Principal Asset Management℠

Principal Edge

2023 year-end review

U.S. equities finished on a high note as stocks rallied into year end. While the "magnificent 7" contributed a significant portion of the market's overall return, small and mid-cap companies finished especially strong in the final two months. The Russell 2500 Index was 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 was made against inflation during the year, with November headline CPI settling at 3.1%. 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.

EQUITY INCOME: PERFORMANCE

Equity Income outperformed its benchmark—the Russell 1000 Value Index—on a gross basis on the year after digging out of a sizeable hole created over the first six months. Non-dividend paying stocks within the Russell 1000 Value that we will not own were a meaningful headwind, specifically large-cap tech stocks. But with the removal of Alphabet, Meta, and Netflix as part of Russell's annual reconstitution in June, performance started to improve.

KKR & Co (KKR) was first purchased in 2018 and has been a strong performer. The company was not only the top contributor to relative performance in 2023, but the top contributor over the past five years. KKR's capital markets business and the use of their balance sheet to invest into their funds separates them from other managers in the industry. Over the trailing year, KKR's capital raise came in at $54 billion, none of which has come from their flagship strategies.

Two long-time industrial holdings, Parker-Hannifin (PH) and PACCAR (PCAR), also had a strong 2023. Both companies have leveraged their competitive advantages to take share in their respective industries. Parker-Hannifin is a global leader in motion and control technologies and has benefited from local sourcing, multiple vendors, and simple product designs. Specifically, the company saw strong sales and orders in their aerospace segment. PACCAR, a manufacturer of trucks under the Peterbilt, Kenworth, and DAF brands, upped market share in both North America and Europe over the past year.

Meta Platforms Inc. (META), a non-dividend payer, was added to the Russell 1000 Value Index in 2022 and grew to become the second largest weight within the index prior to its removal mid-year. Following a challenging 2022 for the company, shares rebounded in 2023 and it was the top detractor from relative performance.

Another top detractor was Hormel Foods (HRL). Investors reacted negatively to the company's investor day guidance, which included increased investments that could weigh on near-term growth.

The short-lived regional banking crisis in Q1 took down First Republic Bank (FRC) and was a meaningful detractor on the year. The company had become our smallest financial weight in the portfolio coming into the year as we grew concerned about the net interest margin pressure FRC was experiencing. The bank came under deposit pressure following the collapse of Silicon Valley Bank and we moved out of the name in quick fashion.

EQUITY INCOME: WHAT HELPED

With our sector neutral approach, stock selection is the dominant driver of returns over the long-term, and this was the case in 2023. Stock selection was positive in seven out of 11 sectors on the year.

The health care sector was the second worst performing sector within the Russell 1000 Value Index but contributed the most to relative performance. Not owning Johnson & Johnson (JNJ) and Bristol-Myers Squibb (BMY) aided results as both companies saw their shares fall on the year. Owning the large Swiss pharma company Novartis (NVS-US) contributed to relative performance. The company has five areas of focus: cardio, immunology, neuroscience, solid tumors, and immunology. That focus produced results in 2023, with the company's phase III breast cancer drug, Kisqali, reporting positive results earlier than expected.

Parker-Hannifin (PH), PACCAR (PCAR), and Trane Technologies (TT) all helped results within the industrial sector. These three names were positive total return stories as the stocks were all up over +47% and grew their dividends on the year. PCAR also paid a special dividend of $3.20 on the year along with paying a 50% stock dividend. Trane, a global-pure play on climate systems (Thermo King and Trane) continues to see strong demand for their HVAC solutions and management has stated they believe they are taking market share as their Q3 backlog hit $6.9 billion, which is 2.5x historical levels.

EQUITY INCOME: PORTFOLIO DECISIONS

As long-term investors, we remain focused on pre-identifying quality businesses and patiently waiting for the market to give us the opportunity to purchase on quality franchises when they are out of favor. We are confident in the power of our fundamental research and the seven names that were added and eliminated from the portfolio.

The communication services sector saw the biggest changes in the year. In Q1 we added Omnicom (OMC), a marketing communications company. We believe the fragmentation of media consumption has increased the complexity and reinforced the role of ad agencies. OMC stands to benefit from higher complexity which should allow OMC to raise prices, leading to margin expansion. T-Mobile (TMUS) was added to the portfolio following the announcement the company would begin paying a quarterly dividend going forward. We believe TMUS is the best-positioned U.S. wireless carrier due to its network capacity, untapped pricing potential, and its focus on costs. We eliminated both Verizon (VZ) and Cable One (CABO) and used the proceeds to build our position in TMUS.

Within consumer staples we swapped Tyson Foods (TSN) for Procter & Gamble (PG) as we lost confidence in TSN's management. We believe PG, with its well-recognized line up of brands ranging from Pampers, Tide, and Gillette, should continue to gain share and see gross margin tailwinds in the coming years as transportation and supply chain headwinds continue to abate.

Union Pacific Corporation (UNP) had performed well for us within the industrial sector as their operating ratio improved meaningfully over recent years due to the company's investments into precision railroading. However, we believe future improvements may be challenged. Carrier Global (CARR), a high-quality, leading brand in the HVAC space was added to the portfolio. CARR was spun out of United Technologies Corporation in 2020 and we believe the historic underinvestment creates a long runway for organic growth.

Dividend growth, or the lack there of, can often be an important indicator. With Digital Realty (DLR) we had concerns over the company's growth outlook following a pause in annual dividend increases. Prologis (PLD), which owns, manages, and develops well-located, high-quality logistics facilities, was added to the portfolio as we believe PLD stands to benefit as e-commerce becomes a larger percentage of total retail sales, and logistics and distribution capabilities becomes a key need for retailers.

SMID DIVIDEND INCOME: PERFORMANCE

The SMID Dividend Income strategy meaningfully outperformed its benchmark—the Russell 2500 Value Index—on a gross basis in 2023, including during the fourth quarter rally. Although non-dividend paying stocks outperformed dividend payers in the Russell 2500 Value Index during the year, we were able to offset this headwind with strong stock selection across a number of sectors.

Although interest rates remained elevated, our strongest relative performers during the year were housing-related companies. Within Consumer Discretionary, homebuilder M.D.C. Holdings, Inc. (MDC) and home product retailer Williams-Sonoma, Inc. (WSM) led results despite significant housing-related headwinds during the year. We had originally purchased MDC because we believed it was one of the leading homebuilders that was focused on the affordable segment of the market and would benefit from the millennial homebuying wave. The company also benefited from the migration away from high cost, densely populated areas. Despite higher interest rates causing a headwind to home affordability, a lack of existing home inventory kept home prices high, and pushed buyers toward new homes, benefiting builders like MDC. Similarly, we owned WSM during the year. We added the home products company following soft performance in 2022, as investors worried about the impact of higher interest rates on housing and home products. We like that 95% of products that WSM sells are proprietary and the opportunity the company had to increase margins as it moved towards e-commerce. During the year, WSM's management team did an excellent job managing its profitability despite the soft demand backdrop, as it pivoted away from promotional activity and continued to benefit from its proprietary products and high e-Commerce mix.

Another company that posted positive results was Hamilton Lane (HLNE), a financial services company we purchased in 2021. HLNE is a global private market investment firm that designs private market portfolios across private equity, infrastructure, private debt, real estate, natural resources, and venture capital. Our initial investment thesis was that HLNE would continue to outpace its peers due to its strong fund franchise, steady double-digit earnings growth, and specialization in the growing alternatives market. The company did not disappoint with asset growth and fee earnings exceeding expectations. Fee paying AUM was $61 billion, with an average rate of 62 basis points as the company saw higher demand for its specialized funds business, particularly its evergreen platform.

Organon & Co. (OGN), a hybrid pharma company with an established brands portfolio, a focus on women's health adjacencies, and a growing biopharma business lagged during the year. Specifically, Organon missed expectations twice due to weakness in China, loss of a patent infringement case, and a shift in the timing of sales of Nexplanon, a large and important drug franchise for the company.

Cullen/Frost Bankers, Inc. (CFR), a long-time portfolio holding in the banking sector, lagged during the year. The Texas-based bank has a strong long-term track record, consistent dividend growth, and a historically strong underwriting culture. CFR lagged early in the year as investors became concerned about its expense growth as the bank expands in Houston and Dallas and invests in IT, advertising, and hiring. Broader concern about regional bank commercial real estate exposure and a small uptick in non-performing loans and deposit outflows later in the year also hindered performance.

Finally, not owning Builders FirstSource Inc. (BLDR), a large building products company, hindered results as new home sales held up better than expected, despite higher interest rates. BLDR does not pay a dividend.

SMID DIVIDEND INCOME: WHAT HELPED

With our sector neutral approach, stock selection is the dominant driver of our returns over the long-term, and that was the case again in 2023.

The financials sector is the largest sector in the Russell 2500 Value Index, and stock selection within the sector was the largest driver of relative performance for the year. In addition to Hamilton Lane, several other companies in the financial sector aided results. An investment in Federal Agricultural Mortgage Corp (AGM), which is a government sponsored enterprise, helped returns. AGM is the only congressional chartered company established to provide a secondary market for agriculture loans, which gives it a favorable cost of capital. Earnings were up 35% year-over-year, driven by new business volumes and minimal credit issues. Additionally, our investment in title insurer Fidelity National Financial (FNF) contributed to performance. The company also outperformed as its margins held up well despite pressure on title volumes. Investors became more optimistic about a title volume rebound in a flat or declining rate environment.

As previously mentioned, two of our strongest relative performers during the year were housing-related companies in the consumer discretionary area. Homebuilder MDC and home product retailer Williams Sonoma were strong performers despite significant housing related headwinds during the year. A lack of existing home inventory kept prices high and pushed buyers toward new homes, benefiting builders like MDC. Williams Sonoma did an excellent job managing its profitability despite the soft demand backdrop as it pivoted away from promotional activity and continued to benefit from its proprietary products and high e-commerce mix.

SMID DIVIDEND INCOME: PORTFOLIO DECISIONS

As long-term investors, we remain focused on pre-identifying quality businesses and patiently waiting for the market to give us the opportunity to purchase quality franchises when they are out of favor. We are confident in the power of our fundamental research. Four companies were added during the year, while six were eliminated from the portfolio.

The REIT sector saw the biggest changes in the year. In Q1 2023, we added Essential Properties Realty Trust, Inc. (EPRT) as a replacement for STORE Capital Corporation (STOR) which was taken over by private equity. This marked the 39th takeover in the history of the SMID strategy. During the quarter, we also chose to eliminate Medical Property Trust (MPW). We had become concerned about the sustainability of MPW’s dividend in late 2022 and exited the company in the first quarter. MPW ended up cutting its dividend mid-year which clearly impacted its stock price. Avoiding dividend cuts and eliminations has helped relative performance over time.

The holdings identified do not represent all of the securities purchased, sold or recommended for advisory clients during the period. 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. Securities identified as detractors that were not held during the period represented acted as detractors to the active return due to the firm’s decision to not invest. The decision to not invest resulted in a decrease to the active return due to the security outperforming relative to the other constituents.

Within financials, we added and eliminated one company. During the regional banking crisis in the spring, we used the sell-off to exit Washington Trust Bancorp (WASH) in favor of higher quality companies that we already owned in the portfolio. Additionally, we added Jefferies Group (JEF) during the third quarter as the investment banking and securities firm had underperformed as capital markets activity declined due to higher interest rates.

In health care, we chose to exit Mesa Laboratories (MLAB) in favor of Quest Diagnostics Incorporated (DGX). DGX is a leading U.S. lab testing company, providing a wide range of lab services to individuals and health care providers with scaled operations throughout the U.S. We believe DGX's balance sheet, capital return focus, and free cash flow generation will be positive, and valuation was also more attractive than MLAB. We believe DGX will benefit from long-term volume both in in-vitro diagnostics and emerging genetic and specialty testing.

Within industrials, EnPro Industries, Inc. (NPO) was sold. We believe our investment thesis of the company's portfolio repositioning towards higher margin sealing and advanced surfaces technologies has largely played out and decided to exit in favor of other industrial companies with higher growth prospects. AGCO Corporation (AGCO) was added in the 4th quarter. 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.

Our dominant eye remains on company-level fundamentals and investing in advantaged businesses that can do it all: grow their revenues and profits, generate ample free cash flow, and enhance shareholder return through regular payment of a growing dividend. With this in mind, we had become concerned about the growth prospects for two companies and subsequently eliminated them. In communications services, we sold John Wiley & Sons (WLY), a journal and textbook publisher. Textbook revenues had declined, and we were worried about the potential impact of artificial intelligence on their educational business. Finally, in consumer discretionary, we eliminated Hasbro, Inc. (HAS). Outperformance of other consumer discretionary companies led us to be overweight the sector at the same time we became concerned about growth prospects and an overreliance on its Wizards of the Coast brand.

LOOKING AHEAD

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 healthy labor market painted a more favorable picture. With so many forces moving in different directions, we are convinced that there isn't a historical playbook for us to rely on in these unique times and it's no wonder that most 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 looking ahead, the economic outlook is far from certain. The opposing forces at work on the economy will continue to fuel a tension between growth, inflation, 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 increasing 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, grow their sales, generate ample free cash flow, outmaneuver the competition, invest in long term growth, and consistently return capital to shareholders along the way.

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