

Principal SmallCap Growth I Portfolio

Co-sub-advised by AllianceBernstein Investments, Columbus Circle Investors, Brown Advisory and Emerald Advisers, Inc.



AllianceBernstein is one of the world's largest investment management firms. The firm offers an extensive selection of global equity services based on its long-standing expertise in growth and value management, as well as its wide array of fixed income and style-blend products. All of these services draw on the intensive research efforts of AllianceBernstein's fundamental and quantitative buy-side equity, fixed income and economic analysts. The firm's buy-side analysts are part of a larger research team where all — along with the firm's highly regarded sell-side arm — share a culture in which insightful research is paramount.

Investment Philosophy and Process

The Principal SmallCap Growth I portfolio is available as a mutual fund and as a separate account that invests wholly in Institutional class shares of the mutual fund.

Philosophy

AllianceBernstein's small-cap growth strategy is bottom-up in nature and managed on a team basis. Each of the analyst-managers has primary responsibility for stock selection within his or her respective sector. Decisions on investment strategy, asset allocation and portfolio construction are made by the team.

The investment advisor's investment philosophy and strategy may not perform as intended and could result in a loss or gain.

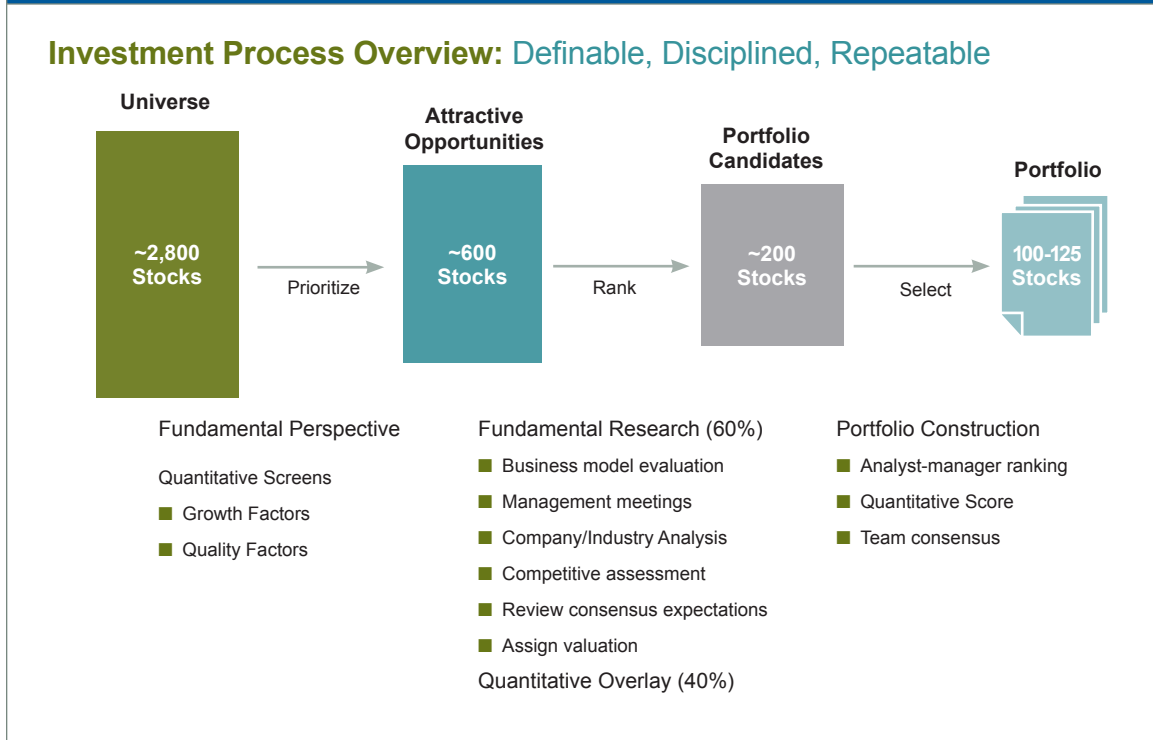
Process

The small-cap growth team employs a highly disciplined and consistent stock selection process (Figure 1 on page 2) combining thorough fundamental analysis with objective quantitative tools. The team identifies stocks of U.S. small-cap companies that offer superior growth potential and improving fundamentals. The portfolio's premium should come primarily from bottom-up stock selection.

Not FDIC or NCUA insured

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

Figure 1: AllianceBernstein's Investment Process



The team believes strong and improving company fundamentals — especially earnings — drive superior small-cap returns. Specifically, the team looks for companies with favorable earnings revision trends, positive earnings surprises and accelerating and improving earnings momentum. The team’s objective is to capture opportunities before the market recognizes each investment’s full earnings potential. The capabilities of AllianceBernstein’s dedicated small-cap growth team are the foundation for the team’s success, supplemented by the resources of a large, global investment firm.

The team narrows the U.S. small-cap equity universe to approximately 600 stocks, using the team’s quantitative models and fundamental research. The universe is further narrowed using a stock-ranking system in each sector that is based on fundamental research and a proprietary quantitative model:

- **Fundamental ranking.** In the team’s fundamental analysis, each team member ranks stocks on a scale of 1 to 5 based on expected returns over a six to 18-month time horizon.
- **Quantitative ranking.** The team uses a proprietary model to rank stocks on a scale of 1 to 5 from a quantitative standpoint, using earnings revision, earnings momentum, earnings acceleration and earnings surprise as inputs.

Clear portfolio construction parameters are employed to help control risks. The portfolio typically consists of 100-125 stocks, which are chosen from the top one-third of compiled rankings. Sector allocations are derived from security selection but are typically close to the benchmark. The portfolio generally is diversified broadly among many industries. Portfolio positions rarely exceed 2% and average about 1%.

Factors that influence position sizes include a risk-reward assessment of potential upside, portfolio analyst-manager conviction in a given company's fundamentals and a security's trading liquidity.

While the team members do monitor the portfolio's tracking error, they do not manage the portfolio to maintain a specific tracking error relative to the benchmark. However, the portfolio's tracking error is expected to be in a range of 6% to 10% versus the Russell 2000 Growth Index over a full market cycle.

Strong internal research capabilities are critical to making opportune investment decisions. A group of analyst-managers is dedicated solely to the small-cap growth market. Organized by broad economic sectors, the analyst-managers provide an in-depth research process. Thus, the Small Cap Growth team conducts in excess of 1,000 research meetings with company managements each year, both at AllianceBernstein and on-site.

Developing a deep understanding of management's goals and business strategy provides the team with a clear vision of a company's future growth prospects and allows the team to establish a standard for tracking performance.

While the small-cap growth team conducts its own research, it also draws on the expertise of the entire research staff at AllianceBernstein to gain a better understanding of industry trends and competitive issues. AllianceBernstein employs a team of fundamental growth analysts who cover key industries around the world.

Portfolio management team

Bruce K. Aronow has been with AllianceBernstein since 1999. He earned a B.A. in Philosophy and Economics from Colgate University. Mr. Aronow has earned the right to use the Chartered Financial Analyst designation.

N. Kumar Kirpalani has been with AllianceBernstein since 1999. He earned a BTech from the Indian Institute of Technology and an M.B.A. from the University of Chicago. Mr. Kirpalani has earned the right to use the Chartered Financial Analyst designation.

Samantha S. Lau has been with AllianceBernstein since 1999. She earned a B.S. in Finance and Accounting from the Wharton School, University of Pennsylvania. She has earned the right to use the Chartered Financial Analyst designation.

Wen-Tse Tseng has been with AllianceBernstein since 2006. Prior to joining the firm, he spent four years as the health care portfolio manager for the small-cap growth team at William D. Witter (the same team had previously managed assets for Weiss, Peck & Greer). He earned a B.S. from National Taiwan University, an M.S. in Molecular Genetics and Microbiology from Robert Wood Johnson Medical School-University of Medicine and Dentistry of New Jersey, and an M.B.A. from Graziadio School of Business and Management at Pepperdine University.



Principal Global Investors offers expertise in the management of growth equity portfolios through its subsidiary, Columbus Circle Investors (CCI). CCI provides a strong history in growth-oriented equity investment management with a consistent emphasis on independent, fundamental research and bottom-up stock selection.

Investment Philosophy and Process

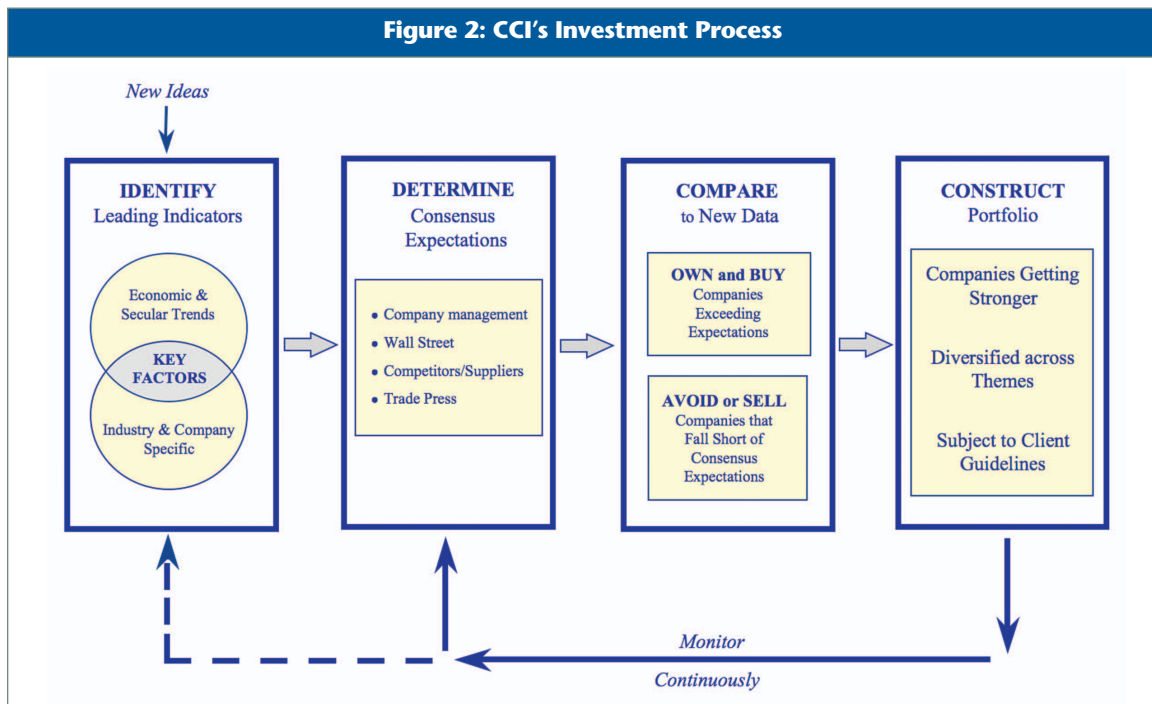
Philosophy

CCI's investment philosophy is simple and straightforward and based on the premise that companies doing better than expected will have rising securities prices, while companies producing less than expected results will not.

The investment advisor's investment philosophy and strategy may not perform as intended and could result in a loss or gain.

Process

Through a process (Figure 2) that involves in-depth analysis of company fundamentals in the context of the prevailing economic environment, CCI's team of investment professionals selects companies that meet the criteria of positive momentum and positive surprise.



CCI's process is comprised of four steps:

1. CCI identifies the six to 10 leading indicators for a specific company's business.
2. CCI determines the consensus expectation for each of the leading indicators.
3. CCI compares actual results to the expectations, with the objective of finding companies with positive surprise.
4. A diversified portfolio is constructed that consists of companies with positive momentum and positive surprise.

CCI's small-cap portfolios invest in companies with average market capitalizations around \$1 billion. The investment objective for the small-cap portfolios is to exceed the rate of return of the Russell 2000 Growth Index over a full market cycle and to achieve an above-median ranking within a universe of growth-oriented equity managers.

Portfolios are broadly diversified by sectors as well as themes (a group of stocks sharing a common driver) across 70-90 individual companies. Portfolios are diversified into a minimum of eight themes and limited to a maximum theme exposure of 25%. Maximum sector exposure is the greater of 25% or 10% over the index.

CCI provides a strong history in growth-oriented equity investment management, with a consistent emphasis on independent fundamental research and bottom-up stock selection. CCI is distinguished by its depth of investment management expertise, long-term continuity of its senior professionals, focused investment process and consistent performance.

Portfolio management team

Clifford G. Fox has been with CCI since 1992. He earned an M.B.A. from the Stern School of Business, New York University, and a B.S. from the Wharton School, University of Pennsylvania. Mr. Fox has earned the right to use the Chartered Financial Analyst designation.

Katerina Wasserman has been with CCI since 2000. She earned a B.S. in Biochemistry from the State University of New York at Stony Brook and a master's in Public Administration from the Robert F. Wagner Graduate School at New York University.

Asset allocation/diversification does not guarantee
a profit or protect against a loss.



Brown Advisory (Brown) was founded in 1993 as an investment management arm of Alex. Brown & Sons, an investment bank founded in 1800. Brown became independently owned through an employee-led buyout in 1998. The firm has principal offices in Baltimore, Maryland and Washington, D.C. Approximately 70 percent of Brown Advisory is owned by employees. Each full-time employee has an equity interest in the firm, aligning employees' interests with the growth in clients' assets and serving as a powerful tool to attract and retain high-caliber professionals.

Brown (and its affiliates) strives to meet its investors' unique requirements through a broad array of investment styles and asset classes — including U.S. equities, international equities, sustainable investing, fixed income, private equity, real estate and other alternative assets.

Investment Philosophy and Process

Philosophy

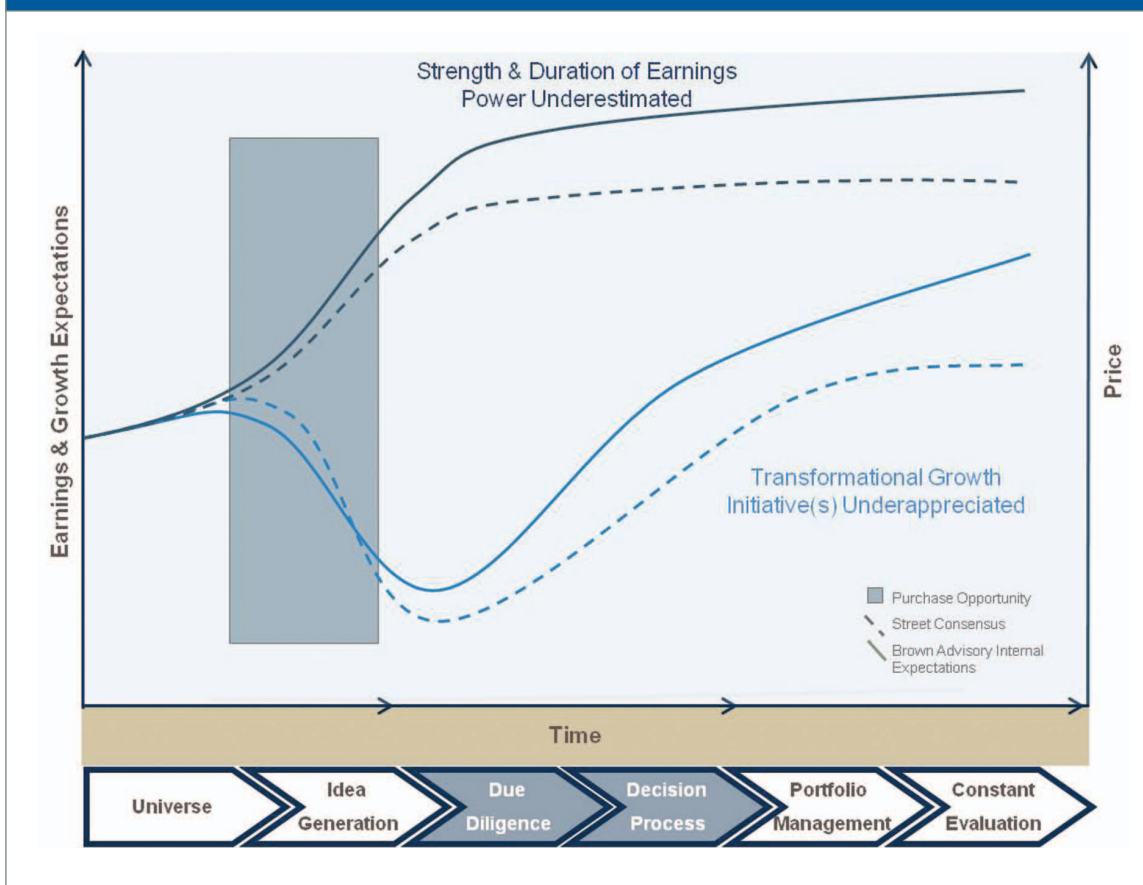
Brown Advisory's Small-Cap Growth Equity strategy seeks to produce competitive long-term, risk-adjusted returns through a concentrated portfolio of equity securities with generally above-average growth potential, sound management and favorable competitive positioning. By leveraging the firm's analytical team and extensive investment network, the strategy conducts deep, fundamental due diligence to exploit the inefficiencies — both fundamental and behavioral — that exist in the market.

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Process

The investment process (Figure 3 on page 7) is focused on conducting rigorous bottom-up research on businesses within the extensive small-cap universe.

Figure 3: Brown Advisory's Investment Process



The research team seeks to invest in high-quality businesses that it knows and understands, with the following characteristics:

- Large and/or growing addressable market
- Market leader or share gainer
- Product/service/business model differentiation
- High/rising margins
- High/rising returns on capital
- Sound management (i.e. capable, honest, shareholder friendly)
- Attractive valuation (i.e. supportable through tangible assets, cash flows or strategic value)

The managers believe in maintaining a concentrated portfolio comprised of the best long-term ideas. This ensures that each holding is highly scrutinized by the investment team, earning its right to be in the portfolio versus other eligible investment ideas.

Although the portfolio is concentrated, diversification is achieved by owning 40-60 companies within the portfolio with varying growth rates, business models, economic sensitivity, valuation metrics and sector exposure — diversification is not measured by looking at sector weights versus a benchmark. A security will be added or eliminated if such a move potentially would enhance the overall risk-adjusted return of the aggregate portfolio.

The portfolio maintains a simple, three-factor sell discipline. A position is eliminated when:

1. An investment thesis is violated,
2. All present and future good news is discounted in the share price, or
3. A better investment opportunity presents itself.

Brown Advisory's small-cap growth portfolio managers have over 25 years of combined investment experience. The portfolio managers are supported by a team of sector analysts. Brown Advisory continually reinvests in its asset management businesses by hiring and retaining some of the most qualified professionals in the industry. Furthermore, the firm constantly strives to supply its research team with the technology and other resources it needs to maintain and improve the research, investment and risk management processes that have been critical to the success of the firm's investment approach.

Portfolio management team

Timothy W. Hathaway has been with Brown since 1995 and has been the co-portfolio manager of the firm's Small-Cap Growth Equity strategy since 2005. Mr. Hathaway earned a B.A. from Randolph-Macon College and an M.B.A. from Loyola College in 2001. He has earned the right to use the Chartered Financial Analyst Designation.

Christopher A. Berrier has been with Brown since 2005 and has been the co-portfolio manager of the firm's Small-Cap Growth Equity strategy since he joined the Firm. Mr. Berrier earned an A.B. from Princeton University.

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a profit or protect against a loss.



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.

Investment Philosophy and Process

Philosophy

Emerald seeks to maximize returns and minimize risks by capitalizing on the inefficiencies inherent in today's small-cap markets. Emerald is dedicated to intense fundamental, bottom-up research designed to identify unrecognized, under-researched and undervalued growth companies.

Emerald believes there is extraordinary opportunity in the small-capitalization markets. Emerald strives to construct portfolios which bear little resemblance to the broad market and are comprised of companies that the firm "strives to know better than anyone else."

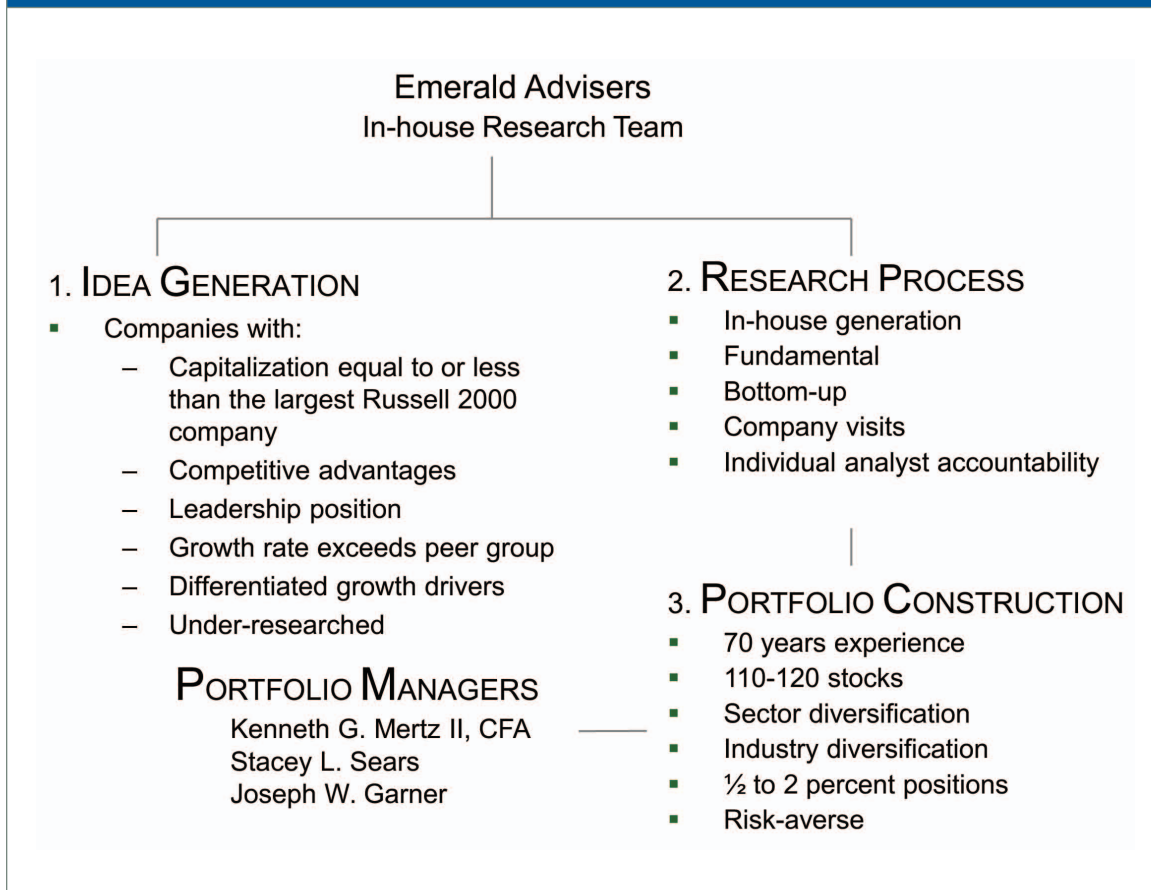
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Process

In its investment process (Figure 1 on page 10), Emerald seeks only companies that have distinct competitive advantages within their respective industries and superior growth rates relative to their peers and the market.

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Figure 1: Emerald Advisers, Inc. Investment Process



Emerald’s analysts are constantly on the road visiting companies, meeting management and workers and touring facilities. This hands-on approach provides Emerald with insight into industry trends as well as company-specific trends. The firm believes this provides them with an advantage over other managers that rely solely on research from Wall Street firms.

Emerald believes that by digging deeper and applying more resources than its competitors, the firm will naturally uncover more money-making opportunities. With its team of highly-trained and educated investment professionals, Emerald deploys an extraordinary amount of energy and personnel to the small-cap area of the market.

The investment team visits 2,000 companies each year. In addition, Emerald conducts extensive sector and industry research by contacting customers, competitors, suppliers and distributors.

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Portfolio management team

Kenneth G. Mertz II has been with Emerald since 1992. He earned a B.A. in Economics from Millersville University. Mr. Mertz has earned the right to use the Chartered Financial Analyst designation.

Stacey L. Sears has been with Emerald since 1991. She earned a B.S. in Business Administration from Millersville University and an M.B.A. from Villanova University.

Joseph W. Garner has been with Emerald since 1994. He earned a B.A. in Economics from Millersville University and an M.B.A. from the Katz Graduate School of Business, University of Pittsburgh.

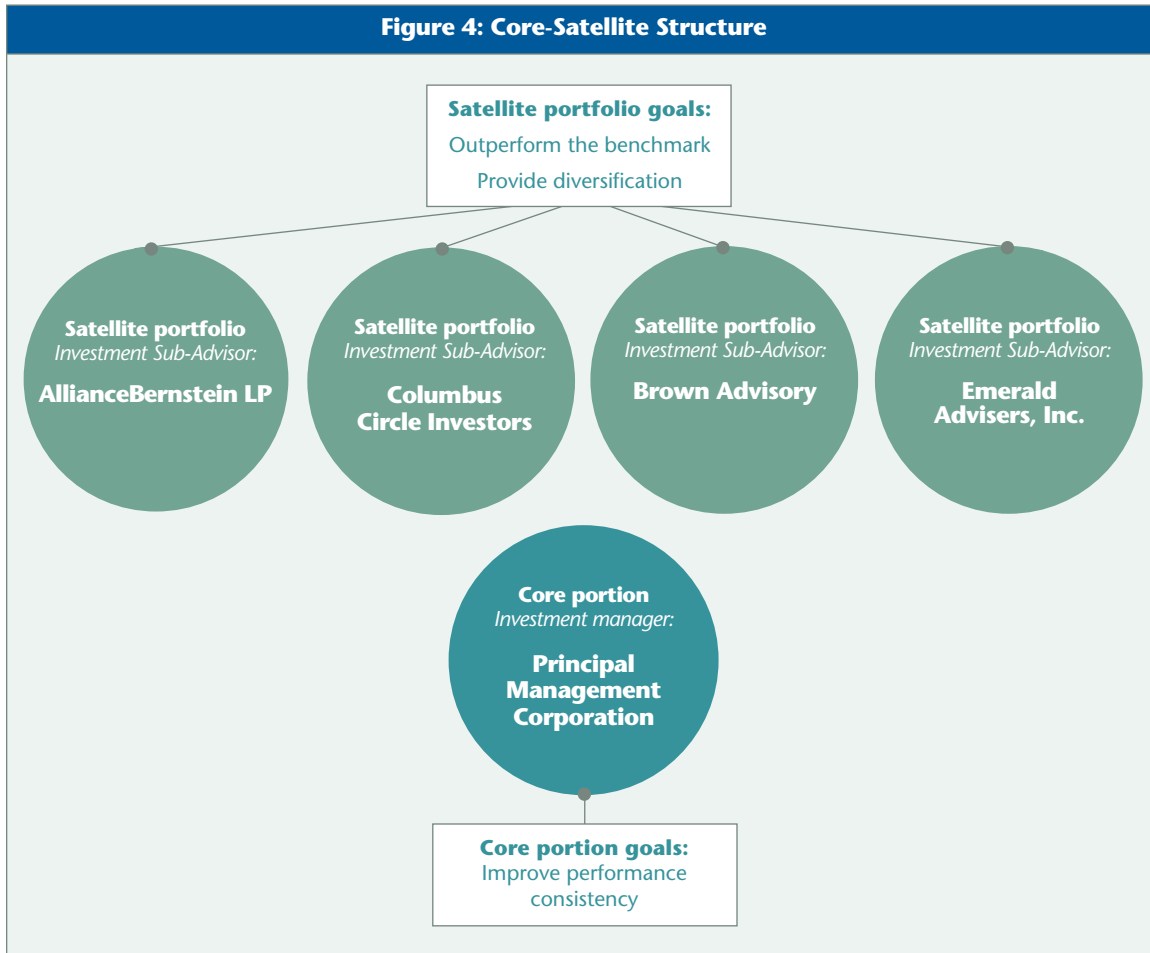
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SmallCap Growth I Core-Satellite Structure

AllianceBernstein, Columbus Circle Investors, Brown Advisory and Emerald Advisers, Inc. employ unique investment philosophies which we believe are complementary to one another. Historically, these sub-advisors have exhibited strong performance in different market environments. For SmallCap Growth I, we combined these sub-advisors with the goal of improving the consistency of the overall portfolio.

Core-satellite structure overview

A core-satellite investment option is comprised of a “core” portfolio plus two or more “satellite” portfolios. As seen in Figure 4, AllianceBernstein, Columbus Circle Investors, Brown Advisory and Emerald Advisers, Inc. are the satellite sub-advisors for Principal SmallCap Growth I, and the core portfolio manager is Principal Management Corporation.¹



¹ Principal Management Corporation is the advisor to Principal Funds, Inc.

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The core portfolio serves as the foundation, or “home base,” for the investment option. It is actively managed within narrow risk constraints. A key focus for the core portfolio is to help reduce volatility within the investment option. Principal Management Corporation does this by maintaining a core composition that tilts SmallCap Growth I away from stocks having certain return-generating characteristics that may bring greater volatility to the portfolio. The core is actively managed within narrow risk constraints.

On the other hand, the satellite portfolios — also actively managed — strive to deliver excess return relative to the benchmark. Due to their mandate to strive for higher returns than the core, the satellite portfolios have correspondingly wider risk constraints.

The core portfolio’s goal is to improve performance consistency by reducing volatility (risk), while the goal of each satellite portfolio is to provide investment diversification and generate outperformance relative to the benchmark.

Potential Benefits Provided By the Core-Satellite Structure

Our goal is to provide for a more consistent return pattern, by striving to hit first and second quartile Morningstar peer group performance more consistently. The essence of this strategy is to minimize the probability that the option falls into the fourth quartile within peer groups.

Besides offering the potential for improved performance consistency, this structure provides additional benefits:

A truly active product. While the primary goal is to provide competitive performance with a more consistent return pattern, our portfolio advisors are very conscious of maintaining characteristics within the fund that are reflective of a truly active strategy. Often, a misperception exists that combining multiple managers can result in a strategy that closely resembles the market at large. Our portfolio advisors are focused on helping to ensure that each fund maintains an Active Share that keeps it distinct from market indexes. Active Share is simply the percentage of the portfolio that is not held in common with a corresponding index. It is a measure of how “active” an active strategy truly is.

Helps to maintain availability of certain investment options in typically capacity-constrained asset classes. The multi-manager aspect of the core-satellite structure offers increased capacity so that investment options in asset classes prone to capacity issues – for example small- and mid-cap equities – will be less likely to experience closures. As a result, these asset classes are more likely to remain available, providing additional diversification for use by investors.

Broader range of satellite managers. The structure makes it easier to leverage talented investment managers who maintain concentrated or wide-constraint portfolios that may experience greater volatility than more diverse or risk-controlled portfolios. The structure helps make it easier to utilize these managers without having to worry about investor reactions to extreme performance characteristics over short time periods.

Mitigates impact of adverse manager events. The core-satellite structure can potentially limit risk should a qualitative event negatively impact one of the sub-advisors (i.e. portfolio manager lift out, firm sale, etc.) and facilitate a smooth transition process should a manager need to be replaced.

Portfolio management team

Randy L. Welch is a Senior Vice President and Portfolio Manager of Principal Management Corporation. He joined the Principal Financial Group in 1989 and oversees the functions of the Investment Services group, which includes investment manager research, investment consulting, performance analysis, and investment communication. He is also responsible for the due diligence program that monitors investment managers used by Principal Funds, Inc. Randy has FINRA Series 7, 24, 63 and 66 registrations and is also an affiliate member of the Chartered Financial Analysts (CFA) Institute. He earned his undergraduate degree from Grand View College and an M.B.A. from Drake University.

James Fennessey is a Vice President and Portfolio Manager of Principal Management Corporation. He joined the Principal Financial Group in 2000. He is the Head of the Manager Research Team that is responsible for analyzing, interpreting, and coordinating investment performance data and evaluation of the investment managers under the due diligence program that monitors investment managers used by Principal Funds, Inc. James graduated from Truman State University with a B.S. in Business Administration, with an emphasis in Finance, and a minor in Economics. He has earned the right to use the Chartered Financial Analyst designation.

About Principal Management Corporation

In addition to serving as the advisor to Principal Funds, Principal Management Corporation has responsibility for portfolio management of the core portion for all of the core-satellite investment options. In managing the core portion, Principal Management Corporation utilizes a team approach overseen by a portfolio manager. Principal Management Corporation has been registered with the SEC as an investment adviser under the Investment Advisers Act of 1940 since 1968. As advisor to Principal Funds, Principal Management Corporation oversees our proprietary due diligence process for identifying, selecting and monitoring investment managers. Principal Funds offers a full range of investment options covering all core style boxes and several niche options. The Funds are sub-advised by a variety of investment managers representing some of the nation's leading asset managers and investment boutiques.

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Additional Information

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, or calling 1-800-547-7754. Read the prospectus carefully before investing.

Before directing retirement funds to a separate account, investors should carefully consider the investment objectives, risks, charges and expenses of the separate account as well as their individual risk tolerance, time horizon and goals. For additional information contact us at 1-800-547-7754 or by visiting principal.com.

Investment options are subject to investment risk. Shares or unit values will fluctuate and investments, when redeemed, may be worth more or less than their original cost.

This investment option is available through a separate account or Principal Funds, Inc. mutual fund. Separate accounts are made available through a group annuity contract with the Principal Life Insurance Company, Des Moines, IA 50392.

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.

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. Investors cannot invest directly in an index.

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WE'LL GIVE YOU AN EDGE®

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Insurance products and plan administrative services are provided by Principal Life Insurance Company. Principal Funds, Inc. is distributed by Principal Funds Distributor, Inc. Securities are offered through Princor Financial Services Corporation, 800-547-7754, Member SIPC and/or independent broker/dealers. Securities sold by a Princor Registered Representative are offered through Princor®. Principal Funds Distributor, Princor and Principal Life are members of the Principal Financial Group®, Des Moines, IA 50392. Investment options may not be available in all states or U.S. commonwealths. Separate accounts are available through a group annuity contract with Principal Life Insurance Company. See the group annuity contract for the full name of the separate account. Principal Life Insurance Company reserves the right to defer payments or transfers from Principal Life separate accounts as permitted by the group annuity contracts providing access to the separate accounts or as required by applicable law. Such deferment will be based on factors that may include situations such as: unstable or disorderly financial markets; investment conditions which do not allow for orderly investment transactions; or investment, liquidity, and other risks inherent in real estate (such as those associated with general and local economic conditions). If you elect to allocate funds to a separate account, you may not be able to immediately withdraw them.