

Quarterly Commentary

Ticker	Inv Manager or Sub-Advisor	Benchmark	Morningstar Category	Investment Objective
PMAAX	Principal Global Investors	Russell 2000 Growth Index	Small Growth	Small Company

Economy & Market Overview

During the fourth quarter, equities markets rebounded globally from the prior quarter's extremely weak performance, though not enough to fully recover from their third-quarter losses. Interestingly, while it was generally accepted that excess debt among developed nations drove the third-quarter sell-off,¹ the fourth-quarter rebound had no clear spark to trigger the upward move (though improving fundamentals in the U.S. could have helped initiate the rally).

Europe remained in a state of crisis during the quarter as its countries' governments worked to plot a course out of the excess leverage of Greece, Portugal, Italy, Ireland and Spain. However, obstacles continued to obstruct progress. The key issue to be resolved was determining who should be responsible for the losses incurred by the banking sector when the write-offs of sovereign debt occur. In terms of Greece, Ireland and Portugal, their debt already is far in excess of their ability to pay. Greece has an agreement to write down its debt by 50%, and when some of the covenants are taken into account, the write-off is closer to 70-75%.² Should similar write-downs from other nations occur, the losses to the European banking system could wipe out most (if not all) of the banks' capital base. While Germany has argued that recapitalization of the banking system is the responsibility of each individual nation, countries such as France, Spain and Italy likely can't afford the additional liability. The question of where the capital will come from continues to be a major overhang on the markets. It is particularly so in the currency markets, where the U.S. dollar has rallied 10% against the euro since summer 2011.

In the U.S., Congress's debt ceiling stand-off earlier in 2011 has faded from immediate focus. However, it hasn't gone away and likely will play a significant role in the political debates leading to the November elections. For the time being, focus has shifted to economic fundamentals, which have shown some improvement. Third-quarter GDP came in at 1.8%;³ while not a strong growth report, it is nowhere near recession level. Similarly, corporate earnings continued to increase, exceeding analysts' expectations and leading to a drop in unemployment from 9.4% in December 2010 to a revised 8.7% in November 2011.⁴ Consumers responded with heightened interest in spending, as reflected by a 4.1% increase in holiday sales for 2011 vs. 2010.⁵

For the quarter, U.S. equities returned 12.1%, with small-cap stocks outpacing large-caps. Value stocks performed better than growth due in part to a rally in financials (the largest sector within the Russell 3000 Value Index). The strong fourth-quarter performance bumped U.S. equities to a positive 1.0% return for the year.⁶ Meanwhile, international equities delivered 3.7% for the quarter and were down -13.7% for the year.⁷

As risk aversion abated, fixed income generally underperformed stocks for the quarter. Interest rates rose initially, reaching nearly 2.40% in late October, but ended up falling modestly from 1.91% to 1.88% at quarter-end. The 2-year U.S. Treasury yield fell from 0.25% to 0.24%, leaving the shape of the yield curve roughly unchanged from the prior quarter.⁸ At its December meeting, the Federal Reserve decided to maintain its current target range for the federal funds rate at 0.00% to 0.25%, stating that economic conditions are "likely to warrant exceptionally low levels for the federal funds rate at least through mid-2013."⁹ This assurance is likely to anchor the short end of the yield curve.

With risk back in favor, high-yield corporate bonds led U.S. fixed income with an absolute return of 6.46% for the quarter.¹⁰ Commercial mortgage-backed securities also performed very well, outpacing duration-adjusted Treasuries by 2.49%.¹¹

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Performance Contributors

Positive Contributors

During last quarter:

Stock selection in industrials, energy and health care providers contributed positively. Among industrial holdings, Colfax Corporation added the most value; this manufacturer of pumps and fluid-handling equipment reported strong operating results. In energy, Complete Production Services (provider of well completion and production services) was up sharply following news it would be acquired by competitor Superior Energy Services. Among health care providers, the portfolio's managed care companies contributed the most to portfolio performance as benefit costs remain contained and their ability to help states control Medicaid costs became obvious to investors.

During last 12 months:

Stock selection in the information technology, financial and consumer discretionary sectors added value. Within financials, MarketAxess Holdings was the largest contributor; shares of this electronic fixed income trading firm reported better-than-expected trading volumes and market share. Among information technology holdings, Liquidity Services was the top contributor; shares of this business-to-business website reported solid results throughout the year and announced an attractive acquisition. Within consumer discretionary holdings, Polaris Industries led results as its off-road vehicles continued to dominate that market.

Negative Contributors

During last quarter:

The Cooper Companies (parent company of CooperVision, which manufactures soft contact lenses) declined on news that some of its contact lenses were subject to a recall. Also, RF Micro Devices (manufacturer of semiconductors and components for use in wireless devices such as smartphones) suffered on news of weakness in Chinese wireless. Additionally, though the portfolio's footwear retailers (DSW and Finish Line) continued to see strong consumer demand, their shares retreated somewhat from strong gains in previous quarters.

During last 12 months:

Stock selection in the health care and materials sectors detracted. Weakness in health care was driven by the portfolio's biotech and pharmaceuticals companies holdings, which experienced disappointing product announcements. Within health care, Gentiva Health Services and HealthSouth detracted amid worries about reduced Medicare reimbursement rates in the face of the federal government's budget crisis and corresponding Budget Control Act. In materials, shares of silver miner Hecla Mining weakened as silver prices retreated from earlier in the year and a series of accidents interrupted production in a key mine.

Changes to the investment option's structure or portfolio:

No material changes occurred in the portfolio structure.

SmallCap Growth 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 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 12/31/2011	QTR	YTD	1 Year	3 Year	5 Year	10 Year	Since Inception	Inception Date	01/16/2007
SmallCap Growth Fund (A) (excl. sales charge)	14.01	-4.18	-4.18	14.75	-1.69	0.74	0.37	Ext. Perf. Inc. Date	12/06/2000
SmallCap Growth Fund (A) (incl. sales charge)	7.68	-9.45	-9.45	12.62	-2.80	0.18	-0.14	Total Inv. Exp Gross	1.72
Russell 2000 Growth Index	14.99	-2.91	-2.91	19.00	2.09	4.48	-	Total Inv Exp Net	1.58
Small Growth Category	13.56	-3.55	-3.55	18.45	1.30	4.38	-	Waiver Date	02/29/2012
Morningstar Percentile Ranking	-	-	58	86	89	96	-	Contractual Cap Date	02/29/2012
Total Funds in Category	787	764	764	676	573	368	-	Contingent Deferred Sales Charge	-
								Maximum Up-front Sales Charge	5.50

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.

SmallCap Growth Fund (A)

Statistics Summary as of 12/31/2011

	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 Fund (A)	-3.33	0.98	98.26	0.68	-1.31	24.40	21	15	6.29	-5.46	93.91	103.22
Russell 2000 Growth Index	N/A	N/A	N/A	N/A	N/A	N/A	21	15	6.70	-5.29	100.00	100.00
	5 Year						5 Year					
SmallCap Growth Fund (A)	-3.66	1.00	98.00	0.01	-1.08	24.80	34	26	4.97	-6.22	92.73	103.26
Russell 2000 Growth Index	N/A	N/A	N/A	N/A	N/A	N/A	34	26	5.36	-6.02	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 11/30/2011

Security	Net Assets (%)
Manhattan Associates, Inc.	2.15
Colfax Corporation	2.00
RBC Bearings, Inc.	1.82
Treehouse Foods, Inc.	1.77
Belden, Inc.	1.70
TIBCO Software, Inc.	1.67
Plantronics	1.57
The Finish Line Inc	1.56
Ann, Inc.	1.53
Liquidity Service, Inc.	1.53
Total % in Top 10	17.30

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

SmallCap Growth Fund (A)

Manager(s)	Start Date	Degree	Alma Mater
Phil Nordhus	05/11/2009	M.B.A.	Drake University
Brian W. Pattinson	07/20/2011	M.B.A.	University of Iowa

Fund Strategy

The investment seeks long-term growth of capital. The fund invests at least 80% of net assets in equity securities of companies with small market capitalizations (those with market capitalizations similar to companies in the Russell 2000 Growth Index) at the time of 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 Principal Global Investors

Principal Global Investors managed \$47.8 billion in global equity assets as of December 31, 2010. The firm's capabilities encompass large-cap, mid-cap and small-cap stocks in developed and emerging equity markets worldwide. Principal Global Investors draws on a unified investment philosophy focused on independent fundamental research and superior stock selection. 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 \$68.9 billion in mutual fund assets under management (as of December 31, 2011). Principal Funds has special expertise in providing asset allocation solutions, and is the 4th 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 September 30, 2011). 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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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.

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.

Effective February 17, 2012, the SmallCap Growth investment option will merge into the SmallCap Blend investment option.

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.

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Important Notes

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.

¹ "U.S. Stocks Tumble, Capping S&P 500's Worst Quarter Since 2008," businessweek.com, October 1, 2011; businessweek.com/news/2011-10-01/u-s-stocks-tumble-capping-s-p-500-s-worst-quarter-since-2008.html

² "A Voluntary Greek Debt Deal?", Matina Stevis, WSJ Blogs, December 30, 2011; blogs.wsj.com/brussels/2011/12/30/a-voluntary-greek-debt-deal

³ U.S. Dept. of Commerce, Bureau of Economic Analysis, December 22, 2011; bea.gov

⁴ U.S. Dept. of Labor, Bureau of Labor Statistics Economic News Release, January 6, 2011; bls.gov/news.release/pdf/empsit.pdf

⁵ National Retail Federation

⁶ Russell family of indexes

⁷ MSCI ACWI ex-U.S. Index

⁸ Source: FactSet

⁹ U.S. Federal Reserve Press Release, December 13, 2011; federalreserve.gov

¹⁰ BarCap High Yield Index: FactSet

¹¹ Barclays Capital Point

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Important Notes

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

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