

Second Quarter 2010

Quarterly Commentary

Ticker	Investment Advisor	Benchmark	Morningstar Category	Investment Objective
PTDAX	Prin Mgmt Corp/Prin Global Inv	Principal LifeTime 2040 Blended Index	Target Date 2036-2040	Balanced

Economy & Market Overview

Following four positive quarters in a row, both U.S. and international stocks fell in the second quarter of 2010. The rally ended as investor concerns mounted about economic stability in Europe, slowing growth in China and the sustainability of the U.S. recovery.¹

Europe's troubles, which started with the revelation of Greece's staggering deficit and debt load, broadened as it became apparent other countries (such as Spain and Portugal) faced similar issues. Markets reacted negatively to the exposure of European banks to the sovereign and corporate debt of these countries, despite the nearly \$1 trillion bail-out plan put in effect by the European Union and International Monetary Fund. In China, the government's decision to reign in real estate growth weighed on international investors, as did new data indicating a slowdown in China's pace of economic growth.²

Negative economic data reported during the quarter pointed to slowing growth across the U.S. economy: Employers continued their reluctance to add staff; May payrolls were meager, following gains in April and March.³ Gross Domestic Product (GDP) for the first quarter came in lower than expected; the 2.7% gain was a sharp drop from the 5.6% increase for fourth quarter 2009.⁴ After rising for three consecutive months, consumer confidence fell unexpectedly in June, reflecting consumers' uncertainty about jobs and income.⁵ Following expiration of the home buyer tax credit in April, new-home sales fell in May to a seasonally adjusted, annual rate of 300,000 (the lowest number since the government began tracking the figure in 1963);⁶ meanwhile, existing-home sales fell 2.2% in May after gaining 8% in April.⁷

After its June meeting, the Federal Reserve reaffirmed its belief that economic recovery is proceeding, but also acknowledged that "financial conditions have become less supportive of economic growth" and restated its intention to keep the fed funds interest rate very low "for an extended period."⁸

For the quarter, the broad U.S. stock market posted a return of -11.3% as all sectors within the Russell 3000 Index delivered negative performance. The economically sensitive materials sector struggled the most. Financial stocks also were under acute pressure, as investors grappled with the changing landscape of regulatory reform and how it might impact the industry. In this environment, growth and value performed similarly among large- and mid-cap stocks, while within small-caps, value slightly underperformed growth. From a market-cap perspective, small-caps outperformed large-caps.⁹

International stocks in developed markets returned -14.0%,¹⁰ reflecting in part the precarious financial situation in Europe. Emerging markets performed better, but still delivered -8.37%.¹¹

Real estate investment trusts returned -4.0%¹² to outperform the broad U.S. stock market. Although real estate fundamentals were still unfavorable, access to capital for commercial real estate had improved, which drew investors hoping to participate in the asset class's recovery.

Within fixed income, risk aversion was apparent as many investors turned to the "safe haven" of U.S. Treasuries, which outperformed other fixed-income sectors. By quarter-end, the yield on the benchmark 10-year Treasury had fallen from 3.84% to 2.95%. (Bond prices and yields move in opposite directions.) Meanwhile, investment-grade corporate bonds fell -2.25% relative to duration-adjusted Treasuries. Returns were slightly worse in the financial segment of the corporate bond market (down 2.97% relative to duration-adjusted Treasuries), due in part to uncertainty and anxiety surrounding financial regulation reform. Commercial mortgage-backed securities and asset-backed securities also lagged Treasuries, while mortgage-backed securities managed to outperform Treasuries by 0.01%.¹³ Finally, high-yield bonds returned -3.86% relative to duration-adjusted Treasuries, with the lowest-rated (highest risk) high-yield bonds performing the worst.¹⁴

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:

As a whole, the international equity component of the Principal Lifetime portfolios positively impacted performance, outperforming the MSCI EAFE Index over the period. The allocation to the Principal Emerging Markets Fund, sub-advised by Principal Global Investors, added the most to this outperformance. Also, the domestic equity asset class as a whole performed in line with the broad Russell 3000 Index, due in large part to the performance of the Principal Large Cap Growth I Fund, co-sub-advised by T. Rowe Price and Brown Advisory, and the Principal SmallCap Growth I Fund, co-sub-advised by AllianceBernstein and Columbus Circle Investors.

During last 12 months:

Unlike the quarterly performance, the non-traditional/specialty asset classes significantly contributed to the positive returns the Principal LifeTime portfolios experienced for the 12-month period. In particular, the portfolios benefited from the specialty asset class exposures provided by the International Emerging Markets Fund, High Yield I Fund, Preferred Securities Fund and Real Estate Securities Fund. Also, the Bond & Mortgage Securities Fund, sub-advised by Principal Global Investors, significantly added to positive performance due to its focus on non-U.S. Treasury fixed-income sectors.

Negative Contributors

During last quarter:

While exposure to investment options in non-traditional/specialty asset classes added to performance over the 12-month period, some of these same investment options detracted over the most recent quarter. In particular, the High Yield I Fund, co-sub-advised by J.P. Morgan and Neuberger Berman, and the Preferred Securities Fund, sub-advised by Spectrum, underperformed the Barclays Capital Aggregate Bond Index, and the Real Estate Securities Fund, sub-advised by Principal Real Estate Investors, underperformed the Russell 3000 Index.

During last 12 months:

For the 12-month period, the domestic equity component of the Principal Lifetime portfolios as a whole underperformed the broad Russell 3000 Index. Also, the Real Estate Securities Fund (the best-performing investment option on an absolute basis) underperformed the MSCI U.S. REIT Index over the period, which detracted from relative performance.

Changes to the investment option's structure or portfolio:

Several changes have recently been made to Principal LifeTime portfolios. These changes started taking place during the first quarter of 2010 and were completed by the end of the second quarter: The Principal SmallCap Value II Fund replaced the Principal SmallCap Value I Fund; the Principal SmallCap S&P 600 Index Fund, Principal SmallCap Value Fund, Principal LargeCap Value III Fund and Principal Disciplined LargeCap Blend Fund were removed; and, the Principal LargeCap S&P 500 Index Fund, Principal International Equity Index Fund, Principal Bond Market Index Fund and Principal Diversified Real Asset Funds were added. Additionally, the Principal LargeCap Blend I Fund is scheduled to be removed from the Principal LifeTime portfolios in July 2010.

Principal LifeTime 2040 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 06/30/2010	QTR	YTD	1 Year	3 Year	5 Year	10 Year	Since Inception	Inception Date	06/28/2005
Principal LifeTime 2040 Fund (A) (excl. sales charge)	-10.07	-5.77	15.00	-9.29	-0.44	-	1.73	Ext. Perf. Inc. Date	03/01/2001
Principal LifeTime 2040 Fund (A) (incl. sales charge)	-14.99	-10.99	8.64	-10.99	-1.55	-	1.11	Total Inv. Exp Gross	1.58
Principal LifeTime 2040 Blended Index	-9.79	-6.06	12.73	-7.94	0.29	0.36	-	Total Inv Exp Net	1.19
Target Date 2036-2040 Category	-9.58	-5.89	14.40	-9.05	-0.25	-1.09	-	Waiver Date	02/28/2011
Morningstar Percentile Ranking	-	-	36	50	51	-	-	Contractual Cap Date	02/28/2011
Total Funds in Category	201	200	194	128	56	7	-	Contingent Deferred Sales Charge	-
								Maximum Up-front Sales Charge	5.50

Risk and Return Statistics Summary as of 06/30/2010

	3 Year Return vs. Rank						5 Year Return vs. Risk					
	Alpha	Beta	R2	Sharpe Ratio	Info Ratio	Std Dev	Alpha	Beta	R2	Sharpe Ratio	Info Ratio	Std Dev
Principal LifeTime 2040 Fund (A)	-0.38	1.09	99.00	-0.43	-0.50	20.96	-0.37	1.09	98.97	-0.10	-0.33	16.89

Relative to Principal LifeTime 2040 Blended Index

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.

Principal LifeTime 2040 Fund (A)

Upside/Downside Capture Ratio Summary as of 06/30/2010

	3 Year Upside/Downside Capture Ratio						5 Year Upside/Downside Capture Ratio					
	# of Months		Avg Returns %		Market Benchmark %		# of Months		Avg Returns %		Market Benchmark %	
	Up	Down	Up	Down	Up	Down	Up	Down	Up	Down	Up	Down
Principal LifeTime 2040 Fund (A)	17	19	3.91	-5.70	109.07	112.98	35	25	2.89	-4.76	109.36	113.90
Principal LifeTime 2040 Blended Index	19	17	3.59	-5.04	100.00	100.00	38	22	2.64	-4.17	100.00	100.00

Top Ten Holdings as of 05/31/2010

Security	Net Assets (%)
Principal Large Cap Growth I Inst	12.72
Principal Large Cap Value I Inst	11.83
Principal Large Cap Growth Inst	6.55
Principal Large Cap Value Inst	6.39
Principal Large Cap Blend I Inst	6.33
Principal High Yield I Inst	6.29
Principal International Growth Inst	5.96
Principal International Value I Instl	5.87
Principal Intl Emerging Markets Inst	4.34
Principal International I Inst	3.98
Total % in Top 10	70.26

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

Principal LifeTime 2040 Fund (A)

Manager(s)	Start Date	Degree	Alma Mater
Dirk Laschanzky	03/01/2001	M.B.A.	University of Iowa
Michael P. Finnegan	05/29/2007	M.A.	University of Iowa
James Fennessey	05/29/2007	B.S.	Truman State University
Randy L. Welch	05/29/2007	M.B.A.	Drake University
Tim Dunbar	03/31/2008	B.S.	Iowa State University

Fund Strategy

The investment seeks a total return consisting of long-term growth of capital and current income. The fund invests in underlying Principal domestic and foreign equity, hybrid, and fixed-income funds according to an asset allocation strategy designed for investors having an investment time horizon comparable to that of the fund. It allocates the assets more conservatively over time. The fund may invest in any of the Institutional Class shares of the equity funds or fixed-income funds of Principal Funds, at the sub-advisor's discretion.

About Principal Global Investors

Principal Global Investors, the institutional asset management affiliate of the Principal Financial Group, currently manages \$215.4 billion in assets as of December 31, 2009. The firm focuses on delivering consistently competitive investment performance and superior service on behalf of its clients. Principal Global Investors has expertise in equities, fixed income and real estate investments, as well as specialized overlay and advisory services. The firm upholds the highest standards of excellence in investment research, risk management, ethics, fiduciary responsibility and client service. Principal Global Investors is a member of the Principal Financial Group®.

About Principal Management Corp

Principal Management Corporation has served as advisor to the Principal Funds since 1969. The Principal Funds currently have \$55.6 billion in assets under management as of December 31, 2009. As advisor to the funds, Principal Management Corporation oversees the Principal Due Diligence Program, their proprietary process for identifying, selecting and monitoring investment managers. The Principal Funds offer a full range of investment options covering all core style boxes and several niche options. The Funds are sub-advised by a variety of investment managers representing some of the nation's leading asset managers and investment boutiques.

About Principal LifeTime

Principal LifeTime portfolios invest in underlying Principal Funds and each is managed toward a particular target (retirement) date, or the approximate date the participant or investor starts withdrawing money. Investors choose the portfolio most closely matching their approximate retirement date. As each Principal LifeTime portfolio approaches its target date, the investment mix becomes more conservative by increasing exposure to generally more conservative investment options and reducing exposure to typically more aggressive investment options. The portfolio continues to be managed for approximately 15 years beyond the original target date. It is expected that within 10 to 15 years after its target year, the allocation will match that of the Principal LifeTime Strategic Income investment. Principal LifeTime portfolios assume the value of the investor's account will be withdrawn gradually during retirement.

Neither the principal nor the underlying assets of the Principal LifeTime investment options are guaranteed at any time, including the target date and investment risk remains at all times.

You're in good company with Principal Funds

GLOBAL INVESTMENT MANAGEMENT
<ul style="list-style-type: none">• 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
<ul style="list-style-type: none">• 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 fund, including alternative asset classes.
RETIREMENT LEADERSHIP
<ul style="list-style-type: none">• Training, advanced strategies, and dedicated retirement specialists to help you capture a great share of the rollover IRA market.

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, 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.

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.

Equity investment options involve greater risk, including heightened volatility, than fixed-income investment options. Fixed-income investment options are subject to interest rate risk, and their value will decline as interest rates rise.

Fixed-income and asset allocation investment options that invest in mortgage securities are subject to increased risk due to real estate exposure.

Asset allocation does not guarantee a profit or protect against a loss. Investing in real estate, small-cap, international, and high-yield investment options involves additional risks. Additionally there is no guarantee this investment option will provide adequate income at or through retirement.

principalfunds.com



Principal Life Insurance Company, Des Moines, Iowa 50392-0001, principal.com 06/2010
#T10071201mi

Important Notes

This Principal LifeTime Fund indirectly bears its pro rata share of the management fees incurred by the underlying Principal Funds in which this fund invests. Based on the asset allocation of the Principal LifeTime Funds outlined in the prospectus dated March 1, 2010, the weighted average operating expenses of the underlying funds are: Principal LifeTime Strategic Income, 0.58%; Principal LifeTime 2010, 0.68%; Principal LifeTime 2020, 0.73%; Principal LifeTime 2030, 0.76%; Principal LifeTime 2040, 0.78%; Principal LifeTime 2050, 0.79%. While the operating expenses of the underlying mutual funds are not part of the Principal LifeTime Fund's operating expenses they are included in the Total Investment Expense. Performance results shown for the Principal LifeTime Fund reflect the application of these expenses.

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.

The individual Principal LifeTime Funds may be combined with the Principal LifeTime Strategic Income Fund if the Board of Directors of Principal Funds, Inc., determines at the time that the combination is in the best interests of Fund shareholders.

¹ Source: On the Other Hand: Economic Insights, Second Quarter 2010, by Bob Baur and the Principal Global Investors Economic Committee

² Source: The Conference Board Leading Economic Index[®] (LEI) for China, measuring economic activity, increased 0.3% in April following increases of 1.2% in March and 0.4% in February.

³ Source: U.S. Bureau of Labor Statistics: Employment Situation Summary 6/4/2010 (available at www.bls.gov)

⁴ Source: Bureau of Economic Analysis, US Dept of Commerce (data available at www.bea.gov)

⁵ Source: Data available at www.conference-board.org

principalfunds.com



Principal Life Insurance Company, Des Moines, Iowa 50392-0001, principal.com 06/2010
#T10071201mi

Important Notes

⁶ Source: National Association of Home Builders (data available at www.nahb.com)

⁷ Source: National Association of Realtors (data available at www.realtor.org)

⁸ Source: Federal Reserve press release dated 6/23/10 (available at www.federalreserve.gov)

⁹ Source: As measured by Russell family of indexes

¹⁰ Source: As measured by the MSCI EAFE Index

¹¹ Source: As measured by the MSCI EM Index

¹² Source: As measured by the MSCI U.S. REIT Index

¹³ Source: As measured by components of Barclays Capital Aggregate Bond Index

¹⁴ Source: As measured by components of Barclays Capital High Yield Index

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

principalfunds.com



Principal Life Insurance Company, Des Moines, Iowa 50392-0001, principal.com 06/2010
#T10071201mi