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Data and the Diamond Cutter

In important ways, investment management is like diamond cutting – multifaceted with success dependent upon the skill of those wielding the mallet and chisel. Back in the day, the diamond cutter would sharpen his chisel, carefully size up the stone, craft a plan (experience helps) and then set it in motion. The world has changed dramatically. Today, diamond cutting is computer-assisted. Images of rough stone dimensions are fed into computer programs, and software is used to design the perfect weight and cut, which is then produced using a robot.

Modern technology is, in many ways, similarly influential on the discipline of investment management and securities analysis. Just a few generations ago, a securities analyst would contact the investor relations division and ask that the latest annual report, 10Ks and 10Qs be mailed out. Once the documents arrived, and depending on the tech savviness of the analyst, either a yellow legal pad and pencil came out or the data was hand entered into an IBM 5150 running Lotus 1-2-3 software to construct rudimentary spreadsheets. Those spreadsheets helped the analyst gain insights into the absolute profitability of the subject company. Understanding the relative strength of a given stock required performing the above on every peer.

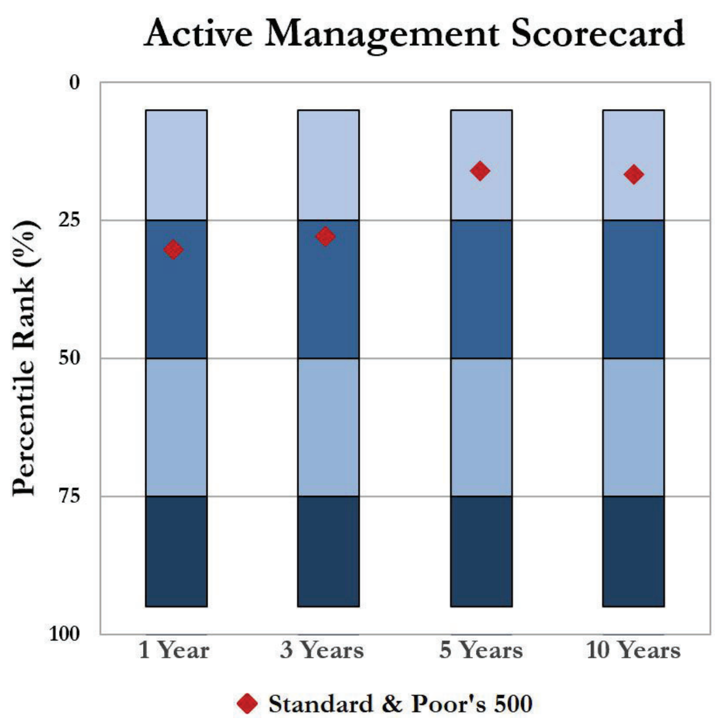
Like a hammer and chisel to a diamond, securities analysis proved arduous and time-consuming.

It was not until the mid-1960's that the first comprehensive financial database (Compustat, now Capital IQ) started posting annual data on S&P 500 companies. It then expanded in the 70's and early 80's to include quarterly data on a broader universe, until eventually developing into a database encompassing 88,000 global securities that make up 99% of worldwide market capitalization[1]. Its offerings span historical data, daily pricing and forecasts.

Several others followed suit, including Bloomberg, FactSet, Interactive Data Corp., Moody's Analytics, Morningstar and Thomson Reuters.

Advances and innovations continue to emerge, raising questions about information excess. Case in point: The newest phenomenon in investment research is data mining. Programmers scan the internet, social media, blogs, news sites, etc., looking for words and word patterns that they wager may affect the prospects of businesses, economic sectors or the general market globally. Data mining programs produce an abundance of information and are widely used. They have altered the investing landscape – but not, in our view, necessarily for the better.

Efficient access to useful information is, of course, advantageous. But now one needs to be mindful of what to do with the deluge of data. Has the instantaneous access to fundamental data resulted in improved results for active managers? Frankly, no. Too many active managers are still operating under the assumption that acquiring information is key without also recognizing that fundamental data is a commodity.



Source: eVestment Large Cap Core Universe as of 3/31/2020

Availability is a given, data is relatively cheap and, for the most part, reliable. So why hasn't this resulted in better performance for active managers? Several aspects of data use need to be explored to arrive at a reasoned answer.

Reliability

Financial databases (structured data) have, as noted, expanded to include data on 88,000 global securities, displaying hundreds of thousands of data points[1]. Unstructured data sources (social media, etc.) produce 2.5 quintillion bytes of data on a daily basis[2]. Is every data point correct? Experience shows that one must apply the reasonableness test. One must compare and contrast what is displayed versus what one would expect to be displayed; again, experience helps. If, in constructing a financial ratio, the output is seen in multiples of one hundred, you have a problem. Also, comparing current data points to like historical data points can be effective in sorting out bad data.

Use

All calculations of economic value, free cash flows, etc. are not equal. Understanding how contrived/calculated data points are produced is vital in assessing the usefulness of the data. Failing to understand how the data is calculated or derived can lead to bad decisions using good data.

Patterns vs. Noise

Given the vast amount of structured and unstructured data, one must determine what is a pattern and what is simply noise. Is there a cause-and-effect relationship? For example, a single manufacturing plant adds capacity, a second shift and more employees. An uptick in volume at the Burger King across the street follows. The next and obvious question is: What caused the increased demand for Whoppers? Possible answers: a new residential development, the closure of the McDonald's down the street, a taste trend change (Whoppers are delicious) or the above-mentioned expansion of the manufacturing plant.

Data alone does not give the answer. This is where our diamond-cutting analogy loses its edge. Expert human research and analysis not only comes into play but becomes paramount in our efforts to seek to ensure an accurate read on the nuances of all available information.

While computers and data have proven tremendous assets in diamond cutting, their impact is not as clear-cut on financial analysis. It appears the individuals wielding the proverbial mallet still matter. To be sure, tech marches on, and the rise of artificial intelligence could one day change this dynamic. But for now – and the foreseeable future – bona fide human beings remain indispensable.

Here at Aristotle Capital, we seek to identify what we believe to be high-quality businesses that are trading below our estimate of intrinsic value, with company-specific catalysts within management's control. A combination of art and science is required. In doing so, we sift through years of history, speak with hundreds of management teams and read what can seem like endless pages of annual reports. Our process is a patient one designed to build focused, yet diversified, portfolios. We are not looking for the next great "stock" but rather looking to build long-lasting knowledge of businesses and industries. By following this recipe, we sometimes find a company that meets our Quality-Valuation-Catalysts criteria – a true diamond in the rough!

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James (Jim) Henderson is a member of the Aristotle Capital investment team and a veteran of the investment industry. Jim was a senior analyst and Portfolio Manager at Reed, Conner & Birdwell, LLC (RCB) for 10 years. (RCB combined its business with Aristotle Capital in January 2012.) Prior to his tenure with RCB, Jim served as a partner and Portfolio Manager at Metropolitan West Capital Management, LLC and Van Deventer & Hoch, Investment Counsel.

Jim earned his Bachelor of Science degree in Finance and Economics from California State University, Northridge. He is a CFA® charterholder.

Sources:
[1]https://www.spglobal.com/S&P-Capital-IQ
[2]https://www.digitalinformationworld.com/2018/06/infographics-data-never-sleeps-6.html