

# Quarterly Commentary

Ticker	Inv Manager or Sub-Advisor	Benchmark	Morningstar Category	Investment Objective
PRWLX	Principal Global Investors	MSCI - EAFE Index NDTR D	Foreign Large Blend	Foreign Stock

## Economy & Market Overview

During the fourth quarter, equities markets rebounded globally from the prior quarter's extremely weak performance, though not enough to fully recover from their third-quarter losses. Interestingly, while it was generally accepted that excess debt among developed nations drove the third-quarter sell-off,<sup>1</sup> the fourth-quarter rebound had no clear spark to trigger the upward move (though improving fundamentals in the U.S. could have helped initiate the rally).

Europe remained in a state of crisis during the quarter as its countries' governments worked to plot a course out of the excess leverage of Greece, Portugal, Italy, Ireland and Spain. However, obstacles continued to obstruct progress. The key issue to be resolved was determining who should be responsible for the losses incurred by the banking sector when the write-offs of sovereign debt occur. In terms of Greece, Ireland and Portugal, their debt already is far in excess of their ability to pay. Greece has an agreement to write down its debt by 50%, and when some of the covenants are taken into account, the write-off is closer to 70-75%.<sup>2</sup> Should similar write-downs from other nations occur, the losses to the European banking system could wipe out most (if not all) of the banks' capital base. While Germany has argued that recapitalization of the banking system is the responsibility of each individual nation, countries such as France, Spain and Italy likely can't afford the additional liability. The question of where the capital will come from continues to be a major overhang on the markets. It is particularly so in the currency markets, where the U.S. dollar has rallied 10% against the euro since summer 2011.

In the U.S., Congress's debt ceiling stand-off earlier in 2011 has faded from immediate focus. However, it hasn't gone away and likely will play a significant role in the political debates leading to the November elections. For the time being, focus has shifted to economic fundamentals, which have shown some improvement. Third-quarter GDP came in at 1.8%;<sup>3</sup> while not a strong growth report, it is nowhere near recession level. Similarly, corporate earnings continued to increase, exceeding analysts' expectations and leading to a drop in unemployment from 9.4% in December 2010 to a revised 8.7% in November 2011.<sup>4</sup> Consumers responded with heightened interest in spending, as reflected by a 4.1% increase in holiday sales for 2011 vs. 2010.<sup>5</sup>

For the quarter, U.S. equities returned 12.1%, with small-cap stocks outpacing large-caps. Value stocks performed better than growth due in part to a rally in financials (the largest sector within the Russell 3000 Value Index). The strong fourth-quarter performance bumped U.S. equities to a positive 1.0% return for the year.<sup>6</sup> Meanwhile, international equities delivered 3.7% for the quarter and were down -13.7% for the year.<sup>7</sup>

As risk aversion abated, fixed income generally underperformed stocks for the quarter. Interest rates rose initially, reaching nearly 2.40% in late October, but ended up falling modestly from 1.91% to 1.88% at quarter-end. The 2-year U.S. Treasury yield fell from 0.25% to 0.24%, leaving the shape of the yield curve roughly unchanged from the prior quarter.<sup>8</sup> At its December meeting, the Federal Reserve decided to maintain its current target range for the federal funds rate at 0.00% to 0.25%, stating that economic conditions are "likely to warrant exceptionally low levels for the federal funds rate at least through mid-2013."<sup>9</sup> This assurance is likely to anchor the short end of the yield curve.

With risk back in favor, high-yield corporate bonds led U.S. fixed income with an absolute return of 6.46% for the quarter.<sup>10</sup> Commercial mortgage-backed securities also performed very well, outpacing duration-adjusted Treasuries by 2.49%.<sup>11</sup>

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## Performance Contributors

### Positive Contributors

#### During last quarter:

Portfolio relative outperformance was driven by stock selection. On a sector basis, stock selection was positive in energy and financials. In energy, Royal Dutch Shell reported strong third-quarter results, with stronger liquid natural gas trading profitability aiding net income. In financials, Swedbank AB (a pure retail bank in Sweden) benefited from being strongly capitalized and well-funded in a strong sovereign. Also, Prudential (UK) continued to show solid growth in Asia and was relatively less exposed to Europe. On a country basis, stock selection was positive in the U.K., where holdings in Imperial Tobacco Group and British American Tobacco continued to outperform due to strong free cash flow generation and generous shareholder remuneration.

#### During last 12 months:

Over the 12-month period, the portfolio experienced strong relative performance driven by stock selection, particularly in financials and telecommunications services. In financials, the portfolio benefited from defensive positioning in European financials (with a skew toward Nordic and U.K. banks and non-life insurance companies). In telecommunications services, NTT DoCoMo benefited from better revenue trends in its Japanese wireless operations, and Vodafone outperformed as it refocused its operations and increased cash returns to shareholders. On a country basis, stock selection was positive in the U.K; holdings in Imperial Tobacco Group and British American Tobacco continue to outperform due to strong free cash flow generation and generous shareholder remuneration.

### Negative Contributors

#### During last quarter:

Stock selection in the materials sector detracted from performance. Holdings in IAMGOLD Corp and Kinross Gold Corp weighed on performance as gold prices declined from the early September highs of around \$1900 /oz. to end the year at around \$1565 /oz. Stock selection in the technology sector also detracted from performance. Holdings in Taiwanese technology firms Largan Precision and Catcher Technology suffered from profit-taking as well as pricing pressure on components manufactured for tablet computers and smart phones. Additionally, stock selection in Hong Kong negatively impacted results. SJM Holdings (a casino operator in Macau) underperformed as indicators for future revenues began to soften.

#### During last 12 months:

Stock selection in France contributed negatively to performance; about half of the underperformance was attributable to Alcatel-Lucent; a restructuring of the company failed to deliver the hoped for improvement in profits (the position was sold during 2011). Also, stock selection in the consumer discretionary sector detracted from performance; Faurecia and Tata Motors were the main detractors. Faurecia (a French auto components supplier) is at risk from likely production cuts at the original equipment manufacturers as European auto demand is likely to decline. On a country basis, stock selection in Australia detracted from results, primarily within commodities (including stocks such as Rio Tinto and BHP Billiton), which underperformed the banks, where the portfolio was underweight.

#### Changes to the investment option's structure or portfolio:

No material changes occurred in the portfolio structure.

# Diversified International Fund (A)

## Performance

*Investment results shown represent historical performance and do not guarantee future results. Investment returns and principal values fluctuate with changes in interest rates and other market conditions so the value, when redeemed may be worth more or less than original costs. Current performance may be lower or higher than the performance data shown. The gross fund expense figure does not reflect any waivers or caps on the mutual fund. Performance shown reflects the application of net expenses of the fund. For more performance information, including most recent month-end performance, visit [principalfunds.com](http://principalfunds.com), or contact your financial representative of The Principal.*

*In situations where the net and gross fund expense figures are different, the investment manager has contractually agreed to limit the investment option's expense. Differences may also be shown due to the investment manager choosing to pay certain expenses that would normally be payable by the fund. The gross fund expense figure does not reflect any waivers or caps on the mutual fund. Performance shown reflects the application of net expenses of the fund.*

Average Annual Total Returns (%) as of 12/31/2011	QTR	YTD	1 Year	3 Year	5 Year	10 Year	Since Inception	Inception Date	06/28/2005
Diversified International Fund (A) (excl. sales charge)	5.22	-11.64	-11.64	8.04	-4.94	4.89	2.09	Ext. Perf. Inc. Date	12/06/2000
Diversified International Fund (A) (incl. sales charge)	-0.60	-16.49	-16.49	6.03	-6.01	4.30	1.57	Total Inv. Exp Gross	1.53
MSCI - EAFE Index NDTR D	3.33	-12.14	-12.14	7.65	-4.72	4.67	-	Total Inv Exp Net	1.53
Foreign Large Blend Category	4.48	-13.97	-13.97	7.79	-4.65	4.00	-	Waiver Date	-
Morningstar Percentile Ranking	-	-	21	48	56	29	-	Contractual Cap Date	-
Total Funds in Category	852	817	817	737	563	317	-	Contingent Deferred Sales Charge	-
								Maximum Up-front Sales Charge	5.50

These calculated returns reflect the historical performance of the oldest share class of the fund, adjusted to reflect a portion of the fees and expenses of this share class. For time periods prior to inception date of the fund, predecessor performance is reflected. Please see the fund's prospectus for more information on specific expenses, and the fund's most recent shareholder report for actual date of first sale. Expenses are deducted from income earned by the fund. As a result, dividends and investment results will differ for each share class.

## Diversified International Fund (A)

### Statistics Summary as of 12/31/2011

	Risk and Return Statistics Summary						Upside/Downside Capture Ratio					
	Alpha	Beta	R2	Sharpe Ratio	Info Ratio	Std Dev	# of Months		Avg Returns %		Benchmark %	
							Up	Down	Up	Down	Up	Down
	3 Year						3 Year					
Diversified International Fund (A)	0.61	0.97	95.73	0.45	0.08	22.59	18	18	6.46	-4.16	98.60	96.88
MSCI - EAFE Index NDTR D	N/A	N/A	N/A	N/A	N/A	N/A	17	19	6.55	-4.30	100.00	100.00
	5 Year						5 Year					
Diversified International Fund (A)	0.05	1.02	96.05	-0.15	-0.05	23.49	29	31	5.16	-5.19	103.38	103.17
MSCI - EAFE Index NDTR D	N/A	N/A	N/A	N/A	N/A	N/A	29	31	4.99	-5.03	100.00	100.00

Risk and return statistical data is calculated by Morningstar, Inc. Please see Important Notes section for definitions of Risk and Return Statistics.

### Top Ten Holdings as of 11/30/2011

Security	Net Assets (%)
Royal Dutch Shell PLC Class B	1.60
Vodafone Group PLC	1.54
Nestle SA	1.50
Total SA	1.28
Novartis AG	1.26
British American Tobacco PLC	1.22
BG Group PLC	1.17
Roche Holding AG	1.16
HSBC Holdings PLC	1.11
Rio Tinto Ltd	1.08
<b>Total % in Top 10</b>	<b>12.92</b>

Information is current as of the date noted. Keep in mind that all current and future portfolio holdings are subject to risk.

## Diversified International Fund (A)

Manager(s)	Start Date	Degree	Alma Mater
Paul H. Blankenhagen	12/22/2003	M.S.	Drake University
Juliet Cohn	06/14/2004	B.S.	Trinity College

### Fund Strategy

The investment seeks long-term growth of capital. The fund invests primarily in equity securities of companies domiciled in any of the nations of the world, including those in countries with emerging markets. It has no limitation on the percentage of assets that are invested in any one country or denominated in any one currency, but the fund typically invests in at least 30 countries.

### About Principal Global Investors

Principal Global Investors managed \$47.8 billion in global equity assets as of December 31, 2010. The firm's capabilities encompass large-cap, mid-cap and small-cap stocks in developed and emerging equity markets worldwide. Principal Global Investors draws on a unified investment philosophy focused on independent fundamental research and superior stock selection. Principal Global Investors is a member of the Principal Financial Group®.

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The value of the investment options will fluctuate so that when redeemed, shares or units may be worth more or less than the original cost.

Returns shown for periods of less than one year are not annualized. All returns displayed here are after Total Investment Expense of the investment option. Any operating expenses of a mutual fund or underlying mutual fund that are part of net Total Investment Expense are obtained from the mutual fund's most recent prospectus. The operating expenses shown as part of the Total Investment Expense include voluntary expense limits and fee credit.

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International and global investment options are subject to additional risk due to fluctuating exchange rates, foreign accounting and financial policies, and other economic and political environments.

These calculated returns reflect the historical performance of the oldest share class of the fund, adjusted to reflect a portion of the fees and expenses of this share class. For time periods prior to inception date of the fund, predecessor performance is reflected. Please see the fund's prospectus for more information on specific expenses, and the fund's most recent shareholder report for actual date of first sale. Expenses are deducted from income earned by the fund. As a result, dividends and investment results will differ for each share class.

MSCI - EAFE Index NDTR D is listed for foreign stock funds (EAFE refers to Europe, Australia, and Far East). Widely accepted as a benchmark for international stock performance, the EAFE Index is an aggregate of 21 individual country indexes.

Extended Performance Inception Date (Ext. Perf. Inc. Date) - Inception date of the oldest share class of the fund, or underlying fund of the Separate Account.

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## Important Notes

### **Risk and Return Statistics:**

**Alpha** - The difference between an investment's actual returns and its expected performance, given its level of risk (as measured by beta).

**Beta** - An investment's sensitivity to market movements.

**R-squared** - Ranges from 0 to 100 and reveals how closely an investment's returns track those of a benchmark index.

**Standard Deviation** - Measures how much an investment's returns are likely to fluctuate.

**Sharpe Ratio** - Measures how an investment balances risks and rewards. The higher the Sharpe ratio, the better the investment's historical risk-adjusted performance.

**Information Ratio** - A risk-adjusted measure commonly used to evaluate an active manager's involvement skill. It's defined as the manager's excess return divided by the variability or standard deviation of the excess return.

<sup>1</sup> "U.S. Stocks Tumble, Capping S&P 500's Worst Quarter Since 2008," [businessweek.com](http://businessweek.com), October 1, 2011; [businessweek.com/news/2011-10-01/u-s-stocks-tumble-capping-s-p-500-s-worst-quarter-since-2008.html](http://businessweek.com/news/2011-10-01/u-s-stocks-tumble-capping-s-p-500-s-worst-quarter-since-2008.html)

<sup>2</sup> "A Voluntary Greek Debt Deal?", Matina Stevis, WSJ Blogs, December 30, 2011; [blogs.wsj.com/brussels/2011/12/30/a-voluntary-greek-debt-deal](http://blogs.wsj.com/brussels/2011/12/30/a-voluntary-greek-debt-deal)

<sup>3</sup> U.S. Dept. of Commerce, Bureau of Economic Analysis, December 22, 2011; [bea.gov](http://bea.gov)

<sup>4</sup> U.S. Dept. of Labor, Bureau of Labor Statistics Economic News Release, January 6, 2011; [bls.gov/news.release/pdf/empsit.pdf](http://bls.gov/news.release/pdf/empsit.pdf)

<sup>5</sup> National Retail Federation

<sup>6</sup> Russell family of indexes

<sup>7</sup> MSCI ACWI ex-U.S. Index

<sup>8</sup> Source: FactSet

<sup>9</sup> U.S. Federal Reserve Press Release, December 13, 2011; [federalreserve.gov](http://federalreserve.gov)

<sup>10</sup> BarCap High Yield Index: FactSet

<sup>11</sup> Barclays Capital Point

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## Important Notes

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