

# Quarterly Commentary

Ticker	Inv Manager or Sub-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

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:

Exposure to equities helped overall performance significantly as equities markets rebounded during the quarter. Performance also was aided by continued strong returns in both fixed income and U.S. Treasury Inflation Protected Securities. Additionally, exposure to corporate credit (as opposed to U.S. government debt) aided both the Bond and Mortgage Securities Fund (sub-advised by Principal Global Investors) and the Core Plus Bond I Fund (sub-advised by PIMCO). Small-cap equities added to performance as well, through both strong sector performance and solid execution by the sub-advisors within the sectors. Similarly, the Global Diversified Income Fund and the Diversified Real Asset Fund (managed by Principal Management Corporation) posted strong gains.

#### During last 12 months:

The Bond and Mortgage Securities Fund added value due to performing well over the 12-month period, though an underexposure to U.S. government credit held it back slightly versus the Barclays Capital Aggregate Bond Index. As for the quarter, the Global Diversified Income Fund and the Diversified Real Asset Fund benefited overall performance due to posting positive returns.

### Negative Contributors

#### During last quarter:

Execution within large-cap equities hurt performance, as the Principal LifeTime portfolios' large-cap holdings underperformed the S&P 500 Index. In addition, exposure to international equities detracted from performance; although the underlying international funds used within the Principal LifeTime portfolios had strong relative performance, in absolute terms international equities significantly lagged domestic equities during the period.

#### During last 12 months:

Within the fixed income sector, the Core Plus Bond I Fund underperformed the Barclays Capital Aggregate Bond Index due to large overweights to non-U.S. government credits. In addition, the Preferred Securities Fund (sub-advised by Spectrum) suffered from a third-quarter loss that caused it to lag the Barclays Capital Aggregate Bond Index for the period.

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

No material changes occurred in the portfolio structure.

# 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](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
Principal LifeTime 2040 Fund (A) (excl. sales charge)	8.52	-3.69	-3.69	12.73	-1.23	3.24	3.04	Ext. Perf. Inc. Date	03/01/2001
Principal LifeTime 2040 Fund (A) (incl. sales charge)	2.56	-9.01	-9.01	10.63	-2.34	2.66	2.50	Total Inv. Exp Gross	1.41
Principal LifeTime 2040 Blended Index	8.13	-1.22	-1.22	12.19	-0.11	3.80	-	Total Inv Exp Net	1.15
Target Date 2036-2040 Category	8.05	-3.49	-3.49	12.95	-1.26	3.24	-	Waiver Date	02/29/2012
Morningstar Percentile Ranking	-	-	43	55	46	67	-	Contractual Cap Date	02/29/2012
Total Funds in Category	209	202	202	183	100	16	-	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.

# Principal LifeTime 2040 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					
Principal LifeTime 2040 Fund (A)	-0.19	1.07	99.19	0.74	0.26	18.45	20	16	4.75	-3.92	106.01	106.43
Principal LifeTime 2040 Blended Index	N/A	N/A	N/A	N/A	N/A	N/A	21	15	4.48	-3.68	100.00	100.00
	5 Year						5 Year					
Principal LifeTime 2040 Fund (A)	-0.83	1.09	99.02	-0.04	-0.46	18.96	30	30	3.96	-4.42	106.60	112.42
Principal LifeTime 2040 Blended Index	N/A	N/A	N/A	N/A	N/A	N/A	32	28	3.71	-3.94	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 (%)
Principal Large Cap Growth I Inst	12.30
Principal Large Cap Value I Inst	11.93
Principal Large Cap S&P 500 Index Inst	7.39
Principal International Value I Instl	6.54
Principal Large Cap Growth Inst	6.30
Principal High Yield I Inst	6.18
Principal Large Cap Value Inst	6.08
Principal Diversified Intl Inst	6.05
Principal Intl Emerging Markets Inst	4.18
Principal International I Inst	3.91
<b>Total % in Top 10</b>	<b>70.85</b>

Information is current as of the date noted. Keep in mind that all current and future 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
Randy L. Welch	05/29/2007	M.B.A.	Drake University
James Fennessey	05/29/2007	B.S.	Truman State University
David Blake	03/31/2008	M.B.A.	Saint Louis University
Jeffrey R. Tyler	03/01/2011	Master	Northwestern 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, real estate investments, 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 invests in PFI Institutional Class shares of underlying funds.

### About Principal Global Investors

Principal Global Investors, the institutional asset management affiliate of the Principal Financial Group, managed \$232.4 billion in assets as of December 31, 2010. 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®. (Principal Global Investors is the asset management arm of the Principal Financial Group® (The Principal®) and includes the asset management operations of the following subsidiaries of The Principal: Principal Global Investors, LLC; Principal Real Estate Investors, LLC; Spectrum Asset Management, Inc.; Post Advisory Group, LLC; Columbus Circle Investors; Edge Asset Management, Inc.; Principal Global Investors (Europe) Limited; Principal Global Investors (Singapore) Ltd.; Principal Global Investors (Australia) Ltd.; and the majority owned affiliates of Principal International, Inc.).

### About Principal Management Corp

Principal Management Corporation has served as advisor to the Principal Funds since 1969. The Principal Funds had \$66.2 billion in assets under management as of December 31, 2010. As advisor to the funds, Principal Management Corporation oversees the due diligence process of Principal Life, our 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

The Principal LifeTime portfolios, which are target-date portfolios, invest in underlying Principal Funds. Each Principal LifeTime portfolio is managed toward a particular target (retirement) date, or the approximate date the participant or investor starts withdrawing money. 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 asset allocation for each Principal LifeTime portfolio is regularly re-adjusted within a timeframe that extends 10-15 years beyond the target date, at which point it reaches its most conservative allocation. 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 portfolios are guaranteed at any time, including the target date. Investment risk remains at all times.

## 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.

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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.

## 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.

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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.

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.

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## 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, 2011, the weighted average operating expenses of the underlying funds are: Principal LifeTime Strategic Income, 0.59%; Principal LifeTime 2010, 0.67%; Principal LifeTime 2020, 0.71%; Principal LifeTime 2030, 0.73%; Principal LifeTime 2040, 0.74%; Principal LifeTime 2050, 0.76%. 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.

Principal LifeTime 2040 Blended Index is composed of underlying indexes that represent the target asset allocation weights of the Principal LifeTime 2040 portfolio. The index weightings adjust over time as the portfolio changes to become gradually more conservative. The weightings as of March 31, 2011 are 58.60% Russell 3000 Index, 25.80% MSCI EAFE Index, and 15.60% Barclays Capital Aggregate Index.

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.

### **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.

<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](http://blogs.wsj.com), 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)

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## Important Notes

<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/empst.pdf](http://bls.gov/news.release/pdf/empst.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

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

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