up by almost 25% from 2019, when just 42% reported significant use of alternative data.

More than four-fifths of respondents that use alternative data, including 92% of hedge fund respondents, use alternative data in combination with fundamental analysis to make investment decisions. "Fifty percent of hedge funds describe their use of alternative data as 'significant.' I think that is a pretty good number. It means half of hedge funds out there are saying, 'This really matters,'" Greene remarked. "That proportion is only going to grow."

There is anecdotal evidence that managers are hiring more aggressively in the area and building larger teams, Greene said. The survey shows that "more [managers] intend to use [alternative data] more," he observed.

Although hedge funds were the first movers in the space to use alternative data, PE and VC firms are catching up, with VC likely to catch up first. "VC invests more in tech than PE does, so it is not surprising that VC would believe in the power of data more than PE would," Greene opined. Although PE has traditionally been seen as more staid than VC, that, too, is starting to change.

See "EY 2019 Survey Explores Growing Importance of Talent Management, Diversity and Inclusion; Use of Technology, Big Data and AI; and Cybersecurity (Part Two of Two)" (Dec. 19, 2019); and "Ernst & Young 2018 Survey Finds Investors Cooling to Hedge Funds; 'Seismic Shifts' in Tech Capabilities; and Convergence Across Hedge Fund and Private Equity Products (Part One of Two)" (Nov. 29, 2018).

Some Managers May Be Pulling Back

Although there have been significant increases in the use of alternative data, 11% of hedge fund respondents reported "minimal" use of alternative data in this survey, versus a mere 2% in 2019.

It has become harder in recent years "to implement the data, to use it in a way that is helpful," Greene observed. Although data sets are less raw than they used to be, "managers see that you need to have capable data scientists – often teams of data scientists – to understand what you are purchasing, interpret it and then apply it within your investment framework," he added. Some managers have probably determined that they are not yet as good as they need to be to make the most of alternative data, so they are choosing to use less of it.

"I think some [managers] have seen that it is very difficult to successfully incorporate data sets into their investment processes," Greene continued. Most users of alternative data are not making investment decisions exclusively on the basis of that data. "They are making investment decisions on the basis of data fit into their preexisting investment philosophies and frameworks," he said. Alternative data is expensive, and when managers do not see their investments in data translate into returns, "it is natural to question their processes," he observed. Managers may have pulled back after realizing that they were not incorporating data effectively or did not have the right people to work with the data.

It will be interesting in future surveys to ask managers that previously pulled back from using alternative data whether they have reversed course because they now have better teams. It would be helpful to ask, "What are you doing with alternative data, and do you think you are doing a good job with it?" Greene added. A key question is, "Is this helping you generate returns? If it's not, it's a lot of money you can spend elsewhere," he noted.

In-House Versus Vendor Sources of Alternative Data

In 2019, more than two-thirds of respondents said that they acquired alternative data both by purchasing it from vendors and by collecting it in-house. In 2021, less than half of respondents use both approaches. More than one-third said they purchase alternative data from vendors, while 17% develop it in-house. Lowenstein Sandler attributed the growing preference for alternative data vendors to the increasing quality of data and reliability of data providers.

Three-fifths of respondents said that their firms' use of alternative data increased in 2020 and the first half of 2021 compared with 2019. Only 4% said that use decreased during that time. Notably, 83% of VC respondents reported increased use during that 18-month period, versus 58% and 53% of hedge fund and PE respondents, respectively. Eleven percent of PE respondents reported decreased alternative data usage, versus just 3% of hedge fund respondents and no VC respondents. Alternative data usage by VC and PE firms appears to be accelerating faster than usage by hedge funds, Lowenstein Sandler observed.

See "Best Practices for Using Alternative Data: Data Gathering and Managing Data Providers (Part One of Two)" (Feb. 6, 2020).

For regulatory matters involving alternative data vendors, see "SEC Focus on Private Fund Managers: Alternative Data and 'Shadow Trading' (Part One of Two)" (Dec. 2, 2021); and "SEC Action Against Alternative Data Vendor Is Warning to Fund Managers" (Oct. 14, 2021).

Impact of Coronavirus Pandemic

Of the respondents who reported increased use of alternative data in 2020 and the first half of 2021, more than seven in ten said that the increase was driven by the coronavirus pandemic either to a moderate extent (44%) or a large extent (27%). The pandemic appears to have had a much greater impact on alternative data usage by PE and VC firms than hedge funds. Ninety percent of PE respondents and 80% of VC respondents said that the pandemic had been a moderate or significant driver of alternative data use, versus just 58% of hedge fund respondents.

Growing Budgets for Alternative Data

More than three-quarters of respondents, including 83% of VC respondents, indicated that their firms plan to increase alternative data budgets in 2022. Nearly nine in ten respondents overall said that they expect their alternative data budgets to increase by at least 10%, including half that expect increases of more than 25%. One-fifth expect their budgets to increase by more than 50%.

Nearly four-fifths of hedge fund respondents whose firms use alternative data said that their firms plan to increase their alternative data budgets by more than 10%. Notably, 18% said that their firms plan increases of more than 50%, up from just 6% in 2019.

Key Concerns

By far, the most common concern about the acquisition of alternative data – cited by 61% of respondents – is the time and expense needed to vet data vendors and the "quality, integrity and reliability of the data they sell."

More than one-third cited data security and data breach issues as concerns. Three-in-ten cited data ownership/data privacy issues, concerns about acquiring material nonpublic information (MNPI) and data analysis issues. Fewer cited concerns about storage of alternative data; processing or deriving value from alternative data; or increased compliance burdens.

The second and third most common concerns – privacy and MNPI – are the "big compliance concerns," Greene noted. It was pleasantly surprising that those were ranked so high, but the ranking may have been driven by the respondents from compliance and legal functions. "The hedge fund community understands very well the risks of acquiring MNPI and [personally identifiable information], and they are very careful with it," he said. Those are the two most important compliance issues in negotiating contracts with data vendors.

See our two-part series on drafting data privacy and security provisions in vendor agreements: "Assessing the Risks" (Apr. 1, 2021); and "Negotiating Critical Provisions and Responding to Incidents" (Apr. 8, 2021).

Vetting vendors/vendor data quality was also the top concern for hedge fund respondents (56%), followed by data ownership/privacy (42%) and the risk of acquiring MNPI (39%). Those proportions were somewhat higher than in Lowenstein Sandler's 2019 study. One-third expressed concern about data security.

See "Current Insider Trading Regulatory and Enforcement Environments: Appropriate Policies and Procedures (Part Two of Two)" (Jul. 15, 2021); and "Division of Examination's 2021 Exam Priorities: New and Emerging Focus Areas (Part One of Two)" (Apr. 15, 2021).

Notably, only 22% of hedge fund respondents in this survey cited the difficulty of extracting relevant data, compared with 50% in 2019. Similarly, just 14% cited inadequate models, versus 21% in 2019. The declines in those areas suggest that hedge funds are getting better at working with alternative data, according to the Report.

Concerns about the shortage of skilled staff and the ability to extract relevant data "are really important," Greene added. Similar concerns include uncertainty about the ability to derive value from data and lack of sufficiently advanced models. Those four areas overlap and fall into the same general bucket. "We are just not sure we are good enough to use this stuff," he said.

See "AIMA Report Outlines Adoption, Challenges and Prospects for Use of Alternative Data by Hedge Fund Managers" (Jun. 4, 2020); and "Best Practices for Using Alternative Data: Mitigating Regulatory and Other Risks (Part Two of Two)" (Feb. 13, 2020).

Strong Demand for Social Media and Consumer Transaction Data

In 2021, nearly two-thirds of respondents whose firms use alternative data said that they use consumer transaction data, while more than half use social media data. Those proportions are set to switch in 2022, with 61% planning to use social media data and 52% planning to use consumer transaction data. Notably, just 42% of hedge fund respondents said they presently use social media data, but 65% said that they plan to do so in the coming year.

More than two-thirds of respondents who said that their firms use social media data said that they use it to understand consumer sentiment (72%) or to predict business performance and growth (69%). Only 22% said they use it to monitor for investor activism and "retail trading sentiment."

Respondents' perception of what the "next big thing" in alternative data will be varies from year to year, according to Greene. Several years ago, geolocation data was getting lots of attention. This survey revealed "the power of social media," whose use spiked during the pandemic-related lockdowns and had a big influence on retail investing and meme stock trading in the first quarter of 2021. Although hedge funds have been using social media data for several years, it is not surprising that "more and more hedge funds are starting to look into social media data sets," he said. There is evidence that many firms are doing their own mining of social media information about their holdings. There was also a proliferation of new social media data vendors following the market volatility of the first quarter of 2021.

Consumer transaction data, which ranked second in anticipated use, is "tried and true [and provides] direct information as to the behavior of consumers with respect to a particular product or market," Greene remarked. Consequently, "it's never going away."

See "Report Calls for Transparency and Development of Standards in the Alternative Data Market" (Apr. 20, 2020); and "A Fund Manager's Roadmap to Big Data: Its Acquisition and Proper Use (Part One of Three)" (Jan. 11, 2018).

Other Sources of Alternative Data

Two-fifths of respondents' firms presently use cloud platform data. The same proportion said that they plan to do so in the next 12 months.

In 2021, from 33% to 40% of respondents said that their firms use data from web scraping, internet of things, app usage and/or geolocation data. A slightly smaller proportion of respondents said that they plan to use each such type of alternative data in the coming year. Fewer respondents said that their firms use scientific research (18%), satellite imagery (15%) or biometric data (15%), but the proportions of firms using each is set to increase in the coming year, especially satellite imagery (26%) and scientific research (22%).

There is a growing focus on biometric data, but "I have not seen as much biometric data as commentary in the marketplace might suggest," Greene added. That could conceivably become the next big thing in the coming years. The area is constantly evolving, and new technologies could spawn new data sets that attract fund managers' interest.

Alternative Data and ESG

Three-fifths of respondents said that their firms use alternative data to "gain insight and generate alpha in [environmental, social and governance (ESG)] investments" either to a moderate (45%) or significant (16%) extent. Use of alternative data for that purpose is much more prevalent among PE respondents (84%) and VC respondents (75%) than among hedge fund respondents (45%).

From 39% to 45% of respondents indicated that alternative data is useful for improving ESG data availability and transparency for investors; creating real-time sustainability metrics; improving access to and comparability of data; or helping filter or exclude inconsistent data. Approximately one-quarter said they use it to develop new ESG strategies. Use of alternative data for creating sustainability metrics is more prevalent among PE and VC respondents than among hedge fund respondents, probably because of their longer investment time horizons, the Report opines.

See "Survey Identifies Drivers and Obstacles for Sustainable Investing" (Apr. 2, 2020); and "Preparing for the Impact Revolution: How Fund Managers Can Implement the Philosophy of 'Doing Well by Doing Good'" (Mar. 21, 2019).