

Principal Financial Group®

4Q 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

Jimmy Bhullar: JP Morgan

Suneet Kamath: Jefferies

Tracy Benguigui: Barclays

Erik Bass: Autonomous Research

Alex Scott: Goldman Sachs

Ryan Krueger: KBW

Josh Shanker: Bank of America

Presentation

Operator: Good morning and welcome to the Principal Financial Group fourth 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 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 fourth quarter and full year 2022 conference call. As always, materials 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 the call for questions. Others available for Q&A include Chris Littlefield, Retirement and Income Solutions, Pat Halter, Global Asset Management, and Amy Friedrich, US 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 US Securities and Exchange Commission.

Additionally, some of the comments made during this conference call may refer to non-GAAP financial measures. Reconciliation of the non-GAAP financial measures to the most directly comparable US GAAP

financial measures may be found in our earnings release, financial supplement and slide presentation.

Our 2023 outlook call is scheduled for Thursday, March 2, where we will share enterprise and business unit 2023 and longer term guidance. On Wednesday, March 1, we plan to release a recast fourth quarter 2022 financial supplement. It will include the impact of the targeted improvement for long duration insurance contract accounting guidance, or LDTI, which goes into effect with our first quarter 2023 reporting.

Dan?

Dan Houston:

Thanks, Humphrey, and welcome to everyone on the call. This morning, I will discuss the milestones we achieved in 2022 as we executed on our strategy along with key highlights from our fourth quarter and full year 2022. Deanna will follow with additional details on our fourth quarter and full year 2022 financial results, our current financial and capital position as well as an update on LDTI.

In 2021, we outlined our strategic path forward, one balanced with a focus on a higher growth, more capital efficient portfolio and a commitment to return more capital to shareholders. This guided our successful execution in 2022, despite a challenging macroeconomic environment. We have made meaningful progress towards our goals and continue to invest in our long term growth drivers of retirement, global asset management and benefits and protection.

In January, we announced an agreement to reinsure our US retail fixed annuity and universal life insurance with secondary guarantee blocks of business. The transaction closed in May and was a key milestone, reinforcing our strategic focus on continuing to evolve into a higher growth, higher return, more capital efficient portfolio while improving our overall risk profile. We delivered on our strengthened capital deployment strategy and our commitment to right size and return the excess capital that we had built up during the pandemic, with \$2.3 billion returned to shareholders in 2022 through share repurchases and common stock dividends.

We've continued to adapt to the volatile and uncertain macro environment and have taken appropriate actions to manage our expenses with pressured revenue while continuing to serve the needs of our customers, invest for growth and deliver strong total shareholder return.

Starting on Slide 2, we reported \$1.7 billion of full year 2022 non-GAAP operating earnings, or \$6.66 per diluted share. Excluding significant variances, earnings per share increased 2% over 2021, a strong result given the pressured macroeconomic environment.

As shown on Slide 3, we reported \$422 million of non-GAAP operating earnings or \$1.70 per diluted share in the fourth quarter. We ended 2022 with \$635 billion of total company managed AUM. Unfavorable equity and fixed income markets pressured AUM throughout 2022, and \$23 billion was transferred out in the second quarter as part of the reinsurance transaction.

Turning to investment performance on Slide 5, our long-term performance remained strong, particularly in our specialty fixed income strategies. The volatile markets impacted our short-term investment performance throughout 2022 as our investment style, which is focused on high-quality, growth stocks was out of favor for much of the year.

During a volatile and pressured year for asset managers, we generated a positive \$3.9 billion of full year total company net cash flow. This was \$1 billion higher than our 2021 net cash flow and included \$4.4 billion of positive PGI managed net cash flow. This was a very strong result during a period of outflows across the industry. The positive net cash flow in 2022 was driven by strong institutional flows across equities, real estate and specialty fixed income, highlighting the value of our diversified distribution through our institutional, retail and retirement channels. Fourth quarter total company net cash flow was negative \$3 billion. Net cash flow is typically negative in the fourth quarter for both PGI and RIS-Fee. Similar to other asset managers, we experienced retail platform outflows during the quarter as customers moved cash to the sidelines.

While market volatility can impact the timing of when new mandates fund, we are seeing positive momentum with our institutional clients. Early in 2023, we have meaningful commitments for several of our fixed income and special equity strategies, which are expected to fund in the first quarter. The committed pipeline for our real estate products is healthy, which will likely start funding in the second half of the year.

Turning to our growth drivers and some additional highlights for the year - in Retirement, we continued to solidify our position as a top retirement provider as we completed the integration of the IRT business in early 2022. The acquisition provides us with new capabilities, additional revenue-generating opportunities and expanded distribution relationships.

RIS-Fee contract lapses contributed to negative account value net cash flow in the quarter. The fourth quarter is typically the highest quarter for lapses as plans often change providers at the end of the year. Roughly one-third of the lapsed account value was related to a single, low-fee, large case with no Principal Managed assets. Looking ahead to the first quarter, we anticipate positive net cash flow in light of our sales pipeline.

The underlying fundamentals of the Retirement business were strong throughout 2022. Compared to full year 2021, total recurring deposits increased a very strong 26% with a 14% increase on our legacy block. This was driven by employment growth and wage inflation as well as increases in participant deferrals, company matches and higher incentive compensation.

We also saw great opportunities in the future. With the passage of SECURE 2.0, a bill for which we advocated, this legislation expands the U.S. retirement market overall, creating greater access to retirement savings plans for businesses and improving long-term savings in financial security for Americans. While it'll take time and won't have an immediate impact, we expect that the bill will drive increases in new plan formations, employer matches as well as employee participation in deferrals, all of which will help support better retirement readiness and

long-term growth in our business. We're uniquely positioned to benefit from SECURE 2.0, thanks to its focus on small and mid-sized businesses and its support for more cost-effective start-up plans. We're already leaders in this market and applaud the additional options for workers to save more for retirement.

Outside the U.S., we continue to focus on markets with compelling growth opportunities where we can leverage our local and global asset management capabilities and lean into established local partners. During the fourth quarter, we extended and strengthened our asset management partnership with CIMB in Southeast Asia. And at the end of the year, we closed our transaction with China Construction Bank Pension Management Company, acquiring a minority ownership stake in the pension company. This is expected to be immediately accretive and grow over time. Both opportunities expand our existing partnerships of more than 17 years with these market-leading wealth management, mutual fund and pension distributors.

In Global Asset Management, we continue to unify our investment footprint across more than 80 markets we serve, demonstrated by the launch of Principal Asset Management in October and increasing integration with Principal International. We continue to expand our specialty offering in 2022. As an example, our direct lending team doubled its committed capital and increased their foothold in the middle market throughout the year.

Principal Asset Management has once again been named a Best Place to Work in Money Management by Pensions and Investments. This is the 11th consecutive year we have earned this recognition, and it's a testament to the work of our employees to create a positive culture and deliver results for our customers.

In Benefits and Protection, our focus on the small to medium-sized business delivered strong results in 2022. The businesses we serve prioritize providing benefits to attract and retain employees throughout the year. Record sales, strong retention and employment growth is evident in Specialty Benefits's results. We deepened our relationships

with existing customers, attracted new customers and expanded our market share.

In Specialty Benefits, premium and fees increased a robust 11% year-over-year, exceeding the top end of our guidance range, with over half of the growth coming from net new business. Full year sales increased 19% compared to 2021 with continued strong momentum early in 2023.

Our focus on business owner and our diversified set of solutions continues to drive results in Individual Life insurance. Full year business market sales hit record levels, up 73% year-over-year. This growth included record non-qualified COLI sales. Approximately 50% of these sales were with our retirement plan customers, highlighting the value of our integrated business model.

We're delivering on our go forward strategy, transforming our portfolio businesses, resulting in a higher multiple and increased shareholder value. We have de-risked our portfolio, reduced our balance sheet risk and are less capital intensive. We have sharpened our focus on higher growth markets, investing in our business and leveraging our competitive advantages, all while returning more capital to shareholders. While 2023 presents its own challenges, we have a good line of sight and confidence in achieving our long-term financial targets.

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 and full year, our current financial and capital position as well as an update on LDTI.

Full year reported net income attributable to Principal was \$4.8 billion. Excluding income from exited business, net income was \$1.5 billion for the full year with manageable credit losses of \$48 million. Fourth quarter non-GAAP net income excluding exited business, was \$504 million with \$12 million of credit losses. As a reminder, the income from exited business is non-economic and is driven by the change in the fair value of

the funds withheld embedded derivative. Importantly, it doesn't impact our capital or free cash flow and can be extremely volatile quarter-to-quarter. We also had positive credit drift during the year, further demonstrating the quality of our balance sheet.

We reported full year non-GAAP operating earnings of \$1.7 billion, or \$6.66 per diluted share, including \$422 million or \$1.70 per diluted share in the fourth quarter. Excluding significant variances, full year non-GAAP operating earnings was \$1.7 billion or \$6.77 per diluted share. This included \$420 million in the fourth quarter or \$1.69 per diluted share.

Compared to full year 2021, we increased earnings per share 2% as the benefit from share repurchases and strong customer growth was partially offset by macroeconomic pressures on earnings.

As detailed on Slide 15, we had several significant variances that virtually offset and had a slight net positive impact on non-GAAP operating earnings during the fourth quarter. On a pre-tax basis, benefits from lower DAC amortization, higher than expected Latin American Encaje performance and favorable Brazilian inflation more than offset lower than expected variable investment income. These had a net positive impact to reported non-GAAP operating earnings of approximately \$5 million pre-tax, \$2 million after tax, and \$0.01 per diluted share. While variable investment income was positive for the quarter, we experienced lower than expected alternative investment returns, prepayment fees and real estate sales.

Macroeconomic volatility continued in the fourth quarter and pressured earnings in our fee-based businesses. The S&P 500 daily average decreased 3% from the third quarter of 2022, 16% from the fourth quarter of 2021 and 4% on a full year basis.

Relative to our 2022 outlook, the full year 2022 S&P 500 daily average was 17% lower than we expected heading into the year, and fixed income returns were approximately 18% lower. This unfavorable market performance negatively impacted AUM, account values, fee revenue, margins and earnings in RIS-Fee and PGI throughout the year.

Headwinds from foreign exchange rates pressured reported pre-tax operating earnings by a negative \$5 million compared to the fourth quarter of 2021 and a negative \$21 million for the full year. It was immaterial compared to the third quarter of 2022.

Throughout 2022, we took actions across the enterprise to manage expenses as fee revenue was pressured, as we have during previous periods of unfavorable macroeconomics. Our efforts have paid off. On a full year basis, compensation and other expenses excluding significant variances were 3% lower than 2021, and fourth quarter expenses were 8% lower than the fourth quarter of '21, despite approximately \$15 million of elevated severance and restructuring expenses across the fee-based businesses in the quarter. Some expenses naturally adjusted throughout the year like incentive compensation and other variable costs, and we took actions to reduce other expenses while continuing to balance investments for growth. As a result, we didn't see the typical 7% to 10% increase in compensation and other expenses this fourth quarter relative to the average of the first three quarters.

Turning to the business units, the following comments on fourth quarter and full year results exclude significant variances.

RIS-Fee's margin improved in the fourth quarter but ended the year below guidance as the benefit from IRT expense synergies was more than offset by unfavorable market performance, which pressured fees and net revenues throughout the year. Through the end of 2022, we've realized more than \$80 million of run rate expense synergies and are well on track to realize the full \$90 million in 2023.

RIS-Spread net revenue growth and pre-tax margin exceeded our post-transaction guidance for the full year. Favorable investment income, a benefit from rising short-term interest rates and growth in the business helped offset the impacts of the reinsurance transaction. We completed \$1.9 billion of pension risk transfer sales in 2022, including more than \$750 million in the fourth quarter. The PRT pipeline remains very strong as we head into the first quarter.

PGI's pre-tax margin was 39% for the full year and at the low end of our guidance range despite significant macro headwinds throughout the year. The overall management fee rate of approximately 29 basis points remains stable.

In Principal International pre-tax operating earnings were pressured throughout 2022 as underlying growth in the business was masked by the regulatory fee reduction in Mexico and foreign exchange headwinds. On a constant currency basis, full year pre-tax operating earnings increased 5% over 2021 with strong growth in Brazil and Chile.

In Specialty Benefits, pre-tax operating earnings and premium fees both increased the strong 11% over full year 2021. This was fueled by record sales as well as strong retention and employment growth while maintaining disciplined expense management and a stable loss ratio.

Turning to capital and liquidity, despite the volatile environment, we remain in a strong financial position heading into 2023. We ended 2022 with \$1.5 billion of excess and available capital. This is above our targeted levels as we felt it was prudent to be disciplined due to the uncertain and volatile macro environment. This included approximately \$1 billion at the holding company, \$200 million above our \$800 million target, \$425 million in our subsidiaries, and \$80 million in excess of our targeted 400% risk-based capital ratio estimated to be 406% at the end of the year. Our leverage ratio is low at 22% and within our 20% to 25% targeted range. We have the financial flexibility, discipline, and experience necessary to manage through this time of macro volatility and uncertainty.

As shown on Slide 4, we returned \$2.3 billion to shareholders in 2022, including nearly \$1.7 billion of share repurchases and more than \$640 million of common stock dividends. We also deployed \$300 million to debt reduction and approximately \$200 million towards M&A, bringing our full year capital deployments to \$2.8 billion.

In the fourth quarter, we returned more than \$400 million to shareholders with \$250 million of share repurchases and \$156 million of common stock dividends. Last night, we announced a \$0.64 common stock dividend payable in the first quarter, in line with our targeted 40% dividend payout ratio.

We remain focused on maintaining our capital and liquidity targets at both a life company and the holding company and will continue with a balanced and disciplined approach to capital deployment as we head into 2023.

Our investment portfolio is high quality and a good fit for our liability profile. The commercial mortgage loan portfolio is very high quality with an average loan to value of 46% and an average debt service coverage ratio of 2.5 times. 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 a reminder, LDTI goes into effect in the first quarter. Importantly, this 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 plan to release a recast fourth quarter supplement on March 1, the night before our 2023 outlook call. The most notable impact to total company non-GAAP operating earnings is a change to the geography of some variable annuity fees, moving the hedging related fees below the line. This will reduce our operating earnings by approximately \$60 million on an annual basis with no corresponding impact to net income, free cash flow generation or our capital position. In addition, there will be impacts to segment earnings that will largely offset at a consolidated level. More details will be shared during our upcoming outlook call.

Moving to equity, the transition impact from the adoption of LDTI will decrease total stockholders' equity by approximately \$5.3 billion as of January 1, 2021 with nearly all of the impact in AOCI. Sitting here today,

we expect the impact of stockholders' equity from LDTI to be slightly positive as of the fourth quarter of 2022, as interest rates have risen significantly from where they were at the beginning of 2021.

2022 was a transformative year for Principal as we completed the reinsurance transactions mid-year, executed on our go-forward strategy and strengthened our capital management and deployment approach. We're focused on maximizing our growth drivers of Retirement, Global Asset Management and Benefits and Protection, which will drive long-term growth for the enterprise and long-term shareholder value.

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

Operator: 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.

Our first question comes from John Barnidge with Piper Sandler. Please proceed with your questions.

John Barnidge: Thank you very much, and good morning. Other asset managers have announced employee count reductions, given lower assets. Principal always has expense discipline approach with expenses down enterprise-wide, and there was a comment about severance in the Fee business. Can you maybe talk about how you're viewing staffing levels in PGI and maybe more color on that severance in the Fee business, please?

Dan Houston: Yeah, good morning, John, good to hear from you. Just at a high level, as I said in my prepared comments, this is something we do every day, every quarter, every month, and -- to align our expenses with revenues. Again, credit goes to Pat and Kamal for their discipline within PGI. And I think what he'll talk about is not only steps we're taking in right-sizing but also places where we're investing, adding talent to build out organic capabilities to meet investor demand. So Pat, please.

Pat Halter: Yeah, John, thanks for the question.

So maybe just to kind of set the stage, as Dan mentioned, we're very focused on operating margins. And as you saw in the fourth quarter, operating margin tipped a little bit below 37%, 36.8%, which is down from the third quarter of 38.4%. And that was clearly pressured, as you highlight, in terms of the volatility, investor risk aversion and resulting in lower average AUM in terms of fee generation.

And we focus on that absolutely in a very sort of a purposeful way as we think about managing our organization. We think our management team continues to be very, very disciplined in terms of, as you suggest, expense management, and it's really aligning those revenues and those expenses. And clearly, the fourth quarter required us to align the revenue with expenses, given the challenging marketplace.

We're going to continue to be I think very focused on looking at activities that frankly are not producing growth and revenue contribution for the organization. That's our main focus in terms of our expense management proposition. I want to make sure we clearly are staying focused on client interest and serving our clients very, very well. So our teams continue to be focused on that. That is very important, but also it's very important, John, to highlight that we're continuing to make sure that we are absolutely investing and challenging our teams to invest where we can maintain long-term growth and long-term, I think, revenue for the organization.

So we're going to continue to be very focused on expense management, but we're going to be very focused also on investing in talent where we need talent and in terms of capabilities so that we continue to be relevant as investor interest shift and as capabilities shift in terms of their desires. We're going to continue to invest in our distribution, which we have, which is very important to our growth, and we're going to continue to further develop our private investment capabilities. That's very important to our growth going forward, also. So I really want to make sure that we highlight the growth centricity of what we're going to continue to do, and our management team is focused on that.

In terms of expenses, we had some severance expenses in the fourth quarter, around \$5 million of the severance expenses. For the year, our expenses were up around 2% year-over-year. And that's obviously something that we are very conscientious of to make sure that those expenses stay at a very reasonable level in terms of our ability to continue to invest for growth but continue to be very focused on margins.

Dan Houston: That help, John?

John Barnidge: It is very helpful. Thank you. And my follow-up question - exciting news in early January about the pension joint venture. Can you talk about maybe how that's going to impact your business prospects in China? Thank you.

Dan Houston: Yeah, so thanks for calling that out, John; really appreciate that. We're excited about expanding our relationship with China Construction Bank. As you know, we've had a 17-year relationship with China Construction Bank, including asset management and retail funds, so adding retirement -- and all four pillars, by the way, of the China retirement scheme is included as part of that JV. As I said in the earlier comments, the transaction will be accretive, and we look forward to deploying resources against that opportunity, and again, establishing Principal's positioning as being a global retirement player along with asset management. So, thanks for the question.

John Barnidge: Thanks for the answers.

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

Jimmy Bhullar: Hey, good morning. So first, just had a question on flows in the asset management business. If you can talk about to what extent are they being affected by the overall environment that the asset managers are facing versus maybe your performance getting a little worse over the past year? And then I had a question similarly on your outlook for flows

in the Retirement business. Obviously, this quarter Fee retirement flows were pressured because of the lapse of a large case, but what's the -- what's your outlook in terms of deferral rates matching contributions and just flows in that business in the current environment?

Dan Houston:

Well, that's a great question. I appreciate that, Jimmy, and I'll have both Pat and Chris respond. But before I do that, just maybe at a high level, I think what's interesting is the way we report -- and again, that's on us on how we do this, but it reflects the Morningstar retail funds, of which that's a minority share of our overall asset management capabilities. And we actually have very strong performance in particular around the fixed income, which as you know, is in very high demand, and Pat will cover a lot of that.

And then, secondly, just to note that, it's -- some of the most sophisticated investors out there are actually buying third quartile performance because they have confidence in the manager and the strategies themselves. And we have a very positive outlook on what's in the pipeline today and some commitments that have been made. So I know the correlation between investment performance must yield net cash flow, but I think there are instances of where you find growth strategies like ours may be a bit out of favor, and therefore, the commitments come in in spite of not having one-year performance. But a reminder, our long-term performance remains very strong. With that, I'll turn it over to Pat.

Pat Halter:

Yeah, Jimmy, maybe just to start off with sort of fourth quarter, fourth quarter always is challenging. Typically, it's a very challenging seasonal quarter. But it was even more challenging because of the investor sentiment that we experienced in the fourth quarter. It was a sentiment of basically being risk off and positioning their portfolios with a waiting of concern, concern about the Fed, concern about the path of inflation, nervousness around the economic growth and related company earnings.

So, this risk off sort of impact was amplified particularly in the mutual fund investor base, in addition to being sort of focused on accelerating their holdings for tax management reasons, which offset some of the capital gains in this period. So, we definitely saw lower sales but also elevated withdrawals in our retail mutual fund business. And we're not unique in the industry as a result of that.

We definitely have seen outflows in fourth quarter. They were in equities, predominantly, but also in fixed income. We also experienced in the fourth quarter, Jimmy, I think a slowdown in real estate for the first time in terms of new investment activity. But rest assured, we have a very deep, strong pipeline of committed capital in real estate. But given market conditions, we did not deploy as much of that new capital into the markets in the fourth quarter.

Just for framing, for net cash flow, for the full year, we continue to see a very strong net cash flow picture. And I think that's a better view of a net cash flow in terms of trends. We are very pleased to see that managed net cash flow for the year, about \$3.9 billion, Jimmy. And this is up about \$1 billion from 2021, which net cash flow of around \$2.9 billion. So we continue to see, I think, some strong longer term I think expectations toward our ability to generate net cash flow.

Dan, as he highlighted at the beginning of the year, we definitely are seeing a change in sentiment. Investor behavior is becoming I think a more sort of positive in terms of tone, both in the equity, particular in the fixed income markets. And I think one area that I think we're going to be I think quite well prepared and well I think equipped in terms of catch up is in terms of fixed income investments in the flows towards that. We have a great lineup of fixed income investments, whether it's preferred, high yield, emerging market debt, and all those fixed income investments are in the first quartile in terms of Morningstar performance on one, three and five-year basis. And I think we'll continue to see flows in the real estate debt and the private credit space where we still have I think some very strong performance.

So, I think as we kind of look forward in terms of 2023, I think we're well positioned in terms of our ability with the investment performance that we have to continue to attract capital. We'll probably see our real estate flows be a little bit more second half orientated because I think we need to have some of the catch up in valuations.

But I'll just suggest to you, Jimmy, that performance is absolutely on our focus list, but it really requires us to be more deeper when we talk about investment performance to look at the type of investments we are absolutely seeing money in motion toward. And the trend relative to that is definitely in our direction in terms of our capabilities. So very constructive -- I think we have a strong off-season lineup in terms of investment capabilities and look forward to capturing the shifts in the investor sentiment, which is quite positive at this point.

Dan Houston: Thanks, Pat. Chris, some additional highlights on RIS?

Chris Littlefield: Yeah, great. Yeah, thanks for the question, Jimmy. So I think as Dan mentioned, as we've indicated in the past, the fourth quarter is a high outflow quarter for us as plans change a lot. And similarly, we see the opposite effect in the first quarter as sales come on.

The other thing I'd note that, when we have institutional large plan flows, those can be volatile and lumpy in a quarter, both on the deposit side and withdrawal side. And we certainly saw that in the fourth quarter with that single, low fee, large plan, which was about \$3 billion in assets, none of which were managed by Principal. So, we definitely saw that volatility. I mean, I think as we've talked about it, net cash flow is one lens, but we also look at the underlying fundamentals of the business and how we're doing in earning Principal investment management mandates.

And if we look at how we're focused on profitability and driving increased revenues, we have very good trends in earning Principal Managed assets throughout 2022 across all segments. We saw significant fewer investment changes out of Principal managed investments in the fourth quarter, and we're seeing significant success winning mandates from

existing customers who came over from IRT, all of which are very healthy.

If we look at our historic strength in SMB for the full year, just looking at SMB flows, net cash flow was over \$2 billion for 2022, so also health in that core part of our market. If we look at the fundamentals, I think Dan mentioned recurring deposits where we see healthy recurring deposit trends. The number of participants deferring are up, the number of participants receiving a match are up, the average match dollars are up, and the number of participants with account value are all up, so healthy trends there. And specifically with respect to the first quarter, again, we do see seasonality. It tends to be a higher inflow quarter for us. We think that trend will continue. We expect to see positive net cash flow due to higher sales and healthy recurring deposit trends in the first quarter, so feel overall good about the overall business.

Dan Houston: Jimmy, a lot of detail there. Was that helpful?

Jimmy Bhullar: It was very helpful. Thank you.

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

Suneet Kamath: Thanks. First question, just on capital - as we think about 2023, I think, Deanna, in your comments you talked about having some prudence in terms of managing capital. But can you give us a sense of just capital return for next year, what your thoughts are and maybe couch it as a percentage of earnings? I know it's all going to change under LDTI, but maybe under the current accounting construct, if you could just help us with that.

Dan Houston: Yeah, please go ahead.

Deanna Strable: Yeah, Suneet, what I'd say is we plan to give more color on our 2023 capital deployment at Outlook, but I think you can go back to kind of what we've talked about. We continue to feel that 75% to 85% of net

income is a really good free cash flow percentage, given our portfolio of businesses and how we think about very high bars relative to organic deployment of capital. We are rolling over a slightly higher excess capital as we go into 2023, and we'll assess whether to deploy that as we go throughout the year as we get more clarity on the economic environment. So that's how I would think about it. But again, we look forward to discussing that more in early March.

Dan Houston: Suneet?

Suneet Kamath: Yeah, I did have -- just one that just jumped out at me a little bit was the LDTI disclosure. The \$60 million impact is not big for the overall company, but I think it's a decent percentage of RIS-Fee, or certainly larger than I thought. So maybe if you could just -- can you just tell us like how much of RIS-Fee earnings come from variable annuities?

Dan Houston: Deanna, please.

Deanna Strable: Yeah, that isn't something that we disclose. What I would say is, as you're aware, we have about \$9 billion in-force block of VA business. That business has consistently performed very well and contributed to our overall retirement franchise. We've always managed that on a net income basis because we knew there was some differences between the geographies of the fees and where the hedging gains and losses do.

As we went through the LDTI process, which we've been working on for many, many years, we got a better information that allowed us to split the fees between hedging and non-hedging fees. And even though there's not a consistent treatment of this across the peers, we think this is a better alignment of those fees as well as where those hedging gains and losses go.

So again, we like our VA business, it's a key part of our retirement franchise. It's performed well, given how we've managed that in a very disciplined approach. And ultimately, we continue to think that'll be a part of a contributor to our retirement franchise going forward.

You didn't ask it, but I did want to just mention the other impacts of LDTI. Even though the \$60 million is what we think is the enterprise impact, we actually do see some other impacts to operating earnings with items such as DAC. The reason that we didn't include those is they virtually offset at an enterprise level, very immaterial at an enterprise level. We do expect to see some positive impacts in RIS offset by some negative impacts in Individual Life. But we plan to give you much more clarity on that when we recast our fourth quarter supplement the night before our Outlook Call in early March.

Dan Houston: Thanks for the questions, Suneet.

Suneet Kamath: Thank you.

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

Tracy Benguigui: Thank you. I also have some capital questions. So 4Q buybacks, it came in lower than what you shared with us in the third quarter of that \$450 million range. I mean, you did say the level of buybacks would depend on market conditions, and market recovery came in later in the quarter. So, my question is should we expect a catch up in 2023 for coming in below your annual plan of \$2.5 billion to \$3 billion for the year to shareholders?

Dan Houston: Yeah, Tracy, it's a good question. Hopefully, you can appreciate, given this volatile economic environment that we're in, that this isn't a matter of conservatism; it's a matter of just being incredibly prudent and understanding how these businesses are going to perform. But with that, I'll ask Deanna to provide you with additional clarity.

Deanna Strable: Yeah, I think it's important to go back and think about the underlying market conditions that underpinned our \$2.5 billion to \$3 billion at Outlook. And as we went throughout the year, obviously, we saw equity market daily averages be 17% lower than what would've been included in that outlook, and as impactful, fixed income values were 18% lower.

And obviously, that range of \$2.5 billion to \$3 billion didn't contemplate that level of macro pressures as we went through the year.

I actually think if you fast forward and look at our full year results, \$2.3 billion to -- relative to that \$2.5 billion to \$3 billion range, and the fact that even if you just look at the excess capital in our holdco and our lifeco, which was virtually \$300 million at the end of the year, if you would've deployed that -- and again, going back to Dan's comment, given the volatility and the uncertainty on 2023, we made the decision to be prudent, we would've been at \$2.6 billion, so well within that range, despite the macro pressure that we saw through the year. And that macro pressure is on those fee businesses that have a higher level of free capital flow.

So, as we go into 2023, we're going to continue to be prudent. Obviously, as we thought about fourth quarter, I'd say our excess capital ended the year slightly higher than what we thought. But there's always timing between when you put your share buyback plans in place and when you see some of that free capital flow actually materialize during the quarter. And as you mentioned, markets were actually -- throughout the quarter got more positive toward the end.

So as we move into 2023, and we'll talk about it more on Outlook Call, we'll continue that. If things go well, there is a path to bringing down that level of excess capital. But our approach to capital deployment and capital management will be consistent with what you've seen throughout 2022.

Dan Houston: Follow up, Tracy?

Tracy Benguigui: Yeah. And just sticking with the macro, and you may touch upon this on your 2023 Outlook Call, if we enter a recession this year, even a shallow one, what type of credit risk and impairment scenarios are you thinking about? I remember back at the onset of the pandemic, you thought about \$400 million to \$800 million of losses that didn't end up materializing.

Dan Houston: Yeah, you're correct. Deanna, you want to frame that for us in terms of our outlook?

Deanna Strable: Yeah, a couple things I'll put into perspective there, Tracy. The first thing I would say is our balance sheet is different than it was when we went into the pandemic. So the first thing you saw is we did reinsure \$20 billion to \$25 billion away. And so just on a dollar amount perspective, the credit losses that we would see in the drift impact would be less relative to that.

I'd also say and point you to our investment portfolio that we gave a highlight of in our slides today. And if you look across that, you can continue to see that we have a very high quality balance sheet that is also very well fit with our liabilities as we sit here today.

We ended full year 2022 with actually positive impacts of drift and very little net income or capital gains and losses, and so a very modest impact. We'll give more color on the dollar amount for 2023, but as we sit here today, we do think it'll go back to more of a normal level, thinking that \$100 million range, but obviously very, very manageable when you think about capital. And we'll continue to make sure we update you on that as we go forward.

Dan Houston: Thanks for the questions, Tracy. We really do feel good about the quality of that portfolio. And even in a challenging time, it has truly been positioned to weather this sort of challenging environment. So appreciate the question. Next question please.

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

Erik Bass: Hi. Thank you. So, we've seen a number of companies announce layoffs recently, and it seems like more of this is coming from large employers. I was hoping you could talk about what you're seeing in terms of employment trends from your clients and how this affects your outlook for both retirement recurring deposits as well as Specialty Benefits's premiums.

Dan Houston: Yeah, I'll try to make a couple of high level comments, and then throw it over to Amy to provide -- and you may have already seen, Erik, I picked up in the Wall Street Journal a couple of weeks ago -- it was January 26, but they had actually gone back to February of 2020. And in that period of time since February of 2020, SMBs under 250 employees had actually hired 3.67 million individuals, and that was net of layoffs and quits. Likewise, on employers more than 250 employees, the large businesses if you will, they had cut net 800,000 jobs. Our focus is not on hospitality, it's not on retail; it is really around the professional businesses. And Amy is really truly one of our experts around the SMB. So, Amy, how's it impacting our business? And then maybe we'll get Chris to make a couple of comments on the retirement side, as well.

Amy Friedrich: Yeah. So you've done a nice job, Dan, talking about kind of the broad macro conditions. When we look at our block -- and again, there's going to be no surprise in this -- our block is performing really well from an employment growth perspective. So what we're seeing and what we would extrapolate to kind of the larger small business is that the sector, and Dan pointed it out, that really is holding up very strongly in terms of employment growth is that under 200 employees, under 250 employees, we're still seeing 4.8% growth in that -- employment growth in that marketplace.

So, I think our message has been small employers will keep hiring and the facts have been small employers are keeping hiring. So, when we look at that, what I'd consider sort of heading into the mid-size, it does begin to taper back just a little bit. So instead of that 4.8%, we'd see something that's closer to that 4%, 4.3% in that let's call it mid-size 200 to 1,000 employees.

Once you pop above that 1,000 employees, that is definitely where you're seeing some of the noticeable employment deterioration. Now, I would note that does skew a little bit even towards jumbo. Again, our block begins to tell us less because we just don't have as much in that segment, particularly for group benefits. But what we're seeing is, if you

hover around still those mid-sizes of having 1,000 and 2,000 employees, the impacts on employment still are not as pronounced as the ones we're seeing happening in that really, larger, jumbo marketplace.

Dan Houston: Very helpful. Chris, anything to add on the SMB space?

Chris Littlefield: Well, I mean, I think the trends are very, very similar. So, we see good growth and momentum in the small-to-mid, and we're watching for the large and jumbo markets as we head into 2023.

Dan Houston: Very good. Erik, follow-up?

Erik Bass: Dan, thank you for the color there. Just one follow-up on capital - your excess capital increased about a \$100 million quarter-over-quarter despite deploying \$600 million. That implies you generated about \$700 million in the quarter, which I think is more than a 100% of earnings. So just hoping you could talk a little bit about the drivers of the capital growth this quarter.

Dan Houston: Deanna?

Deanna Strable: Yeah, just a couple of comments -- we do tend to see a little bit better free cash flow towards the end of the year. Some of that is just more due to movement in some of our unregulated businesses and when we actually dividend up some of that capital. But again, we saw a continuation of just really good trends with all of our businesses really focused on holding the right amount of capital and only deploying capital when we could get the returns that we did.

And so, again, obviously, that -- the fourth quarter deployment did include that approximately \$200 million toward M&A. We had obviously earmarked that coming into the year and then made that -- we're very pleased to make that deployment in fourth quarter. But there is some seasonality that makes fourth quarter a little bit higher relative to free cash flow.

Dan Houston: Is that helpful, Erik?

Erik Bass: Got it. Yes. Thank you.

Operator: Thank you. Our next comes from Alex Scott with Goldman Sachs. Please proceed with your question.

Alex Scott: Hi, good morning. My first question is on the net investment income and just overall sort of sensitivity to interest rates. I know you all had disclosed some sensitivities, and it's fairly low, but there's sort of two components to that - sort of the lost earnings from AUM declining when rates go up, but then also the benefits that you get in net investment income. And the two things -- the timing may not always match up, and it struck me as a pretty strong quarter from a net investment income standpoint. So I just want to understand like how we can expect that to unfold from here? What are the underlying elements within Fee and retire -- in the Spread business in Retirement that are benefiting from rates, and to what degree should that continue as rates remain elevated?

Dan Houston: Thanks, Alex. Deanna?

Deanna Strable: Yeah, I'll make some comments and then see if Chris has anything to add relative to RIS on lines of business. So first of all, I think it is important to understand that that sensitivity that we give is a trailing 12-month basis that kind of assumes the interest rate happens kind of at the beginning. We see very obviously negative pressure on our fixed income values. That impacts our revenue in both RIS and PGI, and you kind of see that continue. And then as you start to invest some new money, you see some cash yields go up. You'll see that the benefits start to offset that to then get to a pretty muted overall impact in the trailing 12 months.

And so, again, you did see that transpire in the fourth quarter. I do think it's important, when you look at our total company net investment income and compare it to last quarter, there's kind of two dynamics I want to point out. One dynamic is obviously variable investment income was not as negative in the fourth quarter as it was in the third quarter.

And then you also, because of equity method accounting for our Brazil joint venture, the strong earnings that we saw in Brazil partially due to inflation, it's flowing through that line of business, as well. So, you need to kind of take that part out.

And then what you're getting to is you are starting to see some impact from the higher interest rates. You'll see that our new money that we're investing in is earning a higher rate. We're also, because of increase in treasury rates, you're going to see that what we're earning on cash, what we're earning on escrow and PGI is seeing some benefit from that.

I do think it's important to point out, especially in RIS, that some of that increase you see in that investment income then gets credited back out to our customers in our BC&S line. And so it doesn't fall to the bottom line as you think about that. But specifically to the bank and trust business in RIS, I think those are the businesses that are benefiting from those higher levels of interest rates. But I'll see if Chris has anything to add there.

Chris Littlefield: No, I think you captured it well. I mean, we certainly are seeing -- I think the thing to step back is we do look at RIS as a single business Fee and Spread together, particularly post IRT and the lines are blurring between Fee and Spread. And so we get the diversification benefit by managing those businesses together. The resilience of the Spread businesses with really compelling returns and the lift they get from short-term interest rates helps offset the pressure that we see from down equity markets. So, we definitely saw some rising short-term rates in Fee. We saw rising rates. We saw growth in our retained business and higher investment yields in Spread. And some of the net revenue beat was really largely macro driven, which is really strong equity performance during the quarter. The open to close was up about 7%, which helped drive overall separate account returns. So I think that's an explanation for the quarter.

Dan Houston: Very helpful. Alex follow-up?

Alex Scott: Yeah, that was very helpful, thank you. Follow-up I had, just to go back to variable annuities for a second to make sure I understand -- so when you all took a portion of the fees and moved it below the line, and considering the cost associated with some of those riders and hedging, could you unpack how you did that in terms of is it relative to attributed fees that under LDTI so you're sort of including enough fees below the line to cover the attributed fees at this point, or is there anything about that dynamic that'll be below the line that I should be thinking about, particularly as it relates to the attributed fees and how they'll compare to the actual fees that are being put below the line?

Deanna Strable: Yeah, Alex, that's exactly what you talked about. As we went through the process of LDTI, it actually allowed us to attribute the fees to how much is coming relative to the hedging cost of how we manage that business and how much of the fees are other fees more relative to the non-hedging aspects of that product.

And so again, that dollar amounts that we charge our customers for those hedging costs will move down below the line. Those are pretty stable quarter-to-quarter, and they will then more offset the hedging gains and losses that always have shown up below the line in our realized capital gains and losses.

So, it's exactly what you talked about. It had nothing to do with market value adjustments or any of those types of things that also could have arisen out of LDTI. Really, ours was really just that geography and attributed fees.

Alex Scott: Got it. Okay. Thank you.

Dan Houston: Thanks for the questions, Alex.

Operator: Our next question comes from Ryan Krueger with KBW. Please proceed with your question.

Ryan Krueger: Hi, good morning. I have a question on more on consolidated G&A expenses. Given that you took action and didn't have the normal higher seasonal 4Q expenses, I guess my question is, as we look forward into '23, should we actually expect expenses to come down from the fourth quarter run rate, given that there are I assume still some seasonal things that impacted the fourth quarter? Or is that kind of a decent level to just think about going forward?

Dan Houston: Yeah, Deanna will handle it, but I would just simply say this - we are going to continue, as I said earlier, to align our expenses with our revenues, and we don't have a crystal ball on what full '23 looks like except to say we're going to be incredibly disciplined and always look to be opportunistic about taking out expenses while at the same time making sure we don't starve the businesses and invest for growth. Maybe Deanna would like to add some additional color.

Deanna Strable: Yeah, a couple things that I'll say there - we did say in our prepared remarks that we had about \$15 million of severance and restructuring cost in the quarter. We did not identify that as a significant variance, partially because we saw, again as you mentioned, our normal fourth quarter seasonality of expenses did not materialize. And so even with those severance costs in there, our overall fourth quarter expenses actually were very aligned with what we wanted them to be. We have severance in every quarter, but obviously, it was a little bit more elevated as we go -- we went into the fourth quarter.

As I think about 2023, you have a lot of moving parts, right? One moving part is some of our incentive compensation kind of resets, and ultimately, that could have an increase in some of our expenses as we go into 2023. But having said that, we're going to continue to focus on all of our expense efforts across the enterprise. You have highlighted kind of the alignment with revenue given macro, but as you're also aware, we continue to make very good progress on the realization of our synergies in the RIS business as well as trying to manage through the stranded costs that came out of us exiting our retail fixed annuity and our ULSSG lines of business.

On both of those, we're actually in line to slightly ahead of where we thought we would be at this point. And then we again have added in the efforts to also make sure, we're aligning with the macro pressures while continuing to make the right investments to drive long-term growth. And so, it's really hard to say where macro's going to be as we go in.

We've obviously had a really good start to January. I think all we know is that we think there'll be continued volatility, and we're going to continue to do what we've done in any period of volatility and pressure is to make sure we align the expenses with revenue, whereas if you look at both fourth quarter and full year, you can see our change in comp and other is very aligned with our change in net revenue, which I think is a testament to that alignment.

Dan Houston: Hopefully that helps, Ryan.

Ryan Krueger: Thanks. Follow-up was on the investment portfolio. I appreciate all the detailed updates that you provided in the slides. I guess just on commercial mortgage loans, the LTV looks -- continues to look very favorable. Can you give any color just on to what extent you've attempted to, I guess, reappraise the portfolio and reflect potential downside to property value, maybe particularly in office?

Dan Houston: Yeah, we look at that constantly, and again, credit goes to Pat and his team, Todd Everett, for having really put together a very competitive and high quality commercial portfolio. Pat, additional color?

Pat Halter: Yeah, Ryan, great sort of follow-up question, I think from a bottom up perspective, we are absolutely always interrogating our commercial mortgage portfolio and in our fixed income portfolio to make sure that we really understand what the macroeconomic environment is doing to each one of our investments. So we have a very disciplined bottom up perspective to both our fixed income and our commercial mortgage portfolio relative to its position and resilience to what we believe would be a recession environment for 2023.

But we also do a top down sort of model sort of stress analysis of our portfolio, and on both sides of the analysis, both the bottom up and the top down, our commercial mortgage portfolio continues to hold up very, very well, Ryan. And you highlighted some of the material that we already provided, but we continue to see very strong resilience in terms of the income durability of the investments we have in commercial mortgages.

The area that you would imagine we take extreme sort of I think vigilance on right now is our office portfolio. We have about 100 loans for about \$3.5 billion in our office portfolio. But even there, as we do our sort of bottom up and our top down analysis, our office portfolio has a 52% loan-to-value, debt service coverage about 2.7 times, it's 90% occupied; that continues to hold up quite well.

But as you can imagine, we're doing again, a lot of bottom up on scenario analysis on tenant rollover, lease maturities, how much some of the properties are giving back space to the markets. And that will continue to be a very strong vigilance for us as we go into 2023, but we're not seeing any sort of major problems surface yet in terms of our overall portfolio or in that office part of our portfolio, Ryan.

Dan Houston: Thanks, Pat.

Ryan Krueger: Thank you.

Dan Houston: Thank you, Ryan. Appreciate the question.

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

Josh Shanker: Yes, thank you very much. Just following up a little bit on Jimmy's question, I understand that a lot of the assets in the portfolio are institutional and not rated by Morningstar, but you've probably done a lot of work on the retail side. Can you talk about how quickly from the

moment you get great Morningstar results, you see funds flow in, and to the extent when the results aren't as strong, retail funds flow out?

Dan Houston: I wish it were easier than it is, because as mentioned, Josh, we actually have some third quartile performance that's seeing large net cash flow and new sales a lot of attention. So, the correlation sometimes is very difficult. You'd think they'd be highly correlated, but the reality is they're not necessarily correlated, and a lot has to do with what's in favor at any given time. But, Pat, you can clean that up for me.

Pat Halter: Yeah, Josh, clearly, Morningstar benchmarking is utilized to inform advisors, gatekeepers, individuals in terms of how well our capabilities and our strategies are doing relative to other investment managers. But it's more complicated than that because decision makers, gatekeepers are really looking at not just the one year performance; they're looking at three year, five year, since inception performance. They're also looking at things such as the investor style, the approach they take in terms of their actual investment portfolio, pricing in the portfolios. In terms of portfolio construction, there's a lot of other things that multi-strategy solution providers look at outside of performance in terms of diversification to their overall mix of performance.

So, it's much more nuanced in terms of just performance relative to the movement of capital toward a capability, away from a capability. And as Dan mentioned, there really is no sort of direct correlation between a timeframe as to when a Morningstar rating is X versus Y in terms of a net cash flow. It's informative for us to have that because it's very important in the eyes of advisors to continue to evaluate our sort of capabilities, but it doesn't have a direct correlation as you suggest.

Dan Houston: Quick follow-up, Josh?

Josh Shanker: Yeah, on the institutional fixed side, are you seeing any changes in the strategies that you're winning mandates for, given views about recession or given views about inflation or whatnot? Have these styles that you engage in change on the fixed side?

Pat Halter: Yeah, it's really great sort of follow-up, too. We're seeing on the fixed income side some real strong interest, particularly right now other blocks and 2023 and high yield. We're seeing also a pivot again toward the emerging market debt space, and we continue to see private debt, private credit interests from institutional investors. So institutional investors are engaged in fixed income in a very clear, purposeful way right now. And I think we'll continue to see very long-term trends from institutional investors towards alternative investment classes, including real estate and including the debt capabilities in the private space.

Josh Shanker: Thank you very much.

Dan Houston: Thanks, Josh.

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

Dan Houston: Yeah, thanks for joining the call today, and again, apologies for those in the queue that we did not have a chance to get to. Humphrey and his team will follow-up accordingly. From our perspective, 2022 was a transformative year. We de-risked our portfolio, reduced the balance sheet, and our businesses are less capital intensive than they've been historically. We'll continue to focus on investing in our growth drivers, managing our expenses and revenues and returning excess capital to shareholders. We'll share more about our 2023 outlook and long-term guidance on the March 2 outlook call. Thank you for taking time out of your valuable day to be part of this Q&A. Thanks so much.

Operator: Thank you for participating in today's conference call. This call will be available for replay beginning at approximately 12:00 PM Eastern Time until end of day March 23, 2023. 13735216 is the access code for the replay. The number to dial for the replay is 877-660-6853 for U.S. and Canadian callers or 201-612-7415 for international callers.

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