

Third Quarter 2017

# Quarterly Commentary

Ticker	Inv Manager or Sub-Advisor	Benchmark	Morningstar Category	Investment Objective
PMFMX	Principal Global Investors	Standard & Poor's 400 MidCap Stock Index	Mid Cap Blend	Growth and Income

## Economic Overview

The global economic recovery that began in early 2016 appears to have reached self-sustaining velocity. The consensus now recognizes the evidence: strong industrial production, robust growth, and improved capital spending. Plus, business and consumer confidence is surging to high or record levels. Bank indices had better returns than the overall market. Mildly rising interest rates also suggest that investors appreciate some of the more recent worries (i.e., risks of deflation, political turmoil in Europe, or a China hard landing) have fallen significantly.

Economic sentiment in the Eurozone is within a whisker of a 17-year high. Confidence improved in every sector and country. Even Italian CEOs have the most optimistic outlook in a decade. The final survey of manufacturing purchasing managers was the highest in over six and a half years. The flash composite of service and manufacturing indices rose. Private demand is driving growth in both consumer spending and investment. In September, inflation stayed modest. Unemployment is falling and job gains are healthy. The 5.6% jobless rate in Germany is the lowest it's been since reunification in the early 1990s. Even Brexit fears can't keep the UK economy from expanding, or household spending from growing. Purchasing manager indices from the National Bureau of Statistics suggest that both manufacturing and service businesses are improving in China. The private-sector gauge from Caixin/Markit slipped a bit, but still shows growth. The People's Bank of China revealed a targeted cut in required reserves for banks that increase lending to small and very small enterprises, so while fiscal stimulus has faded some, there will be plenty of liquidity. Growth is not accelerating, but no near-term hard landing seems anywhere in sight. The U.S. economy has been strong and steady. Real economic growth averaged 2.2%, matching the rate over the entire expansion. Confidence is high, job growth is robust, and inflation is subdued. Profit growth is rebounding, and capital spending is picking up. We expect third-quarter growth to be cut a few tenths by the tragedies that came with Hurricanes Harvey, Irma, and Maria. Rebuilding efforts could add a bit to growth in following quarters.

As the synchronized global economic expansion continues robust and unabated, central banks are re-evaluating the extraordinary policies put in place after the financial crisis. Robust world growth, higher oil prices, and rising investor confidence in the self-sustaining expansion, pushed government bond yields higher, reversing their July-August dip.

## Small/Mid U.S. Equity

U.S equity markets continued their march higher, with major market indexes posting solid gains for the third quarter in a row to start 2017. Many asset classes rose during the period, with investors willing to take on more risk. Categories that are typically more volatile, such as small-cap and international stocks, led the way. Larger companies did maintain their lead over smaller peers, however, when considering all of 2017 to date. From a style perspective growth outpaced value for the third straight quarter. The Russell 2000 index produced a return of 5.67% and the Russel Midcap returned 3.47%. While volatility was apparent as the U.S. 10-year Treasury Yield started the quarter at 2.27%, it touched as low as 2.04% in early September, to only move higher and end the quarter at 2.31%.<sup>1</sup>

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## Performance Contributors

### Positive Contributors

#### During last quarter:

Principal MidCap S&P 400 Index was in line with the S&P 400 Index. The investment option uses an indexing strategy and does not attempt to manage market volatility, use defensive strategies, or reduce the effect of any long-term periods of negative stock market performance. Seven of the 11 economic sectors in the index posted positive returns during the quarter with the energy and industrials sectors providing the best returns. Allegheny Technologies, Avis Budget Group, and Take-Two Interactive Software contributed.

#### During last 12 months:

Principal MidCap S&P 400 Index was in line with the S&P 400 index. The investment option uses an indexing strategy and does not attempt to manage market volatility, use defensive strategies, or reduce the effect of any long-term periods of negative stock market performance. Nine of the 11 economic sectors in the index posted positive returns during the period with financials and industrials sectors providing the largest positive returns. Chemours, IPG Photonics, and Cognex contributed.

### Negative Contributors

#### During last quarter:

The healthcare and telecommunication services sectors recorded the worst returns. MEDNAX, Dick's Sporting Goods, and Uniti Group detracted.

#### During last 12 months:

The telecommunication services and energy sectors recorded the worst returns. SM Energy, QEP Resources, and Avon Products detracted.

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

No material changes occurred in the portfolio structure.

# MidCap S&P 400 Index R3 Fund

## 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. For more performance information, including most recent month-end performance, visit [www.principal.com](http://www.principal.com), contact your representative of the Principal Financial Group®, or contact our participant contact center at 1-800-547-7754.*

*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 09/30/2017	QTR	YTD	1 Year	3 Year	5 Year	10 Year	Since Inception	Inception Date	12/06/2000
MidCap S&P 400 Index R3 Fund	3.01	8.73	16.56	10.30	13.54	8.17	8.51	Ext. Perf. Inc. Date	12/06/2000
Standard & Poor's 400 MidCap Stock Index	3.22	9.40	17.52	11.18	14.43	9.00	-	Total Inv. Exp Gross	0.73
Mid Cap Blend Category	3.57	9.92	15.93	8.00	12.86	6.86	-	Total Inv Exp Net	0.73
Morningstar Percentile Ranking	-	-	46	26	47	31	-	Waiver Date	-
Total Funds in Category	462	448	433	354	321	215	-	Contractual Cap Date	-

**Past performance is no guarantee of future results.** Market indices have been provided for comparison purposes only. They are unmanaged and do not reflect fees or expenses. Individuals cannot invest directly in an index.

# MidCap S&P 400 Index R3 Fund

## Statistics Summary as of 09/30/2017

	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					
MidCap S&P 400 Index R3 Fund	-0.79	1.00	99.99	0.91	-9.87	11.03	24	12	2.52	-2.43	97.45	102.82
Standard & Poor's 400 MidCap Stock Index	N/A	N/A	N/A	N/A	N/A	N/A	24	12	2.58	-2.36	100.00	100.00
	5 Year						5 Year					
MidCap S&P 400 Index R3 Fund	-0.76	1.00	99.99	1.17	-9.76	11.20	41	19	2.81	-2.54	97.61	102.39
Standard & Poor's 400 MidCap Stock Index	N/A	N/A	N/A	N/A	N/A	N/A	41	19	2.88	-2.48	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 08/31/2017

Security	Net Assets (%)
S&P Mid 400 Emini Sep17	2.11
iShares Core S&P Mid-Cap ETF	0.66
Cadence Design Systems Inc	0.66
MSCI Inc	0.62
Take-Two Interactive Software Inc	0.61
Huntington Ingalls Industries Inc	0.59
Trimble Inc	0.59
Cognex Corp	0.57
NVR Inc	0.57
Teleflex Inc	0.57
<b>Total % in Top 10</b>	<b>7.54</b>

## MidCap S&P 400 Index R3 Fund

Manager(s)	Start Date	Degree	Alma Mater
Thomas L. Kruchten	03/01/2011	B.A.	University of Northern Iowa
Jeffrey A. Schwarte	07/29/2016	B.A.	University of Northern Iowa

### Investment Strategy

The investment seeks long-term growth of capital. Under normal circumstances, the fund invests at least 80% of its net assets, plus any borrowings for investment purposes, in equity securities of companies that compose the Standard & Poor's ("S&P") MidCap 400 Index at the time of purchase. The index is designed to represent U.S. equities with risk/return characteristics of the mid cap universe, which include growth and value stocks. As of December 31, 2016, the market capitalization range of the companies comprising the index was between approximately \$952.0 million and \$10.5 billion.

### About Principal Global Investors

Principal Global Investors - a member of the Principal Financial Group® - uses a unified investment philosophy and process that seeks to emphasize independent fundamental research and superior stock selection. The firm's capabilities encompass large-, mid-, and small-cap stocks in developed and emerging markets worldwide.

## Important Notes

Insurance products and plan administrative services, if applicable, are provided by Principal Life Insurance Company. Principal mutual funds are part of the Principal Funds, Inc. series. Principal Funds, Inc. is distributed by Principal Funds Distributor, Inc. Securities are offered through Principal Securities Inc., 800-547-7754, member SIPC and/or independent brokers/dealers. Principal Funds Distributor, Principal Securities and Principal Life are members of the Principal Financial Group®, Des Moines, IA 50392. Certain investment options may not be available in all states or U.S. commonwealths.

**Investors should carefully consider a mutual 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 [principal.com](http://principal.com), or calling 1-800-547-7754. 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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Small-cap and mid-cap stocks may have additional risks, including greater price volatility.

Small-cap and mid-cap investment options are subject to more fluctuation in value and may have additional risks than other investment options with stocks of larger, more stable companies.

Each index based investment option is invested in the stocks or bonds of the index it tracks. Performance of indexes reflects the unmanaged results for the market segment the selected stocks or bonds represent. There is no assurance an index based investment option will match the performance of the index tracked.

The risks associated with derivative investments include that the underlying security, interest rate, market index, or other financial asset will not move in the direction the Investment Adviser and/or Sub-Adviser anticipated, the possibility that there may be no liquid secondary market, the risk that adverse price movements in an instrument can result in a loss substantially greater than a fund's initial investment, the possibility that the counterparty may fail to perform its obligations; and the inability to close out certain hedged positions to avoid adverse tax consequences.

### About Principal Financial Group



The Principal Financial Group® (The Principal®) is a leading global financial company offering businesses, individuals and institutional clients a wide range of financial products and services. Our range of products and services includes retirement solutions, life and health insurance, wellness programs, and investment and banking products through our diverse family of financial services companies and national network of financial professionals.

## Important Notes

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Standard & Poor's 400 MidCap Stock Index includes approximately 10% of the capitalization of U.S. equity securities. These are comprised of stocks in the middle capitalization range.

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.

**Up-Market Capture Ratio** - A statistical measure of an investment option's performance relative to a comparative index in months in which that index has risen. An up-market capture ratio of greater than 100 would indicate that the investment option performed better than the comparative index during months in which the index had risen over a specified time period.

**Down-Market Capture Ratio** - A statistical measure of an investment option's performance relative to a comparative index in months in which that index has fallen. A down-market capture ratio of greater than 100 would indicate that the investment option performed worse than the comparative index during months in which the index had fallen over a specified time period.

\*Unless otherwise stated, all data from Bloomberg

<sup>1</sup>U.S. small-cap stocks: Russell 2000 Index; U.S. mid-cap stocks: Russell Midcap Index



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## Important Notes

This report is not complete unless all pages, as noted below, are included.



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