

Third Quarter 2009

# Quarterly Commentary

Ticker	PULAX
Investment Advisor	Principal Global Investors
Benchmark	6 Month LIBOR Index
Morningstar Category	Ultrashort Bond
Investment Objective	Income

Manager(s)	Start Date	Degree	Alma Mater
Craig Dawson	05/27/2005	M.B.A.	U of Iowa
Doug Earney	11/01/2008	M.B.A.	U of Chicago

## Economy & Market Overview

A tenacious market rally - which began in mid-March and extended through the second quarter - plowed ahead in the third quarter as well. Investors responded positively to the Federal Reserve's commitment to keep the Fed Funds target interest rate very low (0.0% - 0.25%) for "an extended period," and a stream of more-positive-than-negative economic reports raised hopes that the U.S. had exited its worst recession in more than 50 years.

Data released during the quarter revealed a slowly improving U.S. economy. Some key reports: 1. The economy (as measured by real Gross Domestic Product, or GDP) contracted at a much slower pace in the second quarter (-0.7% annualized rate) than it did in the first quarter (-6.4% annualized rate). (Real GDP is the economy's total output of all goods and services, adjusted for price changes that may have occurred between the time periods being compared.) 2. Home prices in the top 20 metro areas rose 1.6% from June to July.[a] This was the third consecutive monthly price increase. 3. 263,000 non-farm jobs were lost in September - a huge number, but down from recent months. On average, 307,000 jobs were lost each month from May through September 2009, as compared to 645,000 per month from November 2008-April 2009.[b]

But serious challenges remain. The jobs situation is seen by many economists as a critical headwind to economic recovery. A sobering 7.2 million jobs were lost from December 2007-September 2009, and the unemployment rate has continued to climb, reaching 9.8% in September.[c] Economists warned that the unemployment rate could continue to worsen for a time, and that both consumer spending and consumer confidence could weaken further as a result. Meanwhile, concerns that real estate issues may flare up again presents another possible roadblock to recovery. A round of commercial real estate losses would inhibit new real estate development and create an overhang of potential loan losses for banks, especially regional and community banks. Also, home prices could resume their decline, based on expanding mortgage delinquencies and a large supply of distressed properties that need to be liquidated.

In U.S. equities, all sectors within the Russell 3000 Index delivered positive returns. The financial sector led the way for the second quarter in a row, returning 24.2%.[d] As most financial stocks reside in value rather than growth indexes, the strong returns within financials led to value beating growth across all market capitalizations. Meanwhile, though small-caps outperformed large-cap stocks, mid-caps posted the strongest returns, delivering 23.6% for the quarter.[e] Developed and emerging international stocks returned 19.5%[f] and 20.9%[g] beating the broad U.S. stock market, which rose 16.3%.[h] A falling U.S. dollar gave a big boost to non-U.S. stocks during the quarter, adding nearly 5% to their returns in U.S. dollars as compared to returns in their local currency.[i]

In the credit markets, investors showed their appetite for risk as high-yield bonds beat duration-adjusted U.S. Treasuries by 12.3%.[j] Meanwhile, commercial mortgage-backed securities led investment-grade bonds for the second quarter in a row, outperforming duration-adjusted Treasuries by 10.9%.[k]

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## Performance Contributors

### Positive Contributors

#### During last quarter:

An out-of-index sector allocation to investment-grade credit contributed positively to performance. Also, out-of-index allocations to securitized assets (specifically, to commercial mortgage-backed securities and asset-backed securities) added value as well.

#### During last 12 months:

For the 12-month period, duration-positioning within the portfolio added value. The portfolio's duration was positioned slightly longer than that of the index over much of the period, which proved beneficial as interest rates fell.

### Negative Contributors

#### During last quarter:

Sector allocation to U.S. Treasuries detracted from performance during the quarter. As a result of this investment option's transition to a composition emphasizing securities eligible for inclusion in a money market investment option, securities held in the portfolio that were not eligible for inclusion in a money market investment option were sold during the period. Proceeds from the sale of these securities were invested in short-duration U.S. Treasuries, which underperformed the investment option's benchmark index during the period as spread (i.e., non-Treasury) sectors outperformed Treasuries.

#### During last 12 months:

An out-of-index allocation to securitized assets (specifically, to ABS and collateralized mortgage obligations) hurt returns. Also, allocations to segregated assets and floating-rate securities detracted from performance, as they underperformed relative to Treasuries.

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

This investment option will merge into the Money Market investment option, sub-advised by Principal Global Investors, in December 2009. To prepare for the merger, the Ultra Short investment option's portfolio has been transitioning since January 2009 to a composition emphasizing securities eligible for inclusion in a money market investment option, and this transition is nearing completion.

# Ultra Short Bond Fund (A)

## 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. 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. For more performance information, including most recent month-end performance, visit [www.principalfunds.com](http://www.principalfunds.com), or contact your financial representative of The Principal.

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 09/30/2009	QTR	YTD	1 Year	3 Year	5 Year	10 Year	Since Inception	Inception Date	03/15/2006
Ultra Short Bond Fund (A) (excl. sales charge)	0.04	-0.34	-9.40	-7.51	-3.24	-	-0.88	Ext. Perf. Inc. Date	06/15/2001
Ultra Short Bond Fund (A) (incl. sales charge)	-0.94	-1.30	-10.30	-7.81	-3.44	-	-1.00	Total Inv. Exp Gross	0.68
6 Month LIBOR Index	0.30	1.27	2.66	4.06	3.96	3.73	-	Total Inv Exp Net	0.46
Ultrashort Bond Category	2.59	6.78	1.74	0.63	1.73	3.14	-	Waiver Date	10/31/2009
Morningstar Percentile Ranking	-	-	95	93	95	-	-	Contractual Cap Date	10/31/2009
Total Funds in Category	124	122	121	112	100	50	-	Contingent Deferred Sales Charge	-
								Maximum Up-front Sales Charge	1.00

## Risk and Return Statistics Summary as of 09/30/2009

	3 Year Return vs. Rank						5 Year Return vs. Risk					
	Alpha	Beta	R2	Sharpe Ratio	Info Ratio	Std Dev	Alpha	Beta	R2	Sharpe Ratio	Info Ratio	Std Dev
Ultra Short Bond Fund (A)	-8.28	-1.81	3.36	-2.21	-2.39	4.79	-3.91	-2.89	8.34	-1.59	-1.77	4.04

Relative to 6 Month LIBOR Index

Risk and return statistical data is provided by Markov Processes International (MPI). Risk & Return Statistics Summary results are based on performance excluding sales charges. Percentile rankings are based on total returns in accordance with the appropriate Morningstar peer group.

## Ultra Short Bond Fund (A)

### Upside/Downside Capture Ratio Summary as of 09/30/2009

	3 Year Upside/Downside Capture Ratio						5 Year Upside/Downside Capture Ratio					
	# of Months		Avg Returns %		Market Benchmark %		# of Months		Avg Returns %		Market Benchmark %	
	Up	Down	Up	Down	Up	Down	Up	Down	Up	Down	Up	Down
Ultra Short Bond Fund (A)	15	21	-0.64	-	-192.71	-	39	21	-0.27	-	-82.58	-
6 Month LIBOR Index	36	0	0.33	-	100.00	-	60	0	0.32	-	100.00	-

### Top Ten Holdings as of 08/31/2009

Security	Net Assets (%)
US Treasury Note 0.875%	3.18
MORGAN STANLEY FDIC GTD TLGP	1.44
JPMORGAN CHASE	0.86
FNMA FRN	0.47
FNMA FRN	0.45
FHLMC	0.41
Bear Stearns Cos FRN	0.35
Discover Card Mstr Tr I 2004-2 FRN	0.35
Indymac Mbs 2005-Ar7 CMO	0.35
Rfmsi Series Tr 2006-S6 CMO	0.34
<b>Total % in Top 10</b>	<b>8.22</b>

Portfolio holdings may not reflect the current portfolio composition and do not constitute a recommendation to purchase or sell a particular security. Information is current as of the creation of this piece. Keep in mind that portfolio holdings are subject to risk.

# Ultra Short Bond Fund (A)

## Fund Strategy

The investment seeks current income while seeking capital preservation. The fund invests primarily in high-quality, short-term fixed-income securities. Over the next 12 months (the "transition period"), it will gradually increase its purchase of high-quality, short-term money market instruments which PGI believes present minimal credit risks with the goal of establishing a portfolio that resembles that of a money market fund.

## About Principal Global Investors

The fixed-income capabilities of Principal Global Investors emphasize a broad array of global credit, mortgage, asset-backed and government debt markets worldwide. The firm also offers extensive capabilities in structured fixed-income strategies. Principal Global Investors manages \$74.5 billion in fixed income assets as of December 31, 2008. Its global fixed-income research efforts span sovereign and corporate debt markets worldwide and draw from 161 fixed-income professionals. The disciplined and repeatable investment research process combines bottom-up and top-down portfolio construction techniques with a strong focus on relative value and broad diversification. Principal Global Investors is a member of the Principal Financial Group®.

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Principal Funds is a leading provider of mutual fund solutions for individual investors and retirement plans, with approximately \$54.1 billion in mutual fund assets under management (as of Sept 30, 2009). Principal Funds has special expertise in providing asset allocation solutions, and is the 5th largest manager of lifecycle funds in the nation based on target-date and target-risk mutual fund assets under management (according to Financial Research Corporation, as of June 30, 2009). Principal Funds are distributed through a nationwide network of independent financial professionals affiliated with brokerage and financial planning firms.

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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. 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.

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. government.

Fixed-income and asset allocation investment options that invest in mortgage securities are subject to increased risk due to real estate exposure.

Effective 12/31/2008 the Ultra Short Bond Fund is closed to new investors.

The 6 Month LIBOR Index is an average of the interest rate for U.S. dollar deposits, known as Eurodollars, of a stated maturity. LIBOR is an abbreviation for the London Interbank Offered Rate.

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## Important Notes

[a] Source: S&P/Case-Shiller Residential Real Estate Index

[b] Source: U.S. Bureau of Labor Statistics

[c] Source: U.S. Bureau of Labor Statistics

[d] Source: Russell 3000 Index

[e] Source: Russell Midcap Value Index

[f] Source: MSCI EAFE Index

[g] Source: MSCI Emerging Markets Index

[h] Source: Russell 3000 Index

[i] Source: MSCI EAFE Index U.S. dollar return 19.5%; MSCI EAFE Index local currency return 14.8%

[j] Source: Barclays Capital US High Yield Index

[k] Source: Barclays Capital Aggregate Bond Index

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