Small Cap Focus Update

POWERFUL FORCES CREATE ATTRACTIVE MARKET CONDITIONS

In this commentary, Alger Small Cap Focus Strategy Portfolio Manager Amy Zhang provides an overview of 2016 and explains why this is an opportune time for using a research-driven strategy that invests in what we believe are exceptional small cap growth companies.

Amy Y. Zhang, CFA®

SENIOR VICE PRESIDENT
PORTFOLIO MANAGER

A Look at 2016

During the first quarter of last year, low interest rates supported a dramatic momentum trade by investors that entailed the following:

- A rotation into equities of companies that pay consistent dividends.
- Dividend yield being one of the top characteristics of stocks that outperformed, according to data from research firm Northfield.
- The bond-like Telecommunication Services sector generating the strongest performance within the Russell 2000 Growth Index.
- The Health Care sector, which includes companies with potential for generating strong earnings growth, performing the worst (see Figure 1).

Figure 1:
Russell 2000 Growth Index Total Return

First Quarter 2016	(%)
Telecommunication Services	12.9
Industrials	5.5
Consumer Discretionary	3.1
Financials	1.4
Materials	0.8
Consumer Staples	0.4
Information Technology	-3.6
Utilities	-5.6
Energy	- 11.6
Health Care	-18.3
TOTAL	**-4.7**

Source: FactSet

INVESTMENT STRATEGY HIGHLIGHTS

Our portfolio utilizes in-depth, bottom-up research to identify and invest in what we believe are exceptional small companies with strong fundamentals, visionary management teams, and potential for generating sustainable revenue and earnings growth.

We believe that those types of companies have the wherewithal to become successful large companies over the long term and to produce attractive risk-adjusted returns over full market cycles. To that end, we pay attention to market volatility and commit considerable effort to differentiate between bumps in the road and permanent impairment of corporate fundamentals.

We believe that the most compelling investment opportunities exist among Information Technology, Health Care, Consumer Discretionary, and Industrials sectors' constituents that have potential for increasing their revenues and earnings. Therefore, those sectors represent a substantial portion of the portfolio's assets. As benchmark-agnostic investors, we focus on absolute performance, although we believe our strategy is well positioned for outperforming its benchmark over full market cycles.

Figure 2:
Russell 2000 Growth Index Total Return

11/09/16 to 12/31/16	(%)
Financials	18.9
Utilities	12.0
Industrials	11.1
Energy	11.0
Real Estate	10.1
Consumer Discretionary	9.7
Telecommunication Services	9.1
Materials	7.6
Consumer Staples	5.5
Information Technology	5.4
Health Care	-0.1
TOTAL	**7.0**

Source: FactSet

As long-term investors, we do not rotate into sectors or into stocks of companies with weak fundamentals that may be temporarily in favor. The portfolio's first-quarter relative performance, therefore, was hurt by its lack of exposure to bond-like equities and by its focus on companies that we believe have strong revenue and earnings growth potential.

Trump Election Sparks Another Momentum Trade

Later in the year, the presidential election of Donald Trump sparked another strong sector rotation and momentum trade, with investors' growing optimism over the economy contributing to the outperformance of cyclical stocks and interest-rate sensitive equities from November 9 until the end of 2016. Conversely, the Health Care and Information Technology sectors substantially underperformed, which created an additional headwind for the strategy's relative performance (see Figure 2).

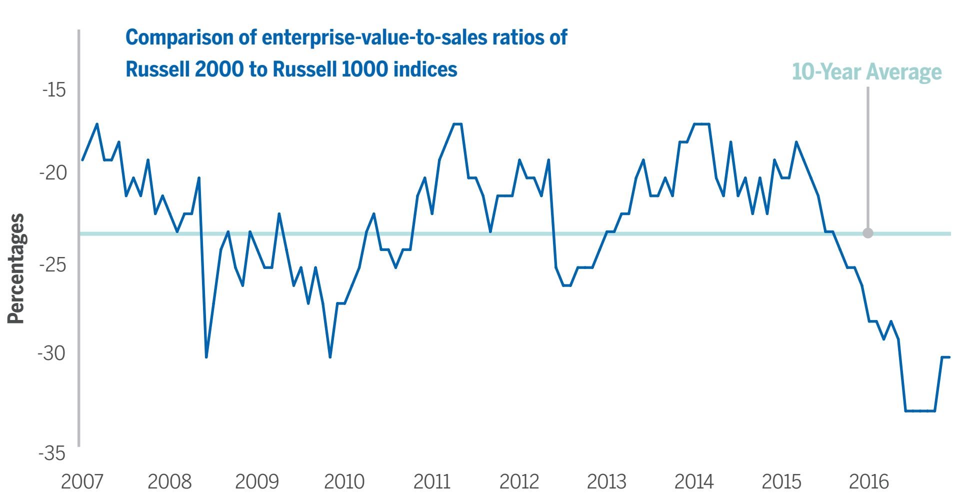
The end of the year momentum trade clearly hurt our relative performance. Despite challenging markets, the Alger Small Cap Focus strategy still generated a positive return for the year.

Growth Investing in 2017

As a result of what we believe was a strong disconnect between equity prices and corporate fundamentals during 2016, in our view, small cap stocks, and more specifically, small cap growth stocks, are trading at discounted valuations and are, therefore, poised to outperform.

Regarding small cap stocks in general, the ratio of enterprise-value-to-trailing-sales (EV/Sales) is noteworthy. At the end of 2016, the ratio for the Russell 2000 Index was at a 30% discount to the Russell 1000 Index, which measures large cap stocks, compared to only an 18% discount at the end of the first quarter of 2015 (see Figure 3).

Figure 3: **Small Cap Stocks are Attractively Valued**



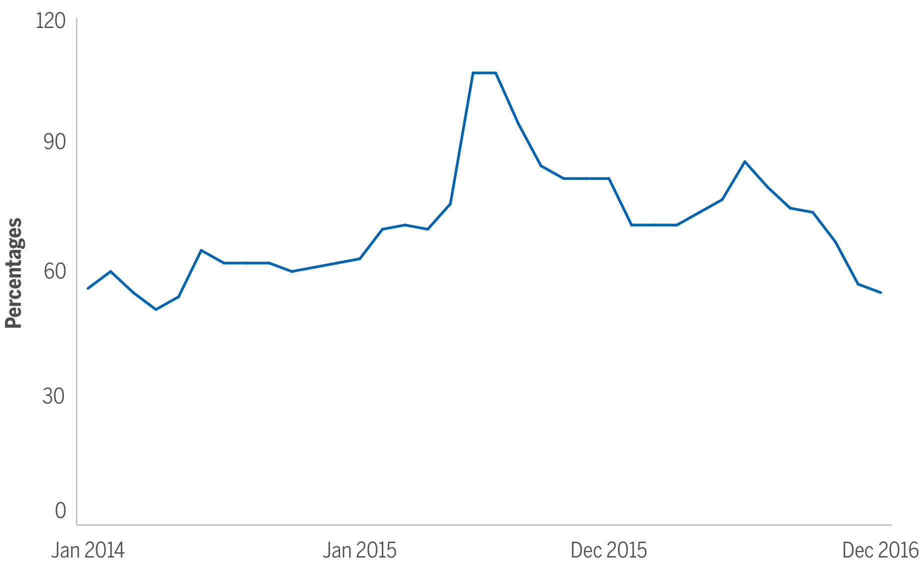
Source: Bank of America Merrill Lynch

Price-to-earnings ratios (P/E) based on anticipated earnings for the next 12 months are also compelling.

- Based on P/E ratios, the Russell 2000 Growth Index typically trades at a premium to its value counterpart.
- As of the end of 2016, the premium was at the lowest level since May of 2014 and nearly half the premium that existed in the middle of 2015 (see Figure 4).

According to some estimates, a 10 percentage point drop in the U.S. tax rate could boost small company earnings by 12%.

Figure 4: **Russell 2000 Growth / Russell 2000 Value P/E NTM**



— Russell 2000 Growth compared to Russell 2000 Value P/E NTM (next twelve months earnings)

Source: Bank of America Merrill Lynch

The Impact of Fiscal Policy

We believe changes in fiscal policy proposed by Trump could be beneficial for small cap growth companies with strong fundamentals for the following reasons:

- The corporate tax rate would be reduced to 15%.
- For Russell 2000 Index constituents, the estimated weighted-median tax rate is 30.6% compared to 25.8% for S&P 500 companies, according to Factset.
- Smaller companies would realize greater tax savings and therefore experience greater increases in earnings than large companies.
- According to some estimates, a 10 percentage point drop in the U.S. tax rate could boost small company earnings by 12%.

Cash Repatriation

Trump has also proposed a tax holiday for corporations to repatriate cash. With more than $700 billion in cash held in foreign countries by U.S. corporations, such a policy could result in companies using repatriated assets for share repurchases, Broadly speaking, investors tend to favor small companies with strong fundamentals when interest rates rise and economic growth is moderate.

dividends, and acquisitions. Nearly three-fourths of cash abroad is held by Information Technology and Health Care companies, so a repatriation program could be beneficial to holdings in the Small Cap Focus strategy, which typically finds growth companies in those sectors.

We also maintain that Trump's tax proposals could free up cash for corporations to invest in technology and for other capital expenditures which we believe could benefit our portfolio. Many of our portfolio companies offer technology, such as manufacturing automation products, enterprise software, and digital media, that can help corporations increase revenues and become more efficient. Smaller innovative companies can also be acquisition targets, so an increase in M&A resulting from cash repatriation and a reduction in corporate taxes could also be beneficial for our portfolio.

Our Outlook for Cyclical Stocks

We also believe that the rotation to cyclical stocks is likely to reverse, or at a minimum, moderate. Consider the following points:

- Robust economic growth is typically required to drive the outperformance of cyclical stocks.
- The economy, however, has already grown substantially in the aftermath of the subprime mortgage crisis, with the labor market at or near full employment.
- With that in mind, we think any potential increase in economic growth is likely to be moderate and could fall short of what is needed to support the performance of cyclical stocks.

We also believe that the stimulus measures could result in higher interest rates. Broadly speaking, investors tend to favor small companies with strong fundamentals when interest rates rise and economic growth is moderate.