Actionable Insights From Alternative Data

A Discussion with Artisan Partners Credit Team portfolio manager Bryan C. Krug, CFA

PORTFOLIO MANAGER
Viewpoints

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Asset managers are increasingly adopting data to make more informed and timely decisions. Can you discuss how the Credit team is using data?

The exponential increase in the variety of data available has allowed us to leverage data and technology in ways that complement and enhance our research efforts in a way consistent with our investment philosophy. At the start of our research process, we leverage data to seamlessly and effectively narrow our opportunity set. With an investable universe of more than 3,000 issues, bonds can vary dramatically by liquidity, quality and relative attractiveness—even among those of the same issuer. Technological and data advancements thus allow us to identify potential investments more efficiently and quantify relative value across the investable landscape in a timelier manner.

To supplement our bottom-up credit research, we leverage both public and private alternative data sources to develop informational advantages—by uncovering actionable insights not apparent in traditional data sources or before they're broadly reported. These efforts help us substantiate an investment thesis, better anticipate potential changes in a business and understand how our investment thesis could go wrong.

Can you talk about how alternative data are integrated into your investment process?

Alternative data is a broad, catch-all term for anything beyond traditional financial data. The investing community has always relied on regularly disseminated fundamental data—company filings, earnings projections and management commentary, among others. Increasingly, though, investors are augmenting their decision making with alternative data sources in an attempt to develop an informational edge.

Our team views alternative data as any unique data set not typically used for investment decision making but that can provide a deeper understanding of a company's financial health. For example, aggregated credit card and merchant-level transaction data can be useful in revenue forecasting by providing insight into spending and growth patterns across products, brands and regions. Other examples include shipping and satellite data to forecast agriculture supply and demand dynamics, web-scraped data to track pricing and inventory across retailer websites, online residential listings for region-specific real estate activity, and weather data to track heating and cooling demand trends.

To be sure, alternative data isn't the main driver of our investment decisions—rather, it's another input we use to verify or challenge our investment thesis. In high yield credit, most issuers tend to be private companies for which the quality and depth of reporting can vary by company and creditworthiness. Our team is always looking for bespoke ways to add depth and context to traditional, fundamental data. In most instances, we're utilizing alternative data to confirm management's narrative aligns with the business reality. We also use alternative data to identify sentiment shifts around a company's products that haven't yet made their way into financials—either by measuring an industry's secular developments or by monitoring industry competition.

Of course, utilizing alternative data isn't without its challenges. For most asset managers today, the biggest challenge isn't necessarily accessing alternative data, but the way the data are managed and contextualized.

The democratization of data has improved accessibility to even the most obscure data sets. The challenges often lie in the data's noise and lack of structure that requires specialized talent to format and integrate. Similarly, before data are integrated, effective means of assessing accuracy and predictive power require methods to measure the data's statistical reliability. Consequently, the process of effectively testing, organizing and visualizing the data is just as important as the data itself. For this reason, our team has a dedicated data scientist, who has been influential in not only leveraging traditional data more intelligently, but in making alternative data sources more accessible and digestible for the team.

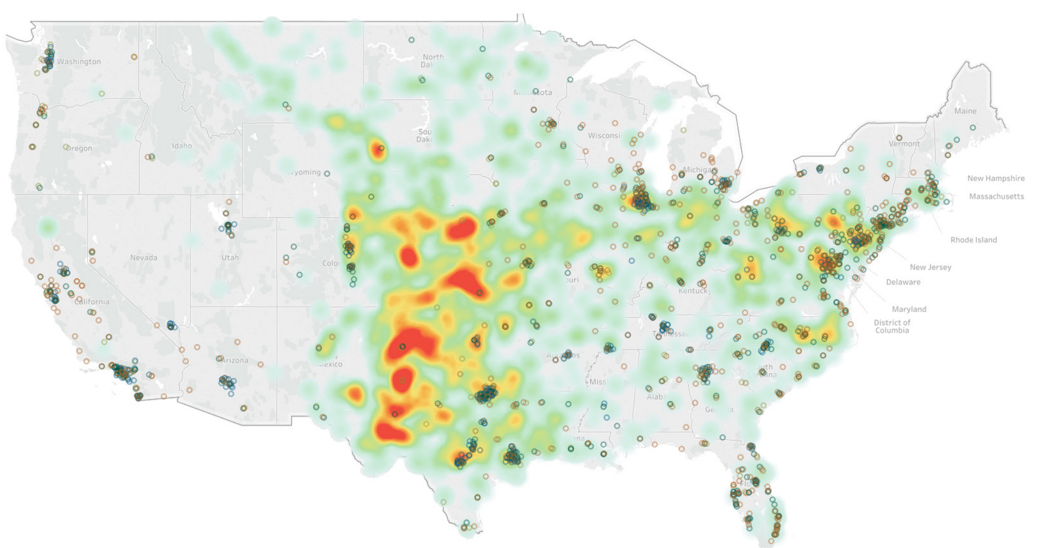
Can you provide an example in which you leveraged alternative data to make an investment decision?

We made an investment in a roofing and building products distributor which had acquired a building-products peer in a debt-financed transaction using a combination of high yield bonds and leveraged loans. The combined company is unique in its relatively lower exposure to cyclical new construction. Close to 75% of its revenues is tied to re-reroofing activities, rather than new builds—making it considerably less cyclical than other building-product peers. As a result, the company's demand drivers are tied to the roof replacement and repair cycle. However, incremental growth and outsized profitability can be meaningfully impacted by severe weather events, with hailstorm activity a material driver of roofing spend. From a credit standpoint, the company benefited from a leading market position in a consolidating building products category. While it is more levered than peers, the company generates significant, consistent free cash flow and has a management team committed to quickly deleveraging.

The debt reached our screens after its price dropped on, among other things, concerns about a more normalized storm season. Two straight years of above-average severe weather had resulted in significant volume and margin growth, but a more normalized weather outlook implied lower volumes and difficult comparisons.

As part of our research process, we spoke with management and a host of former company and industry experts to triangulate the company's progress on its acquisition and develop a full picture of the company's fundamentals. To better understand the difficult weather-associated comparisons which the Street expected, we built a proprietary dashboard to quantify daily hailstorm frequency and severity across every zip code in the United States and overlaid store locations within a 20-mile radius to determine the impact of storm activity on roofing spend. While severe weather was more normalized nationally (as expected), storm activity across the company's geographical store footprint was higher than national trends and not nearly as bearish as the market was pricing. Our analysis, along with our fundamental credit work, gave us the conviction to take a substantial position in the bonds as we anticipated storm-related demand would not be materially different from years past. Subsequent earning releases confirmed our assessment of storm activity on the company's demand picture as cash generation was significantly above market expectations. Sentiment around the company's debt quickly shifted, and prices for our investment eventually traded back toward par for an attractive total return.

Exhibit: Hailstorm Heat Map and Store Locations



Source: National Weather Service/Artisan Partners. As of 30 June 2018. For illustrative purposes only.

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