

First Quarter 2014

# Quarterly Commentary

Ticker	Inv Manager or Sub-Advisor	Benchmark	Morningstar Category	Investment Objective
PPMSX	Emerald Advisers, Inc	Russell 2000 Growth Index	Small Growth	Small Company

## Economic Overview

The first quarter of 2014 was largely dominated by geopolitical influences. Strife in the Ukraine as well as Chinese financial concerns took the primary focus of the global markets. Domestically, the economy grew at a slower pace due in part to continued removal of the Quantitative Easing (QE) stimulus by the Federal Reserve, and the toll of extreme winter weather.

After posting very strong gains in 2013, equity markets moved sideways for the first quarter. The S&P 500 was down in January, up in February, and now stands virtually unchanged for the year as of quarter-end 2014. Meanwhile, the bond market has shown gains as QE tapering has proven a non-event. Rates of the U.S. Treasury ten year note fell from 3.04% at year-end 2013, to 2.73% at end of first quarter 2014.<sup>1</sup>

International markets have largely shadowed the U.S., showing very little movement thus far in 2014. The exception is emerging markets, which are down an additional 0.8% so far this year. A slowdown in the Chinese economy, the turmoil in the Ukraine, and the fragility of numerous emerging markets have influenced the lackluster performance. Within the BRIC nations, Brazil is up 1.97%, Russia is down -14.45%, and China is down -5.87%. India is posting gains, up 7.84%.<sup>2</sup>

On the domestic front, U.S. employment trends continue to look strong. While the headline unemployment rate has held at 6.7%<sup>3</sup>, the trend in weekly jobless claims continued to fall, hitting 311,000 the week of 3/22.<sup>3</sup> This is the best performance in labor statistics since 2007 (except for a few months in late 2013). The housing market continues to post growth, with the Case-Shiller Index of 20 cities showing a 13.2% gain year-over-year, even after a 0.1% decline in January.<sup>4</sup> And, overall consumer spending continues to grow at about a 3.0% overall pace.<sup>5</sup>

Globally, China has shown signs of a weaker and more fragile economy, marked by increased credit defaults and more volatile currency. Prices of some commodities are plunging, especially those at the heart of China's economic growth, including copper, iron ore and coal. Rising financial stresses are evident as profit growth shrinks dramatically, due in part to rising labor costs, particularly relative to other Asian nations. Trouble in China could have a significant impact on the economic fortunes of both emerging and developed markets, particularly the European financial system, which has significant loan exposure to the emerging markets.

## Small/Mid U.S. Equity

U.S. mid-cap equities returned 3.5% for the quarter, outperforming U.S. small-caps (up 1.1%) and U.S. large-caps (up 2.1%). In addition, U.S. mid-caps, U.S. small-caps, and U.S. large-caps outperformed international equities in emerging markets, which returned -0.4%, and international equities in developed markets, which returned 0.7%.<sup>6</sup>

Within value, mid-cap equities beat small-caps, due primarily to stronger performance from the financial and utilities sectors within the Russell MidCap Value Index (up 5.2%) compared to the Russell 2000 Value Index (up 1.8%). There were similar results within growth as mid-cap equities beat small-caps, where better results from the consumer discretionary and information technology sectors helped mid-caps in the Russell MidCap Growth Index (up 2.0%) versus the small-caps in the Russell 2000 Growth Index (up 0.5%).<sup>7</sup>

Within mid-caps, value beat growth, due in large part to better performance from the financial and utilities sectors within the Russell Midcap Value Index than from those sectors within the Russell Midcap Growth Index. Similarly, small-cap value outperformed small-cap growth. The majority of outperformance for the Russell 2000 Value Index was due to stronger performance in the consumer discretionary and financial sectors versus the Russell 2000 Growth Index.<sup>7</sup>

## Performance Contributors

### Positive Contributors

#### During last quarter:

Stock selection was positive for the quarter, led by the health care sector; the largest individual contributor was an overweight to Intercept Pharmaceuticals, Inc. Sector allocation also aided returns, especially an overweight to the health care sector. On average, SmallCap Growth II held less risky securities (in terms of lower debt-to-equity levels) than the index, which enhanced performance.

#### During last 12 months:

Positive stock selection overall contributed to returns, led by the health care sector; the largest individual contributor was an overweight to Intercept Pharmaceuticals. Sector allocation also aided performance, led by an average 3% underweight to the materials sector. SmallCap Growth II was rewarded for having a higher relative strength profile (an overweight to stocks exhibiting upward price movement during the trailing 12-month period) than the index.

### Negative Contributors

#### During last quarter:

Poor stock selection in the information technology sector hindered returns, in particular an overweight to Infoblox, Inc. An average 3% overweight to the financial sector also detracted from performance. SmallCap Growth II was not rewarded for holding stocks that exhibited higher price volatility (experienced more price movement than those within the index) than the stocks in the index.

#### During last 12 months:

Poor stock selection in the information technology sector diminished returns; the largest individual detractor was an overweight to Ixia. An average 3% overweight to the financial sector also detracted from performance. MidCap Growth II was not rewarded for holding stocks that exhibited higher price volatility (experienced more price movement than those within the index) than the stocks in the index.

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

Effective 4/25/2014, Principal SmallCap Growth II will merge into Principal SmallCap Growth I for the Fund and Separate Account only.

# SmallCap Growth II R4 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 03/31/2014	QTR	YTD	1 Year	3 Year	5 Year	10 Year	Since Inception	Inception Date	12/06/2000
SmallCap Growth II R4 Fund	2.74	2.74	32.79	14.53	25.07	8.03	3.76	Ext. Perf. Inc. Date	12/06/2000
Russell 2000 Growth Index	0.48	0.48	27.19	13.61	25.24	8.87	-	Total Inv. Exp Gross	1.40
Small Growth Category	0.32	0.32	26.05	12.59	24.46	8.71	-	Total Inv Exp Net	1.38
Morningstar Percentile Ranking	-	-	10	24	39	73	-	Waiver Date	02/28/2015
Total Funds in Category	738	738	711	633	555	373	-	Contractual Cap Date	02/28/2015

**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.

## SmallCap Growth II R4 Fund

### Statistics Summary as of 03/31/2014

	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					
SmallCap Growth II R4 Fund	0.67	1.03	93.09	0.82	0.18	18.68	23	13	4.73	-3.04	101.94	97.37
Russell 2000 Growth Index	N/A	N/A	N/A	N/A	N/A	N/A	20	16	4.64	-3.12	100.00	100.00
	5 Year						5 Year					
SmallCap Growth II R4 Fund	0.31	0.98	94.97	1.25	-0.04	19.53	41	19	5.38	-3.73	99.61	99.47
Russell 2000 Growth Index	N/A	N/A	N/A	N/A	N/A	N/A	38	22	5.40	-3.75	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 02/28/2014

Security	Net Assets (%)
Russell 2000 Mini Mar14	8.33
MWI Veterinary Supply, Inc.	2.21
Spirit Airlines Inc	2.20
Trex Company, Inc.	2.02
Middleby Corporation	1.90
Proofpoint Inc	1.70
Acadia Healthcare Company, Inc.	1.53
Bank of the Ozarks, Inc.	1.52
Alnylam Pharmaceuticals, Inc.	1.45
SVB Financial Group	1.41
<b>Total % in Top 10</b>	<b>24.28</b>

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

## SmallCap Growth II R4 Fund

Manager(s)	Start Date	Degree	Alma Mater
Stacey L. Sears	09/01/2004	M.B.A.	Villanova University
Kenneth G. Mertz II	09/01/2004	B.A.	Millersville University
Joseph W. Garner	03/01/2006	M.B.A.	University of Pittsburgh
Mariateresa Monaco	06/02/2009	M.B.A.	Massachusetts Institute of Technology
James W. Fennessey	06/02/2009	B.S.	Truman State University

### 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 with small market capitalizations at the time of each purchase. It invests in growth equity securities; growth orientation emphasizes buying equity securities of companies whose potential for growth of capital and earnings is expected to be above average.

### About Emerald Advisers, Inc

Emerald Advisers, Inc., a U.S. Securities and Exchange Commission Registered Investment Adviser (incorporated in November 1991), is a subsidiary of Emerald Asset Management (incorporated in August 1991). Emerald Asset Management is wholly-owned by Emerald employees. Emerald Advisers provides professional investment advisory services to institutional investors, high net worth individuals and the general public through separate account management and The Emerald Mutual Funds. As of December 31, 2013, Emerald Advisers managed \$2.6 billion in assets.

## 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 sold or services offered by a Princor® Registered Representative are offered through Princor Financial Services Corp, 800-547-7754, member SIPC and/or independent brokers/dealers. Principal Funds Distributor, Princor 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.

Principal Funds Distributor, Principal Shareholder Services, Principal Management Corporation, and Principal Funds, Inc. are collectively referred to as Principal Funds.

**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 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.

The manager of the Fund, Principal Management Corporation, invests between 10% and 40% of the Fund's assets in common stocks in an attempt to match or exceed the performance of the Fund's benchmark index for performance.

Effective June 26, 2009, this portfolio is sub-advised by Emerald Advisors and Essex. Prior to June 26, 2009, the portfolio was sub-advised by UBS Global Asset Management, Emerald Advisors and Essex. The portfolio has had various sub-advisors since its inception. Performance results displayed reflect all sub-advisors managing this portfolio during the time periods displayed.

### 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

Russell 2000 Growth Index is a market-weighted total return index that measures the performance of companies within the Russell 2000 Index having higher price-to-book ratio and higher forecasted growth values.

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.

<sup>1</sup>US Treasury

<sup>2</sup>MSCI



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## Important Notes

<sup>3</sup>Bureau of Labor Statistics

<sup>4</sup>Bloomberg

<sup>5</sup>St Louis Fed/ BEA; <http://research.stlouisfed.org/fred2/series/PCE>

<sup>6</sup>U.S. mid-cap stocks: Russell Midcap Index; U.S. small-cap stocks: Russell 2000 Index; U.S. large-cap stocks: Russell 1000 Index; international developed markets: MSCI EAFE Index; international emerging markets: MSCI Emerging Market Index

<sup>7</sup>U.S. mid-cap growth stocks: Russell Midcap Growth Index; U.S. mid-cap value stocks: Russell Midcap Value Index; U.S. small-cap growth stocks: Russell 2000 Growth Index; U.S. small-cap value stocks: Russell 2000 Value Index

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



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