

# Quarterly Commentary

Ticker	Inv Manager or Sub-Advisor	Benchmark	Morningstar Category	Investment Objective
PLLAX	Principal Global Investors	Russell 2000 Index	Small Blend	Small Company

## 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>

**Not FDIC or NCUA insured**

May lose value • Not a deposit • No bank or credit union guarantee  
Not insured by any Federal government agency

### Performance Contributors

#### Positive Contributors

##### During last quarter:

Stock selection in the industrial and energy sectors contributed positively. Among industrial holdings, RSC Holdings was a strong performer; its shares were up sharply on news that this equipment rental company would be acquired by competitor United Rentals. Within energy, the portfolio primarily held oil-related companies, which rebounded from previous quarters along with the price of crude oil. The insurance industry aided performance as well, led by Delphi Financial Group; the firm's shares were up sharply on news that this specialty insurer would be acquired by Tokio Marine Holdings.

##### During last 12 months:

Stock selection in the information technology, consumer discretionary and industrial sectors benefited the portfolio. Among information technology holdings, Liquidity Services was the top contributor; shares of this business-to-business web site reported solid results throughout the year. Within consumer discretionary, Polaris Industries added the most value; its off-road vehicles continued to dominate that market. RSC Holdings was the lead contributor in industrials; its shares were up sharply on news it was being acquired by a competitor.

#### Negative Contributors

##### During last quarter:

Stock selection in consumer finance and retailers detracted the most from performance. Within consumer finance, the portfolio's holdings in pawn and consumer lenders were weak on concerns that their growth rates may be peaking and regulatory scrutiny could increase. Among retailers, both footwear retailers and food retailers were a source of weakness for the portfolio. While consumer demand remained strong for footwear, the portfolio's holdings in DSW and Finish Line retreated somewhat from their strong gains in previous quarters. Among food retailers, the portfolio held and subsequently sold The Fresh Market; shares were weak after the company reported disappointing profit margins because its retail prices failed to keep up with rising wholesale prices.

##### During last 12 months:

Stock selection in the health care sector detracted from results. Among health care holdings, Gentiva Health Svcs and HealthSouth detracted amid worries about reduced Medicare reimbursement rates in the face of the federal government's budget crisis and corresponding Budget Control Act. Additional weakness in health care came from the portfolio's holdings in biotech and pharmaceuticals companies, which were weak due to disappointing product announcements. Also hindering performance was the portfolio's exposure to real estate investment trusts (REITs) that own hotels; these REITs underperformed on concerns that global economic conditions would adversely impact business and leisure travel.

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

No material changes occurred in the portfolio structure.

## SmallCap Blend 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
SmallCap Blend Fund (A) (excl. sales charge)	17.97	-2.17	-2.17	13.39	-1.47	4.50	5.23	Ext. Perf. Inc. Date	12/06/2000
SmallCap Blend Fund (A) (incl. sales charge)	11.48	-7.54	-7.54	11.26	-2.58	3.91	4.70	Total Inv. Exp Gross	1.56
Russell 2000 Index	15.47	-4.18	-4.18	15.63	0.15	5.62	-	Total Inv Exp Net	1.56
Small Blend Category	15.25	-4.07	-4.07	16.77	0.16	5.96	-	Waiver Date	02/29/2012
Morningstar Percentile Ranking	-	-	35	86	77	78	-	Contractual Cap Date	02/29/2012
Total Funds in Category	672	650	650	580	485	296	-	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.

## SmallCap Blend 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					
SmallCap Blend Fund (A)	-1.21	0.94	98.73	0.64	-0.72	23.92	24	12	5.73	-5.70	91.40	94.17
Russell 2000 Index	N/A	N/A	N/A	N/A	N/A	N/A	22	14	6.27	-6.06	100.00	100.00
	5 Year						5 Year					
SmallCap Blend Fund (A)	-1.78	0.95	98.76	0.00	-0.57	23.42	36	24	4.59	-6.18	91.49	96.52
Russell 2000 Index	N/A	N/A	N/A	N/A	N/A	N/A	35	25	5.02	-6.40	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 (%)
GeoResources, Inc.	1.44
Alaska Air Group, Inc.	1.34
Avista Corporation	1.33
Moog, Inc. A	1.28
Manhattan Associates, Inc.	1.27
TIBCO Software, Inc.	1.25
Plantronics	1.22
The Finish Line Inc	1.22
Polaris Industries, Inc.	1.21
Healthsouth Corp	1.20
<b>Total % in Top 10</b>	<b>12.76</b>

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

## SmallCap Blend Fund (A)

Manager(s)	Start Date	Degree	Alma Mater
Phil Nordhus	05/19/2006	M.B.A.	Drake University
Brian W. Pattinson	07/20/2011	M.B.A.	University of Iowa

### Fund Strategy

The investment seeks long-term growth of capital. The fund invests at least 80% of net assets in equity securities of companies with small market capitalizations (those with market capitalizations similar to companies in the Russell 2000(R) Index) at the time of purchase. It invests in equity securities with value and/or growth characteristics and constructs an investment portfolio that has a "blend" of equity securities with these characteristics.

### 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®.

## You're in good company with Principal Funds

### GLOBAL INVESTMENT MANAGEMENT

- A wide range of mutual funds in all core asset classes and investment styles, as well as several niche funds to help you explore new investment opportunities for your clients.
- The extensive asset management capabilities of a number of leading sub-advisors including Principal Global Investors and its boutique affiliates.

### ASSET ALLOCATION EXPERTISE

- Turnkey assets allocation solutions--including target-risk and target-date funds--to help deepen your client relationships and simplify your life.
- Asset allocation strategies powered by our risk-managed funds, including alternative asset classes.

### RETIREMENT LEADERSHIP

- Training, advanced strategies, and dedicated retirement specialists to help you capture a greater share of the rollover IRA market.

[principalfunds.com](http://principalfunds.com)



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.

## Important Notes

Principal Funds, Inc. is distributed by Principal Funds Distributor, Inc., member of the Principal Financial Group®. Principal Funds Distributor, Principal Shareholder Services, Principal Management Corporation and its affiliates, and Principal Funds, Inc. are collectively referred to as Principal Funds.

**Investors should carefully consider a fund's investment objectives, risks, charges, and expenses prior to investing. A prospectus, or summary prospectus if available, containing this and other information can be obtained by contacting a financial professional, visiting [principalfunds.com](http://principalfunds.com), or calling 800-222-5852. Read the prospectus carefully before investing.**

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.

© 2012 Morningstar, Inc. All Rights Reserved. Part of the mutual fund data contained herein: (1) is proprietary to Morningstar and/or its content providers; (2) may not be copied or distributed; and (3) is not warranted to be accurate, complete, or timely. Neither Morningstar nor its content providers are responsible for any damages or losses arising from any use of this information.

Small-cap and mid-cap investment options are subject to more fluctuation in value and may have additional risks than other investment options with stocks of larger, more stable companies.

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.

Russell 2000 Index consists of the smallest 2000 companies in the Russell 3000 Index, representing approximately 10% of the Russell 3000 total market capitalization.

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.

[principalfunds.com](http://principalfunds.com)



Principal Life Insurance Company, Des Moines, Iowa 50392-0001, [principal.com](http://principal.com) 12/2011  
#t1201030322

## 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

[principalfunds.com](http://principalfunds.com)



Principal Life Insurance Company, Des Moines, Iowa 50392-0001, [principal.com](http://principal.com) 12/2011  
#t1201030322

## Important Notes

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

[principalfunds.com](http://principalfunds.com)



Principal Life Insurance Company, Des Moines, Iowa 50392-0001, [principal.com](http://principal.com) 12/2011  
#t1201030322