

Fourth Quarter 2011

## Quarterly Commentary

Ticker	Inv Manager or Sub-Advisor	Benchmark	Morningstar Category	Investment Objective
SRHQX	Edge Asset Management, Inc.	Barclays Capital Credit 1-3 Years Index	Short Term Bond	Corp Bond - High Quality

## Economy &amp; 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:

An underweight position in foreign government agencies was a positive contributor, as this was one of the weakest sectors due to European Union concerns. Additionally, the portfolio's out-of-benchmark position in asset-backed securities (ABS) was a positive contributor as the sector rebounded from the prior quarter. Finally, the portfolio's security selection within the energy sector added value.

#### During last 12 months:

Similar to the quarter, an underweight position in foreign government agencies was a positive contributor. An out-of-benchmark allocation to non-agency collateralized mortgage obligations also aided performance; the sector outpaced the broad corporate market. Finally, security selection within the energy sector benefited results as commodity prices remained high during most of the period.

### Negative Contributors

#### During last quarter:

The top detractor to portfolio performance was security selection in the banking sector as large banks were beset by problems on multiple fronts. Additionally, security selection in the financial institutions sector contributed negatively as contagion from Europe impacted these holdings. Finally, U.S. agencies negatively impacted results because higher-quality holdings generally underperformed during the period.

#### During last 12 months:

The largest negative contributor to the portfolio was security selection within the financial sector (banking and financial institutions) amid concerns over the financial situation in Europe. Also, an overweight to the ABS sector negatively impacted performance as the sector underperformed. Finally, both allocation and security selection within the consumer non-cyclical sector detracted from performance.

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

No material changes occurred in the portfolio structure.

## Short-Term Income 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	11/01/1993
Short-Term Income Fund (A) (excl. sales charge)	0.58	1.03	1.03	5.41	3.86	3.67	4.36	Ext. Perf. Inc. Date	11/01/1993
Short-Term Income Fund (A) (incl. sales charge)	-1.65	-1.26	-1.26	4.62	3.42	3.45	4.23	Total Inv. Exp Gross	0.76
Barclays Capital Credit 1-3 Years Index	0.36	1.75	1.75	5.75	4.68	4.33	-	Total Inv Exp Net	0.76
Short Term Bond Category	0.51	1.66	1.66	5.12	3.48	3.38	-	Waiver Date	02/29/2012
Morningstar Percentile Ranking	-	-	72	40	37	35	-	Contractual Cap Date	02/29/2012
Total Funds in Category	423	405	405	353	322	179	-	Contingent Deferred Sales Charge	-
								Maximum Up-front Sales Charge	2.25

## Short-Term Income 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					
Short-Term Income Fund (A)	0.87	0.78	79.74	2.54	-0.32	2.05	27	9	0.69	-0.32	95.71	104.78
Barclays Capital Credit 1-3 Years Index	N/A	N/A	N/A	N/A	N/A	N/A	27	9	0.73	-0.30	100.00	100.00
	5 Year						5 Year					
Short-Term Income Fund (A)	0.56	0.59	63.69	1.12	-0.44	2.20	45	15	0.57	-0.45	81.25	77.32
Barclays Capital Credit 1-3 Years Index	N/A	N/A	N/A	N/A	N/A	N/A	45	15	0.71	-0.58	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 (%)
New Century He Tr 2005-3 FRN	1.50
Ing Bk Nv 144A 4%	1.31
Fmr 4.75%	1.30
Lloyds Tsb Bk 4.875%	1.28
Fuel Tr 144A 3.984%	1.23
Hsbc Bk 144A 3.5%	1.19
Bk New York Mtn Bk Ent 2.95%	1.18
Commonwealth Bk Australia 144a 3.75%	1.14
Airgas 3.25%	1.08
Dow Chem 7.6%	1.04
<b>Total % in Top 10</b>	<b>12.25</b>

Statistics as of 11/30/2011	
Average Eff Duration (yrs)	1.52
Average Eff Maturity (yrs)	2.38
Average Weighted Coupon	3.86
Average Weighted Price	\$100.43
30-Day SEC Yield - Subsidized (Net) as of 12/31/2011	1.88%
30-Day SEC Yield - Non-Subsidized (Gross) as of 12/31/2011	1.88%

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

## Short-Term Income Fund (A)

Manager(s)	Start Date	Degree	Alma Mater
Scott J. Peterson	01/01/2010	M.B.A.	New York University
John R. Friedl	05/19/2010	M.S.	Seattle University
Ryan P. McCann	05/19/2010	B.A.	Washington State University
Gregory L. Tornga	07/01/2011	M.B.A.	Chapman University

### Fund Strategy

The investment seeks to provide as high a level of current income as is consistent with prudent investment management and stability of principal. The fund invests primarily in high quality short-term bonds and other fixed-income securities that, at the time of purchase, are rated BBB- or higher by Standard & Poor's Rating Service or Baa3 or higher by Moody's Investors Service, Inc. or, if unrated, in the opinion of the Sub-Advisor of comparable quality.

### About Edge Asset Management, Inc.

Edge Asset Management has been a pioneer in the field of actively managed asset allocation investments and has more than \$19.4 billion in assets under management (as of December 31, 2010). Its primary areas of investment expertise are target-risk funds, large-cap equities, and taxable fixed-income securities. Based in Seattle, Washington, the firm has a heritage dating back to 1939, when it launched one of the first 50 mutual funds in the United States.

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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.

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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. Neither the principal of bond investment options nor their yields are guaranteed by the U.S. government.

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

The Short-Term Bond Fund merged into the Short-Term Income Fund effective July 23, 2010.

Barclays Capital Credit 1-3 Years Index is composed of publicly issued U.S. corporate and specified foreign debentures and secured notes that meet the specified maturity, liquidity, and quality requirements. To qualify, bonds must be SEC-registered.

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

### **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.

### **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.

<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/brussels/2011/12/30/a-voluntary-greek-debt-deal), 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)

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## Important Notes

<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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