Principal Asset Management[SM]

PRINCIPAL SMA U.S. SMALL CAP SELECT EQUITY

Quarterly commentary

THIRD QUARTER 2023

Market review

The Russell 2000 Index produced a third quarter 2023 return of -5.1%. Global equity markets pulled back in the third quarter following strong performance in the first half of the year. After a flurry of central bank decisions and resurging oil prices, investors became increasingly concerned that inflation could be more persistent, which will make it difficult for policymakers to reduce rates in the near-term. Equity markets succumbed to selling pressures during the latter stages of the third quarter amid the realization that policy rates and bond yields are likely to remain higher for longer than previously expected. Large-caps outperformed small-caps, while developed markets underperformed emerging markets and value performed better than growth.

Energy and financials were key contributors to the index returns. Energy stocks were strong across the sector as oil prices increased nearly 30% during the quarter. After being off sharply during the first half of the year amid regional bank failures, financials stabilized and posted a small gain as credit quality remains strong and banks indicated that net interest margins were beginning to stabilize.

Health care, information technology, and utilities were key laggards to the index returns. Health care, which had been strong in the first half of the year amid favorable clinical trial results and increased merger and acquisition (M&A) activity, pulled back during the quarter. A variety of factors appeared to weigh on the sector: a smaller proportion of favorable clinical trial results; M&A activity slowing; rising long-term interest rates weighed on development-stage high-growth companies; concerns about the federal government's fiscal situation weighed on companies dependent on Medicare reimbursement; and diabetes and obesity-related disease companies were weak as new weight-loss drugs (GLP-1 agonists) could slow long-term demand for their products and services. Within information technology, higher long-term interest rates weighed on this higher-growth sector, plus semiconductor-related companies were down amid weak economic activity in China and potential export curbs on United States sales of semiconductor equipment to China. Utilities were weak as their dividend yields appear less attractive as interest rates rose for long-term bonds.

Portfolio performance

The portfolio underperformed the index on a gross basis during the quarter.

Automobile components, biotechnology, and aerospace and defense were key contributors to portfolio performance during the quarter. Holdings in automobile components reported favorable operating results driven by their exposure to electric vehicles. Biotechnology holdings had limited exposure to companies reporting unfavorable clinical trial results. Aerospace and defense holdings saw increased contract wins and favorable air traffic volumes.

Consumer services, industrial distributors, and materials were key detractors from portfolio performance during the quarter. Within consumer services, the portfolio's holdings were more adversely sensitive to rising fuel prices and higher interest rates as those could both contribute to slowing consumer demand and higher costs for the companies. Within industrial distributors, easing supply-chain constraints slowed sales as customers brought inventories back down to normal levels. Within materials, the portfolio's holdings were adversely impacted by falling commodity prices.

Top 5 contributors

The five individual stocks contributing most to the portfolio were Modine Manufacturing, Caleres, California Resources, Webster Financial, and BJ's Wholesale Club.

Modine Manufacturing, which produces a variety of thermal management products for a diverse set of end markets, outperformed following strong quarterly results while raising their full-year outlook. Results benefited from pricing actions and healthy end market demand.

Caleres, a portfolio of footwear brands, outperformed amid better-then-expected quarterly results, a stable outlook at a time of softening industry trends, and the resumption of share repurchases.

California Resources, an independent oil and natural gas company operating in California, performed well amid rising oil prices, and continued return of capital to shareholders.

Webster Financial, a regional bank primarily operating in southern New England and New York, outperform amid better-than-expected earnings driven by lower expenses and credit costs. The company also offered positive guidance on its future net interest margin assumptions.

BJ's Wholesale Club, which operates a chain of membership warehouse clubs, benefited from an increase in bulk item grocery spending as consumers continue to seek better value on staple items amid inflation and recession concerns. The company also benefited from higher oil prices which drives higher fuel sales as consumers are attracted to membership warehouses which offer fuel discounts relative to other gas stations.

Top 5 detractors

The five individual stocks detracting most from the portfolio were Allegro MicroSystems, Exact Sciences, Dycom Industries, Life Time Group, and TKO Group.

Allegro MicroSystems, a provider of semiconductors for automotive electronics, underperformed amid slowing demand from Chinese automakers as they destock and adjust their existing semiconductor inventory.

Exact Sciences, an oncology diagnostics focused company, pulled back from prior period strength despite reporting another strong set of quarterly results.

Dycom Industries, a leading provider of specialty contracting services to telecommunications providers, reported strong quarterly earnings but its shares pulled back as their customers reported they were slowing spending.

Life Time Group, a premium fitness center operator, underperformed amid mixed quarterly results and reporting moderating growth in new memberships.

TKO Group Holdings, a media and entertainment company formed following the combination of World Wrestling Entertainment and Endeavor's Ultimate Fighting Championship (UFC), underperformed amid news that a competing media entity would receive an investment from Saudi Arabia's PIF as well as declining expectations for media content broadcast rights values.

Information is based upon a Model (hypothetical) portfolio of the Principal SMA U.S. Small Cap Select Equity strategy. The holdings identified do not represent all the securities purchased, sold or recommended for model portfolio during the quarter. A list of recommendations made, and every holding's contribution to the model portfolio for the strategy during the past twelve months is available upon request. It should not be assumed that recommendations made in the future will be profitable or equal the performance of the securities listed. Past performance is no guarantee of future results.

Outlook

The market environment is likely to remain challenging as economic growth is facing multiple headwinds. The Federal Reserve (Fed) has emphasized that monetary policy will remain restrictive longer as achieving their 2% will take additional time. Rising long-term rates are now serving as an additional brake on the economy beyond just the Fed's higher short-term rates. The COVID-19 payment pause for student loans has now ended and those payments resume this quarter. Excess savings accumulated by consumers during the pandemic have now been spent down to their pre-pandemic levels. Despite these challenges, we will continue to follow our investment approach, which focuses on identifying companies where positive, durable change is enabling them to become better businesses. We will continue to look for companies that are able to adapt to these challenges and provide enduring solutions and services to consumers, businesses, and governments going forward, as positive change is still poised to be a key differentiator in individual stock performance throughout the market cycle.

Risk considerations

Past performance is no guarantee of future results. Investing involves risk, including possible loss of principal. Equity markets are subject to many factors, including economic conditions, government regulations, market sentiment, local and international political events, and environmental and technological issues that may impact return and volatility. Small-cap stocks may have additional risks including greater price volatility.

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