



Trends in alt data: What managers should expect in 2020

Hedge funds are using 'data-mental' analysis to make better and smarter decisions



BY PETER GREENE, 02 DECEMBER 2019

Throughout the fund industry, alternative data is increasingly becoming a vital supplement to fundamental research.

A recent Lowenstein Sandler survey finds that more than four out of five funds of all sizes are using alternative data in some capacity, and even those who are not using it indicate that they are thinking about using it in the near future.

The survey also finds growing concerns about how the rise of alternative data might affect fund managers. That is partly because competition among funds is intense as clients increasingly want alternative data to become part of the traditional diligence and valuation processes.

With this as a backdrop, fund managers need a firm grasp of the budgets associated with alternative data, the top legal and regulatory concerns, and the new data sources that are emerging – and will emerge – in the years to come.

Growing budgets

Funds are already spending a lot to buy alternative data, and they plan to spend a lot more: 81% of funds in our survey are increasing budgets dedicated to the purchase and use of alternative data, with 46% planning to increase spending by as much as 25%.

Clearly, funds and their clients see the potential of alternative data to provide insights that would have sounded impossible even a few years ago. CNN reported over the summer that hedge funds spend millions of dollars on drones to collect data about the lumber industry.

This kind of information often feeds new artificial intelligence (AI) and machine-learning technology. Mutual funds, hedge funds, pension funds, private equity firms, and other entities will spend \$1.7bn on alternative data in 2020, according to projections from alternativedata.org. That organisation also expects ancillary spending on items such as data

sources, data science, IT infrastructure, data management, and systems development to exceed \$7bn next year.

Costs to fully leverage alternative data go beyond mere purchase of the data. Portfolio managers must find qualified employees to vet and analyse new information before it is purchased, and the race for that specialised talent is already on.

The Financial Times reported that, in the past five years, investment groups have more than quadrupled the number of alternative data analysts they employ. Devoting resources and talent to gleaning relevant information from vast amounts of new data sources is important.

However, funds also must invest in maintaining and educating staff to manage security and data privacy issues.

All of this will become increasingly important as regulatory agencies ramp up scrutiny of alternative data and as managers aim to more closely monitor and mitigate the risk of breaches and non-compliance. So far, there are two focus areas for compliance for managers as they increase use of alternative data: insider trading and consumer privacy.

Insider trading

While we have not yet seen an insider trading case involving alternative data, it seems inevitable.

From a regulatory standpoint, the relevant regulations in the US are Section 10(b) and Rule 10b-5 under the Securities Exchange Act of 1934.

In summary, in connection with an insider trading case, there are three questions to determine whether insider trading has occurred:

- Is the information in question material?
- Is the information non-public?
- And how was it obtained?

There is, at least in certain instances, a credible argument that many common alternative data sources (e.g. credit card transactions, social media sentiment, app usage, geolocation, satellite imagery) are material and non-public, meaning that the first two elements of an insider trading claim can be proved by the government.

As such, fund managers procuring alternative data should be careful to make sure that there is permission to acquire and use the data at every step in the information chain, from the original creator/owner of the data all the way to the hedge fund manager purchasing the data.

In most cases, this “data provenance” can be satisfied by employing a thorough due diligence questionnaire, conducting careful and comprehensive diligence with the vendor, and negotiating an agreement with robust representations and warranties. At that point, a manager should feel comfortable buying the data.

An exception is web-scraped data, which, in most instances, is obtained by prohibited means. Nevertheless, the recent *hiQ Labs vs LinkedIn* decision from the US Court of Appeals for the Ninth Circuit, which held that scraping from a public website is permissible even if the site expressly prohibits scraping, provides comfort.

Privacy concerns

Privacy is a hot-button issue in the mainstream media. Look at Apple’s recent television commercial.

But it is also very difficult for fund managers to understand, given the morass of applicable privacy laws.

There is the Gramm-Leach-Bliley Act (GLBA), the California Consumer Privacy Act of 2018 (CCPA), the EU’s General Data Protection Regulation (GDPR), the Geolocation Privacy and Surveillance Act, the American Data Dissemination Act, and the Colorado Protections for Consumer Data Privacy Act.

Some observers hope that a federal law will emerge to clear up some of the ambiguity. Until then, fund managers buying data sets must conduct appropriate due diligence and obtain representations regarding personally identifiable information (PII) in the US and personal information (PI) in the UK and the EU.

Those managers also should ensure that they are not receiving any PII/PI or anything that could be reverse-engineered to determine the identity of a particular person or data point related to a person.

On the broader privacy front, there are some cases worth watching. In *The City of Los Angeles vs IBM/The Weather Channel*, the City claimed the

popular app was using geolocation to collect data on users for more than the delivery of weather reports.

That case ultimately could shed light on how prominently and expressly users must provide consent in connection with the collection of their data.

Emerging data sources

Given the heated competition involving alternative data, funds are turning to newer sources to stay competitive.

The most popular alternative data source now seems to be consumer transaction data, followed by data gathered through social media and cloud platforms.

However, our survey results indicate social media continues to grow in use and importance. Social media feeds, news flow, and corporate announcements are seen as promising indicators of sentiment on stocks, products, and the economy.

We expect further innovation in ways to access alternative data in 2020, including the use of drones and satellite imagery to gauge, for example, how busy parking lots are at major retailers or whose private plane is landing in Omaha.

Berkshire Hathaway’s 2019 deal with Occidental Petroleum, for example, was leaked early from drone footage days before the public announcement, allowing some investors to make an educated bet.

Fund managers are also very interested in biometric and geolocation data, largely because of the massive amounts of data generated through smartphones and apps.

We are in the early phase of biometric technology, but in both cases the sources are personal information, so fund managers must be even more careful to not acquire data that would allow them to reverse-engineer the identity of a natural person. Fortunately, for now, funds seem to be taking great care with these sources when it comes to diligence around data provenance.

We are at a pivot point for the fund industry – even if alternative data has not become the be-all and end-all that some predicted in years past.

Fund managers are not making decisions based purely on the myriad data sets available to them. But, they are combining insights gleaned from alternative data sources with the tried-and-true fundamental analysis – a “data-mental” analysis if you will – as a way to make better and smarter decisions.

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