

Market Factors Suggest that the Rally Off of March 2009 Lows will Continue

With memories of the subprime mortgage crisis and subsequent bear market etched in their minds, many investors are concerned that equities may be due for a substantial decline. For some investors, fear of a market correction has been stoked by speculation that the 30.05% S&P 500 gain during the 16-month period ended July 30 isn't sustainable. While acknowledging those concerns, Alger has identified a variety of factors that should support substantial market appreciation and we have an optimistic outlook for equities.

Long-Term Perspective

Before discussing our optimism, it is important to note that we believe investors should maintain strategic asset allocations that reflect their specific investment time horizons, risk tolerance and savings goals, and they should refrain from making bets on short-term market performance. At the same time, we believe that expectations of equity performance in the coming months are highly relevant as market volatility concerns may cause some investors to delay implementing long-term asset allocations. Of equal concern, investors who have implemented strategic asset allocations and are anxious about market conditions may decide to liquidate equity positions. In doing so, they may miss out on future market gains and then try to make up lost ground by purchasing equities at the end of a rally.

Such short-term trading can quickly evolve into market timing, which in most cases inadvertently results in investors selling assets at market lows and buying assets at or near market peaks. This process and its harmful impact on portfolio performance are well documented. In one study by research firm DALBAR, the average stock fund investor generated annualized returns of only 3.17% compared to the S&P 500 Index return of 8.20% during the 20-year period ended December of 2009¹ (see Figure 1).

Reasons for Optimism

Regarding equity performance, we believe the following factors should support market appreciation:

- Having hoarded record levels of cash, corporations appear ready to invest in strategic initiatives and in equipment to address strong pent up needs for desktop computers and other items.
- Substantial savings for homeowners who are refinancing mortgages will provide a large injection of cash into the economy.
- Retail investors' strong preference for cash and fixed-income mutual funds may eventually subside.
- The Fed Model points to equity markets being undervalued.

Corporate Cash

Corporations currently hold record levels of cash. Indeed, as of the end of March, non-financial corporations held \$1.8 trillion in liquid assets, which is comparable to the combined amount of stimulus spending approved by Congress and the White House in 2008 and 2009. More encouragingly, a recent flurry of acquisition and merger activity implies that corporations are ready to begin investing their cash in strategic initiatives. Also, as we just mentioned, we expect many corporations to begin addressing built up needs for new equipment by purchasing desktop computers and other resources.

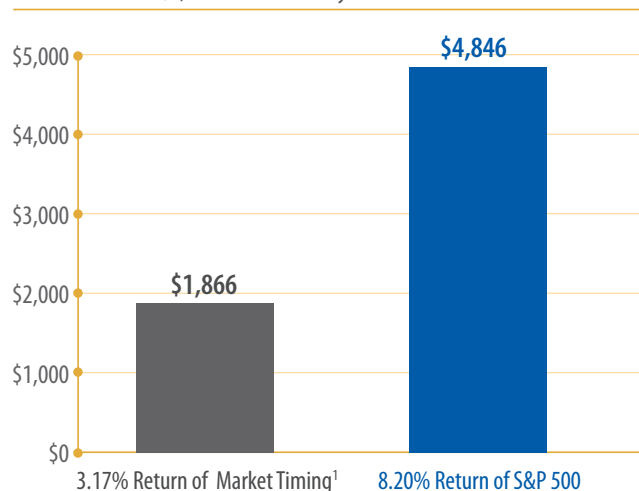
Mortgage Refinancing

One hurdle for the economic recovery has been the U.S. consumer. Fears of a weak job market and substantial declines in wealth resulting from plummeting home values and stock market volatility have caused many consumers to curtail spending. Yet, consumers are about to benefit from an estimated \$46 billion² in annual savings by refinancing mortgages

Market Timing can be Costly

Growth of \$1,000 invested for 20 years*

Figure 1



* Based on average annualized returns as of December 31, 2009. Return of market timing calculated by DALBAR, which uses data from the Investment Company Institute (ICI), Standard & Poor's and Barclays Capital Index Products.

with loans that have record-low interest rates. In August, rates for a 30-year mortgage declined to a record low of 4.4%, compared to the 5.2% rate in August of 2009 and 6.5% rate in August of 2008.

Mortgage savings could be substantial: On a \$200,000 mortgage, a homeowner with a 6.5% loan pays \$1,264 a month. At a 4.4% refinance rate, the same homeowner would pay less than \$1,013, saving more than \$251 per month. In a related matter, Americans have been paying down consumer debt, and in August, credit card financing levels reached an eight-year low. With low credit card balances, sizeable mortgage savings and built up demand for retail items resulting from Americans' frugal behavior during the recession, it's reasonable to expect that consumers will increase their spending, which will provide considerable economic stimulus.

Retail Investor Psychology

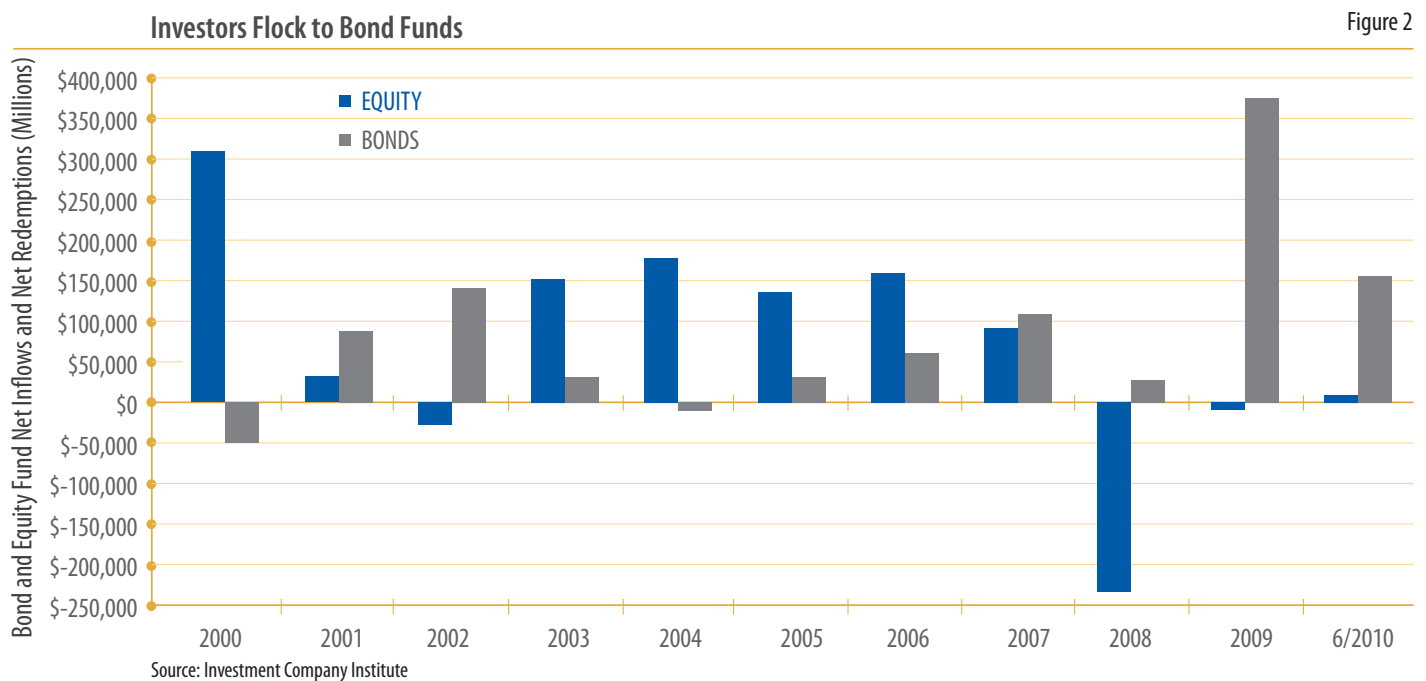
A highly favorable market for fixed-income investing and investors' widespread fear of equity market volatility have resulted in historical levels of assets flowing to the perceived relative safety of bond funds. For example, from the start of 2007 through June of 2010, investors deposited in excess of \$655 billion in fixed-income funds, according to the Investment Company Institute. In comparison, investors redeemed more than \$140 billion from equity funds during that time

period. The fund flow pattern is even more dramatic when compared to the three years leading up to 2007, during which investors allocated only \$81 billion to bond funds. Equity funds, meanwhile, captured an impressive \$473 billion in assets during the same time period (see Figure 2).

We believe many investors have yet to experience periods of substantial declines in fixed-income markets. Indeed, the recession and ensuing efforts to spur economic growth have resulted in a prolonged bond rally. Bonds, which benefit from low interest rates, have reacted favorably to the Federal Reserve's cutting of the Fed Funds target rate to 0 to 25 basis points. It's only a matter of time, however, before the Fed increases rates, which will drive down bond values.

Just as equity investors sold stocks during the bear market following the mortgage debacle, many fixed-income investors seeking to minimize losses will liquidate fixed-income holdings when rising interest rates trigger declining bond prices. This selloff will exacerbate the decline in bond prices, which will cause more investors to liquidate fixed-income assets. This vicious cycle should result in investors moving a sizeable portion of their assets into equity funds, which should boost valuations.

Concerns over the eventual decline in the bond market have even been expressed by Bill Gross, the celebrated bond



manager with PIMCO. Gross recently said the prospect of a strengthening economy and rising interest rates argues against maintaining a large bond allocation and that the nearly three-decade long rally in fixed-income securities may have run its course. With those concerns in mind, PIMCO has decided to add equity portfolios to its investment offerings.

Patterns of recent market performance may also drive investors to sell bonds and purchase equities. During the past 12 months, periods of market declines have been followed by strong gains that have rewarded investors who either purchased stocks during market dips or maintained their equity allocations. If this pattern continues, it may encourage many investors to increase their allocations to equities.

Finally, governments worldwide, including the U.S., have pumped substantial amounts of stimulus into their economies. The U.S. is now producing signs of growth, including expansion of corporate earnings and GDP. With a growing economy, investors are likely to become more optimistic and increase their exposure to equities by moving assets out of fixed-income funds.

Bullish Fed Model

The Fed model is another important factor that, as of September 1, points to equity markets having strong potential for additional gains. The model implies that equities are undervalued if the forward earnings yield of S&P 500 compa-

nies is higher than the yield of a 10-year Treasury. With the S&P 500 Index price at 1,080.29 and estimated 2010 earnings of \$79.93, its yield is 7.40%—which is considerably higher than the recent 2.6% yield of a 10-year Treasury. This difference in yields suggests that investors may find equities to be more appealing than fixed-income assets.

Outlook

At Alger we expect two broad developments to occur: market volatility will continue in the foreseeable future and equity prices, over the longer term, will advance. Uncertainty over U.S. government policies, such as the timing and the extent of withdrawing of financial stimulus programs and the need to manage growing national budget deficits, will drive market volatility. At the same time, high unemployment and other challenges to what some consider to be a fragile economic recovery will continue.

For patient investors with research driven strategies, market volatility will provide compelling opportunities to buy growing companies at attractive valuations. In our view, businesses undergoing Positive Dynamic Change will continue to generate attractive performance for long-term investors. These opportunities, of course, are only available to investors who are willing to maintain an allocation to equities and stay the course, even during times of considerable market uncertainty.

¹Return is based on DALBAR Quantitative Analysis of Investor Behavior (QAIB). The study uses data from the Investment Company Institute (ICI), Standard & Poor's and Barclays Capital Index Products to compare mutual fund investor behavior with an appropriate set of benchmarks. Covering the period from January 1, 1990, to December 31, 2009, the study utilizes the net of aggregate mutual fund sales, redemptions and exchanges each month as a measure of investor behavior. These behaviors are then used to simulate the "average investor." Based on this behavior, the analysis calculates the "average investor return" on both a cumulative and annualized basis. These results are then compared to respective indices.

²David Greenlaw, "Slam Dunk Stimulus," Morgan Stanley, July 27, 2010

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