

PRINCIPAL ALIGNED SMA MIDCAP EQUITY

Quarterly commentary

FIRST QUARTER 2024

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

What helped

Consumer discretionary was the top performing sector last quarter, led by O'Reilly Auto Parts and Hilton. O'Reilly has been investing more in its business and gained market share. Hilton reiterated its commitment to building its brand portfolio, with the goal to win everywhere. Aerospace components business TransDigm and auto salvage and auction business Copart also had strong performance. During a meeting at TransDigm's headquarters in the quarter, founder Nick Howley said a simple and focused strategy is the key to its success. Financial companies KKR and Brown and Brown contributed meaningfully to performance. KKR was active in putting capital to work during the quarter.

What hurt

Software businesses, including Verisign and Ansys, detracted from performance. Verisign is very different from a high-growth tech business, acting more like a utility, with its domain-name registry business. It can lag when high-growth companies are in favor. Brookfield Renewable—an owner and operator of renewable power generating facilities—detracted last quarter. Concerns around capital being more expensive and scarce impacted the industry in general. Brookfield Renewable remained disciplined, lining up projects and financing together to maintain its returns. Lack of any holdings in the energy sector, which had a positive return last quarter, was a headwind to relative performance.

What we did

We added Fair Isaac to the SMA MidCap portfolio. Known for its FICO scores business, Fair Isaac provides analytics software and tools to help businesses manage risk, fraud protection and regulations. We added vertical software business CCC Intelligent Solutions to the portfolio. CCC Intelligent Solutions provides software that helps both auto insurance companies and repair shops during the repair process. CCC has invested more than competitors in products to help repair shops run their business—a competitive advantage. We increased weight in Lennar, a homebuilder with a nationwide-footprint that benefits from scale. We trimmed shares in TransDigm and KKR to manage weight in the portfolio.

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.

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.

Copart is a global leader in providing online auction and vehicle remarketing services for salvaged 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. Benefitting 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.

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 contributed to performance.

Hilton manages and franchises a portfolio of hotels with more than 7,500 properties under 22 brands, in 126 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 shares 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

SBA Communications (SBAC) owns and operates wireless communications infrastructure and is one of the largest tower operators in the U.S., with additional operations in Latin America and Canada. The core business for SBAC is leasing antenna space on its towers to various wireless service providers on a long-term basis. The tower business is very attractive given its scalability and sustainable, predictable growth. Shares declined during the quarter. We remain confident in the outlook for SBAC, as it continues to benefit from the long-term secular driver of increased mobile data demand.

Brookfield Renewable owns, operates, and develops renewable power generating facilities including hydroelectric, wind, solar, and storage facilities. Brookfield Renewable's scale, operating expertise, and access to capital, are significant advantages. The company benefits from accelerating decarbonization efforts, as more corporations and governments announce commitments to net-zero emissions and seek energy security. Shares declined over the last three months and detracted from performance.

Verisign is the phone book of the Internet. Verisign provides stability and security to the Internet by maintaining the directory of all .COM and .NET domain names under its unique agreements with ICAAN and the U.S. Department of Commerce. The technical abilities and scale of Verisign's operations are unique and serve as a competitive advantage. In return for this service, a website address ending in .COM or .NET pays Verisign an annual fee. Verisign detracted during the quarter.

ANSYS is a leading simulation software company, using sophisticated physics to help its manufacturer clients test their wares in a virtual environment. The company has over 50 years' experience in physics-based simulation, which gives ANSYS a level of trust and credibility that competitors do not have. In January 2024, chip design software maker Synopsys announced the acquisition of Ansys.

IDEXX Laboratories is a leader in diagnostics for companion animals, providing testing capabilities in the offices of veterinarians and in their reference labs. As the dominant provider, IDEXX can invest substantially more than competitors in both R&D and their salesforce that calls on veterinarians. The testing business is very attractive, with substantial gross margins and nearly all the revenue being recurring in nature. IDEXX also stands to benefit from the tailwind of more money being spent on the health of pets. Shares detracted from performance last quarter.

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