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Spectra Strategy Update

INVESTORS' SEARCH FOR YIELD DRIVES MARKET PERFORMANCE

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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 commentary, Spectra Portfolio Managers Patrick Kelly and Ankur Crawford share their market observations and provide a midyear strategy update.

Bond-Like Equities Outperform Growth Stocks

It was a difficult first half of the year for the strategy. The strategy invests in companies with potential for generating strong earnings growth. During the first half of this year, however, growth stocks and the strategy underperformed in large part due to a dramatic investor rotation into bond-like equities, or equities with high-dividend yields. The rotation was so extreme that the Utilities sector, which is characterized as having companies that offer attractive dividend yields but have little potential for strong earnings growth, generated its strongest performance in 25 years both on an absolute basis and relative to the overall market (see Figure 1). In an ironic development, investors failed to focus on corporate fundamentals even though technologies such as the internet and revolutionary medical treatments are enabling leading companies to aggressively grow their earnings with innovative products that are disrupting traditional business models. We believe that companies that grow their earnings have strong potential for rewarding investors because stock prices typically increase as earnings strengthen.

Figure 1:
Performance for First Six Months of 2016

S&P 500 Index & Sectors	Return (%)
Telecommunication Services	24.8
Utilities	23.4
Energy	16.1
Consumer Staples	10.5
Materials	7.5
Industrials	6.5
S&P 500 Index	3.8
Consumer Discretionary	0.7
Health Care	0.4
Information Technology	-0.3
Financials	-3.0

Source: FactSet.

Monetary Policy Continues to Drive Down Bond Yields

With moderating global economic growth, central banks have continued to provide monetary stimulus by cutting interest rates and by implementing quantitative easing, or printing money to purchase fixed income securities (and in some cases equities), in an attempt to drive down bond yields. The lower yields in turn entice investors to seek higher returns by embracing equities and, in particular, equities with high-dividend yields. In March, for example, the European Central Bank increased its stimulus by adding non-bank corporate bonds to its asset-purchase program as a follow on to the bank's negative interest rate policy. Since then, yields on European corporate debt have plunged, which in turn has resulted in U.S. and emerging market corporate and government bond yields declining. Recently, the U.S. 10-year Treasury yield hit 1.58%, which was just above a record low; the German 10-year yield hit -0.02%; and the Japanese 10-year yield hit -0.24%. Across the globe, approximately $11.7 trillion in government debt offers negative yields, according to Fitch.

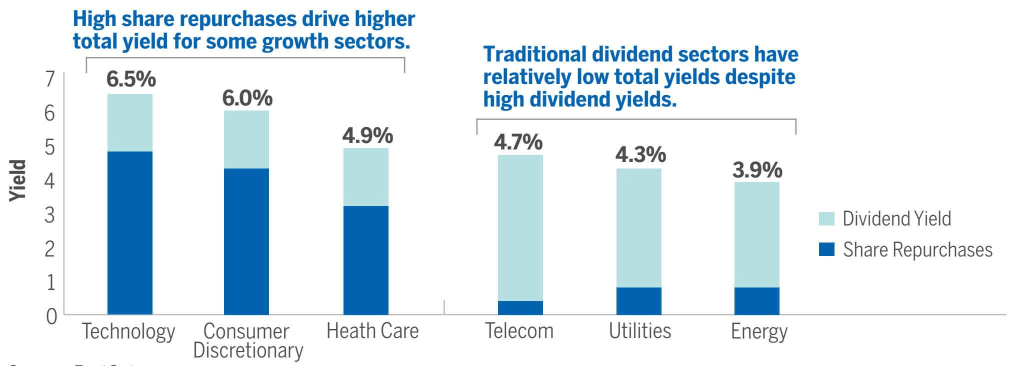
The Appeal of Total Cash Yield

Investors who are focused exclusively on dividend yields are missing out on the potential for stocks with attractive total cash yields to generate strong returns. Total cash yield is the yield resulting from both stock buybacks and dividends. Sectors that have traditionally offered attractive dividends such as Telecommunication Services, Utilities, and Energy currently have lower total cash yields than growth sectors such as Information

Over 60% of S&P constituents have dividend yields that exceed the 1.58% yield of the 10-year U.S. Treasury note.

Technology, Consumer Discretionary, and Health Care (see Figure 2). Furthermore, we believe that U.S. corporate buybacks this year are likely to exceed average levels for the past five- and 10-year periods. We believe that the trend of investors favoring high-dividend yielding stocks is likely to normalize closer to historical averages, in part because growth stocks offer attractive total cash yields. Accordingly, the strategy is positioned to take advantage of companies with potential for providing attractive total cash yields.

Figure 2: **Growth Has Attractive Total Yields Relative to Traditional Dividend Yield Sectors**



Source: FactSet.

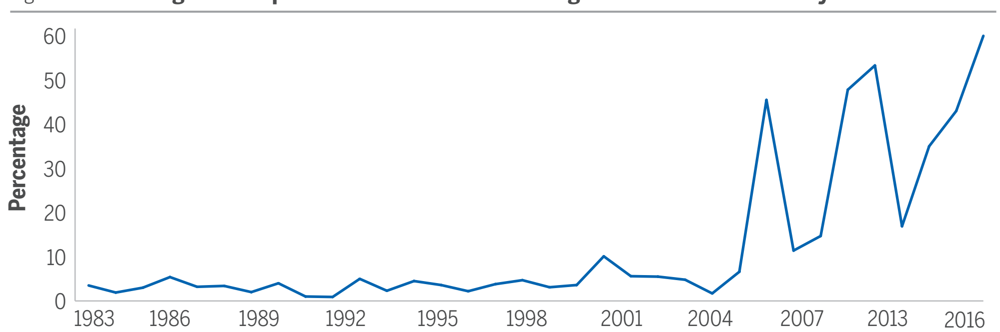
Reasons for Optimism

A number of policy decisions and geopolitical events including terrorism and the vote by the U.K. electorate to leave the European Union have contributed to equity market volatility. Despite these external pressures, the U.S. economy is on good footing and is much better positioned than other economies around the world. Importantly, many of the world's most innovative companies are based in the U.S. They include Facebook, Inc.; Alphabet, Inc. (formerly Google); Apple, Inc.; Amazon.com, Inc.; and many others. Even though gross domestic product (GDP) growth is moderating in the U.S. and across the globe, we believe that low interest rates are a clear positive for America's economy and the performance of U.S. equities. In the case of mortgages, record-low interest rates are supporting household formation, or the process of individuals or families seeking their own housing. Inflation is also low and U.S. consumer finances are healthy, in part due to low prices for gasoline and other energy products. We also believe that equities are highly attractive relative to bonds. For example, over 60% of S&P 500 constituents have dividend yields that exceed the 1.58% yield of the 10-year U.S. Treasury note (see Figure 3). At least one-third of S&P 500 companies offer dividend yields that exceed the yields of the same companies' bonds. Today, equities' total cash yield relative to the yield of corporate bonds is at the highest level in over two decades. From a global perspective, the low yields of fixed income securities abroad are also attracting investors to U.S. equities.

A Look at Industry Disrupters

We believe that companies undergoing Positive Dynamic Change offer the best investment opportunities. We define Positive Dynamic Change as companies experiencing High Unit

Figure 3: **Percentage of Companies with Dividend Yields Higher than 10-Year Treasury Notes**



Data is for S&P 500 Companies Ex-Financials. Source: Standard and Poor's and FactSet.

Volume Growth or companies undergoing Positive Life Cycle Change. 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. The internet is clearly the biggest driver of this disruption in markets today. We continue to highlight this theme because it is disrupting large traditional markets such as the retail landscape, the traditional media sector, and the entire IT industry. The internet is impacting virtually every sector.

Facebook, Inc. is one of the portfolio's largest holdings. It has over 1.65 billion users and impressive growth potential. Its ability to provide customized advertising based on its users' specific interests can allow the company to potentially expand its market share in digital advertising. The company is also capturing advertising from television and other types of traditional media. Facebook captures 11% of total online advertising revenue despite representing over 20% of the time that individuals spend online. We think that gap is likely to narrow. Facebook's photo-sharing platform, Instagram, has a quickly growing user base that is already 500 million strong. We think Facebook will be able to increase Instagram's ad revenue by improving user engagement, increasing the ad load, and serving more targeted or relevant advertisements. Facebook also has other monetization opportunities, including Messenger and WhatsApp (with each having an average of 1 billion monthly users), Virtual Reality, and Payments. We expect margin expansion in 2016 and we believe the company's valuation remains reasonable. We believe Facebook can potentially grow its revenues and earnings significantly through 2018.

Turning our attention to Alphabet, Inc., we believe that the company is well positioned to benefit from the ongoing shift of advertising from traditional media to the internet. Alphabet now has over 1 billion users for each of its seven products that consist of Google Search, YouTube, Android operating system, Google Play, Google Maps, Google Chrome browser, and Gmail. We think revenue for advertising on smartphones and other mobile devices will accelerate this year and in 2017. We believe Alphabet's valuation is attractive relative to the company's growth potential with the company continuing to increase the monetization of its services through a variety of initiatives. The company is expected to generate strong revenue growth and earnings per share (EPS) growth over the next two years. When excluding money-losing businesses such as driverless vehicles, the valuation is even more reasonable, especially compared to content media companies.

Microsoft Corp. is another Information Technology holding. Chief Executive Officer Satya Nadella has accelerated efforts to grow the company's earnings, in part by emphasizing cloud computing and making software available on an off-premises basis. The company's increasing focus on recurring revenues should offset concerns about weakening sales of personal computer software and loss of market share to providers of cloud-based services. In addition, Microsoft's Azure cloud computing platform finished the second quarter with annualized revenues of $2.6 billion and a growth rate that exceeded 100%. The company is one of the few stocks available in mega-cap tech that has accelerating revenue growth, expanding operating margins, and EPS that is growing at a double-digit rate. Microsoft has also been growing its dividend at a double digit rate and its stock now has close to a 3% dividend yield. The company is also likely to buy back another 3% to 4% of its stock.

One of our largest Consumer Discretionary holdings is Amazon.com, Inc. Its disruptive retail business continues to take significant market share. The company is the dominant player in two of the largest secular growth opportunities available to investors today: global e-commerce and cloud computing. Amazon's market share in U.S. e-commerce is approximately 34% today.

Last year, Amazon represented over 50% of U.S. e-commerce growth and almost one-fourth of total U.S. retail growth. We believe Amazon can improve core retail margins as revenue shifts toward higher-margin third-party sales and higher margin categories like apparel and consumer products. Amazon's cloud service, called Amazon Web Services (AWS), generates $10 billion in annual revenue that is growing over 60% a year and has an EBIT margin in the high 20's. We believe AWS will sustain double-digit growth rates for many years as the web service adds additional data, services, and analytics, while expanding in a huge market.

Comcast Corporation is another Consumer Discretionary holding. Comcast's recent investments in its X1 operating system are improving the home-entertainment consumer

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experience. X1 is a cloud-based operating system that provides a single access point for a variety of sources of media content. We think the X1 platform will help support Comcast's fundamentals with the technology helping to reduce the company's customer churn rate. Comcast management also believes market penetration for the company's broadband service can reach 70%, from 43% currently, which is nicely accretive as broadband margins are over 80%. The company also has a strong balance sheet and has a total cash yield of almost 5%.

In the Health Care sector, Allergan PLC is a top holding. The company trades at one of the lowest pharmaceutical multiples even though its revenue and earnings growth rates are roughly double that of its peers. The expected sale of Allergan's generics business, furthermore, would result in the company having $36.5 billion in after-tax proceeds, which would allow the company to pay down $8 to $10 billion in debt, embark on a $10 billion share repurchase program, acquire products, and pursue acquisitions.

The Spectra strategy has a shorting component. During the first half of 2016, we shorted Exxon Mobil Corp., which was the largest short in the strategy as of the end of June. With hydraulic fracking greatly increasing the supply of oil and the role of OPEC weakening, we think it is unlikely for energy prices to return to historical highs, so Exxon Mobil is likely to experience reduced earnings power and decreased return on investment. Margins in the refining sector are also under pressure as demand growth has slowed and gasoline and diesel inventories remain high. Refining income, which was approximately 35% of Exxon Mobil's segment income in 2015, is likely to be materially lower in 2016.

Going Forward

In closing, the U.S. consumer and economy remain healthy and we continue to see a tremendous amount of innovation and change across sectors. We are continuing to invest in innovative companies that are driving positive change in markets, which is consistent with our longstanding Alger investment philosophy.

As of 6/30/2016, the following companies represented the noted percentage of Spectra Strategy assets: Amazon.com, Inc., 4.98%; Apple, Inc., 3.94%; Comcast Corp., 2.02%; Facebook, Inc., 4.49%; Alphabet, 6.83%; Microsoft, 3.94%; Allergan PLC, 2.67%; and Exxon Mobil, -0.54%.