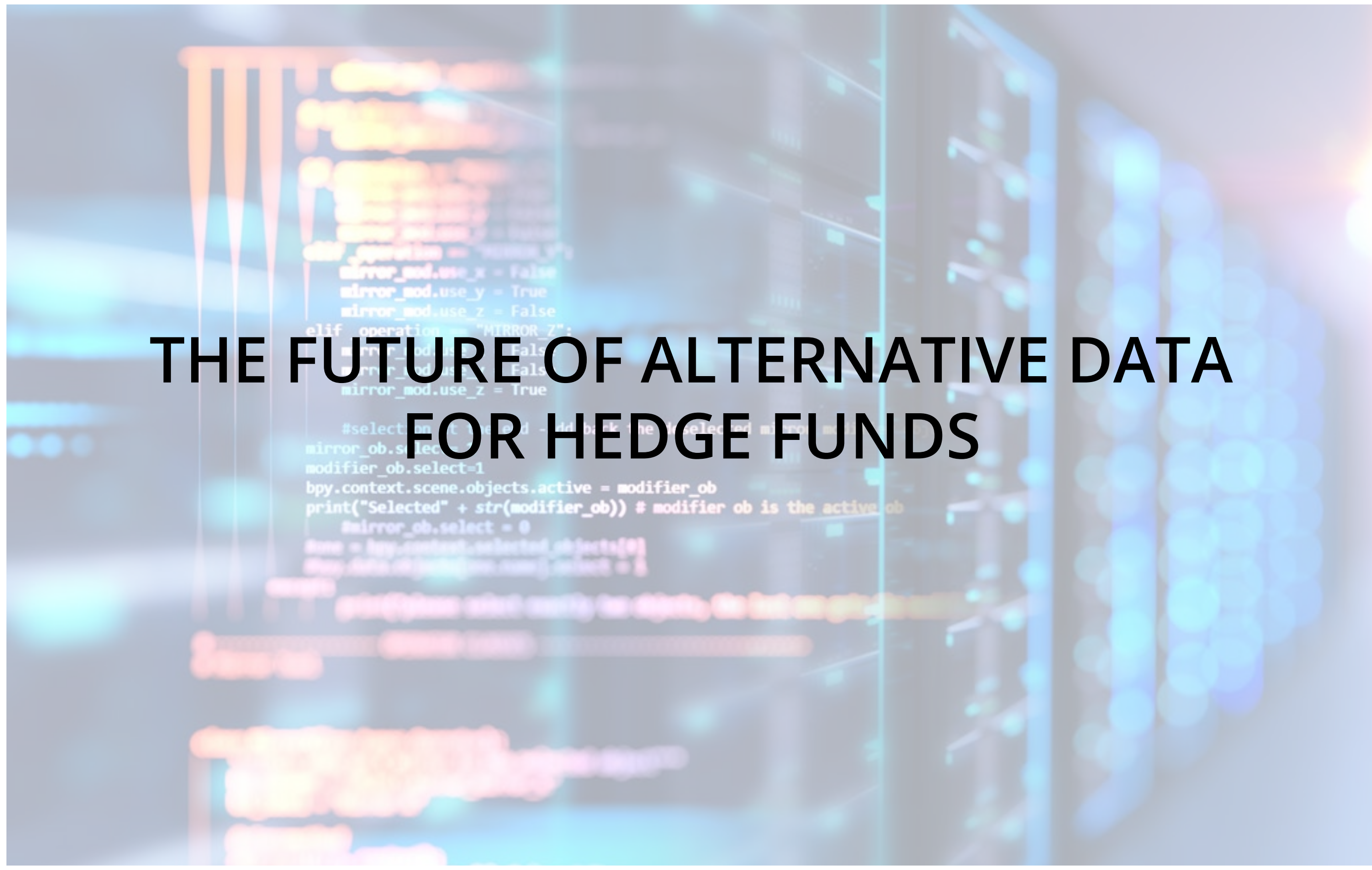

THE FUTURE OF ALTERNATIVE DATA FOR HEDGE FUNDS

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Recent years have seen dramatic increases in the use of alternative data by hedge funds to uncover new investment opportunities, sharpen decision making, mitigate risks and generate alpha.

In a survey we conducted earlier this year with the Alternative Investment Management Association (AIMA), Casting the Net: How Hedge Funds are Using Alternative Data, more than half the respondents said they were actively using alternative data and another 14% were exploring options.

While definitions of alternative data vary widely, it is most easily thought of as any information pertinent to companies, sectors or markets outside the realm of traditional financial and economic data.

Throughout history, businesses have sought to gain an advantage by uncovering patterns and trends that weren't readily apparent through conventional analysis.

What is new is the explosive growth of data available in the digital age, combined with the advancement of intelligent technologies to access, synthesize and analyze it.

Alternative data has become a disruptor in the hedge fund industry. The advantages go to firms that successfully harness it, enhance their existing research, and apply it to their decision-making process, whether human or algorithmic.

The use of alternative data does not replace information gathered through conventional means – company reports, and economic forecasts. Instead, alternative data augments and enhances traditional research with deeper insights into investment opportunities and risks.

The market leaders in hedge funds have been able to mix alternative data effectively into their overall strategy that gives them a unique story for their fundraising efforts with prospective investors.

Adoption Will Continue

All signals point to continued growth in all aspects of alternative data – in the abundance of data available, in the number of providers, and its adoption and application. A substantial majority of respondents to our survey expect more widespread mainstream adoption over the next five years.

We will likely see more innovation among providers, too, as they seek to differentiate their offerings – though eventually, we expect to see a "flight to quality" as managers increasingly figure out which providers are truly delivering value. The focus on value will in turn, drive consolidation among key players.

As for the supply of data, consider 90% of the data available today was generated in just the last two years, and the data supply continues to grow at an estimated 2.5 quintillion bytes per day.

Suffice to say the availability of data won't be a problem. Instead, the challenge for fund firms will be figuring out how to capture the right data, make sense of it, and derive sufficient value from it to warrant the investment in alternative data resources.

To realize the full potential of alternative data and to advance its adoption more rapidly and broadly, fund firms need to have the technology infrastructure and staff resources to aggregate, store, synthesize, analyze and backtest the data.

Large, established funds who view alternative data as core to their process likely have the financial resources to invest in an AI-powered analytics engine and hire data scientists to extract actionable insights from the data. For emerging and mid-size players, these can be formidable barriers to adoption.

However, firms can catch up quickly by working with a technology provider who has already invested in both technology and expertise to support an alternative data initiative. Fund managers can gain scale by outsourcing alternative data aggregation, management and analysis – everything except the investment process itself, which is proprietary to each firm.

Future Applications

Even though alternative data has seen significant growth and generated a lot of buzz in the hedge fund market, it is still in its infancy. There is bound to be a certain amount of trial-and-error as firms try and figure out which datasets are appropriate to their objectives and how to apply the data.

Standards that would enable managers to more easily compare and evaluate vendors, as well as best practices in the application of alternative data, are still being defined.

A regulatory framework specifically addressing alternative data has yet to take shape, raising a number of questions from hedge fund managers – for example, do "exclusive" datasets from a vendor amount to material, non-public information or confer an unfair advantage?

Does the use of photo imagery, social media tracking or mobile download statistics raise personal privacy issues? Current regulations governing the use of the information will evolve to address these questions.

Meanwhile, hedge funds may find that alternative data has applicability beyond portfolio management decisions. In the retail investment world, for instance, mutual fund companies are analyzing trend and investor profile data to optimize their product marketing and distribution.

Fund managers may eventually be using alternative data to understand their investor clientele better and target their fundraising efforts. Firms who want to test the alternative data waters will first ensure they have the necessary software and skillsets to work with the data, and draft policies governing its use.

They will then conduct thorough due diligence on vendors to understand the reliability and integrity of their data sources. Once they have identified the appropriate data and providers, they will engage in a trial agreement and conduct a cost-benefit analysis to determine reasonably quickly the potential return-on-investment (ROI).

After implementation, firms do periodic reviews to evaluate whether alternative data are delivering the desired advantages.

The alternative fund industry is known for its innovation and unbridled creativity relative to other asset managers.

Early adopters of alternative data will continue to play an influential role in shaping the alternative funds industry's to improve investment performance, increase operational alpha, and raise additional funds.