

Quarterly Commentary

Ticker	Inv Manager or Sub-Advisor	Benchmark	Morningstar Category	Investment Objective
SRCMX	Principal Global Investors	Barclays Capital California Municipal Index	Muni California Long	Income

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:

The portfolio's allocation to discount bonds added value for the period. Also, an overweight allocation to the special tax sector contributed positively to relative performance. The portfolio's exposure to inverse floating-rate investments (variable-rate debt instruments that pay interest at rates that move in the opposite direction of prevailing interest rates) was another contributor to relative performance.

During last 12 months:

Security selection in the long end of the curve (specifically, the 20+ years-to-maturity portion, which was bought at a discount) added to relative performance. A significant overweight allocation to (and strong security selection within) BBB-rated bonds contributed significantly to performance for the period. Additionally, overweight allocations to the incremental tax sector benefited relative performance.

Negative Contributors

During last quarter:

The portfolio's underweight allocation to state general obligation bonds (GOs) detracted from relative performance. Also, an overweight allocation to health care credits, and sale of some weaker credits, detracted from performance. Additionally, unfavorable security selection in tobacco bonds negatively impacted relative performance.

During last 12 months:

An overweight allocation to shorter-duration securities hindered relative performance. Also, poor selection of lower-rated credits detracted from performance. The portfolio's significant underweight allocations to state GOs hindered performance as well.

Changes to the investment option's structure or portfolio:

No material changes occurred in the portfolio structure.

California Municipal 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	07/25/1989
California Municipal Fund (A) (excl. sales charge)	2.16	11.37	11.37	11.39	2.30	3.79	5.34	Ext. Perf. Inc. Date	07/25/1989
California Municipal Fund (A) (incl. sales charge)	-1.65	7.23	7.23	9.99	1.51	3.40	5.16	Total Inv. Exp Gross	0.88
Barclays Capital California Municipal Index	2.43	12.28	12.28	9.07	5.04	5.32	-	Total Inv Exp Net	0.88
Muni California Long Category	2.27	11.74	11.74	10.26	3.62	4.40	-	Waiver Date	-
Morningstar Percentile Ranking	-	-	57	18	91	89	-	Contractual Cap Date	-
Total Funds in Category	150	149	149	145	134	109	-	Contingent Deferred Sales Charge	-
								Maximum Up-front Sales Charge	3.75

California Municipal Fund (A)

Top Ten Holdings as of 11/30/2011

Security	Net Assets (%)
Pomona Calif Pub Fing Auth 5%	2.29
San Jose Calif Arpt Rev Rev Bds 5%	2.21
Alhambra Calif Impt Bd Act 191 Re 6.125%	1.69
California St Go Bds 6%	1.55
Bay Area Toll Auth 5.125%	1.47
Riverside Calif Elec Rev Elec 5%	1.44
Chula Vista Calif Ctfs Partn Cops 5%	1.41
San Francisco Calif City & Cnt Rev Bd 5%	1.41
Rosedale-Rio Bravo Calif Wtr S Rev Co 5%	1.40
Highland Calif Redev Agy Tax A Tax AI 5%	1.32
Total % in Top 10	16.19

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

Statistics as of 11/30/2011	
Average Eff Duration (yrs)	7.45
Average Eff Maturity (yrs)	17.80
Average Weighted Coupon	5.51
Average Weighted Price	\$100.45
30-Day SEC Yield - Subsidized (Net) as of 12/31/2011	4.34%
30-Day SEC Yield - Non-Subsidized (Gross) as of 12/31/2011	4.34%

California Municipal Fund (A)

Manager(s)	Start Date	Degree	Alma Mater
Douglas J. Gaylor	09/12/2011	M.B.A.	State University College at Buffalo

Fund Strategy

The investment seeks to provide as high a level of current income that is exempt from federal and state personal income tax as is consistent with prudent investment management and preservation of capital. The fund normally invests at least 80% of net assets in intermediate- and long-term California municipal obligations (municipal obligations that generate interest which is exempt from California State personal income tax). It invests primarily in investment-grade municipal obligations. The fund is non-diversified.

About Principal Global Investors

Principal Global Investors' fixed-income capabilities emphasize a broad array of global credit, mortgage, asset-backed and government debt markets worldwide. The firm also offers extensive capabilities in structured fixed-income strategies. Principal Global Investors managed \$71.0 billion in fixed income assets as of December 31, 2010. Its global fixed-income research efforts span sovereign and corporate debt markets worldwide and draw from its experienced team of fixed-income professionals. The disciplined and repeatable investment research process combines bottom-up and top-down portfolio construction techniques with a strong focus on relative value and broad diversification. Principal Global Investors is a member of the Principal Financial Group®.

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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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Fixed-income investment options are subject to interest rate risk, and their value will decline as interest rates rise. A portion of the Fund's income may be subject to state and/or local taxes, and it may be subject to federal alternative minimum tax (AMT) for certain investors.

Effective September 12, 2011, this portfolio is sub-advised by Principal Global Investors. Prior to September 12, 2011, the portfolio was sub-advised by Invesco.

Barclays Capital California Municipal Index tracks the California part of the Barclays Capital Municipal Bond Index. The Barclays Capital Municipal Bond represents the long-term, investment-grade tax-exempt bond market.

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

Statistics:

30-Day SEC Yield - Subsidized (Net) - This yield citation reflects the income that the investment option produced taking into consideration all expense waivers, caps, and breakpoints in place during the 30 day period. Without these waivers, the investment option's yield would be lower.

30-Day SEC Yield - Non-Subsidized (Gross) - This yield citation reflects the income that the investment option would produce if the investment option did not have a portion of its total investment expense waived or capped.

Average Effective Duration - A time measure of a bond's interest-rate sensitivity, based on the weighted average of the time periods over which a bond's cash flows accrue to the bondholder. Time periods are weighted by multiplying by the present value of its cash flow divided by the bond's price. (A bond's cash flows consist of coupon payments and repayment of capital).

Average Effective Maturity - Average effective maturity is a weighted average of all the effective maturities of the bonds in a portfolio.

Average Weighted Price - The statistic is calculated by weighting the price of each bond by its relative size in the portfolio. This number reveals if the investment option favors bonds selling at prices above or below face value (discount or premium securities, respectively). A higher number indicates a bias toward premiums. This statistic is expressed as a percentage of par (face) value.

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

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Important Notes

¹⁰ BarCap High Yield Index: FactSet

¹¹ Barclays Capital Point

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

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