

## Principal Funds 2009 Tax Reporting Supplement

The enclosed information is provided to assist shareholders in preparing their 2009 tax returns. The information contained herein should not be deemed to be tax advice. Due to the many differences in state and local regulations, shareholders should consult their tax advisors regarding this information. If you have any questions concerning the information we have furnished, please call us at 1-800-222-5852.

### Government Obligations Percentage

A portion of the dividends paid by the following funds during 2009 was derived from investments in obligations of the U.S. government or its agencies. Some of these dividends may be exempt from state and local taxes depending on the tax laws of your individual state or local taxing authority. Some states treat income from federal agency obligations differently than income from direct federal obligations. Please consult your tax advisor to determine which, if any, of the obligations listed below may be exempt from your state income tax.

| <b>Fund</b>  | <b><u>Direct</u><br/><u>Federal</u><br/><u>Obligations</u></b> | <b><u>Indirect</u><br/><u>Federal</u><br/><u>Obligations</u></b> | <b><u>Repurchase</u><br/><u>Agreements</u></b> |
|--|--|--|--|
| PFI Bond & Mortgage Securities Fund  | 3.78%  | 16.62%   | 0.10%  |
| PFI Core Plus Bond Fund I  | 6.03%  | 30.03%   | 0.21%  |
| PFI Disciplined LargeCap Blend Fund  | 0.00%  | 0.00%  | 0.15%  |
| PFI Diversified International Fund   | 0.00%  | 0.00%  | 0.02%  |
| PFI Equity Income Fund   | 0.00%  | 0.02%  | 0.12%  |
| PFI Global Diversified Income Fund   | 0.00%  | 0.00%  | 0.03%  |
| PFI Global Real Estate Securities Fund   | 0.00%  | 0.00%  | 0.04%  |
| PFI Government & High Quality Bond Fund  | 1.81%  | 68.90%   | 0.09%  |
| PFI Government & High Quality Bond Fund*<br><i>*(formerly known as PFI Mortgage Securities Fund)</i> | 2.20%  | 64.74%   | 0.19%  |
| PFI High Quality Intermediate-Term Bond Fund   | 10.12%   | 4.72%  | 0.27%  |
| PFI High Yield Fund  | 0.00%  | 0.00%  | 0.06%  |
| PFI High Yield Fund I  | 0.00%  | 0.00%  | 0.05%  |
| PFI Income Fund  | 2.36%  | 13.36%   | 0.05%  |
| PFI Inflation Protection Fund  | 79.44%   | 0.42%  | 0.00%  |
| PFI International Emerging Markets Fund  | 0.00%  | 0.00%  | 0.04%  |
| PFI International Fund I   | 0.00%  | 0.00%  | 0.06%  |
| PFI International Growth Fund  | 0.00%  | 0.00%  | 0.04%  |
| PFI International Value Fund I   | 0.00%  | 0.00%  | 0.03%  |
| PFI LargeCap Blend Fund I  | 0.00%  | 0.00%  | 0.26%  |
| PFI LargeCap Blend Fund II   | 0.02%  | 0.00%  | 0.11%  |
| PFI LargeCap Growth Fund   | 0.00%  | 0.00%  | 0.78%  |
| PFI LargeCap Growth Fund I   | 0.00%  | 0.00%  | 0.38%  |
| PFI LargeCap Growth Fund II  | 0.00%  | 0.00%  | 0.22%  |
| PFI LargeCap S&P 500 Index Fund  | 0.00%  | 0.00%  | 0.20%  |
| PFI LargeCap Value Fund  | 0.00%  | 0.00%  | 0.10%  |
| PFI LargeCap Value Fund I  | 0.00%  | 0.00%  | 0.16%  |
| PFI LargeCap Value Fund II   | 0.00%  | 0.00%  | 0.14%  |
| PFI LargeCap Value Fund III  | 0.00%  | 0.00%  | 0.14%  |
| PFI MidCap Blend Fund  | 0.00%  | 0.00%  | 0.48%  |
| PFI MidCap Growth Fund   | 0.00%  | 0.00%  | 0.74%  |
| PFI MidCap S&P 400 Index Fund  | 0.00%  | 0.00%  | 0.19%  |
| PFI MidCap Stock Fund  | 0.00%  | 0.00%  | 0.12%  |
| PFI MidCap Value Fund I  | 0.00%  | 0.00%  | 0.25%  |
| PFI MidCap Value Fund II   | 0.00%  | 0.00%  | 0.09%  |
| PFI MidCap Value Fund III  | 0.00%  | 0.00%  | 0.03%  |
| PFI Money Market Fund  | 0.75%  | 5.33%  | 0.00%  |
| PFI Preferred Securities Fund  | 0.00%  | 0.00%  | 0.07%  |
| PFI Principal Capital Appreciation Fund  | 0.00%  | 0.00%  | 0.18%  |
| PFI Principal LifeTime 2010 Fund   | 1.04%  | 8.62%  | 0.11%  |
| PFI Principal LifeTime 2015 Fund   | 2.12%  | 8.98%  | 0.11%  |
| PFI Principal LifeTime 2020 Fund   | 1.57%  | 7.27%  | 0.10%  |
| PFI Principal LifeTime 2025 Fund   | 1.39%  | 6.64%  | 0.11%  |

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### Government Obligations Percentage, continued

| <u>Fund</u>                                  | <u>Direct<br/>Federal<br/>Obligations</u> | <u>Indirect<br/>Federal<br/>Obligations</u> | <u>Repurchase<br/>Agreements</u> |
|--|---|---|----------------------------------|
| PFI Principal LifeTime 2030 Fund             | 0.99%                                     | 4.62%                                       | 0.09%                            |
| PFI Principal LifeTime 2035 Fund             | 0.88%                                     | 4.16%                                       | 0.10%                            |
| PFI Principal LifeTime 2040 Fund             | 0.56%                                     | 2.63%                                       | 0.09%                            |
| PFI Principal LifeTime 2045 Fund             | 0.45%                                     | 2.16%                                       | 0.09%                            |
| PFI Principal LifeTime 2050 Fund             | 0.27%                                     | 1.28%                                       | 0.09%                            |
| PFI Principal LifeTime 2055 Fund             | 0.32%                                     | 1.54%                                       | 0.09%                            |
| PFI Principal LifeTime Strategic Income Fund | 0.08%                                     | 10.55%                                      | 0.12%                            |
| PFI Real Estate Securities Fund              | 0.00%                                     | 0.00%                                       | 0.05%                            |
| PFI SAM Balanced Portfolio                   | 0.91%                                     | 16.13%                                      | 0.09%                            |
| PFI SAM Conservative Balanced Portfolio      | 1.20%                                     | 21.13%                                      | 0.09%                            |
| PFI SAM Conservative Growth Portfolio        | 0.51%                                     | 9.70%                                       | 0.10%                            |
| PFI SAM Flexible Income Portfolio            | 1.30%                                     | 21.35%                                      | 0.08%                            |
| PFI SAM Strategic Growth Portfolio           | 0.01%                                     | 0.01%                                       | 0.11%                            |
| PFI Short-Term Bond Fund                     | 6.57%                                     | 4.96%                                       | 0.13%                            |
| PFI Short-Term Income Fund                   | 1.77%                                     | 0.43%                                       | 0.20%                            |
| PFI SmallCap Blend Fund                      | 0.00%                                     | 0.00%                                       | 0.30%                            |
| PFI SmallCap Growth Fund I                   | 0.00%                                     | 0.00%                                       | 1.17%                            |
| PFI SmallCap S&P 600 Index Fund              | 0.00%                                     | 0.00%                                       | 0.28%                            |
| PFI SmallCap Value Fund                      | 0.00%                                     | 0.00%                                       | 0.21%                            |
| PFI SmallCap Value Fund I                    | 0.00%                                     | 0.00%                                       | 0.25%                            |
| PFI SmallCap Value Fund II                   | 0.00%                                     | 0.00%                                       | 0.31%                            |
| PFI SmallCap Value Fund III                  | 0.00%                                     | 0.00%                                       | 0.07%                            |
| PFI Ultra Short Bond Fund                    | 10.87%                                    | 9.46%                                       | 0.56%                            |

PFI = Principal Funds, Inc

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### Reallocation of Principal Funds, Inc. Distributions: Return of Capital Redesignation

A portion of the income dividends paid by Principal Funds, Inc. – Government & High-Quality Bond Fund and Principal Funds, Inc. – MidCap Value Fund II have been redesignated as non-taxable return of capital. Your Form 1099-DIV for these funds reports the proper amount of “nondividend distribution” for income tax purposes. If a return of capital was reported to you, an adjustment to the basis of your shares will be necessary. Please consult your tax advisor for further information.

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### Alternative Minimum Tax

The percentage of 2009 exempt interest dividends subject to the Federal Alternative Minimum Tax is summarized below. Please consult with your tax advisor to determine if you are subject to AMT.

| <u>Fund</u>                   | <u>AMT %</u> |
|-------------------------------|--------------|
| PFI California Municipal Fund | 12.33%       |
| PFI Tax-Exempt Bond Fund      | 14.75%       |

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### Special Tax Information for Real Estate Securities Fund Shareholders

A majority of the fund’s investments are in real estate investment trusts (REITs), and many REITs will redesignate their 2009 dividends in early February 2010. These redesignations usually reduce ordinary income. Because of this REIT redesignation, shareholders of the Real Estate Securities Fund should be aware that the fund may issue amended Form 1099-DIVs prior to March 15, 2010. Once the final REIT redesignation information has been received, we will determine whether the Form 1099-DIVs will need to be amended.

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### Qualified Dividends

Qualified dividends received and distributed by a fund are eligible to be taxed at lower federal income tax rates. Qualified dividends are generally distributions from domestic corporations and certain qualified foreign corporations that meet certain holding requirements. The ordinary dividends that may qualify for the lower tax rates are shown in Box 1b of Form 1099-DIV. Shareholders must meet the holding period requirement to qualify for the lower ordinary dividend tax rates. To be eligible to treat all or a portion of a fund's dividend as qualified, shareholders must have held the fund's shares for at least 61 days during the 121-day period surrounding the ex-dividend date. For additional information, see IRS Publication 550 at [www.irs.gov](http://www.irs.gov).

### Dividends Received Deduction for Corporate Investors

For corporate shareholders, the table below reflects the percent of the total ordinary dividends paid by the Principal Funds during the calendar year 2009 which qualify for the 70% corporate dividends received deduction.

| <b>Fund</b>                                  | <b>Qualified Dividend Income</b> | <b>Dividends Received Deduction</b> | <b>Fund</b>                                  | <b>Qualified Dividend Income</b> | <b>Dividends Received Deduction</b> |
|--|----------------------------------|-------------------------------------|--|----------------------------------|-------------------------------------|
| PFI Bond & Mortgage Securities Fund          | 0.83%                            | 0.00%                               | PFI MidCap Value Fund I                      | 100%                             | 100%                                |
| PFI Core Plus Bond Fund I                    | 1.00%                            | 0.87%                               | PFI MidCap Value II                          | 100%                             | 100%                                |
| PFI Disciplined LargeCap Blend Fund          | 100%                             | 100%                                | PFI MidCap Value Fund III                    | 100%                             | 100%                                |
| PFI Diversified International Fund           | 100%                             | 0.00%                               | PFI Preferred Securities Fund                | 22.48%                           | 2.74%                               |
| PFI Equity Income Fund                       | 100%                             | 100%                                | PFI Principal Capital Appreciation Fund      | 100%                             | 100%                                |
| PFI Global Diversified Income Fund           | 6.50%                            | 1.66%                               | PFI Principal LifeTime 2010 Fund             | 23.54%                           | 11.83%                              |
| PFI Global Real Estate Securities Fund       | 20.87%                           | 0.45%                               | PFI Principal LifeTime 2015 Fund             | 32.63%                           | 18.04%                              |
| PFI High Quality Intermediate-Term Bond Fund | 1.37%                            | 0.00%                               | PFI Principal LifeTime 2020 Fund             | 31.98%                           | 16.94%                              |
| PFI High Yield Fund                          | 2.72%                            | 0.29%                               | PFI Principal LifeTime 2025 Fund             | 40.19%                           | 22.70%                              |
| PFI High Yield Fund I                        | 0.07%                            | 0.06%                               | PFI Principal LifeTime 2030 Fund             | 39.60%                           | 21.70%                              |
| PFI Income Fund                              | 0.46%                            | 0.46%                               | PFI Principal LifeTime 2035 Fund             | 49.84%                           | 28.17%                              |
| PFI International Emerging Markets Fund      | 100%                             | 0.00%                               | PFI Principal LifeTime 2040 Fund             | 48.98%                           | 27.30%                              |
| PFI International Fund I                     | 100%                             | 0.00%                               | PFI Principal LifeTime 2045 Fund             | 56.93%                           | 31.94%                              |
| PFI International Growth Fund                | 100%                             | 0.00%                               | PFI Principal LifeTime 2050 Fund             | 56.48%                           | 31.45%                              |
| PFI International Value Fund I               | 55.74%                           | 0.00%                               | PFI Principal LifeTime 2055 Fund             | 57.95%                           | 32.85%                              |
| PFI LargeCap Blend Fund I                    | 100%                             | 100%                                | PFI Principal LifeTime Strategic Income Fund | 10.79%                           | 4.43%                               |
| PFI LargeCap Blend Fund II                   | 100%                             | 100%                                | PFI Real Estate Securities Fund              | 9.62%                            | 0.00%                               |
| PFI LargeCap Growth Fund                     | 100%                             | 100%                                | PFI SAM Balanced Portfolio                   | 44.61%                           | 34.73%                              |
| PFI LargeCap Growth Fund I                   | 100%                             | 100%                                | PFI SAM Conservative Balanced Portfolio      | 24.06%                           | 17.75%                              |
| PFI LargeCap Growth Fund II                  | 100%                             | 100%                                | PFI SAM Conservative Growth Portfolio        | 91.97%                           | 74.67%                              |
| PFI LargeCap S&P 500 Index Fund              | 100%                             | 100%                                | PFI SAM Flexible Income Portfolio            | 14.55%                           | 9.67%                               |
| PFI LargeCap Value Fund                      | 100%                             | 100%                                | PFI SAM Strategic Growth Portfolio           | 100%                             | 100%                                |
| PFI LargeCap Value Fund I                    | 100%                             | 100%                                | PFI SmallCap Blend Fund                      | 100%                             | 100%                                |
| PFI LargeCap Value Fund II                   | 100%                             | 100%                                | PFI SmallCap Growth Fund I                   | 100%                             | 100%                                |
| PFI LargeCap Value Fund III                  | 100%                             | 100%                                | PFI SmallCap S&P 600 Index Fund              | 100%                             | 100%                                |
| PFI MidCap Blend Fund                        | 100%                             | 100%                                | PFI SmallCap Value Fund                      | 100%                             | 100%                                |
| PFI MidCap Growth Fund                       | 100%                             | 100%                                | PFI SmallCap Value Fund I                    | 100%                             | 100%                                |
| PFI MidCap S&P 400 Index Fund                | 100%                             | 100%                                | PFI SmallCap Value Fund II                   | 100%                             | 100%                                |
| PFI MidCap Stock Fund                        | 65.50%                           | 64.86%                              | PFI SmallCap Value Fund III                  | 100%                             | 100%                                |

PFI = Principal Funds, Inc

### Foreign Tax Credit

Principal Funds, Inc. invests in foreign securities incorporated in nations outside the United States. Foreign source income is the income earned by a fund from investments in these foreign securities. Many countries impose a tax on income earned by investors beyond their borders. These taxes are paid by the fund. The following funds have elected to pass through to shareholders the foreign taxes paid. Accordingly, this permits a shareholder to either take a federal income tax credit or a deduction from gross income. The amount of foreign tax credit that is utilized by a shareholder may be limited due to general credit limitation rules as well as a reduction in foreign source income associated with qualified dividend income. The percentage of the foreign source income that is qualified dividend income is shown in the Qualified Dividends table of this Tax Reporting Supplement. Refer to the IRS Form 1116 instructions for additional information regarding foreign tax credits. Please consult with your tax advisor to determine whether it is more beneficial for you to take the credit or deduction.

The information below summarizes the portion of income that was derived from foreign sources with regard to the applicable fund.

| <b>Fund</b>                             | <b>Foreign Source Income</b> | <b>Foreign Tax Paid</b> |
|---|------------------------------|-------------------------|
| PFI Diversified International Fund      | 89.31%                       | \$.0259                 |
| PFI Global Real Estate Securities Fund  | 54.15%                       | \$.0088                 |
| PFI International Emerging Markets Fund | 84.95%                       | \$.0597                 |
| PFI International Fund I                | 89.84%                       | \$.0261                 |
| PFI International Growth Fund           | 86.32%                       | \$.0316                 |
| PFI International Value Fund I          | 50.61%                       | \$.0292                 |

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### Tax-Exempt Interest Income by State

A portion of the dividends you received in 2009 may be exempt from state and local taxes, depending on the tax laws of your individual state or local taxing authority. For this purpose, a percentage breakdown of income by state or U.S. possession for 2009 is provided below. For shareholders residing in the state of California, payments of interest-dividends on federally tax-exempt non-California municipal bonds are being reported to the California Franchise Tax Board (FTB) as required under Revenue & Taxation Code (R&TC) Section 18639.

| <u>State</u>         | <u>California Municipal</u> | <u>Tax-Exempt Bond</u> | <u>State</u>     | <u>California Municipal</u> | <u>Tax-Exempt Bond</u> |
|----------------------|-----------------------------|------------------------|------------------|-----------------------------|------------------------|
|                      | <u>Fund</u>                 | <u>Fund</u>            |                  | <u>Fund</u>                 | <u>Fund</u>            |
| Alabama              | 0.21%                       | 1.36%                  | Nebraska         | 0.00%                       | 1.71%                  |
| Alaska               | 0.00%                       | 4.17%                  | Nevada           | 0.00%                       | 1.24%                  |
| Arizona              | 0.00%                       | 2.42%                  | New Hampshire    | 0.00%                       | 1.04%                  |
| Arkansas             | 0.00%                       | 0.00%                  | New Jersey       | 0.00%                       | 3.25%                  |
| California           | 99.44%                      | 9.93%                  | New Mexico       | 0.00%                       | 0.14%                  |
| Colorado             | 0.00%                       | 1.93%                  | New York         | 0.00%                       | 3.52%                  |
| Connecticut          | 0.00%                       | 0.67%                  | North Carolina   | 0.00%                       | 0.00%                  |
| Delaware             | 0.00%                       | 0.00%                  | North Dakota     | 0.00%                       | 0.00%                  |
| District of Columbia | 0.00%                       | 1.63%                  | Northern Mariana | 0.00%                       | 0.00%                  |
| Florida              | 0.00%                       | 6.84%                  | Islands          |                             |                        |
| Georgia              | 0.00%                       | 1.77%                  | Ohio             | 0.00%                       | 4.12%                  |
| Guam                 | 0.00%                       | 0.00%                  | Oklahoma         | 0.00%                       | 0.13%                  |
| Hawaii               | 0.00%                       | 0.83%                  | Oregon           | 0.00%                       | 1.01%                  |
| Idaho                | 0.00%                       | 2.01%                  | Pennsylvania     | 0.00%                       | 1.21%                  |
| Illinois             | 0.00%                       | 9.61%                  | Puerto Rico      | 0.00%                       | 0.18%                  |
| Indiana              | 0.00%                       | 3.04%                  | Rhode Island     | 0.00%                       | 0.01%                  |
| Iowa                 | 0.00%                       | 1.38%                  | South Carolina   | 0.00%                       | 0.90%                  |
| Kansas               | 0.00%                       | 1.77%                  | South Dakota     | 0.00%                       | 0.14%                  |
| Kentucky             | 0.00%                       | 1.76%                  | Tennessee        | 0.00%                       | 2.24%                  |
| Louisiana            | 0.00%                       | 0.72%                  | Texas            | 0.00%                       | 6.94%                  |
| Maine                | 0.00%                       | 0.00%                  | Utah             | 0.00%                       | 1.71%                  |
| Maryland             | 0.00%                       | 1.75%                  | Vermont          | 0.00%                       | 0.00%                  |
| Massachusetts        | 0.00%                       | 2.38%                  | Virginia         | 0.00%                       | 0.76%                  |
| Michigan             | 0.00%                       | 3.89%                  | Virgin Islands   | 0.35%                       | 0.00%                  |
| Minnesota            | 0.00%                       | 0.94%                  | Washington       | 0.00%                       | 2.79%                  |
| Mississippi          | 0.00%                       | 0.17%                  | West Virginia    | 0.00%                       | 1.29%                  |
| Missouri             | 0.00%                       | 1.76%                  | Wisconsin        | 0.00%                       | 2.94%                  |
| Montana              | 0.00%                       | 0.00%                  | Wyoming          | 0.00%                       | 0.00%                  |