

Quarterly Commentary

Ticker	Inv Manager or Sub-Advisor	Benchmark	Morningstar Category	Investment Objective
PRRAX	Principal Real Estate Inv	MSCI US REIT Index	Real Estate	Speciality - Real Estate

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,¹ 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%.² 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%;³ 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 2011.⁴ Consumers responded with heightened interest in spending, as reflected by a 4.1% increase in holiday sales for 2011 vs. 2010.⁵

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.⁶ Meanwhile, international equities delivered 3.7% for the quarter and were down -13.7% for the year.⁷

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.⁸ 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."⁹ 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.¹⁰ Commercial mortgage-backed securities also performed very well, outpacing duration-adjusted Treasuries by 2.49%.¹¹

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Performance Contributors

Positive Contributors

During last quarter:

Underweights to suburban office owners Commonwealth REIT, Mack-Cali Realty and Corporate Office Properties Trust contributed positively to performance. (Many suburban owners registered negative returns, hampered by slack fundamentals and a continued weak financing market for suburban properties.) Decisions to overweight owners of data centers and technology-related office space in the U.S. also aided results; specifically, overweights to Digital Realty Trust and Dupont Fabros Technology outperformed as demand-drivers appeared to be less correlated with overall economic conditions. Strategic overweights to Host Hotels, Starwood Hotels & Resorts and LaSalle Hotel Properties proved beneficial; the hotel sector rallied as the result of improving U.S. economic conditions, easing of eurozone default concerns and attractive valuations.

During last 12 months:

Simon Property Group, the portfolio's largest single stock overweighting, recorded strong index-relative outperformance. This high-quality owner of regional mall properties benefited from a strong balance sheet, stable properties and strong operations within their outlet center portfolio. Stock selection within the office sector also added to performance, particularly overweight positions in owners of central business district office buildings and data centers. Overweights to Boston Properties and Digital Realty Trust contributed positively, as the companies outperformed the index. Underweighting Corporate Office Properties Trust (a suburban office owner specializing in leasing space to government agencies and defense contractors) proved beneficial as widespread concern over cuts in defense spending, and slow-to-lease development projects, caused the stock to come under pressure.

Negative Contributors

During last quarter:

The largest detractor to performance was the portfolio's position in mortgage real estate investment trust Annaly Capital Management. Annaly has benefited from stable prices and good yields in the past, but underperformed as investors showed more interest in riskier assets. Overweighting the apartments sector also modestly weighed on relative performance; although apartment companies delivered strong recent performance, some investors began to become concerned that robust fundamentals may show signs of slowing in future periods. Additionally, a position in Corrections Corp. of America (a non-index security that owns and operates privatized correctional and detention facilities in the U.S.) underperformed as investors speculated that decreases in government spending would impact future cash flows.

During last 12 months:

Overweighting global warehouse Prologis detracted from results due to material portfolio exposure in Europe as well as aggressive plans for developing new properties in the coming year. The stock came under pressure as investors reexamined their expectations for the company's leasing and development profile. Overweight positions in realty service companies CB Richard Ellis and Jones Lang LaSalle also detracted. These companies' revenue streams primarily depend on sales/leasing commissions; as these payments are variable, stock prices of these companies can be volatile during economic uncertainty. Additionally, overweighting hotel owners detracted from index-relative performance. Hotels also are among the most economically sensitive real estate sectors; investors' belief that economic weakness could crimp both personal and business travel led to the sector's recent sharp sell-off.

Changes to the investment option's structure or portfolio:

No material changes occurred in the portfolio structure.

Real Estate Securities 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, 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
Real Estate Securities Fund (A) (excl. sales charge)	15.69	8.70	8.70	19.96	-0.99	11.32	11.24	Ext. Perf. Inc. Date	12/06/2000
Real Estate Securities Fund (A) (incl. sales charge)	9.32	2.71	2.71	17.71	-2.10	10.69	10.67	Total Inv. Exp Gross	1.45
MSCI US REIT Index	15.28	8.69	8.69	21.55	-1.51	10.16	-	Total Inv Exp Net	1.45
Real Estate Category	14.79	7.51	7.51	21.67	-2.20	9.16	-	Waiver Date	02/29/2012
Morningstar Percentile Ranking	-	-	38	71	23	15	-	Contractual Cap Date	02/29/2012
Total Funds in Category	258	242	242	212	192	105	-	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.

Real Estate Securities 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					
Real Estate Securities Fund (A)	0.02	0.91	99.05	0.76	-0.40	29.53	22	14	7.04	-6.24	94.06	96.05
MSCI US REIT Index	N/A	N/A	N/A	N/A	N/A	N/A	22	14	7.49	-6.49	100.00	100.00
	5 Year						5 Year					
Real Estate Securities Fund (A)	-0.32	0.90	98.96	0.08	0.11	30.72	32	28	6.48	-6.73	93.71	94.61
MSCI US REIT Index	N/A	N/A	N/A	N/A	N/A	N/A	32	28	6.92	-7.11	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 (%)
Simon Property Group Inc	12.94
Public Storage	6.91
Boston Properties Inc	5.95
Equity Residential	5.87
Vornado Realty Trust	4.86
AvalonBay Communities Inc	4.57
Digital Realty Trust, Inc.	4.36
Host Hotels & Resorts Inc	4.08
HCP Inc	3.92
Ventas Inc	3.66
Total % in Top 10	57.12

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

Real Estate Securities Fund (A)

Manager(s)	Start Date	Degree	Alma Mater
Kelly D. Rush	12/06/2000	M.B.A.	University of Iowa
Matt Richmond	09/16/2010	M.B.A.	University of Iowa

Fund Strategy

The investment seeks to generate a total return. The fund normally invests at least 80% of net assets in equity securities of companies principally engaged in the real estate industry, which include real estate investment trusts and companies with substantial real estate holdings such as paper, lumber, hotel and entertainment companies. It is non-diversified.

About Principal Real Estate Inv

Principal Real Estate Investors, which is the dedicated real estate group for Principal Global Investors, managed \$34.7 billion in commercial real estate assets as of December 31, 2010. The firm's capabilities include commercial mortgage-backed securities, real estate equity securities and a broad range of private-market real estate equity and debt alternatives. Principal Real Estate Investors is the fourth largest institutional real estate manager in the United States, based on tax-exempt assets under management (Pensions & Investments, September 10, 2010 issue; Out of 87 managers profiled, as of June 30, 2010).

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Principal Funds is a leading provider of mutual fund solutions for individual investors and retirement plans, with approximately \$68.9 billion in mutual fund assets under management (as of December 31, 2011). Principal Funds has special expertise in providing asset allocation solutions, and is the 4th largest manager of lifecycle funds in the nation based on target-date and target-risk mutual fund assets under management (according to Financial Research Corporation, as of September 30, 2011). Principal Funds are distributed through a nationwide network of independent financial professionals affiliated with brokerage and financial planning firms.

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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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Real estate investment options are subject to some risks inherent in real estate and Real Estate Investment Trusts, such as risks associated with general and local economic conditions.

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 US REIT Index is a capitalization-weighted benchmark index of most actively traded Real Estate Investment Trusts (REITs), designed to measure real estate performance.

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.

¹ "U.S. Stocks Tumble, Capping S&P 500's Worst Quarter Since 2008," 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

² "A Voluntary Greek Debt Deal?", Matina Stevis, WSJ Blogs, December 30, 2011; blogs.wsj.com/brussels/2011/12/30/a-voluntary-greek-debt-deal

³ U.S. Dept. of Commerce, Bureau of Economic Analysis, December 22, 2011; bea.gov

⁴ U.S. Dept. of Labor, Bureau of Labor Statistics Economic News Release, January 6, 2011; bls.gov/news.release/pdf/empsit.pdf

⁵ National Retail Federation

⁶ Russell family of indexes

⁷ MSCI ACWI ex-U.S. Index

⁸ Source: FactSet

⁹ U.S. Federal Reserve Press Release, December 13, 2011; federalreserve.gov

¹⁰ BarCap High Yield Index: FactSet

¹¹ Barclays Capital Point

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Important Notes

This report is not complete unless all pages, as noted below, are included.

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