

Third Quarter 2017

# Quarterly Commentary

| Ticker | Inv Manager or Sub-Advisor | Benchmark                      | Morningstar Category         | Investment Objective         |
|--------|----------------------------|--------------------------------|------------------------------|------------------------------|
| PIXEX  | Principal Global Investors | MSCI Emerging Markets NR Index | Diversified Emerging Markets | Diversified Emerging Markets |

## 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.

## International Equity

Global equity had robust and broad-based gains during the third quarter of 2017, in a continuation of favorable market conditions for the year to date. For another consecutive quarter, the market advance was led by emerging markets and international shares. The synchronized global expansion remained on track. Despite a reversal in September, the U.S. dollar weakened, while industrial commodity prices firmed, both consistent with signs of improving global growth trends. After a prolonged period of returns being driven by multiple rerating in recent years, 2017 has been defined by margin expansion and earnings growth. Corporate profits have returned to health with modest but meaningful top line growth and further extension of cost controls and capital redeployment. Much of the market action during the quarter conveyed a "risk-on" sentiment with sector leadership having a cyclical tilt. The S&P 500 advanced 4.5%, the MSCI EAFE index return posted a 5.5% return, while the MSCI Emerging Markets Index notched another sharp advance of 8.0%, in U.S. dollar terms.<sup>1</sup>

**Not FDIC or NCUA insured**

May lose value • Not a deposit • No bank or credit union guarantee  
Not insured by any Federal government agency

## Performance Contributors

### Positive Contributors

#### During last quarter:

All emerging markets regions contributed. Brazil, India, and China were the most significant contributors. Asia was the best performer on a relative basis. Consumer discretionary and information technology led the way, highlighted by strong stock selection. Sunny Optical Technology group, a leading smartphone camera module maker and optical components supplier in China, TAL Education Group, a leading K-12 after-school tutoring services provider in China, and Weibo, a Chinese social media platform, were the top performers. In Brazil, exposure in the consumer discretionary and health care sectors were the largest contributors, led by Magazine Luiza, one of the largest retail chains. Relative performance in the Europe, the Middle East and Africa (EMEA) region outperformed the index, with Russia, South Africa, and Qatar as the top performing countries. Within Russia, overweight to Sberbank and X5 Retail Group, were notable contributors.

#### During last 12 months:

All regions contributed, with Asia leading the way. EMEA was the next best, followed by Latin America. China, India, and Brazil were the top relative performing countries.

### Negative Contributors

#### During last quarter:

Mexico and Thailand detracted. In Mexico, declines to the industrials and materials sectors were the biggest detractors. Overweight to PINFRA, the Mexican toll road operator, and Cemex, one of the largest cement companies in the world, were notable detractors. In the EMEA region, Poland and Turkey slightly detracted. Lack of exposure to the Chinese real estate sector detracted as the market advanced during the quarter.

#### During last 12 months:

Mexico, Poland, and Thailand were the largest detractors.

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

No material changes occurred in the portfolio structure.

# International Emerging Markets R1 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       | 11/01/2004 |
|---|-------|-------|--------|--------|--------|---------|-----------------|----------------------|------------|
| International Emerging Markets R1 Fund            | 10.79 | 32.42 | 25.64  | 5.36   | 3.38   | -0.13   | 8.90            | Ext. Perf. Inc. Date | 12/06/2000 |
| MSCI Emerging Markets NR Index                    | 7.89  | 27.78 | 22.46  | 4.90   | 3.99   | 1.32    | -               | Total Inv. Exp Gross | 2.13       |
| Diversified Emerging Markets Category             | 7.32  | 26.19 | 19.93  | 3.86   | 4.09   | 1.27    | -               | Total Inv Exp Net    | 2.13       |
| Morningstar Percentile Ranking                    | -     | -     | 15     | 31     | 66     | 86      | -               | Waiver Date          | -          |
| Total Funds in Category                           | 860   | 832   | 797    | 642    | 447    | 183     | -               | 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.

These calculated returns reflect the historical performance of the oldest share class of the fund, adjusted to reflect a portion of the fees and expenses of this share class. For time periods prior to inception date of the fund, predecessor performance is reflected. Please see the fund's prospectus for more information on specific expenses, and the fund's most recent shareholder report for actual date of first sale. Expenses are deducted from income earned by the fund. As a result, dividends and investment results will differ for each share class.

# International Emerging Markets R1 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                        |      |               |       |             |        |
| International Emerging Markets R1 Fund | 0.75                               | 0.92 | 95.53 | 0.40         | 0.14       | 14.83   | 19                            | 17   | 3.30          | -3.37 | 96.15       | 93.17  |
| MSCI Emerging Markets NR Index         | N/A                                | N/A  | N/A   | N/A          | N/A        | N/A     | 21                            | 15   | 3.44          | -3.61 | 100.00      | 100.00 |
|  | 5 Year                             |      |       |              |            |         | 5 Year                        |      |               |       |             |        |
| International Emerging Markets R1 Fund | -0.39                              | 0.95 | 95.05 | 0.29         | -0.19      | 14.01   | 32                            | 28   | 3.00          | -3.33 | 95.42       | 97.78  |
| MSCI Emerging Markets NR Index         | N/A                                | N/A  | N/A   | N/A          | N/A        | N/A     | 35                            | 25   | 3.14          | -3.41 | 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 (%) |
|---|----------------|
| Tencent Holdings Ltd                              | 5.81           |
| Samsung Electronics Co Ltd                        | 5.80           |
| Alibaba Group Holding Ltd ADR                     | 5.37           |
| Taiwan Semiconductor Manufacturing Co Ltd         | 4.75           |
| Naspers Ltd Class N                               | 2.97           |
| China Construction Bank Corp H                    | 2.32           |
| Ping An Insurance (Group) Co. of China Ltd H      | 2.10           |
| Hon Hai Precision Industry Co Ltd                 | 1.82           |
| PT Telekomunikasi Indonesia (Persero) Tbk Class B | 1.62           |
| Maruti Suzuki India Ltd                           | 1.58           |
| <b>Total % in Top 10</b>                          | <b>34.15</b>   |

## International Emerging Markets R1 Fund

| Manager(s)      | Start Date | Degree | Alma Mater                                    |
|-----------------|------------|--------|---|
| Mihail Dobrinov | 05/30/2007 | M.B.A. | University of Iowa                            |
| Mohammed Zaidi  | 12/06/2012 | M.B.A. | Massachusetts Institute of Technology (Sloan) |
| Alan Wang       | 11/12/2014 | M.B.A. | University of Iowa                            |

### Investment Strategy

The investment seeks long-term growth of capital. The fund normally invests at least 80% of its net assets, plus any borrowings for investment purposes, in equity securities of emerging market companies at the time of purchase. "Emerging market country" means any country which is considered to be an emerging country by the international financial community (including the MSCI Emerging Markets Index or Bloomberg Barclays Emerging Markets USD Aggregate Bond Index). It invests in equity securities regardless of market capitalization (small, medium or large) and style (growth or value).

### About Principal Global Investors

Principal Global Investors - a member of the Principal Financial Group® - uses a unified investment philosophy and process that 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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These calculated returns reflect the historical performance of the oldest share class of the fund, adjusted to reflect a portion of the fees and expenses of this share class. For time periods prior to inception date of the fund, predecessor performance is reflected. Please see the fund's prospectus for more information on specific expenses, and the fund's most recent shareholder report for actual date of first sale. Expenses are deducted from income earned by the fund. As a result, dividends and investment results will differ for each share class.

International and global investment options are subject to additional risk due to fluctuating exchange rates, foreign accounting and financial policies, and other economic and political environments.

Instances of high double-digit returns were achieved primarily during favorable market conditions and may not be sustainable over time.

MSCI Emerging Markets NR Index measures equity market performance in the global emerging markets. It consists of 26 emerging market countries in Europe, Latin America and the Pacific Basin.

### 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

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>^</sup>Unless otherwise stated, all data from Bloomberg

<sup>1</sup>International developed markets: MSCI EAFE Index; broad U.S. market: Russell 3000 Index; international emerging markets: MSCI Emerging Markets Index

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



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