Portfolio Manager and Head of Alger Capital Appreciation and Spectra Strategies
Patrick Kelly gives his quarterly update and broader outlook for the markets.

Alex Bernstein: Hello. This is Alex Bernstein of Alger. I'd like to welcome all of you to our quarterly update with Patrick Kelly, Portfolio Manager and Head of Alger's Capital Appreciation and Spectra Strategies. In this podcast, Patrick will discuss the portfolio positioning and market outlook for those strategies which he and Ankur Crawford manage. Before we begin, I'd like to highlight some recent achievements in the portfolios. For the 10-year period ending 12/31/15, the Alger Spectra Fund was ranked the number one fund in the Morningstar U.S. Large Cap Growth Category; a ranking it's held now for seven straight quarters. Additionally, the Spectra Fund’s five-year rolling return placed in the top quartile in the Morningstar Large Growth category for the past 36 consecutive quarters ending 12/31/15. The Alger Capital Appreciation Fund ranked in the top 2% of Morningstar's 10-year Percentile Ranking in the U.S. Large Cap Growth Category. Additionally, our SICAV iteration of the portfolio, the Alger American Asset Growth Fund, received multiple Lipper Fund awards for 2015 in the category Best Equity U.S. Fund over 10 Years including awards for Austria, Germany, France, Netherlands, Switzerland, and the United Kingdom. Of course, all of these achievements are a testament to the entire investment team, our philosophy and our process.

And now, let’s hear from Patrick.

Patrick Kelly: Thanks Alex. Global markets including the U.S. have come under pressure to begin the year. First, oil has broken below $30 a barrel which continues to put pressures on the economies of oil producing nations around the world. It is also causing stress in the financial system across the world. For example, the U.S. High Yield market has come under pressure primarily due to the risk for many high yield energy companies going bankrupt. We believe the oil market will begin to balance toward the end of this year and view the current price of oil as unsustainable. However, we are not expecting a significant bounce in the near term.

Second, China’s growth has continued to slow which has caused a further slowdown in commodity dependent countries that benefited from the growth of China, such as Brazil. Concerns around the implications of further slowing in China have escalated. China’s banking system continues to be a worry. And we remain cautious on China and countries dependent on China.

We are seeing softness across multiple sectors in China and think it could persist across the economy. China's investment spending is nearly 46% of GDP, which we view as unsustainable. China also continues to deal with a number of excesses in their economy.

The decline in oil coupled with the continued slowdown in China is leading to a slowdown in worldwide GDP, and creating credit concerns for financial institutions around the world.

The U.S. economy continues to be on solid footing and is much better positioned versus other countries around the world, but is not immune to the slowdown in worldwide GDP growth. We expect that we will see slower GDP growth in the U.S. and around the world going forward.

However, I think it is important to keep things in perspective despite all of the recent negativity in the markets. Inflation is low, interest rates are very favorable with the 10-year yield below 2%, gasoline prices and energy prices have declined significantly and the U.S. consumer is healthy. In addition, over 60% of the companies in the S&P 500 have dividend yields that are north of the 10-year bond, which is a record. Many of these companies have fairly large buyback programs so the dividend yield does not capture the total cash yield being returned to shareholders. Many companies are being valued as if they will never grow again or being priced as if we are already in a recession. Many of the financial companies have been hit particularly hard recently. It was encouraging to see Jamie Dimon, the CEO of JP Morgan, personally buy $26 million of stock the other day. In addition, the Chairman, CEO, and CFO of Citigroup all bought stock over the past week.

In terms of valuations of stock yields versus bond yields, I think Microsoft is a good example to illustrate my point. Microsoft has transitioned its business model to more of a subscription model which we believe can provide more value on the upside longer term but
also makes the business more defensive in a downturn. Microsoft has $58 billion in net cash on its balance sheet. And we expect them to generate $28 billion of free cash flow in 2016. Given Microsoft’s large net cash balance, we believe that Microsoft can return over 100% of its free cash flow to shareholders in the form of buybacks and dividends. Microsoft has a dividend yield of 3% which they have been growing double digits over the past several years and the company should repurchase another 4% of its stock. We feel this is extremely attractive given the 10-year is yielding 1.8%. Microsoft is being valued as if it will never grow again which we do not feel is the case.

This is also an example of the type of company that we are looking to rotate money into in this current market environment: a large cap company with an attractive free cash flow yield that is in a position to return a significant portion of that in buybacks and dividends. In this case, Microsoft has the ability to return over 100% of its free cash flow due to its strong balance sheet.

As I’ve stated before, we believe 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 in the markets and a significant amount of innovation and disruption of traditional businesses. This change has positive implications for some stocks and negative implications for others. For example, the rapid growth of Internet usage and Internet advertising is a positive for Facebook but a negative for a large number of traditional media companies. The Internet is the biggest driver of this disruption that we are seeing in the markets today.

The Internet continues to drive significant change. It’s disrupting traditional businesses and traditional ways of doing things. It is changing the way we live our lives and changing how businesses operate across industries. Companies have to adapt to this change.

More specifically, the Internet is disrupting the entire media landscape. We have seen the impact on newspapers, radio, and we are just beginning to see the impact on TV broadcasters. The Internet currently represents over 50% of total media time in the U.S., yet just over 35% of ad spend. We think the percentage of time devoted to the Internet will continue to climb, especially with the explosive growth of mobile Internet usage. And at the same time, we expect the ad spending gap between dollars spent and time spent to narrow.

To illustrate the point, Google’s (now Alphabet’s) U.S. advertising revenue accelerated to 23% year-over-year growth in Q4 and Facebook’s U.S. advertising revenue grew 64% to $2.8 billion. The fact that growth accelerated on such a large revenue base highlights the level of disruption occurring in the media landscape.

We are also seeing the Internet drive continued change in the ecommerce market and believe that, like digital advertising, there is a long runway ahead. eCommerce is still in the early stages of growth. eCommerce has grown in the mid-teens over the last several years. As the absolute dollar amount of ecommerce sales increases each year at a double digit rate, the incremental dollar impact on traditional retail becomes that much more significant. Amazon is taking close to 50% of incremental eCommerce spend which will continue to be a problem for traditional retailers. We remain bearish on the majority of traditional retailers for a number of reasons.

One, the Internet is taking significant share and creating price transparency leading to lower overall pricing. Two, more and more products will be sold as loss leaders by various retailers in order to drive traffic. Three, retailers will have to spend an increasing amount of revenue on advertising in order to compete and drive traffic. Four, Internet sales are lower margin sales for most retailers as the cost to fulfill the sales and returns impacts profit and margins. Five, retailers will also have to spend aggressively to improve their online fulfillment to compete with companies such as Amazon. And lastly, many traditional brands are selling an increasing amount of products direct over the Internet versus through traditional retail channels. The retailers are middlemen that are being squeezed. As a result, we think many of the traditional retail business models are challenged and will face continued margin pressure.

And just as the Internet is disrupting the traditional retail and media space, we also believe that the Internet is disrupting the entire traditional IT landscape. We expect many of the on-premise traditional IT vendors will struggle to grow revenues and continue to lose share to the cloud-based service providers.

Amazon Web Services (AWS) may be one of the most disruptive businesses of our generation. AWS is one of the fastest growing businesses in history. AWS has achieved a $10 billion revenue run rate in less than 10 years.

GE is moving 60% of its global IT workloads to AWS and will eventually close thirty of its 34 data centers and move 5,000 of their 9,000 on premise applications to the cloud. According to GE, the move to the public cloud is inevitable. News Corp has recently stated that it plans to migrate 75% of its entire IT infrastructure – 3,200 apps, including its SAP ERP system – to AWS, saving $100 million in costs over a three-year period.

Companies are finding it more cost effective to outsource IT operations to cloud service providers. Cloud service providers benefit from the economies of scale. They are then able to pass cost savings to the consumer. Amazon, for example, in their AWS offering, has made 51 price cuts to its service since its inception in 2006. Amazon and Microsoft’s Azure have emerged as the two market leaders in this area. We also think that the cloud-based service providers are helping to enable the innovation and disruption we are seeing in the market, as it’s now much cheaper and efficient to start a company.

There are also many other Internet companies that are causing a significant amount of disruption such as Uber, Airbnb, LinkedIn, Netflix, and many others. We are also seeing companies such as Google and Tesla advance their auto technology which could eventually disrupt the automotive industry. Businesses have to adapt to the change the Internet is driving. As investors, we want to be positioned in companies that are prepared for this change and avoid those that are not.

I will now briefly go through the sector weightings and discuss some of the individual stocks within the sectors.
Technology is currently 33% of the portfolio. Alphabet (formerly Google), Facebook, and Microsoft were our largest contributors in Q4. Alphabet is currently our largest position in Technology after we increased our position in Q4. Alphabet continues to be one of the primary beneficiaries of the rapid growth of Internet advertising. The recent move by Google to create the Alphabet company was a smart one. Under the new structure, many of the money losing businesses will be separated from the core which will enable investors to better value the overall business. Google is trading at 17x our core earnings estimate for 2016 and 14x our core earnings estimate in 2017. Google has $68 billion of net cash, equating to close to $100 dollars per share. Google has its risks like every other stock, but we believe the risk/reward is very compelling at this valuation, especially for a company that saw its second quarter in a row of accelerated revenue growth, where revenue grew 19% year-over-year in the most recent quarter, and even faster on a constant currency basis.

We continue to remain positive on Facebook, which reported excellent fourth quarter results. Ad revenues grew a staggering 66% year over year excluding the impact of foreign exchange to $5.6 billion. We believe Facebook is a very powerful Internet platform and it remains a huge opportunity in front of them to continue to monetize this platform. We also believe that Facebook will be a primary beneficiary from the shift of brand advertising dollars from TV to digital due to its reach, scale, and targeting ability.

Consumer Discretionary is currently 17% of the portfolio. We remain underweight the traditional retailers and media companies. Amazon was our biggest contributor in Q4. Despite the selloff in Amazon year-to-date, we remain positive on the company. As mentioned previously, Amazon continues to take a significant amount of share in ecommerce and from traditional retailers. We also think that the rapid growth of its third party marketplace is underappreciated, as this should be a very high margin business longer term. And Amazon also continues to have a huge opportunity in front of them with their Amazon Web Services business.

We also added a position in ServiceMaster in Q4, a more defensive company within Consumer Discretionary. ServiceMaster is a leading provider of termite and pest control services and home warranty plans to residential and commercial properties in the U.S. We think there is an opportunity for ServiceMaster to drive incremental shareholder value in the coming years by consolidating small businesses in these highly fragmented U.S. industries. Over the next four years, we think the company’s free cash flow can equal approximately 20-25% of the company’s current market cap.

Healthcare is approximately 20% of the portfolio. We remain overweight Healthcare. Thermo Fisher is one of the biggest positions in Healthcare. Thermo Fisher is a global life sciences tools and services company that helps customers accelerate life science research, improve patient diagnostics, and increase lab productivity. We think that we will see strong earnings growth in 2016 driven by increased government funding, new product launches, and margin expansion. We also think Thermo Fisher can create further shareholder value by deploying capital in accretive acquisitions or returning capital through share repurchases.

We also increased our position in Bristol Myers in Q4. We view Bristol Myers as the one of the pre-eminent biopharma companies based on its continued dominance within the immunotherapy space. Immunotherapy has revolutionized the way cancer is treated in the U.S. and Bristol Myers has been at the forefront of this trend. Bristol Myers’ lead product in this category is Opdivo and continues to ramp well. Importantly, Bristol Myers has transitioned from a traditional pharmaceutical company with the majority of sales in oral drugs to more of a biotech company with the majority of sales coming from complex antibodies.

We also added to our position in Dexcom in Q4. Dexcom is a medical device company that designs technology to monitor glucose levels in the human body. Dexcom’s technology allows a patient to monitor glucose levels on a smartphone, versus the former method of using finger-stick glucose testing. Last year, Dexcom announced a partnership with Google to develop a low cost mobile analytics platform. We see the potential for significant revenue growth over the next five years, given Dexcom’s low penetration of its addressable market and multiple upcoming revenue catalysts including new products and easing government reimbursement for insulin therapy. In addition, we think the partnership with Google is a significant long term call option on the stock.

Industrials is currently 8% of the portfolio. Honeywell remains our largest position in Industrials and we continue to like the stock. Honeywell is a well-diversified technology and manufacturing company with operations in automation and control solutions, aerospace specialty materials, and transportation systems. Honeywell is example of a platform company. We think that Honeywell’s excellent management team and a strong global platform across multiple markets creates a strong foundation for making accretive acquisitions. Going forward, Honeywell should see more aggressive capital deployment as the company has essentially no debt. We think Honeywell can also create further shareholder value by deploying their capital.

Financials is currently 4% of the portfolio. We remain underweight the sector. We have reduced some interest rate exposure given the continued slowdown in China and our expectation for fewer Fed rate increases this year. Our two largest positions are Crown Castle and Blackstone.

Crown Castle’s core business is renting space or capacity on towers that support wireless communications. Crown Castle has an attractive yield in this environment with a dividend yield north of 4%.

We also continue to believe that Blackstone is an attractive long term investment. I thought I would highlight some of the comments that were made by the CEO of Blackstone, Stephen Schwarzman, on their Q415 earnings call, where he stated:

"We’ve done an implied stock price analysis for the next 10 years based on what we believe to be conservative assumptions...I’m personally not selling my Blackstone units, and I believe great things are ahead for this firm."

Energy and Materials is currently 2% of the portfolio, as mentioned earlier. Oil prices have come under significant pressure to start the year. We continue to expect that oil prices will be under pressure in the first half of 2016 until we get a more sustained supply response. We do expect oil markets to rebalance themselves by the end of 2016.
Consumer Staples is roughly 7% of the portfolio. We remain underweight the sector but have increased our position recently given the current environment. The cash return of many of the Staple companies have attractive yields relative to the 10-year bond. Molson Coors and Pepsi are our largest positions.

We think Molson Coors will be a significant beneficiary of beer industry consolidation. The company is purchasing full control of the MillerCoors JV in the U.S. (previously the company owned 42%). Under a single owner, we think MillerCoors can be run more efficiently with improved speed of decision making, and more focused innovation. We think significant cost synergies will help drive 25%-30% EPS accretion in 2017 and 2018.

In sum, we expect a continued slowdown in worldwide GDP growth. However, we do feel that valuations are reflecting a slower growth scenario. Over 60% of the companies in the S&P 500 have dividend yields north of the 10 year and that does not capture the amount of cash being returned through buybacks. We have placed an increased emphasis on names with attractive free cash flow yields who are then positioned to return capital in the form of buybacks and dividends. We also look to continue to invest in companies that are benefiting from the significant change in the market that was explained earlier. And we’ll also look for opportunities that arise from indiscriminate selling.

I will conclude there, but thank you for listening and your continued interest in Alger.

Alex: Thanks, Patrick. And good luck in the upcoming quarter.
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