Forbes

OCTOBER 5, 2011 | WWW.FORBES.COM

Alger's Dan Chung Explains The Delicate Art Of Buying Growth

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What could Apple, Aetna and Chicago Bridge & Iron possibly have in common?

Veteran growth-stock manager Daniel Chung says they're all cheap. No, not cheap in the conventional sense of selling for less than the value of their assets or cash on the books. Cheap relative to potential sales and earnings growth.

As chief executive of venerable growth manager Fred Alger Management, Chung inherited a style that founder Fred Alger developed in the go-go Sixties. It's simple to explain but difficult to execute: Alger tries to identify industries that are undergoing "transformative change," usually due to new technology, and to buy the companies that can best capitalize on (or are catalyzing) that change.

Sure, Chung says, in times like these, with the stock market so volatile, growth might seem risky. But the bigger risk is getting left behind as the world changes.

Chung, 49, knows something about rapid and fundamental change. A Harvard Law School graduate and former Supreme Court clerk, he worked as a corporate lawyer until his father-in-law, Fred Alger, convinced him to join the firm as an analyst in 1994. Tragedy vaulted him to control after a hijacked plane crashed into Alger's offices on the 93rd floor of the World Trade Center's north tower, killing Fred Alger's brother David, then in charge of the firm, along with most of the staff. Chung was promoted immediately to chief investment officer and took over as chief executive in 2003.

Chung survived, like so many that day, because of dumb luck. He had an 8:30 a.m. appointment in midtown with Tyco executives, including Dennis Kozlowski, the soon-to-be-disgraced chief. "We were big enough, they might have come in to see us," Chung says now. "But I decided to visit them personally because I was worried about the stock."

Alger's assets under management, which peaked at $22.1 billion in 2000 before the tech bust, fell to $8.3 billion after 9/11. Today they stand at $17.1 billion. Its flagship Spectra fund, with $1.1 billion in assets, has returned 7.1 % annually over the past five years, compared with 0.7% for the S&P 500.

Chung's argument for buying growth now goes like this: In times of slow growth the riskiest stocks may be the ones that appear the cheapest and safest. Put another way, economic growth just won't be strong enough to lift all corporate boats. But a company that has "a high-growth product or service that is fundamentally challenging an industry"—as Apple and its iPod did with music—will still deliver strong and predictable profits.

For example, Alger owns VMWare, the open-source software firm, that at 27 times free cash flow (after subtracting $8.75 per share in cash on the books) might look expensive. But compare it with Wal-Mart, Chung says, which is in a slow-growth, capital-intensive business and trading at 29 times free cash flow.

VMWare has a monthly subscription model and should show an increasing return on investment as it spreads its costs over a growing number of customers. Wal-Mart, meanwhile, "is being assailed by high-tech competitors, including Web ventures that help local farmers deliver fresh produce to your door," he says.

Chung doesn't restrict Alger to tech companies. In fact, his focus on structural change produces some surprising choices—none more so, perhaps, than Chicago Bridge & Iron, a construction engineering firm whose revenue has fallen 39% since 2008. Nevertheless, he thinks it can capitalize on a shift in the global energy business toward liquefied natural gas, especially as China seeks alternatives to dirty coal-fired power plants and Japan trims its nuclear fleet.

Aetna? ObamaCare's individual insurance mandate should drive more young, healthy customers to buy its policies. And since Aetna specializes in selling managed-care plans to businesses, not government, it's not vulnerable to the coming cost squeeze on Medicaid. "The health-maintenance organizations are going to be the platform by which the majority of us get our coverage," Chung predicts.

Chung will also invest in companies that are in slow-growing or even shrinking industries if an individual firm is going through a "positive life-cycle change." (That's often code for "the CEO just got fired.") He confides that he looks at Eastman Kodak "every two years" to see if management is finally making positive changes. So far that hasn't happened, so Alger doesn't own the stock.

Alger's biggest single holding, however, is Apple, a growth stock by anyone's definition. Yet to hear Chung tell it the computer-cum-media company is practically a value stock. Assuming it meets analyst expectations of $32.60 a share in earnings for the fiscal year ending September 2012, Apple is selling for less than 13 times 2012 earnings and 11 times trailing cash flow, or earnings before interest, depreciation and taxes. Apple traded at 20 to 30 times cash flow through much of the early 2000s, he notes.

Chung's ideal stock is on the upward swing of a curve marked by rapid unit growth. "The trick is getting out before the growth starts to fall apart," he says, as if it were easy, or even possible, to do this consistently These are high-maintenence investments—once Alger buys a stock its analysts keep calling on vendors, competitors and big customers to pick up any signs a company isn't executing smoothy.

"You can't wait for two bad quarters in a row," he says. The big risk in expanding companies is that they will over-estimate the revenue they'll get from new businesses and underestimate expenses. He likes certain Internet startups like LinkedIn—Alger participated in the initial offering but quickly sold out—because they don't burn cash as quickly as fast-growing traditional manufacturing firms.

Alger lost some money on Vistaprint, an online printing service, after the firm surprised investors with higher-than-expected costs and investors began to worry it was growing at an unsustainable rate. Still, Chung says he's keeping an eye on the company and might buy it back if it controls costs.

Another risk is an entire industry going south. Alger invested in Starwood, the hotel operator, under the belief it was better managed than competitors like Marriott and thus would benefit more from a recovering economy.

Investors dumped the entire sector after Marriott reported disappointing earnings earlier this year. Alger bailed out at a loss. "For value investors the difficult part is the buy. Selling is just a matter of discipline. We're the opposite," says Chung.

This article reprint, originally published by Forbes.com on October 5, 2011, is considered sales literature for the Alger funds mentioned only and not for any other products shown. For the period ending September 30, 2011, the Alger Spectra Fund Class A returned the following:

Average Annual Total Returns as of 9/30/11					
Alger Spectra – Class A	YTD†	1 yr	3 yr	5 yr	10 yr
Without Maximum Sales Charge	-9.44%	2.04%	9.64%	6.50%	6.08%
With Maximum Sales Charge	-14.16%	-3.33%	7.70%	5.35%	5.51%
Total Fund Operating Expenses	**Per Prospectus Dated 3/1/11**	**1.74%**			
†Not Annualized					

The performance data quoted represents past performance, which is not an indication or a guarantee of future results. Investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than the performance quoted. For performance data current to the most recent month-end, visit us at www.alger.com or call (800) 992-3863. Performance figures assume all distributions are reinvested. Returns after the maximum sales charge reflect a front-end sales charge on Class A Shares of 5.25%. The Alger Spectra Fund Class A may charge a redemption fee of 2% on shares purchased and redeemed (including by exchange) within 30 days of purchase that, if applied, would reduce the performance shown.

On 9/24/08, the Spectra Fund changed its name to Alger Spectra Fund, and the Fund's Class N shares were redesignated as Class A shares. The Fund operated as a closed end fund from 8/23/1978 to 2/12/1996. The calculation of total return during that time assumes dividends were reinvested at market value. Had dividends not been reinvested, performance would have been lower. Historical performance shown is that of the Fund's Class N shares, which were redesignated as Class A shares on 9/24/08.

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As of 9/30/11, the securities mentioned in this reprint represented the following as a percent of Alger's assets under management: Aetna Inc New (1.23%); Apple, Inc. (3.64%); Chicago Bridge & Iron Company NV (0.05%); Eastman Kodak Co. (0%); LinkedIn Corp. (0.03%); Marriott International, Inc. (0%); Starwood Hotels & Resorts Worldwide, Inc. (0.04%); Tyco International Ltd New (0.56%); Vistaprint Limited (0.85%); VMware, Inc. (0.05%); Wal-Mart Stores, Inc. (0.10%).

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