PRINCIPAL ALIGNED SMA MIDCAP EQUITY

Quarterly commentary

FOURTH QUARTER 2023

The Principal Aligned SMA MidCap Equity portfolio outperformed the Russell Midcap Index on a gross basis in the fourth quarter.

What helped

Alternative asset managers Brookfield Corporation and KKR contributed to performance in the quarter. Both companies added to assets under management last year. Industrial companies TransDigm and Copart had strong performance. TransDigm expanded its non-aerospace business with a large acquisition announced in November. Copart continued to gain share, winning a big customer away from their main competitor. Hilton shares gained in the quarter. The company celebrated 10 years as a public company in December. During this time, Hilton more than doubled its brand portfolio and today has its largest development pipeline in history. Relative performance benefited from not owning any energy companies, the only sector with a negative return.

What hurt

Insurance businesses Markel, Arch Capital, and Aon detracted from performance. A common thread of these companies is their owner-operator management teams, who make strategic decisions based on what is best for the long-term health of the business. The sector that detracted most from relative performance was consumer discretionary. Several of our companies had positive returns (O'Reilly, CarMax, Domino's) but underperformed relative to the index return. Vail Resorts sold off slightly in the quarter, despite reporting an increase in season pass sales. The company has made more investments ahead of this year's ski season. In December the company announced its second acquisition in Switzerland, with plans to build out a European network.

What we did

We increased shares in Brookfield Infrastructure at an attractive valuation. Brookfield Infrastructure is meeting the growing need for digital infrastructure upgrades, with its investments in distribution centers, towers, and fiber networks. We sold our few remaining shares of TransUnion, a consumer credit reporting agency, to reallocate capital to other attractive opportunities. We trimmed shares of TransDigm and Copart to manage their weight in the portfolio following strong share price appreciation this year.

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

Top five contributors

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.

Brookfield Corporation is a global investor and asset manager focused on real estate, infrastructure, renewable power and energy transition, private equity assets 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.

KKR is a global asset management firm with leading capabilities in private equity, credit, and real assets. The company stands apart by aligning interests at all levels, including significant insider ownership of KKR shares. The distinctive way KKR operates allows them to focus on the most profitable opportunities. Their attractive investment track records have enabled them to continually raise larger funds, which are frequently oversubscribed. KKR spent more than a decade developing capabilities outside the U.S., with a regional approach in the Americas, Europe, and Asia. Shares increased over the quarter and contributed positively to portfolio performance.

Hilton manages and franchises a portfolio of hotels with more than 7,400 properties under 22 brands, in 124 countries and territories. They have leading brands in every category, from Waldorf Astoria on the high end to its value-driven offering, Spark by Hilton. Historically Hilton owned many of its properties, but today the company is primarily an asset light business as a franchisor and manager. Hilton has a strong network effect, generating better returns for hotel owners, which attracts more capital and allows them to build out their network further. Hilton announced three new brands in 2023, aiding its development and conversion pipelines. Hilton shares contributed to performance.

Copart is a global leader in providing online auction and vehicle remarketing services for salvage vehicles. Founded in 1982 by Willis Johnson (now chairman) as a single salvage yard in California, Copart gradually expanded through organic growth, to over 250 locations in 11 countries. Benefiting from its scale, network effect, barriers to entry, and relationships with major insurance companies, Copart continues to post impressive results and profitably grow market share. Copart's shares rose over the quarter and contributed to performance.

Information is based upon a model (hypothetical) portfolio of the Principal Aligned SMA MidCap 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

Markel is a specialty insurance underwriter, focusing on non-standard and hard-to-place risks, such as specialty property, marine, classic cars, energy, and event insurance. Markel's culture of disciplined underwriting has resulted in attractive returns on capital and higher growth rates versus its competitors over decades. Tom Gayner has had success investing the company's float over the last 20+ years. The company continues to grow its Markel Ventures unit, a diversified collection of non-insurance companies, bound by shared values. The Markel family and insiders have significant ownership stakes. Markel's shares detracted from performance during the quarter.

Arch Capital is a provider of specialty insurance, reinsurance, and mortgage insurance. Arch is led by an owner-operator management team and has a strong underwriting culture. This has led Arch to adeptly manage through insurance cycles, realizing strong long-term returns. More specifically, Arch limits premium growth during "soft markets" when insurance rates are low and result in poor expected underwriting returns and grows more aggressively during "hard markets" when insurance rates are higher along with expected returns. Arch benefited from this counter-cyclical underwriting approach the past few years in a hardening market, aggressively growing premiums, on top of a strong capital base. Shares detracted from performance during the quarter despite strong operating results.

Aon is a global professional services firm focused on providing a broad range of solutions to corporate clients. Two-thirds of Aon's revenue is derived from insurance and reinsurance brokerage—matching businesses with insurers and insurers with reinsurers. The company also provides health and retirement solutions. The barriers to entry are high as the business relies on built-up expertise and relationships. Aon has scale advantage and a trusted reputation. Shares declined during the quarter. Aon is investing in its core business with innovative technology.

Vail Resorts owns some of the highest rated ski resorts in the United States, Canada, and Australia, including the top five visited ski resorts in North America by skier volume. Opening new ski resorts is very difficult due to lack of new supply, which serves as a barrier from new competition. Vail's profitability has enabled it to reinvest at industry-leading levels to create an unparalleled owned ski resort network in North America. Vail is growing its subscription model through its Epic Pass—which not only provides extraordinary value for skiers, but also gives Vail steadier, up-front revenue, and more information about its consumer base, to better manage capacity and unlock ancillary revenue. Shares declined slightly during the quarter.

Brown-Forman is a 150-year-old Kentucky-based producer of alcoholic beverages, with 40+ brands in 170 countries, including primary brand, Jack Daniels. Over the last decade, the company consolidated its offerings to focus more on premium and ultra-premium brands that deliver excellent returns. This focus on premium brands sets Brown-Forman apart from competition. The company is thoughtful about developing and growing its brands in a way that maximizes long-term value. Brown-Forman's shares detracted from performance in the quarter.

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