

Retirement Income Strategies – Why Diversification Matters

Executive Summary

An investor's satisfaction with his or her financial plan in retirement is highly influenced by the overall available rate of spending and the consistency of that rate over time, heightening the need for effective income-producing strategies. This paper examines how a diversified portfolio of non-core income strategies used alongside traditional core bond holdings has the potential to boost total portfolio income without material increases in risk.

A comprehensive Global Diversified Income Portfolio (GDIP) composed of six non-core income strategies was created using proprietary market insights and investment models, to consist of:

- high-yield bonds;
- preferred securities;
- real estate securities, including real estate investment trusts (REITs) and commercial mortgage-backed securities (CMBS);
- emerging market debt;
- master limited partnerships (MLPs); and
- global value equities.

The yield trends of the six income strategies tend to move up or down in response to macroeconomic and market conditions, particularly changes in interest rates. However, the spread between yields of the strategies can be quite pronounced and even volatile over time. Even so, yield volatility is much lower than the volatility of total return. Because investor sensitivity to large swings in principal values is often underestimated, this paper contends that yield strategies should be evaluated relative to the volatility of each strategy's total return, or principal risk, not relative to the volatility of monthly yields.

Even when this expanded measure of risk-adjusted yield is used, investors will make imperfect allocation decisions if they rely solely on historical data — particularly in unrepresentative periods such as the early stages of the current market cycle (2003-2006), when risk premiums were pushed to extreme lows. The paper argues for the use of historical and forward-looking inputs. Although past risk relationships are generally good predictors of future risk and correlation levels, past relationships of stocks and bond yields have less predictive value. Forward-looking assumptions for yields based on market-consensus models and proprietary yield and risk forecasts appear to be a useful analytical framework for developing and evaluating income strategies.

This paper explores whether, evaluated within this framework, a modest allocation to GDIP within a traditional portfolio of stocks, bonds, and cash may potentially improve portfolio yield while reducing expected portfolio risk.

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The Need for Diversified Sources of Retirement Income

The nature of retirement is changing for both Baby Boomers and the financial professionals who serve them. As with prior generations, Baby Boomers face the dual retirement savings challenges of keeping up with inflation while managing losses due to market swings and other causes. Baby Boomers also face a greater risk of outliving their savings, thanks to increased life expectancy. Moreover, as the uncertainty of having enough retirement income has escalated, so has a retiree's share of the financial responsibility for securing a comfortable lifestyle. Unlike the prior generation, fewer Baby Boomers can rely on employer-provided pension plans for sufficient retirement income and health care coverage. Meanwhile, Social Security will provide proportionately less income replacement than it did for prior generations.

Today, there are 76 million Baby Boomers nearing or beginning their retirement, and two-thirds of these individuals (46 million) are anticipated to retire between now and 2013; the remaining third (30 million) are expected to retire after 2013 or experience a phased retirement. By 2014, it is projected that more money will flow out of qualified retirement plans than into them due to retiring Baby Boomers. The need for customized and well-executed retirement income strategies has never been greater*.

Regrettably, most individuals facing retirement today have yet to design wealth “decumulation” strategies, which convert accumulated savings into long-lived, stable income streams. Fortunately for today's retirees, there has never been a more diverse range of product strategies available for converting personal savings into retirement income. Helping Baby Boomers identify the best of these strategies and navigate their way through them represents a tremendous opportunity for financial professionals.

A variety of techniques are offered by financial professionals for generating adequate retirement income. Most well-conceived approaches will combine income-producing and capital appreciation investments with strategies that address the systematic consumption of the principal balance through time. The amount of accumulated wealth at retirement is a key determinant of the retiree's ability to establish and maintain adequate retirement income. However, the *overall rate* of expected real spending (4% vs. 6% annually) and the *consistency* of the desired spending rate year to year have been shown to be equally important factors in determining the investor's satisfaction with their retirement income program.

While a comprehensive retirement income program addresses income generation, growth, and principal consumption strategies, this paper is focused on the design of optimal “income-generating” strategies using traditional mutual funds. Most financial professionals and investors have exposure to the traditional investment-grade “core” fixed-income investments to generate income in portfolios including U.S. Treasury, investment-grade corporate, and mortgage and asset-backed securities. The analysis herein focuses instead on constructing an optimal portfolio of “*non-core*” sources of income, which we recommend be used alongside traditional investment-grade core bond strategies to help balance portfolio income goals with portfolio risk.

The Case for Diversified Income Strategies - Yield and Volatility

Many of the investment theories that support Modern Portfolio Theory and its most common application, strategic asset allocation, can also be applied to the development of optimal retirement income strategies. Just as asset classes and managers with different return patterns can be combined in portfolios in an effort to lower risk and improve return, so too can diversified sources of historically high income.

Retirement income strategies that utilize a variety of income-producing investments may reduce portfolio risk within retirement income programs by diversifying across a number of strategy-specific factors such as:

Security Type – Diversification benefits can be achieved by owning securities that reside at different levels in the capital structure or are issued by different types of corporate entities. For example, most fixed-income and preferred securities such as high-yield bonds, emerging market bonds, commercial

*Cerulli Associates, Tiburon Strategic Advisors.

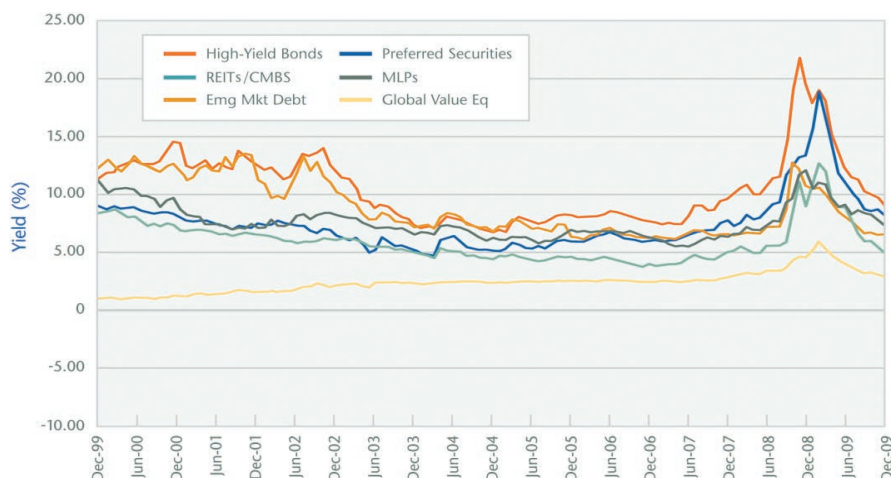
mortgage-backed securities (CMBS), and preferred stock have contractual obligations to pay regular coupons/dividends. Other security types such as common stock give the issuer broad discretion to determine the amount and timing of dividend payments. Finally, tax-sheltered corporate entities, such as real estate investment trusts (REITs) and master limited partnerships (MLPs), have discretion over the amount and timing of income distributions, but generally the IRS requires they distribute 90% of taxable income to shareholders each year in order to maintain their tax-exempt status.

Geography – Investing in income-producing securities issued by non-domestic entities can help maintain or improve a portfolio’s yield profile while diversifying portfolio risk. Risk reduction is achieved by way of currency diversification, dissimilar fiscal and monetary policies, and non-synchronous business cycles, all of which impact the yield and risk profile of non-domestic, income-oriented investments.

Single vs. Multiple Investment Managers – Concentrating portfolio management with a single investment manager can introduce unnecessary organizational and investment process risk to the total portfolio. Utilizing a “best of breed” multiple manager approach mitigates these risks by providing access to multiple specialist firms. This approach reduces reliance on a single alpha generation process tied to one portfolio management team, centralized research inputs, and investment decision-making process.

In Table 1 we illustrate the monthly yield observations for six “non-core” income-oriented strategies available in the mutual fund marketplace today: high-yield bonds, emerging market debt, global value equities, preferred securities, public real estate debt/equity securities, and MLPs. Table 2 illustrates the historical yield spreads of all six strategies relative to 10-year Treasury yields.

Table 1 **Monthly Yield of Non-Core Income Strategies**
(December 31, 1999 to December 31, 2009)



Source: Barclays Capital Live, Wilshire Compass, Merrill Lynch, Alerian Capital.
Past performance is no guarantee of future results. The illustration reflects historical index performance and does not reflect actual fund performance or yield.

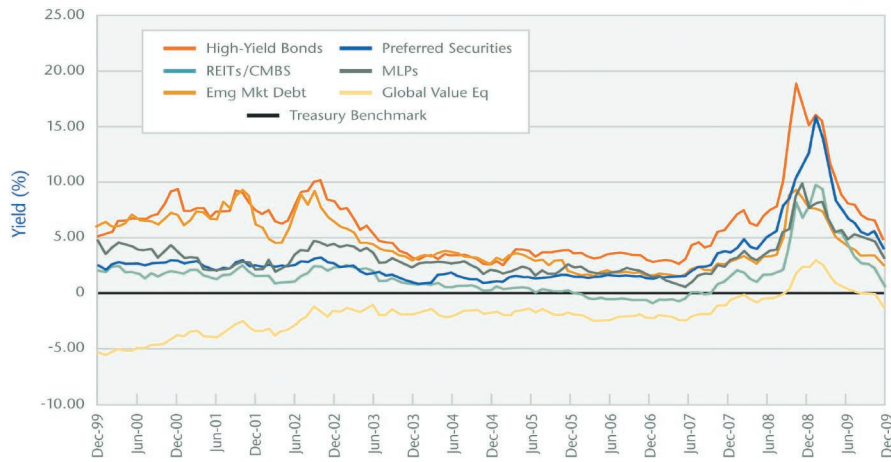
Investment strategies discussed in this paper are represented by the following indices: Barclays Capital (BarCap) U.S. High Yield 2% Issuer Cap, an unmanaged index of the 2% Issuer Cap component of the BarCap High Yield Corporate Bond Index; Preferred Securities is a blend of 65% Merrill Lynch Fixed Rate Preferred Securities Index and 35% Barclays Capital U.S. Tier 1 Capital Securities Index; REITs/CMBS is a blend of 75% FTSE EPRA/NAREIT Global Real Estate Index, designed to represent general trends in eligible real estate equities worldwide, and 25% BarCap CMBS Index, designed to measure the performance of the commercial mortgage-backed securities (CMBS) market; the BarCap Emerging Markets Bond Index, which tracks total returns for U.S. dollar-denominated debt instruments issued by emerging market sovereign and quasi-sovereign entities; the MSCI AC World Value, a free float-adjusted market capitalization index designed to measure the combined equity market performance of developed and emerging market countries excluding the U.S.; and the Alerian MLP Index, a composite of the 50 most prominent energy master limited partnerships (MLPs).

Table 2

Historical Yield Spreads Relative to 10-Year Treasuries

(December 31, 1999 to December 31, 2009)

Benchmark: U.S. 10-Year Treasury Yield



Source: Barclays Capital Live, Wilshire Compass, Merrill Lynch, Alerian Capital.

The information in Tables 1 and 2 demonstrates that changes in monthly yields for all six strategies, on both an absolute basis and relative to 10-year Treasury yields, are generally positively correlated. Predictably, the yields of all six income strategies are unavoidably linked to changes in macroeconomic and market variables, such as interest rates, inflation rates, earnings trends, and investor sentiment. Therefore, we would logically expect to observe similar yield trends among all six income strategies through time.

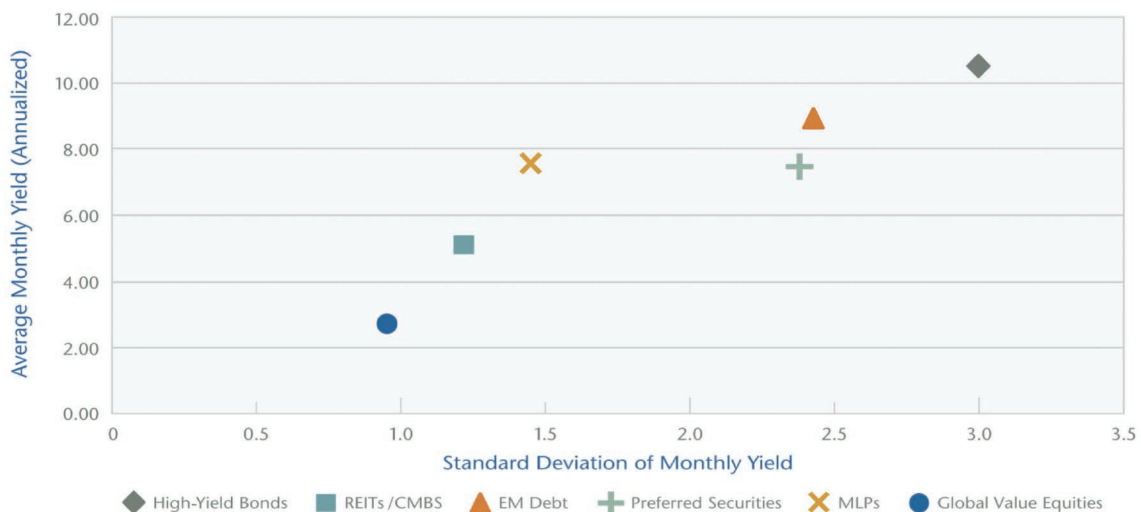
Tables 1 and 2 also show that *differences* in income strategy yields (or “relative yields”) are not constant through time or among differing strategies. Notice in the tables the narrowness of yield differentials among all six income strategies from 2005-2006 and how they begin to widen in 2007. Lastly, note the peak differences in relative yields during the fall of 2008, when the global financial markets were teetering. These types of changes in relative yields are common, and they can provide investors with attractive opportunities to improve portfolio results.

In Table 3 we observe the volatility of monthly yields. Table 3 displays the average monthly yield and the yield volatility for all six income strategies over the past ten years (December 1999-2009).

Table 3

Volatility of Monthly Yields

(December 31, 1999 to December 31, 2009)



Standard deviation measures how much an investment’s returns are likely to fluctuate.

Like the differences in monthly yield, the differences in *volatility* of monthly yield can be quite pronounced across the different yield strategies. Notice in Table 3 that the average yield of high-yield bonds over the most recent ten-year period is nearly 30%-150% greater than the other yield strategies, and its volatility is more than 100%-300% greater. So, historically retirees who valued more *consistent* month-to-month yield would have benefited from investing a portion of their income-oriented assets in public real estate and global equity income strategies. (It is important to note that past performance or historical sector/security activity may not be indicative of future behavior or guarantee results.)

It is also important to note that the volatility of yield has been much lower than the volatility of total return for the six income strategies. For example, the volatility of yield is generally 20%-40% of average yield, while the volatility of total return is 200%-500% of average total return.

Diversified Yield Strategies in a Portfolio Context – A Historical Perspective

Because the volatility of yield is generally low for all six strategies, especially in relation to average yield, *Principal Management Corporation (Principal)** believes yield strategies should be evaluated relative to the volatility of each strategy’s total return. We refer to this measure as “principal risk” throughout the remainder of this paper. More importantly, we believe investor sensitivity to *large* swings in principal balances is often underestimated, including income-oriented investors. As such, financial professionals need to carefully weigh the benefits of higher yield potential against the incremental default, duration, operational, regulatory, and business model risks embedded in most high-yield investments. In other words, “there is no free lunch,” and higher yield comes at a price. Accordingly, Principal believes the primary measure of “risk-adjusted yield” should be average yield relative to principal risk, not the volatility of monthly yield.

Table 4 displays “risk-adjusted” yield calculated as average yield divided by principal risk for all six income strategies from December 1999 – December 2009.

Table 4 **Risk-Adjusted Yield**
Yield vs. Principal Risk
(December 31, 1999 to December 31, 2009)



*Principal Management Corporation provides investment advisory services to Principal Funds, Inc. through a management agreement. Principal Management Corporation is an indirect subsidiary of the Principal Financial Group®.

Unlike the data in Table 3, the results in Table 4 indicate that over the most recent ten-year period, investors have not experienced the expected trade-off between higher yield and higher principal volatility. In fact, the two strategies with the highest yields in this time period – high-yield and emerging-market bonds – had the lowest levels of volatility. While this outcome may seem illogical and inconsistent with capital market theory, it is not uncommon over short to moderate time horizons, especially when the global economy and credit markets are stable and risk premiums are steady to declining. This recent outcome can be explained by the fact that high-yield and emerging-market bond risk fell to very low levels (e.g. 50%-60% of their long-term averages) from 2002 to mid-2007. In contrast, the average yields on high-yield and emerging-market bonds over the same period were similar to their long-term averages. The net effect of this dislocation was that high-yield and emerging-market bonds earned unusually high risk-adjusted yields.

However, it is important to note that high-yield and emerging market bonds are prone to extended periods of very high volatility. High volatility often occurs during times of economic uncertainty such as in 2008. High volatility can also occur in response to unforeseen events in the global credit market such as the failure of the high-yield firm Drexel Burnham in the late 1980s or the Russian debt crisis in 1998.

Diversified Yield Strategies in a Portfolio Context – A Forward-Looking Perspective

Investors will make imperfect allocation decisions if they rely solely on historical data for yield and principal risk assumptions, especially when the historical data is representative of market structures or economic environments that are no longer relevant. Better assumptions may be developed by combining historical yield and principal risk data with forward-looking inputs for the same variables. This is the approach advocated by Principal.

Methodology

Our forward-looking assumptions are based on market-consensus models that use current prices of asset class indexes to solve for the market's implied rate of return (or yield) for a particular asset class or strategy. We also incorporate proprietary asset class yield and risk forecasts developed by the Economic Committee of Principal Global Investors.*

Fixed-income strategies: Yield forecasts for fixed-income strategies, such as high-yield bonds, preferred securities, CMBS, and emerging market debt, are determined using a “building block” approach. Under this approach, historical and forecasted data are used to develop assumptions for the “building blocks” of fixed-income returns, including real interest rates, expected/unexpected inflation rates, and risk premiums relating to credit, prepayment, or liquidity risk.

REITs and MLPs: Yield assumptions for the REIT component of the public real estate strategy and MLPs are based on current dividend yields plus/minus expected changes in the long-term growth rate of dividends.

Global value equity: The dividend yield assumption for the global value equity component is based on current dividend yields plus/minus expected changes in historical pay-out ratios and the long-term growth rate of dividends.

*Asset allocation/diversification does not guarantee a profit or protect against a loss.
Past performance is no guarantee of future results.*

*Principal Global Investors, LLC, and its affiliates are members of the Principal Financial Group® and are sub-advisors to many of the Principal Funds. The Principal Global Investors Economic Committee is a group of the firm's senior economic thought leaders who support investment areas by forecasting and analyzing economic and market changes.

Principal’s assumptions for principal risk and cross correlations are primarily based on historical data, rather than on forecasts of future risk levels. We believe past risk relationships are generally good predictors of future risk and correlation levels. However, judgment will be applied when appropriate to adjust for fundamental changes in risk behavior or when new and evolving risk relationships are not adequately captured in the historical data.

Data derived using this methodology offers a more logical trade-off between yield and risk because our assumptions (1) are based on behavior over longer time horizons than previously considered and (2) combine historical and forward-looking inputs. Under this more practical analytical framework, investors seeking higher levels of yield (i.e., by moving from lower-risk preferred securities to higher-risk high-yield bonds, emerging-market debt, and MLPs) can expect greater volatility in the principal value of their retirement investment portfolio.

The chart in Table 5 highlights historic correlation data for all six income strategies. Our correlation assumptions for public real estate securities and global value equities with the other four income strategies (in blue) are generally low, which indicates portfolio risk can be lowered without a commensurate reduction in total portfolio yield. Additionally, global value equities and public real estate securities have tended to have more *consistent* yield levels than the other income strategies. Finally, while total return characteristics are typically of secondary concern to income-oriented investors, the equity nature of public real estate and global value equity can provide a boost to the overall portfolio’s total return potential, especially when fixed-income-based strategies are challenged.

Table 5 **Return Correlations**
(as of December 31, 2009)

Asset Class	REITs/ CMBS	MLPs	High- Yield Bonds	Emg Mkt Debt	Preferred Securities	Global Value Eq
Public Real Estate (REITs/CMBS)	1					
MLPs	0.31	1				
High-Yield Bonds	0.63	0.56	1			
Emerging Market Debt	0.51	0.27	0.71	1		
Preferred Securities	0.53	0.45	0.49	0.38	1	
Global Value Equity	0.64	0.37	0.65	0.60	0.49	1

Constructing a Global Diversified Income Portfolio

Principal has developed a comprehensive portfolio strategy that combines all six income strategies in a risk/return efficient manner using mean/variance optimization techniques and efficient frontier analysis. Our analysis uses historical yield, risk, and correlation data, shown in Tables 4 and 5, along with proprietary yield and principal risk estimates and correlation assumptions.

Table 6 depicts the structure of Principal's efficient income portfolio, which endeavors to maximize yield per unit of principal risk subject to certain constraints employed to minimize liquidity and manager concentration risks.

Table 6 Global Diversified Income Portfolio Strategy Targets

Strategy	Target Weight	Range
High-Yield Bonds	35%	25 – 45%
Preferred Securities	20%	10 – 30%
Public Real Estate (REITs/CMBS)	15%	5 – 25%
MLPs	10%	5 – 15%
Emerging Market Debt	10%	5 – 15%
Global Value Equity	10%	5 – 15%

Ranges may not reflect current allocations.

Table 7 shows historical portfolio characteristics and statistics for the combined Global Diversified Income Portfolio including average monthly yield, yield volatility, and annualized total return and risk.

Table 7 Global Diversified Income Portfolio Characteristics
(December 31, 1999 to December 31, 2009)

Average Monthly Yield	7.88%
Monthly Yield Volatility*	2.19%
Total Return (annualized)	8.07%
Principal Risk (annualized)*	11.26%
Yield/Principal Risk	0.70

Source: Wilshire COMPASS, FactSet
For Global Diversified Income Portfolio composition, see page 11.

*As measured by standard deviation. Table reflects historical data for indices included in the portfolio construction (defined on page 3). The index blend is shown for illustration purposes only and does not reflect any sales charges or fees. It is not possible to invest directly in an index.

Over the past ten years, the economy has experienced periods of expansion and contraction, rising and declining interest rates, and bull and bear markets. During this period, the portfolio's historical yields, total returns, and volatility would have been attractive on an absolute basis and relative to any of a number of individual income strategies alone. Moreover, while the yield/principal risk ratio for the combined portfolio (0.70) would have lagged that of high-yield bonds (0.78) and emerging debt (0.78) (as a result of the 2002-2007 period of below-average risk), it would have exceeded that of public real estate securities (0.17), MLPs (0.41), preferred securities (0.39), and global value equities (0.18).

Table 8 displays the same historical yield and principal risk data shown in Table 4, but includes the combined Global Diversified Income Portfolio index blend. (Keep in mind that high-yield and emerging bond market risk fell to levels nearly half of their long-term averages in 2002-2007, a dislocation that resulted in unusually high risk-adjusted yields during this time period.) The proprietary longer-term, forward-looking yield and risk forecasts used by Principal in internal analysis make even more apparent the diversification benefits of combining multiple income strategies with low correlations.

Table 8 Yield/Risk Including Global Diversified Income Portfolio

Yield vs. Principal Risk*
(as of December 31, 2009)



*Information shown is drawn from index-based data. It does not reflect the performance or yield of the Principal Global Diversified Income Fund or any sales charges, transaction costs, or other ongoing mutual fund expenses, nor does it guarantee future performance.

Note that the Global Diversified Income Portfolio does not seek to produce the highest yielding solution; however, it does strive to plot as the most “northwesterly” point on the graph. This position signifies that the combined portfolio’s yield/principal risk ratio is designed to be greater than that of any of the six underlying income strategies alone.

Global Diversified Income Portfolio in a Traditional Portfolio Context

The preceding analysis discusses the diversification benefits investors can achieve by combining multiple high-income strategies in a single portfolio. Next, we examine the return and diversification benefits investors can achieve within a traditional portfolio of stocks and bonds by including a modest allocation to a Global Diversified Income Portfolio.

Table 9 presents historical return and risk values for U.S. stocks, international stocks, and U.S. bonds.

Table 9 **Historical Long-Term Values**
(December 31, 1999 to December 31, 2009)

	Total Return	Standard Deviation
U.S. Stocks	-0.95	16.13
International Stocks	1.17	17.82
U.S. Bonds	6.33	3.83
Global Diversified Income Portfolio	8.07	11.26

For Global Diversified Income Portfolio composition, see page 11.

Table 10 highlights the impact modest allocations to the Global Diversified Income Portfolio can have on the overall portfolio's return and risk statistics.

Table 10 **Effect on Investment Results of Global Diversified Income Portfolio (GDIP)**

Asset	GDIP @ 0% Weight	GDIP @ 10% Weight	GDIP @ 20% Weight	GDIP @ 30% Weight
U.S. Stocks	50%	45%	40%	35%
International Stocks	10%	9%	8%	7%
U.S. Bonds	40%	36%	32%	28%
GDIP	0%	10%	20%	30%
Portfolio Total Return	2.66%	3.22%	3.78%	4.34%
Portfolio Risk*	9.73%	9.68%	9.68%	9.73%
Return/Risk	0.03	0.08	0.14	0.19

*As measured by standard deviation

U.S. Stocks are represented by the S&P 500, a market capitalization-weighted index of 500 widely held stocks often used as a proxy for the stock market; International Stocks by the MSCI EAFE Index, a market capitalization index designed to measure the equity market performance of developed markets, excluding the US & Canada; U.S. Bonds by the BarCap Aggregate Bond Index, which covers the U.S. investment-grade, fixed-rate bond market.

The results in Table 10 present a compelling case for investing a portion of an investor's total portfolio in a Global Diversified Income Portfolio. Note a 10% investment in the GDIP (funded from a proportional reduction in the allocation to each stock and bond strategy) improves the total portfolio return by 0.56%, or 20%, while slightly reducing portfolio risk. Increasing the GDIP allocation to 20% of total portfolio assets (with proportionate reduction in allocations to stocks and bonds) maintains the same risk level as the 10% allocation, while increasing return by an additional 0.56%. The portfolio with the 30% allocation to GDIP is shown to have the same risk level as that with no GDIP allocation, while total return rises by 1.68%, an increase of over 60%.

Conclusion

As Baby Boomers enter retirement, we assume the demand for well-executed income strategies will grow dramatically. Principal believes the successful income strategies of tomorrow will be those that provide attractive potential yields on a consistent basis without exposing investors to undue principal risk. As such, we believe the best income strategies will be those that pay equal attention to incremental yield and incremental principal risk, are rebalanced in a thoughtful and disciplined manner, and blend multiple layers of diversification (by geography, security type, and sub-advisor) to produce efficient high-yielding portfolios that meet investors' income objectives in all market environments.

Calendar Year Return of Indices

December 31, 1999 - December 31, 2009

Annual Returns for Period Ending	BarCap U.S. High Yield 2% Issuer Cap Index	Preferreds Blended Index	Real Estate Blended (REITs/CMBS)	MSCI World Value Index	BarCap Emerging Markets (USD)	Alerian MLP Index
12/31/00	-5.78	16.21	13.93	0.11	13.71	45.72
12/31/01	5.46	9.10	-0.37	-14.93	1.43	43.73
12/31/02	-0.24	10.78	5.94	-19.95	12.25	-3.37
12/31/03	28.78	10.49	30.82	38.12	26.92	44.54
12/31/04	11.14	5.67	28.85	18.52	11.88	16.67
12/31/05	2.77	1.92	11.95	9.54	12.28	6.32
12/31/06	10.76	7.04	32.00	25.09	9.95	26.07
12/31/07	2.25	-8.57	-3.67	3.42	5.14	12.74
12/31/08	-25.88	-27.52	-41.27	-40.39	-14.75	-36.93
12/31/09	58.77	29.13	36.15	26.68	34.22	76.43

The Global Diversified Income Portfolio Blend represented in this paper is allocated among the following indices: 35% BarCap U.S. High Yield 2% Issuer Cap; 20% Preferreds Blended Index (65% Merrill Lynch Preferred Stock Fixed Rate Index/35% Barclays Capital, Capital Securities Tier 1 Index); 15% Real Estate Blended Index (75%FTSE EPRA/NAREIT Global Real Estate Index/25% BarCap AAA CMBS Index); 10% MSCI AC World Value Index;10% BarCap US Dollar Emerging Markets Bond Index;10% Alerian MLP Index.

The commentary reflects the opinions of The Principal® and may not come to pass.

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A mutual fund's share price and investment return will vary with market conditions, and the principal value of an investment when you sell your shares may be more or less than the original cost.

Equity investment options involve greater risk, including heightened volatility, than fixed-income investment options.

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.

Real estate investment options are subject to some risks inherent in real estate and real estate investment trusts (REITs), such as risks associated with general and local economic conditions. Investing in REITs involves special risks, including interest rate fluctuation, credit risks, and liquidity risks, including interest conditions on real estate values and occupancy rates.

International investing involves increased risks due to currency fluctuations, political or social instability, and differences in accounting standards.

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