

ALGER

Inspired by Change, Driven by Growth.

Autumn 2021

Capital Markets: Observations and Insights

The Interest Rate Threat



Alger is committed to sustainability and is a signatory to the PRI.

The Interest Rate Threat

As the lagged impact of massive stimulus combines with supply chain bottlenecks and recovering demand, interest rates threaten to move higher from their historic lows. Clearly, this would be negative for fixed income securities and may challenge the traditional approach of so-called balanced portfolios as we discussed last quarter. But what would be the impact on stocks?

Equity represents ownership of corporate cash flows, not a fixed coupon stream. For many companies, higher inflation may be a positive for their growth prospects -- in particular, inflation may support pricing power for a company's products or services and may drive higher growth and/or levels of net income and free cash flows for shareholders. At Alger, we believe, and indeed look for, companies that have a stronger margin structure than average, driven by competitive advantages that support both pricing power and lower costs than their competitors. We have long invested in companies with "network effects" within their business. Payment networks and ecommerce-driven marketplaces are two examples of business models that may benefit from inflation and higher prices, in our opinion, because their revenues are based on a "toll" or "take rate" that is a percentage of value transacted by consumers and businesses operating on or using their network service offering.

Our research suggests that interest rate changes often significantly impact short-term trading in the stock market, but over time the market rewards fundamental growth and quality which, for many sectors and companies, are not materially impacted by interest rate changes. We believe the opportunity in the near term is again to invest in growth stocks of the leading innovators and disruptors of our time for long-term wealth creation.



Daniel C. Chung, CFA
Chief Executive Officer
Chief Investment Officer



Brad Neuman, CFA
Senior Vice President
Director of Market Strategy

Key Observations and Themes

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Higher interest rates may impact asset allocation, but we believe company fundamentals are unlikely to be significantly impacted, keeping our growth equity focus intact.

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Excess savings and still-recovering areas of the economy may provide a strong base for growth, but fiscal tightening and less accommodative monetary policy are headwinds.

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With the non-U.S. valuation discount historically large, investors may be able to find the growth they crave at the values they want outside of the U.S.

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Secular investment trends may transcend economic volatility, politics and central bank actions, producing compelling investment opportunities over the long term.

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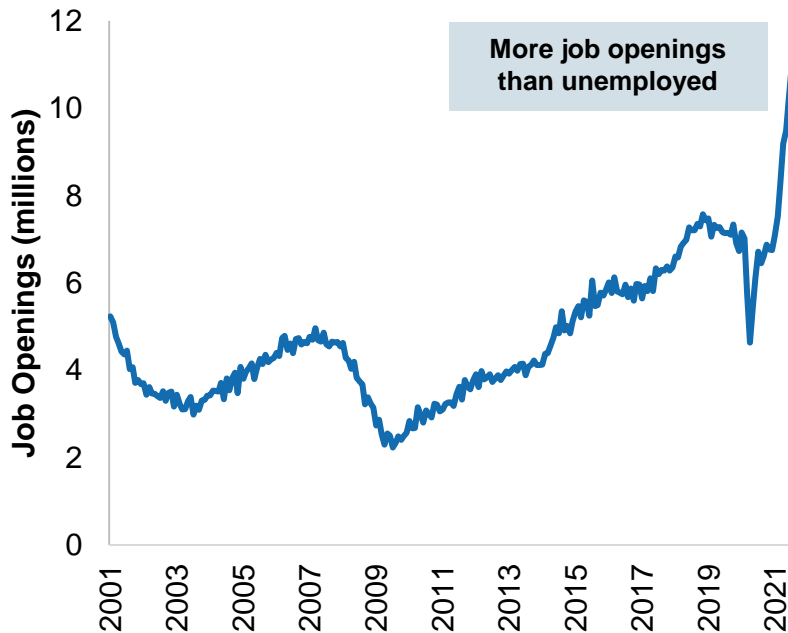
Powerful structural forces may keep the long-term trend of Growth outperformance intact, in our view.

Interest Rate Threat

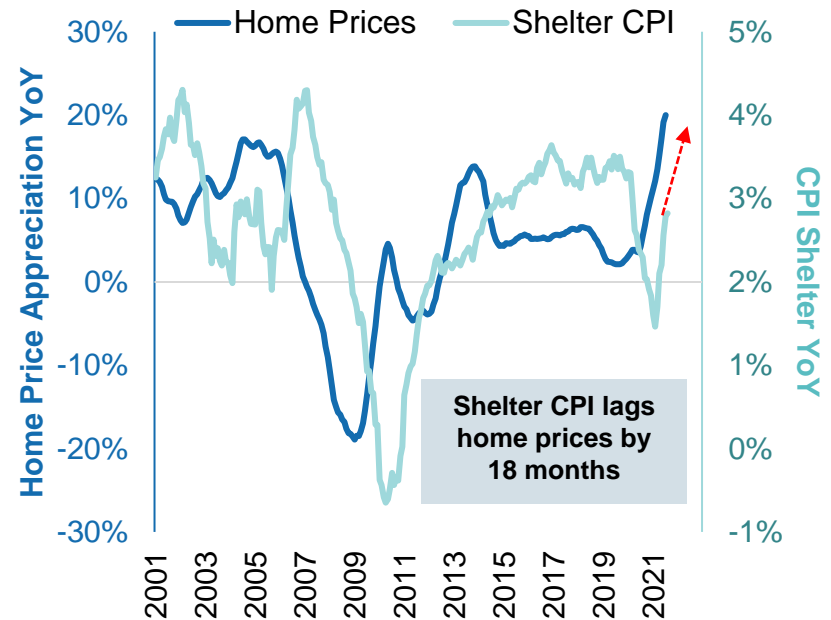
Inflation Pressure – Wages and Housing

- While input prices of all kinds have increased significantly, including raw materials and energy, forthcoming growth in wages and shelter may put upward pressure on inflation

Record U.S. Job Openings To Drive Higher Wages?



Higher Shelter Expense to Support Inflation?



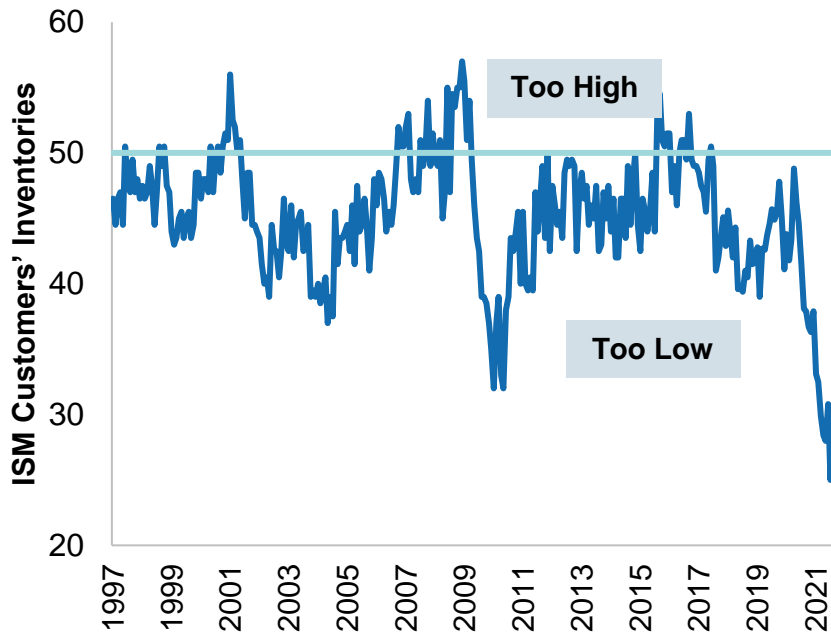
Source: Bureau of Labor Statistics. The Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by U.S. urban consumers for a market basket of consumer goods and services. Shelter CPI, which measures the cost of rent or the equivalent cost of rent for U.S. homeowners, is one-third of total CPI.

Interest Rate Threat

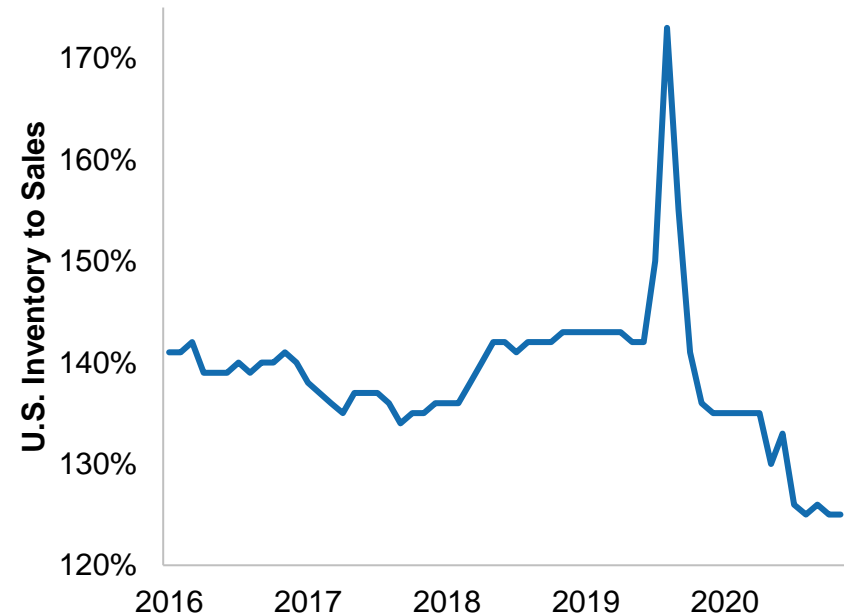
Inflation Pressure – Supply Chain

- Supply chain problems and input shortages are hampering production and causing low inventories
- The resulting supply/demand imbalance may allow companies to boost price levels across the economy

Inventories Are Too Low...



...Particularly Relative to Sales



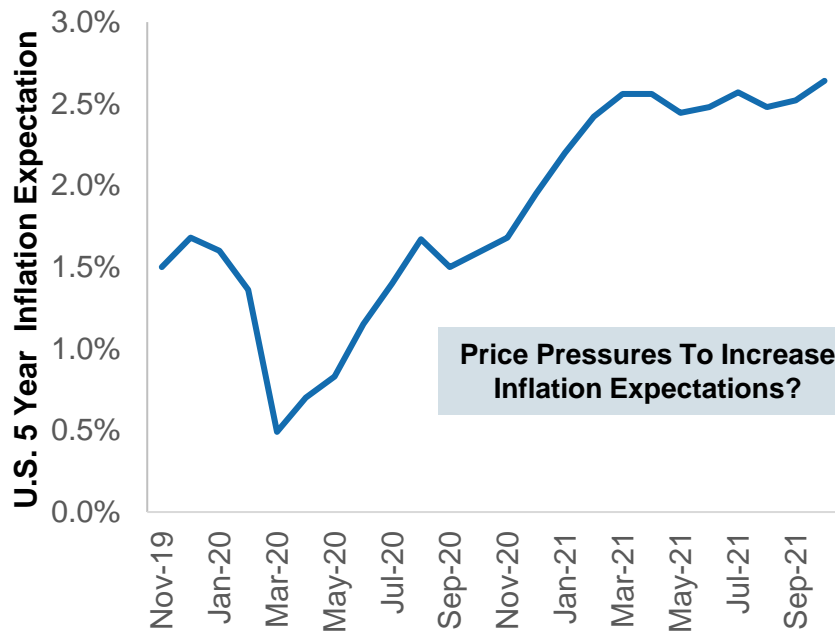
Source: Institute for Supply Management® (ISM) Manufacturing Report On Business® and U.S. Census Bureau.

Interest Rate Threat No Where to Go But Up?

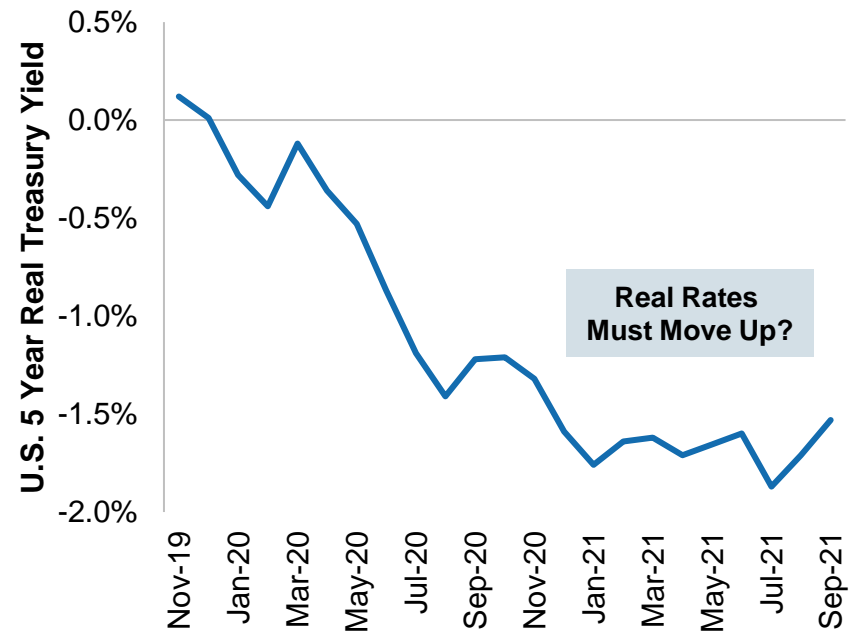
- If inflation expectations move higher, they are unlikely to be offset by lower real interest rates, which are more likely to move up than down, in our view

Two Main Components of Interest Rates

Inflation Expectation



Real Rates

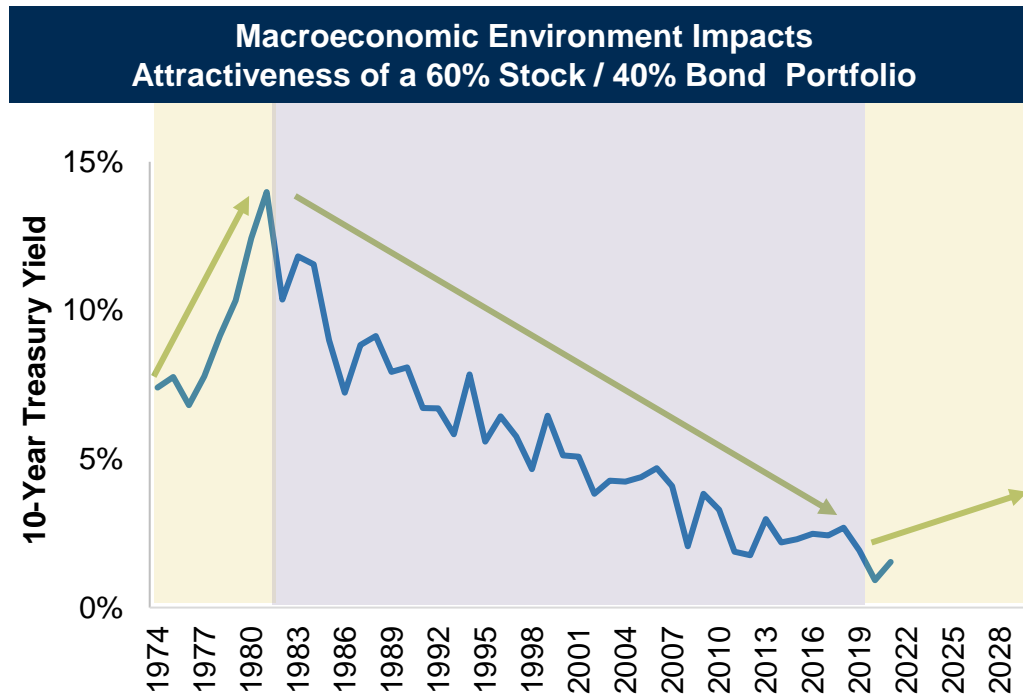


Source: FactSet. Note: inflation expectations based on difference between 5-year nominal U.S. Treasury and inflation-adjusted yield. U.S. 5-Year Real Treasury Yield represented by 5-year TIPS (Treasury Inflation-Protected Securities).

Interest Rate Threat

Trouble for Bonds and Balanced Portfolios?

- What worked in a declining interest rate environment may not work going forward
- The next decade is unlikely to be as friendly to fixed income and a balanced portfolio given very low bond yields and the lack of further downside to interest rates, in our view



■ Sharpe ratio for stocks exceeds 60%/40% portfolio

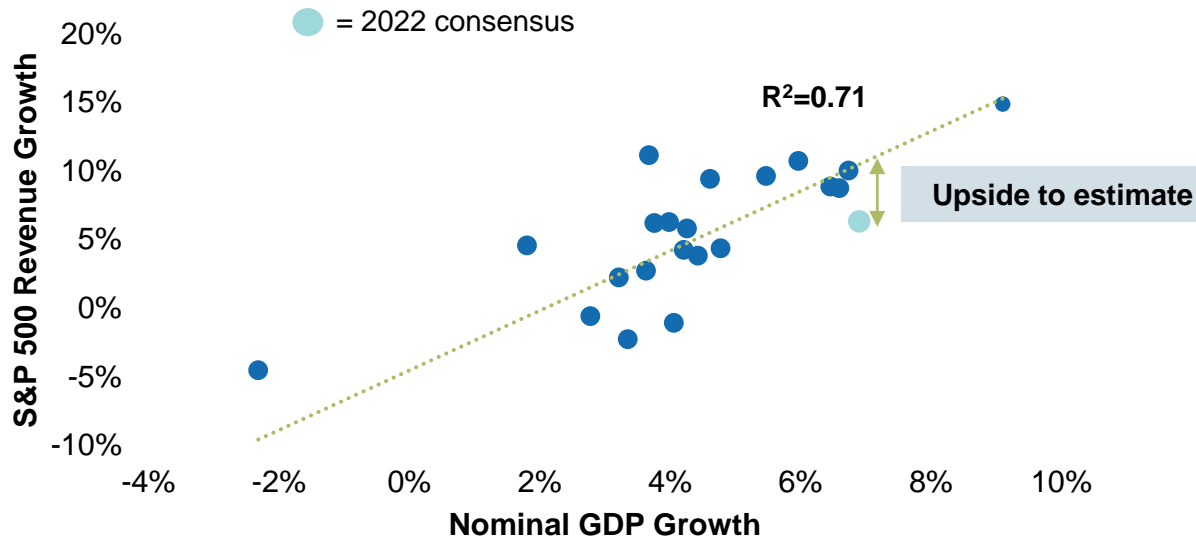
Source: FactSet and Alger. Stocks represented by S&P 500 and bonds by Bloomberg Barclays U.S. Aggregate Bond Index. Last datapoint is 9/30/21. Sharpe ratio is a measure of risk-adjusted return and is calculated as the difference of the return of a portfolio and the risk-free rate divided by the standard deviation of those excess returns.

Interest Rate Threat

Equity Fundamentals Are Nominal

- Corporate sales tend to grow with nominal GDP, which equals real growth plus inflation
 - Current GDP forecast implies more than 200bps upside to revenue estimates
- Companies with pricing power or less input pressure may grow their earnings at or faster than revenue while others may see margin degradation

Inflation Helps - S&P 500 Revenue Grows with Nominal GDP



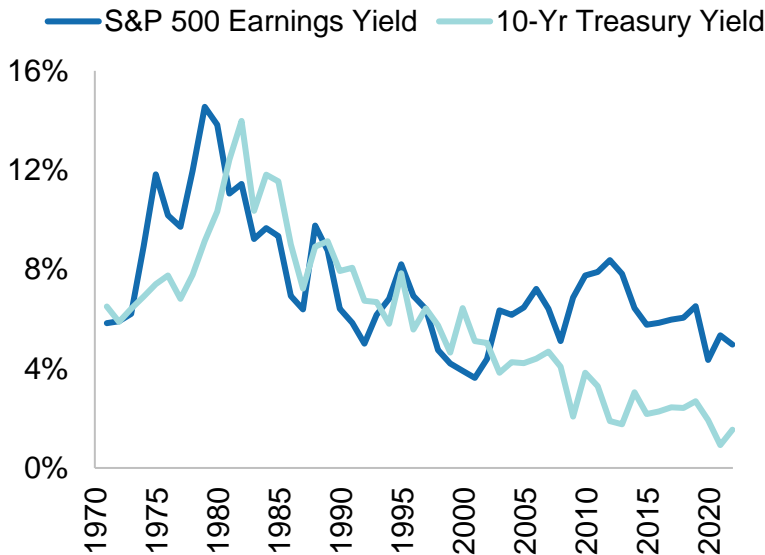
Source: FactSet. Annual data from 2000 through 2021. R-squared measures a relationship estimate between two variables.

Interest Rate Threat

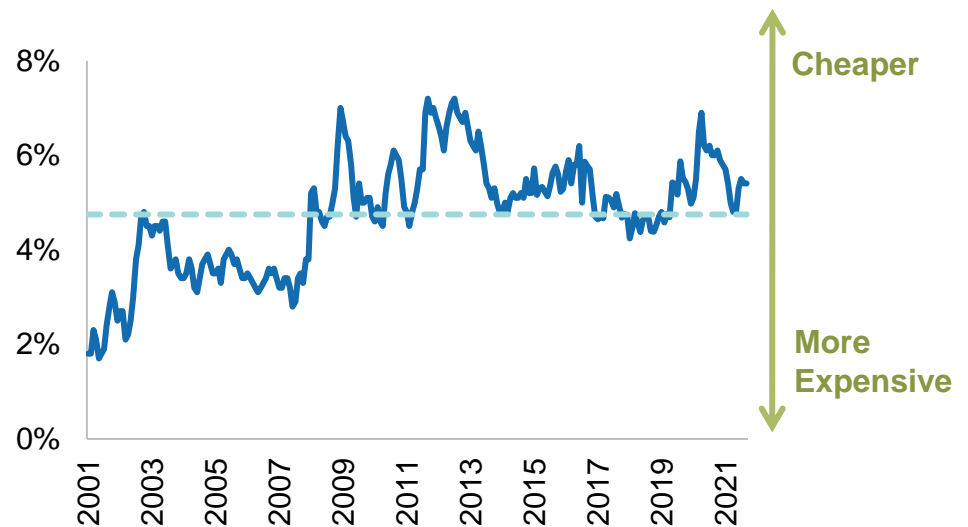
Shock Absorbers for Stocks?

- Stocks look relatively inexpensive to bonds, whether measured by the earnings “yield” over bonds or the equity risk premium
- This means that a modest increase in interest rates may not make stocks look expensive to bonds all else equal

Bond vs. Equity “Yield”



Estimated U.S. Equity Risk Premium



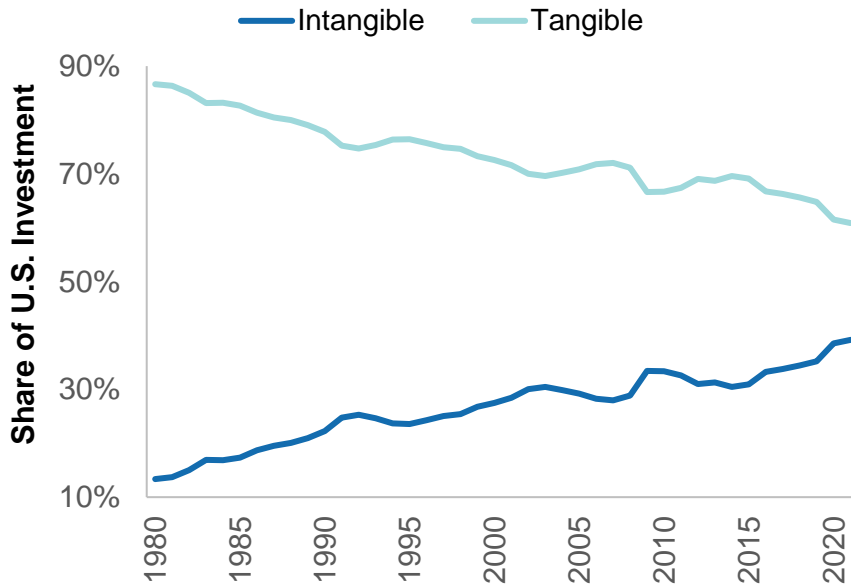
Source: FactSet, Goldman Sachs. Note: The market implied equity risk premium (ERP) is the rate that at each point in time makes the theoretical value from GS Dividend Discount Model equal to the observed market price.

Interest Rate Threat

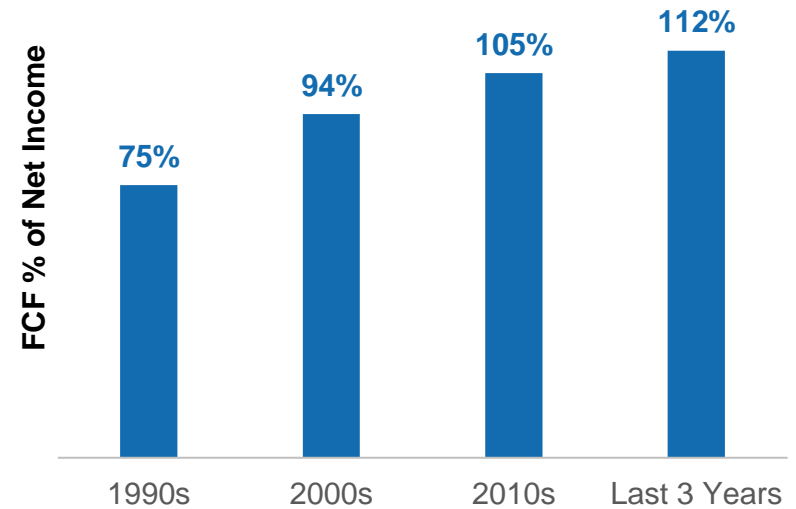
Accounting Errors

- Companies are increasingly investing more in intangible assets (e.g., R&D), that are expensed rather than capitalized, causing earnings to decline relative to free cash flow
- We believe that if higher free cash flow conversion is considered, it would imply a higher price-to-earnings ratio is appropriate relative to history

Rising Intangible Investment



Free Cash Flow Conversion Increasing



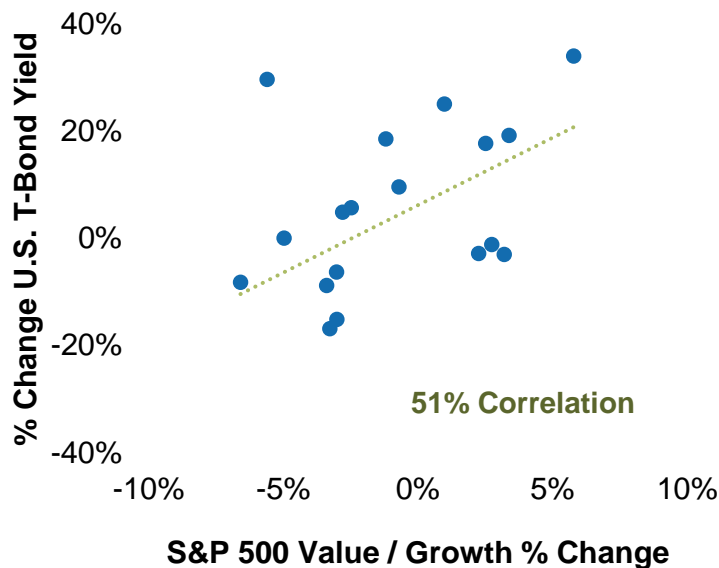
Source: Share of U.S. investment is based on gross private nonresidential domestic investment from the Bureau of Economic Analysis through 2Q21. Free cash flow conversion, which is free cash flow divided by net income, is from FactSet as of 9/30/2021.

Interest Rate Threat

Fundamentals, Not Rates, Drive Style Performance

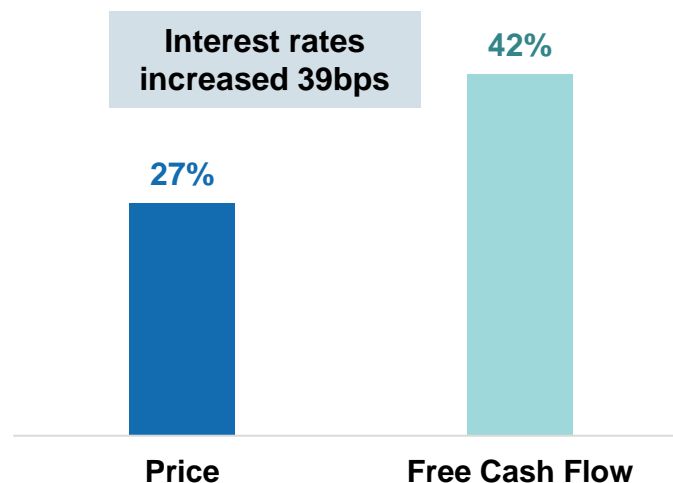
- Value has tended to outperform Growth stocks when interest rates rise in the short term (e.g. monthly)
- Driven by Value's greater economic sensitivity and more Financials exposure
- Over the longer term, trading dynamics may fade, and fundamentals may dominate
- For example, during the pandemic, when rates rose but Growth dramatically outperformed

Style vs. Interest Rates
March 2020 – Present (Monthly)



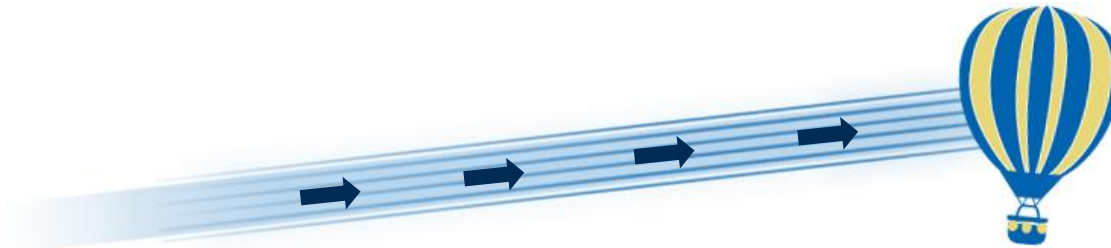
Style vs. Interest Rates
March 2020 – Present

S&P 500 Growth / Value Relative Performance



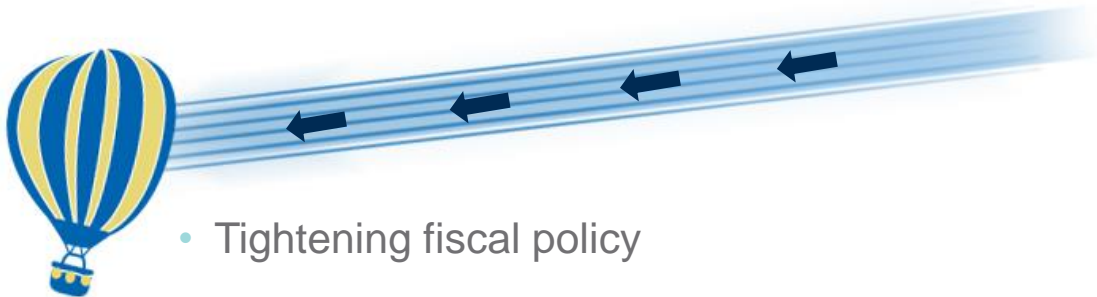
Source: FactSet and Alger. Free cash flow represents trailing 12-months. The performance data quoted represents past performance, which is not an indication or a guarantee of future results.

Tailwinds



- Robust consumer savings
- Growing corporate profits
- Inventory rebuilding
- Strong labor market
- Recovery in depressed economic areas

Headwinds



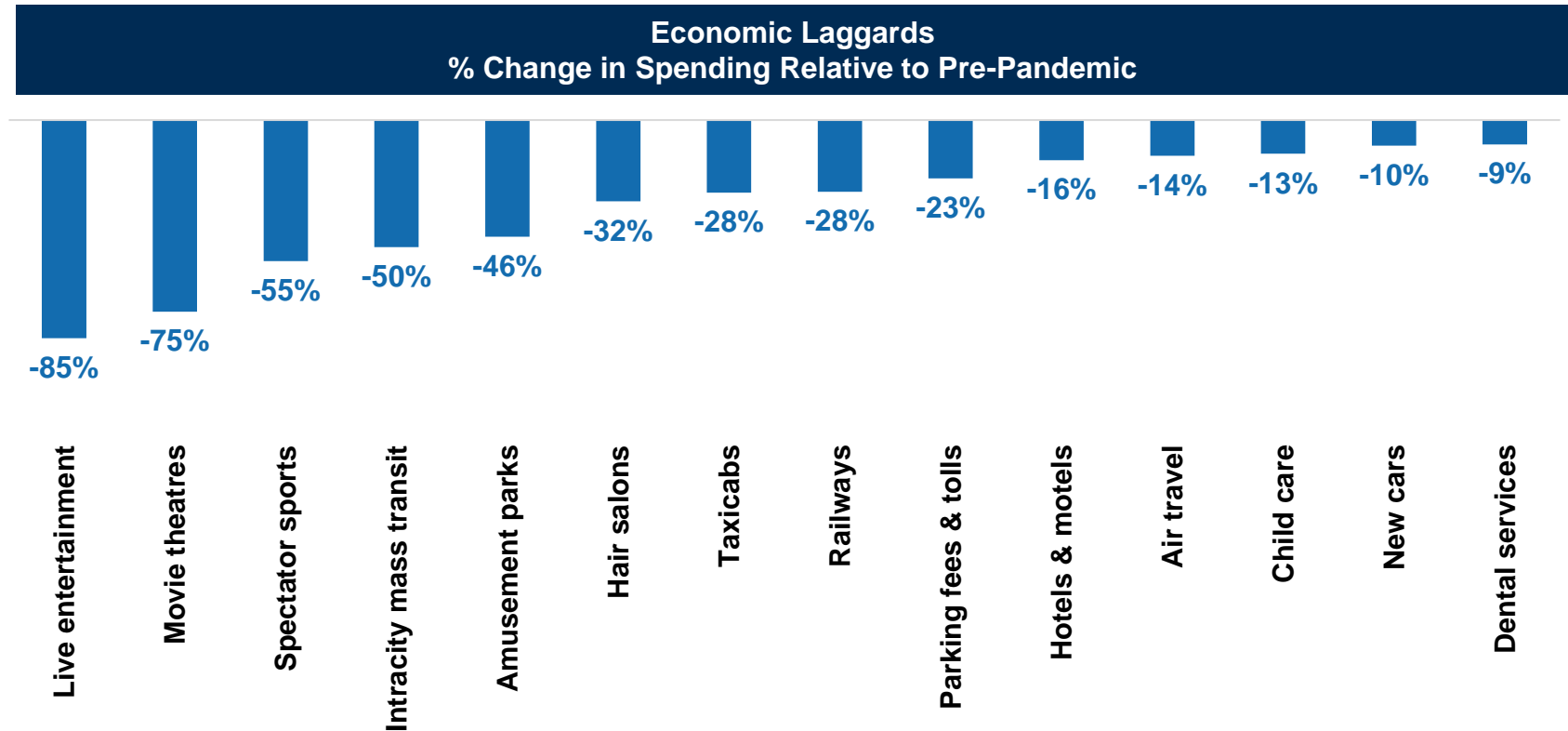
- Tightening fiscal policy
- Less accommodative monetary policy
- Inflation pressures
- China growth slowdown



Economic Crosscurrents

Reopening Tailwind

- Some areas of the U.S. economy have not yet recovered including spending in travel & leisure, personal care, and transportation
- As life returns to normal, spending in these categories should grow



Source: U.S. Bureau of Economic Analysis and Alger. Data through August 2021 and is compared to December 2019.

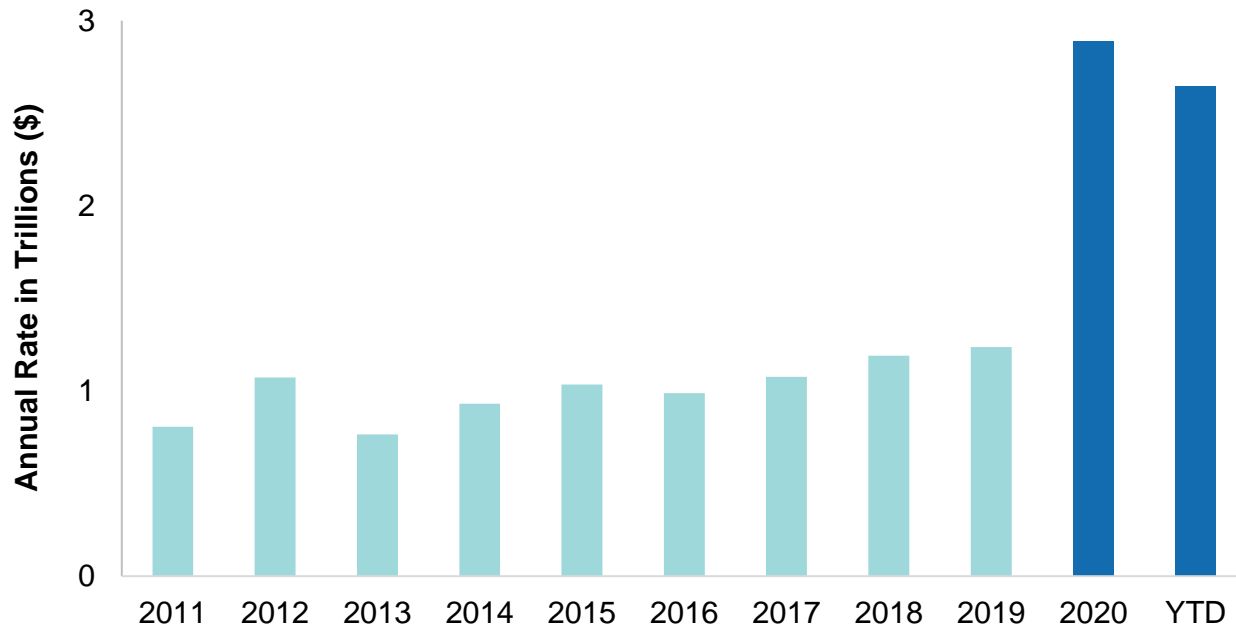


Economic Crosscurrents

Surging Savings

- Stimulus has driven very high savings levels, a portion of which will ultimately be spent and may drive very strong consumer spending, in our view

U.S. Personal Savings Explodes Higher



Trillions of dollars of recent *incremental* savings could come back to the economy

Source: U.S. Bureau of Economic Analysis. Data through Aug 2021 which was reported in early October 2021.

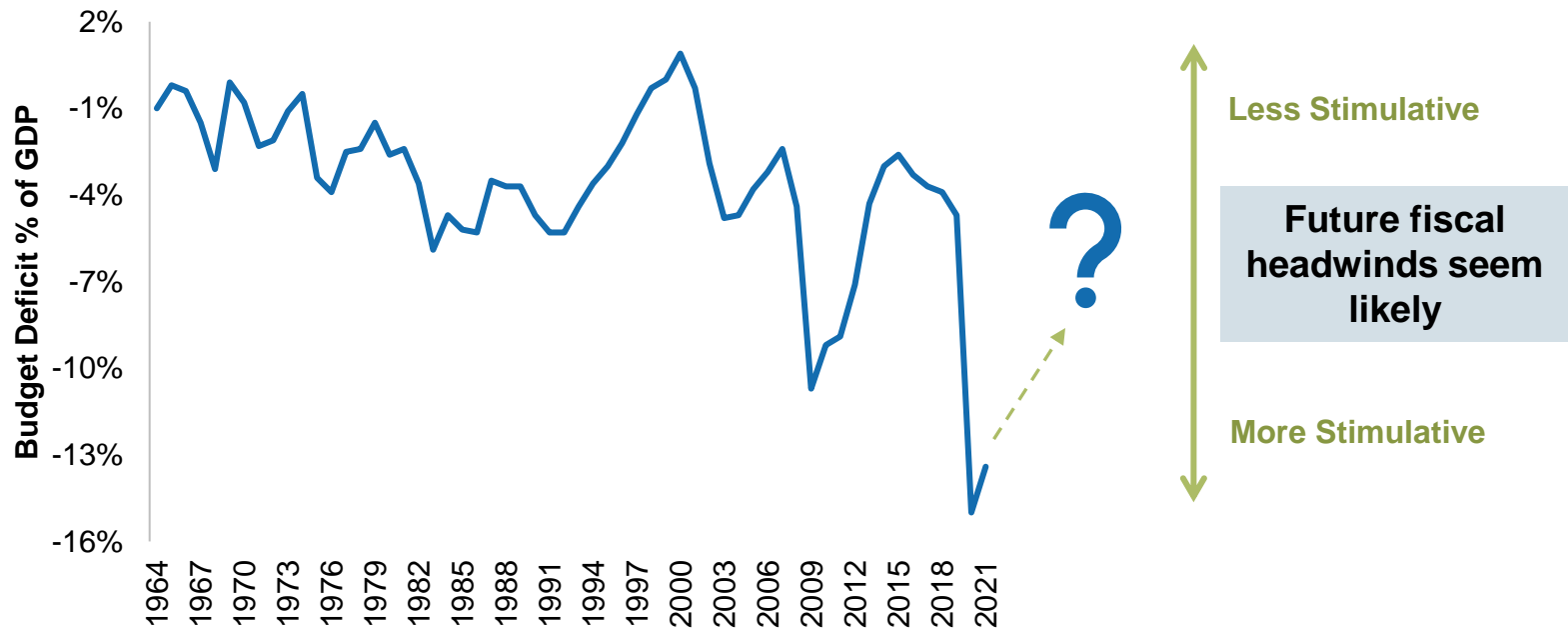


Economic Crosscurrents

Fighting Fiscal Pressure

- The U.S. economy experienced large fiscal stimulus during Covid but that is set to wane next year and beyond as government outlays fall and higher taxes increase receipts
 - Government spending averaged 30% of GDP during the pandemic as compared to the 20% average in the past couple of decades

Lower Fiscal Deficits May Weigh on the Economy



Source: Congressional Budget Office, July 2021.

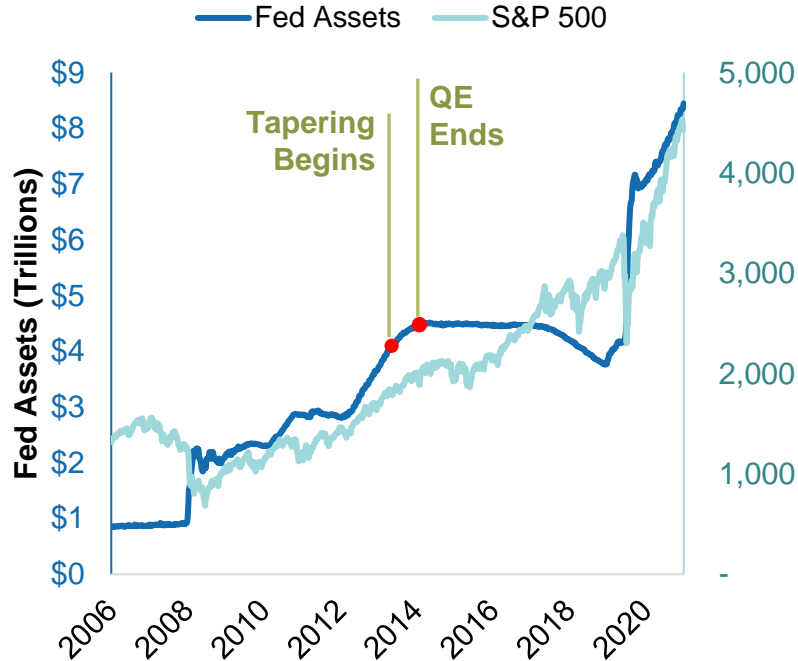


Economic Crosscurrents

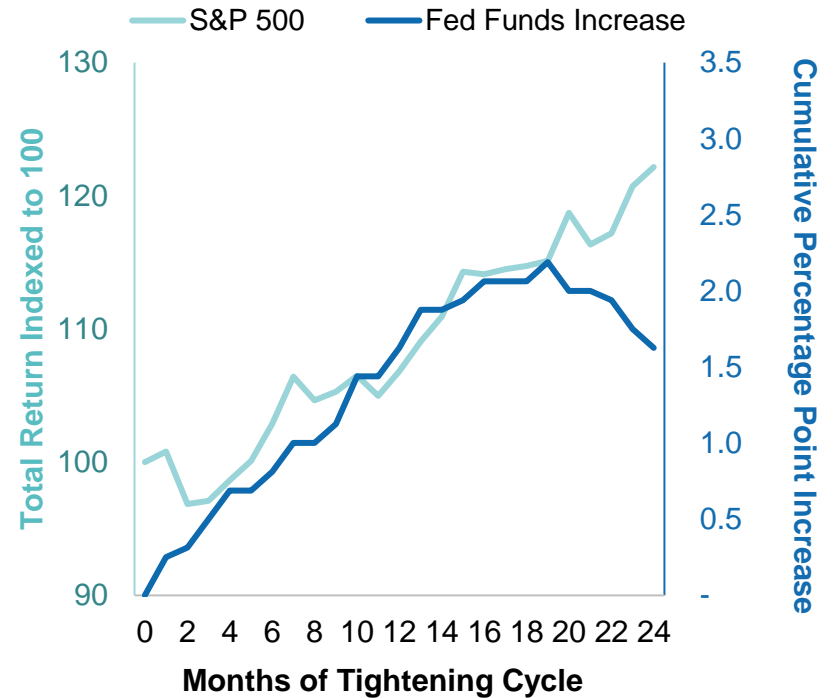
Fed to End the Party?

- When the Fed tapered last, the stock market continued to rise
- Equities have historically rallied through the Fed tightening cycle

Tapering Did Not Crush the Equity Rally



Stocks Have Risen Through Fed Tightening



Source: FactSet, Alger. Average of the four most recent two-year tightening cycles beginning in February 1994, June 1999, June 2004, and December 2015. The performance data quoted represents past performance, which is not an indication or a guarantee of future results.

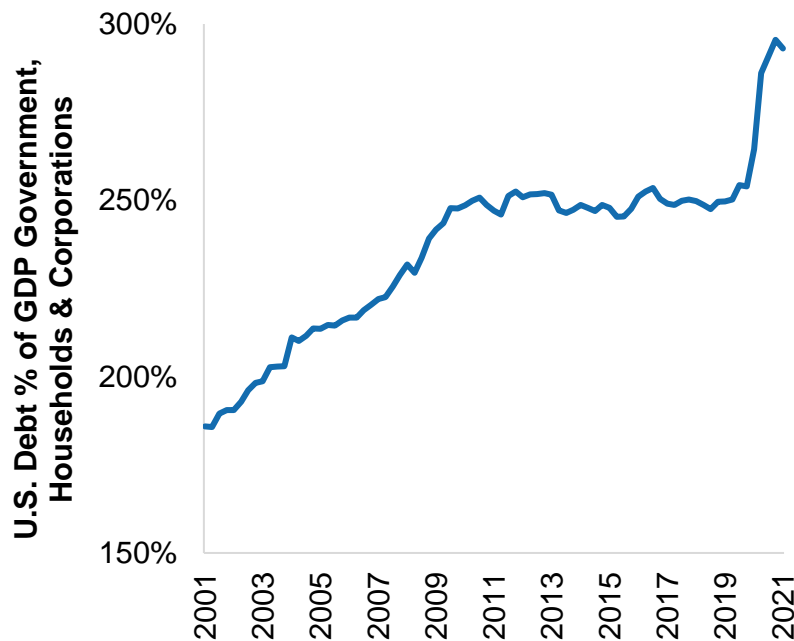


Economic Crosscurrents

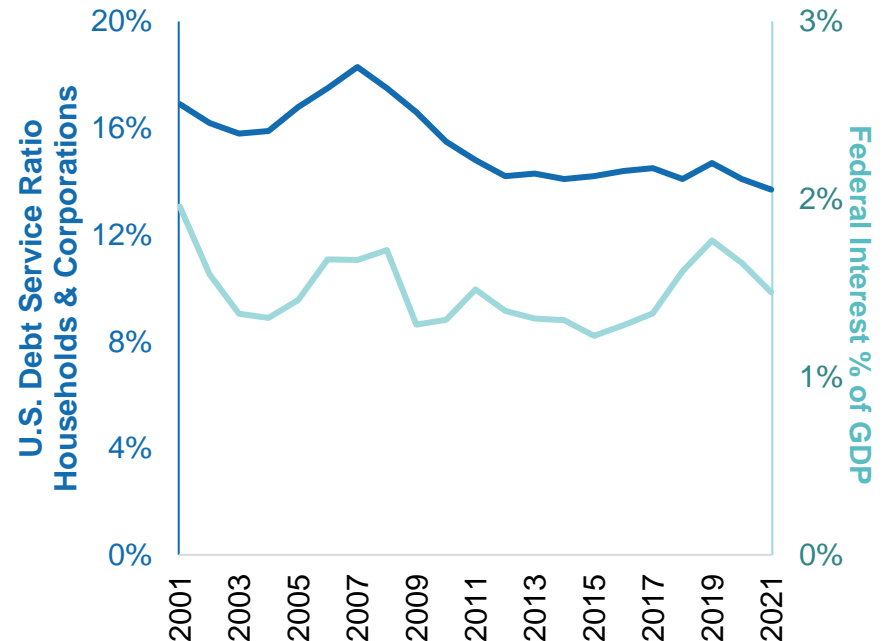
No Debt Hangover Yet?

- Huge fiscal stimulus and easy financial conditions have caused a surge in U.S. debt
- However, the cost to service the private and federal debt is not high relative to history

U.S. Debt Levels Are Very High...



...But The U.S. Debt Service Burden Is Not

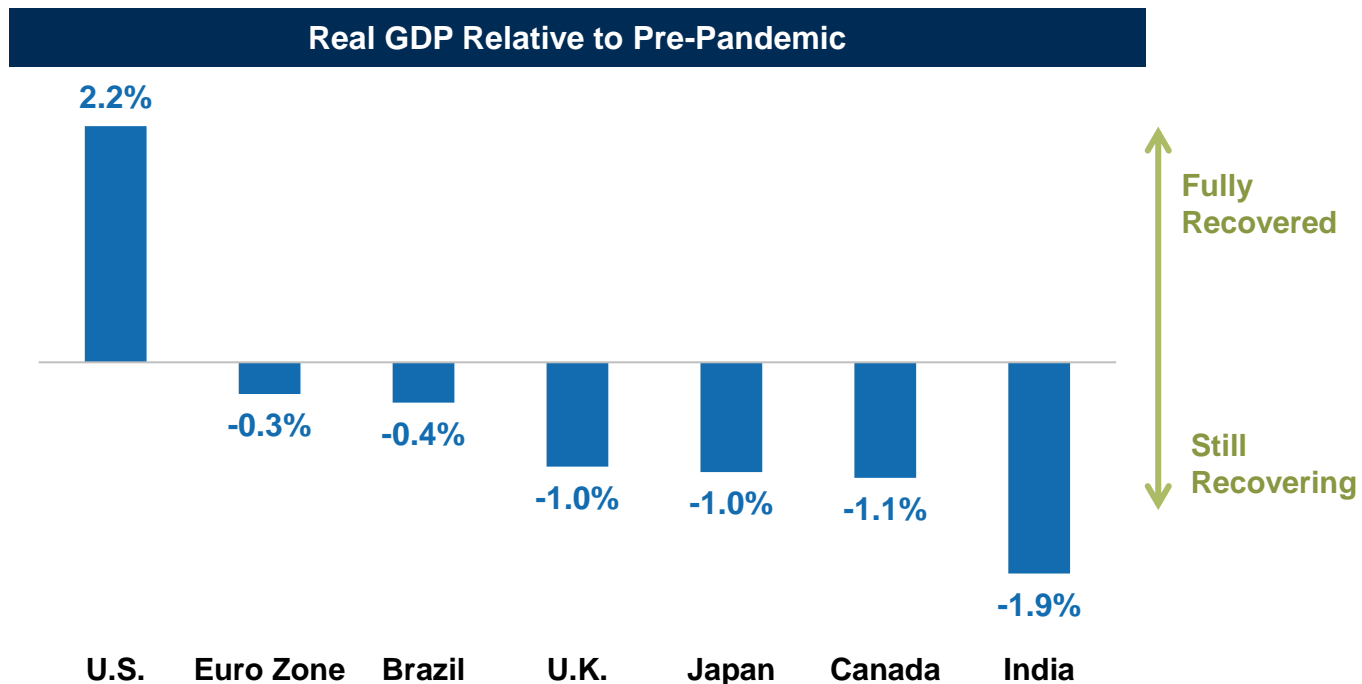


Source: Bank for International Settlements, September 2021 and Congressional Budget Office. Debt Service Ratio is the share of income used for interest payments and amortizations in the non-financial private sector.



Looking Abroad Playing Catch-up

- Many countries are behind the U.S. in battling the pandemic
- International and emerging markets may be attractive as they catch up economically

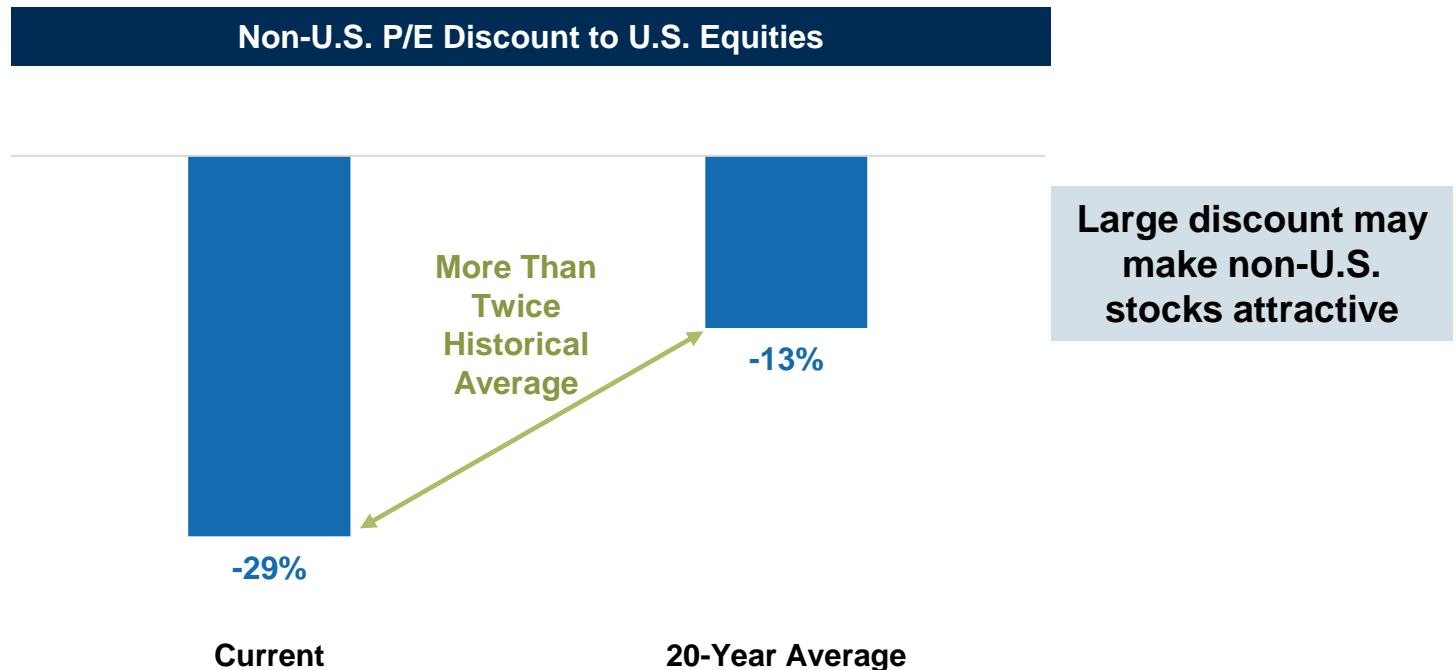


Source: FactSet. Each country's pre-pandemic baseline is its end of 2019 real GDP. Data is through 3Q21 using estimates as of 9/30/21.



Looking Abroad On Sale

- Non-U.S. stocks typically trade at a discount to U.S. equities, but that discount is more than twice as large as it has been historically



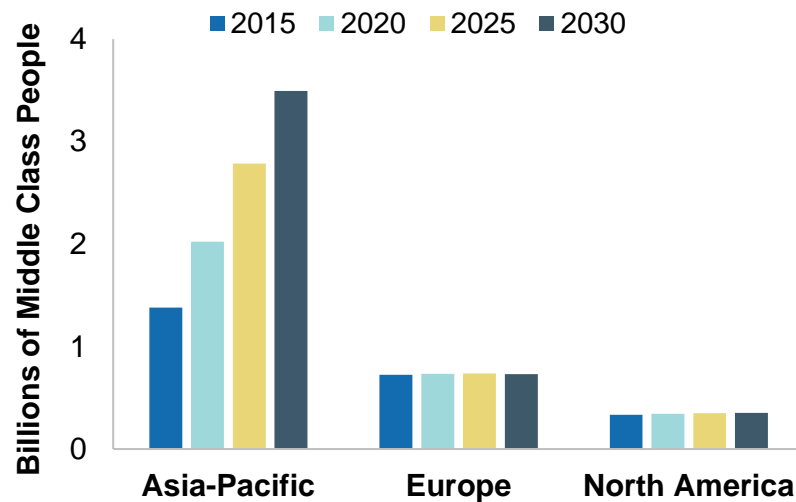
Source: FactSet and Alger as of 9/30/21. Non-U.S. stocks represented by MSCI AC World ex-U.S. index. U.S. stocks represented by S&P 500.



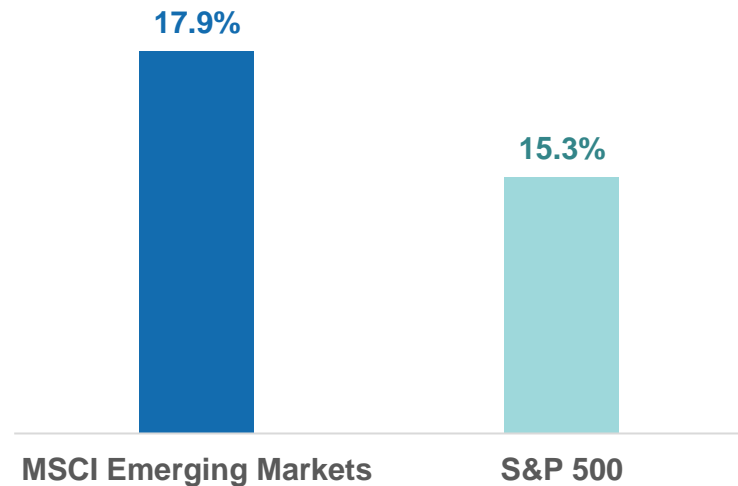
Looking Abroad Emerging Market Growth

- The demographics in emerging markets is a significant growth factor
- Drives materially stronger long-term earnings growth within emerging markets

The Asian Middle Class Is Expected to Grow



Long-Term EPS Growth Greatest in EM



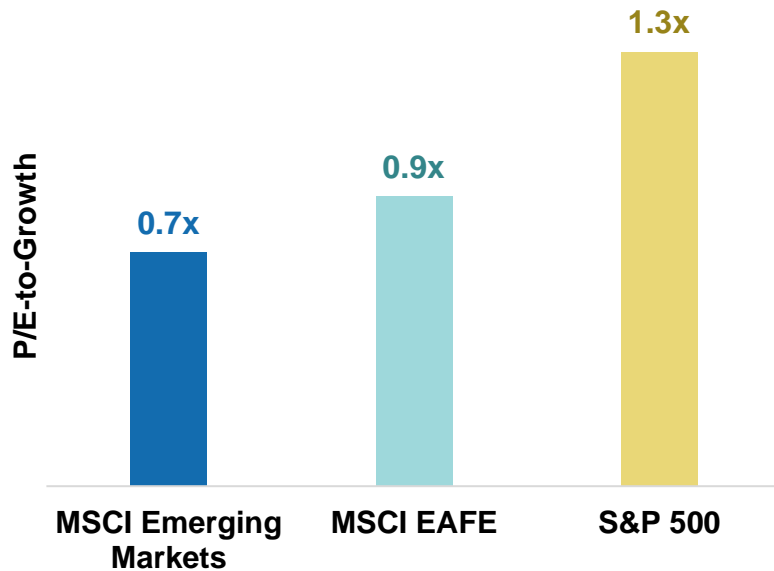
Source: Middle class estimates from Brookings Institution. A middle-class family has an approximate income of \$16,000 to \$160,000 in purchasing power parity terms. EPS growth estimates from FactSet as of 9/30/21.



Looking Abroad Cheaper Growth

- Investors may be able to find the growth they crave at the values they want in non-U.S. stocks
- Equities in key innovation categories often trade for much cheaper valuations in foreign markets as compared to those within the U.S.

Growth is Cheaper Outside of the U.S.



Innovative Themes Available For Less in Non-U.S.

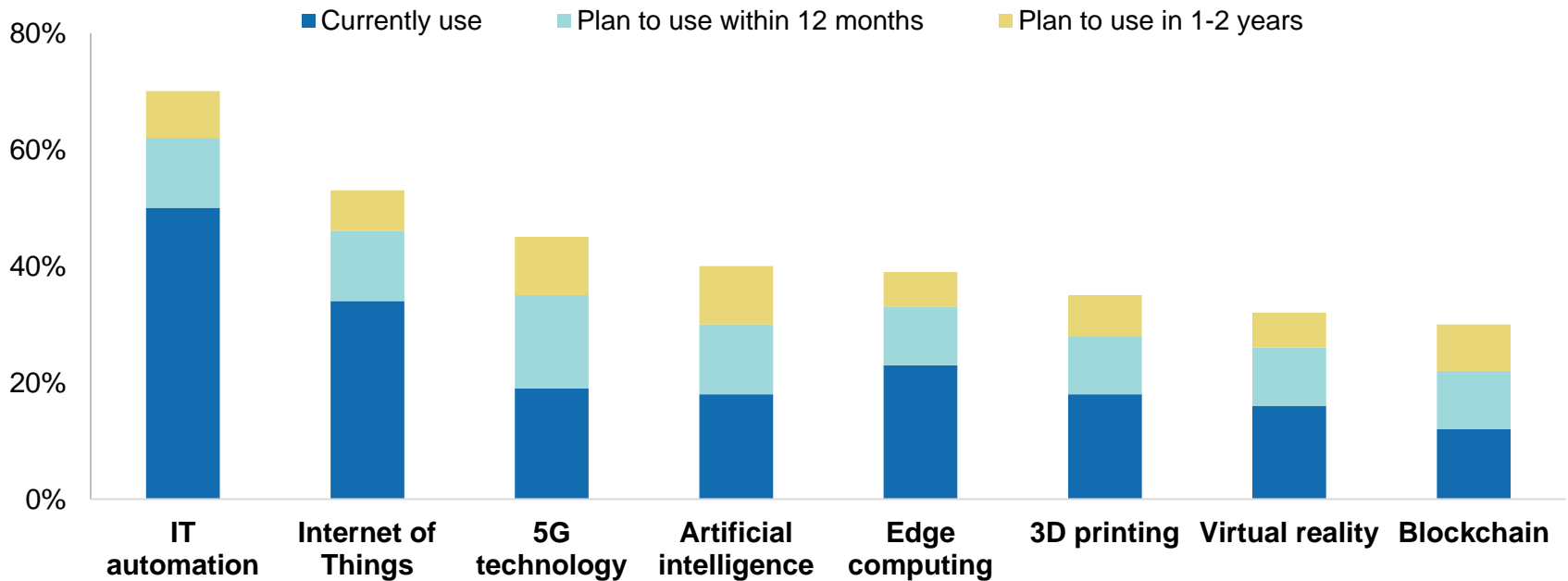
Industry	Large Non-U.S. Discount?
Communication Platform as a Service	✓
Business Process Automation	✓
Renewables	✓
Electrification	✓
E-Commerce	✓

IV

Enduring Themes Convergence of Technologies

- The current environment has more innovation than ever, in our view
 - Companies across the economy are going through a digital transformation

Organizational Adoption of Technologies



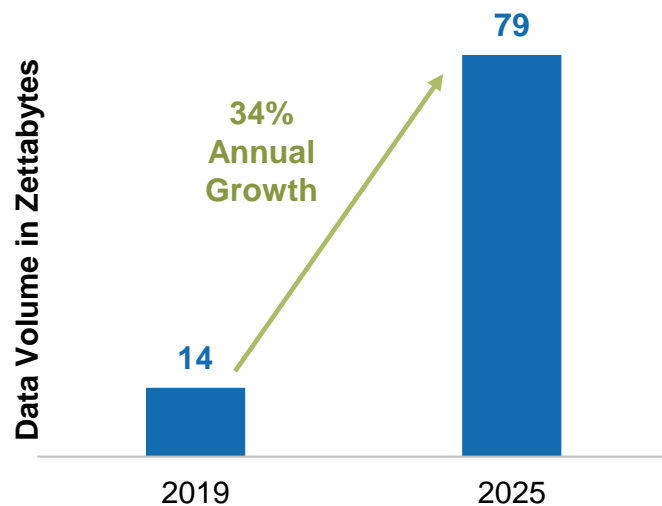
Source: Spiceworks, The 2022 State of IT, October 2021, survey of more than 1000 technology buyers in companies across North America and Europe.

IV

Enduring Themes Internet of Things

- The explosion in connected devices is creating the “Internet of Things” or IoT, transmitting valuable and actionable information
 - Drivers of IoT spending include security, data analytics, efficiencies, reliability, customer service, improved ROI, and compliance

IoT Worldwide Data Volume



IoT Worldwide Revenue In 2030

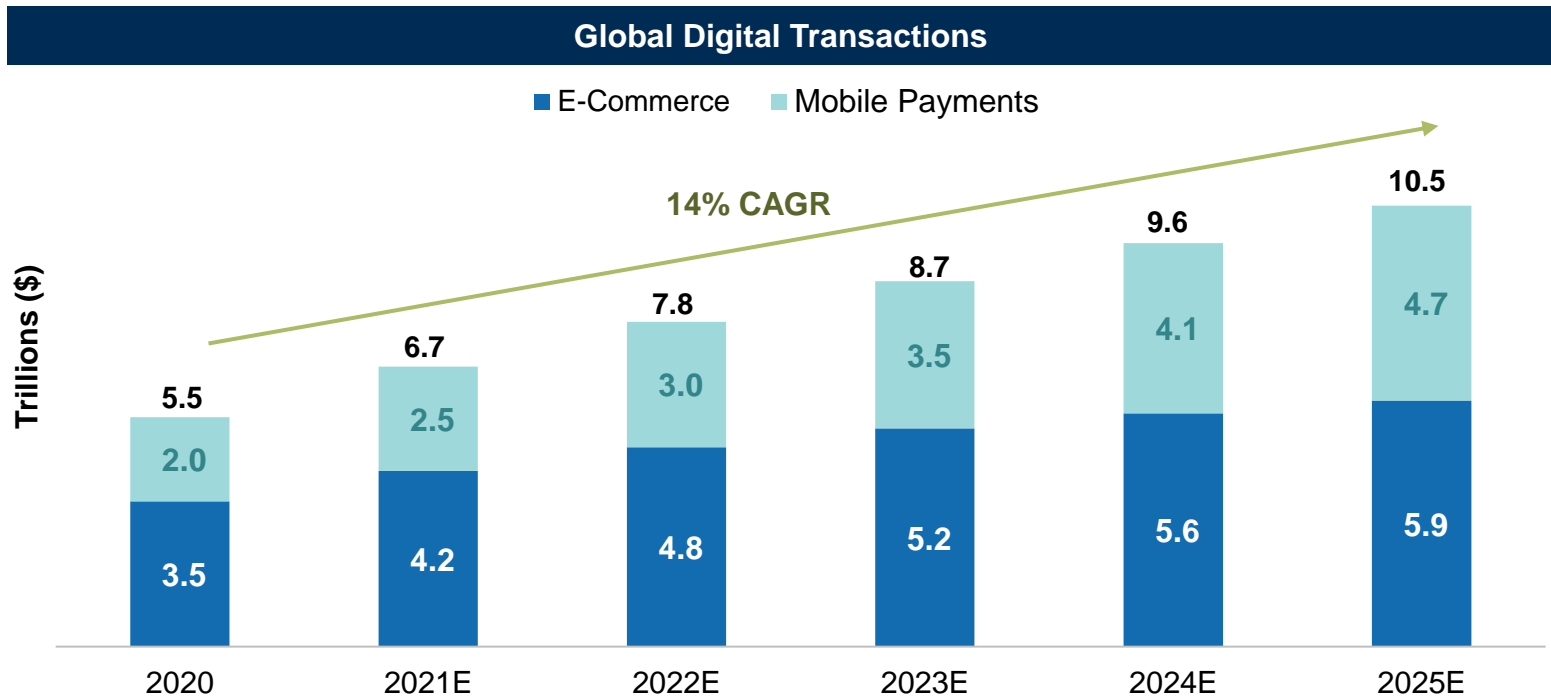
Use Case	\$B	Use Case	\$B
Consumer Media	203	Personal Monitoring	31
Connected Vehicles	198	Precision Robots	27
Closed Circuit TV	107	Lighting	26
Smart Grid	98	White Goods	26
Security & Fire	56	HVAC	24
Building Automation	54	Road Infrastructure	24
Payment Terminals	53	Inventory Management	21
Asset Tracking	38	Other	74

Source: Data volume of IoT devices from IDC, July 2020. 2030 estimated revenue from Transforma Insights, December 2020.

IV

Enduring Themes Digital Payments

- Digital payments continue to outgrow the broad economy as they gain penetration, driven by increasing e-commerce and mobile payments
 - China has the largest volume of digital payments and Europe is growing fastest
- Payment networks, processors, and software companies can capitalize on the trend



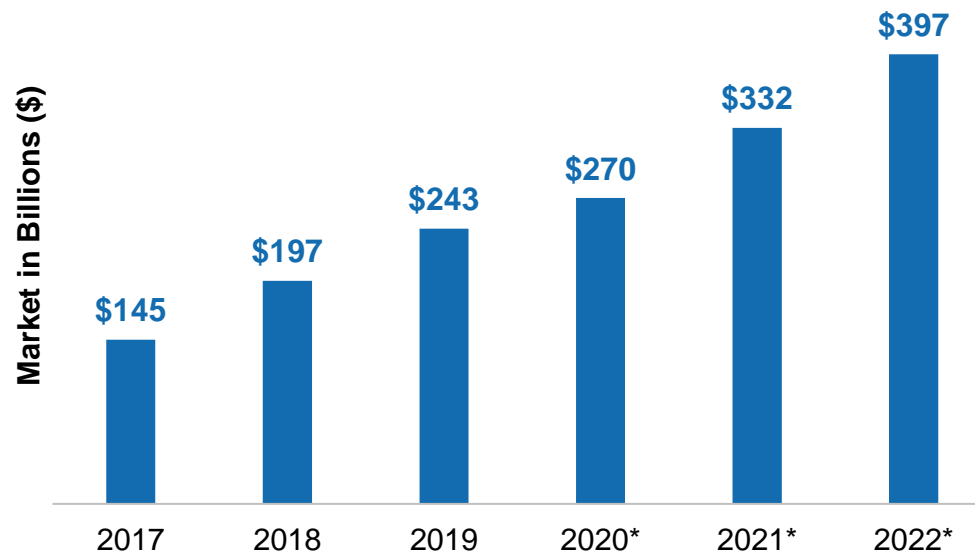
Source: Statista Digital Market Outlook 2021. CAGR is compound annual growth rate, the rate of return required for a quantity to grow from its beginning balance to its ending balance. Mobile payments occur when smartphones are used to process transactions using wireless communication or scan QR barcodes.

IV

Enduring Themes Cloud Computing

- Cloud computing optimizes IT assets, reducing costs and improving flexibility and accessibility
 - The growth in online streaming entertainment, e-commerce, work from home, telehealth, e-sports, and virtual learning are all enabled by cloud computing

Cloud Computing Market Is Growing Rapidly

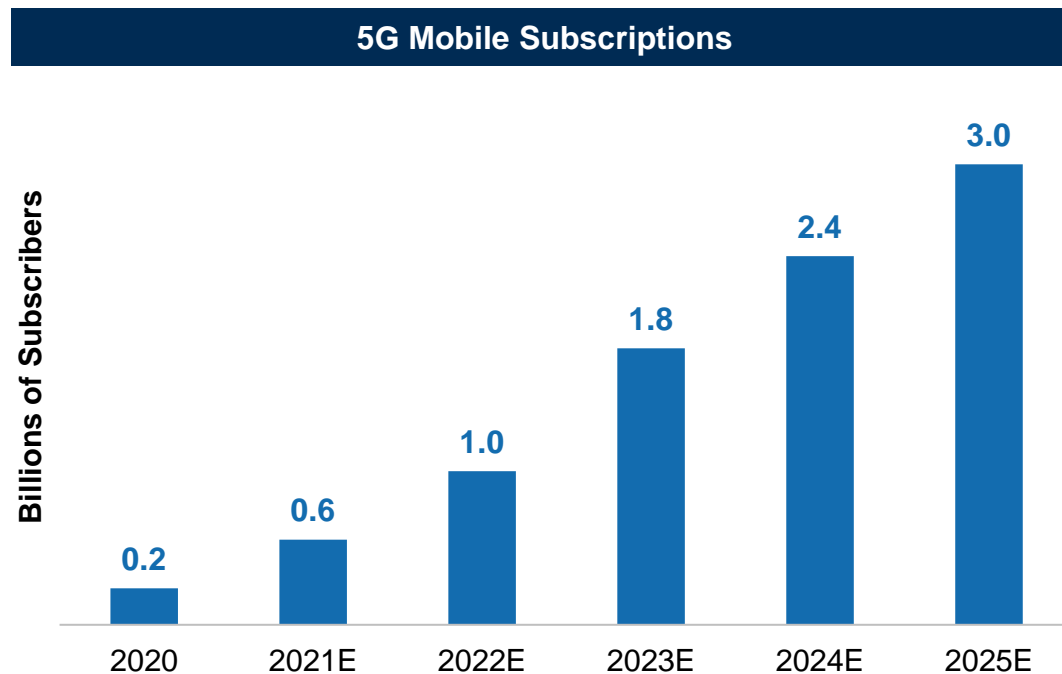


Source: Gartner, April 2021. *Forecast. Market includes cloud application services, infrastructure services, business process services, and security.

IV

Enduring Themes 5G Wireless

- The next generation of wireless technology, 5G, is bringing faster speeds, increased capacity, much lower latency and more efficient spectrum utilization
 - 5G helps enable telematics, advanced health care monitoring, remote work, augmented/virtual reality, and autonomous driving applications



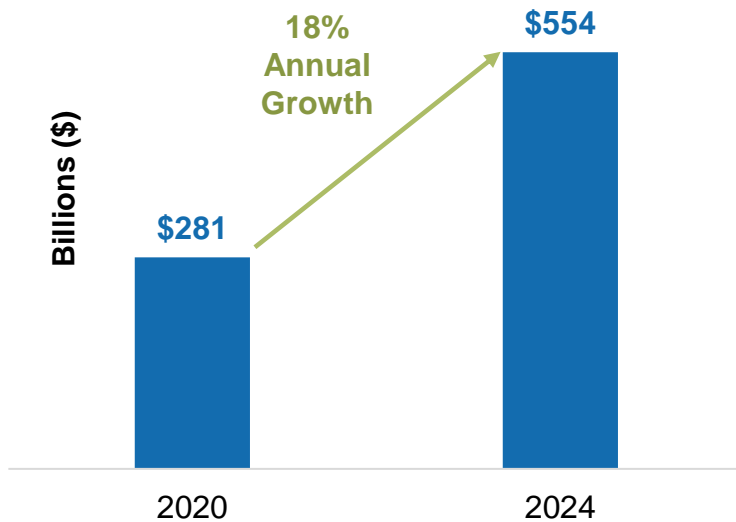
Source: 5G Americas, May 2021.

IV

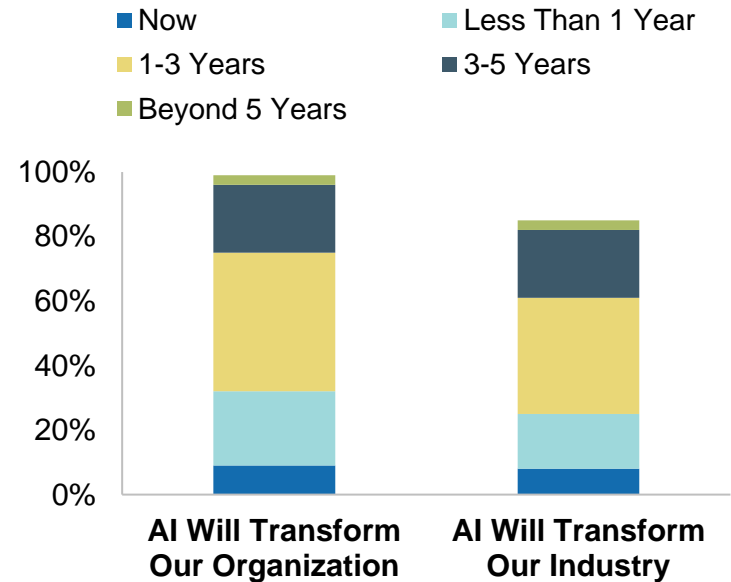
Enduring Themes Artificial Intelligence

- Companies providing AI-based software services and hardware have a large opportunity
- AI will transform organizations and industries with higher investment likely leading to stronger market share

Global AI Market



Leading AI Use Cases

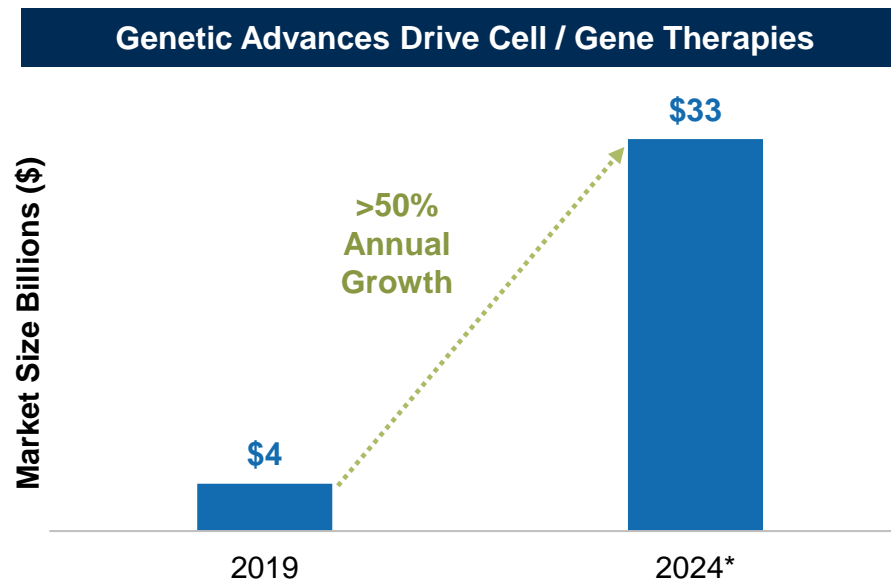


Source: AI market size estimate from IDC, February 2021. AI data on organization/industry transformation from Deloitte, July 2020 survey of 2,737 global business executives

IV

Enduring Themes Genomics Innovation

- Genetic analysis and manipulation will increasingly impact the practice of health care
 - Turning sick care into preventive health care by giving insight into predisposed diseases
 - Delivering more efficacious treatments via targeted therapies (e.g., immuno-oncology)

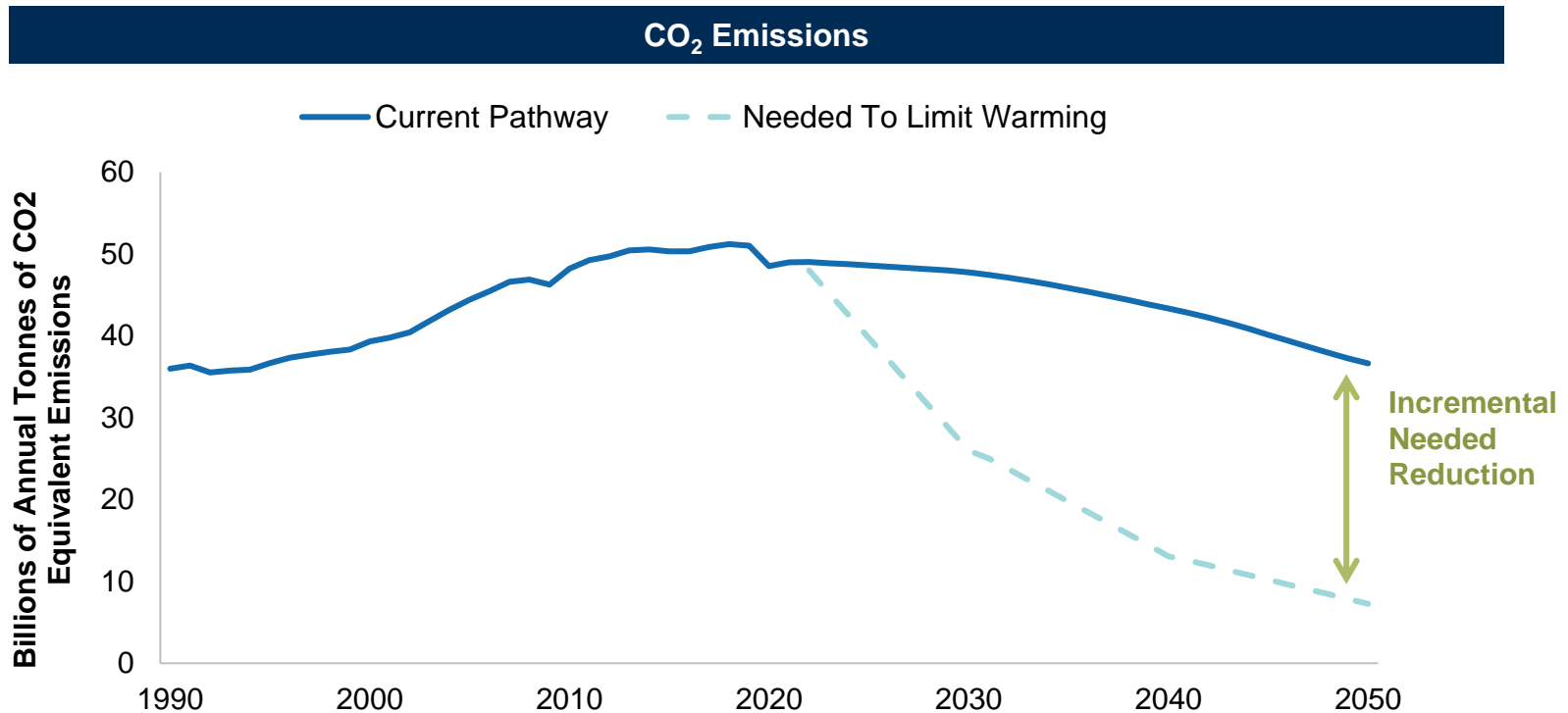


Source: Cell & gene therapy market data from Cryoport, 2020. *Estimated.

IV

Enduring Themes Emission Reductions

- The rate of CO₂ emissions is not sustainable in our view and current emission targets need to be reduced further
- Reducing emissions may provide opportunities in alternative energy sources and in electric vehicles and related products and services



Source: Climate Action Project, May 2021/ Current pathway represents average of high and low “pledges and targets” scenario while needed to limit warming is based on median to achieve 1.5 degrees Celsius warming.

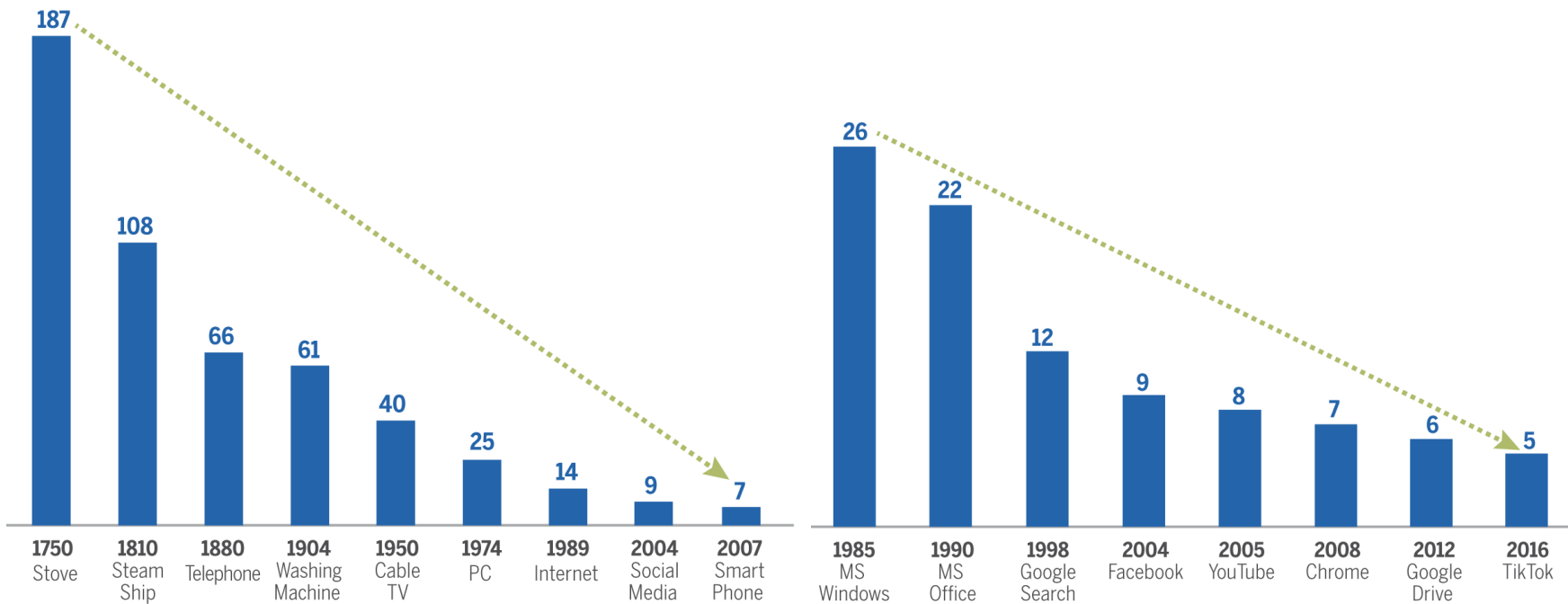
V

Style Wars Accelerating Change

- Innovation is accelerating across many areas of the economy, causing new products and services to diffuse through society faster and disrupt businesses at a greater pace
- This may be a tailwind to growth companies, which we believe are the drivers of innovation, and a headwind to value stocks, which may be victims of change

Years from Market Entry to 50% Penetration

Years to Reach 1 Billion Users

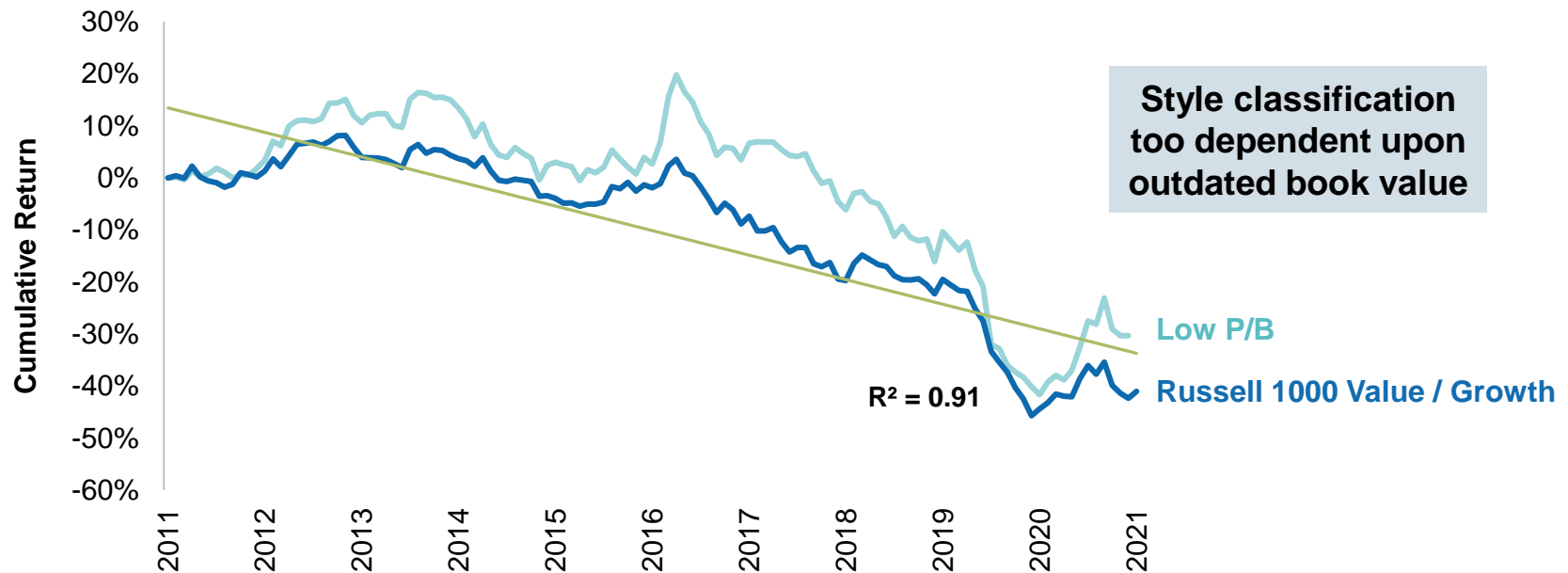


Source: Asymco, Visual Capitalist, company disclosures, Alger estimates.

V

Style Wars Structural Issues Driving Growth vs. Value

- Even after underperforming this year, Growth stocks have dramatically outperformed Value stocks over the past decade
- The driver has been the very weak performance of the Price-to-Book valuation metric, which is used heavily in index classifications of Growth vs. Value stocks
- As accounting fails to keep up with the changing economy, book value may no longer be as relevant (e.g., R&D is not capitalized in book value)

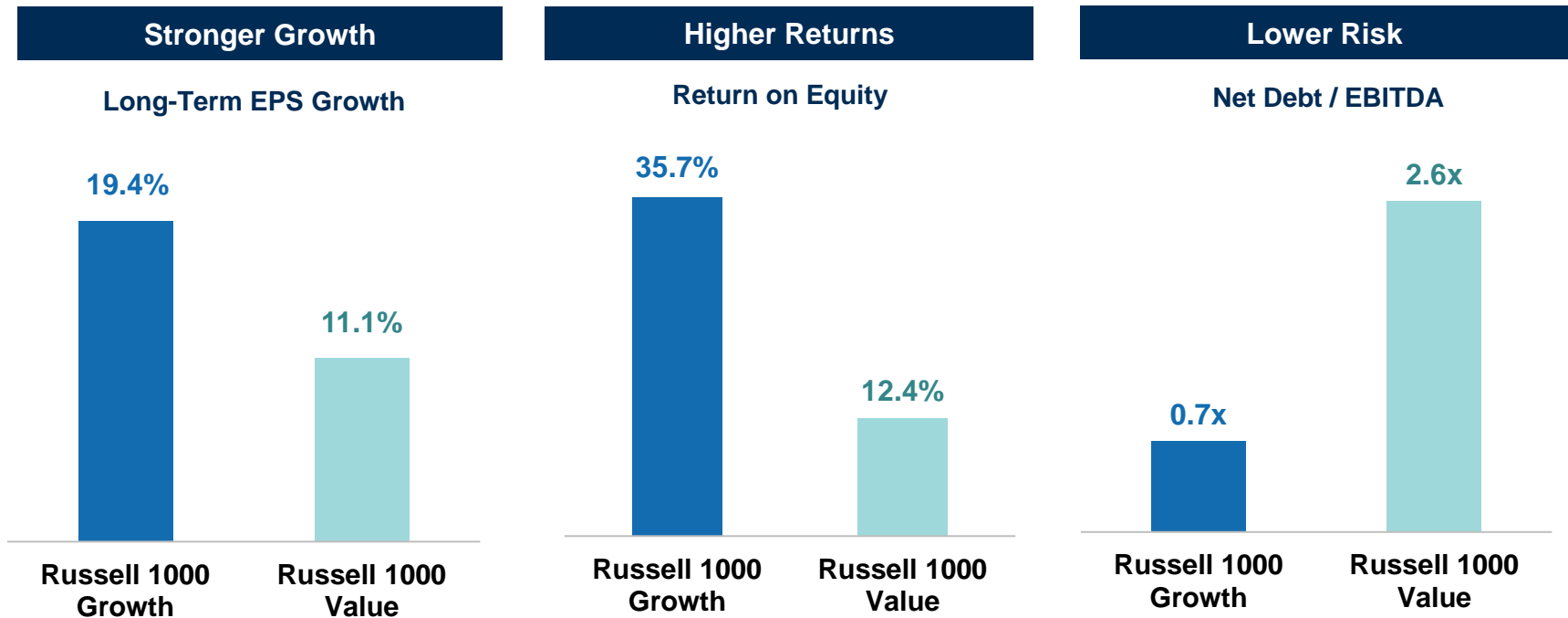


Source: FactSet, Kenneth R. French, and Alger through August 2021. Low price-to-book returns are based on the B/P Fama/French factor for the CRSP universe which includes US firms listed on the NYSE, AMEX, or NASDAQ. The performance data quoted represents past performance, which is not an indication or a guarantee of future results.

V

Style Wars The Growth Advantage

- Three variables drive P/E multiples: growth, return on capital, and risk
- The Russell 1000 Growth Index has higher expected EPS growth, higher return on equity, and lower risk in the form of better balance sheets as compared to the Russell 1000 Value Index



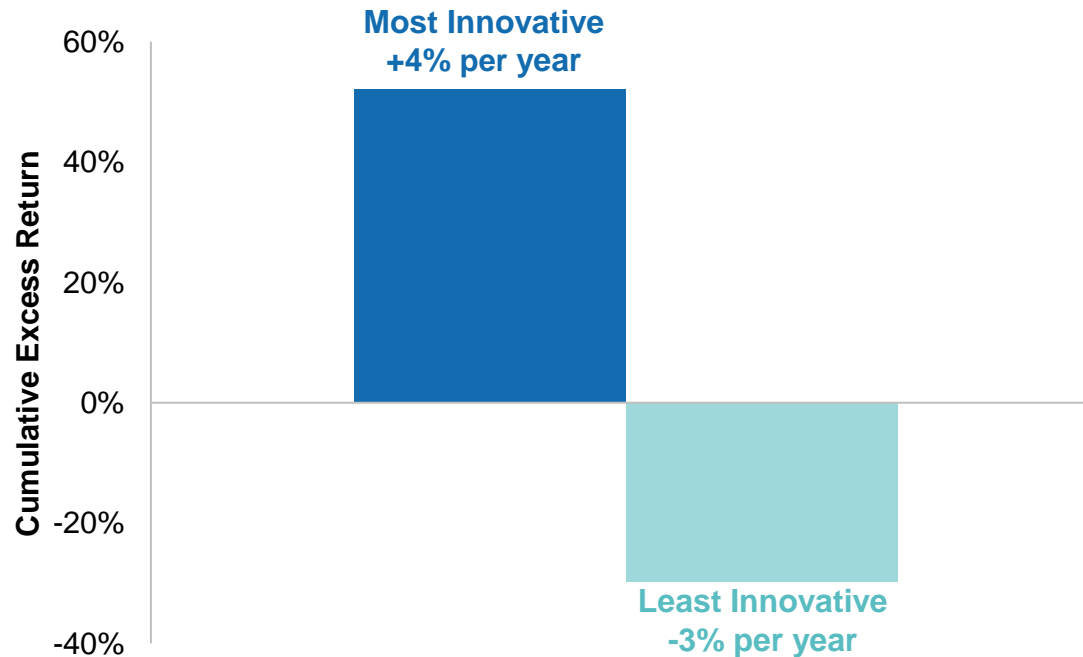
Source: FactSet as of 9/30/21. Growth represents consensus long-term analyst estimates and actual future EPS growth rates might be materially different than the forecasts shown.

Style Wars

A Powerful New Investing Factor?

- Studies have shown and our research demonstrates that the most innovative companies grow their sales, earnings, and stock prices faster*

Innovative Companies Have Outperformed Over the Past Decade



Source: FactSet. Excess performance of the quintiles of R&D as a percentage of revenue with the most innovative being top quintile and the least innovative being bottom quintile of the stocks in the S&P 1500 index. Stocks were divided into quintiles based on R&D spending-to-revenue and calculated monthly for the 10-year period ended August 2021. *Baruch Lev and Suresh Radhakrishnan, "The Stock Market Valuation of R&D Leaders." **The performance data quoted represents past performance, which is not an indication or a guarantee of future results.** Innovative companies may be defined as those companies with a high ratio of annual R&D investment to revenue. Investing in innovation is not without risk and there is no guarantee that investments in research and development will result in a company gaining market share or achieving enhanced revenue.

Disclosure

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Disclosure

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