

Fourth Quarter 2011

## Quarterly Commentary

Ticker	Inv Manager or Sub-Advisor	Benchmark	Morningstar Category	Investment Objective
PGBAX	Multiple Sub-Advisors	Global Diversified Income Custom Index	World Allocation	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:

An overweight to the master limited partnerships (MLPs) sleeve and an underweight to the emerging market debt sleeve provided positive return contributions. All sleeves except the high-yield bonds and commercial mortgage-backed securities (CMBS) sleeves outperformed their respective return benchmarks for the period, led by the global real estate investment trusts (global REITs) sleeve. Within global REITs, the top contributor to performance was an allocation effect resulting from an aggressive underweight to Japanese development companies.

#### During last 12 months:

An overweight to the MLPs sleeve provided a positive return contribution for 12-month period. Also, the global REITs and global value equities sleeves outperformed their respective return benchmarks for the period. Within global REITs, the top relative performance contributor was an allocation effect resulting from an underweight to Japanese development companies. As for the global value equities sleeve, stock selection was favorable in most sectors and regions, with the greatest strength seen in energy, financials and utilities.

### Negative Contributors

#### During last quarter:

An overweight to the preferred securities sleeve and an underweight to the infrastructure sleeve provided negative return contributions. Additionally, the high-yield bonds and CMBS sleeves delivered negative returns. Within the high-yield bonds sleeve, an allocation to bank loans negatively impacted performance, as their overall return lagged that of high-yield bonds. Middle-market issues also underperformed. Within the CMBS segment, underperformance of out-of-index positions detracted from performance.

#### During last 12 months:

An overweight to the global value equities sleeve provided a negative return contribution. Also, the emerging market debt, high-yield bonds, CMBS, preferred securities and MLPs sleeves delivered negative returns. The emerging market debt sleeve had the most negative impact on overall results, due in large part to overweights to Argentine provinces, Indonesian high-yield credits and Russian corporates.

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

During the quarter, an infrastructure sleeve was added to Global Diversified Income and the global real estate sleeve was separated into two sleeves: Global REITs and CMBS.

# Global Diversified 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	12/15/2008
Global Diversified Income Fund (A) (excl. sales charge)	6.31	2.70	2.70	18.82	-	-	19.07	Ext. Perf. Inc. Date	12/15/2008
Global Diversified Income Fund (A) (incl. sales charge)	2.33	-1.18	-1.18	17.33	-	-	17.58	Total Inv. Exp Gross	1.16
Global Diversified Income Custom Index	6.25	3.84	3.84	20.86	-	-	-	Total Inv Exp Net	1.16
World Allocation Category	4.10	-3.99	-3.99	10.53	1.59	5.87	-	Waiver Date	02/29/2012
Morningstar Percentile Ranking	-	-	11	2	-	-	-	Contractual Cap Date	02/29/2012
Total Funds in Category	483	375	375	232	146	79	-	Contingent Deferred Sales Charge	-
								Maximum Up-front Sales Charge	3.75

## Global Diversified Income Fund (A)

### Top Ten Holdings as of 11/30/2011

Security	Net Assets (%)
Enterprise Products Partners LP	1.00
Hsbc Hldgs Pfd	0.85
Magellan Midstream Partners, L.P.	0.84
Kinder Morgan Management LLC	0.83
Williams Partners LP	0.83
Buckeye Partners, L.P.	0.81
Energy Transfer Partners, L.P.	0.67
Plains All American Pipeline LP	0.63
Claudius Limited 7.875%	0.59
Catlin Ins Co 144A FRN	0.58
<b>Total % in Top 10</b>	<b>7.64</b>

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

## Global Diversified Income Fund (A)

Manager(s)	Start Date	Degree	Alma Mater
Kelly D. Rush	12/15/2008	M.B.A.	University of Iowa
Mustafa Sagun	12/15/2008	Ph.D.	University of South Florida
L. Phillip Jacoby IV	12/15/2008	B.S.	Boston University
Chris Lepherd	12/15/2008	M.S.	Securities Institute of Australia
Simon Hedger	12/15/2008	M.B.A.	University of New England

### Fund Strategy

The investment seeks consistent cash income through a diversified, yield-focused investment strategy. The fund invests a majority of its assets in fixed income asset classes, such as high yield bonds, preferred securities, commercial mortgage-backed securities, and emerging market debt securities, in an effort to provide incremental yields over a portfolio of government securities. In addition, the fund invests in equities of global companies principally engaged in the real estate industry, equities of global infrastructure companies, and value equities of global companies to provide dividend yields and diversify fixed income-related risks in the fund.

### About Spectrum

Spectrum Asset Management offers specialized expertise in the management of preferred securities. Spectrum Asset Management is an affiliate of Principal Global Investors, with \$11.3 billion in assets under management as of December 31, 2010. The firm was founded in 1987 and is based in Stamford, Conn. Spectrum's clients include insurance companies, corporations, retirement plans, charitable trusts and financial institutions in the United States and abroad.

### About Principal Real Estate Inv

Principal Real Estate Investors, which is the dedicated real estate group for Principal Global Investors, managed \$34.7 billion in commercial real estate assets as of December 31, 2010. The firm's capabilities include commercial mortgage-backed securities, real estate equity securities and a broad range of private-market real estate equity and debt alternatives. Principal Real Estate Investors is the fourth largest institutional real estate manager in the United States, based on tax-exempt assets under management (Pensions & Investments, September 10, 2010 issue; Out of 87 managers profiled, as of June 30, 2010).

### About Tortoise Capital Advisors, LLC

Tortoise Capital Advisors, L.L.C. (Tortoise) is an investment manager specializing in listed energy infrastructure, such as pipeline and power companies. As of December 31, 2010, Tortoise had approximately \$6.1 billion in assets under management. The firm was founded in 2002 and is headquartered in Leawood, Kansas (a suburb of Kansas City, Missouri).

### About Guggenheim Investment Mgmt

Guggenheim Investment Management, LLC (GIM) was founded in 2001, to manage high-yield corporate bond and bank loan credit strategies. As of December 31, 2010, GIM managed and sub-advised approximately \$23 billion for institutional clients in separately managed accounts, structured vehicles and commingled funds. Most of GIM's assets under management are for sophisticated investors in longer-term strategies.

## 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 W.H. Reaves and Co., Inc

Reaves Asset Management is an SEC registered Investment Advisor that has been managing institutional portfolios since 1978. Reaves' portfolios target a disciplined balance of earnings growth and income in a wide variety of critical, non-discretionary, infrastructure industries. The firm is located in Jersey City, NJ. As of June 30, 2011 Reaves had approximately \$2 billion in assets under management.

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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. Lower-rated securities are subject to additional credit and default risks. Risks associated with preferred securities differ from risks inherent with other investments. In particular, in the event of bankruptcy, a company's preferred securities are senior to common stock but subordinated to all other types of corporate debt. International investing involves increased risks due to currency fluctuations, political or social instability, and differences in accounting standards, these risks are magnified in emerging markets. REIT securities are subject to risk factors associated with the real estate industry and tax factors of REIT registration.

Effective September 16, 2009, Guggenheim was added as an additional sub-advisor. Effective September 23, 2009, Tortoise Capital Advisors was added as an additional sub-advisor. Performance results displayed reflect all sub-advisors managing this portfolio during the time periods displayed.

Global Diversified Income Custom Index is composed of 38% Barclays Capital U.S. Corporate High Yield 2% Issuer Capped Index, 20% blend of 50% BofA Merrill Lynch Fixed Rate Preferred Securities Index and 50% Barclays Capital U.S. Tier I Capital Securities Index, 14% Barclays Capital U.S. Dollar Emerging Markets Bond Index, 7% blend of 65% S&P 500 Utilities Index, 25% S&P 500 Telecom Services Index and 10% S&P 500 Energy Index, 6% Tortoise Midstream MLP Index, 5% FTSE EPRA/NAREIT Developed Index, 5% Barclays Capital Investment Grade CMBS Index and 5% MSCI All Country World Value Index. The blended index historic returns reflect the allocation as of the time of production. Previous allocation changes are not restated.

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## Important Notes

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.

<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, 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)

<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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