

A Relentless Pursuit of Positive Dynamic Change

PATRICK KELLY, CFA

Executive Vice President

Portfolio Manager

Head of Alger Capital Appreciation and Spectra Strategies



ALEX BERNSTEIN: Hello, I'm ALEX BERNSTEIN: Hello, I'm Alex Bernstein and you're listening to The Alger Podcast, Investing in Growth and Change. Investors familiar with Alger will likely also be familiar with our long-standing philosophy of investing in companies experiencing Positive Dynamic Change. Today's guest, Portfolio Manager Patrick Kelly, has shown a relentless pursuit of investing in Positive Dynamic Change companies – across all market cycles – for more than 22 years now. And today, we're discussing the Alger Focus Equity portfolio which celebrates its 10-year anniversary this month. Patrick, thank you so much for joining me this afternoon, and congratulations on Focus Equity's 10-year anniversary.

PATRICK KELLY: Thanks, Alex.

ALEX: Patrick, this past year, investors have witnessed possibly the most challenging market of the last decade. However, despite fears of inflation and the Fed continuing to raise rates, you remain quite confident in the holdings of the Focus Equity portfolio. Tell me about that.

PATRICK: Sure, thanks. Yes, there's clearly a lot of anxiety over inflation and Fed policy which is creating a lot of near-term uncertainty, but we do think the near-term concern is setting up for very attractive long-term opportunities across our portfolio. And stepping back from all of the macro noise, we do see a tremendous amount of innovation and change across the economy that we think will continue to create winners and losers across sectors. Our investment philosophy revolves around investing in positive change, and we are looking to invest in companies that are innovating, benefiting from the secular trends and change, while avoiding those that are being disrupted.

ALEX: Just to stay with inflation for a minute, do you believe that the current high level of innovation within our economy is actually a long-term deflationary force? And if so, how do you reconcile what we're experiencing now

versus your long-term expectation for inflation?

PATRICK: We've had a perfect storm of events impacting inflation. COVID and the Russia/Ukraine war have exacerbated the inflation issues. COVID led to additional fiscal and monetary stimulus and disrupted global supply chains creating supply demand imbalances. The Russia/Ukraine war has disrupted food and energy prices.

And we do think some aspects of inflation will be sticky. Labor is an issue in the U.S. given a number of factors. There's demographics, early retirements, long COVID, reduced immigration, reshoring, and we think one underestimated impact has been the gig economy where everything is now delivered to the door, whether that's food or goods, which is a big pull on labor.

There are other areas where we see deflation or the beginning of prices rolling over. We're seeing prices for most goods roll over as supply demand normalizes, and we're now seeing global shipping rates roll over as well, which can be a leading indicator for goods pricing. And the supply demand imbalances have led to temporary pricing power for many companies. I would also say, as the retail sector is digitized, most products are being sold directly to the consumer and middlemen have been eliminated. We think there's now almost complete transparency in everything that we buy and increased competition from most products that we purchase which should lead to lower prices.

And I think taking a much longer-term view, we do believe that innovation will be a long-term secular deflationary force. We think the advancements in AI will be deflationary long term and can potentially have a significant impact on productivity. Autonomous technology for autos, autonomous robots/machines could have a significant impact on labor and productivity.

In the near term, we expect energy, nat gas prices to remain high, but long term, if we take a much longer term view, we do expect lower energy prices as electric



PATRICK continued: vehicles make up a much larger percentage of the global auto fleet and advances in green energy. The path to getting there is a bit uncertain, but we think the market is saying the Fed will do its job in reducing inflation.

ALEX: Patrick, you've referenced near-term pain but with medium- to long-term wealth creation a few times. Can you give some concrete examples from the portfolio?

PATRICK: Sure. We're seeing a number of companies with a fair amount of near-term earnings uncertainty with very attractive long-term opportunities, and currently the market is taking a very narrowed view in valuing companies given all the near-term uncertainty and seems unwilling to look out over a multiyear period in most cases. Now, we are starting to see signs that this is beginning to change, but the market is taking a fairly narrow view in how they're valuing companies right now.

And I thought I'd illustrate this through one example of a company in the portfolio, it's Marvell. This is a semiconductor. They sell chips in datacenters, telecom infrastructure, enterprise networks, automotive applications. It's a combination of a high-unit volume growth stock, a lifecycle change story. Marvell has deliberately repositioned the company to higher growth end markets. The datacenter is now 43 percent of their business, 5G is 18 percent of their business, auto is less than six percent of the business, but represents a big, new growth opportunity for them. And this is a company that was 62 percent consumer oriented in Fiscal Year 2017 and is now only 11 percent consumer oriented.

The consumer portion of their business is a lower multiple and more cyclical business. So, Marvell has now emerged from its

In addition, they believe the auto ethernet will be a \$5 billion plus TAN by calendar year '28 and that they can capture greater than 50 percent of this market.

However, there is near term risk to Marvell's estimates given the current economic backdrop. If there is a significant economic downturn in '23, Marvell may grow their revenues five percent in '23 versus the consensus estimate of close to 15 percent. But long term, we think there may be upside over the next three to five years if Marvell can compound at a 15 percent growth rate with the stock trading at 16 times forward earnings multiple.

So, this is an example of a company in the portfolio with near term uncertainty, but with significant long-term upside. And we are seeing this dynamic across a number of companies across our portfolio.

ALEX: Patrick, probably your greatest long-term theme for the strategy has been innovation, and the current portfolio certainly reflects that. Which industries do you think are currently benefitting the most from innovation?

PATRICK: We continue to see a tremendous amount of innovation that it is impacting companies across all sectors. There's the themes of digital transformation, cloud computing, artificial intelligence, electric vehicles, autonomous vehicles, IoT. The consumer metaverse, enterprise metaverse are just emerging, and this innovation is creating winners and losers across sectors.

The retail sector is also digitized, which has enabled new competition and resulted in persistent challenges for many of the traditional retailers. And as sectors digitize, we are seeing companies having to invest more in software and technology in order to remain competitive within the respective sectors. Microsoft's CEO recently stated that he believes tech spending will go from five percent of GDP to ten percent of GDP over the next decade, highlighting the view that companies will have to invest more in technology in order to remain competitive.

So, in this environment, we are looking for companies that are innovating, benefitting from change, and companies that have strong competitive positions with durable growth profiles. We are also looking for companies that can emerge from the downturn in a stronger competitive position.

ALEX: And you have a particular interest in AI? Artificial intelligence?

PATRICK: Sure. AI is proliferating across the global economy as companies digitally transform. We're seeing exponential growth in data, and then AI is being applied to this data to more effectively and efficiently run businesses. The CEO of Google said many years ago that AI will have a bigger impact on society than fire or electricity, and we are still in inning one of the advances in AI.

There are a number of companies in the portfolio that benefit from the AI theme. And one example that I thought I would highlight is Intuit.

Intuit was one of the first companies to go all in on the cloud years ago to accelerate their innovation. They've said they've had more innovation over the past two years versus the past 20 years. They're one of the most data centric companies in the world. They have personal tax data on 50 million U.S. individuals, nine million small businesses, financial product data on the 125 million customers of Credit Karma, their financial management platform.

PATRICK continued: Intuit is leveraging all this data and applying AI to it to enhance the value of their products. They recently stated the company has 55,000 tax and financial data points per consumer and delivers over 58 billion machine learning predictions daily. Intuit is a company that's been very forward thinking on AI and they now consider themselves an AI driven expert platform. They've also digitized their tax business. Turbo Tax Live is a platform that allows customers to get live assistance from tax experts who can help them with their taxes or do the entire return. AI plays a big role in their live platform in order to best match each customer with the right expert.

Intuit also recently acquired Credit Karma which is now becoming a data platform with powerful network effects. AI is being applied to all this data to better match consumers and lenders.

ALEX: Patrick, I know you are very focused on the Alger philosophy of investing in Positive Dynamic Change companies. And in fact, many of the holdings in the portfolio are positive lifecycle change stories. Can you talk about that?

PATRICK: Yes. One area where we've seen some positive change is companies that are benefitting from the Inflation Reduction Act, which was recently put into place. The IRA or the Inflation Reduction Act, it's the most comprehensive and ambitious climate legislation ever passed in the U.S. It commits \$390 billion of spending credits over the next ten years related to energy and climate change. We see opportunities in utility-scale solar, resi-solar, energy storage, utilities with renewable rate base potential.

There are also multiple second derivative beneficiaries in the industrial and energy infrastructure sector. Solar manufacturing companies such as First Solar could see significant manufacturing tax benefits because of their domestic solar module assembly and we believe are positioned to take significant U.S. market share.

Other solar names such as SolarEdge may benefit from the extension of the investment tax credit which was extended to 2032 with a higher rate than previous. Then there are electric infrastructure enablers which should also benefit from the sizable infrastructure buildout.

One company I would highlight is Eaton which has undergone a lifecycle change and is now benefitting from the recent legislation and a number of secular growth trends. Eaton divested most of its cyclical businesses

several years ago and their business mix is now 70 percent in electrical products, ten percent is in aero, which should benefit from air traffic recovering, higher defense spending. As a result of this, we think Eaton is now a less cyclical, higher margin company with a much better organic growth profile. Their electrical business is benefitting from the electrification of the economy. Eaton is benefitting from three major energy transition trends – the transition to EVs, grain rate renewable energy generation, and grid hardening infrastructure investment.

Even in an economy downturn in '23, we think Eaton will be able to meet consensus estimate forecasts. So, we think Eaton is a company that has repositioned its business mix and is now a more durable growth company benefitting from a number of secular growth trends, primarily the electrification of the economy.

ALEX: Thanks, Patrick. Any final thoughts?

PATRICK: Yes, I think that I'd want to say that I appreciate everyone's time. I know recent performance has been frustrating. It has been frustrating to us. This has definitely been the most challenging period in my career as a portfolio manager. In some instances, recently, I felt a bit like late 2008 where stocks were going lower than expected and through bear cases in some instances. And 2008 was a challenging year for the strategy, but we did have one of our best years ever coming out of the downturn in 2009.

I also became a PM on the strategy at the end of 2004 with little experience at the time, ten years later our funds were number one and number two percentile in their categories, which was a period of many different markets. I don't think I'm a worse PM today than when I first started, although the numbers are a bit different. I think I'd just like to conclude by saying despite the recent poor performance, we have a lot of conviction in our team and our portfolio to deliver strong future returns. And again, I appreciate everyone's time and continued support.

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

PATRICK: Thanks, Alex. Great talking to you.

ALEX: And thank you for listening. For more information on the Focus Equity strategy and for more of our latest insights, please visit www.alger.com.

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