

Quarterly Commentary

Ticker	Inv Manager or Sub-Advisor	Benchmark	Morningstar Category	Investment Objective
PQIAX	Edge Asset Management, Inc.	Russell 1000 Value Index	Large Value	Equity 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:

An overweight to utilities aided performance, as did stock selection within the sector; utilities benefited from investors' search for stability and yield amid economic uncertainty. Stock selection within the financial sector also helped results; the portfolio was underweight large money-center banks due to concerns about loan growth, industry capacity and the effects of regulation. Finally, a slight overweight to the industrial sector added value, as the sector outpaced the benchmark.

During last 12 months:

An underweight to the financial sector aided performance, as did stock selection within the sector; the portfolio was underweight large money-center banks due to concerns about loan growth, industry capacity and potential regulation. Stock selection within the energy sector also helped results, as large integrated oil companies outperformed. Finally, stock selection within telecommunications added value; BCE (the parent of Bell Canada) performed strongly in response to two dividend increases and a strong Canadian dollar.

Negative Contributors

During last quarter:

Stock selection within the consumer discretionary sector hindered results as investors became increasingly nervous about Europe and its effect on global growth. Additionally, stock selection within consumer staples detracted as Kimberly Clark disappointed on weak revenue growth. Finally, the portfolio's allocation to real estate investment trusts lagged the index.

During last 12 months:

Out-of-benchmark stock selection within the consumer discretionary sector hindered results as investments in Canada and Europe underperformed. Stock selection within the health care sector also detracted from performance. While most health care stocks performed well, the portfolio's positions in Teva Pharmaceuticals lagged. Finally, a slight overweight to information technology detracted from results.

Changes to the investment option's structure or portfolio:

No material changes occurred in the portfolio structure.

Equity 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, 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	05/31/1939
Equity Income Fund (A) (excl. sales charge)	12.34	5.07	5.07	13.42	0.09	5.64	8.55	Ext. Perf. Inc. Date	05/31/1939
Equity Income Fund (A) (incl. sales charge)	6.16	-0.69	-0.69	11.30	-1.04	5.05	8.46	Total Inv. Exp Gross	1.00
Russell 1000 Value Index	13.11	0.39	0.39	11.55	-2.64	3.89	-	Total Inv Exp Net	1.00
Large Value Category	11.97	-0.75	-0.75	11.76	-2.00	3.32	-	Waiver Date	-
Morningstar Percentile Ranking	-	-	16	25	18	6	-	Contractual Cap Date	-
Total Funds in Category	1309	1258	1258	1127	996	571	-	Contingent Deferred Sales Charge	-
								Maximum Up-front Sales Charge	5.50

Equity 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					
Equity Income Fund (A)	3.34	0.82	96.91	0.80	0.38	17.50	23	13	4.57	-3.57	86.99	75.49
Russell 1000 Value Index	N/A	N/A	N/A	N/A	N/A	N/A	21	15	5.25	-4.73	100.00	100.00
	5 Year						5 Year					
Equity Income Fund (A)	2.09	0.87	96.37	0.02	0.64	17.87	35	25	3.92	-3.90	91.38	83.02
Russell 1000 Value Index	N/A	N/A	N/A	N/A	N/A	N/A	31	29	4.29	-4.69	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 (%)
Intel Corp	2.36
ACE Ltd	2.32
Digital Realty Trust, Inc.	2.30
Abbott Laboratories	2.24
Merck & Co Inc	2.11
Mattel, Inc.	2.08
Genuine Parts Company	2.07
JPMorgan Chase & Co	2.03
Bristol-Myers Squibb Company	1.98
Chevron Corp	1.95
Total % in Top 10	21.43

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

Equity Income Fund (A)

Manager(s)	Start Date	Degree	Alma Mater
David W. Simpson	03/31/2008	M.B.A.	University of Wisconsin
Daniel R. Coleman	05/19/2010	M.B.A.	New York University

Fund Strategy

The investment seeks to provide a relatively high level of current income and long-term growth of income and capital. The fund invests primarily at least 80% of net assets in dividend-paying equity securities. It usually invests in equity securities of companies with large market capitalizations, but may also invest in equity securities of companies with medium market capitalizations. The fund invests in value equity securities; the value orientation selection emphasizes buying equity securities that appear to be undervalued. It also invests in real estate investment trusts and securities of foreign issuers.

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.

Important Notes

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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, 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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Russell 1000 Value Index is a market-capitalization weighted index of those firms in the Russell 1000 with lower price-to-book ratios and lower forecasted growth values.

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.

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Important Notes

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/empisit.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

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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