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Alternative Data:

The Hidden Source of Alpha

BY ROBERT IATI
DUN & BRADSTREET

Since the credit crisis of 2008, capital markets have undergone a seismic shift in the way investment banks, hedge funds and other market participants approach alpha generation. The advent of "big data" as an alternative for driving performance has reshaped the playing field for all investors. Indeed, investment managers face increased challenges that intensify the need for alternative data and analytics to generate consistently better returns than the broad marketplace.

SO WHAT IS THIS ALTERNATIVE DATA?

– Business performance information that shows public companies' payment experience (i.e., how they pay their creditors)

– Business performance of private companies and how it influences and predicts that of public companies, and

– Corporate Linkage providing a clear picture of total risk and opportunity across related businesses.

In short, alternative data represents a unique set of data that can be the difference between alpha and beta for a professional investor.

BUILDING THE BETTER ALPHA MOUSETRAP

Capital markets investing has become more efficient, and is now overwhelmingly reliant on exhaustive data analysis and advanced scenario modeling to find veiled correlations to predict market movements. Today, the professional investor leaves little to 'gut feelings'. As more and more unsophisticated investors migrate to low-cost, passive strategies, only the most resourceful of active managers are consistently able to beat the market.

Many active managers use historical information to refine the universe of investment options, while a subset of highly quantitative managers utilizes predictive models to build strategies capable of outperforming their benchmarks. Those strategies rely exclusively on data and analytics to build prescient investing models able to consistently outperform the market averages. The growth of these quantitative funds—totaling as many as two thousand, depending on the source—has led to an increased pressure for alpha generation strategies that have more than a few months of viability, creating an intense need for these 'quants' to find data that is differentiated and valuable.

Advantages of the past, such as speed, now are available to most participants, leveling the playing field and making the capture of alpha more difficult. As recently as 2010, high frequency trading accounted for 60% of U.S. equity trading volume. However, the decrease in market volatility and limitations caused by growing regulatory oversight has driven many firms to seek alternative strategies for alpha generation.

The democratization of financial technology, which has enabled even the smallest boutique to easily access the same tools and sources of data used by larger competitors, compounds this challenge. In this new paradigm, market participants must revise their current strategies for alpha generation, focusing more on data intelligence and agility than on speed. Accomplishing this task requires that they seek out data providers that offer access to genuinely alternative data sets, as well as the tools and technology needed to extract valuable insights.

THE HIDDEN ALPHA

A better understanding of public *and* private companies can provide investment managers with valuable insights. Professional investors seek new sources of actionable information that shine a light on opaque evidence and offer trends and patterns that are highly correlated with investment performance.

Two types of this business performance data, in particular, can contribute to investment models, but remain largely untapped because they have been so hard to obtain.

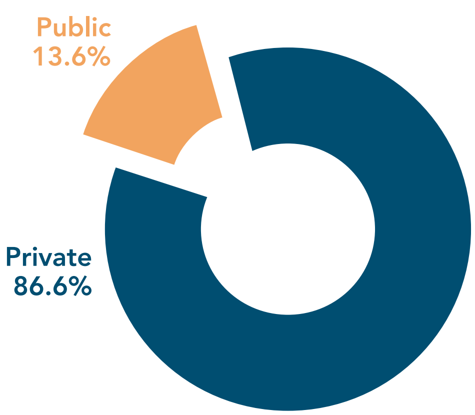
– Data on *public companies* that highlights the timing of payments made by those companies to their creditors, and

– Data from *private companies*, illustrating financial behavior patterns that are predictive indicators of performance of public companies

Professional investors thoroughly analyze petabytes of transparent information on publicly traded companies and intricately massage it in trading models designed to generate differentiated returns. Critical, albeit opaque, information on these companies, such as payment behaviors and corporate linkages regularly is overlooked.

Similarly, these investors often ineffectively deploy, or even ignore, private company data as a source for alpha generation. To underscore the tremendous potential of private company data as a source of alpha, consider this: among companies with 500 or more employees, over 85% are privately held (Exhibit 1). *Of the nearly six million US businesses in existence in 2013, only 1% represented publicly held companies.*

EXHIBIT 1: US FIRMS WITH > 500 EMPLOYEES



ALPHA IN THE PUBLIC MARKETS

In evaluating public companies, professional investors assessing an investment's prospects spend a great deal of time and effort applying unprecedented volumes of data to their models, seeking that singular extraordinary signal that will enable them to achieve alpha returns. However, despite the increased availability of data on public companies, they constantly seek to fill in the slightest of information gaps—the so-called needle in a haystack—that will complete their puzzle and provide them with unique, winning insight that raises their performance above that of the competition.

This is where alternative business performance data on public and private companies – although hard to obtain – can play an important role. Using trends and patterns of these businesses, today's refined analytics can identify correlations between their actions, such as their financial condition, payment behaviors, and customer trends, and the performance of the public markets or particular sectors within those markets.

THE PAYMENT EXPERIENCE

For example, access to alternative data for the public companies that service a large global corporation can yield information that is otherwise unavailable, such as the timing of the company's payments to its suppliers. The signals derived from variations in that company's payment behavior are of particular interest to analysts; a plus or minus change can provide useful insights into the health of the company's business.

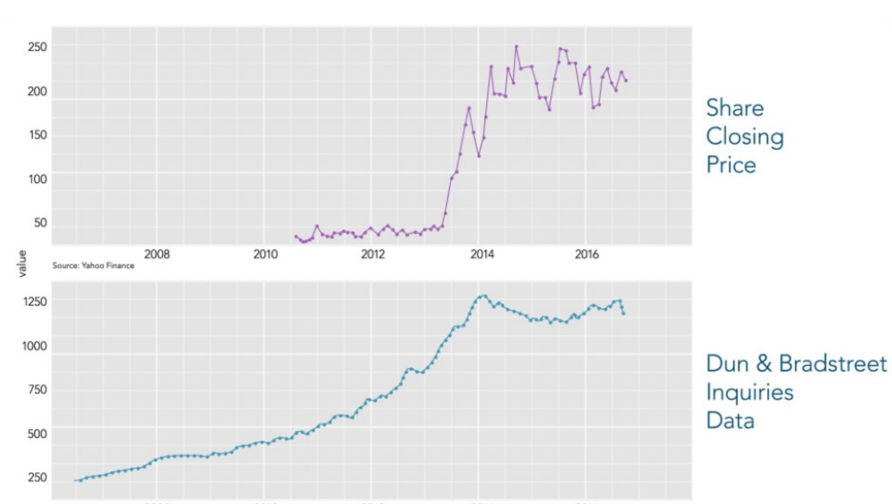
The ability to access this type of data can provide a definitive edge in investment performance. While a small number of providers have developed models that track widely available information such as SEC reports, venture capital financings and other limited financial information for private companies, these sources provide only a simple set of information.

For instance, as a business grows, new and potential trading partners and suppliers may formally inquire about its credit and payment experiences. Alternatively, increased credit inquiries may provide an indication of a business that is struggling to pay its bills. In both cases, payment inquiries data used in conjunction with other datasets can provide strong predictive indications of future share price.

Deciphering the different types of inquiries received by a business can indicate its growth or decline. The attributes derived from these datasets allow investors to measure the volume and types of inquiries against similarly sized peers, to flag a change in company strategy or to predict a shift in direction of that company's performance.

In the case of an auto manufacturing company (Exhibit 2), an increase in valuation followed a consistently increasing trend of private market inquiries. This shows the positive correlation between investor inquiries, ultimate valuation and subsequent stock performance.

EXHIBIT 2: AUTOMOTIVE MANUFACTURING COMPANY



THE VALUE OF BENCHMARKS

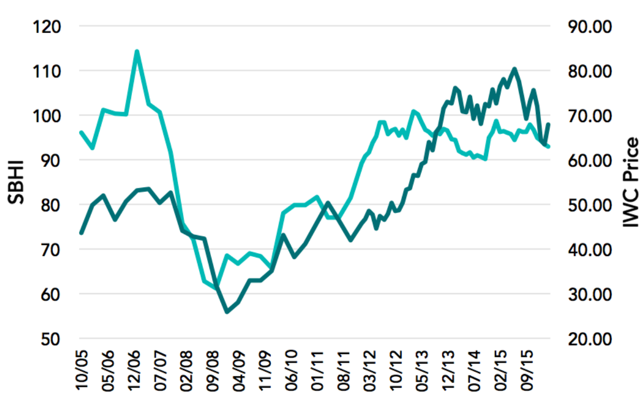
Business performance is about more than the increased knowledge of the supplier ecosystem surrounding public companies. Because of the strong correlation with public market movements, benchmarks or indexes created using underlying *private* company data sets can also predict movements in the *public* markets.

It is easy to recognize that the many businesses in the private marketplace will feel the impact of economic changes earlier (and maybe more intensely) than do those in the public markets. With so many more businesses—most of which are smaller and more economically sensitive than their public counterparts—the private market often identifies market-changing signals, such as slower payments to vendors or struggling supply chains that indicate strengthening or weakening of economic conditions, earlier than those in the public market.

> As a result, benchmarks created using business performance data for private market companies represent unique macroeconomic tools for analysis of future direction of the public markets. When combined with advanced analytics, these data sets can be highly correlated with standard metrics to predict market or sector moves.

Dun & Bradstreet has identified correlations between the health of small private businesses (SBHI) and acknowledged public market indices (IWC = iShares Micro-Cap ETF) that can serve as predictive signals for public market movements (Exhibit 3). For the professional investor seeking valuable data points to contribute to sophisticated investing models, this kind of alternative data can mean the difference between adding a few crucial basis points to that model's investment returns.

EXHIBIT 3: SBHI OVERALL VS IWC



ALPHA IN THE PRIVATE MARKETS

By nature, investing in private markets, consisting mainly of venture capital, private equity and private debt issuance is opaque. As such, those investing in private markets live and die on their ability to find irreplaceable data and analyze it in ways that enable them to realize distinct value in their investments.

As more companies choose to remain privately held, funding to fuel their growth will become more difficult to attract. This is in part because access to reliable financial data for these companies becomes more difficult for managers to assess a given company's financial health, impeding their ability to evaluate accurately a potential investment. Distinctive data sets, such as its payment timeliness, customer relationships and legal entity hierarchies that uncover patterns in that company's financial performance and clarify its market position, are used as input to formulate alpha generation strategies, for valuation of debt issuances and in pricing IPOs.

Pricing illiquid securities offers a similar use case for this type of data. Many OTC derivatives, swaps, investment grade and high yield bonds trade infrequently. So information that offers transparency into the state of the entities that underlay these securities is extremely helpful in managing the inherent risk of these instruments. In 2008 for instance, transparency into the corporate hierarchy of Lehman Brothers, its customers and suppliers, would likely have exposed the risks of investing in, or trading with, Lehman, painting a very different picture for the investors in its securities and counterparts to its trading business.

Used in tandem with company fundamental data and today's sophisticated programs to identify precise correlations, predictive analytics deploying this kind of exclusive company data can expose patterns that predict a business's behavior. This intelligence can provide a valuable window into the company's current valuation and projected growth that would not be possible using publicly available information. By incorporating predictive business analytics into meticulously validated models, the result is unique, actionable data.

THE VALUE OF INIMITABLE DATA SETS

By collecting data covering more than 70 million public and private US businesses over the past ten years, Dun & Bradstreet proprietary datasets bring together business relationships, credit information, corporate linkage, and hierarchies, financial reports and predictive indicators of performance, providing special insight into the short- and long-term prospects for potential investments.

Dun & Bradstreet's business performance data and analytical tools allow traders and managers to leverage data on company payment attributes, make peer-group comparisons and perform due diligence on public and private companies that exceeds that of other datasets.

Dun and Bradstreet's proprietary inquiries dataset provides comprehensive private company historical analytics, giving analysts the ability to look for predictive signals utilizing their own models.

CONCLUSION

The democratization of financial services data and technology, together with more intense competition, makes the needs of today's market participants vastly different from those of previous generations. In a world where alpha generation and execution speed no longer exist hand-in-hand, common algorithmic suites and low latency platforms have ceased to provide the ultimate advantage.

> To successfully capture alpha in the current environment, firms must locate untapped sources of data for both public and non-public companies. This alternative data, such as payments data and other non-public information, from sources beyond the common channels, can be a predictive indicator of market performance; a difference maker in assisting firms as they develop models to evaluate their investments.

While this business performance data has tremendous alpha generation potential, it is also an area most fund managers lack a depth of understanding. Collaborating with a provider able to decipher and deliver this untapped resource can help traders and managers gain the necessary insights to this source of potential alpha.

Dun and Bradstreet's proprietary datasets provide comprehensive, historical company coverage of private companies, allowing market participants to take full advantage of this hidden potential for alpha. By combining our unique data sets with advanced analytics, traders, analysts, and managers can seek predictive signals and actionable information utilizing their own models.

Contact Dun & Bradstreet at www.dnb.com/capital-markets or at **973.921.6344.**

dun & bradstreet

103 JFK Parkway
Short Hills, NJ 07078

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