Alger Spectra Fund and Capital Appreciation Fund 2Q14 Update with Patrick Kelly

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

Click **here** for more information on the **Alger Spectra Fund** and **here** for information on the **Alger Capital Appreciation Fund**.

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. I'll talk to our updated thoughts on the market, our investment themes and our latest sector positioning. Much of this will be the same from our previous podcast, but we'll provide our updated views.

The U.S. economy continues to be strong. I wanted to make a number of points as to why we remain positive on the U.S. economy.

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.

Second, despite recent home price moderation, we still think the housing outlook is positive over the next several years. The Case-Shiller National Home Price Index increased 11%, year-over-year, in the month ending April, the last month reported. We still expect home prices to be up low to mid-single digits in 2014. Housing starts in the U.S. continue to be well below normalized levels. The improvement in the U.S. housing sector is a big positive for the U.S. economy, as housing is the consumers' largest asset.

The third point is the rising U.S. oil and natural gas production. This is a significant positive change for the U.S. economy. In 2013, U.S. oil production rose by approximately one million barrels a day, which is a 17% year-over-year increase. We think the U.S. will be producing over 12 million barrels of oil five years from now, up from eight million today. Overall, we believe that the U.S. should be able to meet approximately 96% of its energy needs by 2020, up from approximately 70% of its needs in 2013 and just 57% in 2008. Again, the continued growth in oil and natural gas production is extremely positive for the U.S. economy. It lowers consumer and business energy costs. It lowers inflation. It makes U.S. manufacturing more competitive, increases jobs, boosts capital equipment spending, lowers the trade deficit, boosts revenue for energy producing states, raises spending for infrastructure, and changes the geopolitical balance in favor of the U.S.

The fourth point is rising U.S. investment spending in equipment, construction, and technology which also ties back to the rising U.S. natural gas and oil production. U.S. investments represent 15% of GDP in the U.S. We think that percentage could continue to expand over the next several years, moving to beyond 18%, driven by record high domestic corporate profits of public and private companies, accelerating corporate cash and the recovery in the manufacturing and energy industries. We would note that the U.S. investment spending as a percentage of GDP is significantly lower than China. Approximately 48% of China's GDP is in investments. We believe that number in China is unsustainable while the U.S. investment as a percentage of GDP should rise.

The fifth point is shareholder activism. Activists are forcing companies to be extremely efficient with their operations and their capital. This 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, such as Procter and Gamble, Apple, Pepsi and Microsoft. We expect this trend to continue, which we believe will be a positive for the market.

The next point is M&A activity, which has been very strong recently driven by strong business confidence, low interest rates and healthy corporate balance sheets. Led by Healthcare and Technology, cash on S&P 500 companies' balance sheets has risen to the highest levels of the century. The announced deal volume in the first half of 2014 is up 58% year-over-year. We expect M&A to remain very strong going forward.

Lastly, on valuations, despite the significant increase in the market in 2013 and the positive results year-to-date, we think equities remain attractive. Forward earnings multiples are just above average levels on a historical basis. The S&P 500 earnings multiple from a bottoms-up perspective is 16.5x on 2014 earnings and 14.8x on 2015 earnings, which we feel is reasonable based on the fundamentals and also given the low rate environment. Over 26% of the companies in the S&P 500 still have dividend yields north of the ten-year Treasury bond. The dividend year-over-year growth rate of the companies in the S&P 500 remains near a 60-year high. And 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 continues to benefit the market.

I'll now turn to our 2014 investment themes. Before I do, just a reminder on our investment philosophy. 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 market. One of the biggest changes that we're seeing in the market, currently, is driven by the Internet. And that's the biggest theme within the portfolio.

So, the first theme I'll talk about is investing in companies that are well-positioned to benefit from increased Internet usage. The Internet is disrupting traditional businesses and traditional ways of doing things. It is eliminating middle men and providing a more efficient way of getting things done. It is driving massive secular changes. In the process, it is changing the way we live our lives and changing how businesses operate across industries.

More specifically, the Internet is driving very disruptive changes in the traditional retail world. The traditional way of selling goods and products was to open a storefront and sell products to consumers in the local community. With the Internet, you can now open up a web-based store and sell your products to the entire world without the overhead and cost of running a physical store. Traditional retail companies need to adapt to the growth of Internet-based commerce or risk going out of business. We have seen many local community stores close their doors and we have also seen much bigger stores such as Borders and Circuit City go bankrupt. Clearly, the Internet has disrupted the traditional way of selling books and electronics. It will eventually disrupt the traditional way of selling virtually everything. This trend is still in its early stages, with the Internet currently accounting for only 10% of U.S. retail sales.

The Internet has also been very disruptive to traditional media businesses. There has been a big change in the way we consume media which has driven the big change in the way advertisers allocate their ad dollars. This has been to the benefit of many Internet-based companies and to the demise of many traditional media businesses. To date, this change has been very detrimental to the radio and print industries and we believe the Internet is just beginning to alter TV budgets. We do believe the Internet will be the best advertising medium versus all traditional forms of media such as TV and print.

Currently, the Internet represents 41% of average daily media consumption in the U.S., yet only 29% of total U.S ad spend. We think the percentage of time devoted to the Internet will continue to climb. And at the same time, we expect that spending gap to narrow. We believe Internet advertising will grow over 15% year-over-year for many years to come and even faster internationally, surprising to the upside. We also think we are still in the early innings of growth of mobile devices accessing the Internet. We estimate that nearly 70% of global handsets will be smart phones in 2017, up from 37% in 2013. In addition, we think it will be much easier to access the Internet from the evolving handsets, and the networks will continue to improve. Mobile adoption will contribute to the disruption of the Internet.

YouTube, which is owned by Google, meanwhile, has become one of the largest media businesses in the world. I thought I'd read off some YouTube stats to illustrate how the Internet is changing how we consume media and thus how advertisers will be allocating advertising dollars.

- More than 1 billion unique users visit YouTube each month.
- Over 6 billion hours of video are watched each month on YouTube — that's almost an hour for every person on Earth.
- 100 hours of video are uploaded to YouTube every minute.
- 80% of YouTube traffic comes from outside the U.S.

- According to Nielsen, YouTube reaches more Americans aged 18-34 than any cable network.

We continue to believe that there's huge opportunity for Google to monetize the usage of this platform. And Google is one of the largest positions in the portfolio.

In another example of the power of the Internet and how it is changing the traditional ways of doing things and traditional thinking I recently became involved in a charity to help save the life of a four-year-old girl named Eliza from a horrible degenerative disease called Sanfilippo Syndrome. The family of Eliza is in a race against time to raise millions of dollars to fund the research and clinical trials of a potential cure for this disease later this year. The cruel reality of the disease is that Eliza will likely stop talking within a year, suffer irreversible brain damage by age six, and degenerate from there, and will very likely die in her teens. No child deserves this kind of death sentence. It is a parent's worst nightmare.

The family's goal is to raise $2 million to fund the research and clinical trials at the Nationwide Hospital by October of this year. It is very difficult to raise money from corporations for these kinds of rare diseases; so Eliza's family – the O'Neils – are dependent on the community and individuals to help raise money. In order to do this, the family and friends have engaged in grassroots fundraising, including various charity events – dance-a-thons, golf events – while at the same time raising awareness at various community events such as football games. The O'Neills were having some success with these efforts but they were nowhere close to reaching their goals. They decided to make a YouTube video and put it on a site called GoFundMe.com. On the site, you can watch the video and learn about Eliza's story and easily share the video with all of your Facebook friends. You can click on a button to donate and make a comment to the family. Over $700,000 was raised in the first four days after the video was released and it has now raised over $1 million dollars. The video has gone viral and thousands of people across the world have donated to find a cure.

The story of Eliza demonstrates the power of the Internet and the power of platforms such as YouTube and Facebook. It demonstrates how the Internet is changing the traditional ways of thinking and doing things. With their daughter's life on the line, the O'Neills had to challenge the traditional way of fundraising, the traditional way of thinking, and leverage the power of the Internet to raise money for their daughter and Sanfilippo Syndrome. I would encourage anyone listening to this to visit the site (http://www.gofundme.com/elizaoneill).

Businesses will also have to adapt to the change the Internet is driving, by changing their traditional ways of thinking and marketing. As investors, we want to be positioned in companies that are well-positioned for this change and we want to avoid those that are not.

The second theme I'll discuss is investing in companies that benefit from the significant scale of cloud-based services. Just as the Internet is disrupting the traditional retail and media space, we also believe that the Internet is disrupting the traditional IT landscape.

The impact of cloud computing on legacy on premise technology vendors is just beginning. Cloud models are enabling a whole new level of automation, agility and cost control within IT organizations, which in turn leads to higher utilization and rationalization of assets. As we look out beyond 2014, 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 third theme is favoring market dominant companies with strong brands that are well-positioned to benefit from worldwide growth.

The fourth theme is positioning in companies that are benefitting from recovering domestic housing activity. Last quarter, we did reduce some of our exposure to the domestic housing theme in favor of companies that benefit from a recovery in domestic non-res spending. And I'll speak to that theme momentarily.

The fifth 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 yields.

And lastly, we're investing in companies that would benefit from an acceleration in U.S. nonresidential construction spending. We expect to see a cyclical recovery in non-residential construction in 2014. We are looking for market level growth to turn firmly positive in 2014 before accelerating in 2015.

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

Technology is approximately 28% of the portfolio, down 1% from last quarter. Apple continues to be our largest position in technology.

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 very strong brand with high switching costs, unlike traditional hardware technology companies.

We expect a number of catalysts in the second half of this year.

- We believe that Apple will enter the wearable device market with an iWatch which we believe will be a very successful product .

- We believe that they will release a larger screen iPhone, which we think will be a very big upgrade cycle.

- We believe that they will introduce payment technology for their devices which will make their platform more sticky and should also provide incremental revenue opportunities to Apple.

We think the valuation remains attractive on an enterprise value to free cash flow basis. Apple has $22/share in net cash.

We also like the commitment management has made to returning capital to shareholders. Apple is returning $100 billion over the next three years and will generate

$40 billion in annual free cash flow.

Google is our second largest position in technology. We believe Google will benefit from the shift of advertising dollars from offline to online. Google continues to dominate search advertising and has positioned itself to capitalize on the rapidly growing mobile and online video ad markets. We also think Google is taking steps to significantly increase the monetization of mobile search where it has a dominant position.

We also think that Google has the opportunity to significantly increase the monetization of YouTube. In addition, Google is now offering product listing ads to ecommerce sites. These are more robust search ads that would show photos and prices for various retail goods from a selection of retailers. We believe that these ads are working well for ecommerce companies and will drive significant incremental revenue to Google in 2014 and beyond.

We also continue to remain very bullish on Facebook as we believe this is a very powerful internet platform, and that there is a huge opportunity in front of Facebook to continue to monetize this platform.

Consumer Discretionary is approximately 18% of the portfolio, 2% lower than Q1. That is largely due to a reduction in our media holdings. Home Depot and Amazon are our largest positions in Consumer Discretionary. We did recently reduce our position in Amazon, given our view of significant near-term investment. However, we remain positive on the long-term outlook of the company. We feel that Amazon is the best positioned company to capitalize on the shift of retail sales from offline to online. Not only is Amazon disrupting the traditional retail space, it is also disrupting the traditional IT landscape. We also continue to be positive on Home Depot. We believe that the investment cycle in home improvement will continue for the next several years. The company continues to execute very well. And we expect Home Depot to return a significant amount of cash to shareholders over the next several years.

Healthcare is approximately 17% of the portfolio, up approximately 1% from last quarter. Covidien and Gilead were the biggest contributors in Q2. We added to our biotech exposure during the sell-off in Q1, and we remain positive on that sector vs. the large cap pharma space. We added to our largest positions in Healthcare which are Gilead, HCA and Actavis.

HCA is the largest urban hospital operator in the U.S. We see HCA as one of the biggest beneficiaries of the Affordable Care Act given approximately 8% of the admissions are uninsured. We believe that the valuation of the stock does not fully reflect this positive change. And we believe that the consensus earnings estimates remain too low.

We continue to be positive on Gilead. The company is in the beginning of a multi-year earnings growth story driven by a new drug for Hepatitis C. We believe Gilead has the potential to generate close to a $100 billion of free cash flow over the next five-six years driven by higher than expected Hepatitis C franchise sales. And we believe that this free cash flow generation is not properly factored into the stock.

Industrials is approximately 11% of the portfolio. We have recently been reducing some of our exposure in industrials given the valuations relative to the rest of the market.

Honeywell remains our largest position within Industrials.

Honeywell is a diversified technology and manufacturing company with operations in automation and control solutions, aerospace, specialty materials and transportation systems. In the past six-nine months, management has placed increased emphasis on deploying the firm's growing excess capital. We think that Honeywell's excellent management team and a strong global platform across multiple markets creates a strong foundation for making accretive acquisitions. We estimate that the company will generate $27 billion of cumulative free cash flow over the next five years which is over 35% of its market cap. In addition, we expect Honeywell to see improving organic growth as we progress through 2014. Longer term, we like the company's leverage to a commercial construction recovery, which represents 20-25% of earnings.

Tyco also remains a large position within Industrials. Tyco is benefitting from the recovery in commercial construction. Tyco is also in the process of optimizing its cost structure. These self-help efforts are sufficient to generate approximately 15% earnings growth over the next two to three years, even in a modestly growing global economy.

Energy and Materials is approximately 11% of the portfolio, up roughly 2% from last quarter. We are neutral-to-cautious on the Energy sector longer term, given the secular decline in gasoline demand in developed markets and the rising production in the U.S. In Q2, we did move to more of a neutral stance within Energy given the situation in Russia and Iraq, as well as finding some interesting company-specific opportunities.

Weatherford was a name that we added to. It's our largest position in Energy and was the biggest contributor within Energy in Q2. Weatherford is a diversified global oilfield services company. Weatherford is particularly strong in artificial lift, well construction, completions, and formation evaluation, where it has either the number one or number two position in highly concentrated markets. However, the company owns other businesses that account for 30% of revenues and generate negative margins. The company will divest or exit these non-core businesses which we view very favorably. Further, we think the management execution will significantly improve with the addition of CFO Krishna Shivram who joined the company in November 2013, and was the former Treasurer of Schlumberger. Weatherford is the classic positive lifecycle change story. A significant amount of change is leading to earnings acceleration and multiple expansion.

Rockwood is still our largest position in materials. Rockwood sold seven non-core businesses over the past year to focus on two great businesses, their lithium and surface treatment businesses. And today, it was announced that Albermarle is acquiring Rockwood for $6.2 billion which validates our thesis on the stock.

Financials is approximately 7% of the portfolio, slightly lower than last quarter.

We continue to remain positive on the financial sector. One, we think it can be one of the biggest beneficiaries from the recovery in the U.S. housing market. Two, valuations are attractive, and we think that the risk premiums in the valuations will come down over the next several years, allowing for multiple expansion. Lastly, we expect the financial sector to increase the return of cash to shareholders over the next several years, which we think can help multiples expand.

We continue to like Morgan Stanley, which is the largest position in financials. Their mix of business is undergoing significant change. The business mix was 90% Investment Bank and 5% Wealth Management in 2006. We believe this mix will be 33% Investment Bank and 67% Wealth Management/Asset Management in 2018. We think this mix shift will lead to a more consistent result, a higher ROE, and a higher earnings multiple, as a result. We also believe that the mix shift will free up a significant amount of capital over the next five years that can be returned to shareholders. We do not feel that the valuation of Morgan Stanley accurately reflects the changing business mix of the company.

We continue to favor the alternative asset managers including Blackstone Group. These companies are benefiting from investors' growing interest in alternative asset managers. We view Blackstone as one of the premier investment managers and alternative asset managers in the world. We believe that the Street continues to underestimate the potential of Blackstone's business model in three areas: 1) raising capital; 2) investing capital; and 3) returning capital in the form of dividend distributions. We think assets under management could more than double over the next five years due to a combination of share gains and a continued shift of assets to alternative managers. The fundraising environment for Blackstone remains strong. We also believe that the dividends could be higher and more sustainable than the street is currently modeling.

Consumer staples is approximately 6% of the portfolio, consistent with last quarter. CVS continues to be our largest position in staples. The company continues to execute very well in both its retail business and its pharmacy benefit management business line. We also think they are having a particularly strong selling season in their PBM business. CVS also continues to generate a significant amount of free cash flow and we continue to believe a majority of that will be returned to shareholders through dividends and buybacks.

In sum, we remain positive on the U.S. equity markets due to our expectation for a low inflation environment, and improvement in the U.S. housing sector, the significant increase in U.S. oil and natural gas production, the increased merger and acquisition activity, increased shareholder activism, and valuations and the cash yields on equities remaining attractive relative to bonds.

In addition, we continue to see a tremendous amount of change in the equity markets and we look to capitalize on that change.

I will conclude there. 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.

As of 6/30/2014, the following represents the Alger Spectra Fund's assets under management: Actavis, Plc 1.65%; Amazon.com, Inc. 1.80%; Apple, Inc. 5.18%; Blackstone Group 0.75%; Covidien Plc 1.18%; CVS Caremark Corp. 1.95%; Facebook, Inc. 2.74%; Gilead Sciences, Inc. 2.38%; Google, Inc. 3.26%; HCA Holdings, Inc. 2.02%; Home Depot Inc. 1.93%; Honeywell International, Inc. 1.98%; Microsoft Corp. 1.06%; Morgan Stanley 1.20%; Pepsico, Inc. 1.24%; Procter & Gamble Co. 0.59%; Rockwood Holdings, Inc. 2.00%; Schlumberger Ltd. 0.36%; Tyco International Ltd. 1.20%; Weatherford International Plc 1.62%.

As of 6/30/2014, the following represents the Alger Capital Appreciation Fund's assets under management: Actavis, Plc 1.64%; Amazon.com, Inc. 1.78%; Apple, Inc. 5.17%; Blackstone Group 0.76%; Covidien Plc 1.35%; CVS Caremark Corp. 1.96%; Facebook, Inc. 2.78%; Gilead Sciences, Inc. 2.35%; Google, Inc. 3.09%; HCA Holdings, Inc. 2.01%; Home Depot Inc. 1.96%; Honeywell International, Inc. 2.01%; Microsoft Corp. 1.05%; Morgan Stanley 1.25%; Pepsico, Inc. 1.24%; Procter & Gamble Co. 0.60%; Rockwood Holdings, Inc. 1.62%; Schlumberger Ltd. 0.36%; Tyco International Ltd. 1.20%; Weatherford International Plc 1.47%.

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.

The Alger Spectra Fund may engage in selling stocks short. In order to engage in a short sale, Spectra arranges with a broker to borrow the security being sold short. In order to close out its short position, Spectra will replace the security by purchasing the security at the price prevailing at the time of replacement. Spectra will incur a loss if the price of the security sold short has increased since the time of the short sale and may experience a gain if the price has decreased since the short sale. The use of short sales could increase the Fund's exposure to the market, magnifying losses and increasing volatility.

Investors should consider a Fund's investment objectives, risks, and charges and expenses carefully before investing. For a prospectus containing this and other information about an Alger fund, click on www.alger.com. Read the prospectus carefully before investing. Distributor: Fred Alger & Company, Incorporated.

Member: NYSE Euronext/SIPC.