ALGER



# Alger Capital Appreciation & Spectra Strategy Update

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*Trade conflicts have increased volatility in the market as uncertainty looms. However, we believe innovators and disruptors should be able to weather any economic slowdown.*

In our latest podcast, Patrick Kelly and Dr. Ankur Crawford, Portfolio Managers for Alger Capital Appreciation and Spectra Strategies, give their update for the Alger Capital Appreciation, Alger Focus Equity and Spectra strategies, as well as their broader outlook for the markets.

**ALEX BERNSTEIN:** Hello. I'm Alex Bernstein and you're listening to the Alger Podcast: Investing in Growth and Change. Today, I'm excited to be talking with Patrick Kelly and Dr. Ankur Crawford, both of whom are Executive Vice Presidents and Portfolio Managers for the Alger Capital Appreciation and Spectra Strategies, which encompass our Capital Appreciation, Alger Focus Equity and Spectra portfolios. In today's podcast, Patrick and Ankur discuss innovation and how digital transformation continues to drive the economy. We're also going to look at the recent market volatility stemming from the U.S.-China trade conflict. Patrick, Ankur – thanks so much for taking the time to speak with me today.

Ankur, outside of the U.S., we saw trade conflict driving volatility at the end of last year. And now it's in the news again. Do you see trade issues continuing to have an impact?

**ANKUR CRAWFORD:** Trade conflict risks have increased volatility in the market as the uncertainty looms. It will impact consumers directly via higher pricing and secondary impacts on consumer and business confidence. So far, the impact of tariffs has been mitigated by the depreciation of the Yuan and the Chinese supply chain giving companies better deals in order to keep their capacity full. We calculate that if all the tariffs announced go through – the net impact on retail consumption is a 2-2.5% increase in pricing which would offset the impact of tariffs, and could also impact GDP by 50-75 basis points. This is why President Trump wants to see the Fed lower interest rates, because it is a de facto stimulus to the consumer to counter any tariff-related impact. We have already seen the impact of lower interest rates. With the 10-year approaching 1.8% – consumer spending could be more robust than expected. For example, the number of mortgage applications have surged 22% in the last month. Buying a new home, or refinancing a home generally leads to a flurry of consumption.

There are a few companies that are moving manufacturing out of China, however this process can take years, and not months.

We do not know when the trade conflicts will be resolved, but Trump strategically needs for the economy to be in good shape before the election and as the election nears we think he will be amenable to a "truce" or "deal." Therefore, we expect that he will have a more conciliatory tone as we approach 2020. He is already backing away from European Auto Tariffs and trying to mollify other trade partners.

**ALEX:** In light of all this, how are you thinking about your positioning?

**ANKUR:** Our cyclical exposure in the portfolio is low as we have worried about global growth slowing and have seen Europe starting to show signs of being in a recession, which has emboldened our lower cyclical positioning. In industrials for example we own companies like Cintas – which is a compounding growth story that is less levered to the cyclical gyrations, or Sherwin Williams, which is a beneficiary of a more robust consumer and lower interest rates as they remodel homes. We have also shied away from traditional staples because they too face secular pressure and potential for pricing and margin compression – however, we have positioned in staple-like companies like Ball (a can manufacturer) that has a life cycle change story and improving fundamentals, and a lower than average multiple than a staple.

This lower cyclical positioning is countered by investing in the innovators and the disruptors – which should be able to weather any economic slowdown with penetrating markets and share of spending. Therefore, our largest overweights are in those sectors that we see as being the disruptors – Software, Communication Services (Internet), Healthcare and Consumer Discretionary.

**ALEX:** One of the things I know you're often asked is whether the large cap space has suffered from the movement from active to passive. Do you have an opinion on this active/passive debate?

**ANKUR:** What we find interesting is that if you look at the S&P 500 – we think that 30% of the S&P is being disrupted by the changes that we discussed earlier. This disruption is being caused by only 14% of the S&P – which means that there is still quite a bit of market cap that can accrete to the disruptors. An example of this would be Facebook and Amazon winning in advertising against the entire advertising landscape. Or Software companies accreting share from the likes of old world companies that have not embraced the new world like Oracle.

This actually leads to another question that we are often asked – is it time to own value? Our answer is that given this disruptive force, the growth and profit for this much of the S&P being under pressure for many years will lead to what we expect are not "value stocks" but "value traps".

**ALEX:** Ankur, I want to talk about the tech industry for a minute and the recent regulatory announcements that have been made. What are your thoughts regarding regulation and the impact on the tech industry names you're following?

**ANKUR:** We are watching the recent regulatory announcements closely on Facebook, Alphabet, Amazon and Apple. In early June, the Department of Justice announced the launch of an anti-trust probe on Alphabet, and the FTC announced it will examine Facebook's effect on digital competition. It's difficult to assess the extent of the risks as we don't know the full scope of the probes. And these reviews could be a multi-year overhang. In some cases, there is risk that the companies will be broken up into pieces. And in the case of Amazon, it's possible that the value of the parts – AWS and retail – is greater than the combined entity. We believe that at least some of the risk is priced into these names already, with Facebook and Alphabet both trading near 15 to 16x times the Alger earnings.

That said, the current laws limit the actions the government can take against Big Tech. So, we believe this process will require acts of congress to truly pursue, to full extent, the dissolution of Big Tech.

**ALEX:** Thanks, Ankur. Patrick, I want to turn to a favorite subject of this team: innovation. What are your current thoughts on innovation? And how do you think it might impact inflation?

**PATRICK KELLY:** The repeated theme in our podcasts has been innovation. We believe we are in the early days of one of the most innovative times in history. We have argued that innovation is underappreciated not only across companies and sectors, but also across the entire economic landscape. For example, we have been arguing that technology is a huge secular deflationary force and one of the most underappreciated aspects of innovation is its effect on inflation. We noted in our last podcast that the Fed has overestimated inflation for seven straight years and they will very likely be proved wrong once again in 2019.

Inflation remains very much in check and below the Fed's 2% target.

We recognize there are a number of factors impacting inflation, such as U.S.-China trade war and lower global growth. We also recognize that lower yields around the world are leading to lower yields in the U.S. However, we feel that technology and innovation are one of the most underappreciated aspects of lower inflation and thus lower rates.

We have seen over the past year how important inflation is to the economy and the stock market. In Q4 of 2018, the market declined close to 15% as rates were rising on fears of higher inflation and higher rates. This concern has completely reversed in 2019 as inflation is below target and the Fed is cutting rates. The 10-year bond traded as high as 3.1% in Q4 of 2018 and now stands at 1.8%. The evidence of innovation's impact on inflation is all around us. Virtually every industry is digitizing, leading to complete price transparency and often more competition, which is lowering prices for almost everything we consume. Technology is also driving significant efficiencies for many companies by allowing them to cut out middlemen and sell directly to the end consumer which is leading to more competitive prices. Tech innovation has also had a huge impact on oil prices which continue to remain contained. And we could go on and on.

**ALEX:** How do you think innovation is impacting the broader economic landscape?

**PATRICK:** Innovation is leading to downward price pressure for most things we consume causing inflation to be lower than traditional economic models would imply. The Fed's traditional model is clearly not working. The idea of structurally lower inflation is in turn supporting equity valuations and elongating economic expansions. This is a very important point! Historically the economy grows until it is operating at or above its potential. Then inflation accelerates, the Fed raises rates and finally the economy slows.

The downward pressure on inflation allows global central banks to maintain easier monetary policy for longer periods, extending the business cycle and supporting higher equity prices.

**ALEX:** And do you think this will affect equity valuations?

**PATRICK:** The U.S. consumer is a big beneficiary of lower inflation given that the consumer represents approximately 70% of U.S. GDP. While wage gains remain strong, inflation is modest. For example, The U.S. consumer benefits from lower loan rates, and low loan rates on asset purchases such as homes and autos. The 30-year mortgage rate is now down over 17% year-over-year.
We believe equity multiples will remain above historical levels due to our outlook for lower long-term bond yields.

We continue to think the S&P 500 is attractive relative to 10-year U.S. Treasury bond yields. The S&P 500 is trading at 15.8x 2020 EPS. We think this is reasonable with a 1.5% U.S. 10-year Treasury yield and many sovereign debt yields around the globe below zero.

In addition, more than 50% of the companies in the S&P 500 have dividend yields that are north of the 10-year U.S. Treasury bond. Many of these companies have fairly large buyback programs so the dividend yield does not capture the total cash yield being returned to shareholders. We estimate that total S&P 500 stock repurchases will exceed $750 billion in 2019.

**ALEX:** Shifting to your portfolios, which primary themes have you, Ankur, and the investment team been focusing on?

**PATRICK:** There are a number of big picture trends which will have a significant impact on companies across sectors. There are the continued trends in the Internet and mobile Internet and the emergence of trends such as cloud computing, digital transformation, artificial intelligence, electric vehicles, autonomous vehicles, robotics, augmented reality, IoT and 5G.

Our investment philosophy centers around our belief that companies undergoing positive dynamic change offer the best investment opportunities. The good news for us is that we continue to expect a tremendous amount of change and innovation in the market over the next five to ten years. One of the reasons that we like to invest in change is that people often underestimate the change that is occurring, especially when it is as significant as it is today.

We believe that investors continue to underestimate the impact of technology and innovation not only across sectors but across the entire economic and investment landscape.

We have continued to highlight digital transformation as one of the biggest trends in the economy. We continue to believe digital transformation is a huge sector trend and that companies across sectors need to digitally transform themselves. Sectors are digitizing and businesses need to adapt and digitally transform themselves to remain competitive and relevant in their respective industries. This is creating winners and losers across sectors.

Banking is digitizing which will have a significant impact on business models. The structure and concept of a bank is changing. Historically, traditional consumer banking was based on a branch model and consumers selected a bank based on proximity and services. Consumer decisions are driven by who provides the best digital app and services vs. who has the closest bank branch.

The industry is now digitizing, evolving to digital mobile offerings. We believe the digitizing of the banking sector will result in increased competition and lead to higher deposit rates and lower loan rates.

Retail is digitizing. How goods are bought and sold is rapidly evolving and changing. The idea of a local store selling in a local market with the overhead of a store is becoming a much more challenging business. Products that used to be sold in local physical stores are now being sold on global internet platforms. This is enabling new competitors to emerge; competitors that could traditionally not compete because they lacked distribution. Businesses can now effectively compete by selling directly to end consumers through the internet or through one of the Internet platforms. Examples would be brands such as allbirds or influencer marketing companies. Kylie Jenner has built a billion dollar business through social media and Instagram. The digitization of the retail sector will lead to lower prices for the goods we consume.

Logistics are digitizing. Companies are leveraging data to optimize the speed and accuracy of delivery. Legacy operations that involve phone calls, faxes and emails to create shipment orders and find carriers are being replaced by digital workflows that will automate these processes. Uber, Convoy, Amazon have digital logistics apps linking supply and demand for freight. We can spend a fair amount of time talking about what Amazon is doing in logistics but will summarize by saying that what they are doing in logistics is incredibly disruptive. The digitizing of logistics should lead to increased efficiencies and lower prices for shipping goods.

The media industry is digitizing. The need for scale and a direct-to-consumer service is paramount. Netflix wants to use its feedback loop of more spending to drive more viewership and replace the cable bundle and crowd out its competitors in streaming. The competition is realizing they need to adapt and digitize. Disney will be rolling out its direct to consumer service Disney+ later this year, which is a significant change in their business model. AT&T/Time Warner and Comcast/NBC are launching a direct to consumer offering later this year. CBS has been aggressive trying to grow its direct to consumer offering and will combine with Viacom to give their offering the scale it needs. Consumers can now save substantial amounts on their cable bill without sacrificing much content. This is very deflationary as the average consumer spends well over $200 a month on its cable bill. These bills have been increasing for years, but that is now changing.

In summary, digital transformation will create winners and losers across sectors. Microsoft, Salesforce.com, and Adobe are three large software holdings that are well-positioned to benefit from digital transformation. Microsoft is our largest position in the portfolio. A recent J.P. Morgan published CIO survey ranked Microsoft as a top partner to help with digital transformation.

**ALEX:** Can you talk a bit about cloud computing?

**PATRICK:** We have continued to highlight this theme and have noted that the cloud disruption is staggering. We believe this is one of the most disruptive trends in the history of the technology sector. Cloud computing is in the early stages of disrupting the $3.5 trillion worldwide global IT market. We have seen cracks emerge in a number of traditional on-premise technology companies over the past several months. Names such as Network Appliance, Juniper, TechData and HP Enterprises.

Recently, Andy Jassy, Amazon's CEO of Web Services estimated that cloud computing represents only 3% of IT workloads, significantly less than the consensus' view of 10-15%. We believe the vast majority of workloads will move to the cloud over time. The rapid growth of cloud computing continues to be a material tailwind for

Microsoft, Amazon and Google.

**ALEX:** Patrick, Ankur, any final thoughts?

**PATRICK:** We continue to emphasize the bigger picture of innovation. Innovation is impacting companies across every sector. It's creating winners and losers across sectors and is creating a number of exciting investment opportunities. Our in-depth, fundamental research process focuses on investing in many of the most innovative companies in the market. Our competitive edge is identifying companies in the midst of positive dynamic change and seeking to capitalize on that change before it is recognized by the rest of the market.

**ALEX:** Patrick, Ankur, thank you both so much for speaking with us today. And thank you for listening. For more information on Alger Capital Appreciation and Spectra strategies, please visit **www.alger.com**.

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