Introducing the Alger Russell Innovation Strategy

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ALEX BERNSTEIN: Hello, I'm Alex Bernstein and you're listening to The Alger Podcast: Investing in Growth and Change. During the first week of January, Alger launched the Alger Russell Innovation ETF–Ticker INVN–an ETF strategy that, while highly focused on innovation, looks and behaves quite differently than other Alger products. For one thing, it's a top-down strategy created in conjunction with Russell, that takes its starting point from the Russell 1000 index. For another, its history starts with what some might consider "outdated accounting standards". Here to break things down with me, is one of the architects of this new ETF, Alger's Director of Market Strategy, Brad Neuman. Brad, thanks so much for joining me this afternoon.

BRAD NEUMAN: Thanks, Alex.

ALEX: Brad, just to get started, this product is a real departure for Alger in many ways. In so many words, how would you describe it to somebody on the street?

BRAD: Well, the strategy is called the Alger Russell Innovation strategy, and it seeks to identify companies that are very innovative and where that innovation may be, we believe, underrecognized or undervalued in the stock market. So, we think it solves a few problems that exist. Number one, accounting hasn't been keeping up with the changing nature of the economy. So, investments in intangible assets like software or new drug development that research and development isn't captured on financial statements adequately, and so this, we believe, solves that problem. So, it's really allowing investors to directly invest in R&D and innovation.

ALEX: This strategy has multiple managers working on it. Who else is on the product other than you?

BRAD: Well, Dan Chung, our CEO and CIO, so his experience is always helpful and guidance, and then Greg Adams who is head of Risk, and he has a lot of experience in managing risk and putting together portfolios. So, his experience is also very helpful.

ALEX: Brad, before we break down what the strategy actually is and does, I want to take a step back and discuss how, to some degree, outdated accounting practices drove the philosophy behind this new product. You wrote a piece awhile back about this, called "Big Changes are Coming," which people can still find on Alger.com. What Big Changes were you talking about – and why were they so important?

BRAD: So, the Financial Accounting Standards Board determines how companies account for investments that they make and the revenue they take in and expenses they spend to make that revenue happen. They right now deem research and development, especially when it's done internally, to be an expense and not lead to an asset. So, because they don't see any asset that R&D necessarily leads to, it isn't capitalized on the balance sheet, and that means that it's missing from the balance sheet, missing from book value, and it means that it detracts from a net income. It’s just purely an expense, and it doesn't get recognized over many years like an investment in a tangible asset would.

The Financial Accounting Standards Board I think has recognized that that needs to change, and so they're exploring ways to give investors more detail on intangible assets like research and development, and those are the changes that are coming, but they're coming at a glacial pace. I think it will take many, many years.

ALEX: What kind of intangibles are we talking about here?

BRAD: So there's two kinds of assets, tangible assets – those are things like property, plant, equipment, things that you can taste and touch and feel – and intangible assets that you can't touch. So, an example of a tangible asset would be like a factory property, plant and equipment, inventory. Those are all tangible. Intangible are things like brands, human resources training, software code, patents on new drugs, those kinds of things, and the research and development that goes into those intangible assets is accounted for very differently than the same expenditure on property, plant and equipment.

So, a tangible investment is normally capitalized. That means that it goes on the balance sheet, and if you spend $100 million on say your bank, and you spend $100 million on a bunch of bank branches to attract new customers, you might depreciate that over, I don't know, five or ten years.

If, however, you spent that $100 million on research and development on software that you thought was going to attract new customers as kind of a virtual bank, and you've developed that internally, that $100 million would be expensed, and so it would not appear on the balance sheet. It would not be in book value, it would be $100 million of expenses. So, it would dramatically weigh down your earnings much more than the same decision to invest in tangible assets. So, it's accounted for totally differently, yet I don't think that that necessarily makes sense because the intangible investment could be just as much or even a better asset than the tangible one.

ALEX: Something like branding, for example.

BRAD: Yes, branding, coding. Google has arguably one of the better assets in the history of business in the Google search engine, and the Google search engine has a value of precisely zero on the balance sheet. It's missing from the balance sheet, despite the fact that everyone knows it's a fantastic asset, and that's because it was intangible investment done internally, and no one could put a value on it when they were doing the research and development.

ALEX: And of course, we live in an AI world now. What's the impact of AI as an intangible?

BRAD: So, research and development on AI models, so all that training that models go through, very compute-intensive and a lot of data, that also is generally expensed as it's done internally. So, these AI models clearly are very powerful, and I think that they’re assets for everyone who uses them, yet they would detract from income statements and be missing from the balance sheet generally.

ALEX: So, this idea of bad accounting for intangibles really stays with you, and ultimately you and the team actually turn the idea into a fully formed strategy – the Alger Russell Innovation Strategy. Tell me about that.

BRAD: Well, the strategy brings research and development and intangible investment out of the shadows of financial statements and allows investors to be able to use it to find potentially attractive investments. So, research and development, like I said, is really just a negative to the extent that you even find it on financial statements. It's missing from the balance sheet like we said, and it can be an expense or just missing from the income statement. But if you can treat it as an asset or look at it relative to the value that the market ascribes to the business, then you could potentially highlight intangible assets or innovative assets.

ALEX: So, how does this strategy actually work? As we mentioned, it's a very different product for Alger. A top-down strategy created in conjunction with Russell, that starts with the Russell 1000 index? How do you get from the Russell 1000 to Alger Russell Innovation?

BRAD: Well, there's kind of two pieces to the strategy. The first is we eliminate companies in the bottom third of the Russell 1000 in terms of free cash flow relative to sales. So, companies with weak free cash flow margin are excluded from the universe, and that's because when we look at innovative companies, we want to look at companies that are mature, have businesses that have strong profitability. We don't want kind of like pre revenue companies or companies very early in their lifecycle when we look for innovation.

So anyway, once we have whittled down the Russell 1000 universe by that free cash flow margin metric, we simply take the top 50 companies ranked by research and development to enterprise value. Now you can think of enterprise value a lot like market capitalization. It's the value of the entire business, so not only the value for the equity but also the value for the debt less cash. So, companies that are spending a lot of money on research and development, but it's not necessarily being valued that highly by investors, those are companies that rise to the top of this screening.

And you could think of it as kind of a new factor. And I think with the way the economy is evolving, innovation is probably the most important investment a company can make, and this strategy focuses on that innovation investment and allows investors to express this factor as part of their portfolio and I think really for the first time allows investors to have an allocation to innovation.

ALEX: And how did you first approach Russell?

BRAD: Well, we came to Russell, and we said we had this idea for this strategy, and we think it was being misunderstood in the market or not adequately valued in the market. Then once they did research, we started talking about what was most optimal in terms of how often it should be rebalanced and how many holdings it should have, and what exact metrics should go into building it. So, I think they helped refine it, but we brought the idea.

I think Russell brought obviously some brand recognition. A lot of our clients are very familiar with Russell, and they trust Russell's analysis, and Russell, even though we had done our own analysis, Russell did its own analysis of the factor performance or of the testing of what we wanted to do, and they were impressed. So, Russell brings both a brand expertise and ability to manage and promote the index and also brought some good analysis to the table.

ALEX: And you decided on 50 names? And how often do you rebalance?

BRAD: So, we decided to rebalance it quarterly. To rebalance it more often wouldn't add that much in performance and would create some more tax headaches. We decided to use 50 stocks because the signal is so strong from the metric. So, it's going to be equal weighted, two percent of holding, balanced quarterly, and we're using the Russell 1000 but, truthfully, the strategy works whether you do it within the Russell 1000 Growth, within the Russell 1000 Value or internationally frankly.

ALEX: And as I mentioned, this is Alger's first rules-based, top-down product. Why is that significant for Alger?

BRAD: So, Alger has a 60-year history of investing in growth and change, and we've always done it from a bottom-up fundamental basis. I think, though, that there is another way to identify innovation, and that is through a top-down systematic approach by looking at innovation across companies and seeing how the market is valuing that innovation. So, this top-down approach is different from the bottom-up approach that Alger has used for 60 years. Still trying to identify innovative assets that will produce strong returns for the company and shareholders, but it's doing it in more of a quantitative way than a fundamental way, and I think that that's really neat.

ALEX: Can you give an example of a company that emphasizes the strategy's overall philosophy?

BRAD: So, AppLovin is a company that perfectly fits the intangible mold. It's a software company that helps apps monetize better and find larger audiences, so perfectly suited for the mobile Internet, and AppLovin was a stock that suffered greatly in '22 and '23, and I think it did that because the company was spending a lot of money on research and development and coming up with a fantastic solution for app developers, yet the market wasn't valuing that innovation yet. So, I think that's a good example of the type of software company that is represented in the strategy.

By the way, on the flip side of that, it didn't own Apple over the past year or two. So why didn't it own Apple? Well, Apple market value relative to its research and development was more or less elevated because the company's products have already found a fantastic audience. I'm not saying it's not innovative. It still is an innovative company, but its innovation is widely understood by the market, whereas this strategy, we believe, is more likely to pick out innovation that's not well recognized or understood by investors.

ALEX: Brad, I have a very general question: why does the world need another innovation strategy?

BRAD: Well, I don't really think there is another innovation strategy quite like this. There isn't anything that really looks at research and development to enterprise value the way we're looking at it. I think there's very few assets that are allocated to innovation and none in the way that we're doing it.

ALEX: Do you think this new strategy will give investors more ways to invest in innovation with Alger?

BRAD: So, I think historically for 60 years Alger has typically invested in innovation from a bottom-up fundamental basis by trying to figure out what products and services that companies were working on that would succeed in the future, so what was in their innovation pipeline like new drugs, new software products, et cetera. This is a way, instead of doing it bottom-up on a fundamental basis, this does it top-down and more of a quantitative and systematic way. So, I think it rounds out the ability for investors to allocate to innovation within Alger.

ALEX: Final question, why this strategy for Alger right now?

BRAD: Well, I think the time was right from Alger's perspective. It was our 60th anniversary. We're looking for new strategies to celebrate the milestone. So, I think that played a role into it. It's also clear that the trends continue to accelerate. We keep moving to a more digital world where innovation is more important, not less important. I talk a lot about this, that it used to take many decades to reach 50 percent household penetration from, say, the washing machine or dishwasher being introduced, whereas the Internet and social media took only 14 and nine years, respectively, and the tablet took seven years.

So, innovation is happening a lot faster. It took the Microsoft Office and Windows products about a quarter of a century to reach a billion users, whereas many of the Google products did it in under a decade, and TikTok did in five years, and ChatGPT may do it even sooner. So, I think that the trends have accelerated, and it was the right time for Alger.

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

BRAD: Thanks, Alex. Great talking with you.

ALEX: And thank you for listening. For more information on the Alger Russell Innovation Strategy–Ticker INVN–and for more of our latest insights, please visit www.alger.com.

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