Principal Asset Management℠

EDGE SMA SMID DIVIDEND INCOME

Quarterly commentary

FOURTH QUARTER 2023

Market review

U.S. equities finished on a high note as stocks rallied into year end. Small and mid-cap companies finished especially strong in the final two months, with the Russell 2500 Index up +20.6% vs. the Russell 1000 Index, which returned 14.7%, as investors embraced the narrative of easing financial conditions. The Federal Reserve (Fed) maintained the benchmark rate of 5.25%-5.5%, the highest level since 2001. Meaningful progress against inflation was made during the year with November headline CPI settling at 3.1%; and with inflation cooling, the Fed tweaked their December statements that indicated a dovish pivot. U.S. Treasury 10-year yields briefly hit 5% during the period, but following the Fed's updated statements, 10-year yields fell and finished the year at 3.9%. Against this backdrop, volatility (as measured by the CBOE VIX) fell to the lowest level since before the pandemic.

Performance was positive across U.S. small and mid-cap equities during the quarter, with the Russell 2500 Value Index (+13.7%) outperforming the Russell 2500 Growth Index (+12.5%) by 116 basis points. From a sector standpoint, 10 out of 11 sectors in the Russell 2500 Value Index posted a positive return with the financial sector leading the way with a return of +19.9%. Consumer discretionary (+16.7%) and real estate (+16.1%) rounded out the top 3 sectors, while the energy sector (-4.6%) fell into 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 12/31/2023

Annualized performance (%)	3-month	YTD	1-year	3-year	5-year	10-year	Since inception (3/1/2007)
Edge SMA SMID Dividend Income (gross)	14.09	19.43	19.43	11.11	10.72	8.53	9.93
Russell 2500® Value Index	13.76	15.98	15.98	8.81	10.78	7.42	6.94
Gross excess return	0.33	3.45	3.45	2.30	-0.06	1.11	2.99
Edge SMA SMID Dividend Income (net)	13.27	15.94	15.94	7.84	7.47	5.34	6.70
Net excess return	-0.49	-0.04	-0.04	-0.96	-3.32	-2.08	-0.24

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

East West Bancorp, Inc. (EWBC) is the largest Chinese American-focused bank in the U.S. and one three U.S. banks that have a banking license in China. We like EWBC's niche focus on small and medium businesses and higher growth rate of the Asian-American population. During the quarter, the bank outperformed after affirming its strong credit quality and capital position. EWBC also announced that it would begin to buy back stock, which was welcomed by investors.

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 concerns about the commercial real estate market and increased funding costs, OZK beat expectations with strong revenue growth while payoffs slowed. OZK also hiked its dividend during the quarter.

M.D.C. Holdings, Inc. (MDC) added to results as sentiment for housing improved when interest rates declined. MDC builds and sells homes through its subsidiaries under the name Richmond American Homes in Colorado, Virginia, Maryland, California, Arizona, and Nevada. MDC has shown solid margin and balance sheet management in the face of softer year-over-year housing demand and is now benefiting from a rebound in purchases of new homes. Additionally, existing home inventory in their markets remains scarce and employment trends have been resilient. The company's pivot to more speculative building has allowed it to maintain market share.

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 they 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 demand.

Monolithic Power Systems, Inc. (MPWR) designs, develops, and markets integrated power semiconductor solutions and power delivery architectures. The company contributed to results due to strong demand in its storage/computing and enterprise data segments and excitement about its role in artificial intelligence growth. MPWR also announced approval for a $640m buyback over the next three years during the quarter which boosted the stock.

As of 12/31/2023

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

Select Medical Holdings Corporation (SEM) detracted from performance during the quarter. SEM is one of the largest operators of critical illness recovery hospitals, rehab hospitals, outpatient rehab clinics, and occupational health centers in the U.S. We like the diversified business mix and relatively lower Medicare/Medicaid exposure vs. peers. With market share gains and tuck in acquisitions, we believe there is opportunity for revenue growth and margin expansion. Although labor costs continued to weigh on SEM this quarter, we see labor improvements on the horizon and the company is continuing to deleverage its balance sheet.

Kinsale Capital Group, Inc. (KNSL) is a property and casualty insurance company that operates in the excess and surplus lines segment. We believe that the company has an advantaged business model including core competencies in underwriting and claim handling. During the quarter, the company's top line growth slowed from 40% to 33%. Given the higher historical growth, the company carries a higher multiple which was impacted by the slowdown in growth as well as higher interest rates.

STERIS plc (STE) is a provider of infection prevention products and services. The company provides healthcare, life science, and service solutions such as sterilizers and washers, surgical tables, gastrointestinal endoscopy accessories, and services including equipment installation, maintenance, and repair solutions. We like the company's exposure to the secularly expanding infection protection area as well as the shift towards recurring revenue. Despite beating expectations and reiterating guidance, its higher margin contract sterilization business was weaker than expected which weighed on profitability. Additionally, destocking in the dental area led to falling revenues in the segment.

Organon & Co. (OGN) is a global pharmaceutical company which consists of women's health, biosimilar, and established brand segments. The company missed expectations during the quarter as Nexplanon, its largest established brand, revenues declined 3%. The company also saw weakness in China during the period.

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 detracted from relative performance as the energy sector lagged the broader benchmark during the quarter.

As of 12/31/2023

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Buys

AGCO Corporation (AGCO) manufactures and distributes agricultural equipment and replacement parts. We like the turnaround that its current CEO has enabled and believe the company has nice growth opportunities, particularly in their Precision Planting segment, as well as a product mix change which is margin accretive.

Quest Diagnostics Incorporated (DGX) was purchased during the quarter. DGX is a leading U.S. lab testing company, providing a wide range of lab services to individual and healthcare providers with scaled operations throughout the U.S. DGX replaced Mesa Labs as we believe their balance sheet, capital return focus, and free cash flow generation will be attractive while valuation was also more compelling. We believe that the company will benefit from long-term volume both in in-vitro diagnostics and emerging genetic and specialty testing. The company has increased its dividend every year since 2012.

Sells

Mesa Laboratories, Inc. (MLAB) was sold in favor of Quest Diagnostics.

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

2023 proved confounding for many investors as interest rates fluctuated, inflation decelerated, and the highly anticipated recession never materialized. The 10-year Treasury rate traveled round trip from 3.8% to 5% and back to 3.9% while investors grappled with the implications of an intense but relatively short-lived regional banking crisis, 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.

We expect 2024 to be no less confounding. With inflation abating and the broad expectation that the Fed is done raising interest rates, 2023 came to a close with a surge of investor optimism driving the S&P 500 within a hair of its all-time high. But the economic outlook is far from certain. The opposing forces at work on the economy will continue to fuel a tension between growth and interest rates, creating a backdrop that will require fundamental, bottom-up investing to drive outperformance.

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, 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 look to 2024, we expect to see a divergence in performance between companies as they contend with the tension between growth and interest rates. This environment has the potential to 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

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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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MM6013B-31 | 01/2024 | 3314719-052024