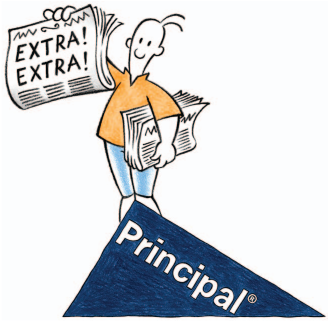

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The Principal® Perspective

SUMMER 2011

SOMETHING PRICEY THIS WAY COMES

Inflation is on the way. How prepared is your portfolio?

In many parts of the world, inflation has already arrived. **Rising prices for commodities — everything from oil to cotton to steel — are resulting in a rash of inflation** in many regions.

In 2010, for example, retail prices in China rose almost five percent. The cost to borrow money in China and Europe is escalating quickly. And in April of this year, World Bank President Robert Zoellick said that the global economy is "one shock away from a full-blown crisis" due to rising food prices.

In the U.S., we're already starting to feel the pressure.

Gas prices are climbing steadily. Clothing prices are predicted to rise by 10 percent this year. The USDA forecasts a 3.5 to 4.5 percent jump in grocery store prices, with the cost of some food items — such as beef and pork — rising by as much as eight percent. Prices are also increasing for electronics, appliances, and more.

Inflation, of course, is **one of the biggest threats to long-term investing.** It can eat away at the purchasing power of your portfolio and create a surprisingly big gap between what you *thought* you could afford and what you can actually afford.

Take a look at the table on the right for examples of the impact inflation can have on retirement income needs. As you can see, even a one percent increase in the average inflation rate can have a big impact on purchasing power over time.

Minimize inflation's impact

Although you can't prevent inflation, you can help minimize its impact on your portfolio. One investment option worth considering is real assets. Real assets are tangible assets like gold, land, buildings, and commodities.

Real assets offer several advantages, including:

- **A hedge against inflation.** The value of real assets tends to rise with consumer prices. That can help protect the purchasing power of your investment.
- **Diversification.** Because real assets have a historically low correlation to traditional stocks and bonds, they help to lower your overall portfolio risk.
- **Enhanced return potential.** With attractive historical returns, real assets have the potential to enhance total portfolio return in various market environments.

Aside from investing in individual real assets (which could be complex and time-consuming), another option is a mutual fund with exposure to real assets. Because different kinds of real assets perform differently depending on the economic conditions — and since no single strategy performs well in all

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The Long Arm of Energy Inflation

Pricey fill-ups at the gas station are bad enough. But unfortunately, that's not the only impact of rising energy prices. Other prices are likely to rise along with the cost of gas, including:

- Air travel
- Fast food
- Produce
- Mailing/shipping
- Beef and pork
- Coffee
- Orange juice
- Chocolate

Current Annual Income Need	Years to Retirement	Annual Income Needed at Retirement (3% average inflation)	Annual Income Needed at Retirement (4% average inflation)
$50,000	15	$77,898	$90,047
$75,000	15	$116,848	$135,071
$100,000	15	$155,797	$180,094
$50,000	20	$90,306	$109,556
$75,000	20	$135,458	$164,334
$100,000	20	$180,611	$219,112

FINANCIAL TIPS *for* Recent Grads

Help the recent college graduate in your life start out on the right financial footing.

Few times in life are as exciting and filled with opportunity as college graduation. Final exams are finished, the freshly minted diploma is in hand, and the new college graduate is ready to take on the world.

As graduates enter the "real world," now is a great time to encourage them to establish good financial habits. Share the following tips to start the conversation.

1 PAY YOURSELF FIRST.

The best time to save money is before you even see it. Set up regular automatic transfers from your checking account (through your bank) or from your paycheck (through your employer) to an investment account. If you start these contributions right away, you won't even miss the money, and you'll take an important step toward building life-long financial security.

2 AVOID CREDIT CARD DEBT LIKE THE PLAGUE.

Credit card debt is one of the biggest threats to your short- and long-term financial security. If you choose to use a credit card, it's best to pay it off every month *in full*. Credit card interest can snowball quickly, and that can limit your ability to invest for the future and buy the things you need today.

3 SET UP AN EMERGENCY FUND.

One of your first investing goals should be building an emergency fund. Think of this as your "Oh, shoot" fund. (As in, "Oh, shoot — my car needs a new transmission." Or, "Oh, shoot — my roommate just moved out, and I have to pay the rent myself." Or, even worse, "Oh, shoot — I just lost my job.").

The ultimate goal for this fund is three to six months worth of living expenses; however, even a month or two of living expenses is a great start. This financial cushion will help you avoid turning to a credit card in the event of unexpected costs.

4 IF YOUR EMPLOYER OFFERS FREE MONEY, TAKE IT.

Hopefully, your first job comes with a retirement plan, such as a 401(k) or 403(b) plan. The great thing about these plans — in addition to the fact that you don't pay taxes on money you put into the plan until you take it out at retirement — is that they often include an employer match.

An employer match is a way for your company to help you save for retirement, by contributing money into your retirement plan. But you have to contribute some as well. Let's say your employer matches 50 percent of the first six percent you contribute into the plan. If your gross pay for a pay period is $1,500 and you contribute six percent of that (or $90) into the plan, your employer will then pitch in another $45 (50 percent of $90). That's like an instant 50 percent return on your investment.

5 LEARN THE ART OF FINANCIAL COMPROMISE.

Careful spending doesn't necessarily require all-or-nothing decisions. You can still enjoy life and invest for the future through small compromises. For example, buy a used car instead of a new one. Wait for sales. Bring your lunch a few days a week instead of eating out every day.

6 CHOOSE INVESTMENTS CAREFULLY.

When selecting investments, consider when you'll need the money. For instance, your emergency fund should be invested conservatively. If you're investing for the long term (such as for retirement), however, a more aggressive fund from Principal Funds may help your investment gain in value over time. No matter your station in life, Principal Funds offers a number of investment options for the long-term investor.

Here's one last bit of advice. If managing money isn't your forte, consider working with a financial professional. These experts can give you the one-on-one guidance you need to help you form a strong financial foundation, and one that will continue to pay off throughout your life.

Visit DreamAgain.com to Dream — and Plan — for the Future

Recent college graduates have a lot of dreams. So many, in fact, they may need to prioritize them. Principal Funds can help with a fun new tool called the Dreamcatcher. The Dreamcatcher is an online social application that allows people to create a photo collage of their dreams.

Once they've completed their Dreamcatcher, we can help create a plan to achieve those dreams. Our planning center at DreamAgain.com has the resources they'll need, including information and tools for retirement planning, life-stage planning, and money management.

ASSET ALLOCATION IN A POST-RECESSION WORLD

Are we entering a new age of asset allocation thinking? Todd Jablonski, Head of Asset Allocation at Edge Asset Management and Portfolio Manager of the Principal Strategic Asset Management (SAM) Portfolios, shares his insight.

The market crash of 2008 was a shocking event for most investors. In fact, some are just beginning to recover their losses. That dizzying drop in portfolio values led some experts to question traditional thinking about asset allocation.

Does this thinking need to change? Are we entering a new age of asset allocation? Well, yes and no. First, let's take a look at the current thinking.

The most widely followed asset allocation approach over the past 50 or so years is known as Modern Portfolio Theory. It introduced the now-familiar notions of risk, reward, and diversification to asset allocation portfolios.

One of the theory's assumptions is that asset class performance, over the long run, resembles the classic bell curve many of us are familiar with from high school. However, as Todd Jablonski explains, this is at odds with real-world experience. Actual asset class returns haven't looked like a typical bell curve. Rather, they've looked liked a bell curve with "fatter" tails. These fatter tails indicate higher tail risk, or the risk of more extreme performance.

"It's the risk that the 'unlikely' may actually be more likely than anticipated," says Jablonski. "For instance, the statistical chance that the S&P 500 might be up or down by 30 percent in a given year is greater than what the pioneers of Modern Portfolio Theory originally thought." Unfortunately, many investors learned this the hard way.

Another of the theory's limitations also became evident during the crash. "In market downturns, asset class returns tend to be more highly correlated — or to perform more similarly to each other — than they are when markets are steady or going up. That exposes portfolios to more risk during downturns," says Jablonski.

An art and a science

Because any asset allocation theory will have unique flaws, the SAM Asset Allocation Team doesn't rely solely on one asset allocation approach. Instead, they use a three-step active asset allocation approach as seen below.

"Instead of blindly following one theory, asset allocation really does need to be viewed as a combination of art and science," Jablonski explains. "It also requires ongoing monitoring and revising. It's a process, not a set-it-and-forget-it event."

Your financial professional can help

Asset allocation can be complex. If you need help selecting and monitoring your overall portfolio mix, a financial professional can help.

SAM PORTFOLIOS THREE-STEP ACTIVE ASSET ALLOCATION APPROACH

STEP 1

STRATEGIC ANALYSIS
Sets long-term strategic asset class targets.

STEP 2

TACTICAL ANALYSIS
Determines near-term targets based on current market conditions and investment outlook.

STEP 3

ACTIVE IMPLEMENTATION
Construction of portfolio based on fund-specific research utilizing cash flow management and rebalancing as needed.

ONGOING RISK MANAGEMENT
The process is revisited and refined for efficient risk management over time.

"Something Pricey This Way Comes"

Continued from Page 1

inflationary environments — the **Principal Diversified Real Asset Fund (PRDAX)** combines multiple strategies.

The Principal Diversified Real Asset Fund uses an approach that targets broad inflationary and market concerns. It achieves diversification by allocating assets among:

- Treasury Inflation-Protected Securities (TIPS)
- U.S. real estate investment trusts (REITs)
- Natural resource stocks
- Commodities
- Master limited partnerships

Premier sub-advisors, chosen for their experience and track record, manage each strategy within the Fund. Principal Management Corporation provides overall asset allocation and day-to-day management of the Fund.

To learn more about the Principal Diversified Real Asset Fund visit principalfunds.com/DRA, or contact your financial professional.

Fixed-income investment options are subject to interest rate risk, and their value will decline as interest rates rise. Neither the principal of bond investment options nor their yields are guaranteed by the U.S. or any other government entity. Investments concentrated in natural resources industries can be affected significantly by events relating to those industries, such as variations in the commodities markets, weather, disease, embargoes, international, political, and economic developments, the success of exploration projects, tax and other government regulations, and other factors. Investing in derivatives entails specific risks relating to liquidity, leverage, and credit that may reduce returns and/or increase volatility.

REIT securities are subject to risk factors associated with the real estate industry and tax factors of REIT registration. An MLP that invests in a particular industry (e.g., oil and gas) may be harmed by detrimental economic events within that industry. As partnerships, MLPs may be subject to less regulation (and less protection for investors) under state laws than corporations. In addition, MLPs may be subject to state taxation in certain jurisdictions, which may reduce the amount of income paid by an MLP to its investors.

IN THE NEWS

Social Security Changes

The Social Security Administration (SSA) announced several changes that may impact you, even if you don't currently receive Social Security benefits:

- **Elimination of statements.** The SSA has suspended mailing statements to all workers and retirees in an effort to cut expenses. All other methods for requesting a statement have also been disabled, such as online and telephone requests. You can still get an estimate of your Social Security benefits, however, by using the SSA's Retirement Estimator at ssa.gov/estimator.
- **Elimination of the do-over option.** Individuals will no longer be able to begin payments at age 62, pay back all the benefits received at age 70 without interest, and then reclaim at a higher rate due to delayed claiming. Under the new rules, Social Security beneficiaries may withdraw an application for retirement benefits only within 12 months of their first Social Security payment and are limited to one withdrawal per lifetime.
- **Retroactive benefit suspensions halted.** Retirees will still be allowed to temporarily suspend their benefits and restart them later, which can result in bigger Social Security checks to account for the months or years in which payment wasn't received. However, beneficiaries won't be able to retroactively suspend benefits and pay back money already received in exchange for higher payments going forward.
- **No longer issuing paper checks.** Retirees who applied for Social Security benefits on or after May 1, 2011, no longer have the option of receiving a paper check in the mail. Seniors can have their entitlement payments directly deposited into a bank or credit union account or loaded onto a prepaid Direct Express Debit MasterCard.

If you have questions about these changes, contact your financial professional or visit the Social Security Administration website at ssa.gov.

Principal® Funds

WE'LL GIVE YOU AN EDGE®

GLOBAL INVESTMENT MANAGEMENT • ASSET ALLOCATION EXPERTISE • RETIREMENT LEADERSHIP

Investors should carefully consider a fund's investment objectives, risks, charges, and expenses prior to investing. A prospectus containing this and other information can be obtained by contacting a financial professional, visiting principalfunds.com, or by calling 800-222-5852. Read the prospectus carefully before investing.

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.

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