

ALGER

Inspired by Change, Driven by Growth.

Winter 2023

Capital Markets: Observations and Insights

Yearning for Earnings



Alger is a signatory to the PRI and carbon neutral.

Yearning for Earnings

“In the short run, the market is a voting machine but in the long run, it is a weighing machine.” – Benjamin Graham

Stock prices may have fluctuated over the past year mostly based on interest rate movements, but we agree with Graham that over the longer term, earnings and cash flows will determine stock prices. We believe that the rise in interest rates and the corresponding decline in equity valuations is subsiding, leaving Graham’s proverbial scale to determine where stocks are headed. In short, the stock market outlook boils down to earnings, in our view.

In the near term, corporate earnings face headwinds from the lagged impact of tighter monetary policy, as leading indicators confirm these challenges and point to weakening corporate fundamentals. However, earnings have been quite resilient over time, rising in all 10-year periods over the past half century, growing at nearly 7% annually. Earnings are driven by GDP growth, which in turn is propelled forward by productivity, which is the result of innovation in our view. While financial media and investor attention tends to shun innovation during market declines, our research suggests that innovation is not only alive and well, but in fact accelerating. We believe this suggests that earnings could grow considerably over the medium and long-term, potentially registering higher equity returns on Graham’s scale.



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Key Observations and Themes

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With the rise in interest rates and the corresponding decline in equity valuations seemingly abating, we focus on a key driver of stock prices: earnings.

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What's Priced In?

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With investors focused on risk and asset prices down, we examine valuations to identify areas of the capital markets that may look attractive.

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Economic Crosscurrents

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Solid labor market and balance sheets are being more than offset by headwinds from higher interest rates and less accommodative fiscal policy.

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Enduring Themes

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

V

Style Wars

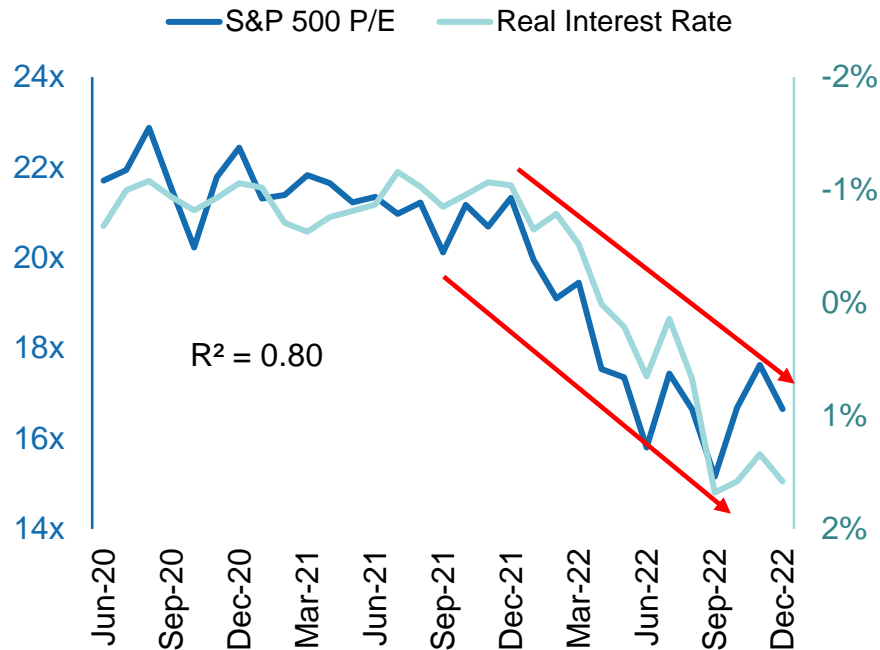
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Powerful structural forces may keep the long-term trend of growth outperformance intact, in our view.

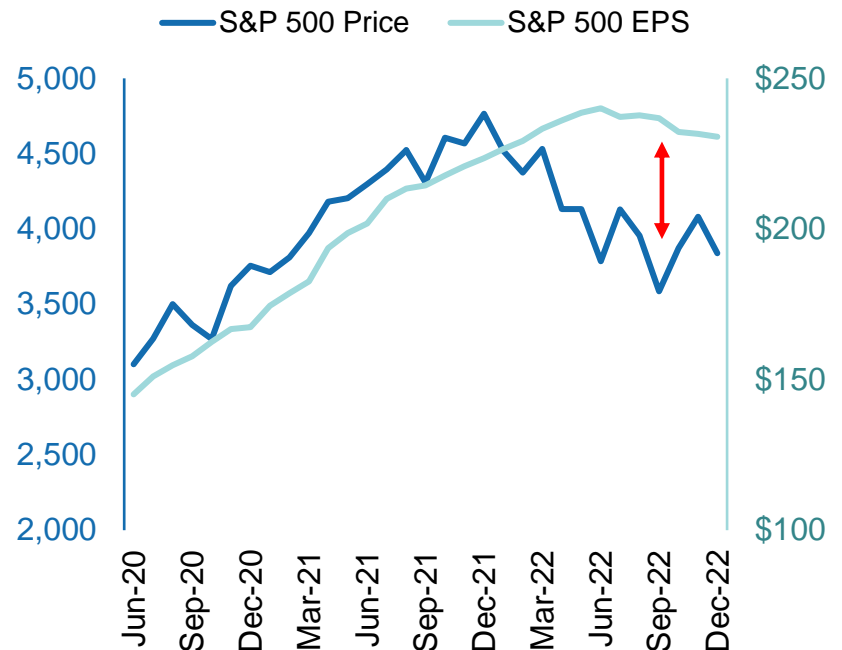
Yearning for Earnings Moving On?

- Higher interest rates have caused a decline in equity valuations
- Is that dynamic over and will earnings once again drive stock prices?

Higher Interest Rates Have Driven Lower Valuations



Causing Divergence Between Stock Prices and EPS

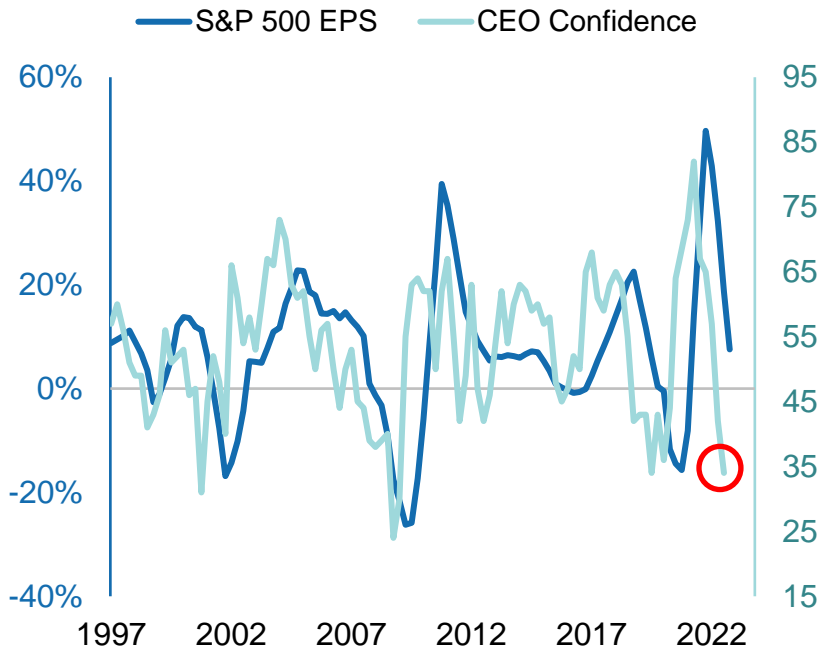


Source: FactSet. Real interest rate is 10-year Treasury Inflation Protected Security (TIPS) yield. EPS is consensus next 12-month estimates. Earnings per share (EPS) is the portion of a company's earnings or profit allocated to each share of common stock. Price-to-earnings is the ratio for valuing a company that measures its current share price relative to its earnings per share. Data through 12/31/22. R-squared is a statistical measure used to analyze how differences in one variable can be explained by the difference in a second variable. **The performance data quoted represents past performance, which is not an indication or a guarantee of future results.**

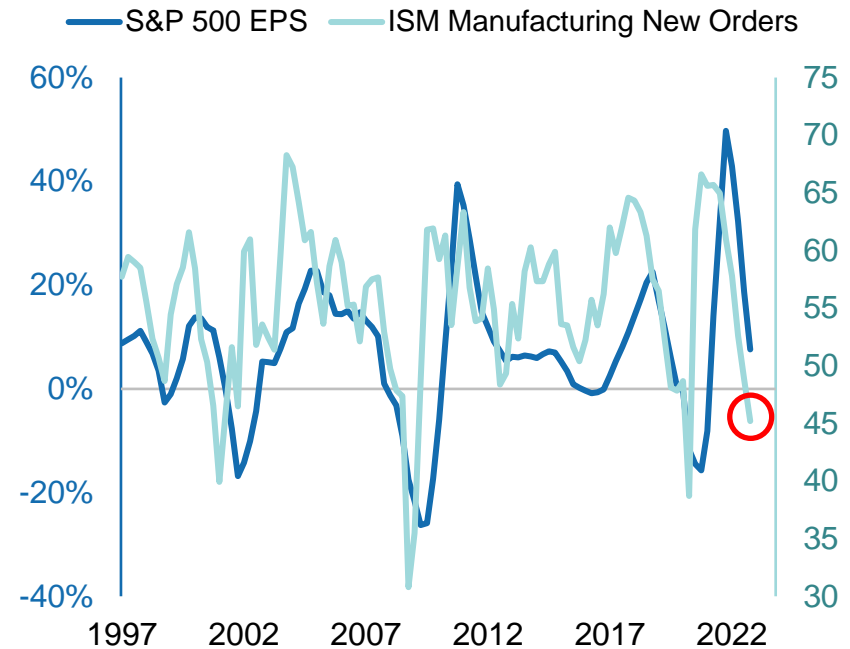
Yearning for Earnings Short-Term Headwinds

- Various leading indicators suggest further deceleration in earnings growth or even outright declines in earnings

Business Confidence Indicates Declining EPS



Manufacturing Orders Indicate Declining EPS



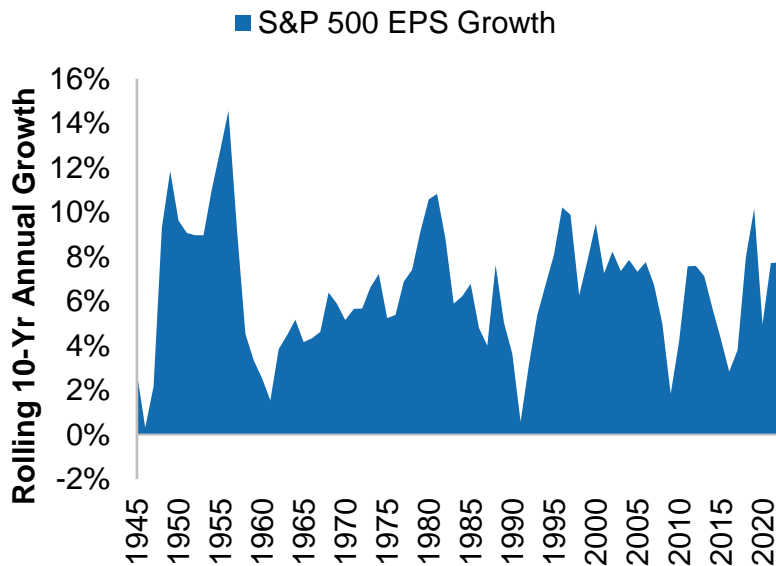
Source: S&P 500 EPS is year-over-year change from FactSet. CEO confidence (which is based on CEOs' perceptions of current and expected business and industry conditions) from The Conference Board. ISM® Manufacturing New Orders (which indicates the magnitude of growth or decline in new orders from customers of manufacturing firms reported by survey respondents compared to the previous month) from The Institute of Supply Management ISM® Report On Business® – Manufacturing (PMI®)

Yearning for Earnings

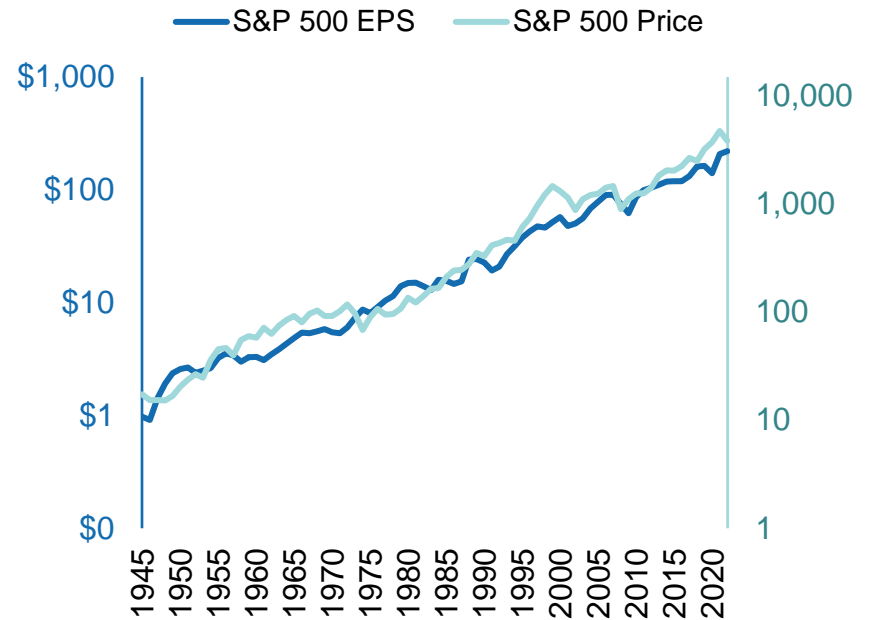
Powerful Long-Term Trends

- Earnings have historically grown over full cycles
- Post WWII, S&P 500 EPS has always grown over 10-year periods
- The S&P 500 price has increased in-line with the 7% annual growth in earnings
- Huge wealth creation despite 12 recessions and several wars

Earnings Have Historically Grown...



...Driving Stocks Prices Upward at a Similar Rate

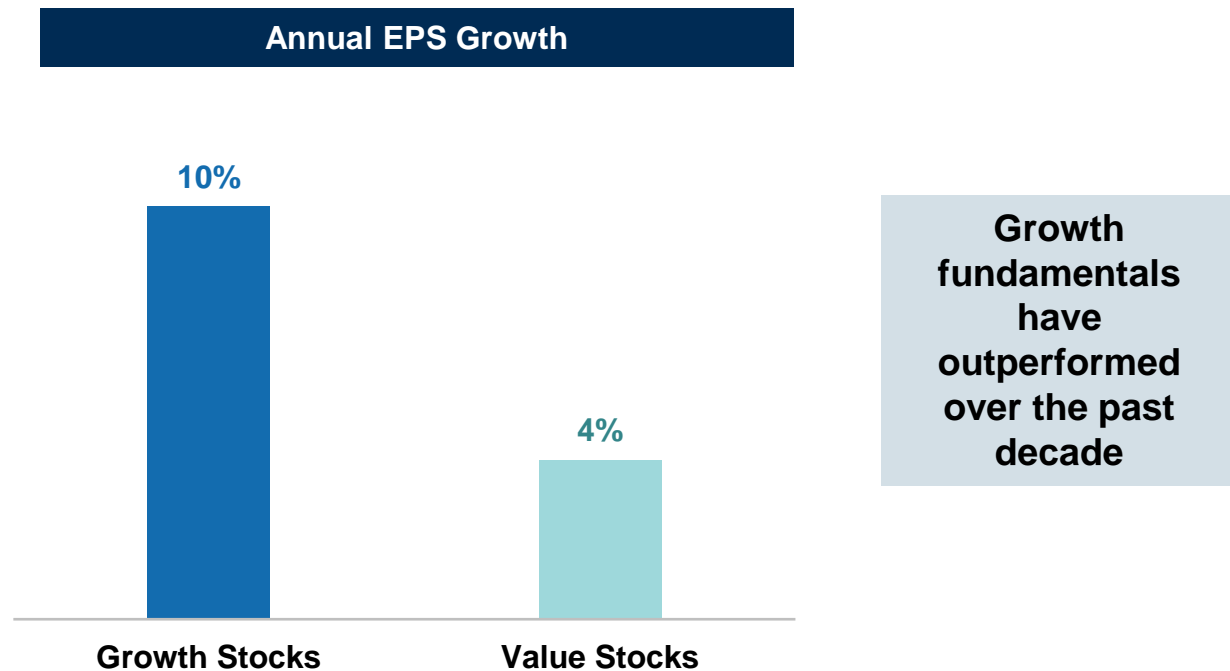


Source: FactSet. P/E is trailing 12-months. EPS and Price data through 12/31/22. The performance data quoted represents past performance, which is not an indication or a guarantee of future results.

Yearning for Earnings

Growth vs. Value

- Growth stock outperformance over the past decade has been driven by fundamental outperformance

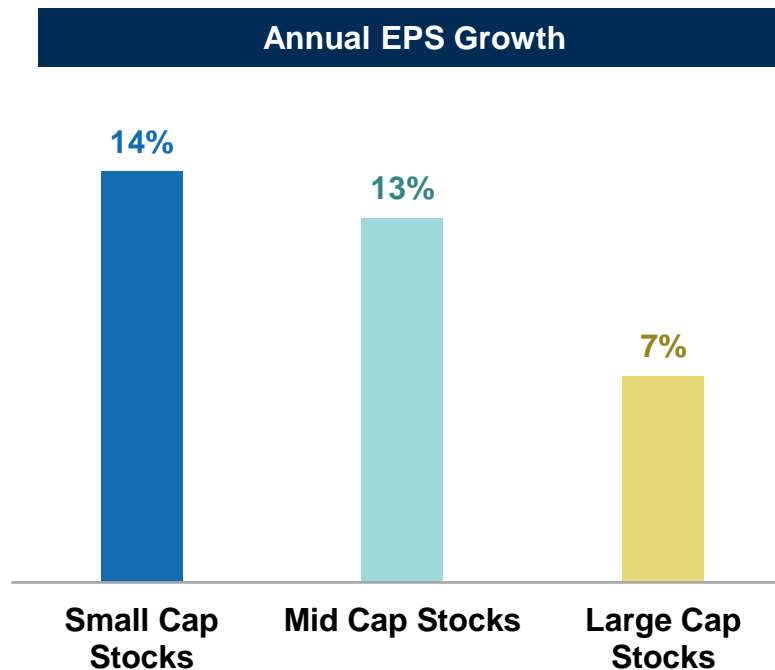


Source: FactSet for the 10-year period ended 12/31/22. Growth stocks represented by S&P 500 Growth and value stocks by S&P 500 Value. EPS is based on last 12-months.

Yearning for Earnings

David vs. Goliath

- Smaller public companies have historically grown faster than large caps because they often have a smaller penetration of their addressable market and a larger tailwind from margin expansion



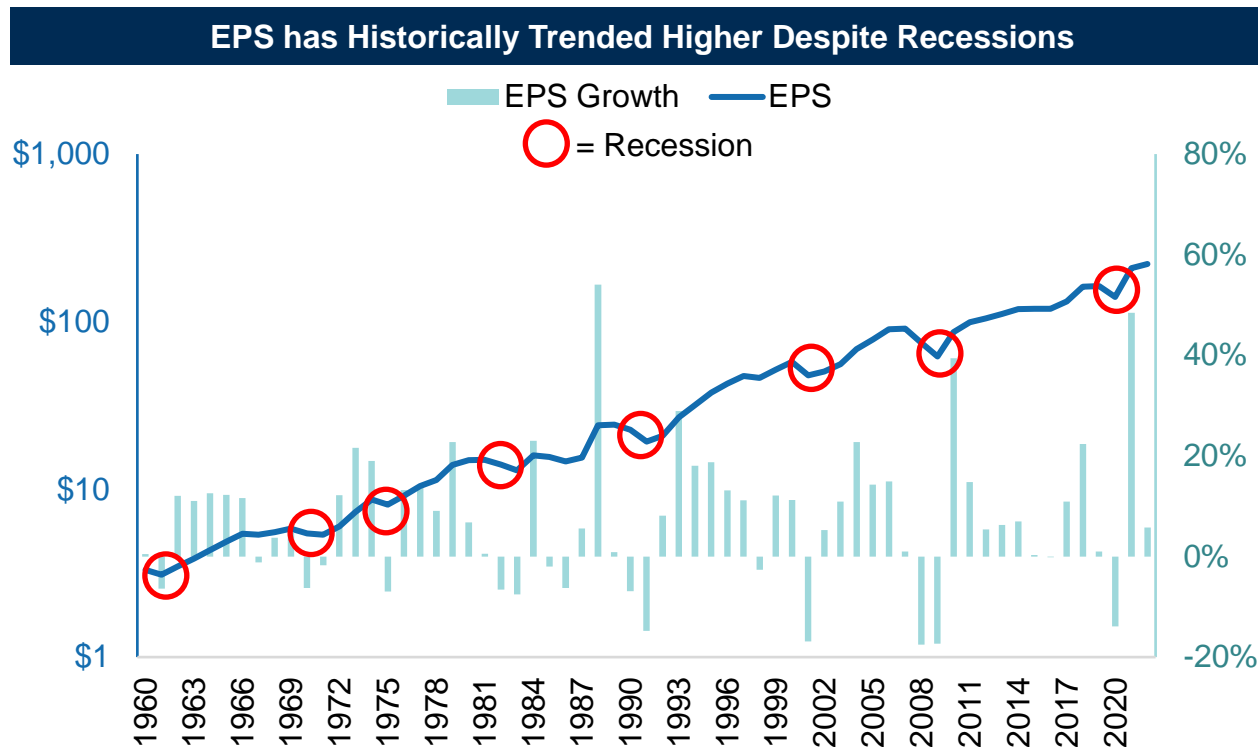
Smaller stocks have historically had stronger fundamental growth

Source: FactSet for the 10-year period ended 12/31/22. Small cap stocks represented by S&P SmallCap 600, mid cap stocks represented by S&P MidCap 400, and large cap stocks represented by S&P 500. EPS is based on last 12-months.

Yearning for Earnings

Recessions and Recoveries

- S&P 500 earnings have declined in past recessions, but historically, EPS has reached or nearly reached a new high in the first or second year after the recession ended
 - Temporary EPS declines shouldn't theoretically impact long-term value significantly

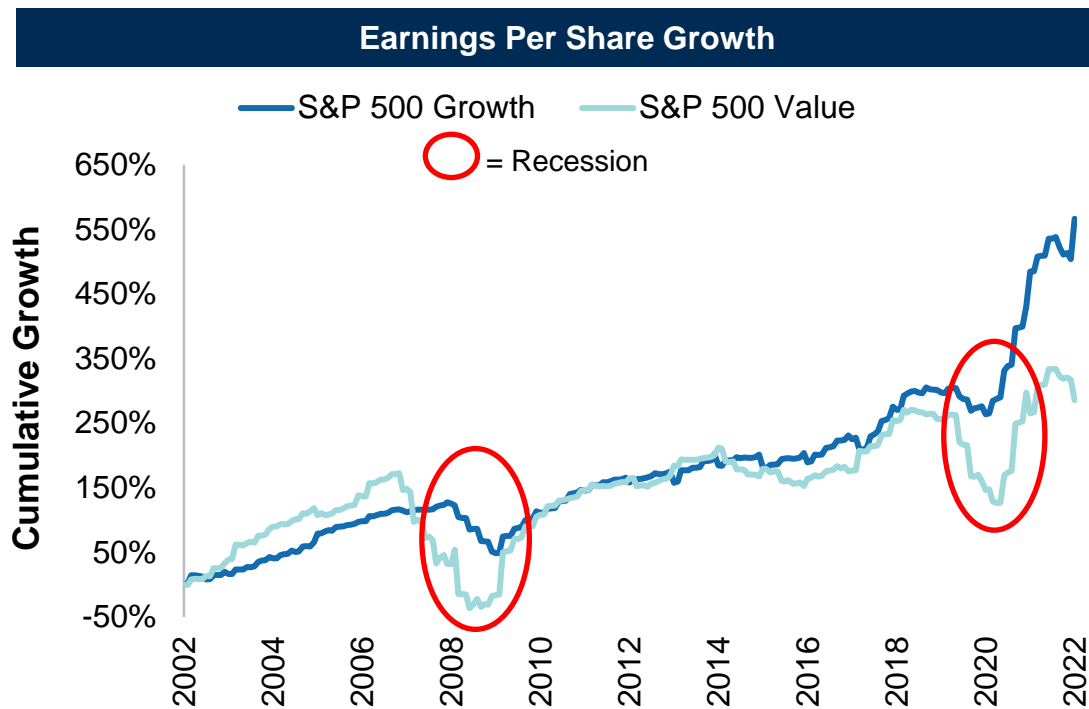


Source: S&P reported EPS 1960-1987. S&P operating EPS 1988-1995, FactSet S&P 500 Operating EPS 1996 to present.

Yearning for Earnings

Earnings Resilience

- Market share gains have enabled growth stocks to post better fundamentals in past recessions than more economically sensitive value stocks



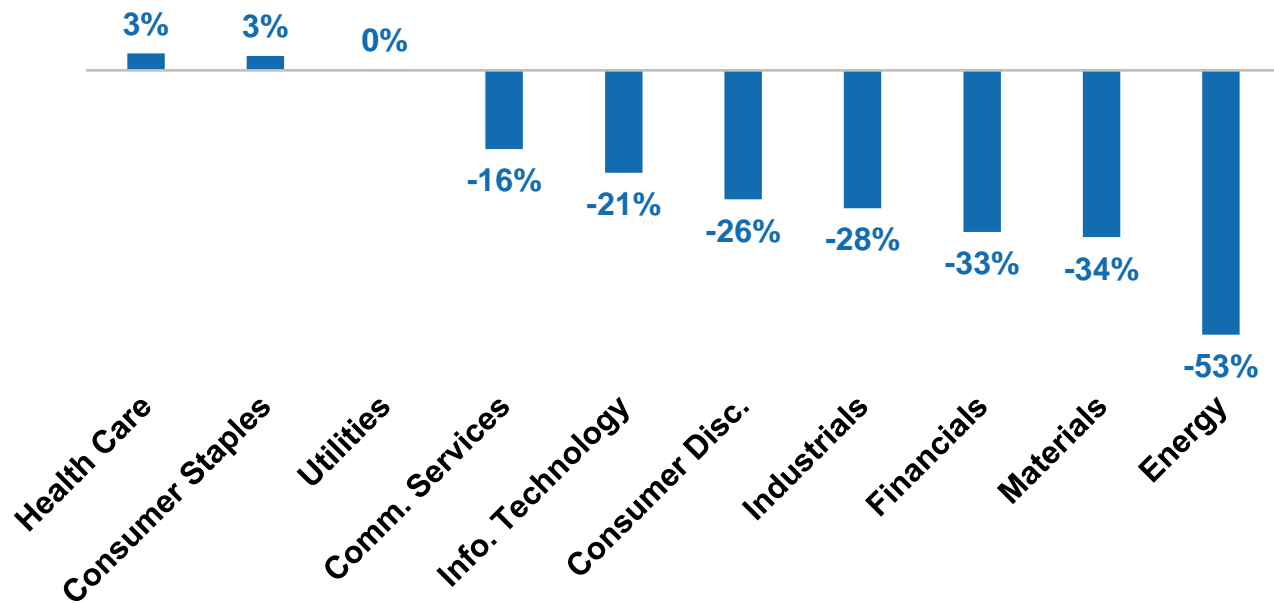
Growth stock fundamentals have fared better in recessions

Source: FactSet. EPS is a last 12-month calculation.

Yearning for Earnings Sector Standouts

- Some sectors of the market are more cyclical and historically their earnings have declined more in recessions, while others have had more defensive fundamentals

EPS Estimate Change
Average of Past Three Recessions



Health care fundamentals have held up best in previous recessions

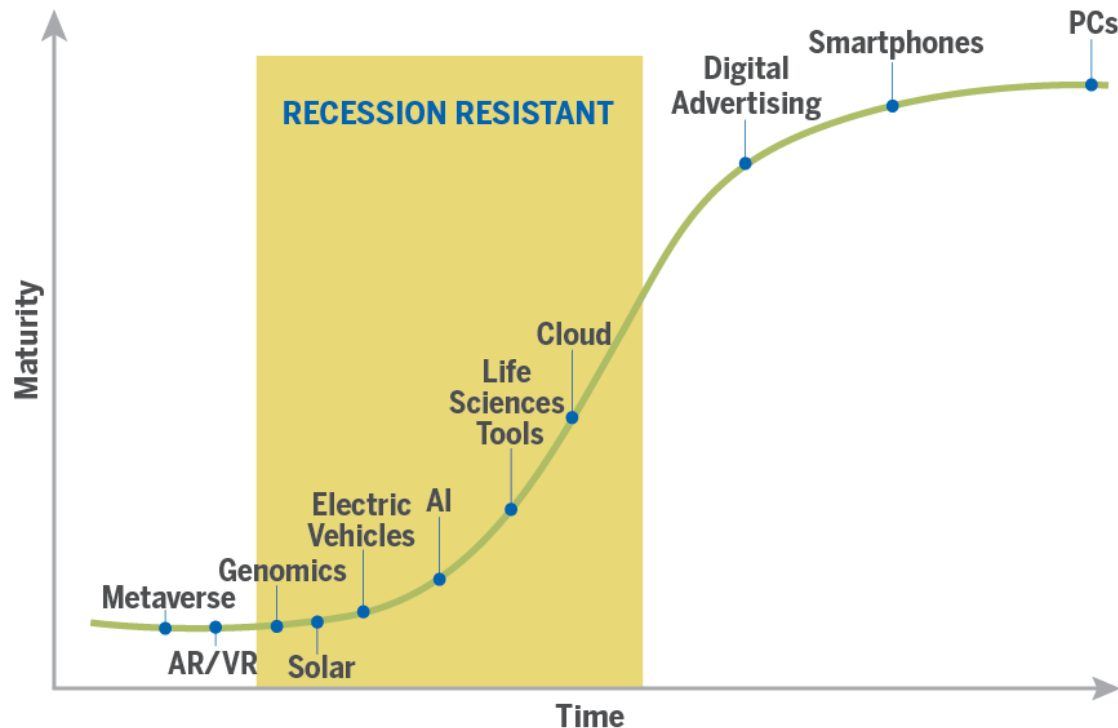
Source: FactSet. EPS estimate is based on consensus next 12-month estimates. Recession periods are 3/31/01 – 11/30/01, 12/31/07 – 6/30/09, and 2/28/20 – 4/30/20.

Yearning for Earnings

The Importance of Market Share Gains

- Industries or technologies early in their lifecycle are less susceptible to economic volatility because of their potential for market share gains, in our view

Growth Buffers Economic Volatility



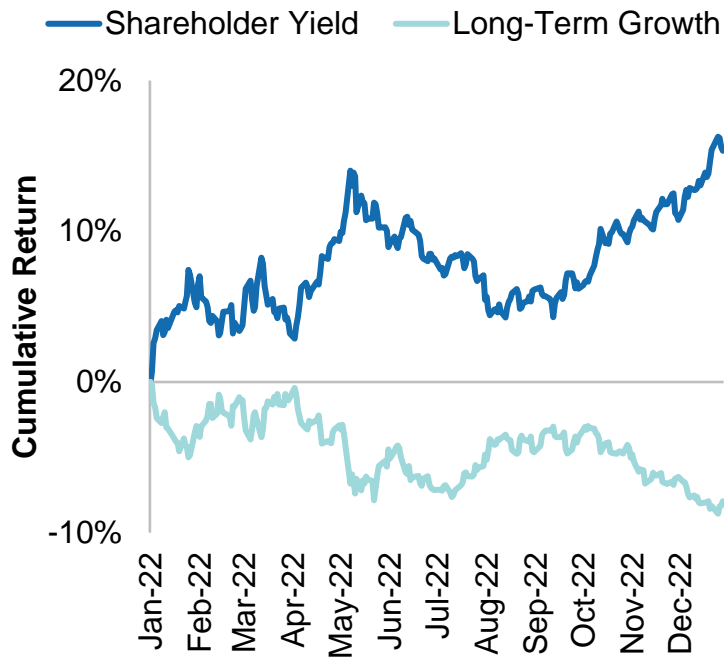
Source: Alger.



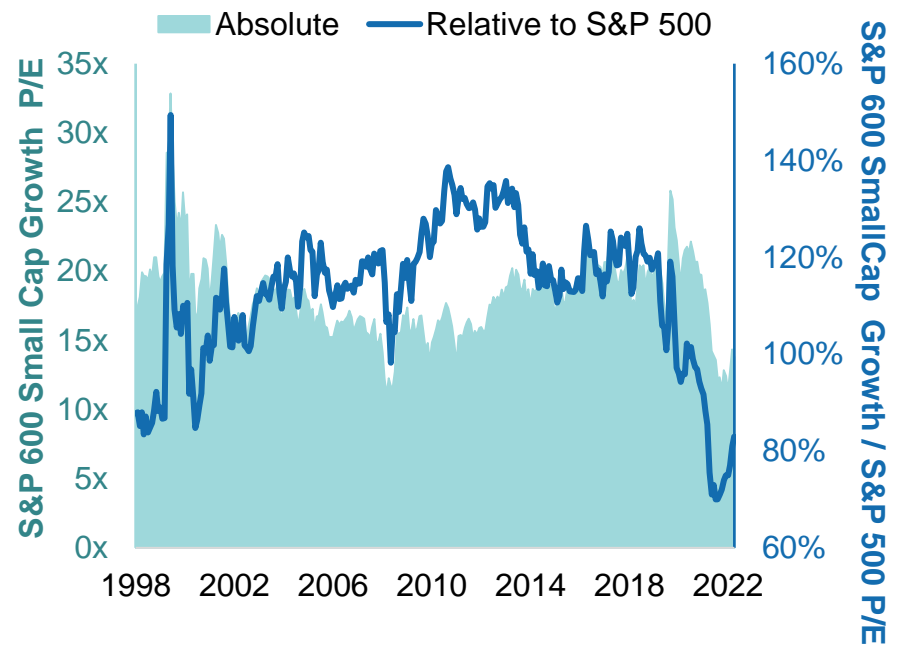
What's Priced In? Long Duration Appears Cheap

- The duration trade has driven investors to seek more current cash flows at the expense of growth...
- ...while pushing down valuations of longer duration, growth assets to attractive valuations, in our view

The Duration Trade



Small Growth Attractive Valuations?



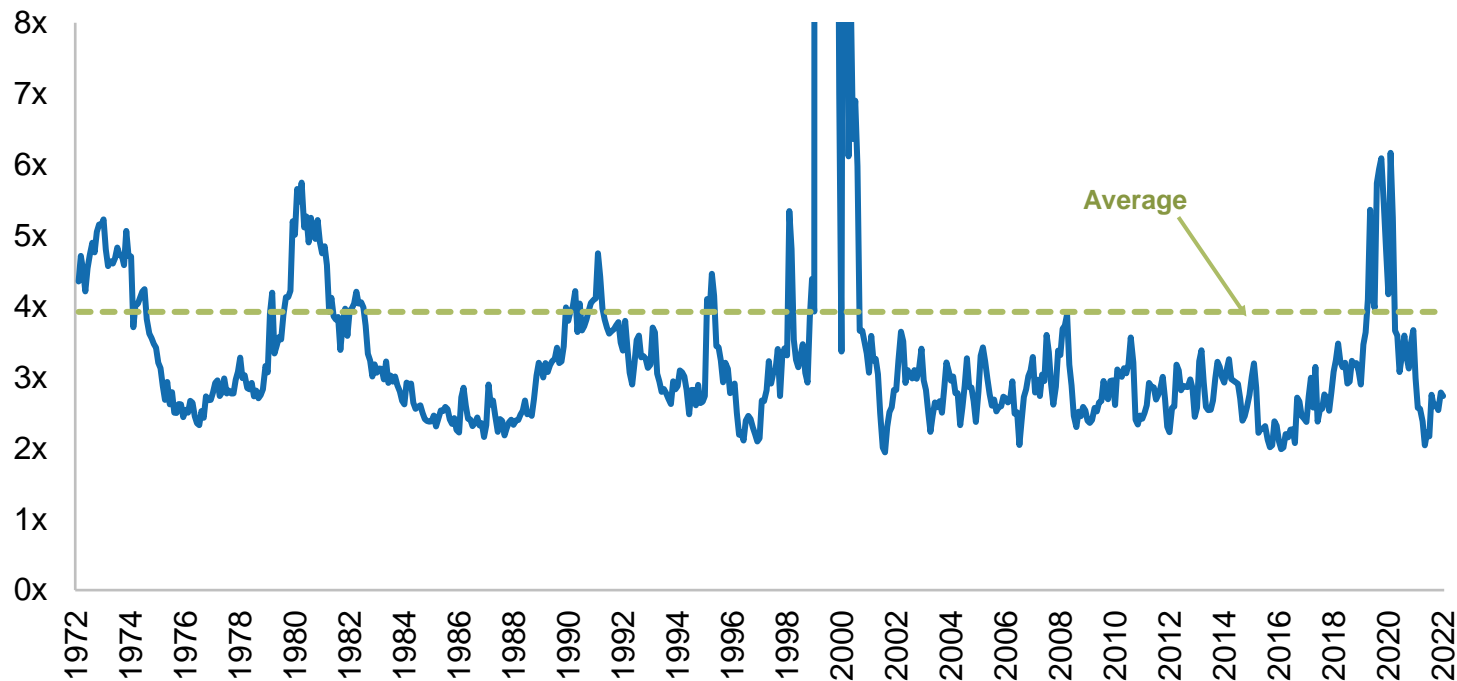
Source: Piper Sandler and FactSet as of 12/31/22. Factor performance relative to the S&P 1500, which is sector neutral and is calculated by taking the relative performance of the top quintile of stocks against the bottom quintile of stocks for each factor. The constituents in the quintiles are rebalanced monthly. Shareholder Yield is [LTM Common and Preferred Stock Purchased - LTM Common and Preferred Stock Sold + LTM Total Common Dividends] / Market Capitalization. Long-term Growth is mean estimated 5-year EPS growth. P/E is price divided by earnings per share over last 12-months.



What's Priced In? Fastest Growth at a Discount

- Valuations of the fastest-growing large stocks have fallen dramatically
 - First driven by the economy reopening and then by rising discount rates

The Fastest Growers - Relative Price/Sales Ratio



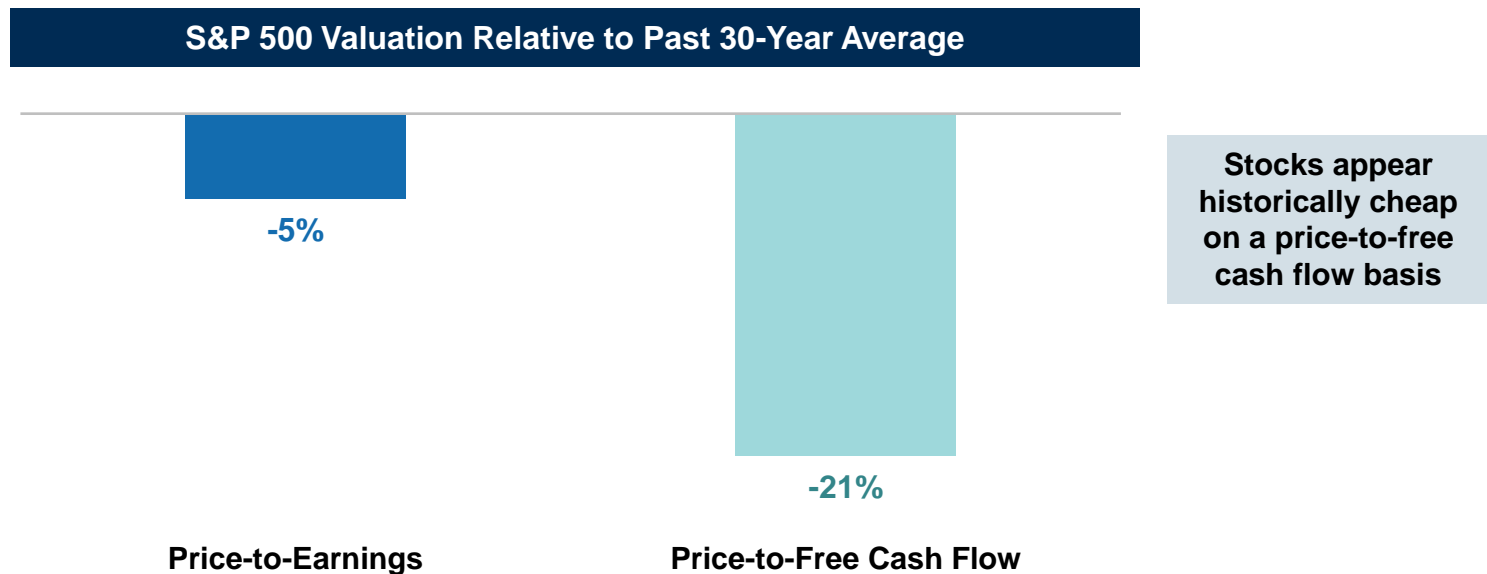
The fastest growing large cap stocks are now historically inexpensive relative to the market

Source: Empirical Research Partners. Equally weighted data. Fastest growers are the top 10% or 75 of stocks of the largest 750 U.S. public equities based on a scoring methodology including forecasted revenue growth, trailing revenue growth, stability of revenue growth, and return on equity. Data through December 2022.



What's Priced In? Paying Less

- U.S. equity valuation multiples have declined to levels that appear inexpensive relative to history, in our view
 - Increased investment in intangible assets, which are expensed rather than capitalized, may be depressing earnings relative to free cash flow, making the stock market look cheaper on free cash flow than earnings

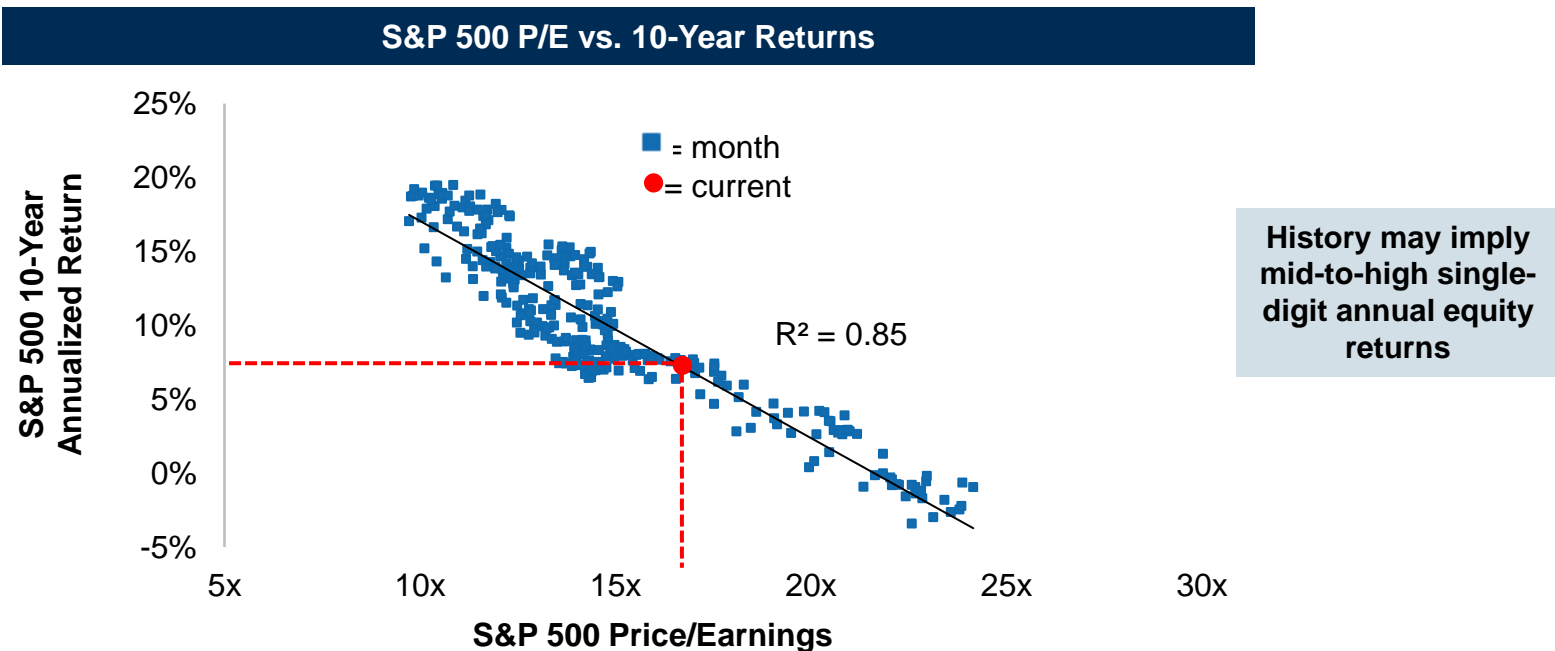


Source: FactSet. As of 12/31/22. Earnings and Free Cash Flow based on last twelve months calculation. Free cash flow is the cash a company generates after taking into consideration cash outflows that support its operations and maintain its capital assets.



What's Priced In? Many Happy Returns?

- There is a strong relationship between starting equity valuations and ensuing 10-year returns
 - Current valuations suggest stocks should produce solid long-term returns, in excess of Treasury bond yields



Source: FactSet. Each dot represents the P/E during that month and the returns generated over the subsequent 10 years. The starting P/E ratio is the price divided by the next 12-month earnings per share estimate at the start of each 10-year period measured. Monthly data through December 2022 and beginning in January 1986. R-squared is a statistical measure used to analyze how differences in one variable can be explained by the difference in a second variable. **The performance data quoted represents past performance, which is not an indication or a guarantee of future results.**



Economic Crosscurrents

Headwinds Outweigh Tailwinds

Tailwinds



- Firm labor market
- Healthy corporate and consumer balance sheets
- Inflation weakening

Headwinds



- Tightening monetary policy
- Geopolitical conflict
- Less accommodative fiscal policy
- Softening corporate earnings

I

II

III

IV

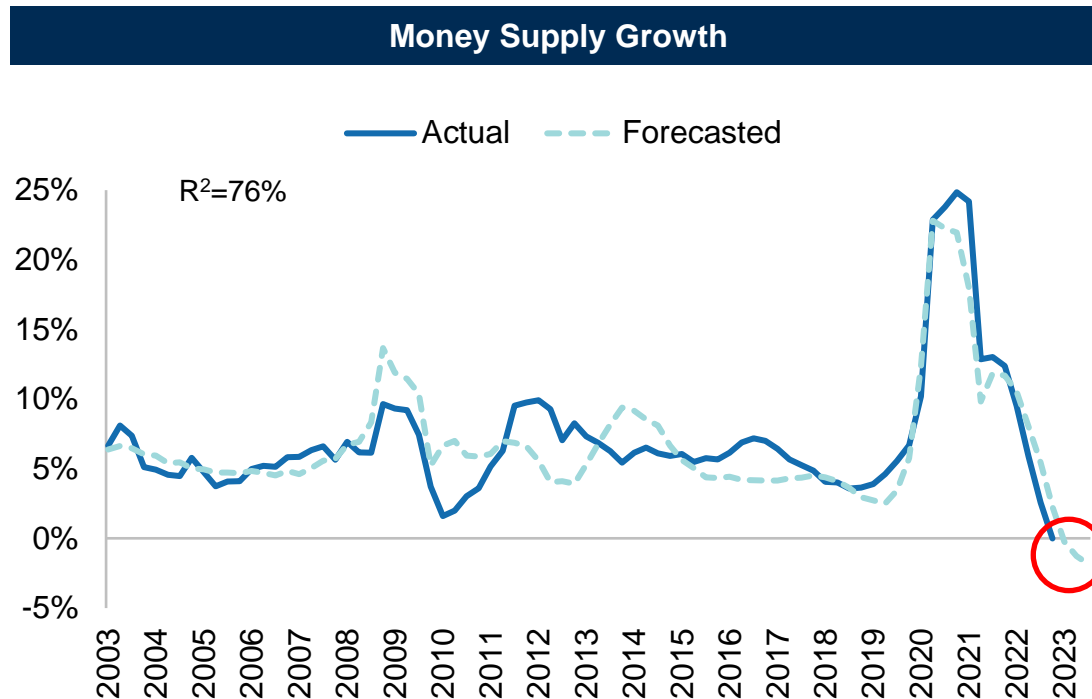
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Economic Crosscurrents

Slowing Money Supply

- The increase in the Federal Funds rate, decrease in the Federal Reserve's assets, and slowdown in government spending is constricting money supply growth and moderating economic activity



Money supply is forecasted to shrink for the first time since the 1930s

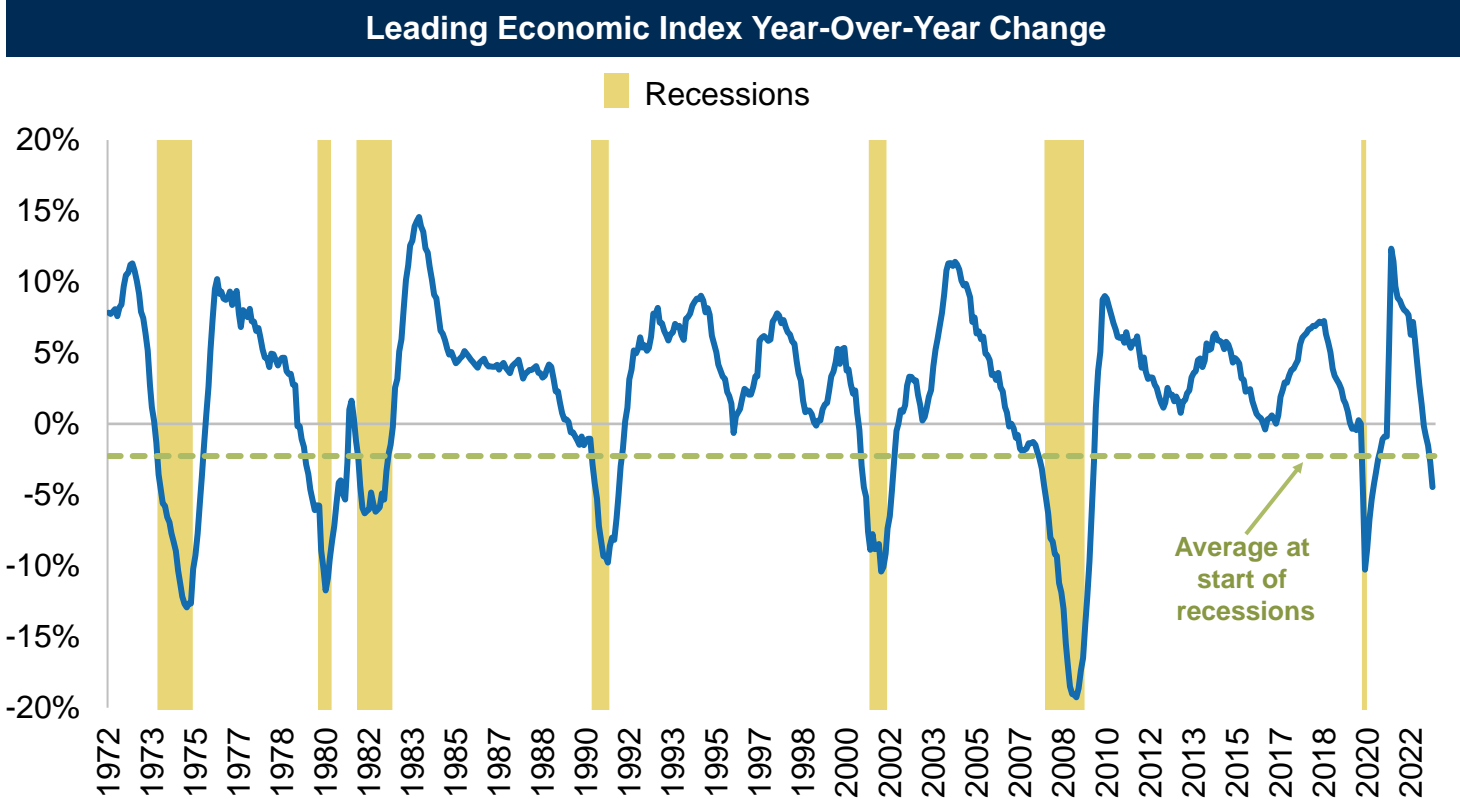
Sources: Actual data is the year-over-year change in M2 money supply, calculated by U.S. Federal Reserve. Last actual data point is November 2022. Forecasted data is based on Piper Sandler regression using year-over-year change in Federal Funds rate, Federal Reserve's assets, and U.S. Federal Expenditures.



Economic Crosscurrents

Recession Signals

- The Leading Economic Index has typically declined preceding recessions
 - Typically bottoms two months before the recession ends



Source: The Conference Board with last data point for November 2022, NBER. The Leading Economic Index (LEI) is a monthly index of 10 economic components used to predict the direction of global economic movements in future months. Average at start of recessions utilizes data going back to 1960.



Economic Crosscurrents

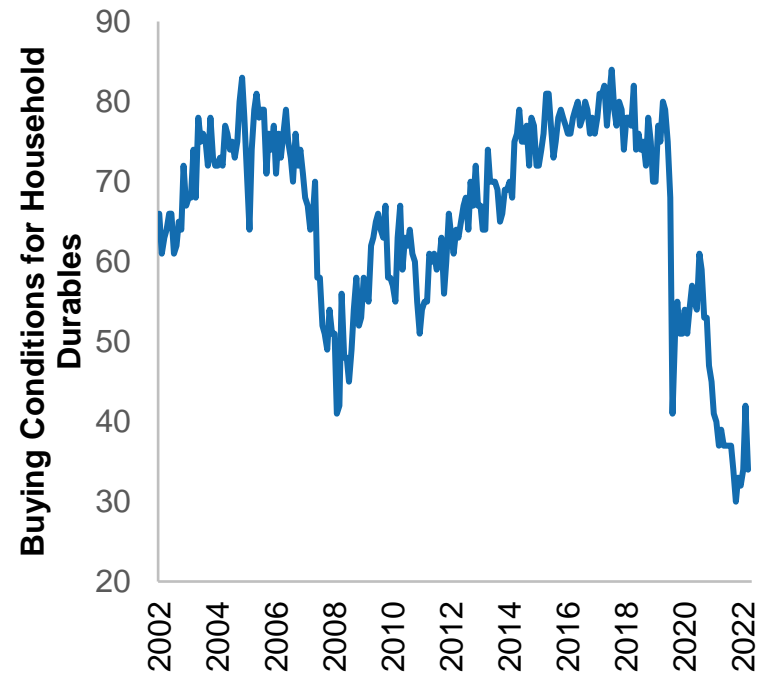
Interest Sensitive Industries Hurting

- Housing has come under pressure as mortgage rates have risen
- Consumer purchases of big-ticket items are rolling over

Home Buying Sentiment Is Getting Crushed



Softening Durable Goods Spending



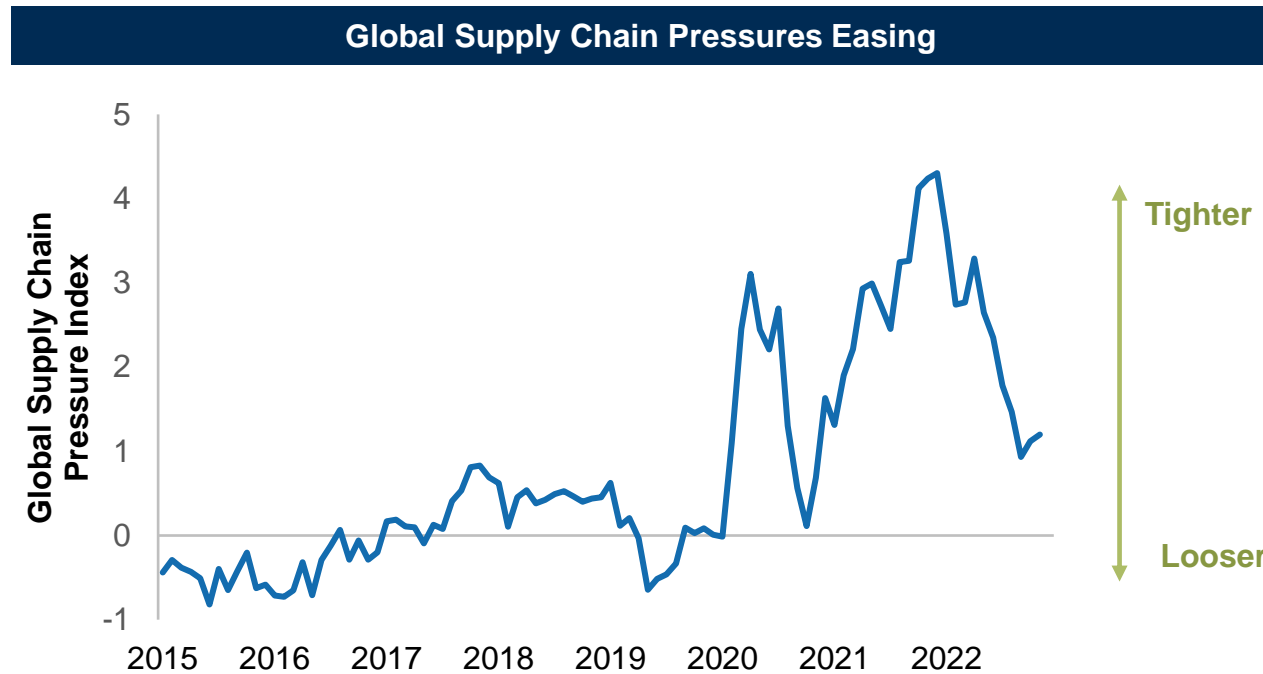
Source: University of Michigan Survey of Consumers Buying Conditions For Houses and Buying Conditions for Large Household Durables, % saying Good Time to Buy as of November 2022.



Economic Crosscurrents

Supply Chain Pressures Easing

- Easing supply pressures, along with moderating demand, should help reduce inflation, in our view
 - As we had previously anticipated, goods are seeing weaker pricing



Source: Federal Reserve Bank of New York Liberty Street Economics. The Global Supply Chain Pressure Index (GSCPI) is global measure that encompasses several indicators used to capture supply chain disruptions. Consensus is earnings estimates as determined by a consensus of analysts at financial services firms and provided by FactSet. Last data point is November 2022.

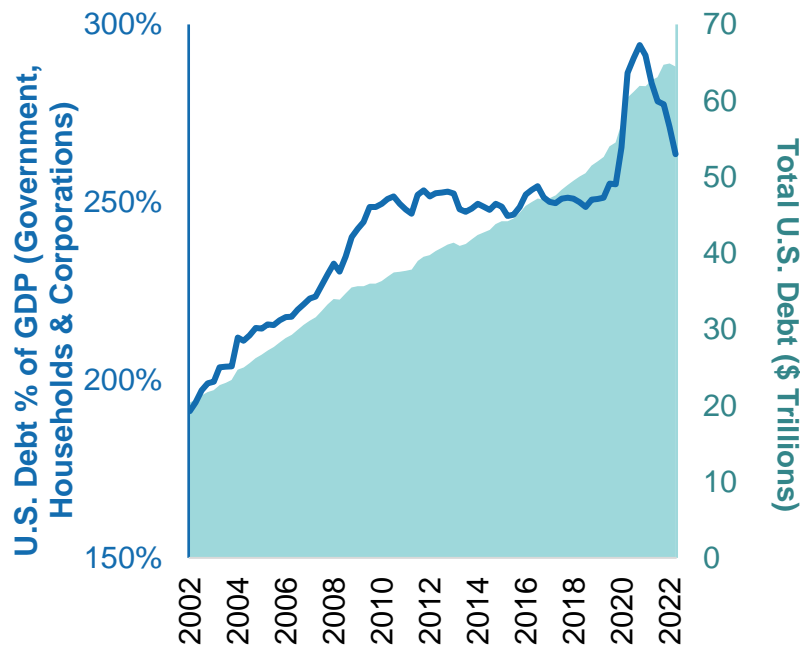


Economic Crosscurrents

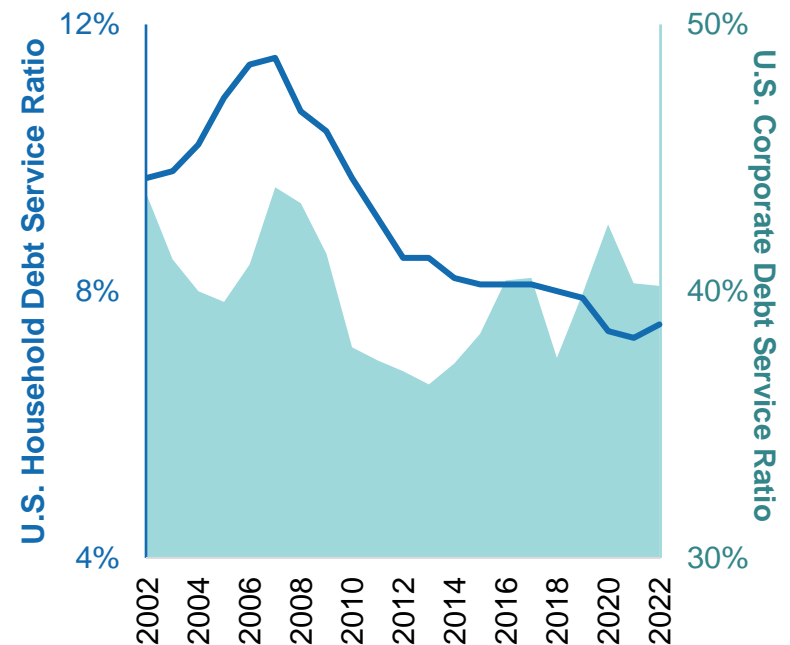
Solid Balance Sheets

- While debt has moderated relative to GDP after the pandemic, it remains high compared to history
- However, the cost to service the U.S. household and corporate debt is not high relative to history

U.S. Debt Levels Are High...



...But The Debt Service Burden Is Not



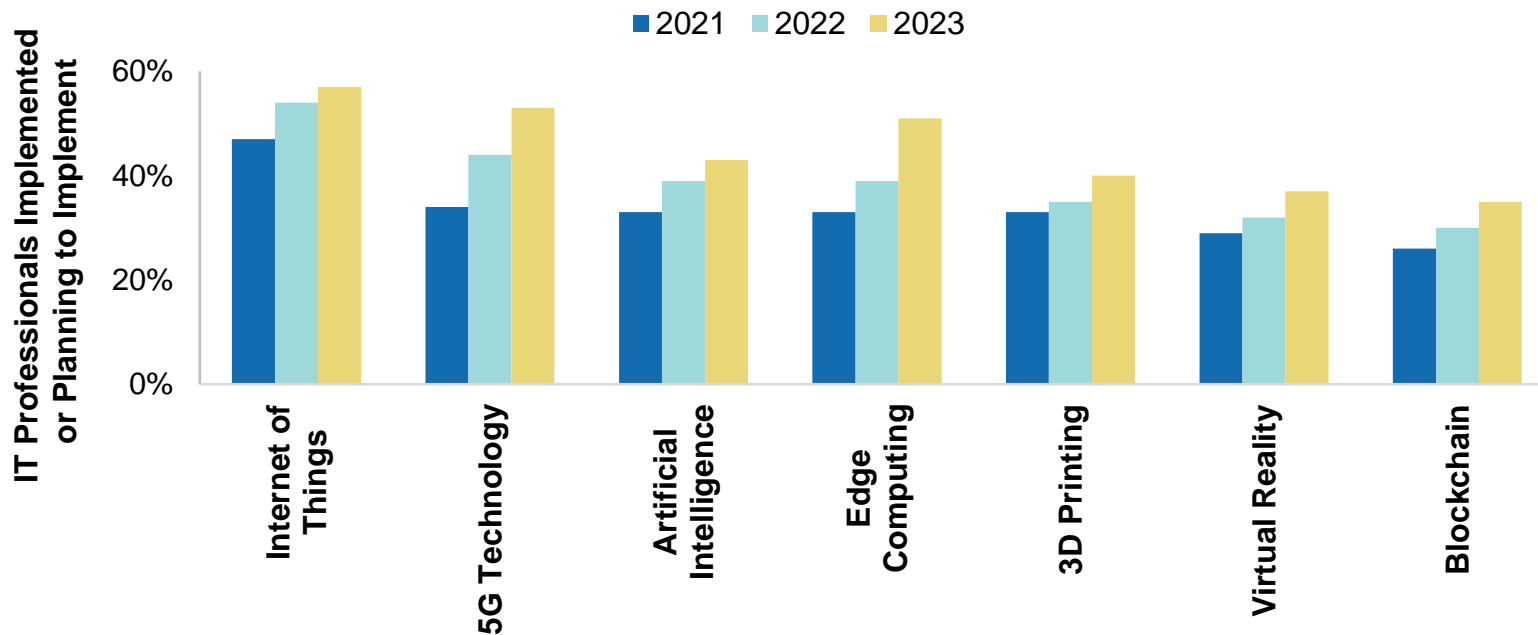
Source: Bank for International Settlements. The debt service ratio reflects the share of income used to service debt (interest and principal). Last data point is 2Q22.

IV

Enduring Themes Age of Connected Intelligence

- We believe we are in a new technological revolution where intelligent computing will be ubiquitous and pervasive
 - Data is the new oil and advances in cloud computing and AI will turn this now abundant raw material into better decision making for companies and individuals in our view

Emerging Technologies Expand Over Time



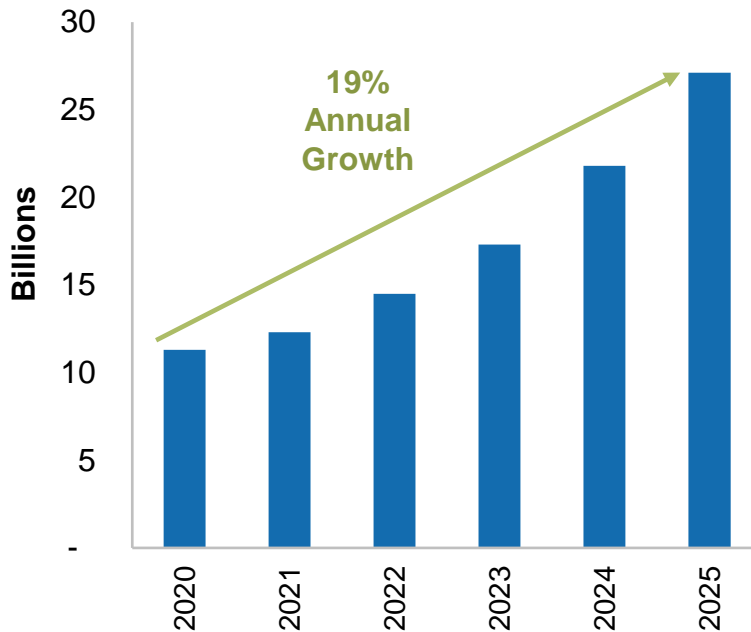
Source: Spiceworks Ziff Davis, The 2023 State of IT, survey of more than 1,400 IT professionals in companies across North America, Europe, Asia, and Latin America.

IV

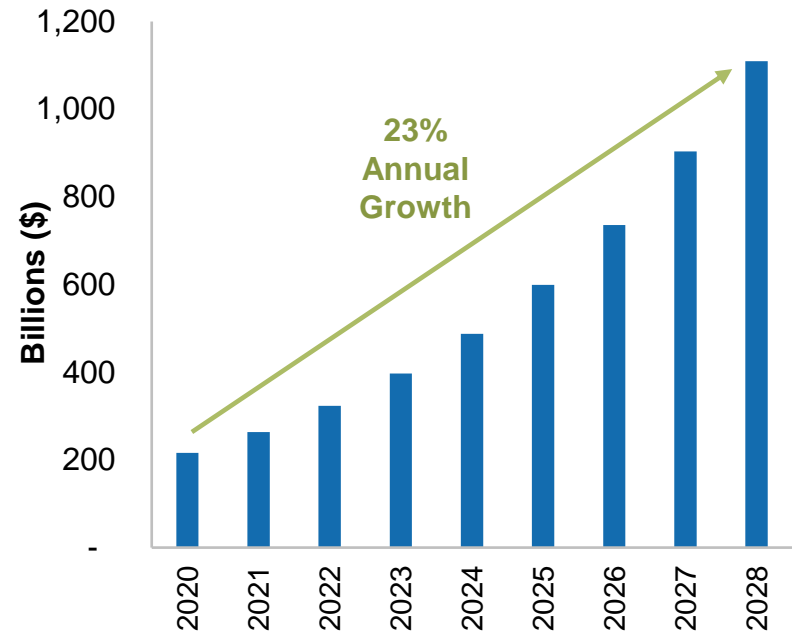
Enduring Themes Internet of Things

- 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

Global IoT Connected Devices



Global Industrial IoT Market Size



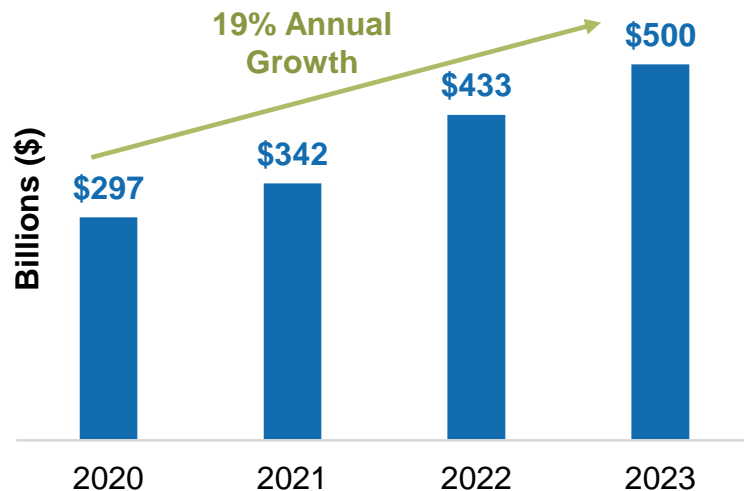
Source: IOT Analytics, September 2021 (2021 – 2025 are estimates), and Grand View Research, March 2022 (2021 – 2028 are estimates).

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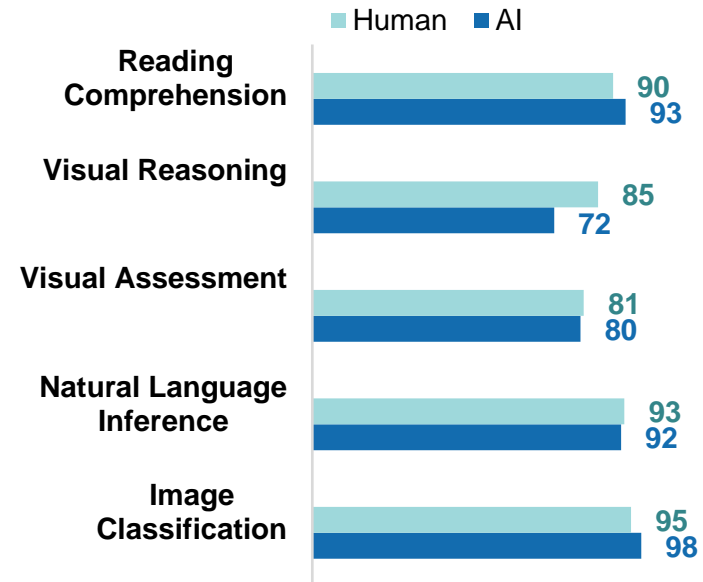
Enduring Themes Artificial Intelligence

- Companies providing AI-based software services and hardware have a large opportunity
- Exhibiting exponential progress, AI capabilities are now close to, or superior to, humans in various tests

Global AI Market



AI vs. Humans – Accuracy (%)



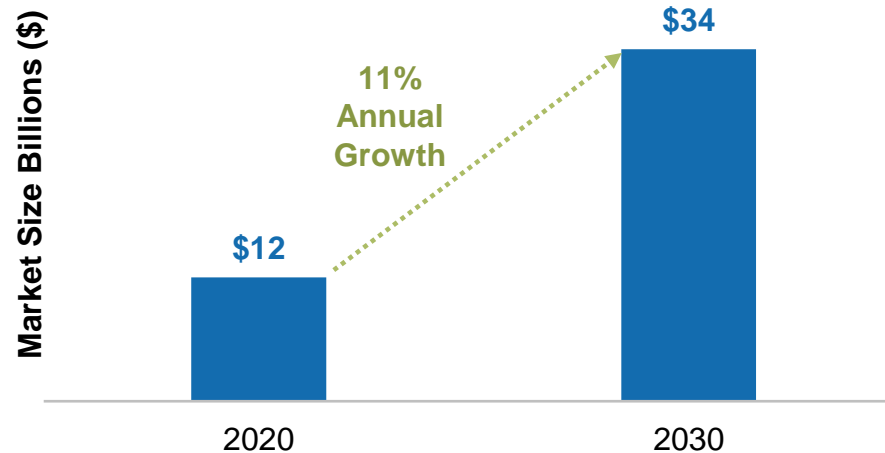
Source: AI market size estimate from IDC, February 2022 (2022 – 2023 are estimates). Artificial Intelligence Index Report 2022.

IV

Enduring Themes Advances in Surgical Technologies

- Improvements in surgical procedures owing to advances in bioengineering and biomaterials should drive improved outcomes for patients and revenue opportunities for innovative companies in our view
 - Robotic surgery
 - Minimally invasive structural heart interventions
 - Organ preservation for transplants

Worldwide Minimally Invasive Surgical Technologies

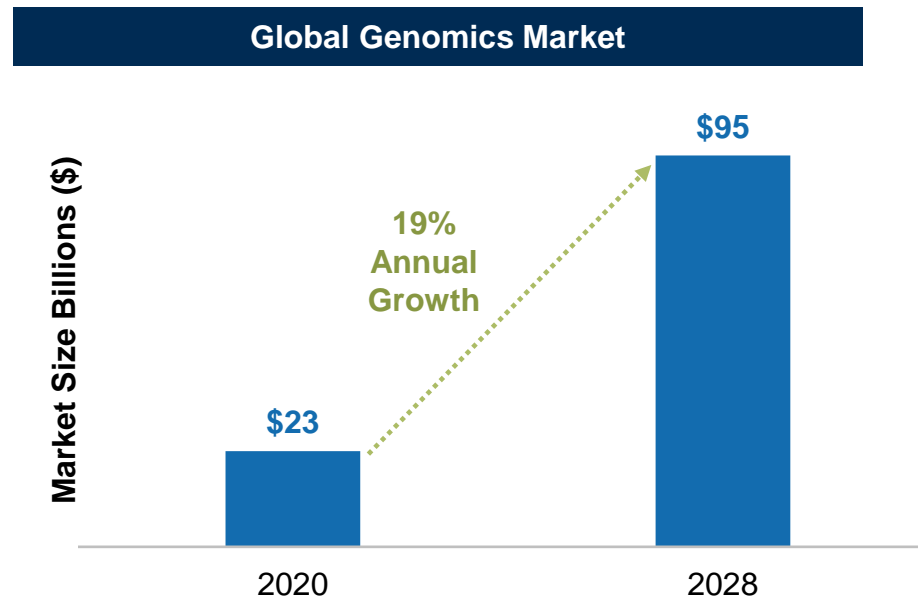


Source: Alger analysis. 2030 is an estimate. Market consists of surgical robotics, percutaneous heart valve repair, and minimally invasive technologies.

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 (e.g., liquid biopsy for early multi-cancer detection)
 - Delivering more efficacious treatments via targeted therapies (e.g., mRNA therapies)

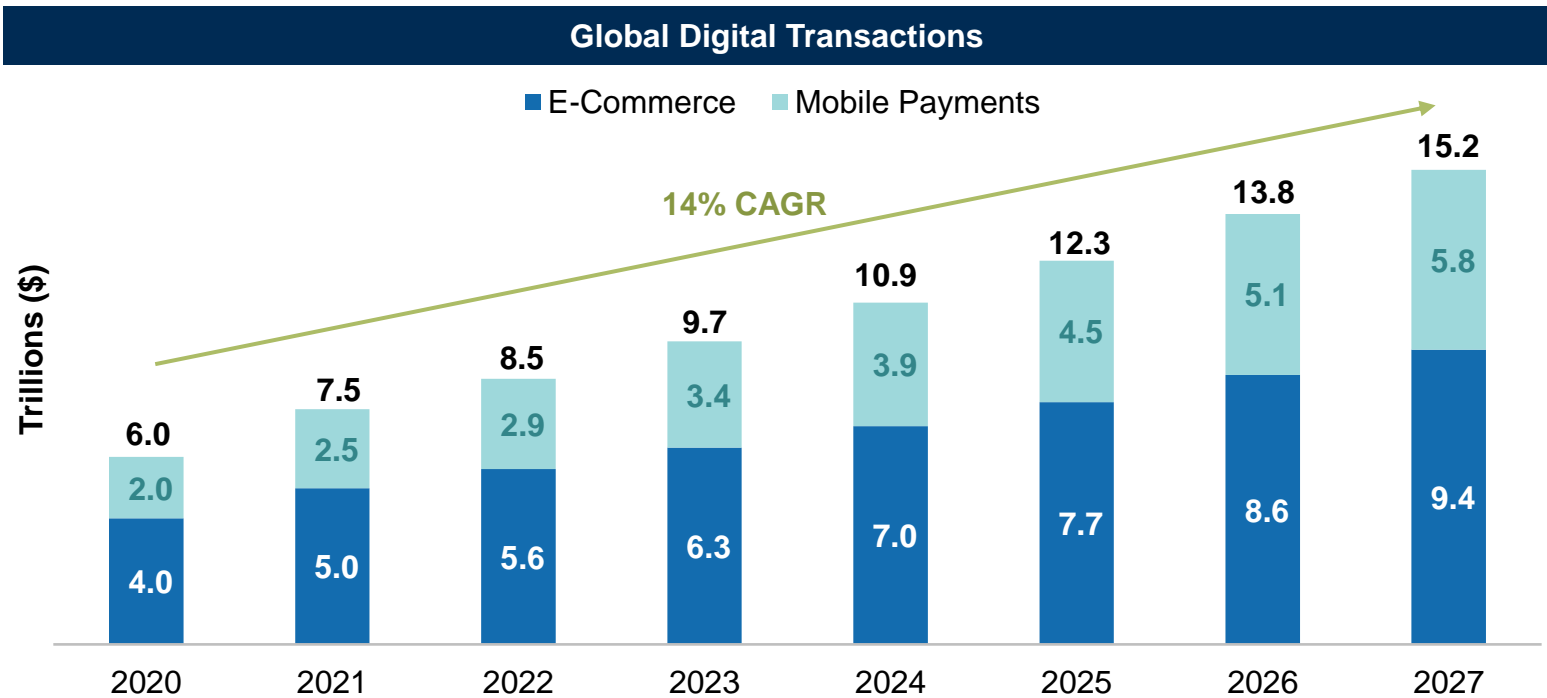


Source: Fortune Business Insights, January 2022. 2028 is an estimate.

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

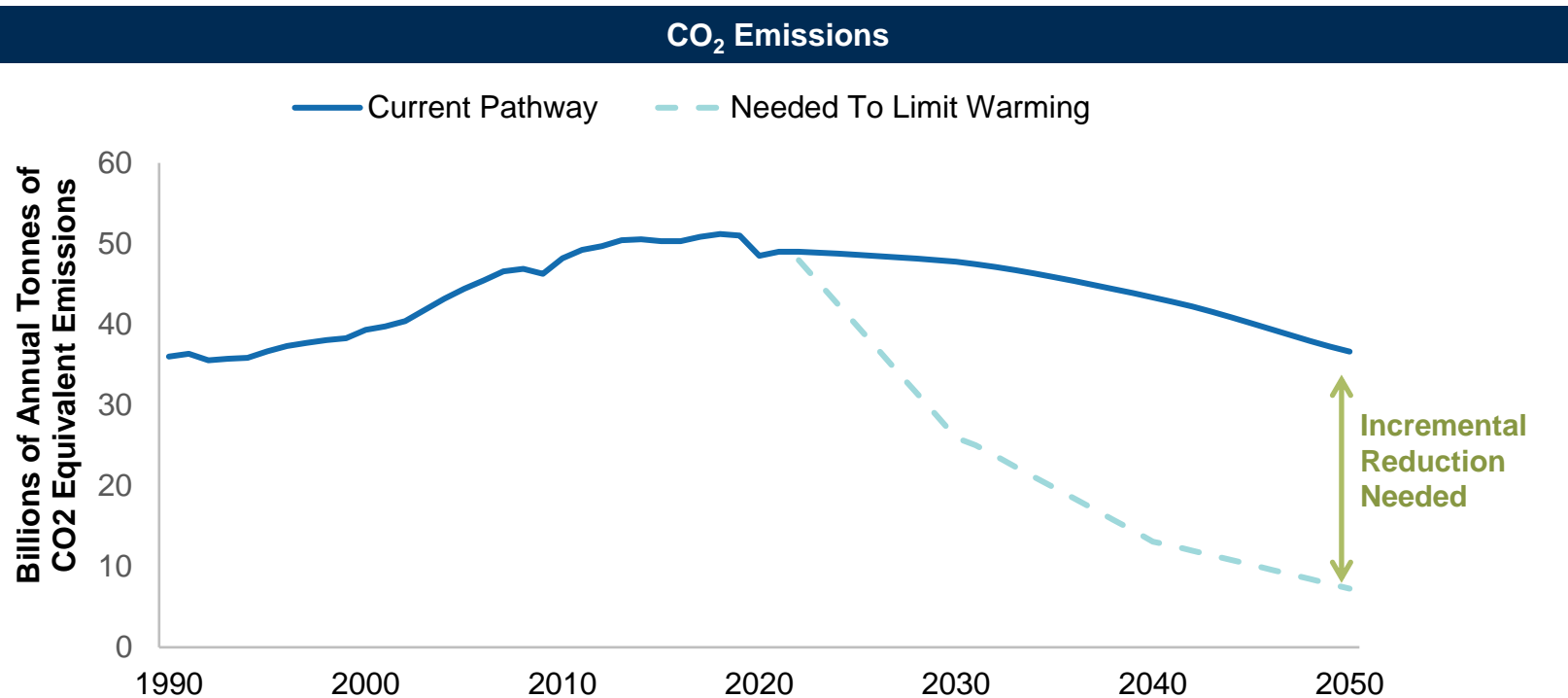


Source: Statista, August 2022 (2022 – 2027 are estimates). E-commerce includes digital remittances. CAGR is compound annual growth rate, the rate of return required for a quantity to grow from its beginning balance to its ending balance. Mobile payments occur when smartphones are used to process transactions using wireless communication or scan QR barcodes.

IV

Enduring Themes 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



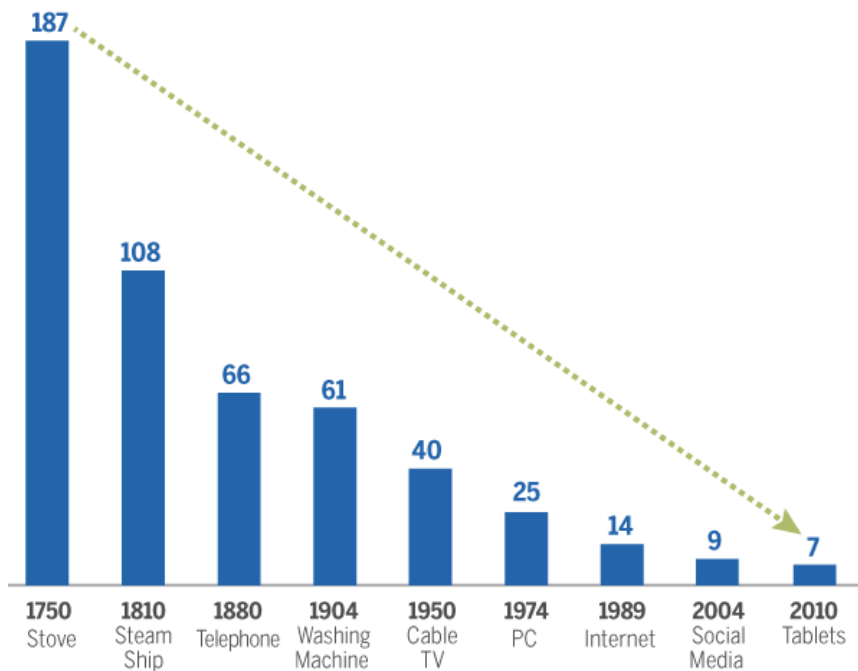
Source: Climate Action Project, May 2021. Current pathway represents average of high and low “pledges and targets” scenario while needed to limit warming is based on median to achieve 1.5 degrees Celsius warming.

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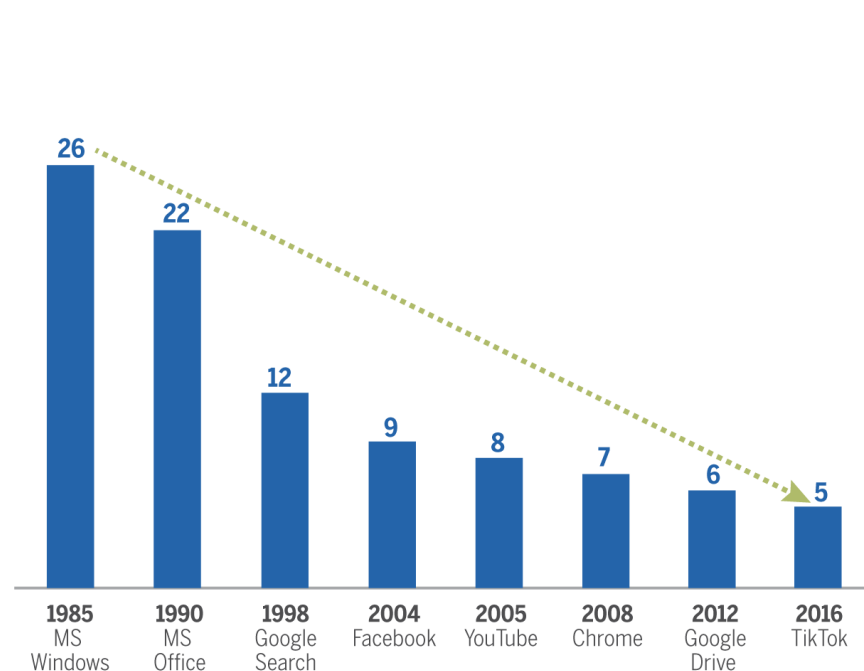
Style Wars Accelerating Change

- 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



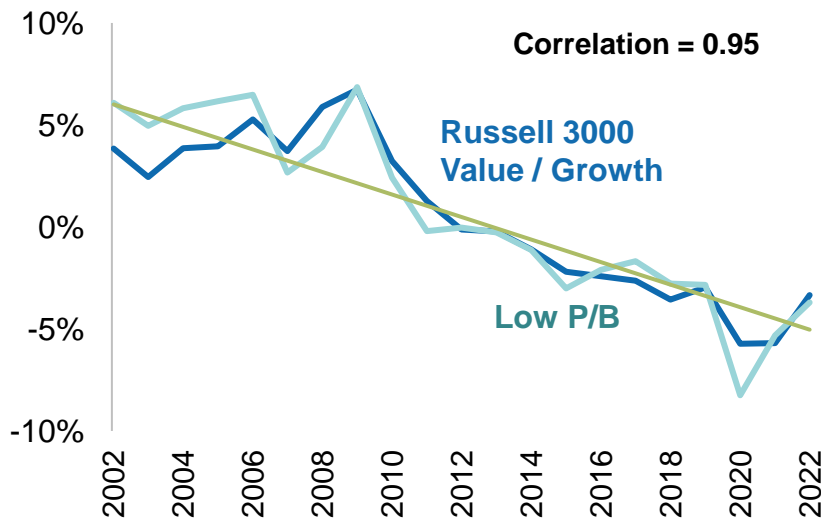
Source: Asymco, Visual Capitalist, company disclosures, Alger estimates.

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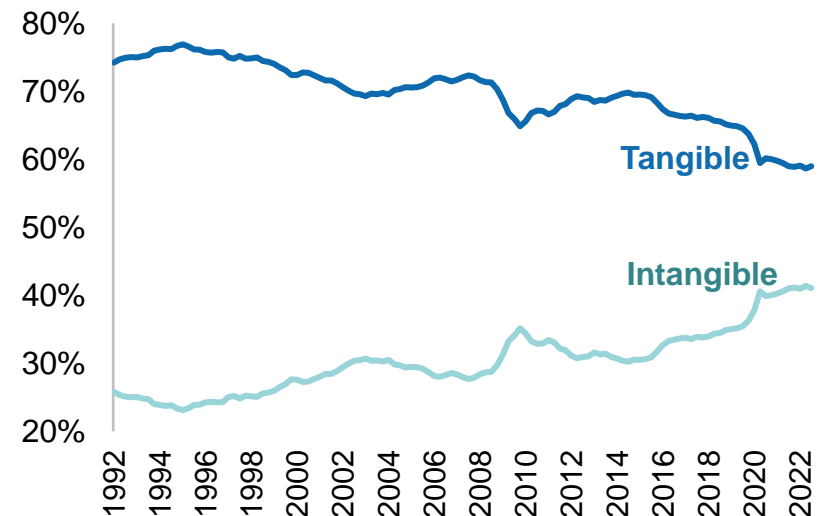
Style Wars Structural Issues Driving Growth vs. Value

- Despite recent outperformance, value stocks have underperformed over the long-term
 - Driven by the very weak performance of the price-to-book valuation metric
- Book value may no longer be as relevant, making current style classification flawed
 - As a result of increasing use of intangible assets that are expensed rather than capitalized

**Value/Growth vs. P/B Cumulative Return
10-Year Rolling Return**



**Business Investment
Intangible vs. Tangible**

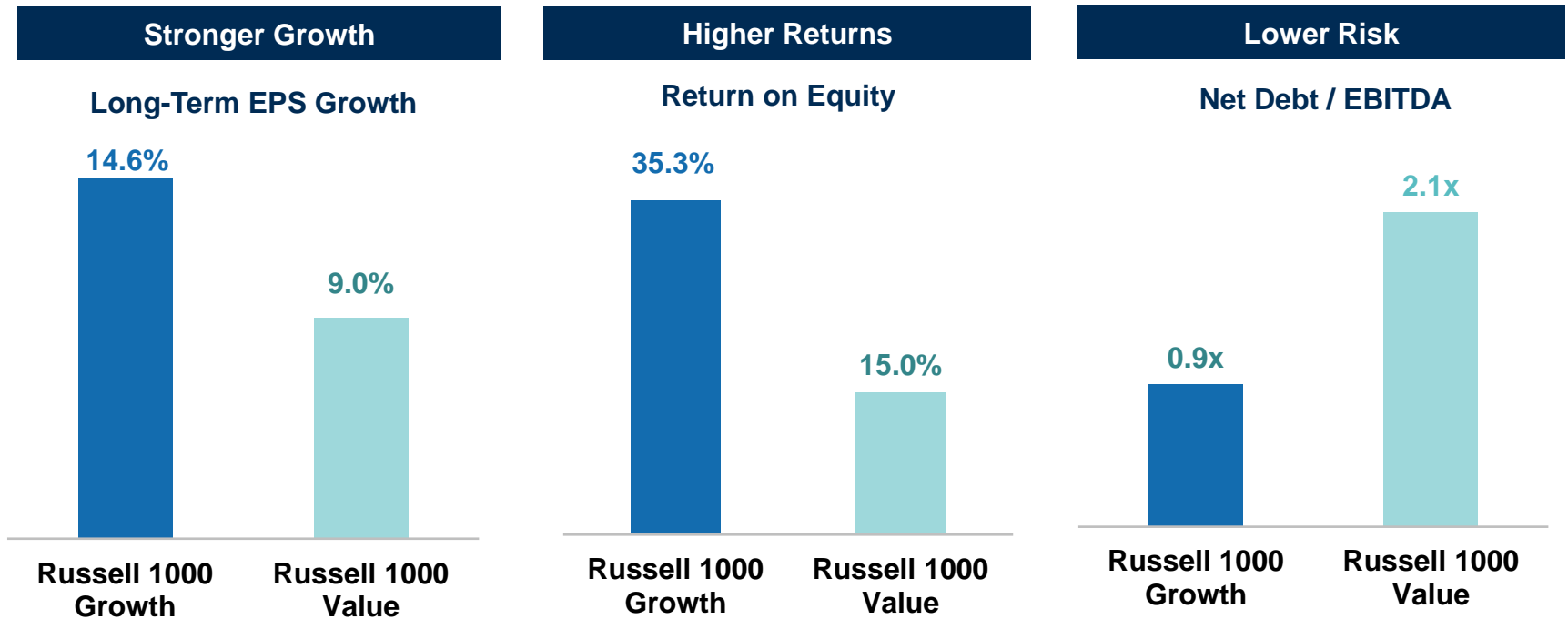


Source: FactSet, Kenneth R. French, FactSet, Bureau of Economic Analysis. Low price-to-book returns are based on the B/P Fama/French factor for the CRSP universe which includes US firms listed on the NYSE, AMEX, or NASDAQ. Correlation measures a relationship estimate between two variables. **The performance 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



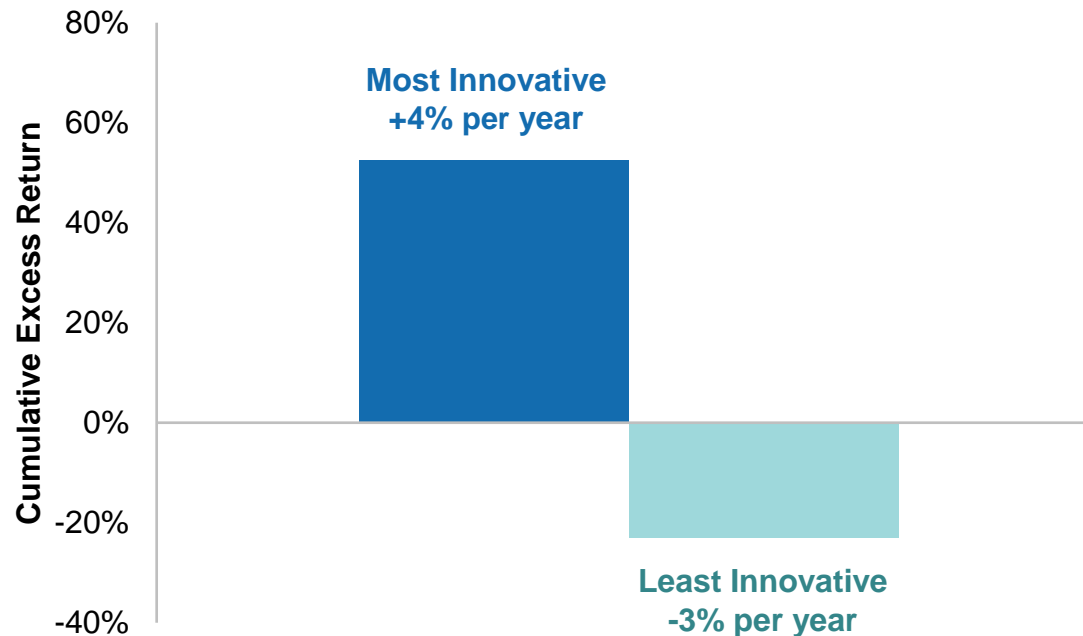
Source: FactSet as of December 2022. Growth represents consensus long-term analyst estimates and actual future EPS growth rates might be materially different than the forecasts shown.

V

Style Wars A Powerful New Investing Factor?

- Studies have shown and our research demonstrates that the most innovative companies have grown 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 November 2022. *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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ALCAPRESSPRP-0123