Portfolio Insights: Alger Dynamic Opportunities Strategy

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Greg Adams and George Dai recently provided a portfolio update for clients in the Alger Dynamic Opportunities strategy. The call was hosted by Tyler Foster, a senior vice president and director of business development in our distribution organization.

Please note, this transcript is from a call on July 22, 2020 and it has been edited for clarity and brevity.

Tyler Foster: Thank you for joining us. I'm joined by Greg Adams and George Dai today, two portfolio managers on the Alger Dynamic Opportunities strategy.

Today's call will follow a Q&A format, which I will moderate, and we will have a couple of segments when we take questions from the audience.

George is senior managing director & co-chief investment officer. He also serves as an analyst for the Weatherbie team, covering diversified business services, health care, and technology. George has been at Weatherbie for almost 20 years.

Greg is senior vice president, portfolio manager, and director of quantitative and risk management at Alger. Greg has been with Alger for nearly 15 years and has over 30 years of experience

And with introductions now covered, let's kick things off and dive into the conversation. Greg, our first question goes to you. Can you provide your views of the long/short equity asset class as a whole and how you see Alger's strategy fitting in among its peers in the alternatives category?

Greg Adams: The equity long/short category has a number of different flavors, from pure quantitatively driven strategies to more macro driven ETF-based strategies. Alger Dynamic Opportunities is a classic fundamental, research driven equity long/short strategy.

The strategy comprises two roughly equal sleeves. The Weatherbie team, which is George along with Josh Bennett and Dan Brazeau, manages one sleeve and focuses on small and smid cap names. The Alger team, which is myself and Dan Chung, our firm's CEO and chief investment officer, manages the other sleeve, and we have more exposure to mid and large cap names. The net result is a fairly all-cap portfolio.

Greg Adams (continued): Both teams work independently using very similar bottom-up fundamental research processes to seek to identify attractive risk-reward opportunities, both long and short. The teams confer formally at least monthly to go over risk analysis and positioning, but in practice there's more frequent interaction.

With typical net exposure in the 30% to 60% range and gross exposure in the 80% to 140% range, we feel the strategy appeals to those looking for exposure to growth equities across the capitalization spectrum but with dampened volatility.

Tyler Foster: Thank you, Greg. Appreciate the overview. Shifting to you, George, would you please tell us about the history of the teams involved in this strategy? Also, in your opinion, what gives the team a competitive advantage or what distinguishes the strategy from our competitors?

George Dai: Yes. Both the New York and Boston teams have been doing long/short investing for more than a decade. And we share substantially the same investment philosophy and process.

The New York team started in 2008 and it focuses on large and mid cap stocks. The Boston team started in mid-2006 with a focus on the small to mid cap part of the universe. Now, together we cover the whole landscape.

In terms of the competitive advantages, first, we aim to add value on both the long and the short side.

Second, both teams are experienced in dealing with market volatility. For example, both teams withstood the test of the Great Financial Crisis in '08 and '09 and the subsequent volatile period, let's say summer of 2011.

We believe our experiences gained in previous volatile periods enabled us to navigate the crisis in early 2020. We moved aggressively in February and March. Subsequently, after the market suffered from a substantial drop, we repositioned the portfolio to try to participate in the upside.

Tyler Foster: Greg, would you please share with us how the team has positioned the portfolio through the ups and downs in 2020, which has led to strong performance?

Greg Adams: Coming into the year, the strategy had net exposure of around 48%. Many of our long positions benefited from the strong start to the year for the equity markets. And this naturally led to an increase in our long exposure and our corresponding net exposure, which reached a peak of around 56% in early February.

Our investment approach relies on a pretty detailed assessment of risk-reward. And as the market continued to climb in early February, a number of long positions started to near and reach their price targets and were reduced or sold. This resulted in a lower net exposure, a trend which then accelerated as concerns about the impact of the COVID virus grew and we further adjusted our portfolio.

Net exposure bottomed out at 27% in late March and was back up to about 36% at quarter end through a combination of short covering and adding back to long exposure as names started to hit attractive levels again, and in some cases even our bear price targets. As our confidence in stimulus efforts and progress in reopening the economy grew, the net exposure was increased throughout the second quarter, and today we're in the 55% to 60% range.

Let me hand it off to George to give you a little bit more detail on how we addressed and monitored the COVID virus and some of the related actions we took.

George Dai: At Weatherbie, we try to use market volatility to our clients' advantage and to potentially add value.

Going back to the beginning of the year, after recognizing the potential negative impact of coronavirus, we made two defensive moves followed by two offensive moves.

The two defensive moves were as follows: in late January and early February, after realizing that the situation was much worse than the Street expected, we substantially reduced the position sizes of holdings with significant exposure to China, either in revenue or in supply chain. For example, Wayfair, Insulet, Nlight, and Impinj.

Then, in February and March, we did a thorough liquidity analysis of the balance sheet of all of our holdings. So on the long side, we basically reduced the weighting of companies that were unprofitable and/or had high leverage.

George Dai (continued): In addition, we started to use index shorts in late February. Now, the two offensive moves after the market dropped substantially in March. The first is we significantly upgraded the quality of the portfolio, in our opinion, by putting more capital into high conviction names. We also took advantage of the market selloff by buying some of the high-quality new names that were “on sale,” in our view.

On the short side, we actively covered index shorts starting in early April. That's just one week after the bottom of the market, and our confidence was strengthened as more and more stimuli were announced, followed by improvement of the virus situation and the progress made in the detection of virus and in the development of a vaccine and the drugs.

Tyler Foster: I think the coronavirus is a good example, maybe the best example we've seen in years if not decades, of a macro event that was well outside of our control as investors. Of course, as bottom-up investors at Alger and Weatherbie for many decades here, we don't invest in a vacuum. We constantly assess and pay attention to the macro environment.

If you think about where we are now, what are your high level macro views at the moment, and how do these views typically impact the exposures of the strategy? Greg, we'll start with you.

Greg Adams: The equity markets had a very quick and sharp recovery from the March lows, and I think the rapidity of the decline was unprecedented, and I think the recovery has been equally so. We continue to hear mostly positive things from our companies, and more importantly our survey work and discussions with customers and suppliers of the companies we invest in are continuing to be positive as well.

But that said, many names have started to approach our price targets, so we have been reducing exposure a little bit. So far, the resurgence of virus in many parts of the country has remained manageable, but we're closely watching those developments, and another thing we're watching is school openings and how that goes.

And obviously the looming election could start to create some uncertainty and volatility as we exit the summer. Let me hand it over to George for some of his views, and he'll get into a little bit more on how we manage exposure.

George Dai: We are substantially on the same page. We are cautiously optimistic for the following reasons. One is the world economy was on a favorable footing before COVID-19 hit, so the conditions were good. And now since the outbreak, global central banks have together injected more than $11 trillion into the marketplace. In addition, there have been very encouraging progresses made on treatments and on the vaccine fronts. For example, the CEO of Pfizer said publicly that it is very likely that they are going to file for approval for their vaccine in October of this year, so that's going to be very positive news if that becomes true.

From an exposure standpoint, typically both gross and net exposures are driven by the risk/reward opportunities based on individual stocks and supported by our stringent criteria and our robust bottom-up fundamental research processes.

Occasionally, our view from the top down, or let's say the macro view, may lead to additional adjustments in exposure. The recent example would be in February and in March when we aggressively started adding index shorts.

Tyler Foster: Thanks again for your comments. Let’s open it up for questions.

Speaker Question: My question concerns the short book: how do you compose that? Is that composed top-down looking at the macro, at which industries are going to suffer as a result of new trends that are accelerating, or is that also fundamentally driven when you go to conferences and you see companies that are clearly at a disadvantage to a company that you might like? Can you provide any examples?

George Dai: Historically, the majority of the ideas come from our bottom-up research. Every year, we research thousands of companies. Sometimes these companies have been viewed and studied multiple times within the year. We go into every situation with a neutral mind and we study the industry, we study individual companies, their competitive advantages or lack thereof, and certain companies fall into the long bucket and certain companies fall into the short bucket. And then we do very thorough and rigorous research to substantiate our thesis. So that's how the majority of the short ideas are created.

George Dai (continued): Now, once in a while, the top down view actually leads to some short ideas. For example, the one basket of the shorts, which we actually plan to discuss later, are mall-based REITs–these are the real estate investment trusts–and our CIO Dan Chung actually conceived the idea three years ago for a few reasons. One is e-commerce is decimating the brick and mortar companies, retailers, and that's not good for the REITs who actually rent to these retailers. Two, these REITs often have lots of financial leverage, so that's how they boost up their return on investment, return on equity. And so following that theme, we actually collaborated on the research and had come up with a basket of shorts that are in the tier two, tier three categories, and in less economically vibrant neighborhoods. So we use both approaches, and the bottom up is the majority but the top down complements in a nice way.

Speaker Question: How many long and short positions are in the portfolio?

Greg Adams: We are around 120 or 130 names on the long side. And then on the short side, I think we're around 60 or 70 names.

Also, to add to what George said, the Alger process on the short side is very similar. It's very much bottom-up, fundamental driven. Individual stock selection is generated by the same research process that's generating ideas for the long side of the portfolio and our long-only strategies. As we identify what we call the beneficiaries of dynamic change, we're also identifying the companies that are challenged by that change and those often are the names that we're using on the short side.

Speaker Question: You mentioned that you shorted indexes, but you didn't mention any individual stocks, and now I hear that you do short individual stocks. Is shorting an index something that you usually only do in an emergency or an odd situation, or is it a regular thing also?

Greg Adams: Yes, I think we use indexes sporadically, for example in the instances that George outlined with the virus and wanting to reduce exposure, it's a quick and easy way to do that.

I think both teams did things a little bit differently on the index side so whereas George and his team put them out early, at Alger, we actually used the indexes later, late March, early April, as we were really aligned to cover a lot of our shorts that had reached our targets but keep our exposure muted as things continued to get worse for the market.

But typically, the portfolio comprises all individual company shorts and very occasionally, you'll see index shorts as well.

George Dai: Keep in mind that we aim to generate alpha from our shorts and that potential alpha is being driven by individual stock shorts. The index shorts, as Greg mentioned, are used as a supplemental tool and that's not a major vehicle that we use to generate alpha.

Speaker Question: A bit of an observation and I'd be looking for your thoughts regarding market concentration. Currently, Apple and Microsoft make up approximately 23% of some market indices. I'm not sure when before in history we've seen something like this, but does that in general cause you concern or does that give you the opportunity to look at the smaller names that are being ignored because everyone might be chasing those top two names?

Greg Adams: Yes, certainly when you look at the weight of the top names, Microsoft, Apple, you can throw Amazon, Alphabet, Google into that mix, it is very high in the broad indices. Yes, it is fairly unprecedented in the history of the U.S., but there are periods when you can go back and see something similar in the past. Yes, so I think when you get those high weights, it does create opportunity.

At the same time, Microsoft and Apple as examples, we think from a large cap point of view, these are still companies that are relatively attractively valued in our opinion, given their earnings growth and revenue growth prospects. I mean, I think unlike the tech bubble in '99, 2000, the financial underpinnings of some of these large companies are much, much better in terms of earnings generation, cash flow generation, and also in kind of their business model and their ability to continue to benefit from those business models.

George, I don't know if you want to add a little bit on opportunities down the capitalization spectrum.

George Dai: Yes. In our space, small to mid cap, our universe has thousands of companies but we only have approximately 130 long names and approximately 75 short names. So that means that every position is an active bet, and that's how we strive to generate alpha and mitigate risk.

Speaker Question: Can you discuss your views on Wayfair? It's been extremely volatile. How do you use the volatility either to scale in or out because this thing seems to go up or down tremendously and I just want to understand the process of putting orders in whenever you feel it's appropriate to either buy or sell.

George Dai: Wayfair is an e-commerce company that specializes in the home goods area. In fact, its particular addressable market, Wayfair is actually a more competitive player than even Amazon. We believe Wayfair is the best in its marketplace, in the market that it addresses. We started owning Wayfair since its IPO, since day one, so we believe we really know this company really well.

Now earlier this year, to use the example in terms of how we handle the volatility and the process, my connections in China told me that the coronavirus was going to be much worse than the prevailing understanding, so we started to reduce the names with significant exposure to China. Wayfair has significant supply chain exposure to China, so we reduced our position size in March.

Now, it's become a larger position again. Why? In early April the company announced surprising news, which now today may not be surprising at all but at that time it was surprising. It basically said that not only the company would get financing, so it got more cash, but more importantly, its top line growth accelerated from high teen percentage to now more than 40%.

What happened was pretty much all of the brick and mortar home goods shops were closed. Therefore, all the remaining demands flew to e-commerce stores. We did a few calls to talk to some of the industry participants to see whether that is true. And the data comes back to be positive. As a result, we actively rebuilt our positions. So yes, Wayfair has been a volatile stock but since we know the company well, we know the marketplace, we know the competitive situation well, we believe we handled the exposure very well in the last six months.

Tyler Foster: George, you mentioned earlier that the team attempts to generate alpha from both the long and short sides of the portfolio and that it is generated by stock selection. Would you please give us an example or two of both longs and shorts that have contributed to the strategy's current positive alpha?

George Dai: Sure. On the long side, Chegg, which is an online education company. It is the leader in its space and it is much, much bigger than its next competitor. The company has been growing strongly pre-COVID. And because of COVID, a lot of learnings has shifted to online, which provides a further tailwind to Chegg.

Its current growth rate is in the 30% to 60% range, though we believe that this company has just got started and is going to be a much bigger, better and strong company in years ahead.

On the short side, we briefly touched upon some of the mall-based REITS in the early part of our discussion. I'd just like to add that one of the basket of shorts is the company called Seritage Growth Properties. It was created a few years ago with the real estate assets of now bankrupt retailer Sears. The continued deterioration of these retail businesses has driven down the stock price of SRG tremendously. And this is the trend that's going to persist, at least in the foreseeable future, in our opinion.

Speaker Question: What do George's contacts over in China think about the growing tensions between the two countries?

George Dai: It is unpleasant actually to have the number one and number two countries butting heads against each other. So from my point of view, actually, I hope that the two countries can sit down and come up with a reasonable plan and a path forward. And I think that in China the people actually want peaceful development and progress.

However, the government led by the Chinese Communist Party may have a different agenda. So that's the part that we are analyzing, we are following very actively. And I hope that the escalation is not going to get much worse.

Tyler Foster: I have one last question for you, George. How will you and the team continue to take advantage of potential long and short opportunities?

George Dai: The world is always changing, and the changes create opportunities, and it is our job to take advantage of these changes and identify what we believe are great long and short ideas to try to generate strong risk-adjusted returns for our clients. And we see as many opportunities in the future as we have seen in the past.

Tyler Foster: Thank you both very much for your time.

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The following positions represented the noted percentages of assets in the Alger Dynamic Opportunities strategy as of 4/30/20: Chegg, Inc., 4.28%; Wayfair, Inc., 1.35%; Insulet Corporation, 1.39%; Impinj, Inc., 0.70%; Apple, Inc., 0.97%; Microsoft Corporation, 2.04%; Amazon.com, Inc., 2.92%; Alphabet, Inc., 2.14; Seritage Growth Properties, -0.07%; Nlight Inc., 0%; Sears Holding Corp., 0%; and Pfizer, Inc., 0%.