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PODCAST TRANSCRIPT

Recession or Wealth Creation?

BRAD NEUMAN, CFA
Senior Vice President
Director of Market Strategy

ALEX BERNSTEIN: Hello, I'm Alex Bernstein, and you're listening to The Alger Podcast, Investing in Growth and Change. It's no surprise that investors have faced a difficult market over the past year. At Alger, we're endeavoring to provide some guidance through this challenging environment with our latest Capital Markets presentation, "Navigating a Weakening Economy," which you can find on www.alger.com. Here to take a deep dive with me into that presentation is Alger's Director of Market Strategy, Brad Neuman. Brad, thanks so much for joining me this afternoon.

BRAD NEUMAN: Thanks, Alex.

ALEX: So, Brad, just to start off, what exactly do you mean by a "weakening economy"?

BRAD: Well, I think it's clear that the Fed wants to slow down economic activities such that inflation will come down, because inflation is just too high for their taste. They wanted to be kind of more in the two, maybe two to three percent range, and it's in the high single digits depending on which metric you look at, mid to high single digits. So, the way to do that, unless supply chains really ease up, is more through the demand side, and so the Fed's tools to moderate demand would be through higher interest rates. So, they're raising interest rates. That's going to slow the economy, slow the number of open jobs per job seeker, and they're hoping to get wage growth to moderate through that dynamic.

ALEX: The watchword with most investors today is "recession." Do you think we're in or about to face a recession?

BRAD: I do think we're either just beginning or about to start a recession. The Fed's tools are kind of blunt. So, while they would love to very precisely take down the number of job openings per job seeker to one to one, I don't think they're going to be able to just take away excess demand. And I think unemployment is going to go up.

In fact, the money supply, which grew very strongly over the past couple years, in excess of $6 trillion we think because of the actions of the Fed raising interest rates and quantitative tightening, reducing the balance sheet, will cause the money supply which is kind of all the money in the economy – checking, savings and retail money market, those kinds of things – we think that will go negative, so a decline over the next few months for the first time since 1938, and that'll usher in slower economic activity and a recession.

ALEX: Brad, some investors have been hesitant about purchasing equities – and especially growth equities – in this market. But you think investors should reconsider growth equities for a number of reasons. One being that growth – which is usually purchased at a premium – has actually been quite cheap this year. Is that correct?

BRAD: So, when we say growth is cheap, I think the easiest thing to point to is the longest duration stocks that have been hurt the most by rising interest rates. The longest duration equities are small cap growth. Those are the companies with the cashflows furthest in the future because they're early in their maturity lifecycle.

When you look at those small cap growth companies, they're trading at just about the lowest levels we've ever observed relative to the broad market. So, the S&P 600 growth stocks on a price to earnings multiple relative to the S&P 500 is at a 20 to 25 percent discount when typically, it's at a premium.

So yes, we think that there's a lot of value in these long-duration growth stocks like small growth that have been beaten down by the rising interest rates and probably unduly punished to the point where they're now, in some cases, as cheap as we've ever seen them and, in our view, portend higher than average returns going forward.

But I don't think valuations will stay this depressed for long-duration stocks. The market seems to have found a bottom for those stocks. That duration trade seems to be over. I say that because growth outperformed in the third quarter despite rising rates and valuations for some of the longest duration stocks.

So, the next phase of the market headwinds I think is really about declining economic activity and reduction in earnings expectations, and I think growth stocks have proven that they have more resilient fundamentals than other parts of the market.

So, if you go back to previous recessions, earnings declines for growth stocks had been much less severe than say for value stocks. In fact, in 2020 growth stocks held up much better. In fact, small growth stocks actually saw their earnings increase, whereas the rest of the market, particularly value stocks, saw double-digit earnings decline. So, we have a lot of data in the Capital Markets presentation that shows that we think growth stocks are less dependent on economic activity than other parts of the market like value stocks. So, we think they'll hold up better in this next phase of the market headwinds.

ALEX: Brad, one thing you underscore in the new Capital Markets presentation is that you think investors should focus on quality. So, how exactly do you define quality in a growth company?

BRAD: So, a lot of quality we think has to do with strong margins and balance sheets. So, for balance sheets we've shown that companies with higher levels of debt tend to underperform in recessions. At least that was the case in the past couple of recessions. That's due to probably a couple of reasons. One, if you have a lot of debt, you have a lot of interest expense, and that magnifies any change in revenue onto the bottom line. So, for a given decline in revenue, you're going to have a larger decline in earnings if you have more interest expense, all else equal.

The other piece of why it's important to have a high-quality balance sheet is that you don't want to be dependent on the capital markets to roll that debt over. So, if debt comes due, and you can't repay that debt – you could just service it – you don't want to have to be at the market's whims to have to reissue that at a very high interest rate. So, I think that's why high-quality balance sheets are important. High-quality margins are also important, and it's similar reasoning if you have low margins. Well, first of all, if you're losing money, then you might be at the whims of the capital markets for financing, equity financing or convertibles. Any kind of fundraising might be difficult in a bad economy, but also if you have low margins, you generally have higher fixed costs, and higher fixed costs again would magnify any decline in revenues onto the bottom line.

So, we think growth stocks generally have higher margins, particularly higher gross margins and higher return on capital than value stocks, and they generally have much stronger balance sheets than value stocks if you just aggregate up say the Russell 1000 growth or the Russell 3000 growth. So, we think in general growth stocks are higher on the quality side than value stocks. Of course, not all are. You have to pick and choose, but at Alger that's one of the things we focus on is having high-quality companies that are in charge of their own destiny and not dependent on the economy for growth or the capital markets for funding.

ALEX: Another element of high quality that you focus on is "strong moats." Can you tell me what you mean by strong moats and why you think they're important?

BRAD: Right. Good point. So competitive advantage is the ability for a company to earn returns in excess of its cost of capital which is pretty much what business is all about. If you were just earning returns at your cost of capital say for a commodity producer, the business wouldn't be a very good business. So, all companies strive to earn returns above their cost of capital, and to do that, they need to have some kind of advantage, and so you could think of that advantage as kind of a moat around a proverbial castle, and the moat keeps invaders or competitors at bay, and the wider that moat is, the deeper that moat is, and if it's widening, that's even better to keep competitors out and to keep excess returns.

So, we look for strong competitive advantages. That could be with a differentiated product. It could be with a scale advantage. You could think about network effects. And generally, we think that high moat companies outperform, but that that outperformance becomes much stronger, much greater in recessions, and that's probably because more market share is up for grabs, and companies with lower competitive advantages could face financial distress as the economy slows and capital markets become more difficult.

ALEX: Thank you. Brad, another key point you make in the presentation is how crucial the role of innovation becomes during this kind of market cycle, and especially with growth companies. Is that right?

BRAD: Yes, because I think the more exposure to innovation you have, the more that innovation drives your business, the less dependent you are on the economy. So the analogy I like to use is that of a sailboat versus a motorboat. A sailboat, maybe akin to kind of a more economically dependent type value stock if you think about an industrial or financial, like a bank. When the winds of economic growth are blowing, it's great for that business, the sailboat. As it were, it glides over the water and everything is nice, but when the winds of economic growth die down, that sailboat would be more listless and have a tougher time getting from point A to point B, whereas we think of growth stocks as motorboats where they're propelled by not economic winds of growth but by market share gains. So, we think of that market share gains as a steady motor to help propel the business forward, even if there is no economic growth or little economic growth.

What we found is that over time, no matter what's happening in the economy, there's always areas of innovation that are growing. So, in the most recent pandemic that we lived through, ecommerce grew very strongly, but areas like software grew right through the recession. So, you had a lot of software companies, household names that grew double digits during that period where you had a lot of banks, on the other hand, and industrial companies that saw basically the opposite.

When you think about what you really need to run your business, obviously you need things like traditional utilities like electricity, but you also need your operating systems to work and your computers and software to keep your business running. Those things are becoming less and less discretionary, and so they're need-to-haves rather than nice-to-haves, and I think that type of innovation and importance to business can help companies grow through recessions.

ALEX: And which innovations do you think are likely to endure through a possible recession?

BRAD: Areas like electric vehicles or solar. We think they're just coming up the so-called S curve where industries begin to accelerate their rate of growth, and so there's so much share to gain from say electric vehicles within automobiles. So, even if automobile purchases and production decline, electric vehicles may gain so much share that they are actually able to grow through the slowdown. Similarly with solar within energy. And artificial intelligence would be another area. Life science tools would be another area; genomics; automated robotic surgery. We think a lot of those areas can gain share within the economy such that they grow though economic slowdown.

ALEX: Brad, any final thoughts?

BRAD: Well, we all know that it's very hard to time the market. It's hard to predict inflation. It's hard to predict exogenous events in the market and what the Fed will do, but I think at the end of the day it's important to think about what drives real wealth creation, and in our view it's not the actions of a central bank. It's not these shorter cycles, the election cycle that a lot of people are focused on this year, every several years, or central bank cycles or economic cycles. We really think it's longer innovation cycles. We think they happen every 50 years of so. We think we're at the beginning of a new one called the age of connected intelligence which we've written a lot about.

But over the long term, we think stocks are driven by earnings growth which has averaged around five percent over the past hundred years. That earnings growth is driven by productivity which we've seen grow throughout all kinds of economic recessions and depressions. We think that productivity is driven by innovation, and we think innovation is actually speeding up, not steady or slowing down, and so we're really bullish over the long term about innovation, productivity, earnings and stock prices.

So, if you're trying to time the market, I think you're kind of missing the forest for the trees, and the analogy that I use for this is the 1970s. 1974, 1975 was the last recession that we had that was supply side driven, meaning there was an inflation shock driven by tightness on the supply side, in particular oil. There was an oil embargo in 1973 which is akin to kind of the COVID supply chain disruption that we had over the past couple years, and it was a terrible recession. The market fell around 40 percent peak to trough. Earnings declined in double digits and real terms but, if you can believe this, that 40 percent decline in the S&P 500 took the market from around 100 to 60. Today as we record this, we're kind of in the mid 3,000s on the S&P 500 and earnings, instead of around seven dollars per share that they were back then are more like $227 per share.

So yes, that 40 points was painful to those investing back then, but today we routinely move that in a day. Because there's been so much wealth creation, you wouldn't even notice that which was so painful all those decades ago. I think when you look back on this period, investors will have had so much wealth creation that this period, while painful right now, will seem like a small squiggle on a longer uptrend of profitability and wealth creation, and I think that's why investors need to keep focus on the long term.

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

BRAD: Thanks, Alex. Great talking with you.

ALEX: And thank you for listening. To read and download our latest Capital Markets presentation, "Navigating a Weakening Economy" – and for more of our latest insights, please visit www.alger.com.

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