Distribution Is Not Enough

How Data and Analytics Technology Are Driving Demand For Unique Investment Insights

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Abstract

The financial services industry is in the process of mass consolidation. Asset management fee structures have collapsed, forcing many large asset managers to consolidate in order to maximize operational efficiencies associated with scale. However, consolidation in the supporting data and analytics industry has received far less attention. In this paper, we contend that consolidation in the data and analytics industry will accelerate as more firms recognize the need to own underlying data assets to derive and deliver unique insights.

In a market flush with unproven data and noisy signals, institutional grade unique insights have never been more valuable. The democratization of investment technologies means that investors are now leveraging these insights to craft custom investment strategies. While this trend is accelerating, the verdict is still out regarding many data vendors' ability to derive unique insights and monetize their data assets. This paper identifies several companies that are well positioned to derive unique insights, making them the likely winners in the modern data-driven financial services market.

Introduction

Although it seems like an eternity ago, many financial services industry veterans undoubtedly recall when trades had to be placed on a landline phone. Today, we take electronic trading, and the accompanying expansion of retail investing, as a given. As with so many other technology advances, streamlined trading technologies have created winners and losers. The winners are those who have been able to develop and sustain "unique insights" into markets and individual assets.

Unique insights help distinguish "investing" from mere speculation. The meme stock and decentralized shareholder activism phenomena has pushed speculation to its limits and, in the process, revealed its inherent risk to many previously unsuspecting investors. These investors are learning that being able to "trade" a stock does not mean you should "invest" in it. Just like professional asset managers, individual investors are increasingly in need of unique insights in order to make good investment decisions. This trend toward unique insights has the potential to drive differentiation in what has become a largely undifferentiated business.

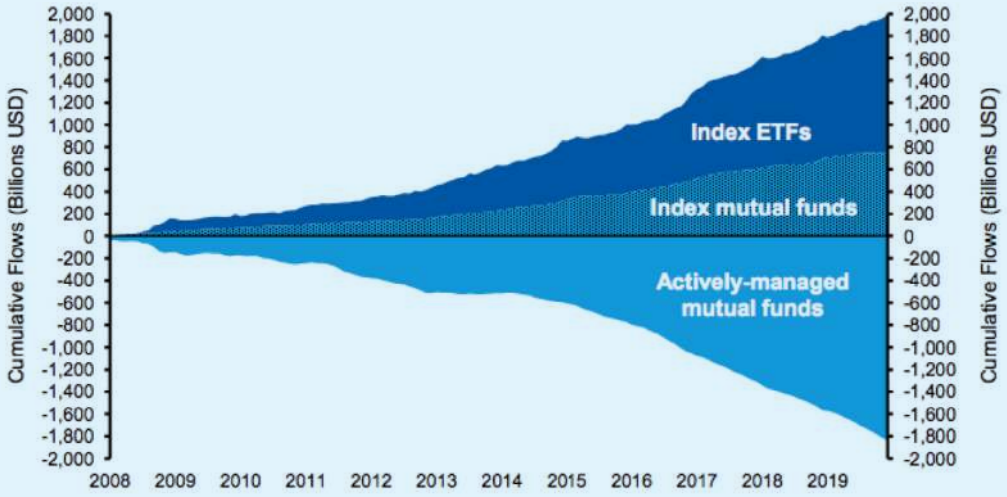
The decline of differentiation in the asset management industry has coincided with falling fee structures associated with the flow of assets from active to passive managers.

As investors have gravitated toward low-cost, undifferentiated, market-performance-tracking products, it is clear that many investors see little need to pay a premium for active management. As a result, capital flows to passive investing have accelerated and prompted asset managers to seek differentiation only by lowering fee structures. These lower fees have put a premium on the efficiencies of scale, pushing the asset management industry toward consolidation.[1] Today, we see an industry where scale and distribution, not insights and performance, are the hallmarks of success.

In many ways, these trends in the asset management community have mirrored trends in

[1] This consolidation has resulted in asset management giants now possessing broader and more diverse trading data provided by retail investors using their platform. This order flow information can be used to drive investment insights, though the primary driver of asset management consolidation remains the need for scale among falling fees.

Figure 1: Assets Flows to Passive/Index Funds Are Dominating



Source: Investment Company Institute.
Note: U.S. domestic equity fund: Mutual fund data is net new cash flow plus reinvested dividends; ETF data is net share issuance and includes reinvested dividends.

the data and analytics market, but for very different reasons. Consolidation in asset management has been driven by the need to cut costs and improve scale, while consolidation in data and analytics is driven by the need to deliver unique insights. These trends have continued for years, but it is now apparent that the confluence of undifferentiated product offerings and low trading fees (in some cases zero fees[2]) has prompted individual investors to seek out information on which to trade directly. The logical conclusion of this trend is the commoditization of signals based on traditional datasets prompting investors to seek out proprietary datasets that yield unique insights.

The remainder of this paper will examine what makes insights genuinely valuable, how proprietary data ownership fuels that value, and how this will likely lead to the democratization of unique insights. The elevated value of insights indicates that asset management is no longer primarily about distribution, it is about empowering clients to build custom investment strategies. AUM is likely to flow to those asset managers who recognize this trend and offer data-driven unique insights coupled with tools for investment strategy customization.

Defining Insights

A great deal has been written about the rapid pace of consolidation in the asset management industry since the financial crisis. Much of that work has emphasized the flow of assets from active to passive management on the heels of every market correction in the past decade. This flow of assets from active to passive has collapsed management fees and forced asset managers to rely on increasing scale to remain viable businesses.[3] Like their asset management brethren, data and analytics providers have begun to consolidate as well. However, unlike asset managers, falling fees have only been one of the drivers of consolidation; the need for sophisticated, proprietary investment insights has been the primary impulse driving consolidation in the financial data and analytics community.

Essentially, consolidation in the data and analytics world has been driven by three factors:

> *1. Improved data infrastructure technologies have lowered unit costs for each datapoint*
>
> *2. Investors are seeking unique insights, not just raw data or undifferentiated products*
>
> *3. Proprietary data is necessary to derive unique insights*

Looking first at the declining unit cost of data, it is apparent that declining compute and storage costs have allowed new entrants into the data market creating competition for basic market data services. This competition has forced the largest data providers to lower costs on basic trading data while increasing the transparency and breadth of their data offerings, so as to maintain or increase total revenues while allowing for some degree of customization rather than bulk offerings. As a result, we've seen rapid growth in the diversity of available datasets, but not all datasets are created equal. Many of these new datasets are simply repackaging or consolidation of existing information; only a select few datasets are proprietary or generate unique insight.

For the purposes of this paper, we are defining "insight" as information that yields a unique and actionable perspective from which investors can make informed decisions. One of the concrete ways that insights have impacted markets in recent years has been the rapid increase in the sophistication of index investing. For instance, so-called "smart beta" ETFs are now commonplace. The ability to calculate smart beta is a fairly rudimentary insight, but it is one of the first steps on the journey from simple, undifferentiated indices to increasingly complex and differentiated index strategies.

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[2] In many instances, zero-fee instruments are economically feasible because the broker is selling order-flow data to affiliated investment firms so they can frontrun on retail investing data.

[3] This consolidation has resulted in asset management giants now possessing broader and more diverse trading data provided by retail investors using their platform. This order flow information can be used to drive investment insights, though the primary driver of asset management consolidation remains the need for scale among falling fees.

Developing Insights

The most basic of investment metrics may be fundamental data reported in regulatory filings, but the cleanliness and comprehensiveness of that data is not uniform, so it is often difficult for investors to derive consistently accurate or differentiated insights from fundamental data. Things only get more complex when investors turn to emerging alternative datasets that may be uncorrelated with existing metrics, but have limited breadth or history, thus making it difficult to backtest many of these signals. The most prominent emerging set of insights in the last couple of years has come from Environmental, Social and Governance (ESG) data. This data is often self-reported without commonly-agreed parameters and with a significant time-lag, making it difficult for many investors to utilize these signals.

Given how complex and resource intensive it is to utilize fundamentals, alternative data and ESG signals, it is increasingly important for data vendors to package derived insights with the data in order to monetize it. Since these insights are often drawn from the relatively new, unproven datasets, data vendors have been thrust into new business lines:

1. *Validating the quality of their data and combining it with other relevant datasets*
2. *Analyzing their data to derive unique insights and demonstrate value*
3. *Owning their data so that they can control it and monetize the derived insights*

These three new tasks have forced data companies to blur the line between data and research. For instance, twenty years ago a researcher might drive around to see how busy local retailers are, now that same researcher is likely purchasing satellite images of parking lots as well as credit card swipe data. While these datasets are significantly more precise than older research methods, they also require data engineering and analytics skills in order to derive investment insights. This means that data vendors have been thrust into not only data engineering tasks, but they must also perform analytics to derive insights from the data for their clientele.

Data analytics and data science have come to dominate the public discourse on data, but these competencies are still nascent in much of the asset management community. In fact, many asset managers still rely on human-based systems or basic spreadsheets. The vast majority of asset management firms lack the data engineering expertise to transform their own systems, so they are increasingly reliant on vendors to provide analytics derived from combining datasets or performing sophisticated analysis on existing datasets.

The most advanced of these analytics can yield actionable insights that assist in creation and management of investment strategies. However, in order to perform such sophisticated analysis, the data company must have the rights to analyze and combine datasets, as well as create investable vehicles based on their data. This essentially means that in order for a data company to succeed in this evolving market, they must own their data assets and have the analytical capabilities to generate insights from the data. If a vendor does not own their data (ie. they are redistributing data assets owned by a third party) or they are incapable of performing the analytics clients require, they are unlikely to be able to compete in the modern data marketplace.

Consolidation as a Means to Monetize Insights

Given that owning data assets, being able to perform analytics and derive insights are all critical to success in the financial data industry, it comes as no surprise that large data and analytics vendors have been consolidating to ensure they each have these assets and capabilities under one roof. In several cases, this consolidation has also brought together the ability to commercialize analytics and insights via indexing and ETF products, as well as expand distribution of raw data. This trend suggests that the industry winners are likely to be the firms that are able to commercialize the same data assets in numerous ways, thereby targeting different segments of the financial services market.

Figure 2: Land Grab for data Assets is Intensifying

Acquirer*	Target	Year	Rationale
NYSE	EURONEXT	2007	• Economies of scale
DEUTSCHE BÖRSE GROUP	eex	2011	• Horizontal diversification
HKEX 香港交易所	LONDON METAL EXCHANGE	2012	• Horizontal diversification
ICE	Interactive Data	2015	• Product diversification
Nasdaq	Quandl	2017	• Product diversification
London Stock Exchange	REFINITIV	Pending	• Product diversification

Entry into Data Market

*Except for the transaction between NYSE and Euronext, which is a merger
Source: various press

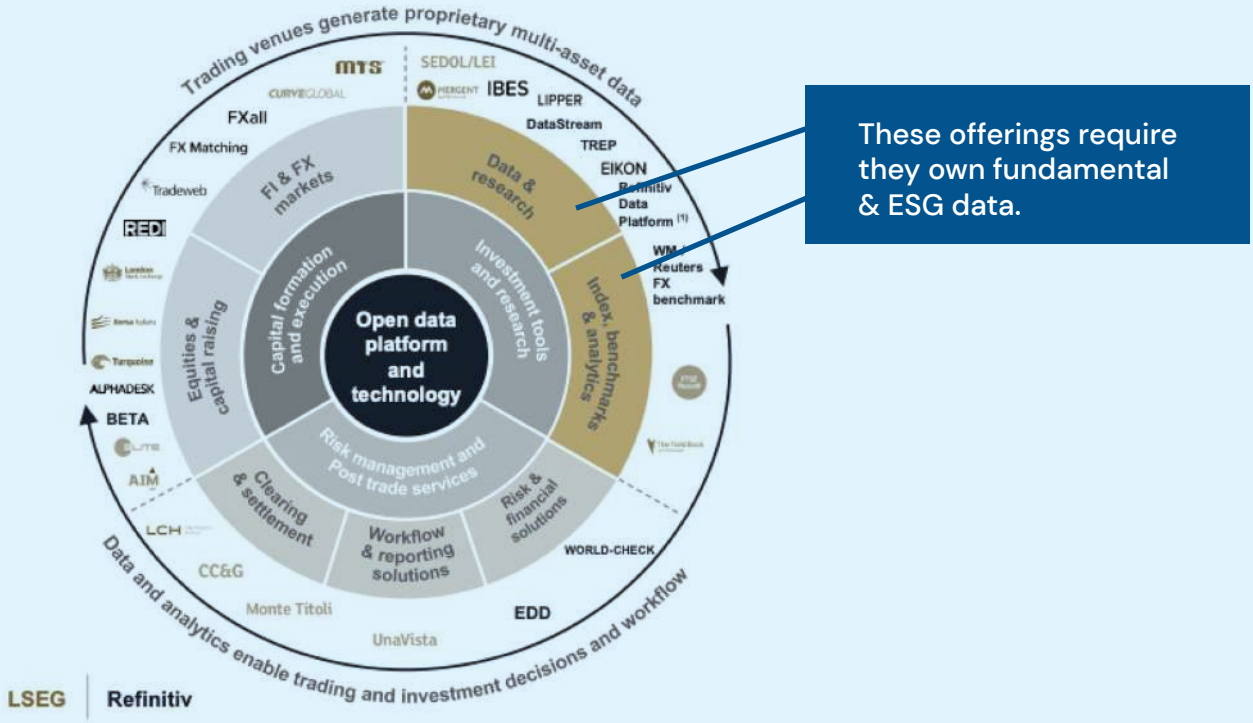
Source: TIME TO (EX)CHANGE by Quinlan & Associates

Data companies have been combining with analytics and indexing firms in an effort to garner market share, gain pricing power and reduce competition. This effort has been fairly successful for a few large data vendors. To date, notable winners include London Stock Exchange Group (LSEG), Nasdaq and S&P (SPGI).

This list is by no means exhaustive, but recent strategic acquisitions by these companies have brought them into direct competition with the industry leader, Bloomberg, and in many ways their recent acquisitions position them to outcompete Bloomberg. However, it is worth noting that Bloomberg is taking notice and entering the M&A fray with the recent acquisition of Second Measure. This move enhances Bloomberg's consumer data and integrates capabilities into their quantamental workflows on and off the terminal.

LSEG is primarily known for their ownership of the London Stock Exchange and their considerable data assets associated with direct data gathering in the exchange business. In 2019, LSEG initiated the acquisition of Refinitiv to expand their data assets and dramatically enhance their analytical capabilities. This costly acquisition ensured LSEG now owns not only their own trading data, but also fundamentals data, ESG data and a limited supply of fundamental research. Additionally, through their ownership of FTSE, LSEG has significant capabilities to create and commercialize indices.

Figure 3: LSEG/Refinitiv Deal Signals Strategic Importance of Data



Source: The New Power Brokers by Marc Rubinstein *Image Source: https://netinterest.substack.com/p/the-new-power-brokers*

Like LSEG, Nasdaq is predominantly known for their exchange business and the ability to directly gather trading data. However, in recent years Nasdaq has made considerable investments in their analytical capabilities as a means to enhance their index products. On the data front, Nasdaq acquired Quandl to enhance their data offerings. Although Quandl does not own many of the datasets offered through the platform, Nasdaq benefits from licensing that often allows them to create and sell derived work from the Quandl data.

While LSEG buying Refinitiv in 2019 made a splash, recent acquisitions by S&P have set the standard for consolidation in the financial data industry. In the last few years S&P has acquired SNL Financial, Kensho and most recently, IHS Markit (as well as several smaller acquisitions). While SNL expanded S&P's data footprint and Kensho enhanced S&P's analytics capabilities, the acquisition of IHS Markit represents the most significant effort to own data assets in the financial services industry.

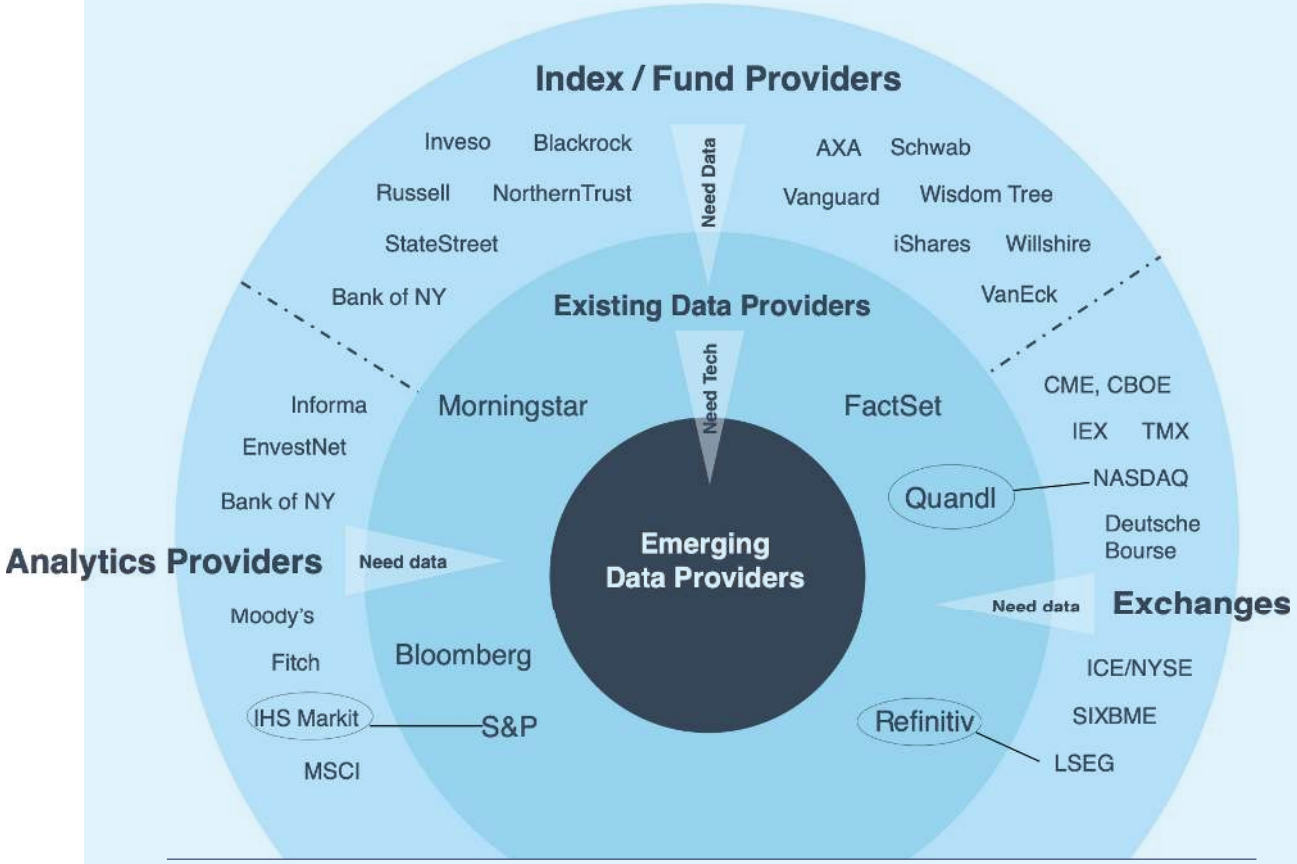
IHS Markit was itself created via a series of acquisitions and the merger of IHS and Markit, so the myriad data assets under their roof may have some overlap with S&P's own data, but also dramatically increases S&P's breadth in research and alternative data. Moreover, one of S&P's core businesses is the creation and commercialization of indices. The vast majority of these indices are fairly simple, but with the new data assets at their disposal, it is likely that S&P may begin creating increasingly sophisticated index options.

S&P, Nasdaq and LSEG have been leaders in the consolidation of the financial data and analytics industry. All three companies have taken significant strategic actions that indicate they see the increased need to own data assets and analytical capabilities, but it remains to be seen whether or not these firms can execute on deriving and selling insights based on these new assets. Nevertheless, these firms appear to be better positioned than many of their rivals who either lack the ability to collect and own data assets, or do not have sufficient analytical capabilities to derive valuable insights from the data they possess.

A high-level review of the landscape for potential data buyers and sellers reveals S&P, Nasdaq and LSEG are well positioned to capitalize on current market dynamics.

As shown in Figure 4, the disproportionately higher number of firms that need to own data compared to the few firms that already own (or can efficiently collect) fundamental data indicates that companies like S&P, Nasdaq and LSEG may soon have a great deal of pricing power, especially for data that yields unique insights.

Figure 4: Landscape For Data Buyers and Sellers



Source: New Constructs

Conclusion

Winners in the financial data industry will be the companies that recognize not only the need to own data assets and analytical capabilities, but also see that creating unique insights is not an end unto itself. It is a means to increasingly democratize financial services and broaden their client base from the biggest asset managers and banks to retail investors.

The democratization of financial services has been underway for generations, but the advent of electronic trading coupled with indexing strategies has commoditized legacy investment industry offerings. The next logical step in the evolution from mutual funds to index funds to meme stock investing is custom portfolio construction based on unique data insights. It seems that many asset managers are aware of this trend and have been working to retain AUM by offering investors the ability to purchase fractional shares, thereby lowering the barriers to creating custom investment strategies.

Like their asset management counterparts, industry leaders in financial data and analytics are readying themselves for the next phase in the democratization of financial services including unbundling and customized services. Although these companies have made significant progress in data ownership and analytics, they have yet to demonstrate the ability to consistently generate unique insights. In order to remain (or become) an industry leader for the next generation, these companies will need to offer enhanced tools for stock selection and portfolio weighting. If small FinTech firms can already provide users the ability to create their own bundle of stocks, with total visibility to the underlying financial data, then the bigger players must move in this direction or they will be disrupted.

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