The following is a transcript of the Alger Capital Appreciation & Spectra Strategy Podcast.

BRAD NEUMAN: Hello, this is Brad Neuman, Client Investment Strategist at Alger. I’d like to welcome all of you to our Capital Appreciation and Spectra Strategy update with Patrick Kelly. At Alger, we base our investment decisions on in-depth fundamental research conducted by our team of experienced analysts. Our focus on corporate fundamentals enables us to find companies that we believe can grow earnings and, in turn, drive strong equity performance. Our research also helps us gain insight into investor behavior, macroeconomic trends, and other large-scale changes. In this podcast, Patrick Kelly, Portfolio Manager and Head of Alger Capital Appreciation and Spectra Strategies – which encompass our Capital Appreciation, Capital Appreciation Focus, and Spectra portfolios - joins me to share his economic and market observations as well as provide an update for the portfolios which he and Ankur Crawford manage.

Patrick, to start off, can you discuss the state of innovation in the global economy and how it relates to Alger’s investment philosophy?

PATRICK KELLY: Thanks, Brad. I believe we are in the midst of one of the most innovative times in our history with the continued trends in the Internet and mobile Internet and the emergence of trends such as cloud computing, artificial intelligence, electric vehicles,
autonomous vehicles, augmented reality, IoT, and 5G. The pace of innovation is accelerating and occurring across sectors. And we believe we are still in the very early days of all of these trends.

Our investment philosophy centers around our belief 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 and innovation in the markets. 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 across the entire economic and investment landscape.

**BRAD:** What are some of the themes that are driving this significant change and how are they manifesting themselves?

**PATRICK:** I’ll highlight a few that I think will have significant implications for companies across sectors in the coming years. Some of these were mentioned in the previous podcast but I think are worth noting again.

The first is the mobile Internet. Mobile adoption is leading to a new generation of computing. The ability to have a computer at the tip of your fingers at any time is creating new business models and disrupting old ones. On average, people spend almost three hours per day on their mobile phones. This is leading to increased Internet usage and an acceleration in Internet advertising and ecommerce spending. We think Internet advertising growth will continue to surprise to the upside and consensus estimates remain too low. Mobile is also driving an acceleration in eCommerce spending and is a big factor behind the disruption of the traditional retail sector. We estimate there were at least 2,700 retail store closures in the U.S. in 2016 and that pace in 2017 is accelerating.

Mobile is also driving significant change in financial services. Historically, customers selected a bank based on proximity and services. Today's customers are
increasingly choosing a bank based on the breadth and quality of mobile services. In the long term, we believe mobile will change the economics of retail banking. Large banks such as JP Morgan and Bank of America should benefit from these trends as they can invest significant sums in technology given their scale. For example, mobile devices at Bank of America now account for over 21% of deposit transactions, up from 11% three years ago.

We also believe the mobile Internet will play a role in dramatically changing the logistics industry and many other areas of the economy.

Another big emerging theme is artificial intelligence (or AI). AI can allow businesses to be more productive and efficient and can potentially change the competitive landscape in various sectors. I recently heard AI described as “overhyped, yet underappreciated” and I thought that was a good way to describe it. Some examples: Alphabet is applying AI across its business lines. In 2016, Alphabet’s CEO made a statement that they are moving from a mobile-first to an AI-first company. Amazon’s Alexa is an AI-enabled device and one that we think will be another disruptive technology to the retail sector.

Gartner is indicating that 85% of customer support interactions will be driven by autonomous agents by 2020. AI will enable the advancement of autonomous vehicles which will drive a significant amount of change and productivity to our economy.

We think that many of the large technology platforms will be the biggest beneficiary of AI but companies across sectors are positioned to benefit as well.

Augmented reality is another emerging innovative trend. Over the next two to three years, we think augmented reality will significantly change how consumers and professionals engage with digital content. We expect to see the biggest applications in gaming, shopping (particularly home improvement), real estate and property experiences, corporate training/education software, and healthcare/medical diagnostics. For example, we think augmented reality in the long term is disruptive to the real estate agency industry and the commission fee levels that
agents receive. We think augmented reality also further accelerates ecommerce penetration, especially in the building products and home improvement categories.

Earlier this year, Apple’s CEO Tim Cook compared the potential impact of augmented reality to that of the iPhone. He described it as a product “for everyone.” Apple has been investing in augmented reality along with other owned companies including Amazon, Google, Microsoft and Facebook.

Cloud computing is another theme that’s helping to enable all of this innovation and is in the early stages of disrupting the $3.5 trillion dollar global Information Technology market. Companies are finding it more cost effective to outsource their IT operations to cloud based service providers. Amazon, Microsoft, Alphabet, and Alibaba will all be big beneficiaries of cloud computing.

**BRAD:** What do you think some of the implications to the global economy could be from these trends in innovation?

**PATRICK:** The impact of innovation goes well beyond the disruption it is causing across sectors. Technology is reshaping the entire economic, inflation and investment landscape. Technology is a secular deflationary force. It is driving price transparency and efficiency. Mobile devices and ecommerce platforms such as amazon are leading to increased efficiencies and lower consumer prices. Technology innovation in the U.S. shale plays is leading to increased well productivity and lower energy costs. It is also impacting other commodities such as corn where it is increasing yields and corn prices have now remained below $4 (per bushel) for most of the past three years.

There is also a continued trend to automation and robotics which will be a long term deflationary force. The production of an automobile today is vastly different from the assembly line era. Nike is bringing production back to the U.S. as they are using technology to automate the production of sneakers. Amazon is increasing the number of robots in its fulfillment centers from 30k to 45k this year. We believe technological innovation will continue to surprise to the upside and will continue to be a stronger deflationary force than people realize. Chicago Fed
President Charles Evans recently said "I sometimes wonder if there isn't something more global, more technological that's effecting inflation that we don't quite have our arms around very well."

We believe that investors are underestimating the role technology is playing in tempering inflation and its role in the entire economic, inflation, and investment landscape.

Despite globalization and technology tempering inflation, we do expect rates to rise from current levels especially if corporate tax reform is passed. Fiscal stimulus on top of an economy that is already at close to peak employment should be inflationary and lead to higher rates. We believe short and long-term rates should move higher but that long term rates will remain contained largely due to the secular deflationary impact of technology as well as the continued impact of globalization. This paradigm shift in rates is positive for equity valuations as we believe equity multiples will remain above historical levels due to our outlook for lower long-term bond yields.

**BRAD:** What does this mean for the growth outlook for the U.S. economy generally and relative to the rest of the world?

**PATRICK:** All of the technology innovation and its role in tempering inflation continues to be a positive tailwind for the U.S. economy and has helped create a goldilocks economy in the U.S. The U.S. consumer is a big beneficiary of lower inflation given the consumer represents 70% of U.S. GDP. Low unemployment is leading to wage inflation which is good inflation while technology and globalization are leading to lower consumer prices and keeping commodity prices in check. For example, technology innovation is leading to lower oil prices. Gas pump prices hit a 10-year low in early July. As a result of innovation, rates remain low despite an unemployment rate of 4.4%. Low rates are enabling better economic growth.

Another key reason for our positive view on the U.S. economy is that the U.S. continues to lead the world economy in innovation. Many of the most innovative companies in the world are U.S. based companies such as Apple, Google, Amazon, Facebook, Netflix, Microsoft, Tesla
and many others. The U.S. continues to lead the innovation in the healthcare sector. The U.S. is also leading innovation in the shale plays and will soon be the largest oil producer in the world by far in the years ahead. The U.S. is well on its way to being energy independent. This is a significant change from the past and extremely positive for the U.S. economy. Rising U.S. oil and natural gas production lowers consumer and business energy costs, it lowers inflation, it makes U.S. manufacturing more competitive and lowers the trade deficit.

**BRAD:** What are the market implications of these trends? Specifically, what is your view of equities in aggregate and which areas of the market, in particular, are attractive?

**PATRICK:** Valuation needs to be analyzed in the context of interest rates. It is a bit misleading to compare historical valuations to current valuations given the change in rates over the past 30 years. It would be correct to compare historical valuations if you believed that long term rates would normalize over time and revert to historical median levels. Despite our belief that rates will rise in the near term, we do not believe rates will revert to historical median levels given all of the deflationary forces in the economy. The 30-year bond is probably the best proxy for where long term rates should be and that remains below 3%. As a result, we believe valuations will remain higher than historical levels. We continue to believe that stocks look attractive relative to bonds despite the move in the equity markets. 33% of the companies in the S&P still have dividend yields that are north of the 10-year bond and this does not include the large amounts of cash being returned through buybacks. We think many of the cyclical companies have become expensive but valuations on the secular growth companies remain attractive. Many large, fast growing tech companies trade at reasonable multiples on next year’s earnings.

The P/E ratios on these companies look even more attractive given the large net cash positions. We also believe that many perceived value stocks may continue to be value traps. The faster pace of innovation today may mean that value stocks that appear cheap may often be victims of change. This has clearly been the case for many traditional retailers and we continue to believe that change
has just begun.

There are also companies such as Amazon which look extremely expensive if you value it on forward earnings but we continue to believe it is one of the most attractive values in the market looking out five to ten years. In sum, there are certain components of the market where valuations look full but we continue to see good opportunities, especially in many of the secular growers. We recognize that multiple expansion is unlikely from current levels and stock appreciation will need to come from earnings growth.

BRAD: Can you talk about the strategy’s current positioning with respect to sector weightings?

PATRICK: We continue to focus on innovative companies that are benefiting from change and avoiding those that are being disrupted.

Technology is our largest sector weighting and our largest overweight. We continue to be positive on the trends that we are seeing in the internet, software and semi subsectors and we believe tech will be a beneficiary from the big picture trends that I discussed previously.

In Consumer Discretionary, we have a slight overweight given our overweight in internet based companies such as Amazon. And we remain underweight in the traditional retail space.

In Health Care, we have a modest overweight in the sector. We favor innovative based health care companies and companies that are helping to control or lower the growth of health care spending such as the HMOs.

We are overweight Financials, as well, and believe the banks will benefit from lower capital requirements, potentially lower corporate tax rates and less regulation. In addition, many of these companies have had to build capital over the years and have been restricted on the amount of capital they can return to shareholders. Payout ratios are now approaching 100% for many of the banks resulting in high cash yields which we find attractive on an absolute basis and especially relative to bonds.
We are underweight Industrials. The fundamentals are strong for most of the Industrial companies but we are finding more attractive risk rewards in other sectors. And we continue to favor secular growth over cyclical growth.

In Staples, we continue to be underweight this sector because there is not much dynamic change and innovation occurring in the sector. In addition, many of these companies are starting to face some secular issues. The changing retail landscape is impacting many companies in the space. In addition, the entrance of the hard discounters is leading to a renewed push into private label products, which could negatively impact the branded companies. And lastly, we think the valuations are unattractive for many companies in the sector given these concerns.

Lastly, we are roughly equal weight energy and materials but these groups remain a small percentage of the portfolio.

In sum, we are focused on companies that are innovating and benefiting from change, and avoiding those that are being disrupted.

**BRAD:** Thanks, Patrick. And thank you for listening. For more information on the Alger Capital Appreciation and Spectra Strategies, please visit www.alger.com.
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