

# Quarterly Commentary

Ticker	Investment Advisor	Benchmark	Morningstar Category	Investment Objective
PPSMX	Emerald / Essex	Russell 2000 Growth Index	Small Growth	Small Company

## Economy & Market Overview

Following second-quarter losses, U.S. and international stocks bounced back markedly in the third quarter as weakening in the U.S. and China appeared to have ended. Worries of a double-dip U.S. recession slowly ebbed when key economic data came in slightly ahead of expectations, and concerns about China's slowing growth faded as its economy picked up steam.<sup>1</sup>

Meanwhile, data released in August showed that the euro zone grew at a 3.9% annual rate during the second quarter, driven by tremendous growth in Germany. However, in the third quarter the euro zone's growth rate began slowing, and worries mounted about the possibility of a sovereign debt default or restructuring for some of the region's more troubled members (e.g., Ireland, Greece, Portugal). Additionally, continued strikes by public workers raised concern that necessary government spending cuts might not be implemented.<sup>1</sup>

Key U.S. economic data released during the quarter was mixed, but showed some slight, unexpected improvement: While the unemployment rate remained at 9.6%, an unexpected decrease in weekly initial jobless claims during September gave investors some hope that the unemployment situation may become less bleak.<sup>2</sup> Second-quarter 2010 GDP was positive at 1.7%; however, it was substantially lower than the 3.7% gain posted in the first quarter as inventories decreased and imports grew faster than exports.<sup>3</sup> Housing market data was weak in July, but ended the quarter on a modestly favorable note. A drop in new-home sales during July tapered off in August to a seasonally-adjusted annual rate of 288,000.<sup>4</sup> Existing-home sales rose 7.6% month-over-month in August, but still remained 19% below August 2009.<sup>5</sup> After improving in August, consumer confidence fell in September, reflecting consumers' grim outlook on future economic growth and job prospects.<sup>6</sup>

In September, the National Bureau of Economic Research (NBER), which has sole responsibility for determining when U.S. recessions officially begin and end, determined that the recession that began in December 2007 ended in June 2009. The NBER also stated that at 18 months, it was the longest of any recession since World War II.<sup>7</sup>

Meanwhile, at its September meeting the Federal Reserve made no changes to its extremely accommodative monetary policy given the slowing pace of recovery in output and employment and noted that it is prepared to "provide additional accommodation if needed to support the economic recovery."<sup>8</sup>

During the third quarter, the broad U.S. stock market posted a return of 11.5% as all sectors within the Russell 3000 Index delivered positive returns. Telecommunications led the way, returning 20.1%, while financial stocks performed the weakest with a modest 5.5% gain.<sup>9</sup> Financials were under pressure as investors continued to grapple with the changing landscape of regulatory reform and how it might impact the capital structure and growth opportunities for the industry. For the quarter, growth styles outperformed value, and small-cap stocks underperformed large-caps.<sup>10</sup>

International markets performed even better than U.S. markets, with developed markets delivering a third-quarter return of 16.5%, led by the energy, telecom and materials sectors. Emerging markets generated a return of 18.0% for the quarter, propelled by the consumer discretionary and industrial sectors.<sup>11</sup>

Real estate outperformed the broad U.S. market, returning 13.2% for the quarter.<sup>12</sup> Although the sector's fundamentals remained uncertain, improved access to capital for commercial real estate properties, combined with their attractive dividend yield, fueled continued demand for the asset class.

In a change from their apparent risk aversion during the second quarter, investors seemed to favor riskier fixed-income asset classes in the third quarter. This switch likely reflected, in part, investors' need for yield at a time when U.S. Treasuries are delivering very low rates (for example, relatively low-risk 10-year Treasuries yielded just 2.52% at quarter-end).<sup>13</sup> In terms of investment-grade bonds, commercial mortgage-backed securities led the way, outpacing duration-adjusted Treasuries by 4.05% for the quarter.<sup>14</sup> High-yield bonds (which are below-investment-grade) also performed well, advancing 4.26% ahead of duration-adjusted Treasuries.<sup>15</sup> Also during the period, the yield curve flattened as the distance between 2- and 10-year Treasury yields fell from 2.36% (at the end of the second quarter) to 2.09% (at the end of the third quarter).<sup>16</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:

Security selection boosted performance relative to the benchmark Russell 2000 Growth Index. Selection was most favorable in information technology, where overweights to Netezza Corp and Verifone Systems helped results, as did an out-of-index exposure to F5 Networks. Selection was also favorable in materials and industrials, where out-of-index exposures to Molycorp Inc. and Bucyrus International were rewarded.

#### During last 12 months:

Similar to the quarter, security selection was most favorable in information technology, where out-of-index exposures to F5 Networks, Netezza and Aruba Networks were well rewarded. Stock selection within health care, industrials and consumer discretionary also boosted returns. A bias toward higher-market-cap stocks was an additional positive. Within small-cap stocks, the stocks on the upper-end of the market-cap range performed best during the 12-month period.

### Negative Contributors

#### During last quarter:

Sector allocation was generally neutral. While stock selection overall was positive, the stocks that detracted the most from performance were out-of-index exposures to Vistaprint and Mellanox Technologies and an overweight to Kirkland's Inc.

#### During last 12 months:

The primary weak spot in performance was the financial sector, where overweights to Private Bancorp, KBW Inc. and Stifel Financial weighed on results.

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

No material changes occurred in the portfolio structure.

## SmallCap Growth Fund II (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 09/30/2010	QTR	YTD	1 Year	3 Year	5 Year	10 Year	Since Inception	Inception Date	06/28/2005
SmallCap Growth Fund II (A) (excl. sales charge)	12.18	7.91	13.62	-8.54	-1.47	-	-2.34	Ext. Perf. Inc. Date	12/06/2000
SmallCap Growth Fund II (A) (incl. sales charge)	5.98	2.01	7.42	-10.24	-2.56	-	-2.92	Total Inv. Exp Gross	2.28
Russell 2000 Growth Index	12.83	10.23	14.79	-3.75	2.35	-0.13	-	Total Inv Exp Net	1.43
Small Growth Category	11.68	8.97	14.26	-5.61	1.38	0.72	-	Waiver Date	02/28/2011
Morningstar Percentile Ranking	-	-	53	77	87	-	-	Contractual Cap Date	02/28/2011
Total Funds in Category	777	767	761	676	556	319	-	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. 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 Growth Fund II (A)

### Statistics Summary as of 09/30/2010

	Risk and Return Statistics Summary						Upside/Downside Capture Ratio					
	Alpha	Beta	R2	Sharpe Ratio	Info Ratio	Std Dev	# of Months		Avg Returns %		Market Benchmark %	
							Up	Down	Up	Down	Up	Down
	3 Year Return vs. Rank						3 Year Upside/Downside Capture Ratio					
SmallCap Growth Fund II (A)	-5.15	0.98	98.16	-0.22	-1.26	27.61	20	16	5.21	-8.30	90.08	102.75
Russell 2000 Growth Index	N/A	N/A	N/A	N/A	N/A	N/A	21	15	5.79	-8.08	100.00	100.00
	5 Year Return vs. Rank						5 Year Upside/Downside Capture Ratio					
SmallCap Growth Fund II (A)	-3.81	0.96	97.76	-0.06	-1.09	22.60	36	24	4.27	-5.75	88.20	99.63
Russell 2000 Growth Index	N/A	N/A	N/A	N/A	N/A	N/A	35	25	4.85	-5.78	100.00	100.00

Risk and return statistical data is provided by Markov Processes International (MPI). Risk & Return Statistics Summary results are based on performance excluding sales charges. Percentile rankings are based on total returns in accordance with the appropriate Morningstar peer group. Please see Important Notes section for definitions of Risk and Return Statistics.

### Top Ten Holdings as of 08/31/2010

Security	Net Assets (%)
Russell 2000 Mini Sep10	2.67
Radiant Systems, Inc.	1.35
Aruba Networks, Inc.	1.30
MWI Veterinary Supply, Inc.	1.21
Volcano Corporation	1.13
Acme Packet, Inc.	1.12
Salix Pharmaceuticals, Ltd.	1.03
Diamond Foods, Inc.	0.99
Thoratec Laboratories Corporation	0.99
Nordson Corporation	0.94
<b>Total % in Top 10</b>	<b>12.75</b>

## SmallCap Growth Fund II (A)

Manager(s)	Start Date	Degree	Alma Mater
Stacey Sears	09/01/2004	M.B.A.	Villanova University
Kenneth G. Mertz II	09/01/2004	B.A.	Millersville University
Joseph W. Garner	03/01/2006	M.B.A.	University of Pittsburgh
Nancy B. Prial	06/30/2006	M.B.A.	Harvard University
Mariateresa Monaco	06/02/2009	M.B.A.	Massachusetts Institute of Technology

### Fund Strategy

The investment seeks long-term growth of capital. The fund normally invests at least 80% of assets in common stocks of companies with small market capitalizations (those with market capitalizations equal to or smaller than the greater of \$2.5 billion or the highest market capitalization of the companies in the Russell 2000 Growth index) at the time of purchase. It seeks to invest in the common stock of companies by utilizing fundamental analysis.

### About Essex Investment Management

Essex Investment Management Company, LLC (Essex) specializes in growth equity investments. Essex manages portfolios for corporations, endowments, foundations, municipalities, public funds, Taft-Hartley accounts and private clients. Essex offers a range of growth equity strategies and employs proprietary fundamental research combined with active portfolio management. As of December 31, 2009, Essex managed a total of \$1.9 billion in assets under management.

### About Emerald Advisers, Inc

Emerald Advisers, Inc. is an S.E.C. Registered Investment Advisor incorporated in November 1991. Emerald Advisers is a subsidiary of Emerald Asset Management, incorporated in August 1991. Emerald Asset Management is wholly-owned by Emerald employees and one outside minority shareholder. Emerald Advisers provides professional investment advisory services to institutional investors, high net worth individuals and the general public through separate account management and The Forward Emerald Mutual Funds. As of December 31, 2009, Emerald Advisers managed a total of \$2.0 billion in assets.

## You're in good company with Principal Funds

GLOBAL INVESTMENT MANAGEMENT
<ul style="list-style-type: none"><li>• 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.</li><li>• The extensive asset management capabilities of a number of leading sub-advisors including Principal Global Investors and its boutique affiliates.</li></ul>
ASSET ALLOCATION EXPERTISE
<ul style="list-style-type: none"><li>• Turnkey assets allocation solutions--including target-risk and target-date funds--to help deepen your client relationships and simplify your life.</li><li>• Asset allocation strategies powered by our risk-managed fund, including alternative asset classes.</li></ul>
RETIREMENT LEADERSHIP
<ul style="list-style-type: none"><li>• Training, advanced strategies, and dedicated retirement specialists to help you capture a great share of the rollover IRA market.</li></ul>

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



Principal Funds is a leading provider of mutual fund solutions for individual investors and retirement plans, with approximately \$55.1 billion in mutual fund assets under management (as of June 30, 2010). Principal Funds has special expertise in providing asset allocation solutions, and is the 5th 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 March 31, 2010). 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.

**Before investing in mutual funds, investors should carefully consider the investment objectives, risks, charges and expenses of the funds. This and other information is contained in the free prospectus, which can be downloaded from our site, by visiting [principal.com](http://principal.com), or by contacting us at 1.800.222.5852. Please 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.

© 2010 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. 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.

The manager of the Fund, Principal Management Corporation, invests between 10% and 40% of the Fund's assets in common stocks in an attempt to match or exceed the performance of the Fund's benchmark index for performance.

Effective June 26, 2009, this portfolio is sub-advised by Emerald Advisors and Essex. Prior to June 26, 2009, the portfolio was sub-advised by UBS Global Asset Management, Emerald Advisors and Essex. The portfolio has had various sub-advisors since its inception. Performance results displayed reflect all sub-advisors managing this portfolio during the time periods displayed.

Effective July 1, 2010, this fund is closed to new investors. Effective August 5, 2010, this fund is closed to new assets.

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



Principal Life Insurance Company, Des Moines, Iowa 50392-0001, [principal.com](http://principal.com) 09/2010  
#t10101903dq

## Important Notes

Russell 2000 Growth Index is a market-weighted total return index that measures the performance of companies within the Russell 2000 Index having higher price-to-book ratio and higher forecasted growth values.

Extended Performance Inception Date (Ext. Perf. Inc. Date) - Inception date of the oldest share class of the fund.

### **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> On the Other Hand: Economic Insights, Third Quarter 2010 edition, by Bob Baur and the Principal Global Investors Economic Committee

<sup>2</sup> U.S. Bureau of Labor Statistics: Employment Situation Summary 9/3/2010 [www.bls.gov](http://www.bls.gov))

<sup>3</sup> Bureau of Economic Analysis, US Dept of Commerce ([www.bea.gov](http://www.bea.gov))

<sup>4</sup> National Association of Home Builders ([www.nahb.com](http://www.nahb.com))

<sup>5</sup> National Association of Realtors ([www.realtor.org](http://www.realtor.org))

<sup>6</sup> Conference Board's Consumer Confidence Index, September 28, 2010 ([www.conference-board.org](http://www.conference-board.org))

<sup>7</sup> Business Cycle Dating Committee, National Bureau of Economic Research, September 20, 2010 ([www.nber.org](http://www.nber.org))

<sup>8</sup> Federal Reserve Board press release dated September 21, 2010 ([www.federalreserve.gov](http://www.federalreserve.gov))

<sup>9</sup> Russell 3000 Index

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



Principal Life Insurance Company, Des Moines, Iowa 50392-0001, [principal.com](http://principal.com) 09/2010  
#t10101903dq

## Important Notes

<sup>10</sup> Russell family of indexes

<sup>11</sup> Developed international markets: MSCI EAFE Index; emerging international markets: MSCI EM Index

<sup>12</sup> MSCI US REIT Index

<sup>13</sup> Source: FactSet, constant maturity US Treasury yield

<sup>14</sup> As measured by components of Barclays Capital Aggregate Bond Index

<sup>15</sup> As measured by components of Barclays Capital High Yield Index

<sup>16</sup> Source: FactSet, constant maturity US Treasury yield

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) 09/2010  
#t10101903dq