Investment Organizations Continue to Find Value in Alternative Data, Despite Challenges and Cost

December 2021

Lowenstein Sandler

EXECUTIVE SUMMARY

Findings from a survey by Lowenstein Sandler LLP suggest increased use and a maturing landscape when it comes to alternative data.

Ninety-two percent of investment organizations—including hedge funds, private equity, and venture capital—that use alternative data to inform their decision-making do so either to a moderate or significant extent. That's according to the latest survey by national law firm Lowenstein Sandler LLP, which also revealed that investment leaders expect larger budgets and even higher use of alternative data going into 2022.

92%

of investment organizations say that they are using alternative data.

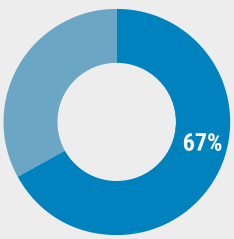
These findings show alternative data's growing importance in the investment world. But another finding reveals something just as significant—that people in the investment world have a maturing understanding of what alternative data actually is.

We come to this conclusion by comparing this year's survey with a similar one we conducted in 2019. That survey of hedge funds found that 82 percent of respondents said they used alternative data, while just 67 percent of hedge funds surveyed this year answered that way. But based on industry trends—and other survey findings—this doesn't indicate a drawback of alternative data use. Far from it. It indicates that respondents actually knew what alternative data was when they answered the question, whereas they might have answered it more generally two years ago. Indeed, respondents were also more likely than their counterparts were in 2019 to increase their usage of alternative data in the next six to 12 months.

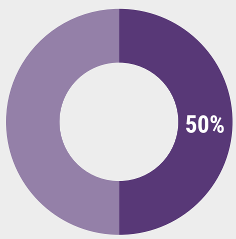
"Put together, our survey findings suggest increased use and a maturing landscape when it comes to alternative data," says Peter Greene, Vice Chair of Lowenstein Sandler's Investment Management Group. "Increased familiarity and knowledge of the space come with a more sophisticated understanding of the amount of work and investment necessary to generate successful ROI and positive alpha impact."

The survey of C-level executives, data scientists, equity analysts, portfolio managers, and legal/compliance officers was fielded in spring and summer 2021. The type of investment organization was analyzed alongside the size of the fund, goals of alternative data use, and expectations for the future.

The list of alternative data sources is long and, in recent years, best represented by a graph that has taken a sharp turn upward. Out of the variety of data available like consumer transactions, geolocation, app usage, and keyword traffic, one source in particular is set to take off, based on our survey data. Interest in social media data sets, both from third-party providers and in-house aggregations, is on the rise, with 61 percent of investment organizations surveyed indicating that kind of alternative data will be the most valuable in the next year. Indeed, TikTok, Reddit, and Twitter have all been a part of recent and massive market fluctuations and brand activity.



67% of hedge funds report use of alternative data today.



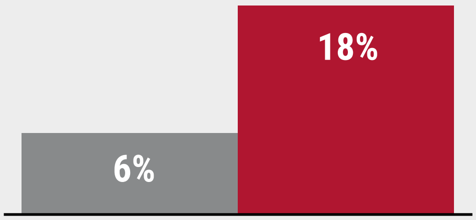
50% of hedge funds describe their use of alternative data as "significant."

Hedge funds have a head start on their investment fund cousins in using alternative data—67 percent of them report use of alternative data today, compared to 48 percent of private equity and 40 percent of venture capital. Further, 50 percent of hedge funds describe their use of alternative data as "significant" compared to private equity (26 percent) and venture capital (33 percent). The disparity in use is no surprise given the varying time horizons and business models of these fund structures. Private equity and venture capital take a longer-term view, which might explain why those respondents were more focused on deploying alternative data on ESG investments.

Across all organization types, of respondents who currently use alternative data, 78 percent plan to invest in it more in the future. And a majority of alternative data users indicated that their usage increased in 2020 and the first half of 2021, with just 4 percent noting a decrease during that time. The velocity of alternative data use can be partly attributed to a pandemic period where so much of the status quo was turned on its head. Seventy-one percent of respondents said the pandemic fueled their increased usage.

The growing number of providers and the increasing savvy of industry professionals are creating some ripples in the field of alternative data. Private equity and venture capitalists are leaning in more than in previous years, and for hedge funds that have spent more time experimenting with alternative data, the organizations that have successfully learned the lessons in earlier tests of the waters are doubling down. In 2019, just 6 percent of hedge fund respondents indicated their budget the following year would increase by at least 50 percent. In 2021, when asked the same question, that number increased to 18 percent.

In 2019, just 6% of hedge funds said their alternative data budget would increase by 50%.



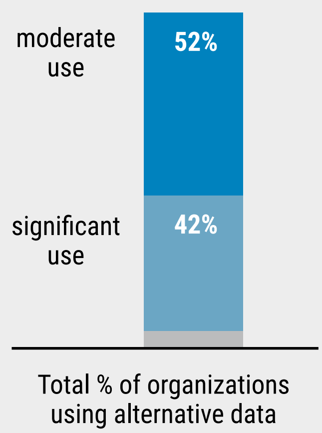
In 2021, 18% of hedge funds reported an increase alternative data budgets by 50%.

Deploying alternative data effectively comes with challenges, but the survey results also make clear that alternative data sources are increasingly seen as necessary to find and maintain competitive edge.

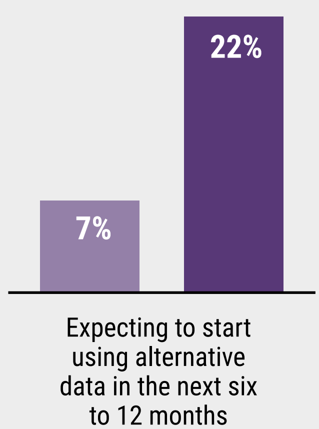
78% of investment organizations plan to increase their alternative data budget in 2022.

KEY FINDINGS

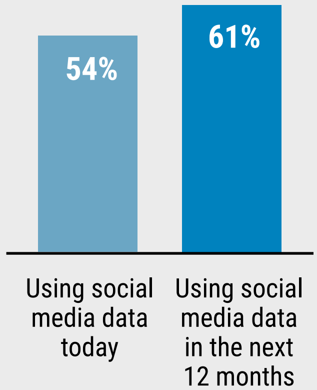
- Of the investment organizations that use alternative data, 92 percent reported using data to a moderate (52 percent) or significant (42 percent) extent in their investment decisions. Additionally, 78 percent of these organizations plan to increase their budget in 2022 — with most planning to increase by at least 10 percent.



- From 2019 to 2021, the percentage of hedge fund organizations that reported using alternative data noticeably dropped. However, the number of hedge funds that reported they expect to start using alternative data in the next six to 12 months grew from 7 percent to 22 percent. This suggests shifting priorities and an increasing knowledge base of the type of investment needed to get the most value from alternative data.



- Social media data sets, followed by consumer transaction and cloud platforms, seem to be set to become the most popular and valuable source of alternative data. Just 54 percent of respondents said they were using social media data today, but 61 percent said they expected to in the next 12 months.



- Hedge funds have a head start in alternative data usage over PE and VC firms. Fifty percent of hedge funds using alternative data reported significant use in contrast to just 26 percent of PE and 33 percent of VC. But a shift is underway. The velocity of increased usage for PE and VC between 2019 and 2020-21 was notable, including the biggest usage change for VC, 83 percent of whom described increased usage of alternative data.

50% **of hedge funds reported significant use of alternative data.**

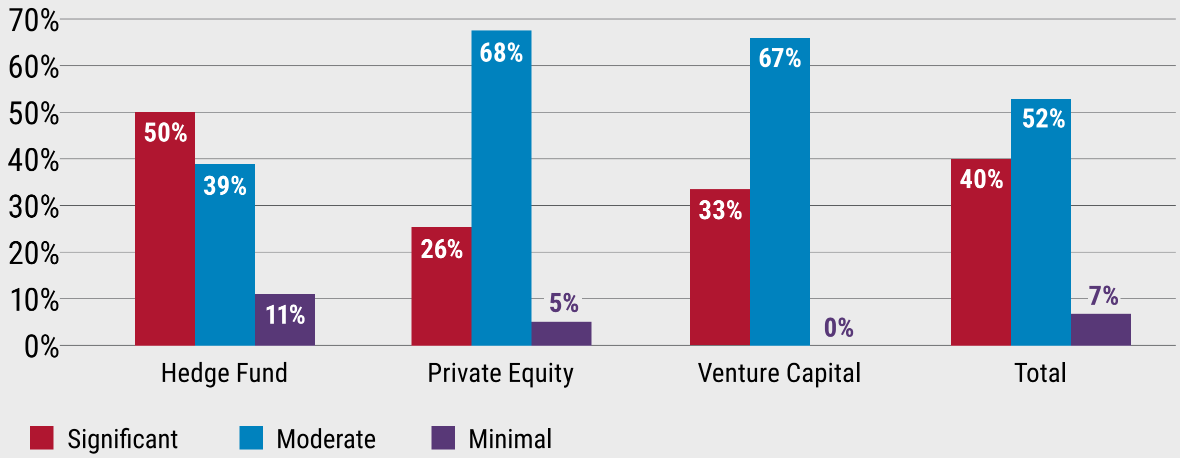
26% **of private equity firms reported significant use.**

33% **of venture capital firms reported significant use, 83% of which described increased usage since 2019.**

INVESTMENT ORGANIZATIONS ARE DOUBLING DOWN ON ALTERNATIVE DATA.

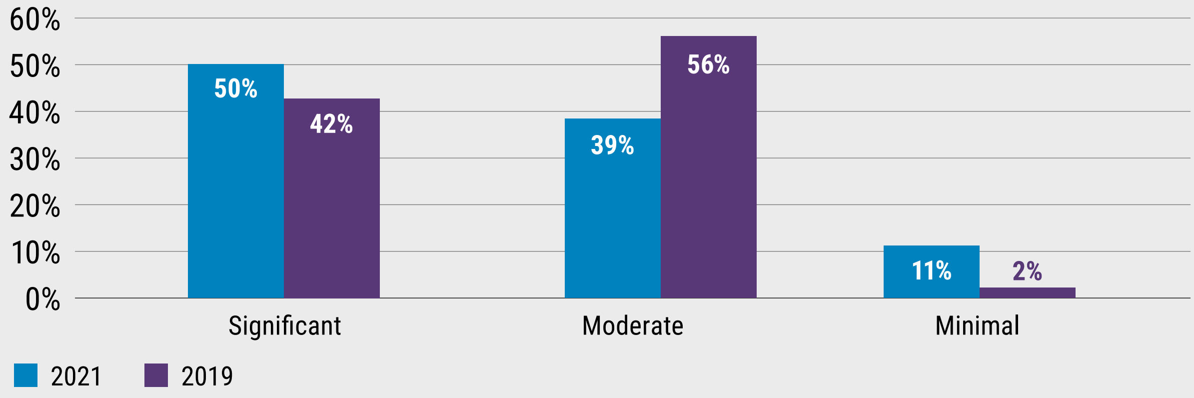
In a survey finding that was both unambiguous and significant, investment organizations that currently use alternative data have every intention of continuing to invest in raw intelligence and capabilities. Ninety-two percent of investment organizations, including hedge funds, private equity, and venture capital firms using alternative data, do so either to a moderate or significant extent. Of the respondents who reported significant use, alternative data takes a prominent role in investment decisions in half of hedge funds, one-third of venture capital firms, and one-quarter of private equity firms.

How extensive is your use of alternative data?



Additionally, hedge funds reported increased use of alternative data between 2019 and 2021. Today, 50 percent of hedge funds use alternative data to a significant extent compared to 42 percent in 2019 (see graph on the following page).

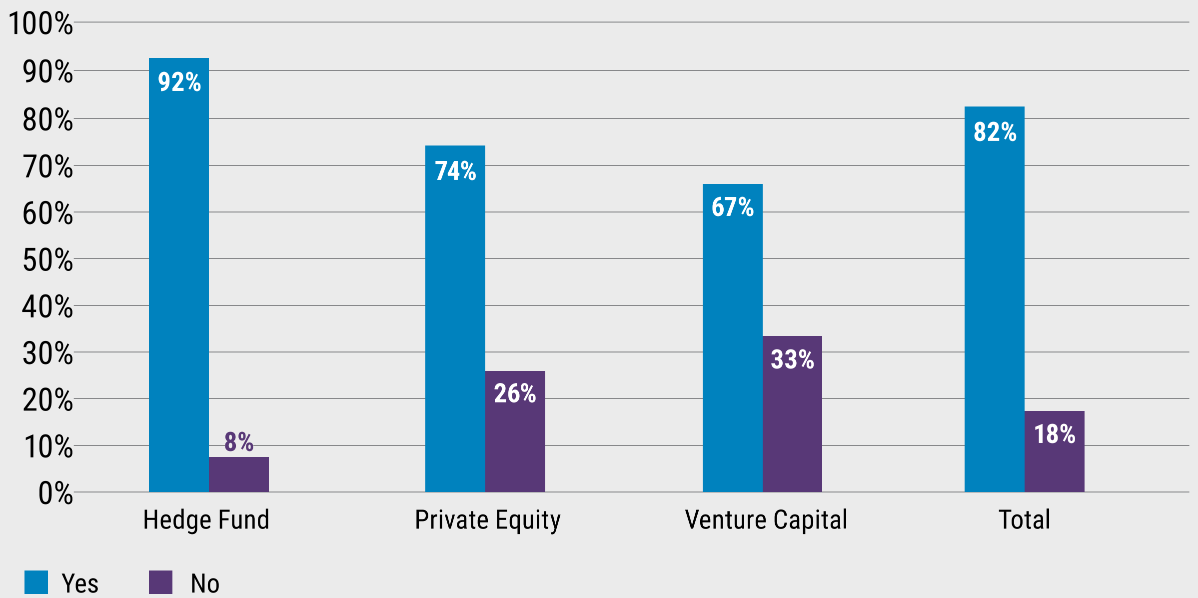
How extensive is your use of alternative data? (cont'd)



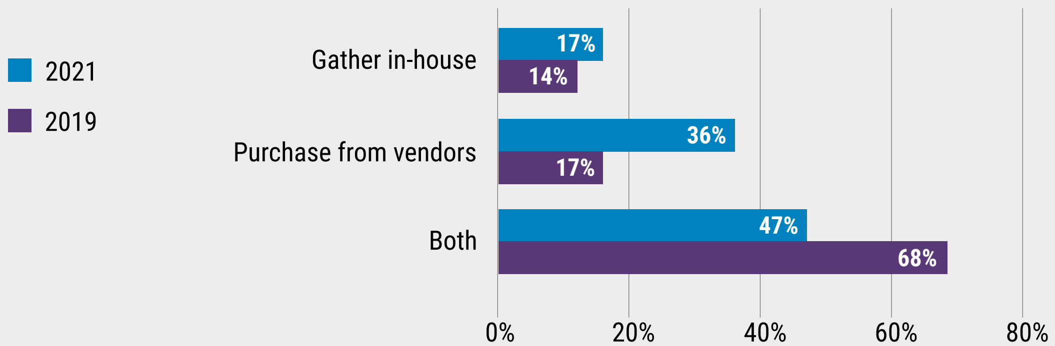
The recent growth in significant use among hedge funds in particular, which have been experimenting with alternative data for nearly a decade, demonstrates that organizations are continuing to find ways to extract more value.

Additional survey results shed light on a steadily maturing and sophisticated landscape for alternative data. Eighty-two percent of all investment organizations reported use of alternative data in combination with fundamental analysis to make investment decisions. Over half of respondents said they gather alternative data in-house as well as purchase from third-party vendors—*hedge funds* are most likely to purchase only from third parties (36 percent). In fact, the number of hedge funds reporting purchasing alternative data from third parties doubled between 2019 and 2021. Perhaps we will see this trend reverse as hedge funds hire more in-house data scientists.

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



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

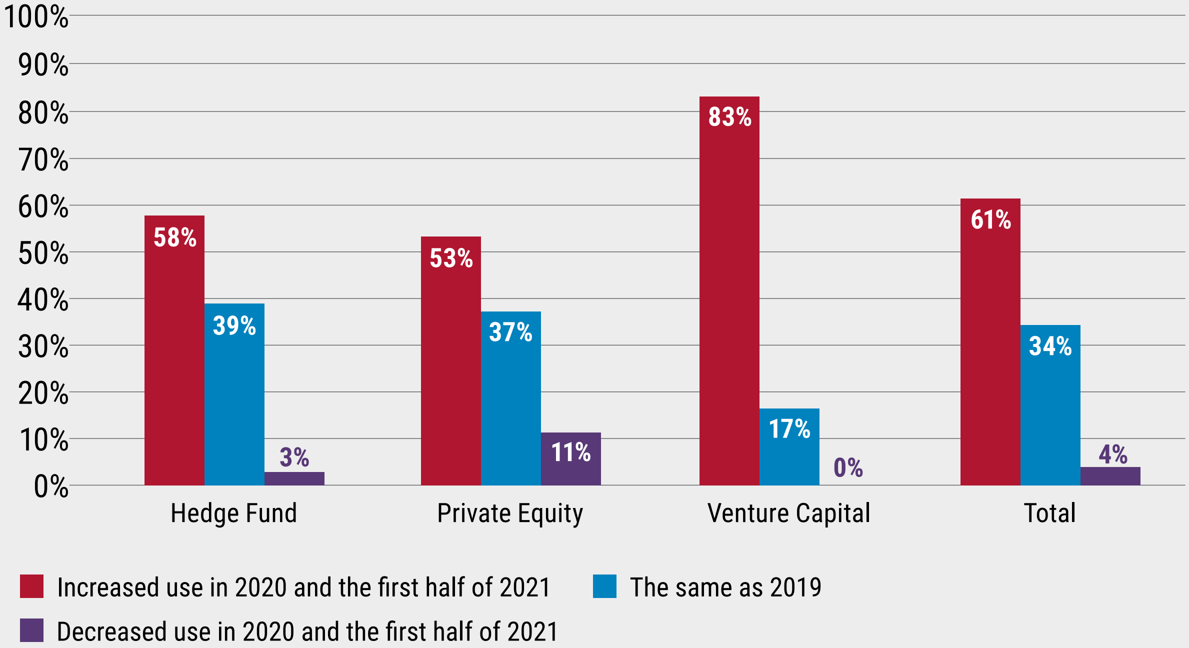


"None of the above" was an option, but was not selected by any respondents.

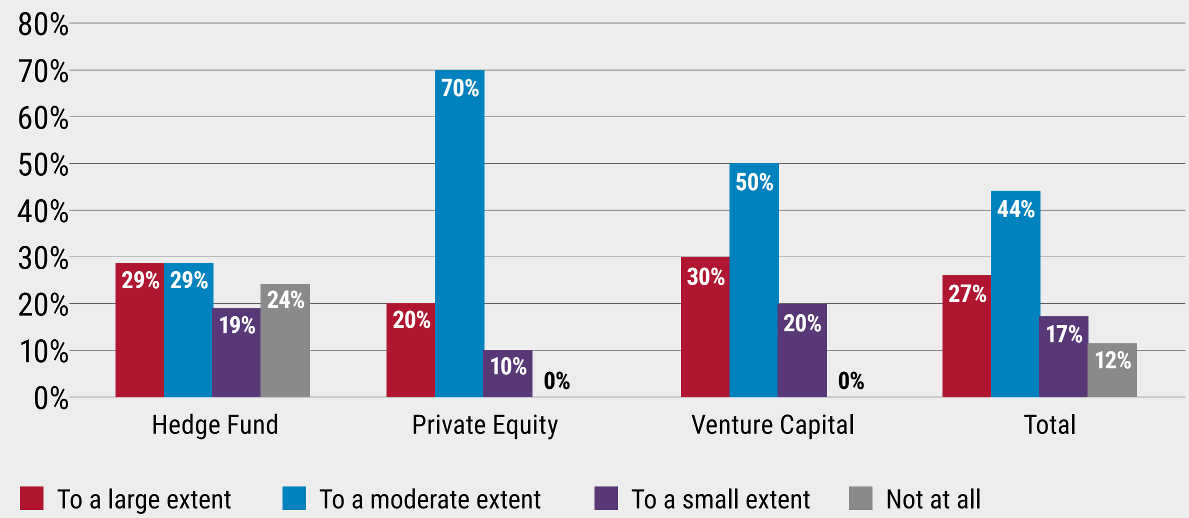
The shift occurring in hedge funds toward relying more on third-party data suggests not only the increasing reliability of the data providers but also increasing comfort in the ability to outsource high-quality data and devote their resources to talent and technology. Getting the data is no longer the biggest challenge; today, the focus is on the best way to deploy it for results.

And while deployment challenges remain (as we'll discuss later in this report), the pandemic may have added fuel to the alternative data fire. Sixty-one percent of all investment organizations reported their use of alternative data increased in 2020 and the first part of 2021, as compared to 2019. This may be a result of investment leaders looking for answers to questions that would have been unimaginable in a pre-COVID world. Finally, investment organizations are doubling down on alternative data by indicating their commitment in the most important way: 78 percent said they planned on increasing their budget for alternative data in 2022.

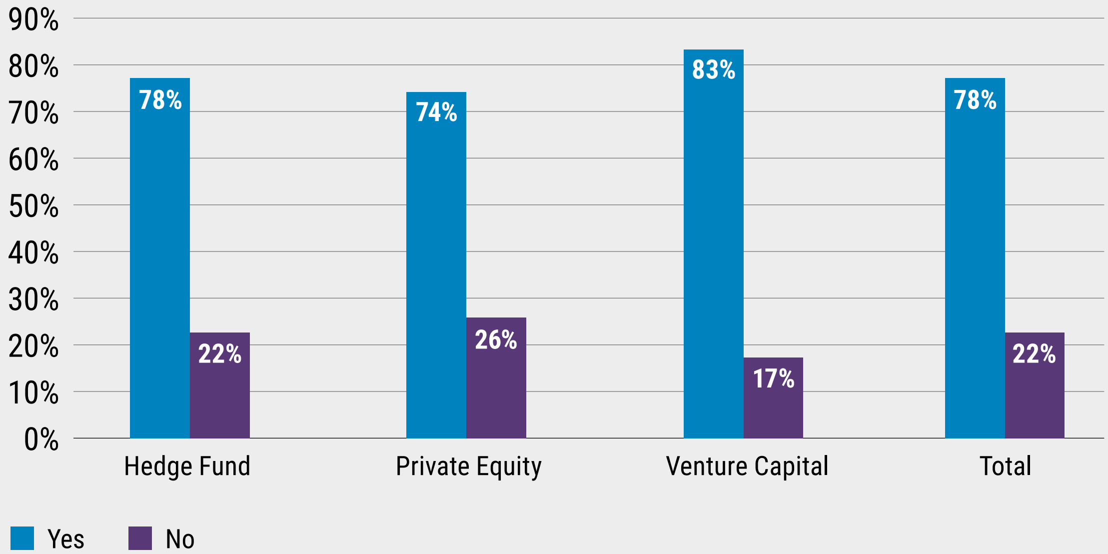
Which of the following describes your organization’s use of alternative data in 2020 and the first half of 2021 compared with 2019?

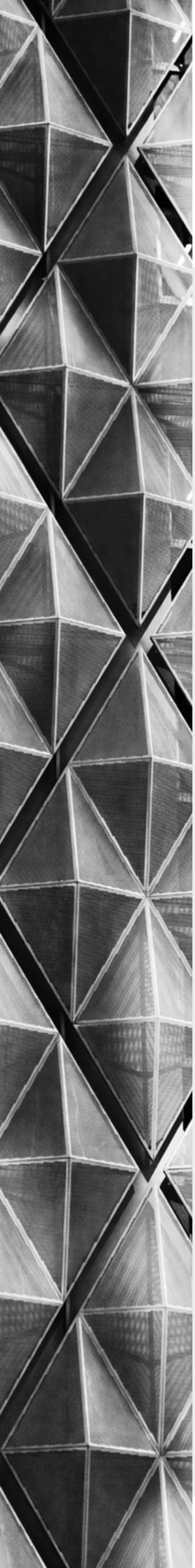


To what extent is the increased use of alternative data driven by the pandemic?



In 2022, does your organization plan to increase its budget for alternative data?

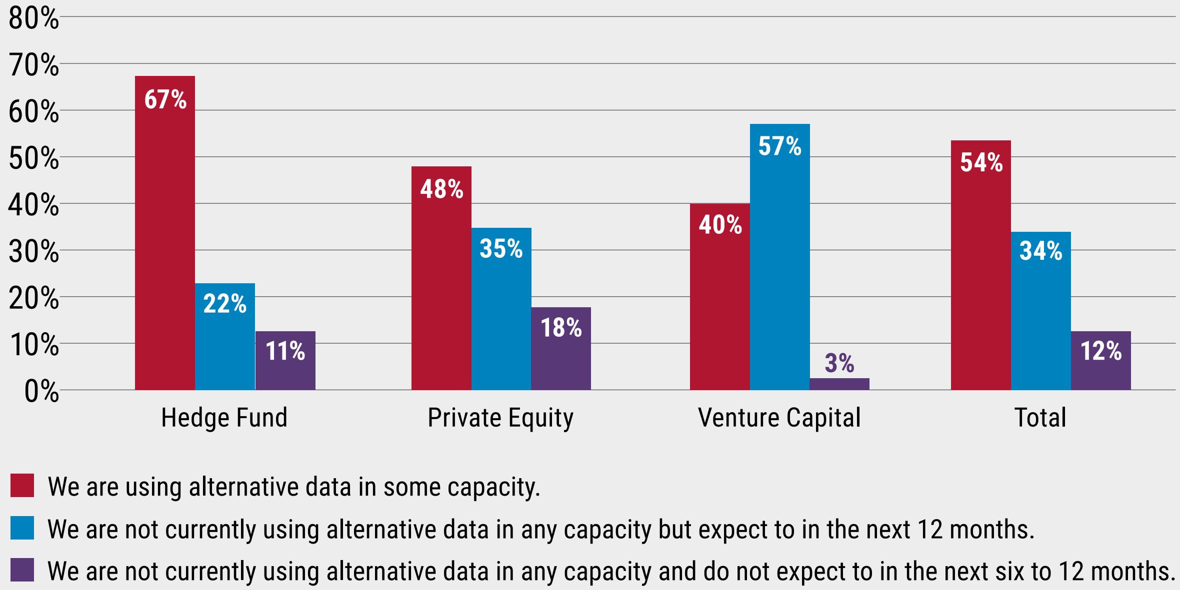




HEDGE FUNDS REFLECT MARKET MATURATION.

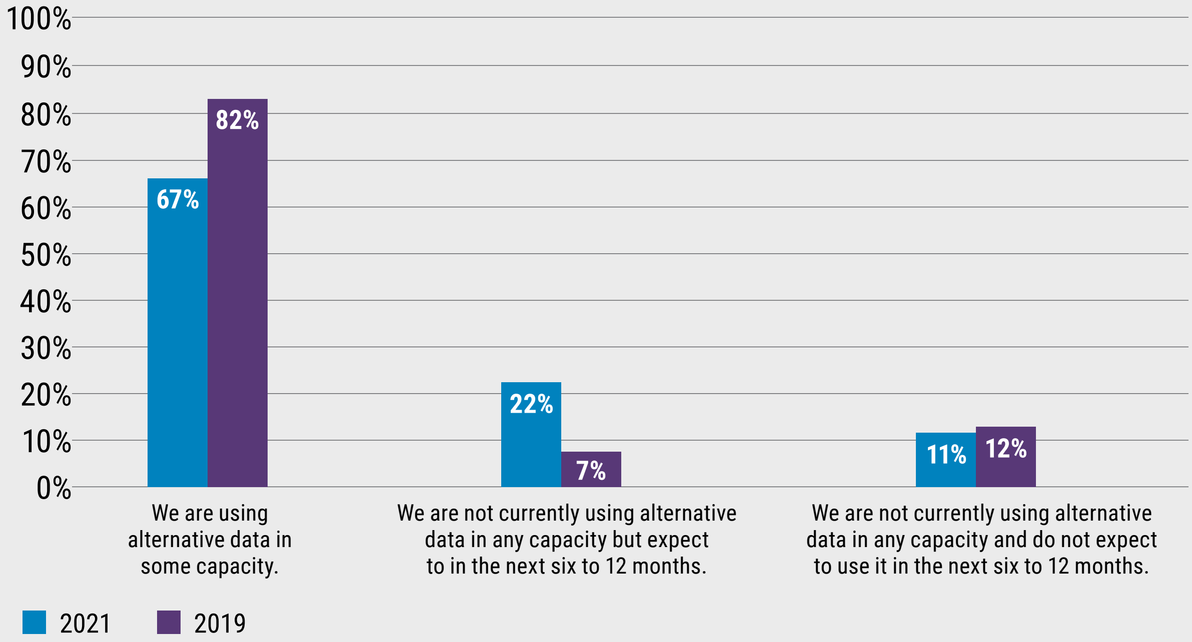
When all respondents across all fund types were asked to describe their use of alternative data, 54 percent said they used alternative data in some capacity. This finding is also in line with another recent survey done by Bank of America, which found that about half of the investors in their portfolio were using alternative data. These findings suggest that, while alternative data's benefits are increasingly understood, there is still a long way to go before full market adoption.

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



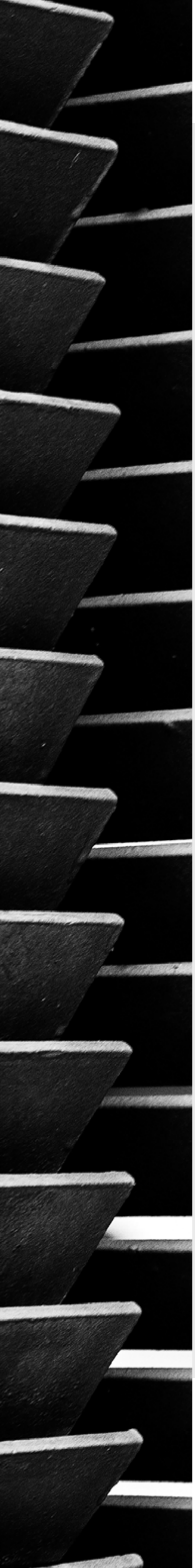
Additionally, when comparing the current survey results to the survey we conducted in 2019, reported use of alternative data at hedge funds dropped from 82 percent to 67 percent. This may be the result of respondents having a better understanding of what should be classified as alternative data. We base that on our regular discussions with industry leaders and a host of other findings in this survey. Perhaps most notably, the percentage of hedge funds indicating they would start using alternative data in the next six to 12 months tripled when compared with 2019. While fewer hedge funds reported using alternative data, far more said they planned to start imminently.

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

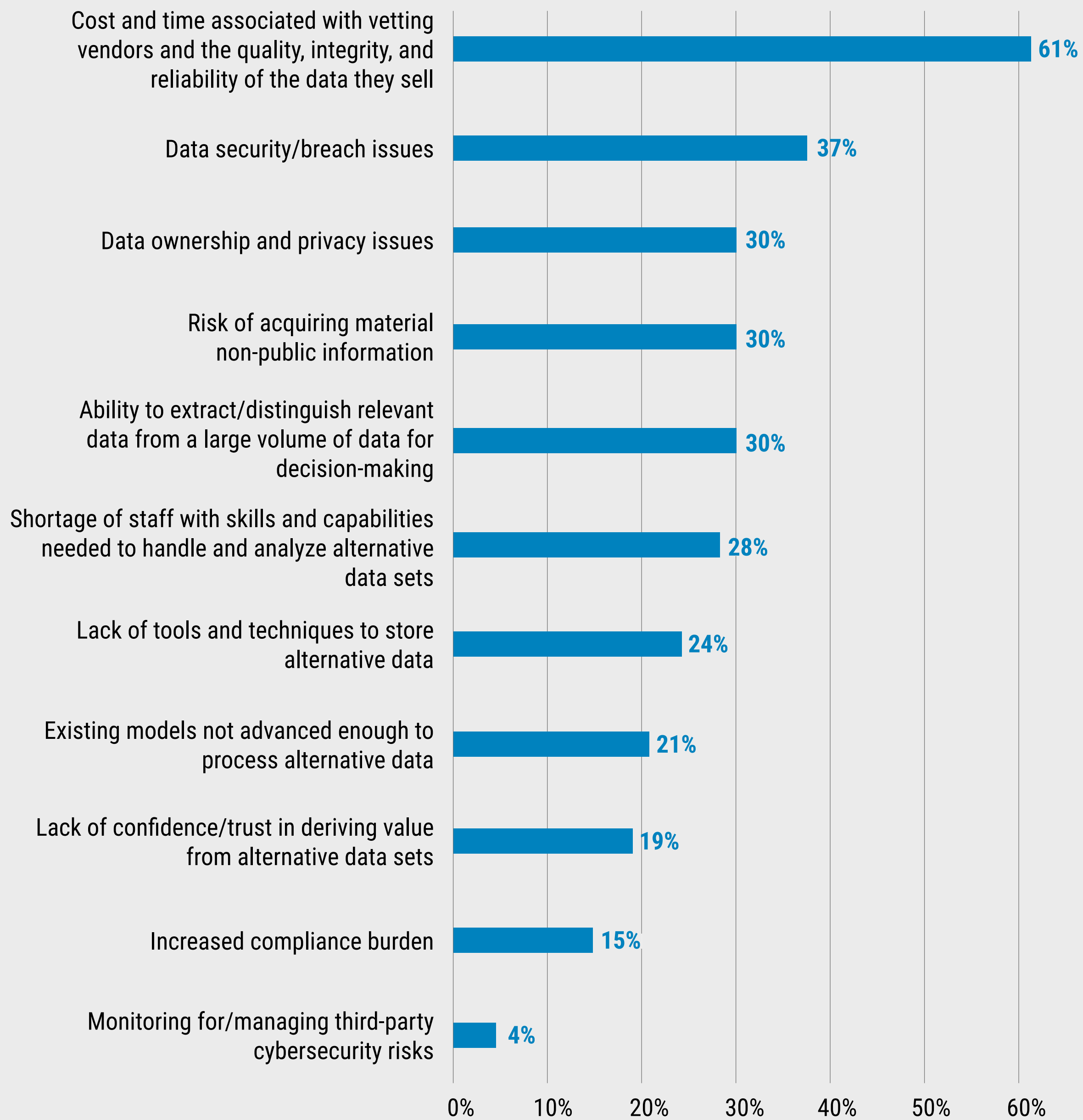


The fact remains that alternative data is difficult to deploy and requires a large degree of investment and commitment at the highest levels of an organization to generate hoped-for returns. A recent comprehensive assessment of the alternative data landscape in the technology news outlet BuiltIn highlighted one of the main ongoing barriers: "The problem today is ... how do we know if a data set is going to be valuable?" Gene Ekster, CEO of Alternative Data Group and an alternative-data professor at New York University, told the publication. "It could take six months of R&D, [and] you have to buy it first. You don't know how much alpha it's going to generate until much later."

Indeed, the cost and time associated with assessing the value of a data set was the leading concern identified among all users of alternative data in our survey, followed by data security, privacy concerns, risk of acquiring material non-public information, and the ability to extract meaningful insights from unstructured data. Apart from the cost and time associated with vetting data, almost all other challenges were experienced roughly evenly, an indication of how hard it still is to use alternative data effectively.

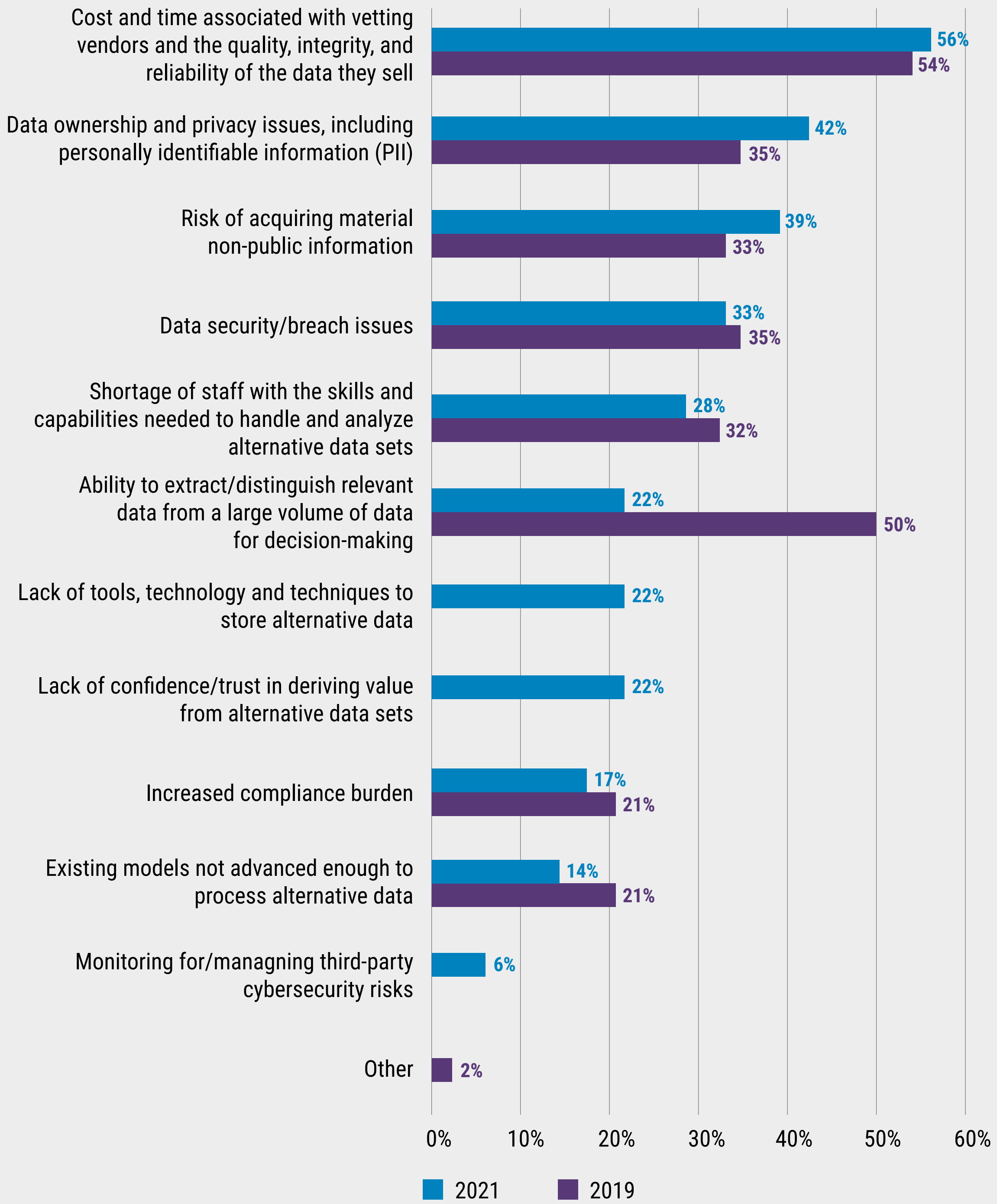


Which of the following are your major concerns when gathering/purchasing and using alternative data?



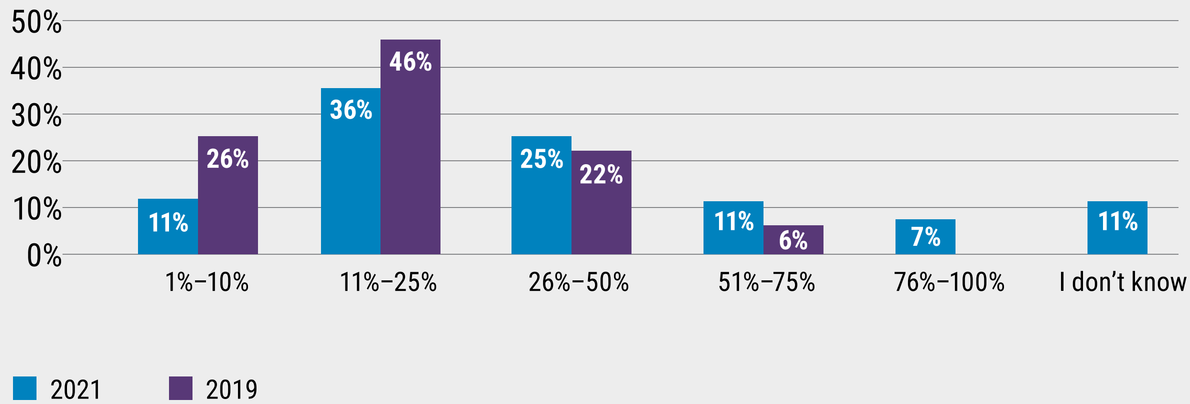
However, among hedge funds, there has been some noteworthy movement in the degree to which these challenges are experienced. In 2019, 50 percent of hedge fund respondents said that the ability to extract meaningful insights was a major concern, nearly tied with data vetting. And while that remained largely unchanged between 2019 and 2021, concerns about extracting meaningful insights fell dramatically from 50 percent to 22 percent, another possible sign of alternative data's maturity and the hiring of in-house data scientists. There was also a drop—from 21 percent to 14 percent—among hedge funds who said that their existing models weren't advanced enough.

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



Lastly, for hedge funds that are using alternative data, there is an increase in those who are not only planning to increase their budget but are planning to do so to a significant degree. Since 2019, the number of hedge funds that plan to increase their budget for alternative data investments more than doubled from 6 percent in 2019 to 18 percent in 2021.

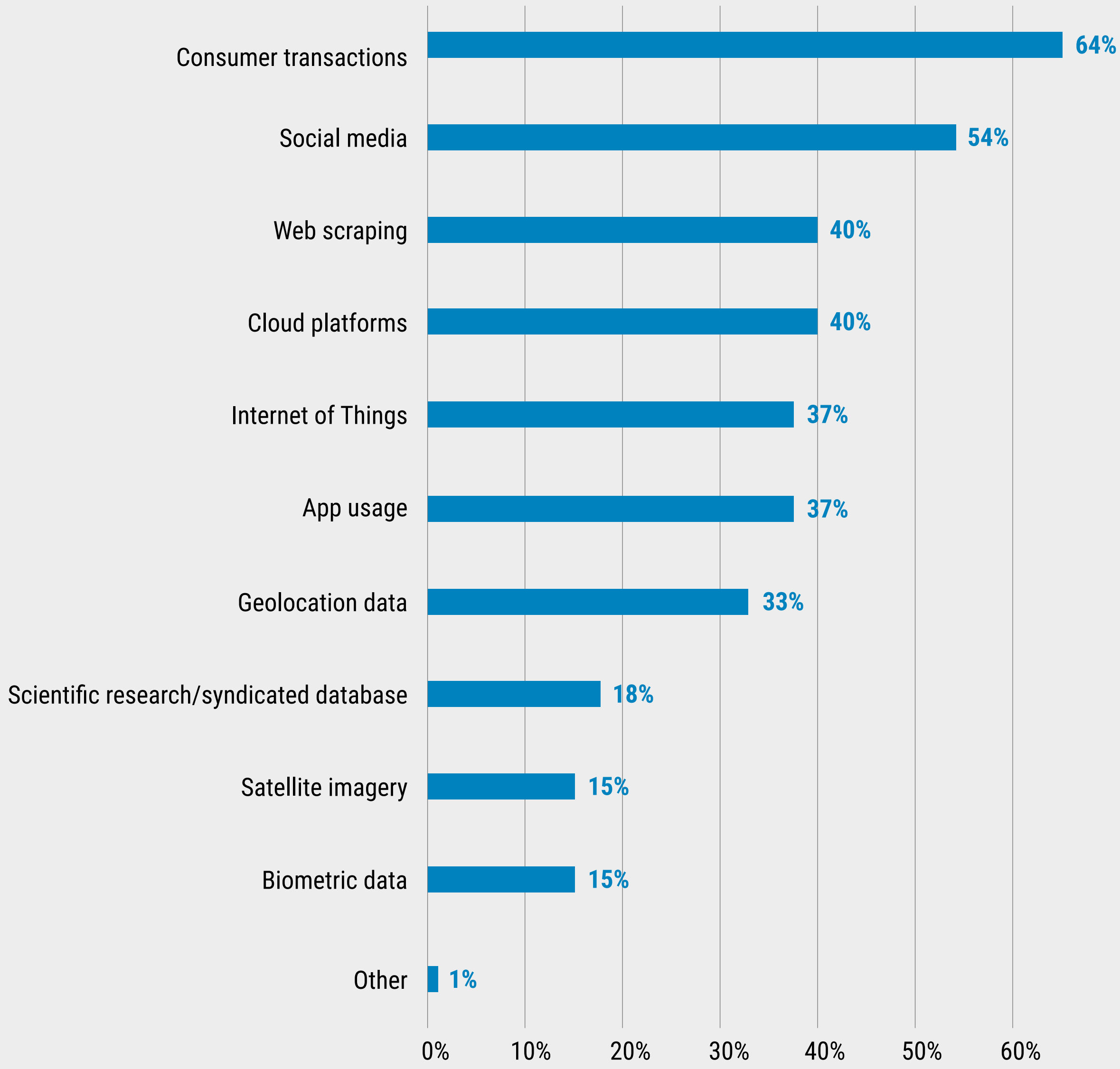
By what percentage does your organization plan to increase its budget?

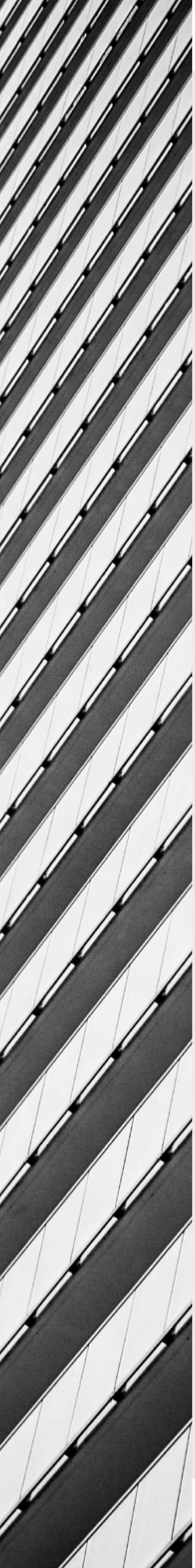


SOCIAL MEDIA IS ON THE RISE AS AN IMPORTANT DATA SOURCE.

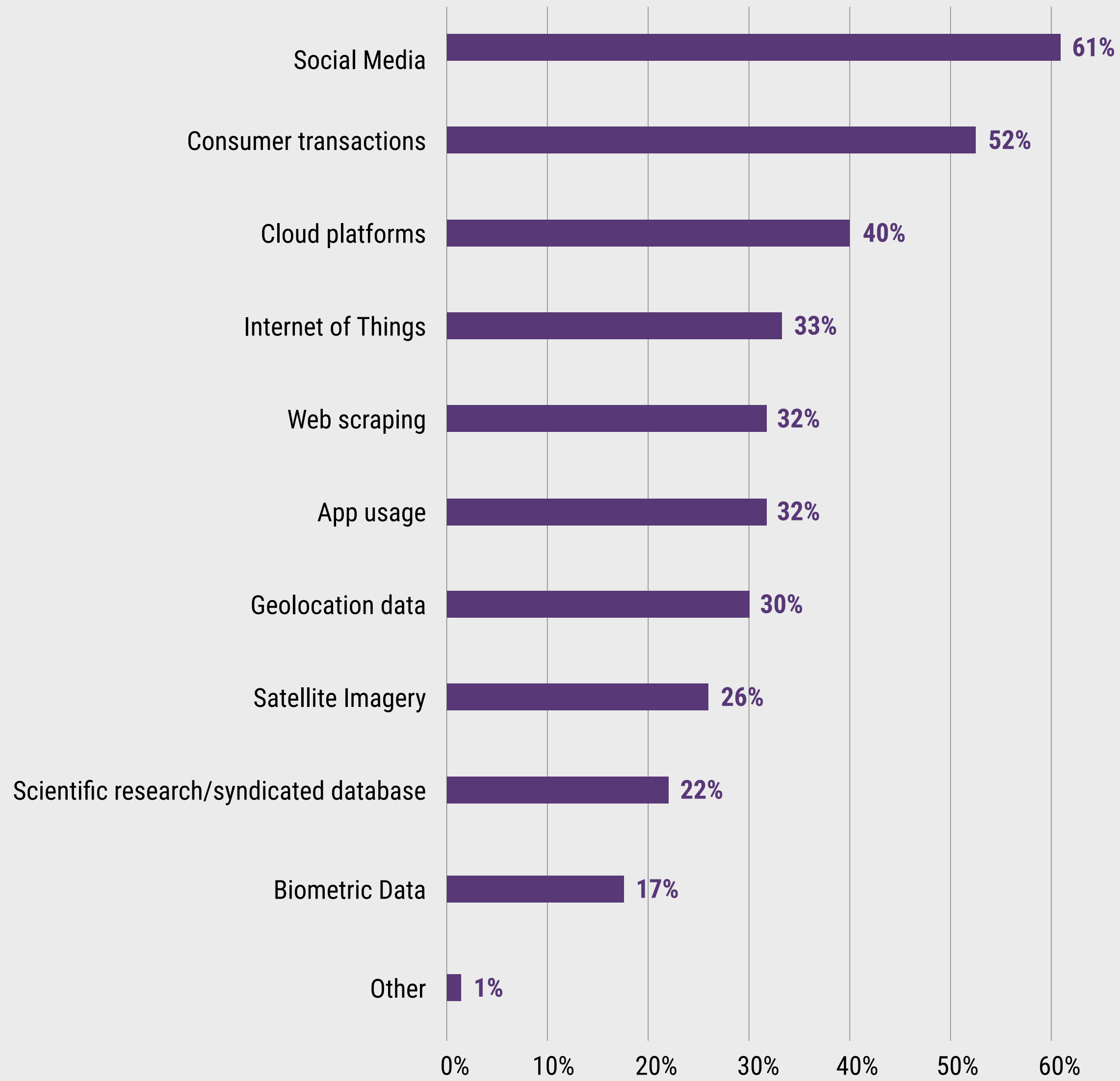
Social media data sets, followed by consumer transaction and cloud platforms, are set to become the most popular and valuable sources of alternative data. Just 54 percent of respondents said they were using social media data today, but 61 percent said they expected to in the next 12 months.

What are your sources of alternative data?





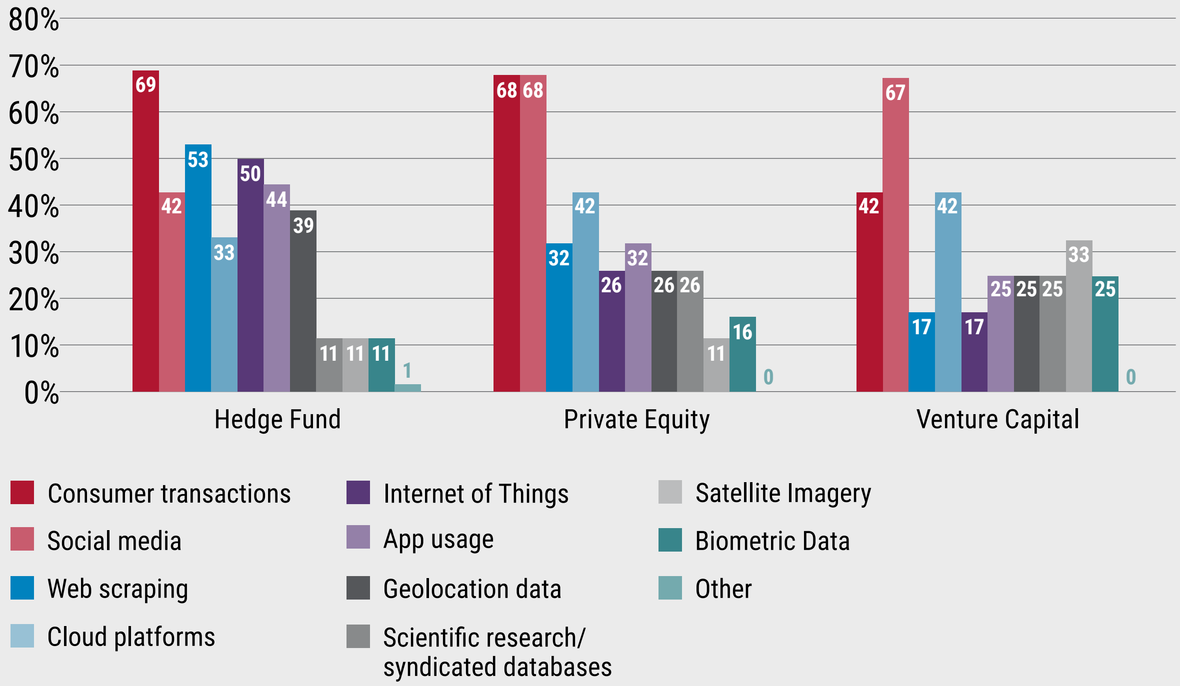
Which alternative data sources do you plan to use in the next 12 months?



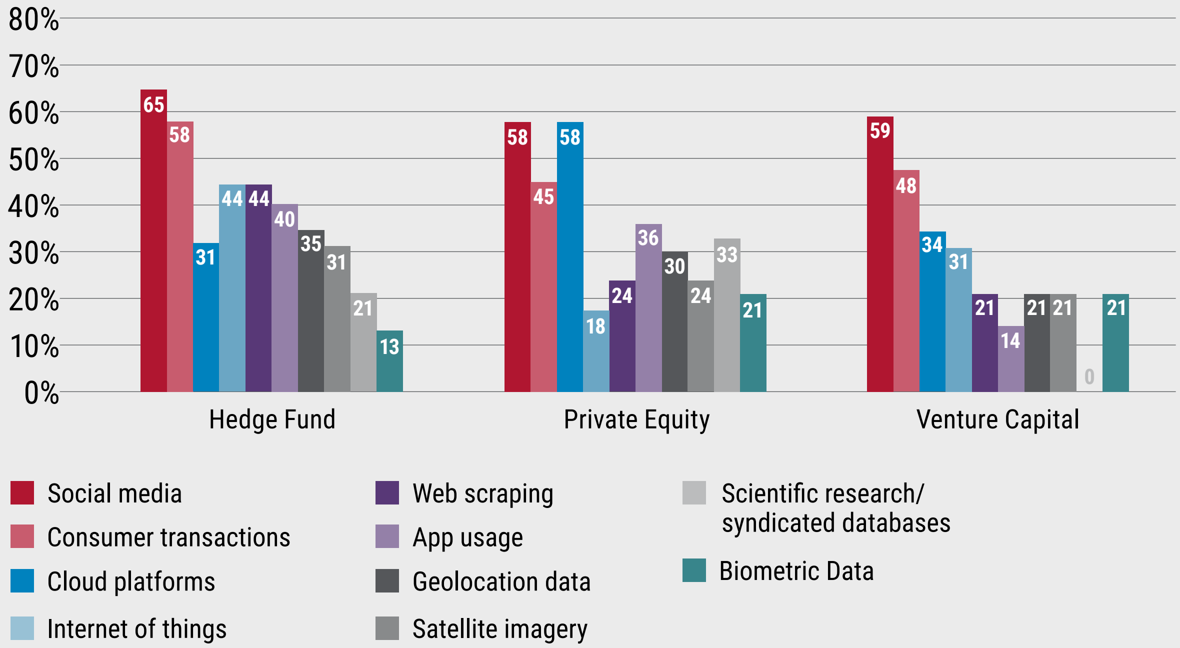
According to finance media outlet Cheddar, “The race is on for hedge funds to better understand how social media is moving markets.” The recent trading volatility sparked by the subreddit r/WallStreetBets demonstrates the importance of the social media subset of alternative data.

Our survey shows that hedge funds are responding to these recent events. Even though 42 percent said they are using social media today, 65 percent said they expect to use it in the next 12 months. Social media’s expected rise in popularity also extends to private equity and venture capital.

What are your sources of alternative data?

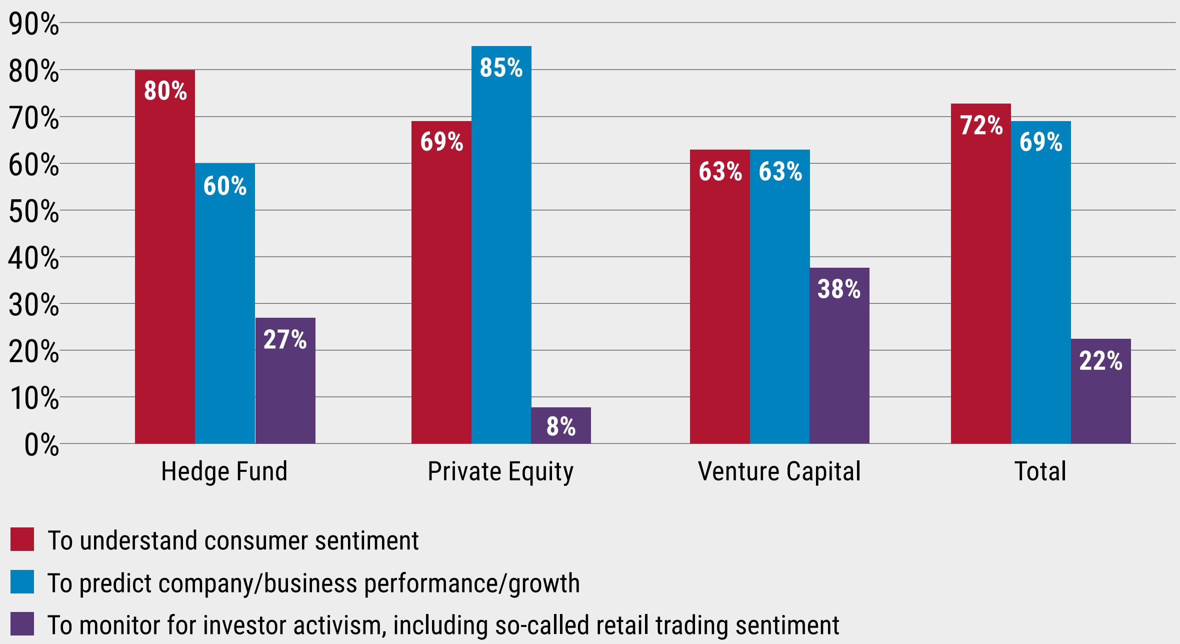


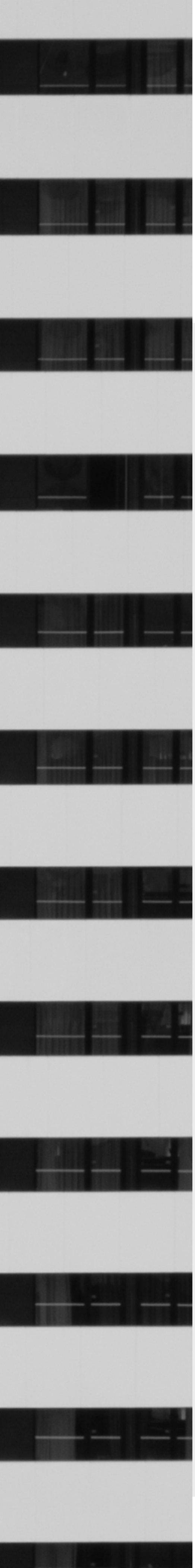
Which alternative data sources do you plan to use in the next 12 months?



When asked how organizations were using social media data sets to inform investment decisions, the most common responses were to monitor consumer sentiment and research a particular company's performance or growth.

In which of the following ways is your organization monitoring social media for alternative data to make investment decisions? (Asked to those who selected 'social media' in the question 'What are your sources of alternative data?')

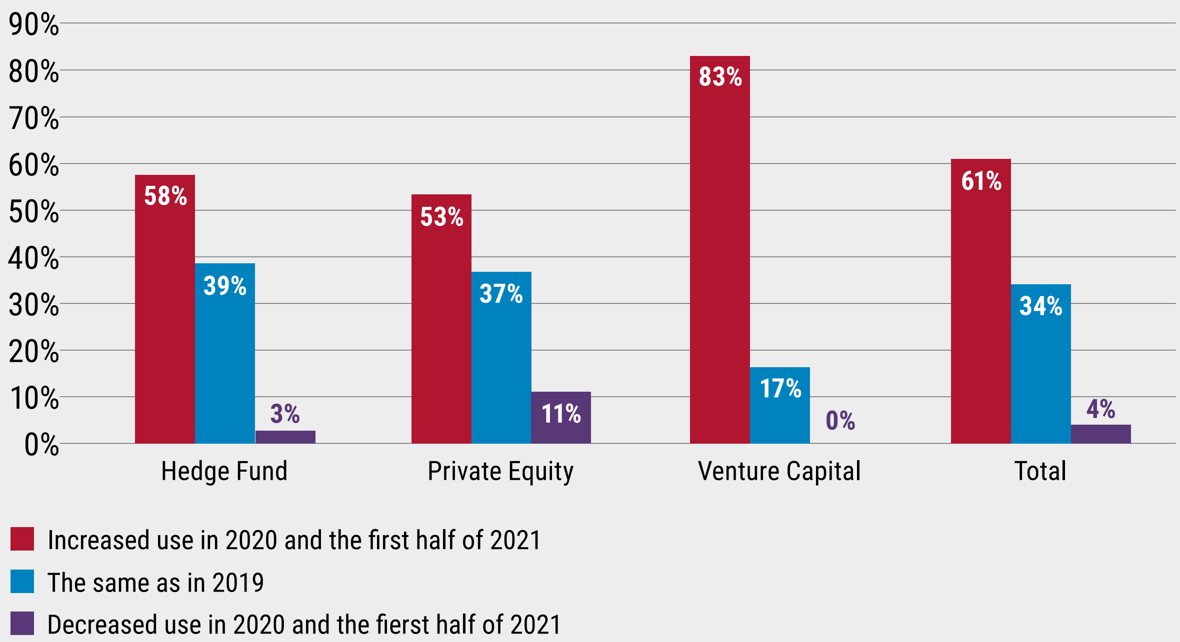




HEDGE FUNDS HAVE A HEAD START, BUT PE AND VC ARE RAMPING UP.

Hedge funds have been using and experimenting with alternative data for over a decade. Private equity and venture capital firms are newer entrants but are increasing their emphasis–and more importantly spending–to advance their capabilities. Just a quarter of private equity and one-third of venture capital firms report using alternative data to a significant degree, compared to 50 percent of hedge funds.

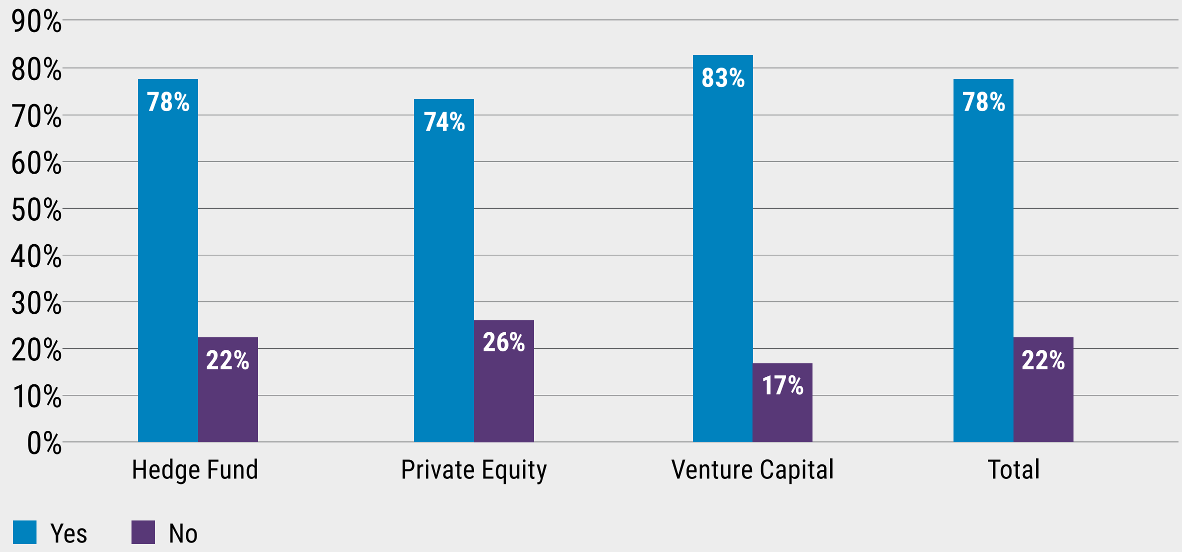
But that could change dramatically over the next few years. The velocity of increased usage for PE and VC between 2019 and 2020-21 was notable, with the biggest usage change for VC, 83 percent of whom described increased usage of alternative data.



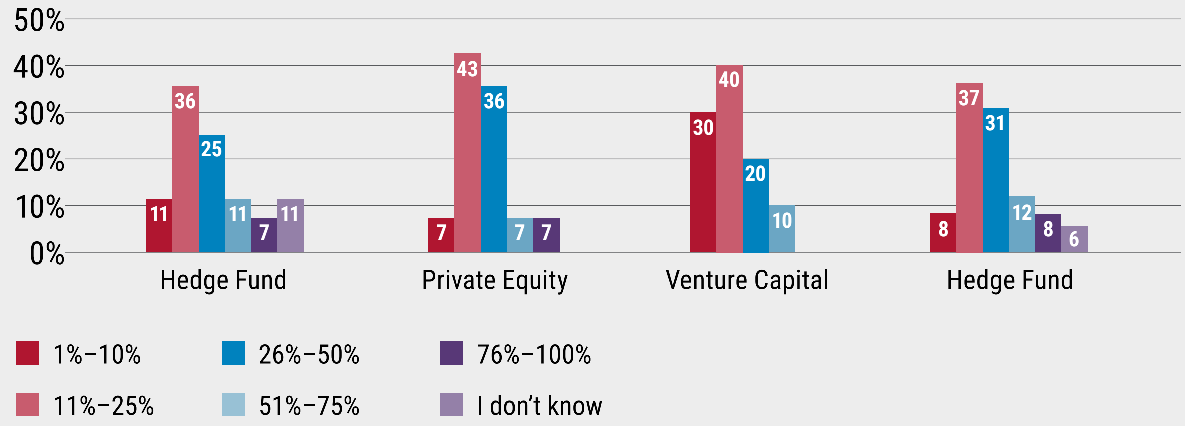
Private equity and venture capital firms also reported their plans to increase budgets for alternative data investments, with venture capital again leading the way. In fact, a majority of VCs plan to increase their budgets by up to 50 percent.

78% **of respondents said their organizations plan to increase budget for alternative data in 2022.**

In 2022, does your organization plan to increase its budget for alternative data?

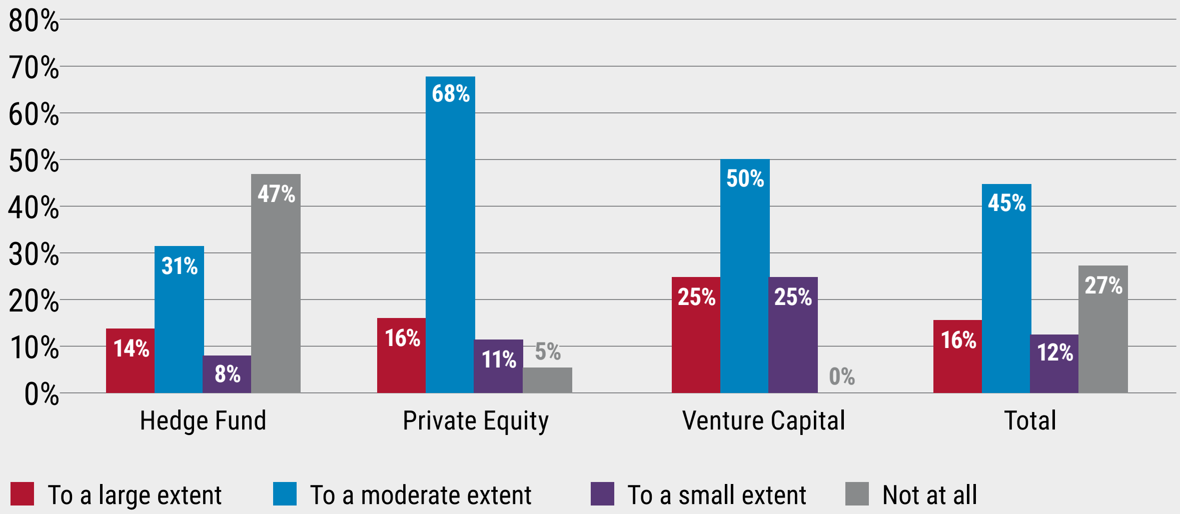


By what percentage does your organization plan to increase its budget?

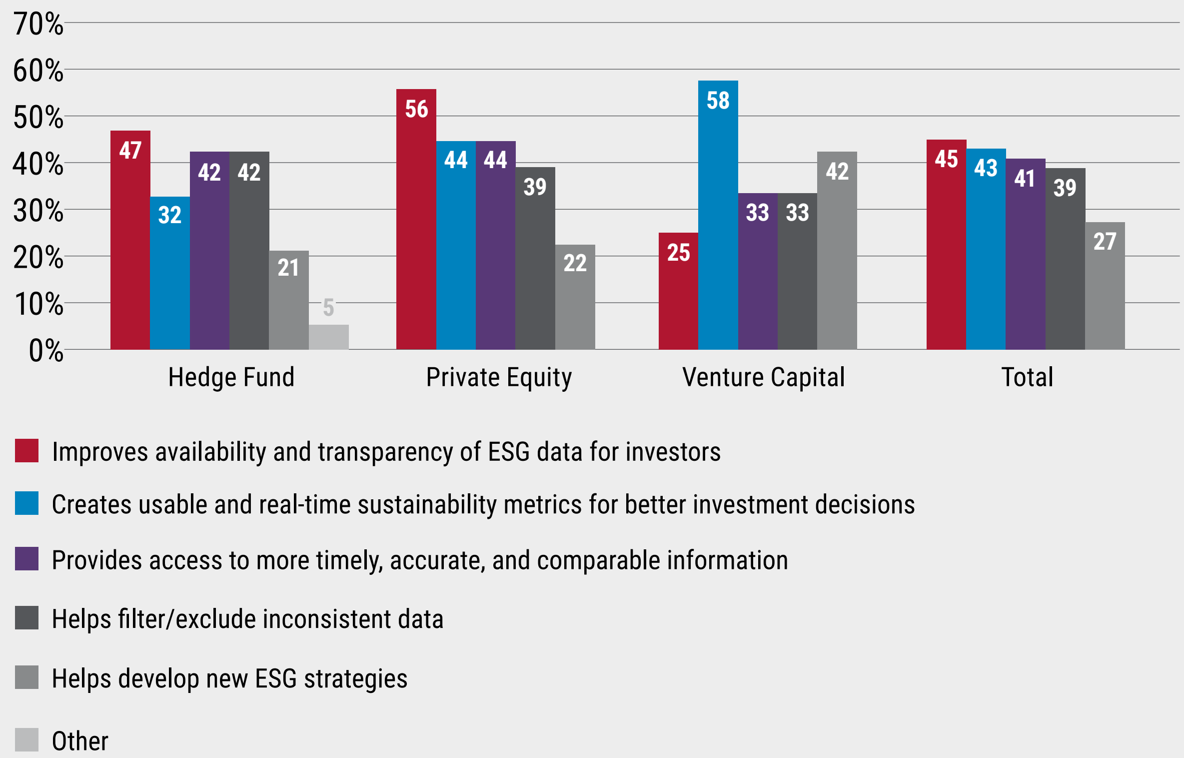


Lastly, differences are emerging about the degree to which different types of investment organizations view ESG metrics as an important element of their investment strategies, and the degree to which alternative data helps with ESG-related decisions. The results clearly indicate much more interest in using alternative data to drive ESG value from private equity and venture capital as compared to hedge funds.

To what extent is alternative data being utilized by your organization to gain insight and generate alpha in ESG investments?



In which of the following ways is alternative data useful for ESG investments?



These differences likely stem from the different business models, and most importantly, time horizons between different types of investment organizations. Private equity and venture capital groups have longer investment timelines factored into their decision-making and are therefore more likely to consider aspects like ESG metrics, which may play into a longer investment thesis.

REPORT METHODOLOGY

In spring and summer 2021, 125 respondents completed an online survey to gauge investment organizations use of alternative data. The results were tabulated, analyzed, and released in December 2021. Respondents included professionals who worked for hedge funds (43 percent), private equity (32 percent) and venture capital firms (24 percent).

The demographics were comprehensive: 34 percent of respondents were C-level executives, while other respondent titles included legal/compliance officer (34 percent), portfolio manager (15 percent), equity analyst (11 percent), and data scientist (6 percent).

With respect to company size, 41 percent of respondents came from organizations with more than 50 employees. Slightly more, 44 percent, hailed from companies with 10-50 employees with, just 15 percent from organizations with less than 10 employees.

Nearly half (49 percent) represented organizations with $500 million to $5 billion under management. Forty-three percent managed less than $500 million, and 8 percent managed over $5 billion.

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