

Principal Financial Group®

2Q 2022 Earnings Call Transcript

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Call participants

Executives

Dan Houston: Chairman, President & CEO

Deanna Strable: Executive VP & CFO

Amy Friedrich: President - U.S. Insurance Solutions

Pat Halter: President - Global Asset Management

Chris Littlefield: President - Retirement & Income Solutions

Humphrey Lee: VP - Investor Relations

Analysts

John Barnidge: Piper Sandler

Tom Gallagher: Evercore ISI

Ryan Krueger: KBW

Erik Bass: Autonomous Research

Tracy Benguigui: Barclays

Suneet Kamath: Jefferies

Jimmy Bhullar: J.P. Morgan

Alex Scott: Goldman Sachs

Michael Ward: Citigroup

Josh Shanker: Bank of America

Andrew Kligerman: Credit Suisse

Presentation

Operator: Good morning, and welcome to the Principal Financial Group Second Quarter 2022 Financial Results Conference Call. There will be a question-and-answer period, after the speakers have completed their prepared remarks. If you would like to ask a question at that time, simply press star, and the number one on your telephone keypad. A confirmation tone will indicate your line is in the question queue. We would ask that you would be respectful of others and limit your questions to one and a follow up, so we can get to everyone in the queue. I would now like to turn the conference call over to Humphrey Lee, Vice President of Investor Relations.

Humphrey Lee: Thank you, and good morning. Welcome to Principal Financial Group's Second Quarter 2022 Conference Call. As always, material related to today's call are available on our website at investors.principal.com. Following a reading of the safe harbor provision, CEO, Dan Houston, and CFO, Deanna Strable, will deliver some prepared remarks. Then we'll open up the call for questions. Others available for Q&A include Chris Littlefield, Retirement and Income Solutions; Pat Halter, Global Asset Management; and Amy Friedrich, U.S. Insurance Solutions.

Some of the comments made during this conference call may contain forward-looking statements within the meaning of the Private Securities Litigation Reform Act. The company does not revise or update them to reflect new information, subsequent events or changes in strategy. Risks and uncertainties that could cause actual results to differ, materially, from those expressed or implied are discussed in the company's most recent annual report on Form 10-K filed by the company with the U.S. Securities and Exchange Commission.

Additionally, some of the comments made during this conference call may refer to non-GAAP financial measures. Reconciliations of the non-GAAP financial measures to the most directly comparable U.S. GAAP financial measures may be found in our earnings release, financial supplement, and slide presentation.

As a reminder, the transaction to reinsure our in-force U.S. retail fixed annuity and universal life insurance with secondary guarantee blocks of business closed in the second quarter. The transaction had an effective

date of January 1, 2022, which resulted in a true-up in the second quarter to transfer the associated revenue, earnings, net income, and AUM to the counterparty. As a result, the second quarter financial results are not comparable to prior periods for RIS-Spread, Individual Life, and Total Company. Also related to the transaction, we've updated our ROE and book value per share definitions to exclude the cumulative change in the fair value of the funds withheld embedded derivatives, as the GAAP accounting treatment is noneconomic.

Additional details of the impact of the transaction are available in the second quarter earnings call presentation available on our website. Dan?

Dan Houston:

Thanks, Humphrey, and welcome to everyone on the call. This morning, I will touch on key performance and business highlights for the second quarter, including our view on the impacts of our current macroeconomic environment.

Deanna will follow with additional details on our results, our financial and capital position, our investment portfolio, and our initial LDTI estimated transition impact. She will also discuss the impacts of the reinsurance transaction, which was a key milestone for Principal, as we continue to transform and evolve our portfolio to focus on our growth drivers.

The value of our diversified business strategy was evident in our second quarter results during a period of volatile markets, high inflation and macroeconomic uncertainty. Strong customer growth across our businesses, rising interest rates, and optimization within our general account are helping us to mitigate some of the headwinds from market volatility.

We have a long track record of managing expenses to weather challenging times, and this period is no different. We are keenly focused on aligning expenses with revenues to help offset some of the near-term pressures on our fee-based margins.

Second quarter financial highlights are shown on Slide 2. We reported \$423 million of non-GAAP operating earnings, or \$1.65 per diluted share.

Excluding significant variances, earnings per share of \$1.70, increased 3%, over the second quarter of 2021.

We returned approximately \$400 million to shareholders in the second quarter and nearly \$1.3 billion, year-to-date, through our share repurchases and common stock dividends.

We closed the second quarter with \$632 billion of total company AUM, reflecting the AUM that was transferred as part of the reinsurance transaction, as well as unfavorable equity and fixed income performance and foreign exchange headwinds.

Our long-term relative investment performance remains strong, while short-term relative performance was pressured by market volatility and a continued rotation from quality and growth to value investing in the second quarter.

We have seen improvement in July. Total company net cash flow was a positive \$1.5 billion in the quarter. This included \$1.4 billion of PGI managed net cash flow driven by strong institutional flows, across equities and real estate, partially offset by industry-wide retail outflows.

The strong year-to-date net cash flow in PGI highlights the appeal and value proposition of our diverse and differentiated investment solutions across equities, real estate, and fixed income.

We continue to develop products and capabilities to meet the needs of our customers. We recently launched an actively managed real estate ETF that combines two core strengths of Principal, active management, and real estate investing.

It is focused on nontraditional real estate sectors, including data centers, life sciences, single-family rental, medical office, and self-storage properties, and provides retail investors access in a liquid ETF structure.

We're also continuing to build our direct lending team and private credit capabilities. We now have 30 professionals on our team, deploying over \$1.2 billion in the last two years, following the funding of our first loan.

The demand for our differentiated solutions remains robust, and we'll continue to expand our existing capabilities to meet our clients' needs.

A few other business highlights from the quarter, starting in Chile. Despite a level of uncertainty in the future state of Chilean pension system, our business continues to grow.

In the second quarter, Cuprum experienced its fifth consecutive quarter of positive net RIM, the salary base upon which we earn fees, as well as a positive net transfers of new customers, suggesting more Chileans are choosing to move their mandatory savings to Cuprum.

We remain engaged on the development on pension reform in Chile, and we continue to work with industry peers and stakeholders to promote a more inclusive and well-funded pension system to help improve financial security for all Chileans.

In the U.S., the small to midsized business segments we target are weathering the current environment well, similar to previous periods of uncertainty. Employers are continuing to seek solutions to help attract and retain talent, and they are leaning into Principal to help in a very competitive labor market.

This is especially evident in Specialty Benefits, where premium and fees increased 11% over the year ago quarter. Roughly half the growth was driven by net new business. This includes customers moving their benefits to Principal, selling additional products to existing customers, attracting customers that are offering benefits for the first time and maintaining strong retention.

The remaining growth is attributable to employment growth and higher salaries from existing customers.

Our dedication to creating unique tech-driven solutions and Group Benefits is receiving recognition. DALBAR recently rated Principal #1 for online Group Benefits administration with its Communication Seal of Excellence for superior web experience.

This award spotlights one of our strategic priorities, customer experience, by listening to our customers and responding with

systematic improvements to both, digital and human interactions. We are consistently improving the customers' experience and helping them take the necessary steps towards financial security.

In Individual Life, our targeted focus on the business market is paying off. Compared to a year ago, sales of nonqualified deferred compensation and business owner solutions increased 76% on a quarterly basis and 57% on a year-to-date basis, nearly offsetting the impact of our decision to focus solely on this market.

Through continuous tracking of our brand health metrics, we're seeing steady increases in brand favorability among SMBs. This, in combination with focused distribution efforts and the market demand for our employer solutions, are driving these strong results.

The resiliency of the SMB market also comes through our U.S. retirement business. And RIS-Fee second quarter reoccurring deposits increased 37% in total and 14% on our legacy block, as compared to a year ago.

We're seeing growth across our participant base, stemming from both net new business and employment growth on our existing block. Existing participants are also saving more.

This, along with strong sales retention, drove \$2.5 billion of positive account value net cash flow in the quarter. DALBAR also recently recognized Principal as one of the top five retirement plan providers with superior mobile enrollment experiences.

This acknowledges our seamless rollover process, making it easy for participants to move their retirement savings to Principal and opting into their new retirement plan.

Overall, we're entering the second half of 2022 with momentum, prepared to navigate uncertainty in the macro environment. Our transformed portfolio focused on our growth drivers will continue to drive financial and customer results. Deanna?

Deanna Strable:

Thanks, Dan. Good morning to everyone on the call. This morning, I'll share the key contributors to our financial performance for the quarter, including impacts of the reinsurance transaction, an update on our

current financial and capital position, details of our investment portfolio and our initial estimate of the LDTI transition date impact.

As Humphrey mentioned, the reinsurance transaction closed at the end of May, and was a key milestone that reinforces our strategic focus on evolving into a higher growth, higher return, more capital-efficient enterprise, while also reducing our risk profile.

At close, the economics of the reinsured blocks of business transferred to the counterparty with a January 1 effective date. This resulted in a true-up of the related revenue, non-GAAP operating earnings, net income, and AUM from first quarter in our second quarter reported results.

Net income attributable to Principal was \$3.1 billion in the second quarter, reflecting \$2.8 billion of income from exited businesses. This benefit was primarily due to a change in the fair value of the funds withheld embedded derivative, which doesn't impact our capital or free cash flow and can be extremely volatile quarter-to-quarter.

Excluding this \$2.8 billion of income from exited businesses, as well as a negative \$83 million true-up for the first quarter gains in the funds withheld portfolio, net income for the quarter was \$315 million.

Excluding true-ups related to the reinsurance transactions and other significant variances, second quarter non-GAAP operating earnings were \$435 million. Operating EPS of \$1.70 per diluted share increased 3% compared to the second quarter of 2021.

The second quarter non-GAAP operating earnings effective tax rate was nearly 20% on a reported basis and 18%, excluding significant variances. For the full year, we continue to expect to be within the 17% to 20% guided range.

As detailed on Slide 14, we had several significant variances that had a net negative impact on non-GAAP operating earnings during the second quarter.

On a pretax basis, benefits from net favorable variable investment income and inflation in Latin America were more than offset by the

reinsurance transaction true-up, COVID-related claims and higher DAC amortization. These had a net negative impact to reported non-GAAP operating earnings of \$3 million pretax, \$12 million after tax and \$0.05 per diluted share.

Specific to variable investment income, RIS-Fee, RIS-Spread, Principal International, Specialty Benefits and Individual Life benefited by a combined \$56 million pretax, primarily due to higher-than-expected real estate sales and alternative investment returns.

This was partially offset by a negative \$41 million impact in corporate, as the increase in interest rates and decline in equity investments negatively impacted some mark-to-market investments.

With approximately 35,000 U.S. COVID-related deaths in the quarter, we had a negative \$10 million pretax impact, primarily driven by disability claims and specialty benefits and live claims in Individual Life.

The first quarter reinsurance transaction true-up negatively impacted second quarter pretax operating earnings by \$13 million. This excludes stranded costs, as they remain in our reported results and were not part of the true-up.

Details of the line-item impacts of the true-ups for RIS-Spread and Individual Life are available in the appendix.

Macroeconomic volatility continued in the second quarter and pressured earnings in our fee-based businesses.

Unfavorable equity market and fixed income performance relative to both the prior quarter and year ago quarter, negatively impacted AUM, account values, fee revenue and margins and RIS-Fee and PGI, as well as DAC amortization and RIS-Fee.

However, the higher interest rate environment does benefit our businesses over the long term, with our new money yield exceeding 5% in the second quarter.

Foreign exchange rates were a headwind in the second quarter. Impacts to reported pretax operating earnings included a negative \$1 million

compared to the first quarter of 2022, a negative \$5 million compared to the second quarter of 2021, and a negative \$7 million on a trailing 12-month basis.

Encaje performance, in total, didn't impact second quarter results, as \$8 million of higher-than-expected performance in Chile was completely offset by lower-than-expected performance in Mexico.

We're taking actions across the enterprise on expenses due to pressured fee revenue, as we have during previous periods of macro uncertainty and volatility.

We are committed to aligning expenses with revenues, while continuing to invest for growth, but there is a natural lag as we put actions in place.

Turning to the business units, the following comments on second quarter results exclude significant variances.

RIS-Fee pretax operating earnings and margin declined from the year ago quarter, primarily due to unfavorable equity and fixed income markets, pressuring revenue.

Second quarter was also impacted by the final TSA expenses related to the IRT transaction. In RIS-Spread, net revenue was flat, despite the reinsurance transaction, as growth in the business and higher net investment income, including the benefits from portfolio optimization, more than offset the loss of the fixed annuity revenue.

Pretax operating earnings increased, despite flat net revenue, as operating expenses were lower, reflecting impacts of the reinsurance transaction.

Despite macro pressures, PGI reported strong second quarter results with \$1.4 billion of positive net cash flow, and the overall management fee rate of approximately 29 basis points remain stable.

Pretax operating earnings and margin benefited from a net \$30 million of performance fees earned in the quarter.

Excluding the benefit from performance fees, PGI's second quarter margin was strong at 39%.

In Principal International, pretax operating earnings were flat with the year ago quarter, as growth in the business was offset by the regulatory fee reduction in Mexico and foreign exchange headwinds.

On a constant currency basis, pretax operating earnings increased 5%, over the year ago quarter.

As Dan highlighted, Specialty Benefits continues to deliver strong results and increased pretax operating earnings 35%, over the year ago quarter. This was fueled by growth in the business, including an 11% increase in premium and fees, as well as improved life and disability claims and disciplined expense management.

We expect the strong growth in premium and fees to persist throughout the remainder of the year.

Corporate losses were elevated in the second quarter, primarily due to the timing of certain expenses related to strategic initiatives.

We continue to expect to be within the \$370 million to \$400 million guided range on a full year basis, excluding significant variances, implying lower losses in the second half of the year.

Turning to capital and liquidity, we remain in a strong financial position and are focused on returning excess capital to shareholders. We ended the quarter with \$2 billion of total company available cash and liquid assets.

We also have \$800 million of untapped revolving credit facilities available for liquidity purposes. Excess and available capital is currently estimated to be \$1.9 billion and includes \$1.3 billion at the holding company, higher than our \$800 million to cover 12 months of obligations.

Approximately \$370 million in our subsidiaries and \$200 million in excess of our targeted 400% risk-based capital ratio, estimated to be 415%. We also have access to a \$750 million contingent capital facility.

We will continue to maintain a 20% to 25% leverage ratio and expect the ratio to continue to improve, as we pay down \$300 million of long-term debt, set to mature in the third quarter.

Despite the pressures of the environment, we remain in a strong financial position. We have the financial flexibility, discipline, and experience necessary to manage through this time of macro volatility and uncertainty.

As shown on Slide 3, we returned nearly \$1.3 billion of capital to shareholders in the first half of the year. This includes approximately \$400 million in the second quarter, with \$162 million of common stock dividends and \$240 million through share repurchases. \$140 million of the share repurchases this quarter was the balance of the \$700 million accelerated share repurchase program that we initiated in the first quarter.

Last night, we announced a \$0.64 common stock dividend payable in the third quarter, a 2% increase from the dividend paid in the third quarter of 2021. This is in line with our targeted 40% dividend payout ratio and reflects strong business performance.

It's important to note that our full year capital return guidance assumes markets, as of the end of 2021, and the targeted \$2.5 billion to \$3 billion of capital return to shareholders included three sources of capital: excess capital at the holding company, \$800 million of deployable proceeds from the transactions and free capital flow generation from our businesses.

We remain confident in our 75% to 85% free capital flow conversion, but the dollars of capital generated is dependent on the overall market environment and the resulting impact on our fee-based businesses.

We remain focused on maintaining our capital and liquidity targets at both the life company and the holding company and will continue with a rigorous and disciplined approach to capital deployment in the current environment.

Turning to Slide 4. After the close of the reinsurance transaction, our investment portfolio remains high quality, diversified and well-positioned. Our total invested assets decreased \$23 billion, as a result of the reinsurance transaction, during the second quarter.

As we worked with the reinsurance counterparty between sign and close to identify the specific assets included in the funds withheld account, we had the opportunity to retain certain differentiated, higher-yielding commercial mortgage loans and private credit assets.

These assets fit well with the lower liquidity needs of our go-forward liabilities and increase the portfolio yield by approximately 20 basis points. As a result, the impact of the transaction on the company is reduced with RIS-Spread benefiting the most.

The higher yield is driving higher net investment income in RIS-Spread than we assumed in our guidance, benefiting net revenue and margin.

Excluding significant variances, we now expect the margin to be at the high end of our guidance range and a 5% to 10% decrease in RIS-Spread full year 2022 net revenue from 2021, due to the transaction, improved from our outlook of a 20% to 25% decline.

We're comfortable with the risk return profile of the remaining general account. The portfolio is high quality and a good fit for our liability profile.

A few other comments on our investment portfolio. The commercial mortgage loan portfolio has an average loan-to-value of 45% and an average debt service coverage ratio of 2.5x. We have a diverse and manageable exposure to other alternatives and high-risk sectors and, importantly, our liabilities are long term, and we have disciplined asset liability management.

Additional details of our investment portfolio are available in the appendix of the slides.

As many of you know, the targeted improvements for long-duration insurance contracts accounting guidance, or LDTI, goes into effect on January 1, 2023. Importantly, LDTI doesn't change our underlying

economics, free cash flow generation or our capital position, but it will have an impact on our reported financial results.

We are adopting the guidance on a modified retrospective basis, and we'll recast 2021 and 2022 financial results under LDTI, in early 2023. We're currently estimating that the transition impact from the adoption of LDTI will decrease total stockholders' equity, between approximately \$4.8 billion and \$5.8 billion, as of January 1, 2021.

Nearly all of this impact will be in AOCI and is driven by the requirement to update the discount rate assumption on impacted liabilities to the equivalent of a single A interest rate with credit ratings based on international rating standards.

As a result, LDTI is expected to have an immaterial impact to our equity and book value, excluding AOCI. Sitting here today, we expect the impact of stockholders' equity from LDTI to be immaterial as of the second quarter of 2022, as interest rates have risen, significantly, from where they were at the beginning of 2021.

Our transformation into a higher growth, higher return, more capital-efficient company focused on our growth drivers is paying off.

As of the second quarter and excluding significant variances, non-GAAP EPS increased 3%, over the year ago quarter, despite impact from the transactions and macro volatility, and ROE improved to 14.2%.

As we move forward, executing on our go-forward strategy and strengthen capital management approach, we will continue to invest in our growth drivers of retirement in the U.S. and select emerging markets, global asset management and U.S. benefits and protection, all with the aim to drive long-term shareholder value.

This concludes our prepared remarks. Operator, please open the call for questions.

Operator:

And at this time, I would like to remind everyone that to ask a question press star and then the number one on your telephone keypad. We'll pause for just a moment to compile the Q&A roster.

And our first question comes from the line of Ryan Krueger with KBW. Please proceed with your question.

Ryan Krueger: Hi, thanks, good morning. I was hoping to dig into the investment repositioning a little bit. I was trying to do some back of the envelope math, but I'll just ask to see if you can make it a little bit easier. I guess, can you just help us think about, relative to the original guidance you had given for the impact of the reinsurance transaction, how much more--or how much less of a negative impact you'd expect now, due to the repositioning actions that you took?

Dan Houston: Yeah, good morning, Ryan, good to hear your voice. Deanna, do you want to help shape that?

Deanna Strable: Yeah, I think probably the best way to shape that is to look at 20 basis point impact on a pretax basis on the \$70 billion portfolio. And that would be kind of the delta between what we originally assumed and what we receive, now.

On the prepared remarks, we did talk about the impact of spreads outlook, which is where most of that benefit will be. Now we expect net revenue to only be down 5% to 10%, much improved from the 20% to 25% that we talked about, earlier. And that would equate in spread to about \$20 million pretax per quarter of additional earnings.

Dan Houston: Does that help, Ryan?

Ryan Krueger: Yeah, it does. That's great. Thanks. And then just a follow-up on your comment on capital returns. I think you said that the guidance was based on year-end 2021 market. Are you able to frame how you're thinking about things now with markets where they are today?

Dan Houston: Deanna, please?

Deanna Strable: Yeah, thanks for the question, Ryan. Obviously, as you just reiterated, our outlook range of \$2.5 billion to \$3 billion, which included \$2 billion to \$2.3 billion of share buybacks, was based on markets, as of the end of last year.

If we look at our implied daily average sitting here today, that's about 15% lower than what we would have anticipated coming into the year, and we've also seen additional fee pressure from fixed income values.

I do think, as I sit here today and look at year-to-date financial results, I think it's a really good testament of our diversified business model, where strengths in other businesses has offset the revenue pressure that we've seen in PGI and RIS-Fee.

So I do see a path to those outlook numbers. I still feel really good about the 75% to 85% of free cash flow. Obviously, the transaction proceeds are coming in, as expected. But there is obviously still some uncertainty and where we end within the 75% to 85% and where--and what that produces as far as dollar amount of free cash flow is still going to be pretty dependent on the market and how that market plays into our fee businesses because, obviously, those sit at higher percent free cash flow, flowing into that overall company number.

And so again, like I said, I do think we're going to be disciplined in the current environment, but we're also positioned for a much higher dollar amount of capital return, this year. And just as a reminder, we'll also be using some of that capital to pay down debt in the third quarter--that's \$300 million.

And obviously, the China Pension acquisition could come into play this year, as well. So, a strong year of capital deployment, but some market uncertainty could play into the absolute dollar amount.

Dan Houston: Thanks for the questions, Ryan.

Ryan Krueger: Thanks a lot.

Operator: Our next question comes from the line of Tom Gallagher with Evercore ISI. Please proceed with your question.

Thomas Gallagher: Hey, good morning. First question just on PGI earnings. I thought those were quite strong, particularly, when compared to other asset managers. The \$150 million, would you say that's a good run rate heading into Q3

and Q4? And I realize there's an average daily level to consider 2Q versus 3Q, but I think we've covered most of that.

But I guess, my real question is, is there anything unusual in this quarter's earnings on the revenue side, like transactional revenues that may not be recurring? Or do you feel like the \$150 million is a decent baseline of earnings, here?

Dan Houston: I'll have Pat address that. Again, I would just say, Tom, appreciate the question. We did have really strong results coming out of PGI, and there's a little bit of explanation with regards to some of the fees, but I'll have Pat give you those details.

Patrick Halter: Tom, thanks for the question. And maybe the only thing I'd highlight is in the second quarter, we did have some performance fees that were noted, and I think you're aware of those. And that was, predominantly, driven by real estate transactions.

And as you know, the timing of those real estate transactions is quite variable. It kind of depends on market conditions, client demand when they want to sell, our portfolio management views of when the right time to sell.

And so, we did have some elevated performance fees in the second quarter that probably are front end loaded a little bit for the year, relative to the full year outlook to take advantage of some of the market conditions that we saw in the real estate center.

That being said, we continue to have a good pipeline of real estate transactions that I think we will be able to harvest performance fees, longer term. But probably as we look forward into the second half of the year, Tom, performance fees probably will be a little more slightly muted, as market conditions warrant, but continue to have very strong, I think, expectations for the management fee outlook.

Thomas Gallagher: And Pat, just a quick follow-up on that. Is the 39% pretax margin, you think it decent? And I think that's an ex-performance fee margin. Do you think that's a reasonable expectation for near-term results, there?

Pat Halter: Yeah, I think it is, Tom. We clearly continue to see pressures in the management fees, particularly, given the negative equity markets and the fixed income results that we saw in the first half of the year, which will put some pressure on, I think, margins.

But that being said, we are very focused on preserving margins and within a target range that we put into our outlook for the year, which was 39% to 42%. And we expect to be in that range, likely probably at the lower end of that range, but definitely are going to aspire, and our management team is focused on keeping those margins in that range.

Dan Houston: The only other thing I might add is, a lot of Pat's expenses are variable expenses, and we are, across the entire organization, aligning expenses with our estimated revenues. And so a very conscientious effort to preserve as much margin, as we possibly can.

Tom Gallagher: Okay, thanks.

Dan Houston: Thank you.

Operator: Our next question comes from the line of Jimmy Bhullar with JPMorgan. Please proceed with your question.

Jimmy Bhullar: Hi, good morning. So first, a question for Pat, just on investment performance at PGI. And it seems like it's gotten progressively worse, if you look at a 3-year, 1-year versus the 5-year and longer periods.

And wondering if you think this is because of any stylistic differences or anything more company specific? And what's the impact of this, both on PGI where you've shown very strong flows recently, but then also some of your other businesses that rely on PGI?

Dan Houston: Pat?

Pat Halter: Yeah, thanks for the question, Jimmy. So, on the 1-year numbers, we have had some, I think, performance that is in more in the third and fourth quarter, predominantly, due to our style of investing. On the equity side, it's predominantly a quality growth philosophy, in terms of

our investment approach, whereas value in cyclical, certain style of investing has performed much better.

That being said though, Jimmy, we really haven't seen a correlation between 1-year performance and net cash flow, which is really the important, I think, variable to look at. As we see, and as you look at our 3-, 5- and 10-year performance numbers, those are probably more, I think, insightful in terms of what that translates into investment net cash flow, going forward. And we continue to see very strong, I think, results in that longer-term sort of horizon.

We still have a really strong base of strategies that are competitive in the eyes of investors and desired by investors in the marketplace. We saw that in the second quarter with some of our equity capabilities, very desired in the marketplace yet.

We saw that in some of our high--sort of income-orientated capabilities. And we actually think that's continued to create momentum for us in the third quarter, Jimmy. We continue to see very strong desires for some of the things that we offer.

Real estate absolutely continues to be desired. We continue to see desirability for some of our specialty income products, and that's actually starting to accelerate in the high-yield sector and preferreds and emerging market debt. And we continue to see some of our equity capabilities continue to be desired in the marketplace.

So, our sort of solutions, our sort of broad-based capabilities, I think, are still relevant in the eyes of investors, and still feel good about the performance, delivering net cash flow that will be positive, as we look forward.

Jimmy Bhullar:

Okay. And then on fee retirement, the flows, I'm assuming you're obviously benefiting from the strong labor market and competition for talent. But are you seeing any impact from inflation? And is it affecting withdrawal rates at all? Or are you seeing any hardship withdrawals or anything else of that nature because of consumers being stretched?

Dan Houston:

That's a good question, Jimmy. And as we all know, it's a tight labor market to retain and attract talent. You have to have good benefits. And

I'm, like you, awestruck at just how strong the results are. And maybe we'll just have Chris provide some insights and perspective on the strength of the RIS-Fee business.

Chris Littlefield: Yeah, thanks, Dan, and thanks, Jimmy. Again, I think you're right. We are, definitely, benefiting from the labor markets, and the competition for talent, both low employment, higher comp, competition, and we're also seeing very strong customer retention. And we're seeing mid-teen growth in our deferrals and employee matches, above what we would normally expect.

And if we break that down, we're seeing growth in the number of our participants is up, our in-plant participant growth, those that are deferring is up. Our average deferrals, per members, are up. The number of participants receiving an employer match has increased by 10%, excluding IRT. So we're just seeing really, really strong performance from both employee deferrals, employer match increases and the benefits from the labor markets.

On the withdrawal, we definitely are seeing a bit more. a little bit elevated, but it's slight, largely due to the job changing that we're seeing and the churn a little bit in the employment market. So, that's driving a small--a slight increase in participant withdrawals, as a percent of average AV, but it's modest.

Dan Houston: Jimmy, appreciate the questions.

Jimmy Bhullar: Thank you.

Operator: Our next question comes from the line of Alex Scott with Goldman Sachs. Please proceed with your question.

Alex Scott: Hi, first one I had is just around the completion of the transaction. I know the actual, I guess, on fixed annuity transactions were completed. But are you done with the, I guess, in totality, like what you announced at the time you announced that transaction, I think some of it had to do with reserve financings and that sort of thing. So, is there anything left to do there that we should consider, as we look at your capital position?

Dan Houston: Yeah, Alex, appreciate the question. And we've talked about this, previously, and just maybe bring it full circle. The effort that went into the strategic review was really exhaustive, work with the Board of Directors and outside advisers. And we really did feel when we presented a year ago June, our go-forward strategy that we had interrogated every business, every market, every location for its ability to contribute to the long-term success, as we've framed it for you and all the other investors.

I would say any other modifications from here are on the margin around products, around markets, specifically, but the heavy lifting is, for the most part, complete and feel really good about the go-forward strategy. Deanna, any further comments?

Deanna Strable: Yeah, I think your question was really specific to the \$800 million of deployable proceeds and the timing of that. Sitting here today, we have received the majority of that. Some came in first quarter.

Most of it came up until—in second quarter up to today, and a small amount is yet to come probably later this year or maybe a little bit early, next year. And that's either sitting in Hold Co. or sitting in the life company. So, almost all of that is already in hand.

Dan Houston: To get the benefit, we already had two questions answered with one question. So, you still get a follow-up there, Alex.

Alex Scott: Thank you. I guess for the second question, in RIS-Fee, when I think about the strategy to improve margins there as you sort of bring Wells Fargo completely on, TSA fees gone now. Market's a little more volatile though. What does that look like in terms of where margins go from here?

Dan Houston: Chris?

Chris Littlefield: Yeah, thank you. Yeah, I mean, I think, as you noted, the fee businesses are certainly seeing a little bit of margin pressure. But as Deanna pointed out in her comments, we also have a spread-based retirement business. And we do look at managing those, in total, and so, when you get the offset, it's helpful.

As we think about the fee margin going forward, the macro headwinds are providing the greatest pressure to the margin performance.

And obviously, as Deanna mentioned in her comments, there's a natural lag to adjusting to the speed at which the markets moved on both equities and fixed income in the second quarter. So, we're going to be looking at really pulling revenue and expense levers to narrow the gap to the margin guidance we initially provided.

And obviously, some of that will be dependent upon market performance. We certainly have seen a better market performance to start the third quarter. So, the combination of us remaining disciplined on expenses, looking for additional revenue opportunities, as well as market, should help us close and narrow that gap to the margin guidance we originally provided.

Dan Houston: Alex, it's also probably worth noting that--and we've talked about this historically, and that is some of the value creation from the RIS-WSRS platform is captured within asset management, where we're able to get mandates for existing customers and the IRT customers. TRS benefits are captured and oftentimes, within our NQ or the Life area. And of course, the participants' rollover opportunities will show up in our mutual fund complex.

So again, I think we have to be thinking in a very comprehensive way when we think about the value of the retirement platform and where some of these benefits are accruing, within the overall organization. Hopefully, that helps.

Alex Scott: Yeah, got it. Thank you.

Dan Houston: Thank you.

Operator: Our next question comes from the line of Erik Bass with Autonomous Research. Please proceed with your question.

Erik Bass: Hi, thank you. Actually, I wanted to follow up on the RIS-Fee discussion. I was hoping you could talk a little bit more about the drivers of the year-over-year decline in normalized earnings, which were down a bit more

than the market in AUM over the same period. So I guess, was there anything unusual in expenses here? Or is that kind of \$111 million adjusted number a good baseline to think about, going forward?

Dan Houston: Chris, please?

Chris Littlefield: Yeah, sure, Erik. Certainly, the macro pressures are the biggest driver of that. There is some offset and some additional expense pressure happening from some post migration work on IRT and the Trust and Custody businesses. As you will remember, we just brought over the Trust and Custody business, at the end of February.

So, we are seeing some elevated expenses through the balance of this year, as we bring that business and get that business in our normal state. But again, we're going to be really disciplined in working to narrow that gap to the guidance we provided.

Erik Bass: Got it. Thank you. And then maybe a follow-up on just thinking about capital return, beyond the second half of 2022. And I think your plan contemplates drawing down a lot of the excess capital. So, should we think of kind of for 2023, it really being tied to your free cash flow and sort of the total payout ratio for dividends plus buybacks being in that 75% to 85% of earnings range?

Dan Houston: Deanna?

Deanna Strable: Yeah, I think that's the right way to think about it, Erik. Having said that, our 2023 reported results will be adjusted, due to LDTI. So, we'll have to understand kind of how that plays through. But yeah, that really will be the primary driver of our capital deployment, as we think beyond 2022.

Erik Bass: Got it, thank you.

Dan Houston: Thanks, Erik.

Operator: Our next question comes from the line of Tracy Benguigui with Barclays. Please proceed with your question.

Tracy Benguigui: Thank you. Could you walk through the moving parts that drove RBC changes in the second quarter where you're at 415%, and in the first quarter, you're at 400%? To what extent was this due to the amount of excess capital you're drawing down? Or did the reinsurance transaction have an impact? And if I could tag on here, if you're anticipating that your asset allocation changes could impact required capital in any way.

Dan Houston: Good questions, thanks. Deanna?

Deanna Strable: Yeah, there's a couple of moving parts there. Obviously, any of the capital changes of the portfolio would have been reflected in that RBC ratio, as of the end of second quarter. Most of the proceeds of the transactions do flow through the Life company.

And so, we did do a dividend to holdings--to holdco during the quarter, but it did not entirely offset the proceeds from the quarter. And ultimately, we'll plan to weave that back down closer to the 400% target, as we go through the rest of the year.

So it's really driven by the transaction proceeds, obviously, normal gain from operations, but any capital--the required capital needed from the change in the portfolio is reflected in that number.

Tracy Benguigui: Okay. Got it. And directionally, was it--how did that impact?

Deanna Strable: It did have some. It did require some additional capital just given the nature of those portfolio, but very manageable, within our capital levels.

Tracy Benguigui: Got it. And this doesn't affect you guys anymore because--but just because ULSG has come up as a theme this quarter, I'm just curious. Back when you were contemplating various strategic updates and you identified the ULSG block transaction, what was it about the block that got your attention? Was it changes in policyholder behavior like a dynamic lapse function, or something else? I'm just trying to get an industry perspective here.

Dan Houston: I think from my perspective, it had way more to do with the strategic direction of the company that we really didn't feel that we had a product that we would be competitive in, in the retail life insurance business. At

the same time, we had had a strong track record in the business owner executive solutions and around nonqualified deferred comp because, again, it supports our strategy of targeting small- to medium-sized businesses, and this is what they're looking for from us. So, all the other variables around what are long-term interest rates, what's the policyholder behavior, all of those things were interesting to us. But at the end of the day, it was a divestiture of a block of business that we just didn't feel that we had differentiated capabilities to go to the market. And so, maybe I'll ask Amy if she has any additional comments she wants to place there, as we contemplated that book of business. Amy?

Amy Friedrich: Yeah, Dan, I think you've done a nice job answering that question. I think one of the things that's lost a little bit of focus through this strategic review is we actually, prior to initiating the strategic review, had announced that we were going to discontinue new ULSG sales.

And so, this is something that really was, even without the extra strategic review work, was something that wasn't fitting in our portfolio, as well in terms of the future moves we needed to have, the product solutions we needed to have available to those areas that we wanted to grow. So it was, as Dan said, more of a strategic fit issue for us.

Dan Houston: Really appreciate the questions, Tracy.

Tracy Benguigui: Got it. Thank you.

Operator: Our next question is from John Barnidge with Piper Sandler. Please proceed with your question.

John Barnidge: Good morning, thank you. I know people are worried about inflation and job cuts, but group sales is rather strong across products, really. Can you maybe talk about what you're seeing in your core SMB market and maybe how that trended, as the quarter progressed?

Dan Houston: Yeah, I really appreciate that and what a great quarter and first half of the year for Amy and her team and the Group Benefits. Amy, you want to provide some insights. I think maybe, John, just to tag on to that, a little bit around what we're also seeing in the retirement space in terms

of strength in that SMB segment because, as you know, we have a disproportionate percentage of our business in that market space. Amy?

Amy Friedrich: Yeah, so, John, you've already noted great sales. Also, just not across the industry in terms of group benefits, that clearly all of us who have Group Benefits business has been benefiting from kind of that strong competition for labor.

Where I would say Principal's probably uniquely been benefiting is that with that small- to medium-sized business focus, we are seeing a sentiment emerge.

And again, you're aware that Principal does some primary research on this. So, we're starting to see some sentiment emerge that says, even if we are headed into a point where we have inflation or recessionary concerns, I would say those small business owners and midsized businesses have fought so hard for that talent.

What they're saying is, the first action I am not going to take is, I'm not going to impact wages, and I'm not going to impact employment. So, we're seeing very nice persistency in wages and employment. We're also still continuing to see some growth.

So, our indexing in that small to midsized business market, combined with the sentiment we're seeing, is really putting together some nice growth now, and we continue to see that through the future, as Deanna indicated in her comments.

Dan Houston: Chris, any comments you want to add relative to your SMB block and what you're seeing in terms of strength?

Chris Littlefield: Yeah, I mean, we're seeing strength across all plan segments. But with respect to small, medium, large and mega, we're seeing really nice momentum.

In the SMB market, in particular, we saw a really nice cash flow. We saw participant AVs up at about 5%, year-over-year. Our total contracts, our total plan numbers in the SMB space are up, and our recurring deposits in the SMB space, alone, are up about 14%.

And we have concentrations in our retirement business, I think, similar to Amy's in the professional scientific technical services segment, which is a very large portion of our retirement block, which is projected to have the second highest growth, behind health care, over the next seven years or so.

So, we feel really good about our position on the retirement side in the SMB space as well.

Dan Houston: John, do you have a follow up?

John Barnidge: Yeah, thanks, Dan. You had talked about within PGI, there had been some performance fees from real estate gains. Did gain harvesting get accelerated in the first half of the year? And is there a knock on that we should be thinking about variable investment income in the second half from that? Or could you offer maybe a look into the third quarter, since that's a one quarter asset lag? Thank you very much.

Dan Houston: I'll defer to Pat, but I would just simply say this. We think of this as being a decision that lies within our investment professionals on the timing of divestitures. And when we take full advantage of that because, ultimately, we're trying to deliver value to our investors, and without regards to the overall corporation's needs. But Pat, any further insights on the real estate profit harvesting?

Pat Halter: Yeah, thanks, John. The timing really is much more aligned with where the properties are at, their stage of development or stage of just acceptability in terms of sort of harvesting the gains off those properties.

And it's really a market condition evaluation, John, where the real estate values are, what we're actually sort of looking forward and seeing, what our clients' desires are, what our portfolio managers feel is the right time to harvest those gains.

And so, it's not, at all, a financial sort of arbitrage discussion, it's really to optimize the performance of that asset. And so, the timing is variable, and it will be dependent on market conditions and the decision-making of our portfolio managers.

Dan Houston: Thanks, John

John Barnidge: Thank you.

Operator: Our next question comes from the line of Suneet Kamath with Jefferies. Please proceed with your question.

Suneet Kamath: Hi, thanks. I just wanted to follow up on one of John's questions, I don't think you answered. Any just insights into what we should expect for VII, here in the third quarter?

Deanna Strable: Yeah, I'll make a few comments and see if Pat has anything to add. So, I think you're aware, and it really got flowed into the last question, more of our VII than probably some of our peers is driven by real estate. Obviously, prepays and other alts flow into that, as well.

I also think it's worth noting that our alts portfolio is less skewed to private equity than our peers, which does reduce the volatility of our VII.

Sitting here today, just given the lag, we could see negative VII in the second half of the year lower than our expectations. But I also think it's really critical to understand that the makeup of our portfolio does reduce the volatility, both on the upside and the downside, relative to our expected levels. But Pat, do you have anything more to add there?

Pat Halter: No, I just think the second half of 2022, obviously, macro headwinds. And as we talk to the managers, particularly in the private equity side, their current market outlook and lagging nature of the return cycle, we could see some pullback, clearly, in our alts performance and probably be below trend to what we've been seeing in the past.

Suneet Kamath: Got it. And then I guess, it was--maybe if I could just have one quick clarification on it. When you said negative, do you mean like negative relative to expectations or an absolute negative return?

Pat Halter: Negative relative to expectations.

Suneet Kamath: Got it. And then just my follow-up is on the assumption review. I know it's less of an issue for you guys, now. But anything that you're paying particular attention to, as you go through that process? And just wanted to confirm that within the retained Life block that you have, that there's no SGUL sitting in there?

Dan Houston: Good question. Deanna?

Deanna Strable: Yeah, a couple of things, there. You obviously are--we're coming up on our third quarter review since we're sitting here, today. I do think it's important to understand that it's part of the strategic review, and as we worked with third-party consultants, we did take a look at all of our actuarial assumptions. So, I think that will play into the magnitude of the changes that we'll contemplate, as we go through this review.

We obviously will be updating for current starting interest rates. So that obviously, if it stays where it is today, will have a positive impact on our actuarial balances. And then specifically to the ULSG, no, we have no remaining secondary guaranteed business, within our block.

And any impact from an assumption change on the reinsured block would be entirely offset, by a reinsurance credit. And so again, that obviously does reduce the risk in our block of business, as we go into the third quarter review.

Suneet Kamath: Okay, thank you.

Operator: Our next question comes from the line of Andrew Kligerman with Credit Suisse. Please proceed with your question.

Andrew Kligerman: Hi, good morning. Just clarifying, Deanna, based around your comments, I would assume then that from an excess capital standpoint, you want to get to the \$800 million that you had specified at your Investor Day, so draw the excess down to \$800 million?

Deanna Strable: Yeah, Andrew, that is our intent. Obviously, around the edges, whether it gets exactly to \$800 million or a range around that, obviously, things happen at the end of the quarter that you don't always understand. But

that's our desire. Obviously, if anything, greatly increases the risk from a credit perspective, we'll be prudent and disciplined relative to that. But sitting here today, that's our desire.

Andrew Kligerman: Makes sense. And along the way, from an M&A standpoint, are you seeing any acquisitions that you might be interested in? And if so, could you give a little color around that?

Dan Houston: Right now, we feel strongly, Andrew, that our organic investment is where we want to put our focus in all of our businesses. We certainly have a sort of an active pipeline of seeing and putting eyes on asset prices and all the businesses in which we do business.

But at this point in time, we do not anticipate deploying capital beyond Emerald, which is, of course, the investment in--I'm sorry, in China, with regards to our enterprise annuity build-out.

Andrew Kligerman: Got it. Thank you.

Dan Houston: Thank you.

Operator: Our next question comes from the line of Josh Shanker with Bank of America. Please proceed with your question.

Josh Shanker: Yeah, thank you very much for getting in the end. So, I'm hearing mixed things. You obviously, had an interesting commentary about the LDTI impact, prior to this quarter, and now there's a very limited impact going this quarter. There's some volatility in there. But would you be willing to spend any money on hedging merely to manage the volatility in LDTI? Or does that seem like not a useful use of your capital?

Dan Houston: I think it'd be inefficient to do so, but I'll defer to my very capable CFO to respond.

Deanna Strable: Yeah, I think you come back to that LDTI does not impact the underlying economics, free cash flow generation or capital position. We feel good about our hedging positions that we have across our portfolio and don't

feel that LDTI will impact that. I also come back to that a majority of that does sit in AOCI, that volatility.

And again, still feel that looking at equity and book value excluding AOCI is the appropriate metric, one, given the fact of the volatility there and not all assets and liabilities are running through with LDTI or mark-to-market. So we wouldn't contemplate any changes sitting here, today.

Josh Shanker: That's all I need. Thank you very much.

Dan Houston: Appreciate it, Josh.

Operator: And our next question comes from the line of Mike Ward with Citi. Please proceed with your question.

Mike Ward: Thanks, guys, just a quick one. Any update or further detail you might be able to provide on the China Construction Bank deal, potential use of capital?

Dan Houston: Yeah, so again, very much on track having sought and received the regulatory approval. There's some final steps that we're taking with CCB, itself, but definitely see this coming to close before the end of the year and feel very good about leveraging that existing relationship with China Construction Bank.

Mike Ward: Alright, thanks very much.

Dan Houston: Thank you. Appreciate it.

Operator: And we have reached the end of our Q&A. And Mr. Houston, your closing comments, please.

Dan Houston: Thank you, Operator. I appreciate that. I just want to highlight a couple of recent additions to the Principal leadership team. Teresa Hassara will work with Chris Littlefield to lead our workplace savings and retirement business. Teresa has spent the last 25 years helping shape the workplace retirement solutions and will be just a tremendous add, here at Principal.

We also want to welcome Natalie Lamarque, who has joined us as our new General Counsel. Natalie has had extensive experience and unique

experience within the industry that will provide a welcome perspective to the company. She'll also receive compliance and our government relations operations. It's wonderful to have both Teresa and Natalie join the organization.

I look forward to, and I know the other executives look forward to visiting with investors here over the next couple of weeks to answer any unanswered questions. Thank you for your time, today.

Operator:

And thank you for participating today in today's conference. This call will be available for replay, beginning at approximately 12:00 p.m. Eastern Time, until end of day, August 12, 2022. 1373-1251 is the access code for the replay. The number to dial for the replay is 877-660-6853 and that is for the U.S. and Canada, or you can dial 201-612-7415 for international callers.

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