

# ALGER

Inspired by Change, Driven by Growth.

Autumn 2020

## Capital Markets: Observations and Insights

Investing Beyond the Election

# Beyond The Election

“In the short run, the market is a voting machine but in the long run, it is a weighing machine.” – Ben Graham

Voting in an election is like investing. Investors “vote” for candidates and companies, which reflects their collective sentiment. However, over the long term, stocks have historically reflected their fundamentals rather than sentiment with the greatest returns achieved by those companies who showed the strongest earnings and free cash flow growth.

At Alger, we are most focused on the research-intensive endeavor of forecasting which companies will grow fastest over time. Importantly, we do not believe that politics will play a large role in the fundamental development of growth companies over the long term. That is because companies largely hold their destiny in their own hands, in our view. Disruptive innovations can be accelerated or hindered by government policies, but they cannot be stopped. We believe value-added products and services guided by talented and diligent management teams will gain market share, irrespective of macroeconomic conditions.

In the pages that follow, we offer our view of investment themes that we believe will transcend politics and last much longer than the next four years. At Alger, we aim to understand who will win and lose in the global economic marketplace as a result of disruptive change. It is this philosophy of investing in Positive Dynamic Change that we believe has generated strong results for our clients over more than a half century.



**Daniel C. Chung, CFA**  
Chief Executive Officer  
Chief Investment Officer



**Brad Neuman, CFA**  
Senior Vice President  
Director of Market Strategy

# Key Observations and Themes

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We believe there are enduring investment trends that will transcend politics and last much longer than the next four years. These drivers of change may produce compelling investment opportunities over the long term.

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With interest rates at very low levels, stocks look attractive relative to bonds. We believe equities will outperform fixed income over the long term.

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Equity valuation looks more attractive after accounting for low interest rates and changing business models, which generate increased cash relative to earnings.

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On the rebound from the global pandemic shock, the economy has some significant tailwinds.

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## Style Wars

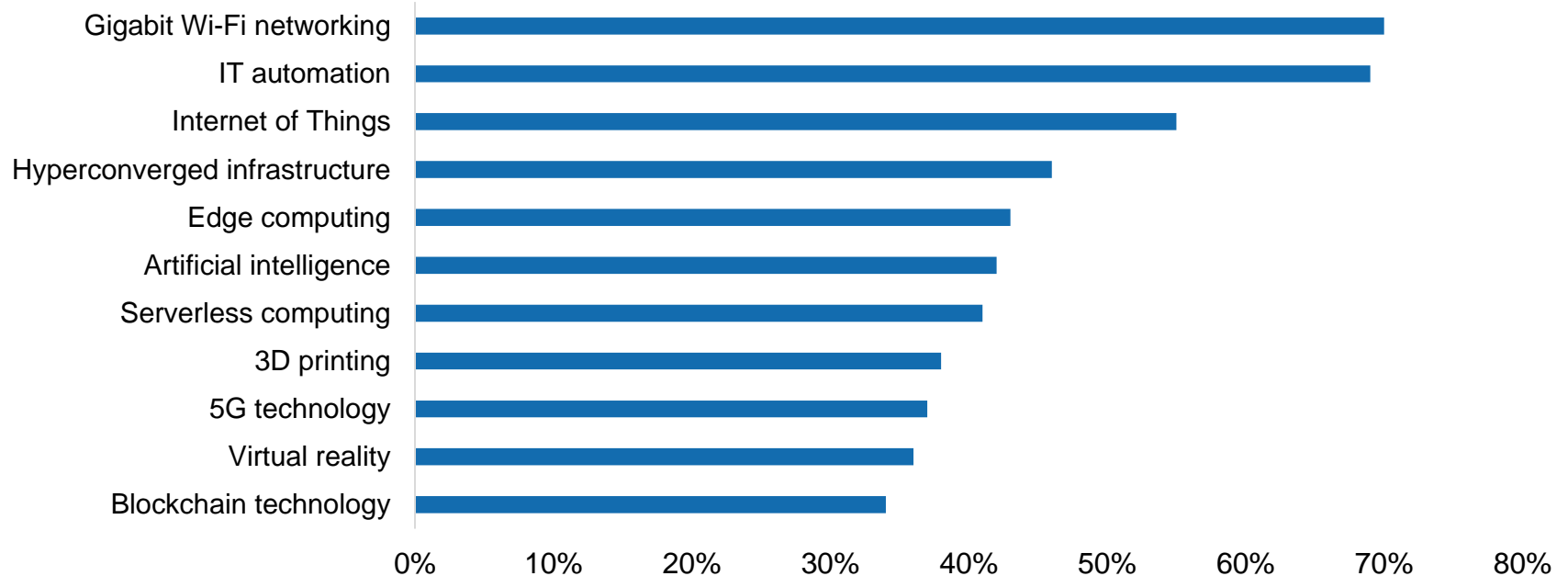
23

Powerful structural forces have caused Growth to diverge from Value. Shifts in leadership are likely but the long-term trend should stay intact, in our view.

# Beyond the Election Convergence

- We believe we are in one of the most innovative times in history
- In the pages that follow, we highlight some of the trends below as well as others that we believe will separate the corporate winners and losers

## Corporate Technology Adoption Currently In Use Or Planned To Use Within Two Years



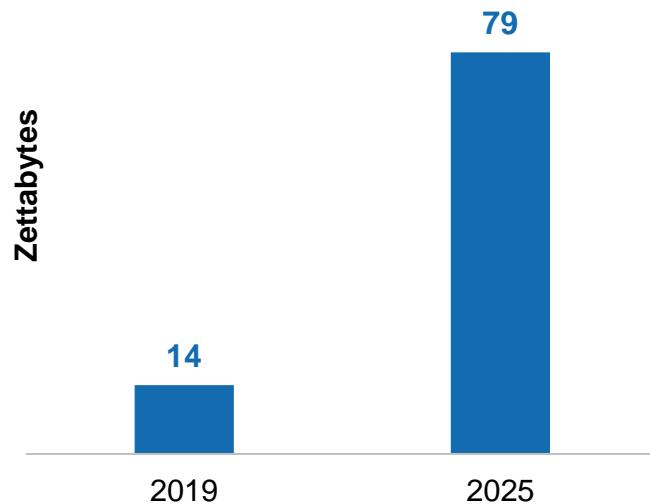
Source: Spiceworks 2019 survey of over 1,000 business technology purchasers, edited by Alger.

# Beyond the Election

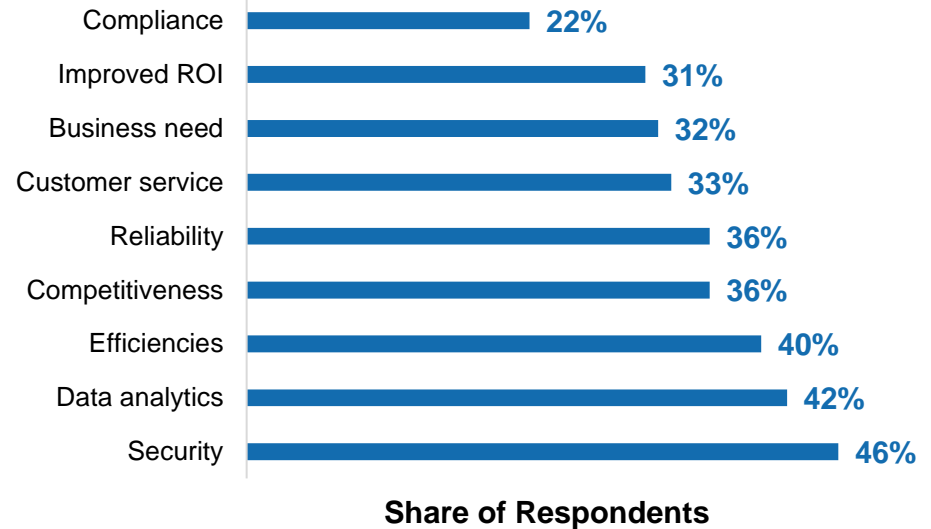
## Internet of Things

- The explosion in connected devices is creating the “Internet of Things” or IoT, transmitting valuable and actionable information
  - Applications include industrial monitoring and automation, health care, security, agriculture, inventory management, smart cities, utility metering, and connected cars

### Data Volume of IoT Connected Devices Worldwide



### Drivers of IoT Spending



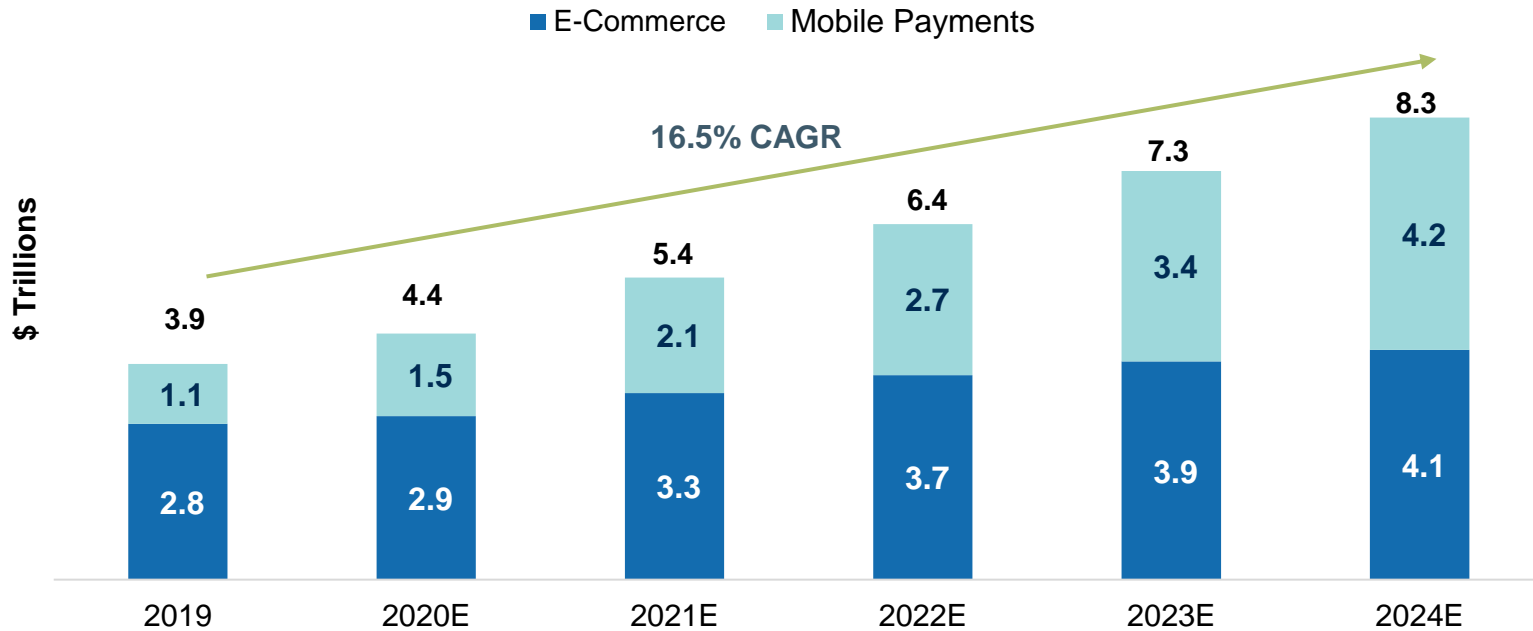
Source: Data volume forecast from IDC, July 2020, and drivers of IoT spending from 451 Research survey, December 2019.

# Beyond the Election

## Digital Payments

- Digital payments continue to outgrow the broad economy as they gain penetration, driven by increasing e-commerce and mobile payments
  - China has the largest volume of digital payments and Europe is growing fastest
- Payment networks, processors, and software companies can capitalize on the trend

### Global Digital Transactions



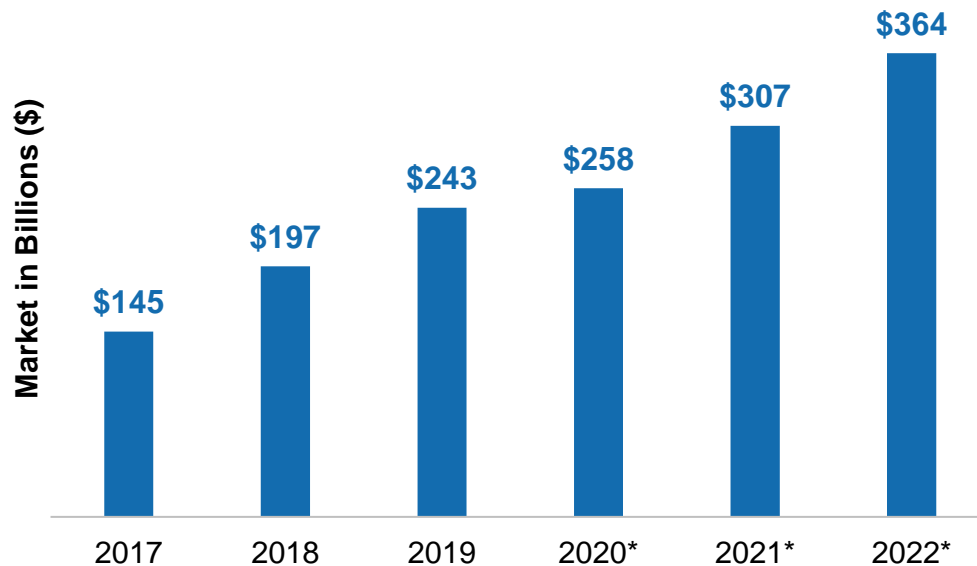
Source: Statista Digital Market Outlook 2020. CAGR is compound annual growth rate, the rate of return required for a quantity to grow from its beginning balance to its ending balance. Mobile payments occur when smartphones are used to process transactions using wireless communication or scan QR barcodes.

# Beyond the Election

## Cloud Computing

- Cloud computing optimizes IT assets, reducing costs and improving flexibility and accessibility
  - The growth in online streaming entertainment, e-commerce, work from home, telehealth, e-sports, and virtual learning are all enabled by cloud computing

### Cloud Computing Market Is Growing Rapidly

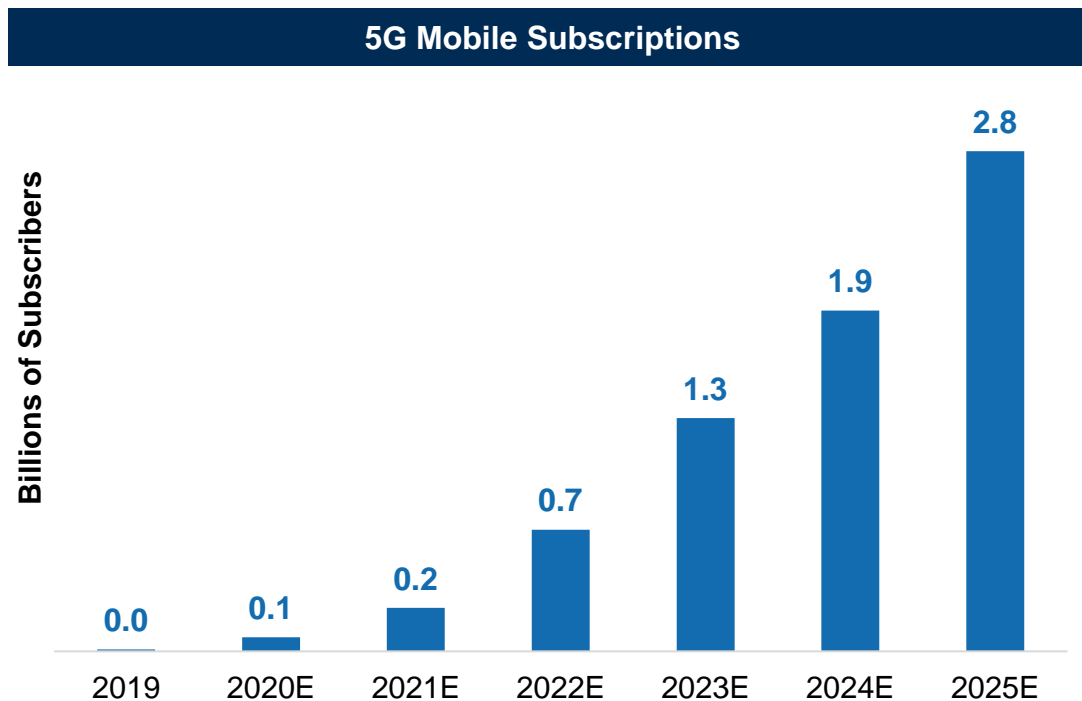


Source: Gartner, July 2020. \*Forecast

# Beyond the Election

## 5G Wireless

- The next generation of wireless technology, 5G, is bringing faster speeds, increased capacity, much lower latency, and more efficient spectrum utilization
  - 5G helps enable telematics, advanced health care monitoring, remote work, augmented/virtual reality, and autonomous driving applications



Source: Ericsson, July 2020.



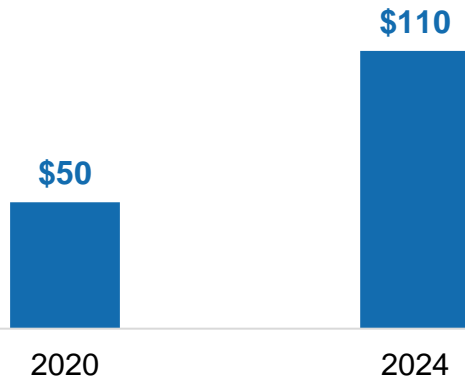
# Beyond the Election

## Artificial Intelligence

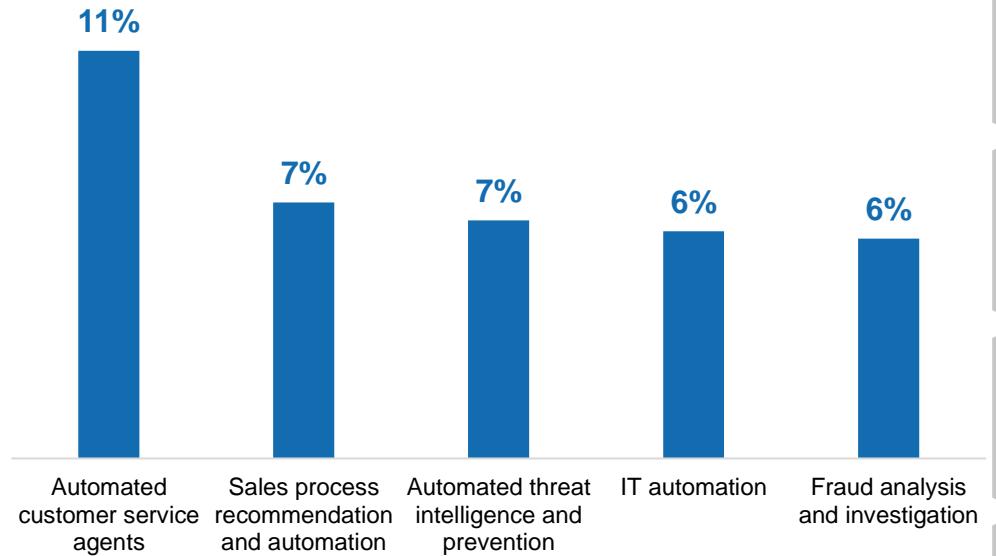
- As data growth explodes and computing becomes more powerful, artificial intelligence is likely to become more advanced and begin to permeate decision making
- AI investment has been most prolific in autonomous driving, drug studies, facial recognition, and digital content\*

### Global AI Spending

Billions (\$)



### Leading AI Use Cases



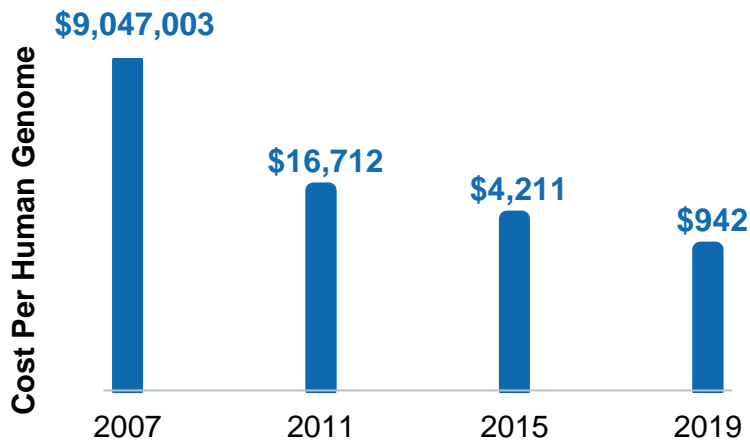
Source: AI spending and use cases from IDC, August 2020. \*Stanford Artificial Intelligence Index, 2019 annual report.

# Beyond the Election

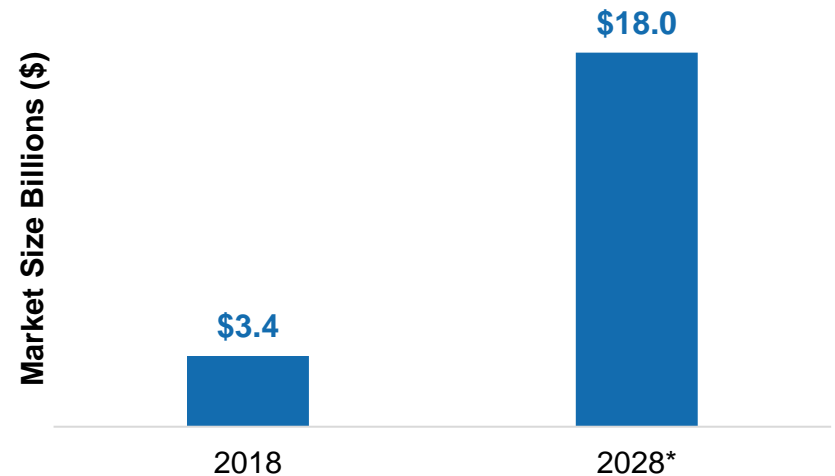
## Genomics Innovation

- Genetic analysis and manipulation will increasingly impact the practice of health care
  - Turning sick care into preventive health care by giving insight into predisposed diseases
  - Delivering more efficacious treatments via targeted therapies (e.g., immuno-oncology)

### As The Cost to Sequence A Genome Declines



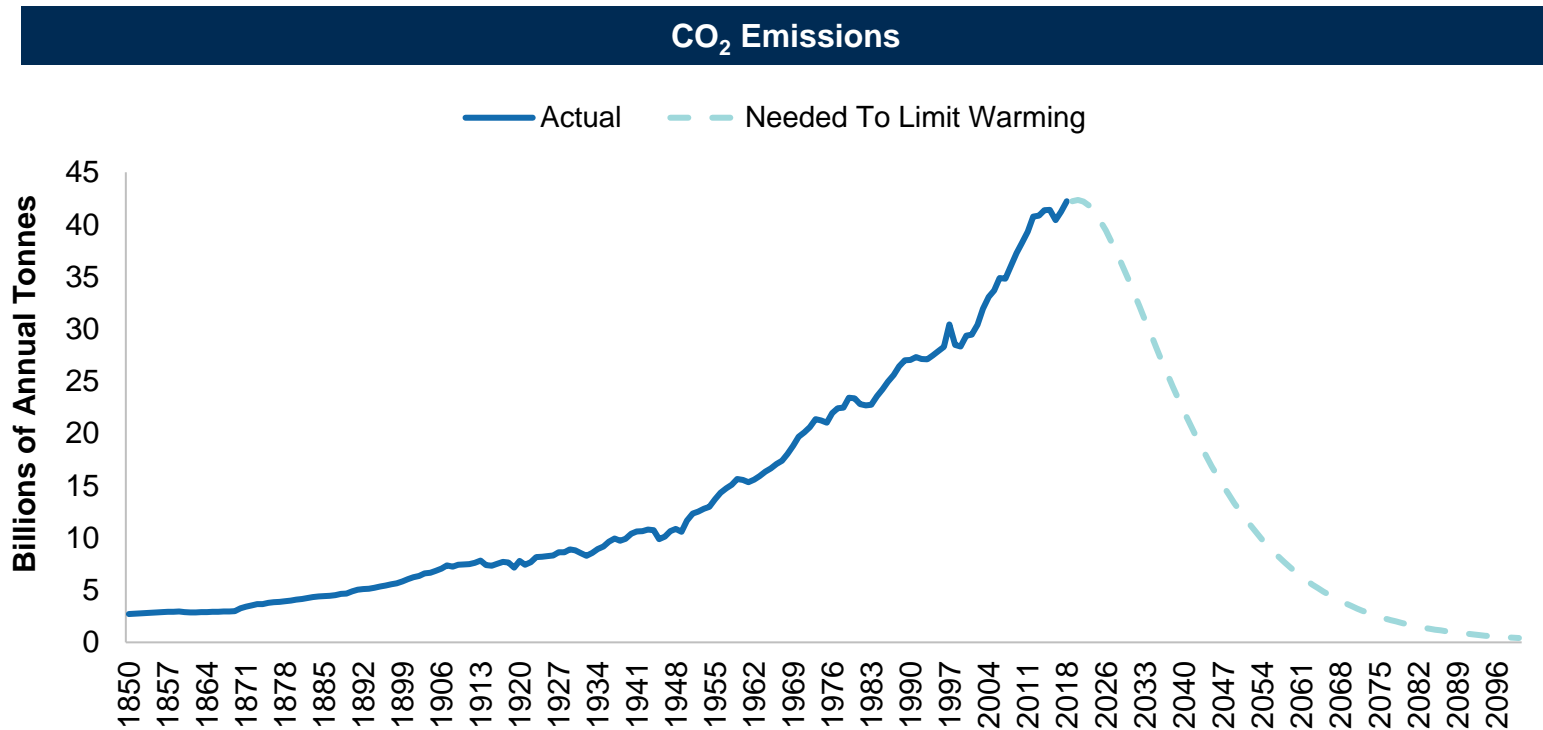
### The Genetic Sequencing Market Expected to Grow



Source: Cost to sequence a genome from the National Human Genome Research Institute and sequencing based monitoring and diagnostic test market from BIS Research.  
\*Estimated.

# Beyond the Election Emission Reductions

- The rate of CO<sub>2</sub> emissions is not sustainable in our view
- Reducing emissions may provide opportunities in alternative energy sources and in electric vehicles and related products and services



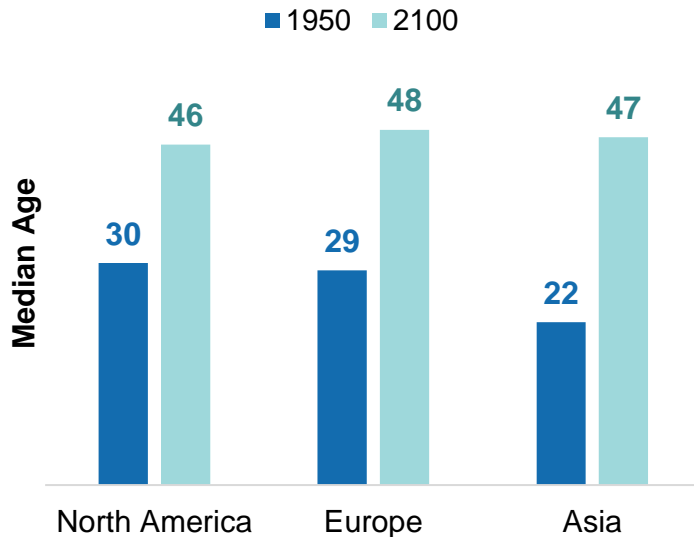
Source: Robbie Andrews (2019) based on Global Carbon Project & IPCC SR15. Carbon budget based on >66% probability of staying below 2°C warming, beginning in 2020.

# Beyond the Election

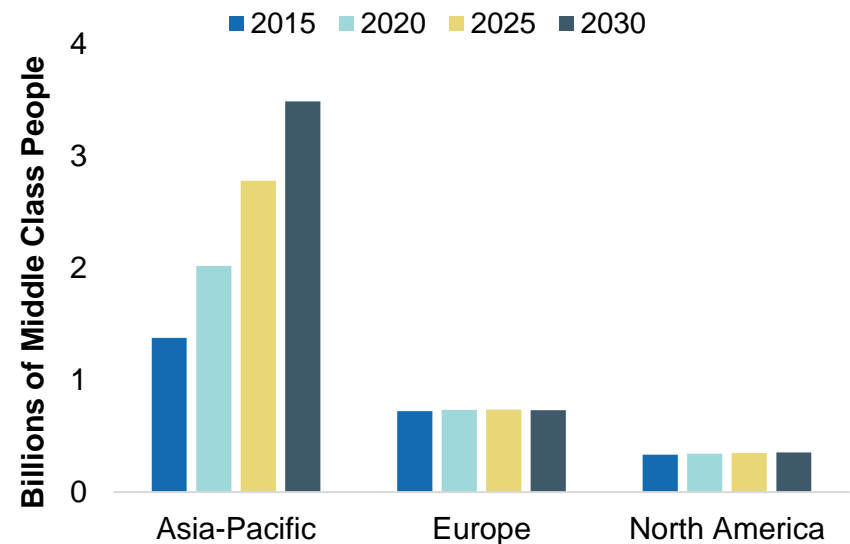
## Evolving Demographics

- An aging population has important economic implications such as increased health care spending
- A burgeoning middle class will considerably impact spending patterns such as meat consumption and automobile ownership

### The World Expected to Be Older in 2100



### The Asian Middle Class Is Expected to Grow



Source: Median age from United Nations Department of Economic and Social Affairs and middle class estimates from Brookings Institution. A middle-class family has an approximate income of \$16,000 to \$160,000 in purchasing power parity terms.

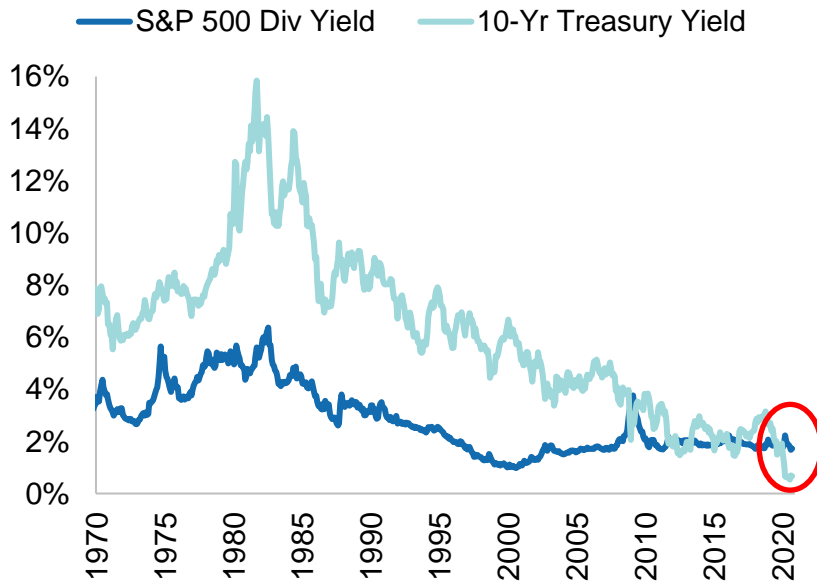


# Lending vs. Owning

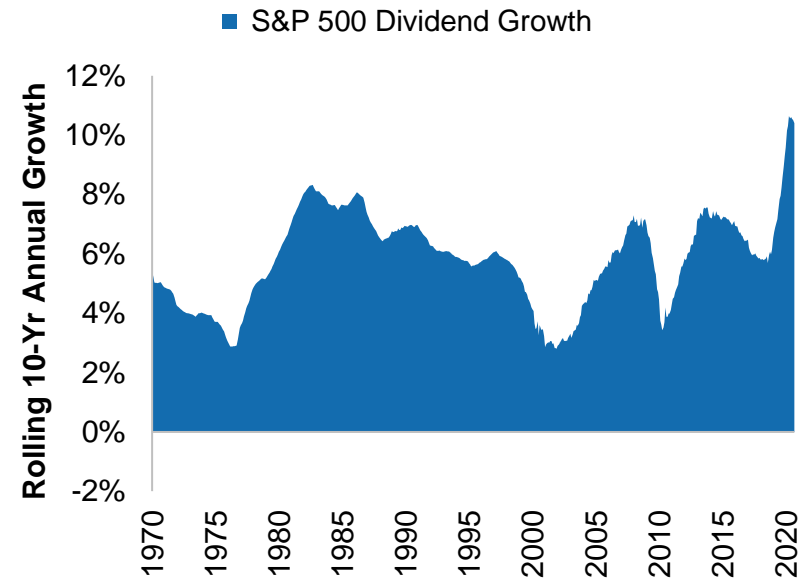
## More Cash in Your Pocket?

- In an unusual occurrence, equity dividend yields are higher than 10-year Treasury yields
  - Over 10-year periods in the past half century, the S&P 500 dividend has grown an average of nearly 6% annually, while a Treasury bond coupon does not grow

### Similar Yields...



### ...But Stock Dividends Can Grow!



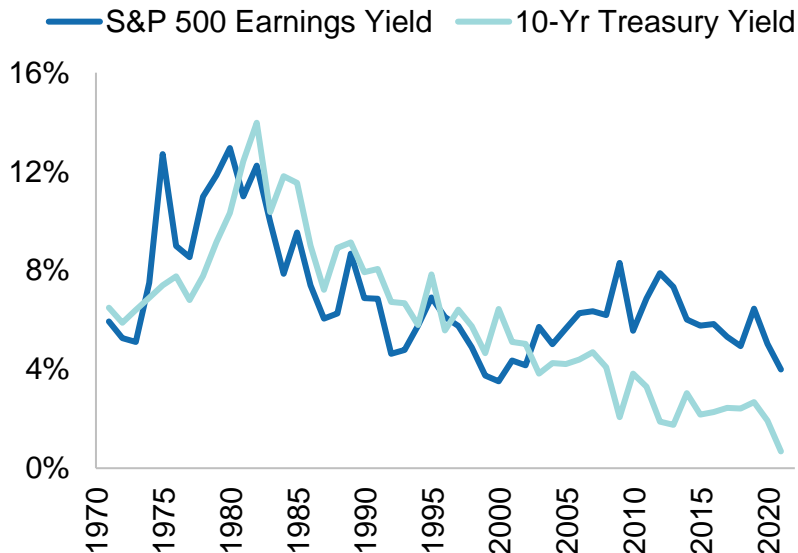
Source: FactSet, Robert Shiller, Alger. The performance data quoted represents past performance, which is not an indication or a guarantee of future results.



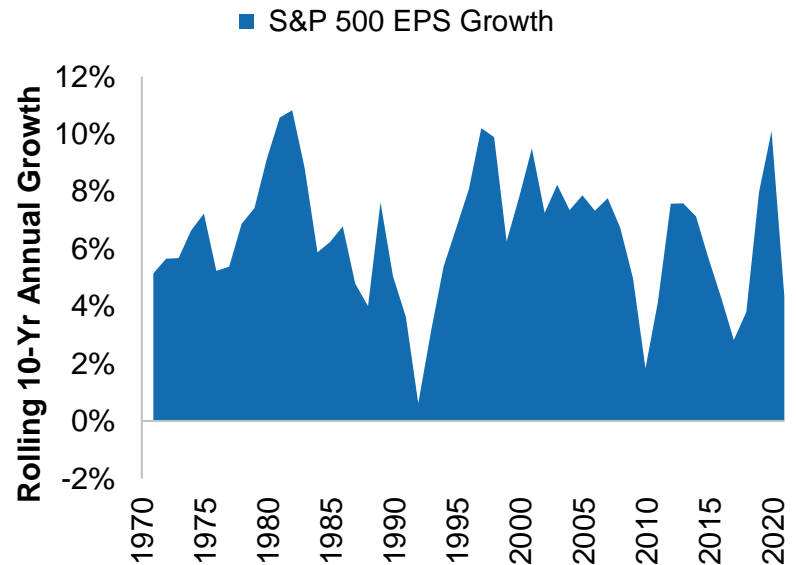
## Lending vs. Owning A Better “Yield”

- Investors are accepting much lower “yields” for the safety of Treasuries relative to equities but how risky are stock fundamentals over the long term?
  - Over 10-year periods in the past half century, S&P 500 EPS has always grown (even through this pandemic), averaging nearly 7% annually, while bond coupons do not grow

### Equity “Yield” Is Attractive Relative to Treasuries...



### ...And Equity EPS Can Grow!



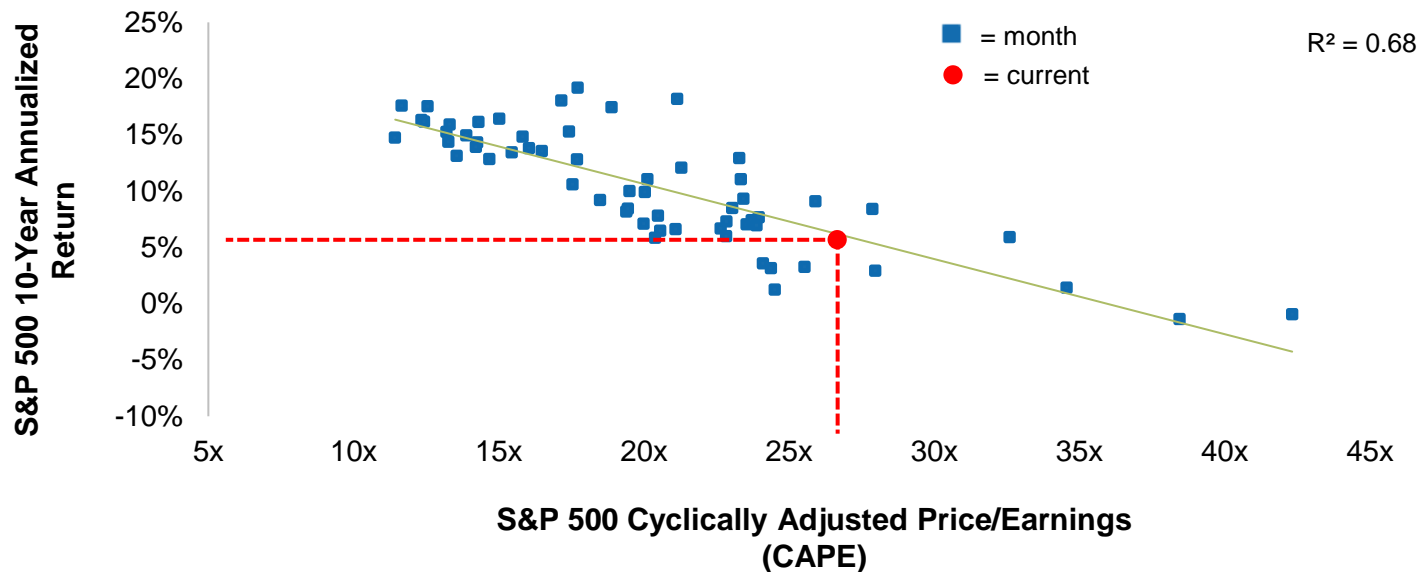
Source: FactSet, Robert Shiller, Alger. Notes: periods used were annual. Equity yield is LTM EPS / Price. Earnings per share (EPS) is the portion of a company's earnings or profit allocated to each share of common stock.



## Lending vs. Owning Many Happy Returns?

- Strong relationship between starting valuations and ensuing 10-year returns with current data suggesting equities will outperform bonds over the coming decade
  - Note that low real interest rates and stronger free cash flow generation imply higher multiples relative to history (see pages 16 & 17)

**S&P 500 CAPE vs. 10-Year Returns**  
Since 1950

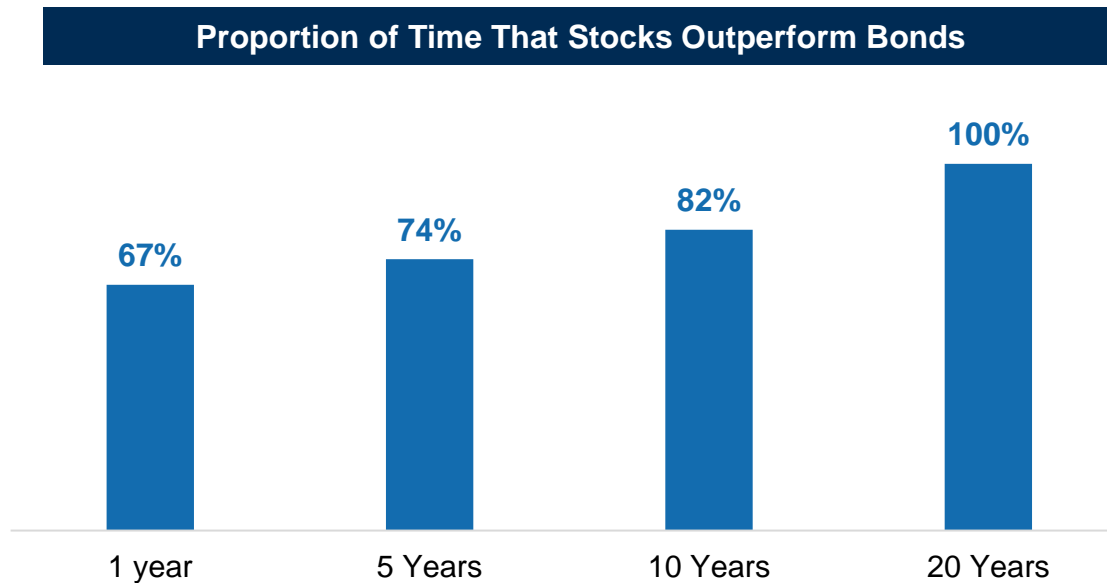


Source: FactSet. Each dot represents the P/E during that year and the returns generated over the subsequent 10 years. The starting CAPE ratio is the price divided by the cyclically adjusted EPS, which is the average of the EPS over the last decade at the start of each 10-year period measured. Annual data utilized from 1950 through 2019. R-squared is a statistical measure used to analyze how differences in one variable can be explained by the difference in a second variable. **The performance data quoted represents past performance, which is not an indication or a guarantee of future results.**



## Lending vs. Owning Long-Term Appeal of Stocks

- U.S. stocks outperformed intermediate-term U.S. government bonds about two thirds of the time over one-year periods during the last 70 years, but beat bonds in every 20-year rolling period
- The standard deviation of returns for stocks is almost three times larger than for bonds over one-year intervals but nearly equal over 20-year rolling periods



Source: Morningstar and Alger. Stocks are represented by the S&P 500 and bonds are the Ibbotson U.S. Intermediate-Term Government Bond Index. Data is annual rolling returns 1950 through 2019. Standard Deviation measures how much the portfolio's return has deviated from its average historical return. **The performance data quoted represents past performance, which is not an indication or a guarantee of future results.**

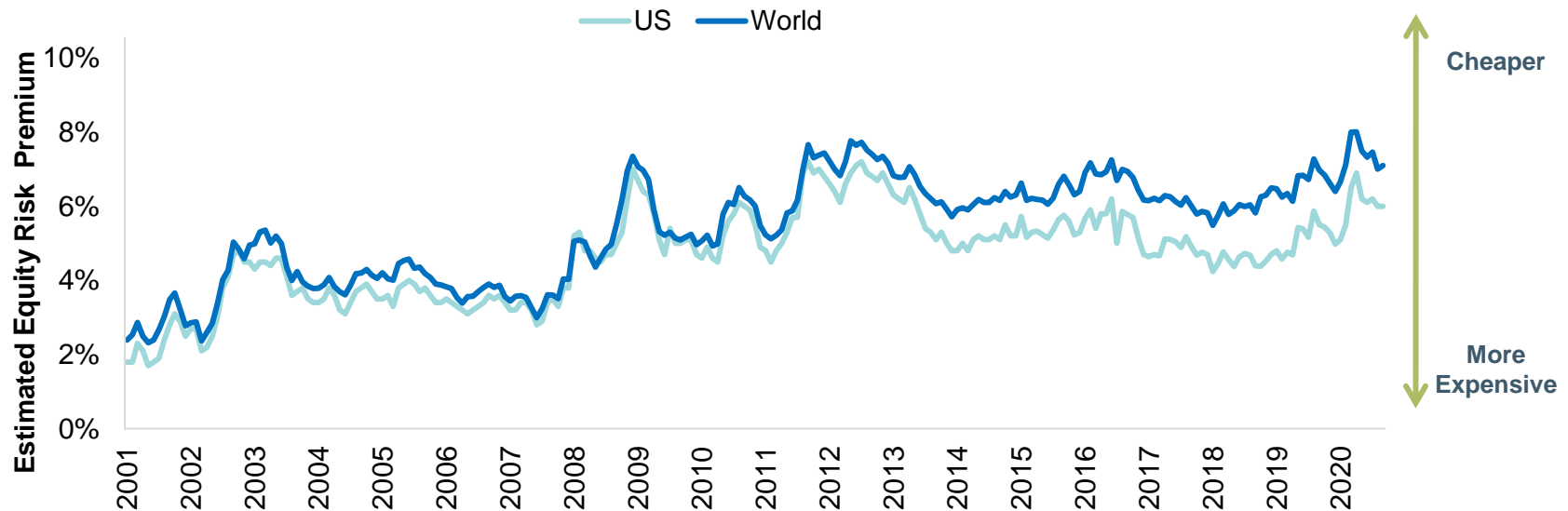




## Valuation Reasonable Relative to Interest Rates

- One good way to incorporate interest rates into valuation is to calculate investors' required rate of return above the prevailing risk-free interest rate
  - Using the so-called Equity Risk Premium shows stocks are attractively valued relative to their historical average

### Equity Risk Premiums Show Stocks Are Inexpensive



Source: Goldman Sachs. Note: The market implied equity risk premium (ERP) is the rate that at each point in time makes the theoretical value from GS Dividend Discount Model equal to the observed market price. U.S. equities are represented by the S&P 500. World equities are represented by a weighted average of MSCI Asia Pac ex-Japan (20%), TOPIX (10%), Stoxx 600 (30%), and S&P 500 (40%).

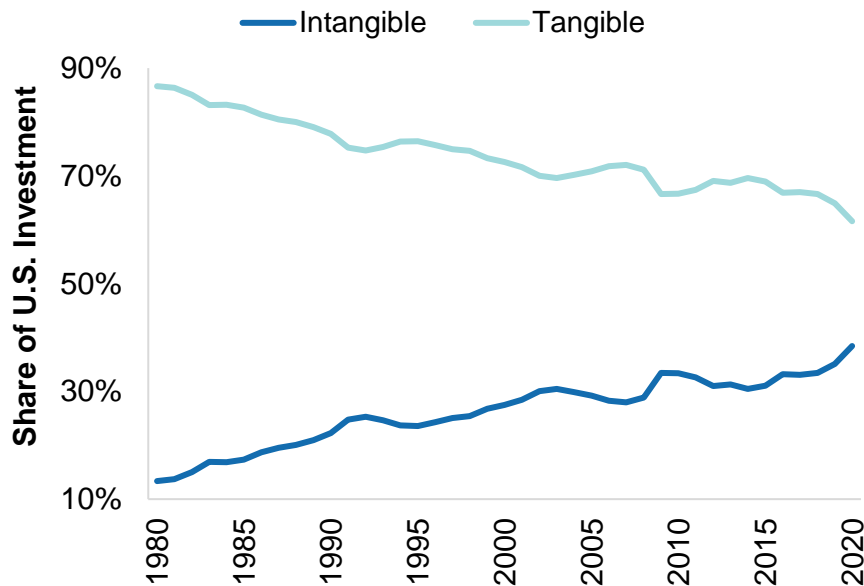


# Valuation

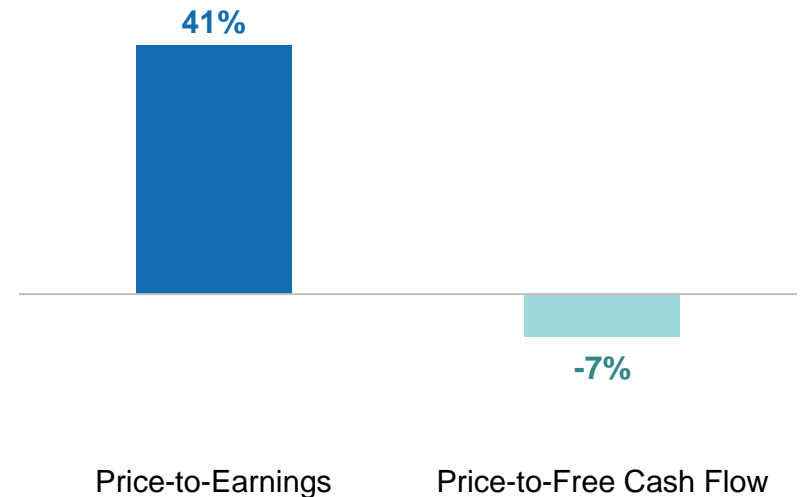
## More than Meets the Eye

- Companies are increasingly investing more in intangible assets (e.g., R&D), that are expensed rather than capitalized
- The result is depressed earnings relative to free cash flow, making the stock market look cheaper on free cash flow than earnings

### Intangible vs. Tangible Investment



### S&P 500 Valuation Relative to Past 25-Year Median



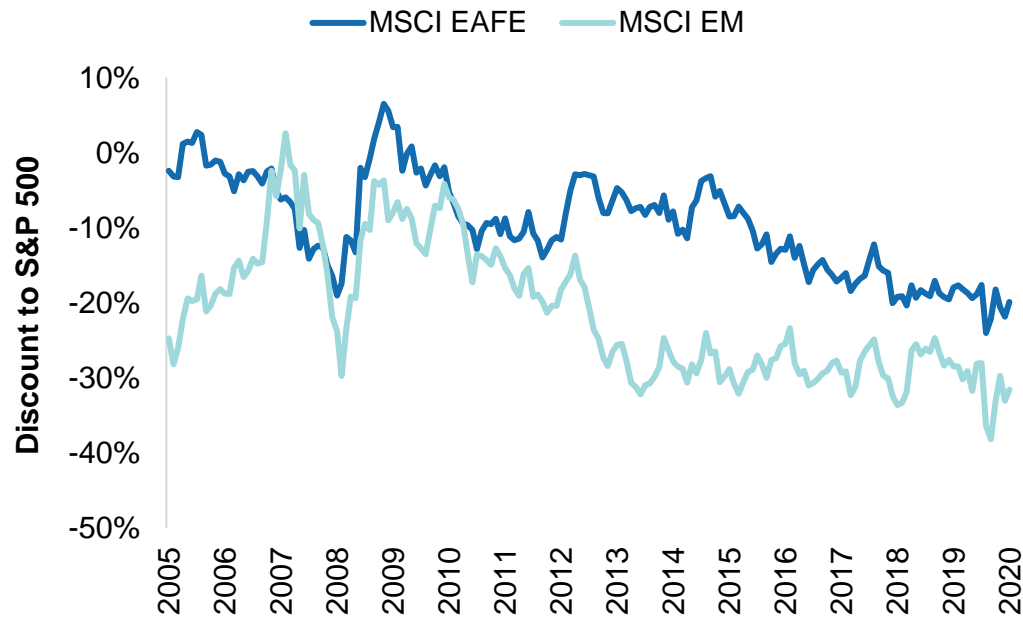
Source: Share of U.S. investment is based on gross private nonresidential domestic investment from the Bureau of Economic Analysis. Valuation is from FactSet as of 09/30/2020 with price-to-earnings being the current market price of a company divided by its last 12 months of earnings. Price-to-free cash flow is the current price of a company divided by its last 12 months of free cash flow.



## Valuation Bargains Abroad?

- International developed and emerging markets are trading at historically large discounts to the S&P 500

### Non-U.S. Stocks are Inexpensive Relative to U.S. Equities



**Non-U.S.  
stocks look  
relatively  
inexpensive**

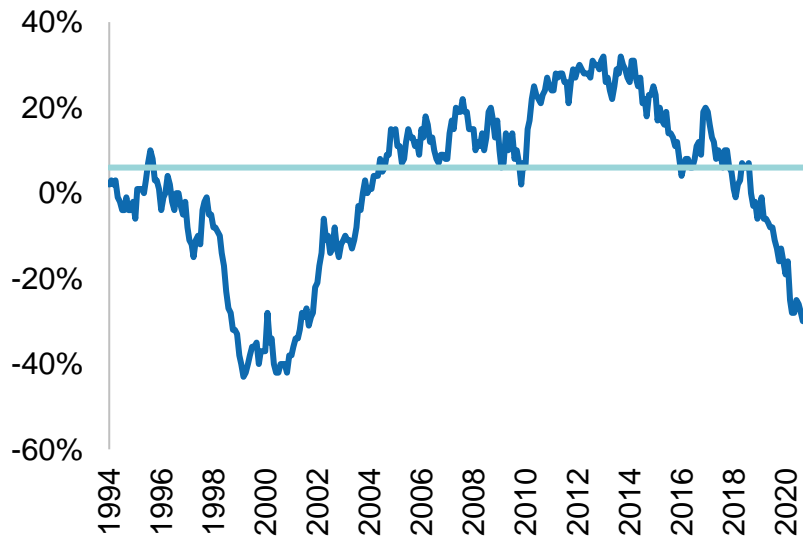


# Valuation

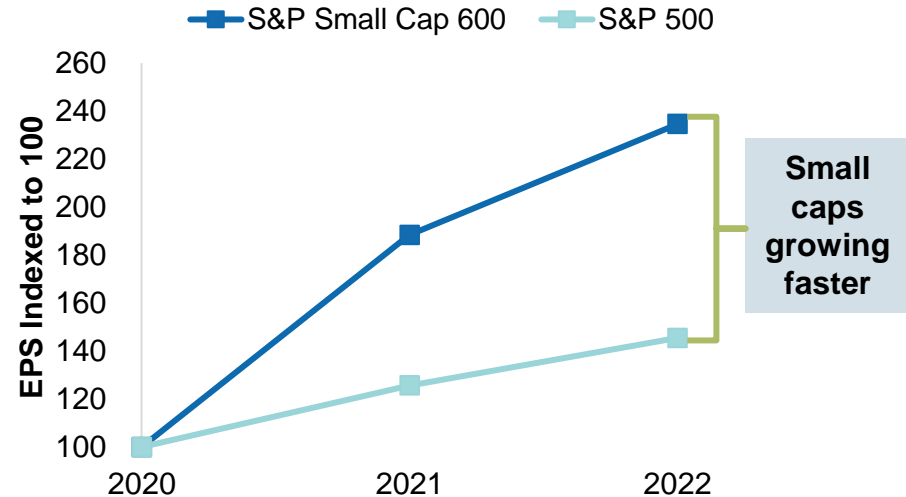
## Smaller Capitalization Stocks Look Attractive

- Underperformance has compressed small cap valuations as compared to history
- Small caps are expected to grow much faster than large caps

### Price-to-Earnings S&P Small Cap 600 / S&P 500



### Estimated Earnings Per Share Trajectory



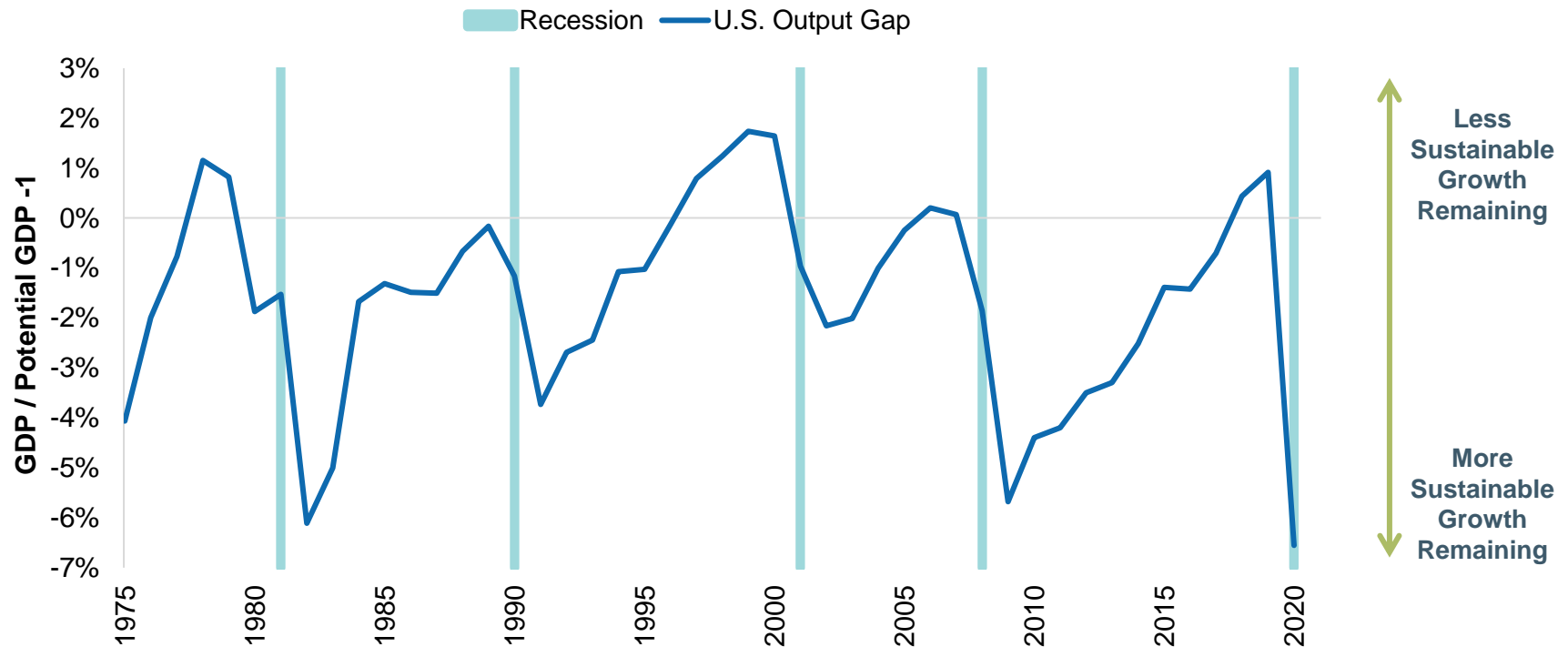
Source: FactSet as of 09/30/20. P/E is price divided by earnings per share over last 12-months. Estimated EPS trajectory based on consensus estimates from FactSet.

# IV

## The Economy Mind the Output Gap

- The U.S. economy is operating substantially below its potential, implying significant room is left in the expansion in our view

### Large Output Gap Implies A Lot of Growth Left

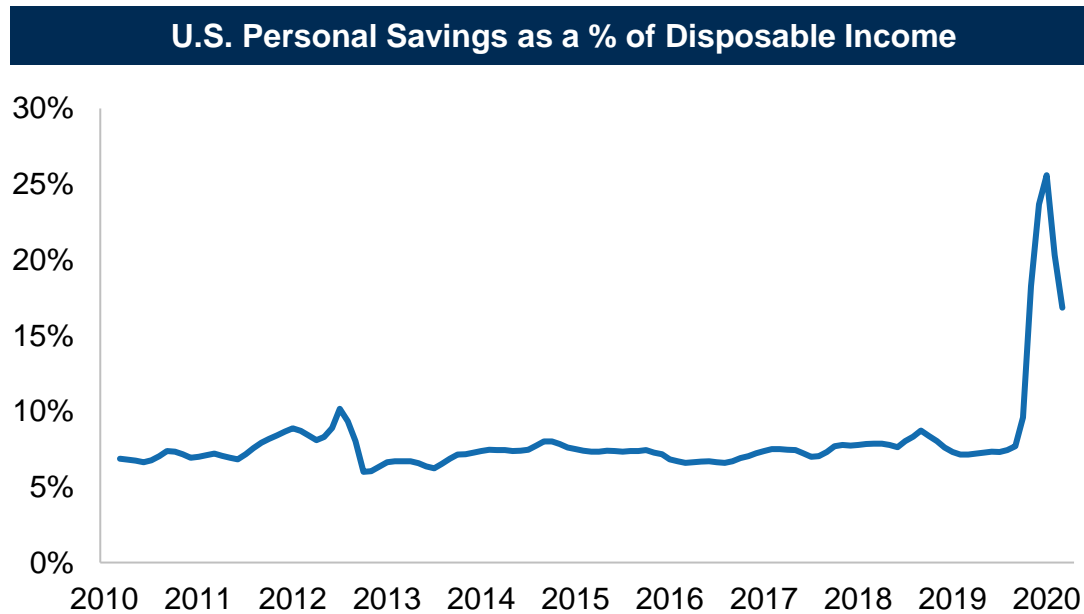


Source: Congressional Budget Office. The output gap indicates the difference between the actual output of an economy and the maximum potential output (the economy's maximum sustainable output with underlying inputs including the natural rate of unemployment, various measures of the labor supply, capital services, and productivity) of an economy.

# IV

## The Economy Banking It

- The U.S. consumer has been saving at an elevated rate, which should support spending going forward in our view



**The U.S. consumer savings rate is historically high**

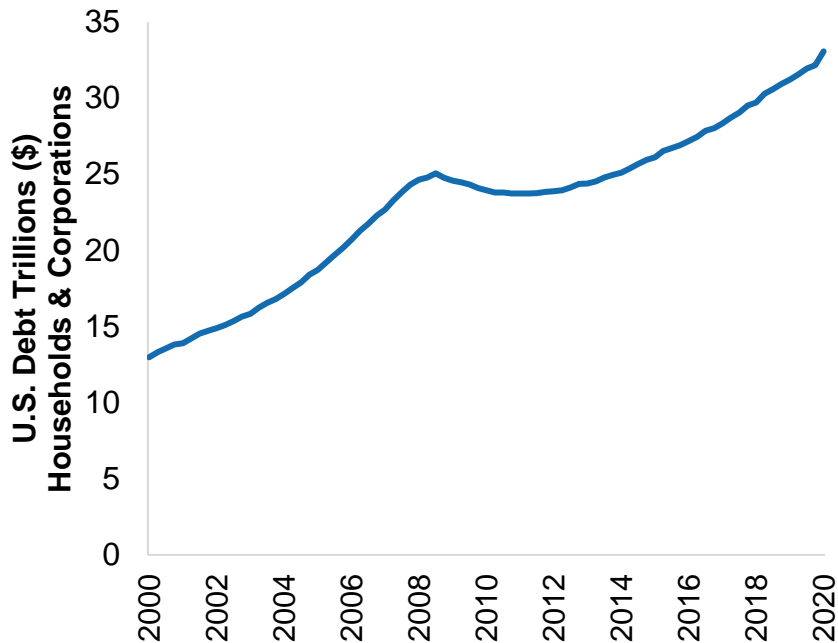
Source: U.S. Bureau of Economic Analysis. Three-month moving average through August 2020.

# IV

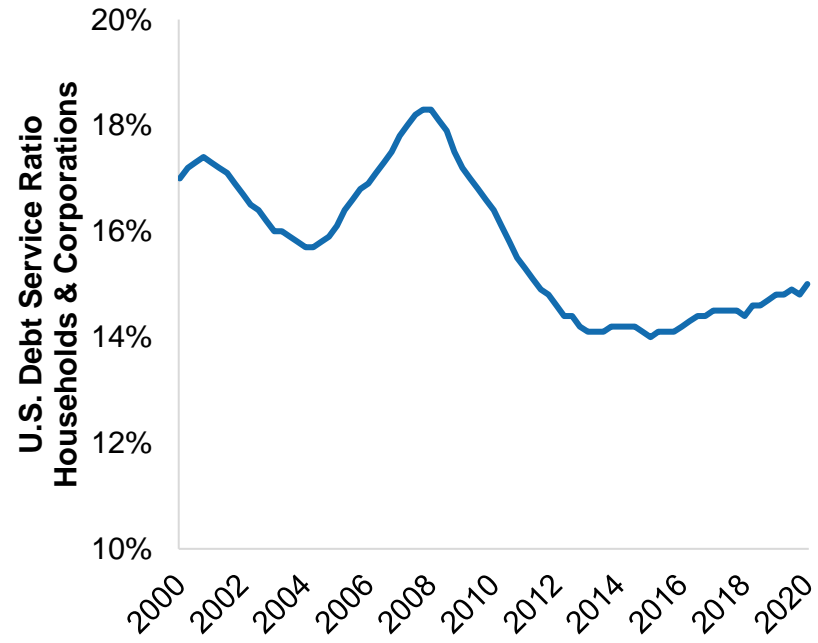
## The Economy Degrees of Debt

- Credit to U.S. households and non-financial corporations is over \$33 trillion and the highest relative to GDP since 2011
- However, the debt service ratio, or share of income used for interest payments and amortizations, is relatively low

### U.S. Debt Levels Are High...



### ...But The U.S. Debt Service Burden Is Not



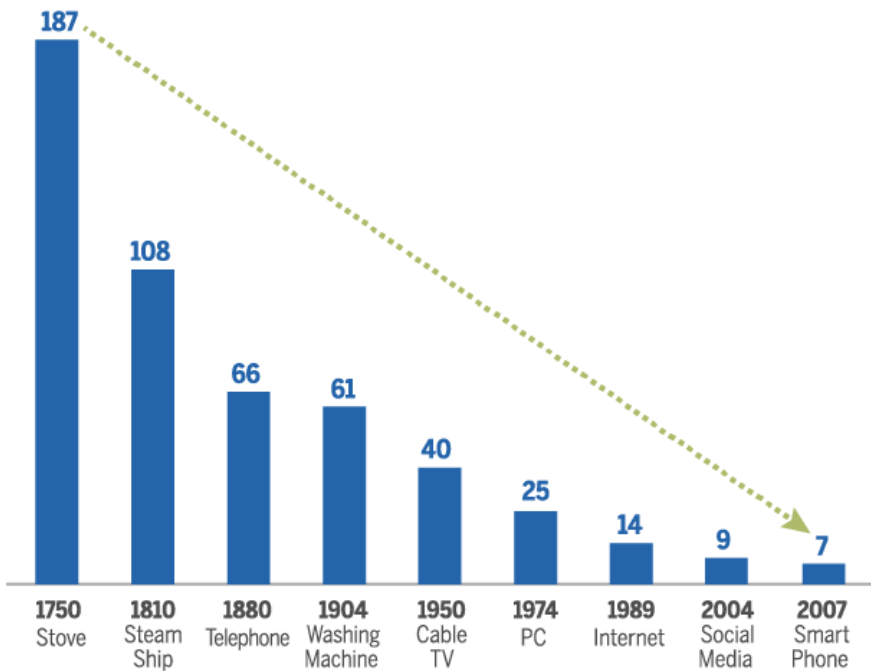
Source: Bank for International Settlements, September 2020. Debt Service Ratio is the share of income used for interest payments and amortizations in the non-financial private sector.

# V

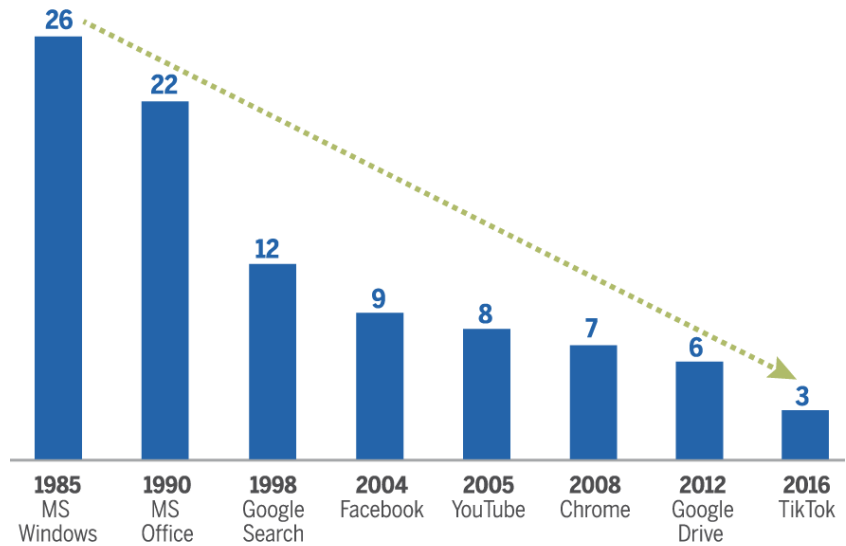
## Style Wars Accelerating Change

- Innovation is accelerating across many areas of the economy, causing new products and services to diffuse through society faster and disrupt businesses at a greater pace
- This may be a tailwind to growth companies, which we believe are the drivers of innovation, and a headwind to value stocks, which may be victims of change

### Years from Market Entry to 50% Penetration



### Years to Reach 1 Billion Users



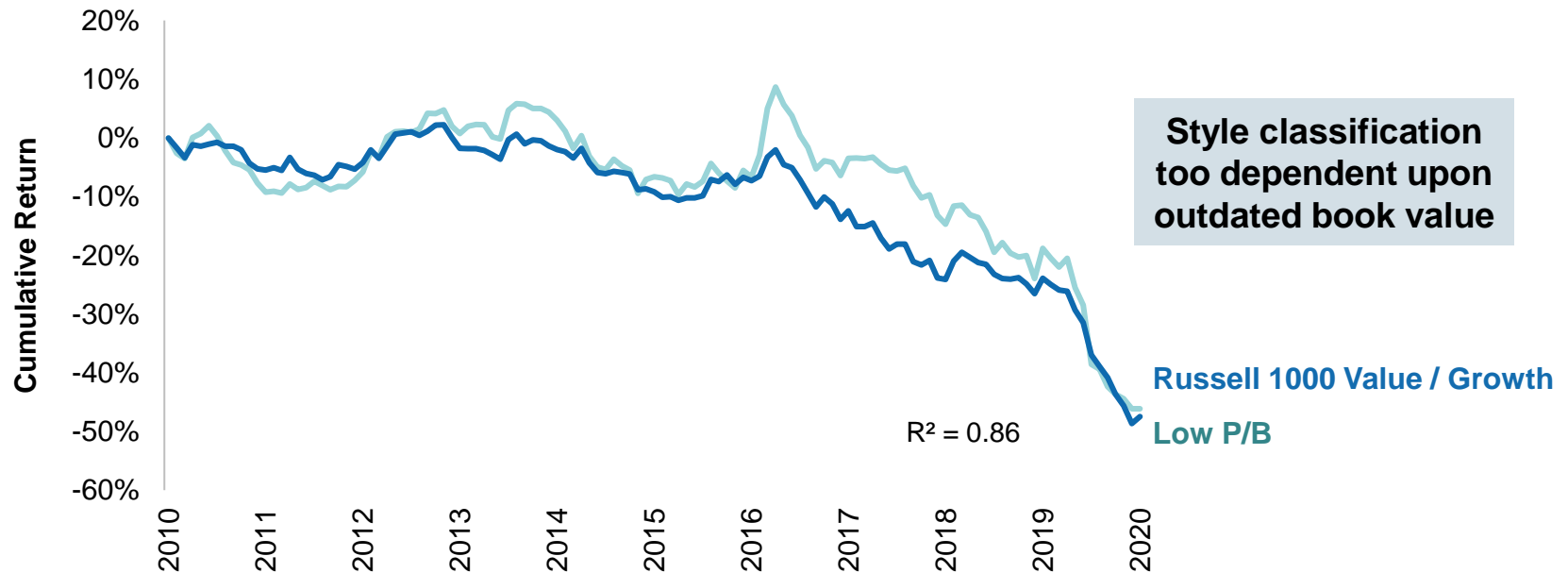
Source: Asymco, Visual Capitalist, company disclosures, Alger estimates.



# V

## Style Wars Structural Issues Driving Growth vs. Value

- Growth stocks have dramatically outperformed Value stocks over the past decade
- The driver has been the very weak performance of the Price-to-Book valuation metric, which is used heavily in index classifications of Growth vs. Value stocks
- As accounting fails to keep up with the changing economy, book value may no longer be as relevant (e.g., R&D is not capitalized in book value)

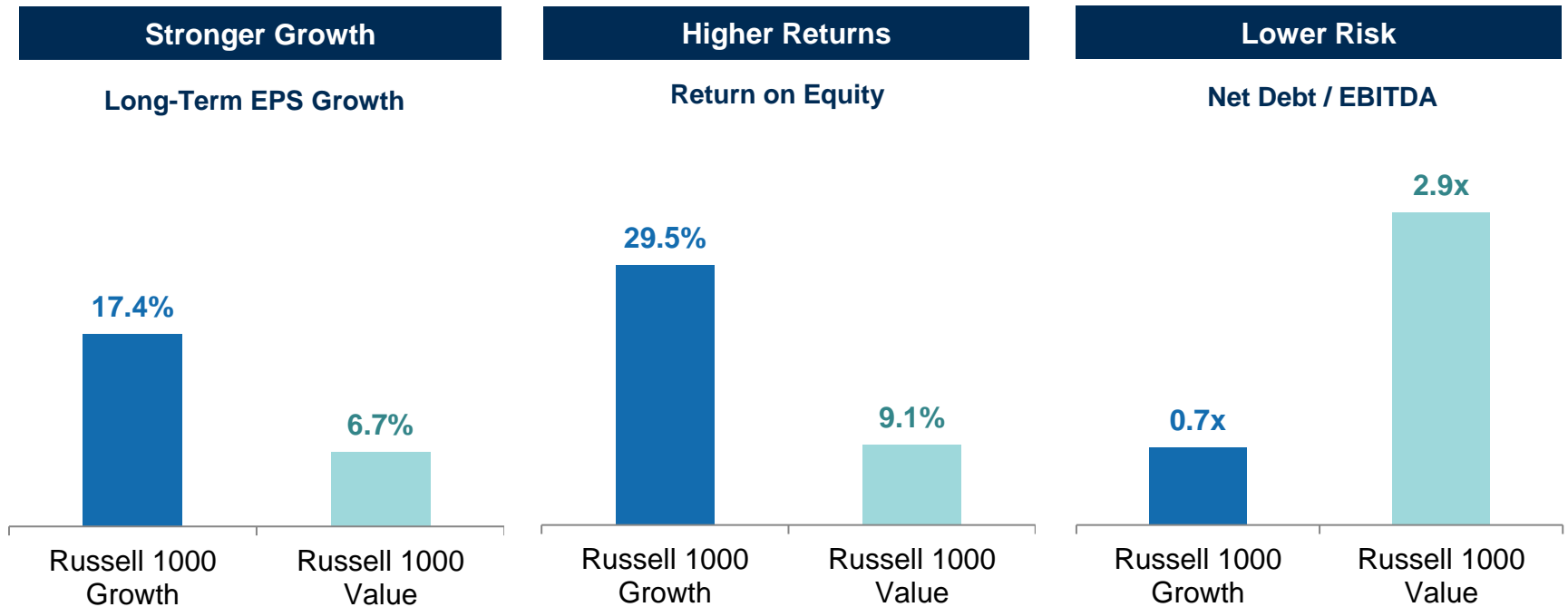


Source: FactSet, Kenneth R. French, and Alger as of September 2020. Low price-to-book returns are based on the B/P Fama/French factor for the CRSP universe which includes US firms listed on the NYSE, AMEX, or NASDAQ. **The performance data quoted represents past performance, which is not an indication or a guarantee of future results.**

# V

## Style Wars The Growth Advantage

- Three variables drive P/E multiples: growth, return on capital, and risk
- The Russell 1000 Growth Index has higher expected EPS growth, higher return on equity, and lower risk in the form of better balance sheets as compared to the Russell 1000 Value Index



Source: FactSet as of 9/30/20. Growth represents consensus long-term analyst estimates and actual future EPS growth rates might be materially different than the forecasts shown.

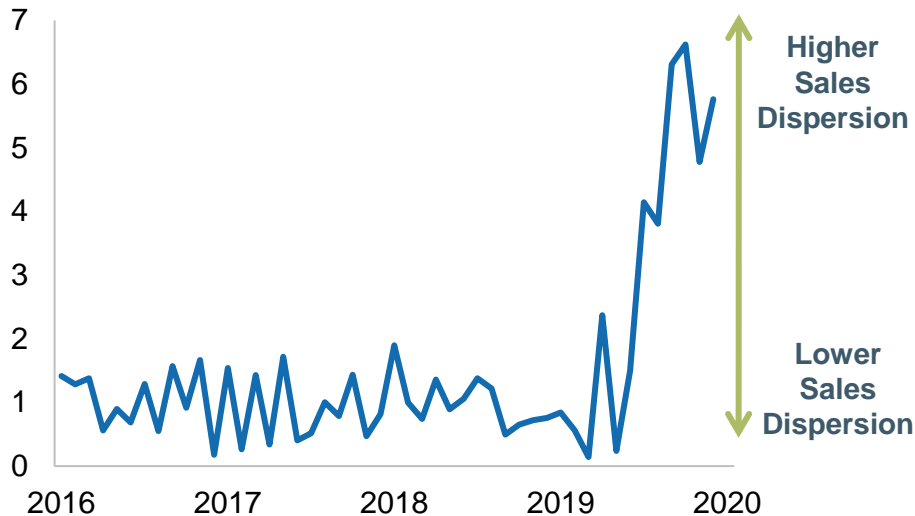
# V

## Style Wars Winners vs. Losers

- Data shows that the spread between economic winners and losers is at historic highs
- Analyst estimates suggest Growth fundamentals are far stronger than Value

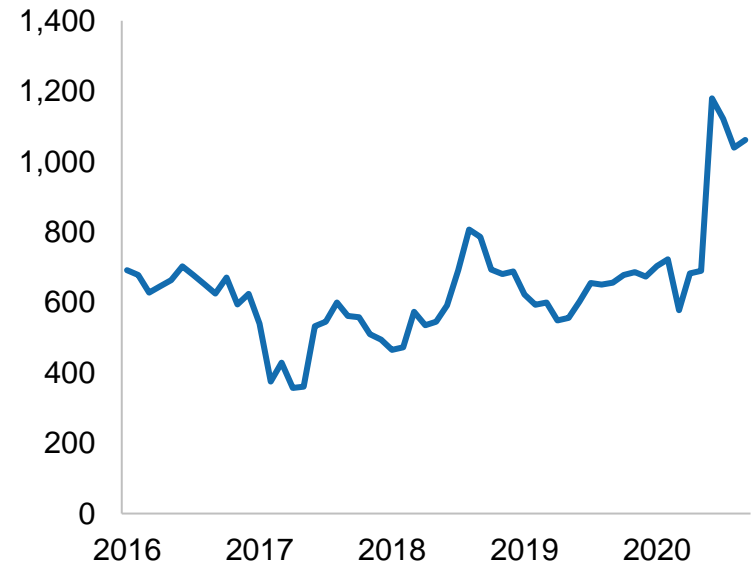
### Corporate Sales Dispersion Has Jumped

The Rate At Which Sales Are Shifting Between U.S. Companies



### Growth Stocks' EPS Expected to Outperform

Estimated Long-Term EPS Growth Spread for Russell 1000 Growth Less Russell 1000 Value (bps)



Source: Survey of Business Uncertainty conducted by the Federal Reserve Bank of Atlanta, Stanford University, and the University of Chicago Booth School of Business to calculate the Expected Excess Sales Reallocation Rate (left chart) through August 2020; and FactSet data through September 2020 (right chart). Long-term EPS growth represents consensus long-term analyst estimates and actual future EPS growth rates might be materially different than the forecasts shown.

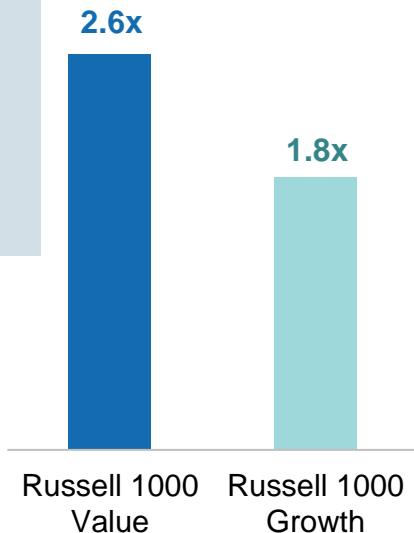
# V

## Style Wars Multiples vs. Fundamentals

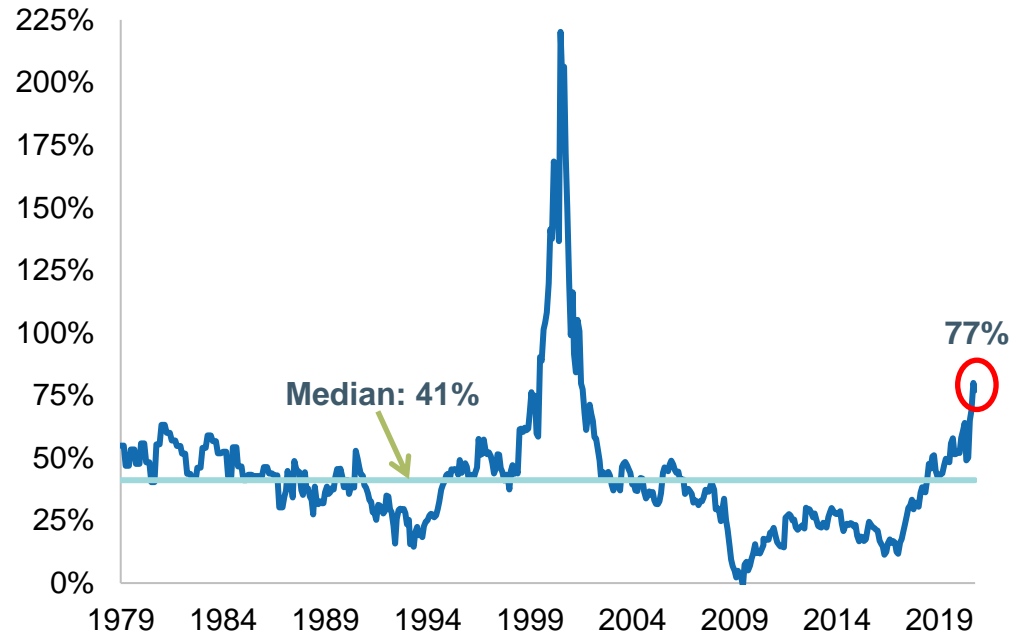
- The large and widening spread in fundamentals helps offset the elevated premium at which Growth stocks trade, making them cheaper per unit of growth

**Russell 1000 Growth vs. Russell 1000 Value PEG Ratio**

Growth stocks are cheaper relative to long-term growth



**Russell 1000 Growth Relative to Russell 1000 Value P/E**



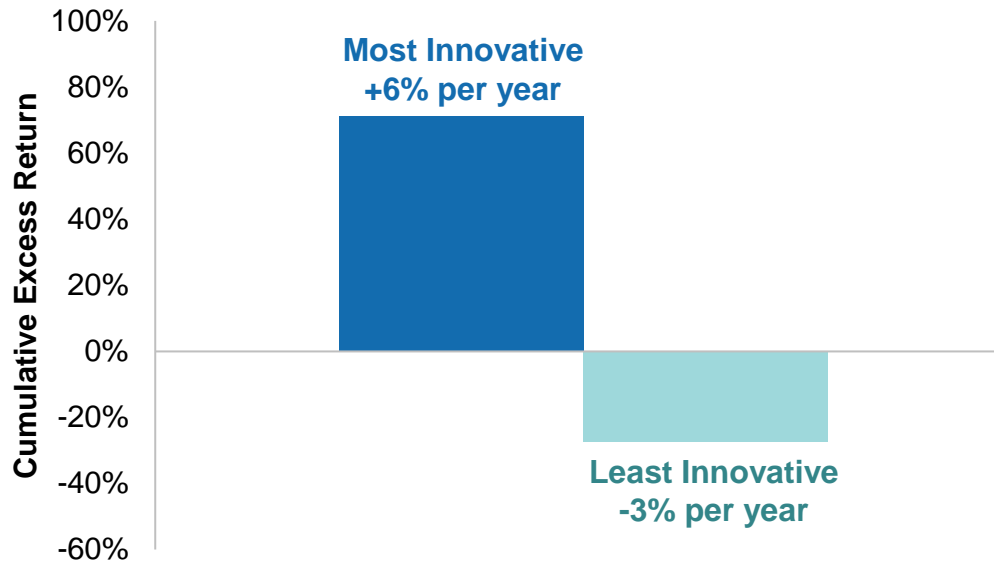
Source: FactSet, Bank of America as of 9/30/20. PEG ratio is P/E divided by long-term growth rate. The performance data quoted represents past performance, which is not an indication or a guarantee of future results.

## Style Wars

### Innovation as Asset Class?

- Studies have shown and our research demonstrates that the most innovative companies grow their sales, earnings, and stock prices faster\*

#### Innovative Companies Have Outperformed Over the Past Decade



Source: FactSet. Most/least innovative stock excess performance is derived from highest and lowest S&P 1500 quintiles based on R&D as % of sales, normalized for market value, using one month returns for 10 years ending August 2020. \*Baruch Lev and Suresh Radhakrishnan, "The Stock Market Valuation of R&D Leaders." **The performance data quoted represents past performance, which is not an indication or a guarantee of future results.**

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# Disclosure

The S&P 500 Index is an unmanaged index generally representative of the U.S. stock market without regard to company size. The S&P 500 Growth and Value style indices are weighted by float market capitalization and they measure the performance of U.S. equities fully or partially categorized as either growth or value stocks, as determined by Style Scores for each security. The S&P Composite 1500 is an unmanaged index that covers approximately 90% of the U.S. market capitalization. The Russell 1000® Growth Index is an unmanaged index designed to measure the performance of the largest 1000 companies in the Russell 3000 Index with higher price-to-book ratios and higher forecasted growth values. The Russell 1000 Value Index measures the performance of those Russell 1000 companies with lower price-to-book ratios and lower forecasted growth values. The Russell 2000 Index is a small-cap stock market index of the bottom 2,000 stocks in the Russell 3000 Index. The MSCI AC Asia Pacific ex Japan Index captures large and mid cap representation across 4 of 5 Developed Markets countries (excluding Japan) and 9 Emerging Markets countries in the Asia Pacific region. TOPIX (Tokyo Stock Price Index) is a free-float adjusted market capitalization-weighted index that is calculated based on all the domestic common stocks listed on the Tokyo Stock Exchange First Section. The STOXX Europe 600 Index is derived from the STOXX Europe Total Market Index. The STOXX Europe 600 Index represents large, mid and small capitalization companies across 17 countries of the European region. The STOXX Europe Total Market Index represents the Western Europe region as a whole. It covers approximately 95 percent of the free float market capitalization across 17 European countries. The Ibbotson U.S. Intermediate-Term Government Bond Index is measured using a one-bond portfolio with a maturity near five years. The Morgan Stanley Capital International (MSCI) Emerging Markets Index (EM) is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets. MSCI Emerging Markets Europe, Middle East and Africa Index (EAFE) is a free float-adjusted market-cap index that measures equity market performance in the emerging market countries of Europe, the Middle East and Africa. S&P SmallCap 600 Index is a market-value weighted index considered representative of small-cap US stocks.

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