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## Alger Capital Appreciation Portfolio 2Q15 Update with Patrick Kelly

***Alger Capital Appreciation Strategy** Portfolio Manager and Head of Alger Capital Appreciation and Spectra StrategiesManager **Patrick Kelly** gives his quarterly update on the Portfolio and his broader outlook for the markets.*

Click **here** for more information on the **Alger Capital Appreciation Portfolio**.

**Alex Bernstein:** Hello. This is Alex Bernstein of Alger. I'd like to welcome all of you to our quarterly update with portfolio manager Patrick Kelly. As always, at Alger, we appreciate any feedback you have on the content or the format of this update. Patrick?

**Patrick Kelly:** Thanks, Alex. Before I begin I wanted to make a couple of announcements regarding the strategy. First, I'm very proud to report that for the ten years ending June 30, 2015, the Spectra Fund is the number one performing large cap growth fund according to Morningstar, and over that timeframe it has not only outperformed all other large cap growth funds but it's also outperformed all mid and large cap funds, whether growth, value, or blend. The Capital Appreciation Fund is the third best performing large cap growth fund over that same time period. This performance has also been highlighted in the most recent issue of *Kiplinger* magazine. This is a testament to the entire investment team, our philosophy and our process. It has also required a tremendous amount of hard work to achieve this level of performance.

Secondly, given the growth and success of the strategy, we thought it was important to dedicate additional resources to the strategy. As a result, Ankur Crawford has been added as a co-portfolio manager to the strategy. Ankur has been with the firm for over 12 years and is one of Alger's most talented investment professionals. I continue to be hopeful and confident for what the future holds for these strategies. I'll also note that we continue to walk humbly. I feel a humble attitude is important to have in this business and any other highly-competitive business. Part of a humble attitude is having a relentless focus on improvement. That's the way it's been for the past ten years, and that is the attitude of the team moving forward.

Moving on to our updated thoughts on the market, our investment themes, and our latest sector positioning; in terms of our view on the U.S. economy, we continue to remain positive for a number of reasons. First, inflation remains low, allowing for easy monetary policy. U.S. energy production, the globalization of the work force and technology advances continue to keep inflation low which we expect will continue. Inflation is also

being tempered by the slowdown in emerging markets, including China and Brazil.

Long-term U.S. Treasury bond yields remain low, despite improvement in many areas of the U.S. economy. The U.S. 10-Year Treasury Yield fell 80 basis points in 2014 and currently sits at 2.20%. Europe is proving to be a major influence on keeping global yields down. The spread with many European bond yields remains elevated with Germany's 10-year bond yield at 0.65% and France's at 0.97%. As a result, while we believe there is a likelihood that short term rates will increase in the coming quarters, we expect long-term yields to remain low.

Second, the housing outlook remains positive in the U.S. Per the Case-Shiller Index, home prices grew 8% year-over-year in 2014, and are up 32% from the 2012 bottom. The positive U.S. housing backdrop is favorable for the U.S. economy, as housing is the consumers' largest asset.

The third point is rising U.S. oil and natural gas production. It lowers consumer and business energy costs. It lowers inflation. It makes U.S. manufacturing more competitive, and lowers the trade deficit. The impact of rising U.S. oil and natural gas production is clearly evident in the prices that we're seeing in the oil and gas markets. And of course the oil decline is a big tax break for consumers which represents 70% of U.S. GDP.

The fourth point is that the U.S. innovation engine is alive and well. This is clearly evident in companies such as Tesla, Facebook, Google, Apple, Airbnb, Amazon, Uber, Salesforce.com, and many others. Fracking technology has helped transform U.S. energy production. There is a tremendous amount of innovation in the U.S. biotech sector with a number of very promising drugs and pipelines.

The fifth point is shareholder activism. Activists are forcing companies to be extremely efficient with their operations and their capital. The level of sophistication of the activists has increased versus prior years. As a result, companies and CEOs are under greater pressure to perform and make the right decisions for the benefit of shareholders. We have seen activists in some of the biggest companies. We expect this trend to continue, which we believe will be a positive for the market.

The sixth point is M&A activity, which has been very strong recently driven by strong business confidence, low rates, and healthy corporate balance sheets. U.S. M&A is on pace to reach an all-time high in 2015. The 2015 total could exceed last year's balance, over $2 trillion. Increased M&A activity is widespread across sectors.

Lastly, on valuations, we think equities remain attractive. Forward earnings multiples are modestly above average levels on a historical basis. The S&P earnings multiple from a top down perspective is 17x on 2015 and roughly 16x on 2016, which we feel is reasonable based on the fundamentals and also given the low rate environment. Over 40% of the companies in the S&P 500 have dividend yields north of the ten-year Treasury bond. Many of these companies have fairly large buyback programs, so the dividend yield does not capture the total cash yield being returned to shareholders. Companies continue to generate strong free cash flow and have demonstrated more of a willingness to return that cash to shareholders, which should continue to benefit the market.

Despite our positive view on the U.S., we remain cautious on China and countries dependent on China.  Earlier this month, the IMF cut its global growth forecast for 2015 to 3.3% from 3.5%.  We are seeing softness across multiple sectors in China and think it could persist across the economy.  Our main point of caution regarding China continues to be that investment spending is 46% of GDP, which we view as unsustainable.  China also continues to deal with a number of excesses in their economy.  The eventual decline in investment spending growth should negatively impact employment and thus consumption.  We think Brazil and other countries dependent on oil and commodities for growth will also face incremental pressure as China's economy slows.

In Europe, growth has exceeded expectations in 2015, but remains sluggish.  The situation in Greece has created volatility in European markets.  The slowdown in China could also impact European growth.

I'll now turn to our investment themes.  As I've stated before, we believe that companies undergoing positive, dynamic change offer the best investment opportunities. The good news is that we continue to see a tremendous amount of change in the markets and a significant amount of innovation and disruption of traditional businesses. This change has positive implications for some stocks and negative implications for others.  For example, the rapid growth of Internet usage and Internet advertising is a positive for Facebook but a negative for a large number of traditional media companies. We are seeing significant disruption across sectors and leadership is narrowing.

The biggest theme in the portfolio continues to be investing in companies that are well-positioned to benefit from increased Internet usage. The Internet continues to drive significant change.  It's disrupting traditional businesses and traditional ways of doing things. It is changing the way we live our lives and changing how businesses operate across industries.  Companies have to adapt to this change.

More specifically, the Internet is disrupting the entire media landscape. We have seen the impact on newspapers, radio, and we are just beginning to see the impact on TV broadcasters. The Internet currently represents approximately 50% of total media time in the U.S., yet just over 30% of ad spend.  We think the percentage of time devoted to the Internet will continue to climb, especially with the explosive growth of mobile Internet usage. And at the same time, we expect the ad spending gap between dollars spent and time spent to narrow.

We continue to believe the Internet will be the most effective ad medium versus other traditional forms of media.  Ultimately, we think digital advertising will be much larger than TV ad spend. We think Internet advertising growth will continue to surprise to the upside which we are already seeing occur in 2015.  We are seeing explosive growth in mobile Internet usage and think we are at an inflection point in video advertising.  Both YouTube and Facebook now have significant scale to take share from TV and other traditional media properties.

I'll give some recent metrics on YouTube and Facebook.

**Facebook**

There are 1.35 billion worldwide users and 864 million worldwide daily active users on the

Facebook network alone; in the U.S., the average user spends approximately 50 minutes a day on Facebook; and there are over four billion videos consumed on Facebook every day.

**YouTube**
More than one billion unique users visit YouTube each month; over six billion hours of video are watched each month on YouTube — that's almost an hour for every person on Earth; despite this, Google said that YouTube watch time actually accelerated in the most recent quarter, with mobile viewing doubling year over year.

We are also seeing the Internet drive continued change in the ecommerce market and believe, that like digital advertising, there is a long runway ahead. eCommerce is currently approximately 15% of U.S. retail sales, still in the early stages of growth. (Our retail sales definition excludes auto, gas/fuel, restaurants and grocery.) eCommerce has grown mid-teens over the last several years as growth rates increasingly add to a much larger absolute dollar amount, now approaching $350 billion in ecommerce sales. As the absolute dollar amount of ecommerce sales increases each year at a double digit rate, the incremental dollar impact on traditional retail becomes that much more significant. We think ecommerce will grow 15% in 2015, or approximately $45 billion dollars, primarily at the expense of traditional retailers.

Amazon's ecommerce growth continues to significantly exceed the ecommerce growth of traditional retailers. Amazon is growing its GMV by 25%, while the vast majority of retailers are barely growing. In Amazon's most recent quarter, paid worldwide unit growth accelerated to 22% year over year growth, and electronics and other general merchandise revenue accelerated to 31% year over year growth. This is despite Amazon's large base of revenue and GMV.

Amazon, this year, is taking close to 50% of incremental ecommerce spend. This will continue to be a problem for traditional retailers. We remain bearish on the majority of traditional retailers. And we believe the growth of ecommerce will continue to put significant pressure on them. We are also seeing the emergence of new disruptive ecommerce competitors. Other successful ecommerce competitors could emerge, beyond Amazon, that could also be disruptive to traditional retailers.

And just as the Internet is disrupting the traditional retail and media space, we also believe that the Internet is disrupting the traditional IT landscape. We expect many of the on-premise traditional IT vendors will struggle to grow revenues and continue to lose share to the cloud-based service providers.

The public cloud computing market is currently $12 billion. We think it could be a $43 billion market in five years, reflecting nearly a 30% annual growth rate. Companies are finding it more cost effective to outsource IT operations to cloud service providers. Cloud service providers benefit from economies of scale. They are then able to pass cost savings to the consumer. Amazon, for example, in their AWS offering, has made 47 price cuts to its service since its inception in 2006. Amazon and Microsoft's Azure have emerged as the two market leaders in this area. We also think Amazon's Web Services is helping to enable the innovation and disruption we are seeing in the market, as it's now much cheaper and efficient to start a company.

There are other examples of disruptions in companies such as Airbnb.  Airbnb is a website for people to rent out lodging. Airbnb has compiled over 1.4 million global listings in 34,000 cities and 190 countries. That volume of listings exceeds all other global hotel chains.  Airbnb is expected to report $10 billion in bookings this year, up 100% year over year. The company is still fairly small vs. the over $450 billion global lodging market, but we think it will begin to have an impact in the coming years. We expect to see a significant increase in bookings and revenues over the next five years.

There are also many other Internet-based companies that are causing a significant amount of disruption such as Uber, LinkedIn, Netflix, and many others.  Businesses have to adapt to the change the Internet is driving. As investors, we want to be positioned in companies that are prepared for this change and avoid those that are not.

The next theme is focusing on platform companies.  We think of companies such as Facebook and Amazon as platform companies, but in this context we are defining platform companies as a market dominant company with a strong management team, and a large distribution platform that enables them to acquire, integrate and consolidate companies, bring them into their existing distribution platform, and drive significant revenue and cost synergies.  Honeywell, Allergan, Avago, Anheuser Busch, Thermo-Fisher and Danaher are all examples of positions in the portfolio that we would classify as platform companies. Many of these companies have very strong perfomance and we would expect that trend to continue.

Allergan, for example, is a global specialty branded pharmaceutical company. We view Allergan as a platform company.  Through M&A, the company has strengthened its management team and drug distribution platform.  Actavis acquired Warner Chilcott, Forest Labs and Allergan over the past several years. With the recent sale of Allergan’s global generic business for $40.5 billion, the company has completed the transformation from a generics only company to a branded specialty pharma company in nearly a 2-year period.  The stock is up 135% over that time period.  We believe with the proceeds from the generics business sale, the company has optionality to do further highly accretive M&A by adding businesses to the existing asset platform.  We believe the company can drive further shareholder value in doing this.

The next theme is favoring market dominant companies with strong brands that are well positioned to benefit from worldwide growth. We're also looking to be positioned in companies that are benefitting from recovering domestic housing activity and in companies that benefit from an acceleration in U.S. nonresidential construction spending. We expect to see a cyclical recovery in nonresidential construction in 2015.

The last theme is emphasizing companies with strong free cash flow yields that are then positioned to return that cash to shareholders through dividends and buybacks. Again, we focus on the cash yield and not just the dividend yield. We're also putting an emphasis on companies where we see a positive change in the cash yield.

I will now briefly go through the sector weightings and discuss some of the individual stocks within the sectors.

Technology is approximately 30% of the portfolio.  Apple continues to be our largest

position in Technology. We have trimmed the stock modestly recently but it remains our largest position. We believe that Apple trades at a valuation of a traditional commodity hardware company, but we view Apple as more of a software platform company that has a strong brand with high switching costs, unlike traditional hardware technology companies.

We also continue to remain bullish on Facebook. We recently added to positions under $80. We continue to be positive on the fundamentals. We believe Facebook is a very powerful Internet platform, and that there is a huge opportunity in front of Facebook to continue to monetize this platform. We believe Facebook will be a primary beneficiary from the shift of brand advertising dollars from TV to digital due to its reach, scale and targeting ability.

Avago is also a solid contributor to the portfolio in Q2. We view Avago as an emerging platform company. We think Avago's synergy targets in the most recent deals are very conservative and we think the valuation is attractive looking out to the earnings power over the next several years.

Consumer Discretionary is approximately 16% of the portfolio. Delphi is one of our largest positions in Consumer Discretionary. Key platforms of growth are: active safety, infotainment, and powertrain. The company is a leader in advanced driver assistance systems. We expect Delphi to have strong earnings growth over the next five years and we think the valuation is attractive relative to that growth.

Healthcare is approximately 22% of the portfolio. We remain positive on Healthcare. One, fundamentals remain strong. Two, there continues to be a tremendous amount of innovation in Healthcare. And three, we expect the sector to continue to consolidate. We believe this will happen across the subsectors of Healthcare.

Allergan and Gilead are our biggest positions in Healthcare. HCA was a top performer in Q2 on the back of the Supreme Court ruling. The portfolio also benefited from M&A activity within the health care provider group. In July, Aetna announced plans to acquire Humana and Anthem announced plans to acquire Cigna.

We also increased our position in Bristol Myers in Q2. Bristol Myers is the leader in the emerging immune oncology area. The company recently received an approval for Opdivo for use in lung cancer. Lung cancer is a very large market with few effective treatment options. We think current Street estimates don't appropriately capture Opdivo's launch in lung cancer. The majority of the upside in Opdivo sales will hit the bottom-line as Bristol Myers' cancer infrastructure is entirely built out.

Industrials is approximately 8% of the portfolio. We have been reducing our exposure to the group. Honeywell is a diversified technology and manufacturing company with operations in automation and control solutions, aerospace, specialty materials, and transportation systems. Honeywell is another example of a platform company. We think that Honeywell's excellent management team and a strong global platform across multiple markets creates a strong foundation for making accretive acquisitions. Going forward, Honeywell should see more aggressive capital deployment as the company has essentially no debt. We think they can create further shareholder value by deploying

their capital.

Energy and Materials is approximately 5% of the portfolio. In Energy, we remained underweight in Q2 but are currently modestly overweight following the reconstitution of the Russell growth benchmarks where energy has been almost entirely removed. We do expect prices to remain weak in the coming months and in the short-term. We do expect prices to begin to return to more normalized levels in 2016. However, we think that the days of $85-$90-$100 oil are over.

Financials is approximately 8% of the portfolio. We remain positive on the sector. We continue to invest in companies that benefit from an improving domestic economy and rising short term rates. However, we have reduced some interest rate exposure given recent events in Greece and the continued slowdown in China. Blackstone was the biggest contributor to performance in Q2, followed by Citibank and Bank of America. We continue to favor the alternative asset managers including Blackstone Group, which is our largest position in Financials. We view Blackstone as one of the premier investment managers and alternative asset managers in the world.

Consumer Staples is approximately 7% of the portfolio. We remain underweight the sector. CVS and Walgreen's are our largest positions. CVS continues to be our largest position in Staples and was again the biggest contributor in Q2. The company continues to execute extremely well in both its retail business and its pharmacy benefit management business line. They continue to generate a significant amount of free cash flow and we like how they have been deploying their capital to further generate shareholder value.

In sum, we remain positive on the U.S. equity markets due to our expectation for a continued low inflation environment, an improvement in the U.S. housing sector, increased merger and acquisition activity, increased shareholder activism, and the cash yields on equities remaining attractive relative to bonds. We are seeing significant disruption across sectors and leadership is narrowing. We look to capitalize on that change by being positioned in companies benefiting from the change and avoiding those being disrupted by the change. Again, we continue to have a positive bias on the U.S. equity markets, but acknowledge that risks remain in many of the markets outside of the U.S. China continues to be the biggest risk factor that we are monitoring. As a result, we are trying to be somewhat neutral in our overall portfolio positioning and allow our stock picking to drive the Alpha within the portfolio.

I will conclude there, but I want to thank you for your time and your continued interest in Alger. Thank you.

**AB:** Thanks, Patrick, and good luck in the upcoming quarter.

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and are for illustrative purposes only. Investing in companies of all capitalizations involves the risk that smaller, newer issuers in which Alger invests may have limited product lines or financial resources or lack of management depth.

The percentile ranking source is Morningstar. Morningstar percentile rankings are based on total return percentile rank (excluding sales charge) within each Morningstar Category. Spectra Fund Class A's ranking, a ranking developed by Fred Alger Management, Inc., based on total return, among all Large Cap Funds (Large Growth, Large Value, and Large Blend): 207 out of 4,318 funds for the 1-year period ended 6/30/15; 118 out of 3,324 funds for the 5-year period ended 6/30/15; 1 out of 2,348 funds for the10-year period ended 6/30/15. Alger Capital Appreciation Portfolio Class I-2's ranking, a ranking developed by Fred Alger Management, Inc., based on total return, among all Large Cap Funds: 154 out 4,318 funds for the 1-year period ended 6/30/15; 117 out of 3,324 funds for the 5-year period ended 6/30/15; 3 out of 2,348 funds for the 10-year period ended 6/30/15. Morningstar percentile rankings are based on total return percentile rank (excluding sales charge) within each Morningstar Category. The highest (or most favorable) percentile rank is 1 and the lowest (or least favorable) percentile rank is 100. If sales charges were included, performance would be lower and the rank may be lower.

As of 6/30/2015, the following represents the Alger Capital Appreciation Portfolio's assets under management: Aetna, Inc. 0.51%; Allergan Plc 4.10%; Amazon.com, Inc. 2.04%; Anheuser-Busch 0.99%; Apple, Inc. 6.25%; Avago Technologies Ltd 0.80%; Bank of America Corp. 0.57%; Blackstone Group 2.29%; Bristol Myers Squibb Co. 1.23%; Broadcom Corp. 0.86%; Cigna Corp. 1.67%; Citigroup, Inc. 1.02%; CVS Health Corp. 1.76%; Danaher Corp. 0.92%; Delphi Automotive Plc 1.32%; Facebook, Inc. 4.82%; Gilead Sciences, Inc. 1.91%; Google, Inc. 2.78%; HD Supply Holdings, Inc. 0.64%; HCA Holdings, Inc. 1.18%; Honeywell International, Inc. 1.73%; Humana, Inc. 0.97%; Linkedin Corp. 0.43%; Microsoft Corp. 0.89%; Netflix Com, Inc. 0.41%; Salesforce.Com, Inc. 1.32%; Thermo Fisher Scientific, Inc. 1.33%; Walgreen Boots Alliance, Inc. 0.92%.

As of 6/30/2015, the portfolios held no assets under management for the following companies: Actavis, PLC; Anthem, Inc.; Forest Laboratories, Inc.; Tesla, Inc.

Investing in the stock market involves gains and losses and may not be suitable for all investors. Growth stocks tend to be more volatile than other stocks as the prices of growth stocks tend to be higher in relation to their companies' earnings and may be more sensitive to market, political and economic developments. Investing in companies of all capitalizations involves the risk that smaller, newer issuers in which the Fund invests may have limited product lines or financial resources or lack of management depth. The use of derivatives involves risks different from, and possibly greater than, the risks of investing directly in the underlying assets. A small investment in derivatives could have a large impact on the performance of the Fund. Derivative instruments involve counterparty risks, liquidity risks, and risks that the derivative does not correlate with the underlying instruments. The cost of borrowing money to leverage could exceed the returns for securities purchased or the securities purchased may actually go down in value; thus, the Fund's net asset value could decrease more quickly than if it had not borrowed. Strategic Insight includes mutual funds and ETFs but excludes exchange traded products, closed-end funds, VA funds and fund-of-funds.

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