Principal Asset Management℠

EDGE SMA SMID DIVIDEND INCOME

Quarterly commentary

FIRST QUARTER 2024

Market review

U.S. equities started 2024 on a positive high note as stocks rallied into year-end as investors embraced the narrative of easing financial conditions and anticipated that the Federal Reserve (Fed) would begin to cut rates later in the year. The Russell 2500 Value Index returned +6.07% during the first quarter.

Performance was positive across U.S. small- and mid-cap equities during the quarter with the Russell 2500 Value Index (+6.07%) lagging the Russell 2500 Growth Index (+8.51%) by 244 basis points. And from a sector standpoint 9 out of 11 sectors in the Russell 2500 Value Index posted a positive return with the Energy sector leading the way with a return of +11.95%. Industrials (+11.94%) and Consumer Discretionary (+9.25%) rounded out the top 3 sectors while the Communication Services (-4.05%) and Real Estate (-2.77%) sectors fell in the red for the quarter.

As markets now move past peak earnings growth and headwinds remain, investors find themselves weighing the tension between growth and interest rates. While 2023 brought double digit returns across U.S. equities, we believe that investors will become more discerning by refocusing on fundamentals and higher-quality, dividend-paying companies.

Performance as of 3/31/2024

Annualized performance (%)	3-month	1-year	3-year	5-year	10-year	Since inception (3/1/2007)
Edge SMA SMID Dividend Income (gross)	8.71	27.09	9.77	10.13	9.10	10.32
Russell 2500® Value Index	6.07	21.33	5.35	9.36	7.68	7.20
Gross excess return	2.64	5.76	4.42	0.76	1.42	3.11
Edge SMA SMID Dividend Income (net)	7.92	23.40	6.54	6.89	5.89	7.08
Net excess return	1.85	2.07	1.19	-2.47	-1.79	-0.13

Past performance does not guarantee future results. Periods over one year are annualized. Net of fees reflects the gross returns reduced by an assumed maximum bundled fee of 3%. Indices are unmanaged and do not take into account fees, expenses, and transaction costs and it is not possible to invest in an index.

Top five contributors

Williams-Sonoma, Inc. (WSM) is the owner of the Williams Sonoma, Pottery Barn, and West Elm brands. We like that 95% of the products WSM sells are proprietary and believe it will benefit from reducing its more costly store base while driving more purchases online which is higher margin. The company also features a strong balance sheet with no debt and has been committed to growing its dividend. WSM reported strong operating margins which management has been able to manage better than investors had anticipated in the face of slowing category demand. During the quarter, management decreased its revenue guidance but guided its margins up, which was well-received in a tough environment.

Comfort Systems, Inc. (FIX) provides comprehensive mechanical contracting services, including HVAC, plumbing, piping and controls, and other electrical components. Projects are for commercial, industrial, and institutional buildings and tend to be more geared toward HVAC. Revenues are split between installation services in newly constructed facilities and maintenance services in existing buildings. During the quarter, the company beat expectations with margins improving and operating income increasing. Additionally, backlog was up 22% with strong demand from data centers, chip fabs, life sciences, food, and battery plants.

MKS Instruments, Inc. (MKSI) is a supplier of instruments and subsystems that measure, monitor, analyze power, and control critical aspects of advanced semiconductor manufacturing. MKSI has core competencies in pressure measurement and control, flow measurement and control, gas and vapor delivery, gas composition analysis, residual gas analysis, and leak detection. MKSI beat expectations during the quarter and management highlighted that it expected to return to growth in Q1 and that it was on track to achieve its targeted synergies from Atotech. Additionally, there is enthusiasm about artificial intelligence and the long-term implications for MKSI due to higher chip demand.

Diamondback Energy, Inc. (FANG) is an independent oil and gas E&P operating exclusively in the Permian Basin in West Texas. FANG is one of the largest Permian operators and has benefited from its acreage footprint in the core of the Permian, and by the early adoption of innovations like high intensity completions resulting in more production for each dollar spent. The company is also committed to returning 75% of free cash to shareholders via a base dividend, variable dividend, and share repurchases. FANG rose during the quarter as the company announced that it would merge with Endeavor Energy Resources, a transaction we expect to be highly accretive.

Targa (TRGP) is an energy services company involved in natural gas gathering/processing and logistics/marketing throughout Texas, Oklahoma, and neighboring states. We like TRGP's exposure to growing Permian gas production and rising demand for Permian takeaway/pipelines. During the quarter, the company missed earnings slightly, but affirmed outlook and announced intention to raise its dividend 50%, indicating management's confidence in the company's free cash flow acceleration story.

As of 3/31/2024.

Source: FactSet. Information is based upon a Model (hypothetical) portfolio of the Edge SMA SMID Dividend Income strategy. Contributors and detractors 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.

Top five detractors

CONMED Corporation (CNMD), a provider of products to general and orthopedic surgeons, is a leader in surgical smoke evacuation products and has a broad portfolio of endoscopic devices, powered surgical instruments, and products that repair soft tissue injuries in orthopedic procedures. During the quarter, CNMD lagged due to its guidance being back end loaded and concerns about Intuitive Surgical's DaVinci robot which utilizes a competitor's insufflation system.

Bank OZK (OZK) is a full-service bank focused on short-term construction loans. We like the company's niche focus, strong credit quality and stringent underwriting standards. Despite beating expectations, management's outlook for positive EPS growth in 2024, and low net charge offs, investors remained concerned about the commercial real estate market and increased funding costs, which could decrease net interest margins.

Not owning Vertiv Holdings Co. (VRT), a company that designs, manufactures, and services critical digital infrastructure technology that powers, cools, deploys, secures, and maintains electronics for networks and data centers, hindered performance as investors flocked towards companies poised to benefit from the growth in AI.

Cathay General (CATY) is a bank founded to serve the growing Chinese American community in L.A. It also operates in NY, IL, TX, WA, Hong Kong, as well as representative offices in Taipei and Shanghai. Despite beating expectations during the quarter, the stock lagged as investors questioned management's guidance on net interest margins.

Cable One, Inc. (CABO) is a rural cable and video company that provides broadband services to residential and businesses in 750 non-metro, secondary markets in AZ, ID, IL, MI, MS, OK, and TX. The company benefits from moving consumers from video to broadband, a trend that was pulled forward during COVID. During the quarter, subscriber growth remained muted due to competition from lower cost fixed wireless offerings and an ongoing lack of housing turnover due to the higher interest rate environment.

As of 3/31/2024.

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Buys

Boston Properties, Inc. (BXP), one of the largest publicly traded office REITs in the United States that develops, owns, and manages primarily premier workplaces, was purchased during the quarter. The company's properties are concentrated in six gateway markets – Boston, Los Angeles, New York, San Francisco, Seattle, and Washington, DC. BXP's portfolio is focused on premier buildings, which have historically had lower vacancy rates and higher net absorption. While we acknowledge the challenges in the overall office market, we believe the company has a healthy balance sheet, great assets within office, and a strong management team that should allow it to navigate the challenging environment.

Hyatt, Inc. (H) was purchased during the quarter to replace MDC, which is being acquired. We like that H has transformed into an asset light model and that on an EV/EBITDA basis it is cheaper than competitors. We believe that, between dividend growth and accelerating buybacks, it offers a strong total return profile.

Magnolia Oil & Gas Corp (MGY) was purchased during the quarter. The energy company has excellent assets in the Eagle Ford. We like the company's focus on efficiency, profitable growth, and returning capital to shareholders.

NRG Energy (NRG) is a retail energy company that manages the power needs for customers in unregulated energy markets, primarily Texas and the mid-Atlantic. It sources power for customers from its own ~13GW generation fleet as well as through purchased power agreements. The retail power market in Texas has consolidated significantly and NRG is the largest player, which we see as an advantage in operating its business profitably. In a tightening and complex power market (driven by higher demand, fossil fuel retirements, and intermittent renewables) we think NRG can earn strong retail margins and the potential to realize more value from its owned generation fleet. The financial profile for NRG has improved in recent years and it expects to be investment-grade rated in 2025. In a rising interest rate environment, NRG's positive FCF and buybacks positively contrast to regulated utilities that regularly need to issue capital to fund growth.

Wintrust Financial Corporation (WTFC) operates in three segments: Community Banking, Specialty Finance, and Wealth Management. The branch network is primarily located in metropolitan Chicago, southern Wisconsin, and northwest Indiana. Wintrust has a top-5 deposit share in the state of Illinois and the Chicago and Milwaukee metropolitan areas as they have been able to consistently compete with the largest banks while taking advantage of the disruption in its market as many small and mid-sized competitors have been consolidated over the years. The company has demonstrated its ability to grow prudently over time with a disciplined lending approach that continues to produce solid asset quality.

Sells

Cathy General (CATY) was sold from the portfolio during the quarter in favor of other banks with stronger growth prospects.

Coterra, Inc. (CTRA) was sold during the quarter. The company performed well over time, and we chose to shift into energy investments with better growth prospects and more attractive valuations.

Quarterly buys and sells represent all new purchases and full liquidations of securities for the model portfolio for the previous quarter. It should not be assumed that securities identified above will prove to be profitable. Any reference to a specific investment or security does not constitute a recommendation to buy, sell or hold such investment security.

Outlook

The last year has been confounding for many investors as interest rates fluctuated, inflation decelerated, and the highly anticipated recession never materialized. Investors grappled with the implications of regional banking troubles, a rising U.S. government debt burden, a war in Israel, geopolitical tension with China, a broad-based inventory correction, concerns about the health of the commercial real estate market, and the highest mortgage rates in over 20 years. At the same time, easing supply chain pressures, falling transportation and commodity costs, resilient consumer balance sheets, and a still healthy labor market painted a more favorable picture. With so many forces moving in different directions, there is no playbook to rely on for these unique times, and it's no wonder that many forecasts coming into the year missed the mark.

The start to 2024 has been no less confounding. Although it appeared inflation was abating and there were broad expectations among investors that the Fed was finished raising interest rates, we remain skeptical and believe that inflation could remain stickier than investors expect, and rates will probably remain higher throughout 2024 than investors are factoring into their current economic scenarios. If we are correct, investors will continue to contend with an economic outlook that remains far from predictable, and the debate by investors will center on the strength of the economy and the Fed's reaction to it. That could make the stock market more choppy than last year, although we are optimistic it will grind higher in 2024.

At Principal Edge, our focus is on identifying quality businesses across sectors that have advantaged characteristics and are trading at valuations that will allow them to outperform their sector peers over our 5-year investment horizon. As we saw in 2023, and expect it to continue in 2024, fluctuations in macroeconomic data make forecasting sector-level outperformance extremely challenging, but we find that quality businesses tend to endure the test of time. Our focus remains on pre-identifying quality businesses we would like to own and then waiting to buy them when they are off the market's radar. While short-term performance can fluctuate with the vagaries of the market, quality investing at reasonable prices has been a long-term recipe for success.

As we move through 2024, we expect to see a divergence in performance between companies as they contend with the tension between growth and interest rates. This environment will be good for some and very challenging for others. If there is a resurgence of inflation, pricing power and strong balance sheets will be paramount. If inflation continues to abate, some will retain price while others will be forced to give back the pricing that was hard won in the higher inflation environment and growth concerns could arise. Either path creates both opportunities and pitfalls. With a playbook that is no more certain this year than last, our dominant eye remains on company-level fundamentals and investing in advantaged businesses that can do it all: maintain a strong balance sheet, generate ample free cash flow, outmaneuver the competition, invest in long term growth, and consistently return capital to shareholders along the way.

The financial market outlook is based on current market conditions. There is no assurance that such events or projections will occur and actual conditions may be significantly different than that shown here. The potential for profit is accompanied by the possibility of loss.

Index Descriptions

Russell Investment Group is the source and owner of the trademarks, service marks & copyrights related to the Russell Indexes. Russell® is a trademark of Russell Investment Group.

The Russell 2500 Value Index measures the performance of the small to mid-cap value segment of the U.S. equity universe. It includes those Russell 2500 Index companies with lower price-to-book ratios and lower forecasted growth values.

Hypothetical/Model Portfolio Objectives The Model Portfolio has been designed to seek a relatively high level of current income & long-term growth of income & capital by investing primarily in small and mid-cap U.S. companies. The portfolio is benchmarked to the Russell 2500 Value Index. The volatility of the index is materially different from that of the model portfolio. Volatility of the model may be subject to loss and investment results portrayed in the model may vary. Individual cannot invest directly in the index.

Hypothetical/Model Portfolio Construction The Model Portfolio has been constructed by selecting companies that have a capacity to pay dividends, consistently grow dividends over time, and/or demonstrate commitment of shareholders.

Disclosures

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. Dividends are not guaranteed. Small- and mid-cap stocks may have additional risks including greater price volatility.

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