PRINCIPAL INTERNATIONAL OPPORTUNITIES ADR (SMA) EQUITY

Quarterly commentary

THIRD QUARTER 2023

Market review

Global equity markets declined during the third quarter largely due to a market sell off in September as investors' rate concerns increased with expectations for central banks to hold rates higher for longer to combat inflation while global growth slows. Surging oil prices are adding to concerns of a potential influx to higher inflation in the near term.

Japan was a source of relative underperformance as previous strong contributors centered around artificial intelligence (AI) gave up some of their prior quarters' gains. We maintain our conviction with exposure to Japan and believe it will continue to benefit from the deglobalization of supply chains and serve as a key supplier of leading-edge AI. Further upside will come from the structural change of improved corporate governance as companies continue to deploy capital to shareholders while reducing their cross shareholdings.

Key sources of alpha from earlier in the year within the semiconductor and luxury goods industries detracted from performance during the quarter amid the rising trends in rates. Semiconductor equipment continues to be a source of high conviction over the longer term as several companies are well positioned to serve as the enablers of AI despite quarterly weakness. Key companies in the higher-end luxury space de-rated during the quarter given in part due to high valuations and a slowing United States consumer. However, the companies posted solid results driven by their strong brands and pricing power.

Past performance is no guarantee of future results. Investing involves risk, including possible loss of principal.

Portfolio performance

Following first-half strength, International Opportunities ADR (SMA) Equity lagged its respective index in the third quarter as global equity markets gave up some of the prior quarter's gains.

Top contributors

Novo Nordisk was a top contributor overall for the quarter. Novo Nordisk is a Danish pharmaceutical company specializing in treatments for diabetes, obesity, and hemophilia/growth disorders. The company announced a drug pipeline update related to its weight loss drug Wegovy that reflected a best-case scenario, a 20% risk reduction in secondary prevention driving its share price higher. Wegovy is now fully re-launched in the U.S. and early Rx trends are very positive.

The strategy benefited from strong stock selection in Germany particularly in the health care sector. Overweight positions in **Fresenius** and **Merck** led to relative outperformance. Fresenius, a diversified health care company, benefited from an improving outlook on medical technology and improvement in their dialysis business after COVID-19. Merck, a pharmaceutical company, benefited from a strong quarter in their health care division led by growth in their drugs Bavencio and Mavenclad.

Stock selection in the energy sector contributed positively during the quarter. Strength was seen within the energy equipment companies. **Schlumberger** posted healthy returns benefiting from the higher oil and gas price environment which will support increased drilling. Overall investment in oil and gas projects has been too low for the last 5-7 years to support the energy needs of the next decade. Current levels of capex are creeping higher due to both inflation and higher commodity prices.

Top detractors

Consumer discretionary faced headwinds during the quarter in part due to our overweight in high-end luxury mainstay LVMH. Despite strong quarterly results, **LVMH** witnessed profit taking driven by the higher rate environment and cues of a slowing U.S. consumer. However, signs of a recovery in China will more than offset any weakness in the U.S. Despite the tough quarter, the company remains a high conviction investment. We believe the brand, diversification, pricing power, and history of strong execution will drive future earnings.

In technology, our exposure to the semiconductor equipment companies detracted from performance during the quarter. Particularly, **ASML**, the leader in lithography tools, a critical part of the semiconductor manufacturing process, contributed to the quarter's underperformance as the market de-rated previous winners that have been identified as enablers of AI. Another detractor in technology sector was **Keyence**. The company develops, manufactures, and sells sensors and measuring instruments used for factory automation and high technology hobby products. Keyence reported a mixed quarter, with both top and bottom-line missing consensus expectations due mainly to weaker capital expenditure conditions in China. However, the advent of technological re-shoring should prove beneficial to the business moving forward.

From a regional perspective, Japan was a key detractor as several of strong performers from previous quarters experienced selling pressure. While in Europe, France was a key detractor with pressure from consumer discretionary and staple companies.

Outlook

We believe we are in the midst of a generational change in global trade flows, as the West reduces its reliance on China and Russia. The U.S., Japan, and Europe should all experience expanding manufacturing bases. As the re-shoring trend accelerates and duplication in global supply chains increases, it will be a net benefit to global companies with the expertise in the capital equipment that will be needed to drive a manufacturing renaissance outside China. Japan has become an early winner in the deglobalization of supply chains with further upside coming from the increased attention surrounding AI.

AI is here to stay but following a significant valuation re-rating for many known to be "intertwined" in the

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opportunity, earnings growth will remain the key over the long run. As the technology improves and additional features/functionalities are developed, generative AI will be embedded across wide swaths of the economy. The total addressable market remains very large domestically and internationally with sizable monetization potential. Generative AI is highly computer-intensive from both an algorithm training and content creation perspective. This level of data creation necessitates the need for significantly more GPUs relative to other compute/training workloads. The long-term structural change remains relevant, but key will be picking the winners from the losers as so many have significant aspirations.

Over the past decade, Japanese companies have made great strides in corporate governance and capital allocation. Former Prime Minister Shinzo Abe's push in 2012-2013 to improve capital allocation in the corporate sector has had a lasting impact, driving more long-term, value-enhancing decisions by Japanese companies.

Continued progress on these fronts is primed to release shareholder value in the coming years. As companies focus on higher profitability and improve balance sheet efficiency, return on assets (ROA) will likely continue to improve given the tailwinds of reshoring and improving governance. Recent conversations with Japanese companies indicate a greater willingness to use strong balance sheets for modest share buybacks. In fact, they seem more attuned to the greater value accretion of counter-cyclical share buybacks (buying when shares are depressed) than U.S. companies—which tend to use traditional rolling buyback programs that don't emphasize buying for value. The early innings of this is coming to fruition in 2023 following years of engagement.

Much of the equity market recovery from the October 2022 lows has been attributable to optimism about a "pivot" to more dovish monetary policy.

Following the equity strength, expectations are for a more challenging backdrop in the near-term driven by:

- Central banks maintaining rates higher for longer.
- Elevated oil prices undermining progress on inflation.
- Consumer pressures led by inflation and expiring student loan moratorium.
- Geopolitics.

Upward pressure on interest rates remains an overhang on broader risk sentiment with the focus being primarily on oil and central banks. Even as some investors are increasingly hopeful about the end of the current tightening cycle, there is risk that the full impact from tighter monetary policy has not yet been experienced. Officials have noted that rates may have to stay higher for longer than the market has expected.

This is not to say opportunities aren't in front of us but rather risks are on the rise. Supportive elements do remain in place, noted below, though have been tempered with the evolving backdrop and healthy gains year-to-date:

- Inflation normalizing.
- Economic soft landing.
- Central banks signal rate cuts.

Following a period of valuation improvement, earnings remain a key catalyst to further upside. Bottom-up stock selection will be key amidst uneven global economy recoveries and fluid central bank policies.

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. International and global investing involves greater risks such as currency fluctuations, political/social instability and differing accounting standards.

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MM13584-01 | 10/2024 | 3190214-022024