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## Alger Spectra Fund and Capital Appreciation Fund 4Q14 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. Some of this will be the same from our previous podcast, but we'll provide our updated views.

The U.S. economy continues to strengthen in many areas. The big recent change is the drop in oil prices which we view as a net positive to the U.S. economy. Crude oil prices are down over 50% since last June. It's estimated that if crude oil prices average $50 in 2015, U.S. nominal energy expenditures would decline nearly 14% year-over-year, saving the economy about $200 billion, or 1.1% of GDP. The oil decline is a big tax break for consumers which represent 70% of U.S. GDP.

Another recent change in 2014 was that the long-term U.S. Treasury bond yields remained low despite steady progress in many areas of the U.S. economy. The U.S. 10-year yield fell 80 basis points in 2014 and currently sits at 1.8%. Europe is proving to be a major influence on keeping global yields down. The spread with European bond yields continues to widen with Germany's 10-year bond yield at 0.32%, Spain's at 1.35%, and France's at 0.54%. As a result of this, we expect U.S. Treasury yields to remain low.

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, falling gas prices, 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. The U.S. average gas price declined each day in Q4. Prices have plummeted (nearly 44%) since last June. The national average price for regular unleaded gasoline is now $2.05 per gallon, the lowest average price per gallon since May 2009, and the U.S. consumer is a big beneficiary of lower inflation.

Second, despite home price moderation, we still think the housing outlook is positive over the next several years. The Case-Shiller National Home Price Index increased 4%, year-over-year, in the month ending November, which is the last month, reported. Per the Case Shiller Index, home prices were up 8% through November, 2014 year-to-date, and up 29% from the 2012 bottom. The value of home equity has been restored. Roughly 10% of mortgages had negative equity as of mid-2014 versus over 25% in 2010. We expect home prices to be up modestly in 2015. Housing starts in the U.S. continue to be below normalized levels. We expect housing starts to grow in the mid-high single digits in 2015. 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 rising U.S. oil and natural gas production. This is a significant positive for the U.S. economy. It lowers consumer and business energy costs. It lowers inflation. It makes U.S. manufacturing more competitive. It lowers the trade deficit, and changes the geopolitical balance in favor of the U.S.

Fourth, the U.S. innovation engine is alive and well. This is clearly evident in companies such as Tesla, Facebook, Google, Apple, Amazon and the cloud technology companies including Workday and Salesforce.com. Fracking technology – the innovation there has helped transform U.S. energy production. There is also a tremendous amount of innovation in the U.S. Biotech sector, with a number of very promising drugs and pipelines for many companies.

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, such as Procter and Gamble, Apple, Pepsi, Microsoft, eBay, Walgreens, and Darden. We expect this trend to continue, which we believe will be a positive for the market. Activist funds currently have more money at their disposal than they did entering 2014. Through November, 2014, activists held $115 billion in assets, up from $93 billion at the start of 2014.

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. As of late December, U.S.-targeted M&A volume stood at $1.6 trillion in 2014, up 43% from 2013, the highest volume on record. We expect M&A to remain strong going forward.

Seventh, is the strengthening U.S. dollar. The U.S. dollar is rallying, supported by a strong U.S. economy relative to other geographies and improving annual deficits. A stronger dollar supports lower commodity prices and lifts consumers' income after food and energy costs. The outlook continues to be positive for the dollar as GDP growth decelerates outside the U.S., in particular in the emerging market and commodity dependent economies.

Lastly, on valuations, despite the solid market returns in 2014, we think equities remain attractive. Forward earnings multiples are modestly above average levels on a historical basis. The S&P 500 earnings multiple from a bottom-up perspective is roughly 16x on 2015 earnings, which we feel is reasonable based on the fundamentals and also given the low rate environment. Over 46% of the companies in the S&P 500 now have dividend yields north of the 10-year Treasury bond. Over the past 15 quarters, dividends per share for the S&P 500 companies have grown over 14%. In addition, 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.

Despite our positive views on the U.S., we remain cautious on the rest of the world. The decline in oil and the rest of commodities will continue to put pressure on petroleum states. The significant drop in oil prices presents the risk of a financial crisis in some of these oil producing countries. We think China's growth is poised to disappoint. Investment spending is roughly 47% of GDP, which we think is unsustainable. The decline in investment spending will ultimately negatively impact employment and thus consumption. And in Europe, we expect growth to remain very sluggish.

I'll now turn to our 2015 investment themes. Before I do, just a quick reminder of 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.

The first theme I'll talk about is investing in companies that are well-positioned to benefit from increased Internet usage. The Internet is driving significant change. It's disrupting traditional businesses and the 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. 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 and it will transform the entire media landscape. There has been a big change in the way we consume media which has driven a 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.

Somebody recently asked me when we will hit the inflection point on TV advertising. We believe the inflection point is here. It will be a gradual process of decline, but the inflection is here. We think Internet advertising growth will continue to surprise to the upside and there are a number of reasons behind this view.

First, the Internet currently represents approximately 47% of total media time in the U.S., yet roughly only 30% of ad spend. We think the percentage of time devoted to the Internet will continue to climb. And at the same time, we expect that ad spending gap to narrow. We think the Internet will ultimately prove to be the most effective advertising medium versus all other forms of traditional media. The second point is that we are seeing explosive growth in mobile Internet usage. In addition, we think it will be much easier to access the Internet from the evolving handsets, and the networks will continue to improve. As a percentage of total media consumption time, mobile Internet represented roughly 19% of total media time in 2013 according to digital research firm eMarketer. That's forecasted to expand to close to 35% in 2018. eMarketer is forecasting mobile advertising spending of $18 billion in 2014 (10% of total U.S. ad spend), growing to $58 billion in 2018 (26% of total U.S. ad spend), a 34% average annual growth rate. The third point is that online video advertising is at the beginning of an inflection point. Online video advertising is currently a $6 billion market in the U.S. that eMarketer expects to grow 150% over the next five years (20% CAGR) and become a $15 billion market by 2019, increasing from 3.6% of U.S. ad spend in 2014 to over 7% by 2019. We believe that these forecasts will ultimately prove conservative.

I mentioned some YouTube stats on our last podcast that I'll reiterate. YouTube, which is owned by Google, has become one of the largest media businesses in the world. 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.

Facebook is also in the very early stages of rolling out mobile video advertisements. And both YouTube and Facebook have significant scale to take share from TV and other traditional media properties. In summary, many businesses will 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 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 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. 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.

A third theme is favoring market dominant companies with strong brands that are well-positioned to benefit from worldwide growth. Apple would be an example of that. However, recently we have put an increased focus on U.S.-centric companies, given the strength of the U.S. economy. For example, we increased our exposure to the restaurant/casual dining space as these companies should benefit from a stronger U.S. consumer.

The fourth theme is being positioned in companies that are benefitting from a recovering domestic housing activity and in companies that benefit from an acceleration in U.S. nonresidential construction spending. 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-residential spending.  We do expect a cyclical recovery in nonresidential construction in 2015.  Companies that we're invested in here that would relate to this theme would be Home Depot, Lowe's, Fortune Brands, Home Depot Supply and Honeywell.

A 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.  We are placing increased emphasis on this theme given the decline in long term rates.

The last theme I'll talk about is focusing on what we would term "platform companies". Platform companies could be platforms such as Facebook and YouTube.  But we also have another form of a platform company which we would define as a market dominant company with a very strong management team that has a large distribution platform which enables it to acquire and integrate companies into its existing distribution platform at a highly accretive rate.  Honeywell and Actavis are two examples of large positions in the portfolio that we would classify as platform companies.

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

Technology is approximately 33% of the portfolio, similar to 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 a traditional hardware technology company.  Apple continues to execute very well.  They continue to innovate and the iPhone 6 has been a huge success.

We also continue to remain very bullish on Facebook which is our second largest position in Technology.   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.  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.  Facebook has multiple ad revenue growth levers, including additional pricing power, video advertising, the monetization of Instagram, and the monetization of the mobile Internet.  In addition, Facebook has several long-term call options, including its recent WhatsApp acquisition, the Oculus virtual reality product opportunity, payments, and the monetization of Graph Search.

Consumer Discretionary is approximately 15% of the portfolio, down 1% from last quarter.  The decrease is largely due to a reduction in select traditional media holdings, which is consistent with our bullish views on digital advertising.  Hilton is one of our largest positions in Consumer Discretionary.   We increased our position there in Q4.  We see upside to 2015 estimates driven by higher revenue per room and margins. Home Depot and Lowe's have been strong contributors to the portfolio.  We remain very positive on their fundamentals.  We recently reduced some exposure to these companies given price appreciation.  We believe that the investment cycle in home improvement will continue for the next several years supported by steady U.S. job gains and more accessible consumer credit. Royal Caribbean was also a solid contributor in Q4. We think pricing and booking trends will steadily improve in 2015. Lower fuel costs are also a tailwind for Royal Caribbean. We are estimating greater than $7 in earnings in 2017. We feel the stock trades at an attractive multiple relative to the earnings power.

Health Care is approximately 19% of the portfolio, up approximately 3% from last quarter. We remain positive on Health Care. Three points: one, fundamentals remain strong, and there continues to be a tremendous amount of innovation within Health Care; two, we expect the sector to continue to consolidate, and believe this will happen across the subsectors of Health Care; and three, valuations remain attractive relative to other sectors.

Actavis and Gilead are our biggest positions in Health Care. Actavis is a global specialty branded/generic pharmaceutical company. We view Actavis as a platform company. Through recent M&A the company has strengthened its management team and drug distribution platform. We believe the company could exceed its stretch (or aspirational) goal of $25 dollars in earnings in 2017. Despite the recent move in the shares, the company is still valued at 11x our 2017 EPS estimate. In addition, we believe there is optionality to do further highly accretive M&A by adding businesses to this existing asset platform.

Industrials is approximately 10% of the portfolio, roughly in-line with last quarter. We did increase our exposure to airlines in Q4. 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. Honeywell is another example of a platform company. We think they have an excellent management team and a strong global platform across multiple markets which 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 expect Honeywell to accelerate their organic revenue growth in 2015. We also like their leverage to a commercial construction recovery, which represents 20-25% of earnings. In addition, we expect the company to generate significant free cash flow over the next several years, and we think much of this will be able to be used for accretive M&A and stock buybacks.

Energy and Materials is approximately 5% of the portfolio, down fairly significantly from last quarter. The biggest decline was in the Materials sector. The decline in oil and natural gas led us to reduce exposure in that area. In addition, we just haven't found as many good ideas in the Materials space. In Energy, we did move to an underweight position in Q4 as oil prices weakened. We expect oil prices to remain weak through the first half of 2015, before U.S. oil production growth begins to decelerate in the second half of 2015. We expect global oil markets to become better balanced in 2016 as U.S. oil supply grinds to a halt and oil production in other geographies outside of OPEC turns negative. We are expecting oil prices to return to a more sustainable $75 level in 2016. With that said, many energy companies have corrected significantly, and we will look for opportunities as they present themselves in that sector.

Financials is approximately 8% of the portfolio, up slightly from last quarter. We remain positive on the sector. We continue to invest in companies that benefit from an improving domestic economy.  We recently added to our position in Bank of America, the leading U.S. consumer bank.  We think steadily improving labor market conditions, lower commodity/oil prices, and a potentially bigger trade up in housing in 2015 should benefit Bank of America.

We also continue to favor the alternative asset managers including Blackstone Group, which is our largest position in Financials.  Alternative asset managers are benefiting from investors' growing interest in the alternative asset management space.  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.  The fundraising environment for Blackstone remains very strong.  We also believe that the dividends could be higher and more sustainable than the Street is currently modeling, and Blackstone could pay out a high single digit yield for years to come.

Consumer Staples is approximately 5% of the portfolio, up slightly versus Q3.  We remain underweight Consumer Staples.  We think the group is currently close to fully valued at nearly 20x forward earnings versus sector earnings growth expectations in the mid-single digit range.  We are finding more opportunities to generate alpha in other sectors.  CVS continues to be our largest position in Staples and was the biggest contributor in Q4.  The company continues to execute extremely well in both its retail business and its pharmacy benefit management business line.  They also continue 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, an improvement in the U.S. housing sector, the significant increase in U.S. oil and natural gas production which is leading to lower prices in these areas, increased merger and acquisition activity, increased shareholder activism, and the cash yields on equities remaining attractive relative to bonds.  For the first time in 14 years, U.S. real GDP growth could exceed Emerging Markets real GDP growth.  In addition, we continue to see a tremendous amount of change in the equity markets and we look to capitalize on that change.  We continue to have a bias on the U.S. equity markets, but acknowledge that risks remain in many of the markets outside of the U.S.  As a result, we are trying to be neutral in our overall portfolio positioning and allow our stock picking to drive the Alpha within the portfolio.

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.

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characteristics or performance of any specific sector, industry, security, group of securities or a portfolio 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.

As of 12/31/2014, the following represents the Alger Spectra Fund's assets under management: Actavis, Plc 3.77%; Amazon.com, Inc. 0.61%; Apple, Inc. 6.12%; Bank of America Corp. 1.21%; Blackstone Group 1.55%; CVS Health Corp. 1.65%; Facebook, Inc. 4.45%; Fortune Brands Home & Security 0.24%; Gilead Sciences, Inc. 2.69%; Google, Inc. 3.41%; Hilton Worldwide Holdings, Inc. 1.41%; Home Depot Inc. 1.17%; Honeywell International, Inc. 2.01%; Lowes Companies, Inc. 1.31%; Microsoft Corp. 2.30%; Pepsico, Inc. 0.72%; Procter & Gamble Co. 0.35%; Royal Caribbean Cruises, Ltd. 1.10%; Salesforce.Com, Inc. 1.39%; Tesla Motors, Inc. 0.34%; Walgreen Boots Alliance, Inc. 0.48%.

As of 12/31/2014, the following represents the Alger Capital Appreciation Fund's assets under management: Actavis, Plc 3.80%; Amazon.com, Inc. 0.61%; Apple, Inc. 6.12%; Bank of America Corp. 1.22%; Blackstone Group 1.56%; CVS Health Corp. 1.66%; Facebook, Inc. 4.50%; Fortune Brands Home & Security 0.20%; Gilead Sciences, Inc. 2.11%; Google, Inc. 3.19%; Hilton Worldwide Holdings, Inc. 1.43%; Home Depot Inc. 1.19%; Honeywell International, Inc. 2.02%; Lowes Companies, Inc. 1.14%; Microsoft Corp. 2.33%; Pepsico, Inc. 0.72%; Procter & Gamble Co. 0.36%; Royal Caribbean Cruises, Ltd. 1.06%; Salesforce.Com, Inc. 1.37%; Tesla Motors, Inc. 0.34%; Walgreen Boots Alliance, Inc. 0.53%.

As of 12/31/2014, the portfolios held no assets under management for the following companies: Darden Restaurants, Inc.; eBay, Inc.; Workday, 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.

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.**
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