

## Quarterly Commentary

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

## 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:

The portfolio's overweight allocation to discount bonds was additive for the period. Also, security selection of California credits aided 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 were bought at a discount) added to relative performance. Also, an increased allocation to California bonds aided performance. Additionally, an overweight allocation to the health care sectors benefited relative performance.

### Negative Contributors

#### During last quarter:

An overweight allocation to short-duration bonds detracted from relative performance. Also, the portfolio's overweight allocation to health care credits and sale of some weaker credits detracted from performance. Additionally, unfavorable security selection in the non-rated sector negatively impacted relative performance.

#### During last 12 months:

An overweight allocation to shorter-maturing securities hindered relative performance. Also, poor selection of lower-rated credits detracted from performance. The portfolio's significant underweight allocations to the state and local general obligation sectors were additional detractors.

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

No material changes occurred in the portfolio structure.

# Tax-Exempt Bond 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	01/03/1977
Tax-Exempt Bond Fund (A) (excl. sales charge)	1.95	11.03	11.03	10.80	3.66	4.54	5.55	Ext. Perf. Inc. Date	01/03/1977
Tax-Exempt Bond Fund (A) (incl. sales charge)	-1.89	6.80	6.80	9.39	2.87	4.14	5.41	Total Inv. Exp Gross	0.90
Barclays Capital Municipal Bond Index	2.12	10.70	10.70	8.57	5.22	5.38	-	Total Inv Exp Net	0.90
Muni National Long Category	2.14	10.64	10.64	9.59	3.81	4.46	-	Waiver Date	02/29/2012
Morningstar Percentile Ranking	-	-	32	24	66	49	-	Contractual Cap Date	02/29/2012
Total Funds in Category	250	246	246	227	211	181	-	Contingent Deferred Sales Charge	-
								Maximum Up-front Sales Charge	3.75

## Tax-Exempt Bond 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					
Tax-Exempt Bond Fund (A)	-0.43	1.31	93.54	1.65	1.04	6.29	26	10	1.66	-1.16	126.09	127.14
Barclays Capital Municipal Bond Index	N/A	N/A	N/A	N/A	N/A	N/A	26	10	1.31	-0.91	100.00	100.00
	5 Year						5 Year					
Tax-Exempt Bond Fund (A)	-2.34	1.24	88.01	0.36	-0.56	6.96	37	23	1.23	-1.64	103.58	138.91
Barclays Capital Municipal Bond Index	N/A	N/A	N/A	N/A	N/A	N/A	41	19	1.19	-1.18	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 (%)
Alaska St Intl Arpts Revs Rev Bds 5.25%	2.00
Milwaukee Cnty Wis Arpt Rev Arpt 5.25%	1.75
Washington St G.O. Vari 6.4%	1.51
Colorado Springs Colo Hosp Rev Hos 5.25%	1.41
Idaho Health Facs Auth 6.65%	1.16
Hudson Yds Infracst Corp Senior Re 5.75%	1.13
Bay Area Toll Auth 5%	1.11
Massachusetts Bay Transn Auth 5.25%	1.03
J P Morgan Chase Putters / Dri Ctfs	1.00
Indiana Mun Pwr Agy Pwr Sply Pwr 6.125%	0.99
<b>Total % in Top 10</b>	<b>13.08</b>

Statistics as of 11/30/2011	
Average Eff Duration (yrs)	7.68
Average Eff Maturity (yrs)	17.60
Average Weighted Coupon	5.70
Average Weighted Price	\$105.81
30-Day SEC Yield - Subsidized (Net) as of 12/31/2011	3.67%
30-Day SEC Yield - Non-Subsidized (Gross) as of 12/31/2011	3.67%

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

## Tax-Exempt Bond 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 a high level of income that is exempt from federal income tax while protecting investors' capital. The fund invests at least 80% of net assets in municipal obligations. Many of these are from California. Generally, municipal obligations pay interest that is exempt from federal income tax. The fund may invest up to 20% of assets in below investment grade bonds. It maintains an average portfolio duration that is within 10% of the duration of the Barclays Capital Municipal Bond Index.

### 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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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. 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 Municipal Bond Index 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

### **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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