Cyclicals vs. Secular: Choosing Wisely

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“For a company to grow from small to large, it must be able to control its own destiny. How do you control destiny? By having a strong, competitive advantage." Portfolio Manager and Active U.S. Equity Manager of the Year Amy Zhang discusses her focus on the long-term advantages of small caps.

ALEX BERNSTEIN: Hello, I’m Alex Bernstein and you’re listening to The Alger Podcast: Investing in Growth and Change. It’s always a pleasure to speak with Alger Portfolio Manager Amy Zhang, who manages several of our mid- and small-cap strategies. Amy has over 26 years of investing experience including 19 years investing in small caps. And I’m particularly excited to have Amy with me today because she’s just been named “Active U.S. Equity Manager of the Year” by Women in Asset Management. Amy, congratulations on this significant achievement.

AMY ZHANG: Thank you, Alex. I’m deeply honored to receive this award. It really means a lot to me and it’s a testament to Alger’s support for female portfolio managers.

ALEX: Amy, as I mentioned, you’ve been managing small caps for 19 years now. That’s quite a record. Has your process changed at all during that time?

AMY: Well, I mean, the core path process has not changed, but of course, I tweaked the process to be better. It’s like a craft, so you always want to improve and adapt with the time. But as I always say, this is really a three to five-plus investment program because small companies really take time to grow.

ALEX: Amy, I know this is an important part of your process. Why do you focus so much on the three-to-five year period?

AMY: Well, because we think small companies, they do not grow in a straight line. It’s really more about step functions. So, we really try to capture the inflection point hopefully before everyone else. A lot of times there’s a lot of bumps in the road, so we spend a lot of time differentiating bumps in the road versus permanent impairment of fundamentals. So, that really requires distinct mind set of patience. Because at the core of what we do is identifying and investing in small companies that have the potential to become successful large companies.

We don't own household names and we think our portfolio acts as an excellent portfolio diversifier for our clients. So, any given quarter a year we could significantly outperform or underperform the benchmark, but over the long-term, defined by three to five years, we look for those long-term compounders that would generate a strong value creation and we believe that we can generate attractive risk-adjusted returns over the long-term. So, that’s how I think about this strategy, and I think about this at a three-to-five-year investment horizon.

ALEX: And what are the types of companies that you typically look for?

AMY: Well, at Alger we invest in companies that are undergoing positive dynamic change. For a small-cap company, we look for companies really coming of age, still undiscovered, but they have something truly differentiated. Usually it’s a science-based company or technology enabled company that’s in the cutting edge of innovation, that can transform and disrupt the market and gain a lot of market share.

So, what we really look for is robust and durable top-line growth, that will trickle down to earnings per share (EPS) growth over the long-term. So, the kind of companies we look for, they start with one product, but over time they will become a platform company and the key is they will spend a lot on R&D. Of course, I’m talking about the bulk of the portfolio, which is healthcare and technology companies, industrial tech companies.

AMY (continued): Overall, scalability is important for all growth companies, but it's also about scaling profitably and how do you scale profitably to balance both growth and profitability is that you really need to have a very strong, competitive advantage that can sustain durable revenue and profitability growth over the long- term.
We also look at management. For management, it's important for them to usually have a founder-led CEO, that's a visionary, but we also generally want it to have a CFO that can balance the growth and profitability. At the end of the day, we want to look for profitability and fuel EPS growth and that that would drive the stock price over the long term.

ALEX: Amy, I wanted to ask about performance of the small cap focus portfolio in 2021, which I know was a challenging time for the strategy. While Alger Small Cap Focus outperformed its benchmark in both the second and third quarter this year, during the first quarter the strategy lagged the benchmark, and broadly speaking, secular growers lagged the overall market. Can you talk a bit about the first quarter of this year?

AMY: Yes. That was the quarter that we underperformed which as I said, any given quarter a year we could significantly outperform or underperform a benchmark. So, this beginning of the year, as reopening was happening, value stocks came back. There was a very strong, violent rotation to value stocks in the small cap space. High-quality small cap growth companies significantly underperformed. That's our universe.
And also, Q1 was a quarter that was very driven by the ten-year yield, and the yield moved sharply up. The bond market was really dominating the stock market. Nothing has changed fundamentally for most of our companies to have that kind of underperformance. So, usually that's a good time to add to the strategy. But unfortunately, it just happened in a very sort of rapid pace.
So, we underperformed. But then Q2, Q3, we made up ground, so we're still on the process.

ALEX: Amy, it seems like the markets have seen a consistent tug of war this year between cyclical stocks and secular names. What do you think the future holds for cyclicals versus secular?

AMY: I think there's going to be a period of time when they can both do well. With earnings season there is going to be idiosyncratic drivers for both, and I think the cyclical companies, some of them, they can still do well because there is some higher quality, cyclical low quality, and the ones that can sustain their earnings growth and the one has some secular drivers in there, probably can continue to do well. However, a cyclical company, as I always say, it's like a sailboat, right? So, they look pretty, but we think they are really very easy to be tipped over by any storm. And I would say secular growth companies, like the kind of companies we're investing in, are really like motorboats. So, they're really powered by value-creating engine, namely innovation for the most part, that would really propel its growth regardless how the wind blows, right? Even on a terrible day, it can still power through.
So, those are the kinds of companies we invest in because we think a lot of cyclical companies will roundtrip each other, right? That's very common in value companies. But for secular companies, we think it's not going to be a straight line, but you're going to capture the trajectory, the growth trajectory and the stock price appreciation will really follow that value creation, that growth trajectory. We believe, for a company to grow from small to large, you have to be able to control your own destiny. How do you control destiny? You have to have a very strong, competitive advantage, a wide moat, and really sustain that moat, have pricing power, coupled with unit growth, of course, and that's very different in cyclical companies.
And in terms of odds, I would say a lot of it is pattern recognition experience. That's what I've been doing for 19 years. Know what we're looking for, be early and be right, think large, think big and think long.

ALEX: Amy, let's dive into your portfolio for a minute. As we mentioned, I know you have a particular focus on innovation, technology, and healthcare. Can you talk about a holding that stands out for you that exemplifies your process?

AMY: Yes. As you know, we invest in companies that save time, lives, money, headaches. But there's nothing more important than saving lives, and healthcare. I've been overweighting healthcare since last year. Healthcare underperforms just relative to some other sectors, but we think we still own a lot of the gems.
The one company that I want to highlight has just been one of our top positions throughout. You basically see it in our top ten almost every quarter: CryoPort. So, we believe the genomics revolution is really the future and it's front and center for investors in healthcare.

AMY (continued): It's been going on for many years, but finally I think it's coming to fruition. I remember investing in the genomics revolution back in 2002, but almost 20 years later I think we can say it's a much better version.

The cell gene therapy market has become a large and a rapidly growing opportunity for biopharma companies and has targeted personalized medicine and its therapies are really garnering significant R&D dollars. As a focus portfolio for healthcare, we generally do not invest in biotech companies because they tend to have very binary outcomes.

So, instead, we invest in companies that provide the picks and shovels to the gold miners. If I were in a gold rush, I'd want to be a hardware store, right? So, CryoPort is one such company. We were very early investors in CryoPort back in May – I remember it was May 1st, 2018. CryoPort, what they do is they provide highly specialized temperature-controlled supply chain solutions to the life science industry. The company has specific expertise in shipping products and samples at cryogenic temperatures. One key indicator for that is minus 196 degrees Celsius.

So, maintaining the correct temperature is absolutely critical and not everybody can do it well and I think they do it the best in their industry, both in terms of depth and breadth of what they could do because you really need to minimize the degradation and avoid spoilage of those extremely valuable therapies, right? It's the therapies, but also the embryo, because they're also an in-vitro fertilization (IVF) business and they also provide near real-time monitoring capabilities for customers to track the location and other critical variables for each shipment.

They really have a very broad exposure to the cell gene therapy. We think that the cell genes therapy market is experiencing explosive growth of 30 to 40 percent. Last year, the company made two highly strategic and transformative acquisitions that really accelerated the company's path to become a truly global platform to serve the biopharma customers. And they are also involved in COVID in terms of both vaccines and therapies, which is very important, about 36 COVID-related vaccine therapies at the end of Q2 this year. So, we really think this is a company that is still small-cap but the future is really in front of it.

ALEX: Amy, one last question for you. In the wake of this year's market fluctuations, how do you think investors should be looking at growth and small caps right now?

AMY: Oh, I think the outlook for growth is very bright, especially for small cap growth. For a small company, how does it become big? We think all the successful small companies are destined to potentially become large companies.

Yes, interest rates are going higher, and people worry about inflation. But we believe all the technologically-enabled innovative companies are deflationary, whether it's in healthcare, whether it's in technology or industrial tech, any growth company – because automation is about costs, right? You know, doing high-throughput diagnostic tests, that's cutting costs. So, we believe anything that's digital transformation, it's turning data into actual information, that's all about cutting costs. So, when we look at our companies, we believe the fundamentals are really very strong. Again, you only reopen once, and generally we're still in that reopen phase. Once life normalizes, we still have to go with companies that have the strongest fundamentals and can grow from small companies to large companies because, again, the power of compounding is very significant. So, to that extent, I think the future for growth is very bright.

ALEX: Amy, thanks so much for joining me this afternoon.

AMY: Thanks, Alex. Great talking to you.

ALEX: And thank you for listening. For more information on Amy Zhang and Alger's Small Cap strategies, please visit www.alger.com.

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The Board of Trustees of the Alger Small Cap Focus Fund has authorized a partial closing of the Fund effective July 31, 2019. Class A, I and Z Shares will be available for purchase by existing shareholders who maintain open accounts and new investors that utilize certain retirement record keeping platforms identified by Fred Alger & Company, LLC, the Fund's distributor. Class I and Z Shares will also be available for purchase by investors who transact with certain brokers identified by the distributor. Please check with your financial advisor regarding the availability of Class I and Z Shares for purchase at their firm. Class Y Shares will remain open to all qualifying investors.

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The following position represented the noted percentages of the Alger Small Cap Focus Fund as of 9/30/21: CryoPort, Inc., 3.75%.

Average Annual Total Returns (%) (as of 9/30/21)

	Q1	Q2	Q3	YTD	1 Year	3 Years	5 Years	10 Years	Since Inception
Class A (Incepted 3/3/08)									
Without Sales Charge	-4.12	5.72	-3.19	-1.87	17.55	13.71	21.79	18.49	12.82
With Sales Charge	-9.16	0.16	-8.27	-7.03	11.37	11.67	20.48	17.89	12.38
Class Z (Incepted 3/3/08)	-4.00	5.81	-3.11	-1.58	17.96	14.13	22.20	18.97	15.58
Russell 2000 Growth Index	4.88	3.92	-5.65	2.82	33.27	11.70	15.34	15.74	11.61

Total Operating Expenses by Class	Without Waiver:	A: 1.22%	Z: 0.85%
(Prospectus dated 3/1/21)	With Waiver:	—	—

Only periods greater than 12 months are annualized.

Prior to August 7, 2015, the Fund followed different investment strategies under the name "Alger Growth Opportunities Fund" and prior to February 12, 2015was managed by a different portfolio manager. Effective August 7, 2015, the Fund's primary benchmark is the Russell 2000 Growth Index.

The performance data quoted represents past performance, which is not an indication or a guarantee of future results. Investmentreturn and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost.Current performance may be lower or higher than the performance quoted. Performance figures assume all distributions are reinvested. Returns with sales charges reflect a maximum front-end sales charge on Class A Shares of 5.25%. For performance current to the most recent month end, visit www.alger.com or call 800.992.3863.

DISCLOSURE

Women in Asset Management utilized several criteria when selecting a recipient of its Active US Equity Manager of the Year award. All qualified nominees were female portfolio managers, or, alternatively, women who have active roles via their research on/analysis of U.S. listed equities. Qualified nominees could be involved in a publicly available fund or in an institutional portfolio. Judges considered portfolio performance statistics as well as evidence of challenges faced and overcome by nominees. No ranking was conducted as part of the winner selection process.

Before investing, carefully consider the Fund's investment objective, risks, charges, and expenses. For a prospectus and summary prospectus containing this and other information or for the Fund's most recent month-end performance data, visit www.alger.com, call (800) 992-3863 or consult your financial advisor. Read the prospectus and summary prospectus carefully before investing. Distributor: Fred Alger & Company, LLC. NOT FDIC INSURED. NOT BANK GUARANTEED. MAY LOSE VALUE.