

PRINCIPAL ALIGNED SMA FOCUSED BLUE CHIP EQUITY

Quarterly commentary

FOURTH QUARTER 2023

The Principal Aligned SMA Focused Blue Chip Equity portfolio outperformed the Russell 1000[®] Growth Index on a gross basis in the fourth quarter.

What helped

Microsoft and Amazon were the top two contributors. Both companies gave updates during the fourth quarter on their respective cloud businesses—Azure for Microsoft, AWS for Amazon—highlighting how they are integrating generative AI services into their platforms. Company selection in financials and industrials contributed most of the outperformance over the benchmark. Brookfield Corporation had strong performance. They are set to achieve their goal of \$150 billion of fundraising this year. TransDigm finished the year strong. They announced another large acquisition last quarter and distributed a \$2 billion special dividend.

What hurt

The portfolio did not have any companies with a negative return during the fourth quarter. The “detractors” mentioned below were just smaller contributors, with returns that trailed the rest of the portfolio. Auto parts retailer O’Reilly, detracted in the quarter. O’Reilly opened its first distribution center in Mexico last year, and in December announced they are entering the Canadian market. Danaher had a small return in the quarter. The company completed the spin-off of its Environmental and Applied Solutions segment (now called Veralto, an independent public company). Danaher is well positioned to act on future life science opportunities. Despite strength in our software holdings (Microsoft, Adobe, Intuit), information technology was the sector that detracted most from relative performance.

What we did

We added to shares of animal health business Zoetis, at attractive valuation. Zoetis is expanding its portfolio of companion animal medicines and vaccines, with a strong pipeline for future growth. We trimmed shares of Microsoft and Alphabet, to manage the weight in the portfolio, following strong share price appreciation this year.

Top five contributors

Microsoft's primary goal is to empower every person and every organization to achieve more. Their two largest businesses, Office and cloud platform Azure, continue to gain share as they make businesses more efficient. Microsoft helps its customers do more with less thanks to productivity gains and consolidation of spend. Satya Nadella and Amy Hood (CEO and CFO respectively) ensure Microsoft is focused on large and growing opportunities. Microsoft has numerous opportunities ahead, from Teams and Azure to advertising and gaming. Shares contributed to performance during the quarter.

Amazon is dominant in online retail and cloud computing. The long-term growth runway is attractive at Amazon Web Services, as more computing gradually moves to the cloud. In retail, Amazon benefits from the virtuous cycle of using its scale and logistics network to offer lower prices and a better experience for customers. The company is leveraging its platform to build a significant advertising business. Shares contributed to the portfolio's performance last quarter.

Brookfield Corporation is a global investor and asset manager, focused on real estate, infrastructure, renewable power and energy transition, private equity, and venture capital. The company's terrific management team, led by CEO Bruce Flatt, owns more than 18% of the company. They are long-term investors that seek opportunities to deploy capital counter-cyclically. Brookfield has a competitive advantage with its global footprint and deep capital base. The company continues to have both investing and fundraising success. Shares contributed to performance.

TransDigm is a supplier of an extensive collection of airplane components led by a highly respected management team. Nearly all military and commercial aircraft have parts made by TransDigm. The business has high barriers to entry—approximately 90% of TransDigm's parts are proprietary, and TransDigm is the sole provider of about 80% of them. Its aftermarket business—selling replacement parts to the owners of aircraft—is exceptionally profitable. Shares increased during the quarter and contributed to performance.

American Tower is an owner and operator of multitenant communications real estate. They own approximately 225,000 cell phone towers and communication sites globally and lease antenna space on these towers to wireless service providers. These long-term contracts make for a very attractive business, with steadily growing cash flow. American Tower also operates 28 data centers across the U.S. The company benefits from global growth in mobile data usage. With American Tower's unmatched scale, the company is the natural provider of choice for global telecom firms. Shares increased in the quarter.

Information is based upon a model (hypothetical) portfolio of the Principal Aligned SMA Focused Blue Chip Equity strategy. The holdings identified do not represent all of the securities purchased, sold or recommended for the model portfolio during the quarter. 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. This commentary may exclude minimal security positions that the investment adviser deems of insignificant or no material impact to the portfolio.

Top five detractors

O'Reilly is a leading auto parts aftermarket retailer, serving both consumers who repair their own vehicles and professional mechanics through their more than 6,000 stores in the United States and 48 stores in Mexico. O'Reilly's investments in distribution centers have put them in a position to quickly deliver a massive array of inventory in a way that competitors cannot match. O'Reilly benefits from the owner-operator culture that is prevalent from the O'Reilly family's leadership to its distribution centers and individual stores. O'Reilly shares detracted from performance in the quarter.

Danaher is a portfolio of twenty global science and technology businesses that benefits from leading competitive positions, long-term growth trends, and revenue that tends to be recurring in nature. Founded by Mitch and Steve Rales, Danaher has achieved tremendous success over decades by buying good businesses and continuously improving them with its kaizen-style Danaher Business System. The Rales brothers remain involved (Steve is the chairman) and collectively own more than 10% of the company. Shares detracted from performance.

Zoetis is a leading animal health company, with vaccines, medicines and diagnostics for companion animals and livestock. The company's operating philosophy of "first to know and fast to market", drives the innovative culture and attracts the best talent. Zoetis' consistency in bringing innovative products to market has led to market share gains and pricing power. This allows Zoetis to invest more in animal health research and development and develop closer customer relationships than its competitors. Zoetis has a strong pipeline of products in development to add to its Pain, Dermatology and Parasiticide franchises.

Netflix is the leading streaming entertainment service with more than 200 million subscribers in over 190 countries. With an influx of new streaming players in the U.S., the company's scale is a competitive advantage. Netflix can outspend rivals on content and still earn better returns on the expenditure, creating a flywheel effect. The company continues to evolve its strategy and is building up its advertising business. Netflix has a unique culture and focus on long-term outcomes. Shares had a positive return in the quarter, but its weight in the portfolio limited the contribution.

Charles Schwab is an asset gatherer that provides securities brokerage, banking, asset management, and related financial services to individuals and institutional clients. The company has a strong brand name and a long history of successfully growing its assets under management. Schwab has an owner-operator culture focused on providing an outstanding customer experience. The company was founded and built with a mission to lowering costs for the end client. Shares had a positive return in the quarter, but its weight in the portfolio limited the contribution.

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