

Principal SmallCap Value II Portfolio

Co-sub-advised by Dimensional; Vaughan Nelson Investment Management, LP; and Los Angeles Capital Management



Dimensional is a leading global investment firm that has been translating academic research into practical investment solutions since 1981. Guided by a strong belief in markets, the firm helps investors pursue higher expected returns through advanced portfolio design and careful implementation. An enduring philosophy, strong client commitment, and deep working relationships with the academic community underpin Dimensional's approach to investing and form the foundation for new strategies.

Dimensional Fund Advisors is a private limited partnership that continues to be owned primarily by directors and employees. Dimensional is headquartered in the U.S. (Austin, Texas), and Dimensional entities have representative offices across Europe, U.S., Canada, Australia and Asia.

Investment Philosophy and Process

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

Philosophy

Dimensional's core belief is that public securities markets are efficient, meaning stock and bond prices reflect the knowledge and expectation of all investors. Though prices may not always be correct, Dimensional believes that intense market competition drives prices toward fair value, making it unlikely that any single investor can routinely profit at the expense of all other investors. The firm distinguishes itself by applying this market-based philosophy to its entire range of investments. Supporting this philosophy are Dimensional's reliance on research and focus on targeting higher expected returns through broadly diversified, cost-effective strategies.

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

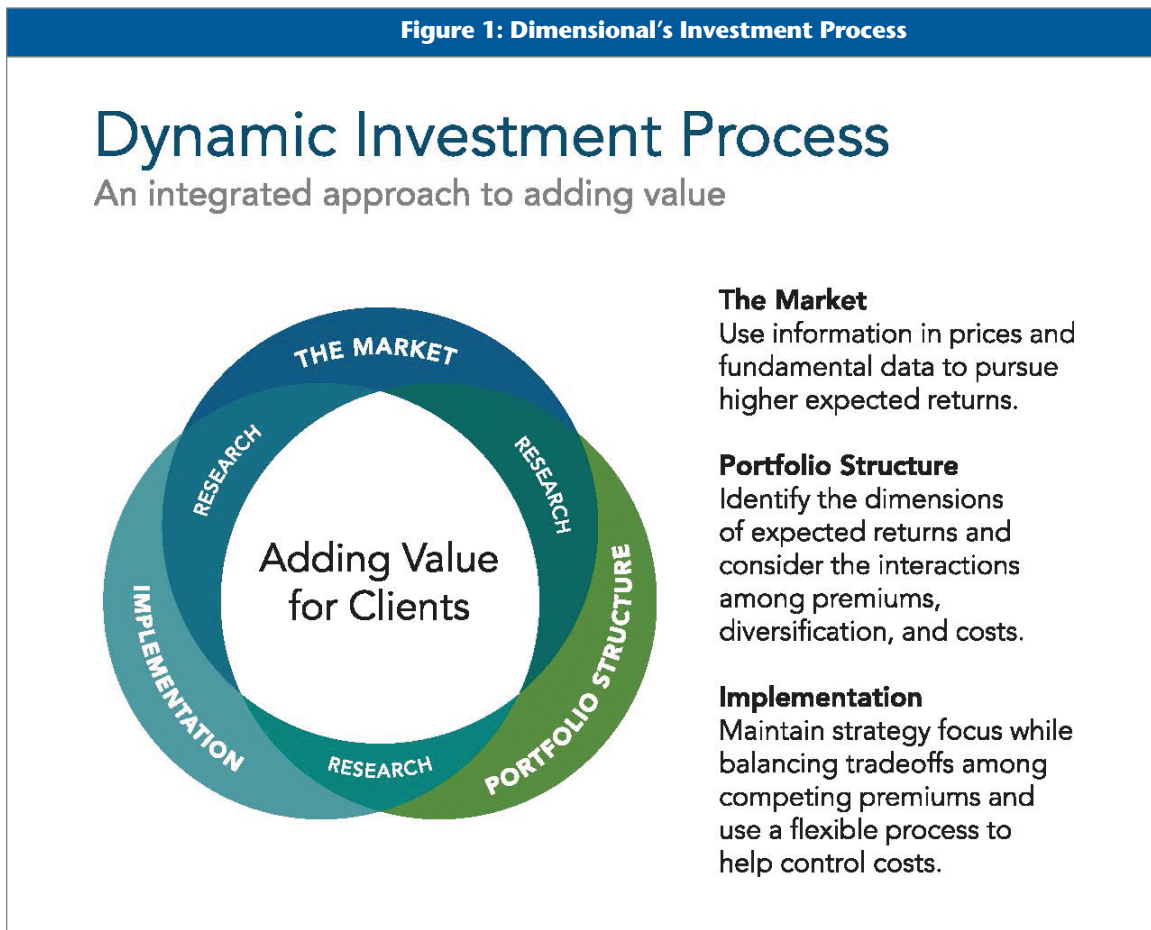
Not FDIC or NCUA insured

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

Process

Dimensional applies a dynamic process that integrates advanced research with methodical portfolio design and careful implementation, while balancing investment tradeoffs. A team of portfolio managers implements the established policies and procedures set forth by the Investment committee, whose members set and review the policies and procedures for overall adherence to investment style and process (Figure 1).

Figure 1: Dimensional's Investment Process



Dimensional Highlights:

- **Leader in small-cap and value.** Dimensional pioneered the application of academic research to small-cap and value styles of investing. Dimensional constructs its investment process based on scientific evidence rather than on commercial indexes. The firm diversifies not only in the number of securities it holds, but also in the range of capital market strategies it explores and develops. Small-cap strategies target smaller stocks more consistently. Value strategies target value returns with greater focus. As a result, investors achieve more consistent portfolio structure.
- **Minimal style drift.** Dimensional's strict adherence to specific parameters helps maintain reliable asset class exposures. Portfolios are continuously monitored for adherence to investment guidelines and any restrictions of the Funds. The firm imposes strict adherence to specific parameters that help maintain reliable asset class exposures. Dimensional monitors the portfolios closely to ensure they adhere to their investment criteria.
- **Value-added trading.** Careful trading can reduce or even reverse the costs borne by traditional managers. Because Dimensional focuses on capturing the systematic performance of broad market dimensions rather than the random fluctuations of individual securities, it can keep costs low by trading patiently and opportunistically. Dimensional concentrates on favorable price execution that neutralizes the effects of momentum and index reconstitution, and maintains portfolio-specific hold ranges that reduce turnover and trading costs.
- **Independent and employee-owned.** Dimensional is owned primarily by current and former employees and directors and manages assets for investors around the world. Since the firm was founded in 1981, Dimensional's leadership has remained committed to fostering a culture of learning, teamwork, innovation and dedication to doing what's right for their clients.

Portfolio manager

Joseph H. Chi has been with Dimensional since 2005. He earned a B.S. and an MBA from the University of California, Los Angeles and a J.D. from the University of Southern California. Mr. Chi has earned the right to use the Chartered Financial Analyst designation.

Jed S. Fogdall has been with Dimensional since 2004. He earned a B.S. from Purdue University and an MBA from the University of California, Los Angeles.

Henry F. Gray has been with Dimensional since 1995. He earned an AB from Princeton University and an MBA from the University of Chicago.



Vaughan Nelson Investment Management, L.P. (Vaughan Nelson) is a Houston-based investment counseling firm staffed by experienced, research-oriented investment professionals. Founded in 1970, the firm's sole investment focus is managing equity and fixed income portfolios. Current clients include foundations, university endowments, public funds, corporate pension funds and individuals. The firm's growth reflects strong client relationships based on solid performance, effective communication and the highest level of client service.

Vaughan Nelson is one of the investment management affiliates operating within the Natixis Global Asset Management, L.P., umbrella. The firm operates independently with its proprietary research process and investment team. The general partner and all of the limited partnership units of the firm are 100%-owned by Natixis Global Asset Management, L.P., based in Boston, Massachusetts.

Investment Philosophy and Process

Philosophy

Vaughan Nelson's small-cap value philosophy is to look for temporary information and liquidity inefficiencies in the small-cap value universe, therefore providing opportunities to invest in companies at valuations materially below their long-term intrinsic value. The firm uses a disciplined valuation methodology combined with fundamental research to take advantage of the inefficiencies inherent in the small-cap value universe.

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Process

Vaughan Nelson's investment process (Figure 2 on page 4) targets companies that have a positive return on capital and strong balance sheets coupled with improving fundamentals. The firm likes to buy when these companies are caught in a liquidity squeeze, driven by either shareholder or market inefficiency.

Figure 2: Vaughan Nelson's Investment Process



Vaughan Nelson focuses on *trading time for value* by sacrificing near-term stock price performance for greater absolute returns over a longer period. Consequently, company visits and discussions with management focus on understanding how the company allocates capital internally to gain a better understanding of its future earnings potential. The small-cap value team interviews management teams and reviews publicly available financial information in order to determine the intrinsic value of companies within the small-cap universe. Several hundred companies are reviewed on an annual basis in order to construct a universe of attractive business models that would be suitable for investment.

The small-cap value product can be described as consisting of small-cap (within the market capitalization range of the Russell 2000 Value Index at time of initial investment), quality and value-priced companies which are believed to be capable of generating a 50% return (15% compounded over three years).

Vaughan Nelson's portfolio managers do not have a pre-selected stock list. Idea generation is focused on companies with stable-to-increasing return on capital that meet stringent valuation criteria. All investments fit into one of three categories:

1. Companies earning a positive return on capital, with stable-to-improving return
2. Companies valued at a discount to their asset value
3. Companies with an attractive dividend yield and minimal basis risk

At Vaughan Nelson, all strategies are managed by focused teams of highly motivated professionals. Unique to the investment management process is the dual portfolio manager/analyst role that key investment professionals play. This role allows for full integration of the two functions and also enables the portfolio manager to be fully aware of all the ideas in the portfolios and have a deep understanding of the marketplace. All team members are investment generalists and contribute equally to the investment research process.

The following key points highlight characteristics that help to make Vaughan Nelson unique:

- **Diversification and Risk Management.** The small-cap value team measures individual security risk by the quality of the company, incorporating security valuation characteristics to assess the risk/reward of individual investments. Diversification is achieved by seeking investment opportunities across multiple industries and monitoring position size of individual securities. The portfolio holds 55 to 85 securities to minimize security risk.
- **Minimal Style Drift.** Vaughan Nelson reviews factor and fundamental exposure relative to the Russell 2000 Value Index to ensure that there is no occurrence of "style drift." In addition, the Northfield Fundamental Risk Model provides a 32-factor risk profile of the product on a monthly basis. Any residual risk exposure greater than 0.25% relative to the Russell 2000 Value Index benchmark is investigated in detail to determine which positions are contributing to the exposure.
- **Unparalleled Commitment.** Vaughan Nelson's competitive advantage is a highly disciplined philosophy and well-constructed investment process. The small, dedicated team is able to quickly evaluate investment opportunities and risks, allowing for efficient decision-making. Clients believe in Vaughan Nelson's proven philosophy and process, which relieves any undue pressure to make investment decisions that may boost near-term performance by sacrificing performance over the long term.

Portfolio management team

Chris D. Wallis has been with Vaughan Nelson since 1999. He earned a B.B.A. in Accounting from Baylor University and an M.B.A. from Harvard Business School. Mr. Wallis has earned the right to use the Chartered Financial Analyst designation.

Scott J. Weber has been with Vaughan Nelson since 2003. He earned a B.S. in Natural Resources from The University of the South and an M.B.A. from Tulane University. Mr. Weber has earned the right to use the Chartered Financial Analyst designation.



Los Angeles Capital Management (LA Capital) is an employee-owned firm that employs a quantitative approach for security selection and portfolio management. Portfolios are tailored to meet the unique return and risk objectives of each assignment. The investment team members developed the investment process at Wilshire Asset Management, where they worked together for 16 years beginning in 1986. In March 2002, the team purchased the business from Wilshire Associates to set up an independent investment boutique.

Investment Philosophy and Process

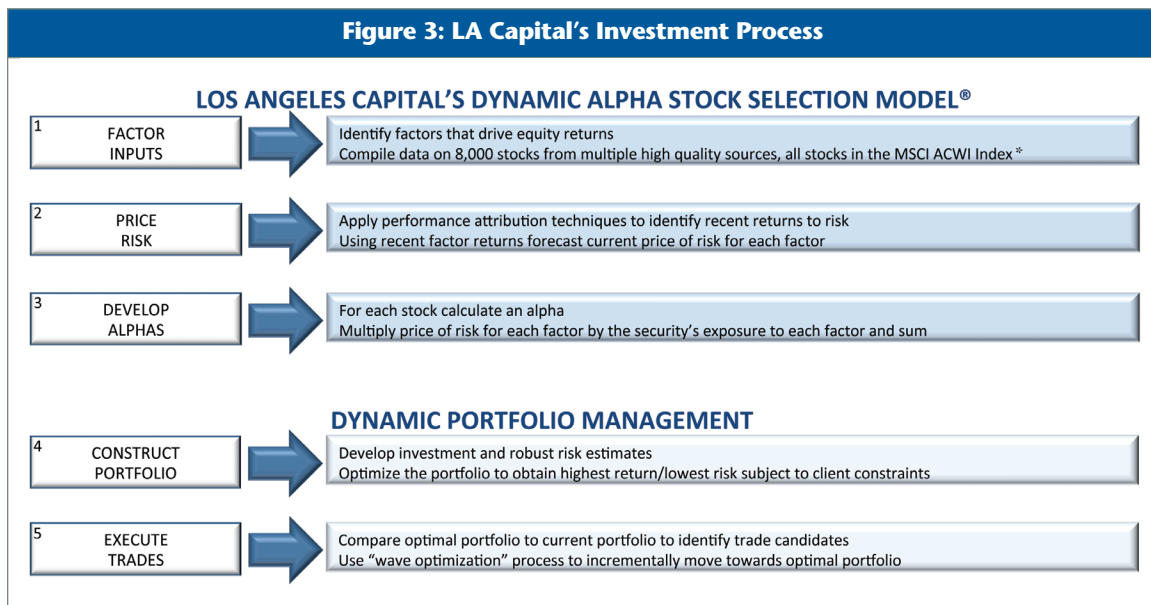
Philosophy

LA Capital believes that investor preferences for specific risk characteristics evolve with changing market conditions.

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Process

The firm's investment process (Figure 3 on page 7) includes a robust research process that identifies investor preferences for specific risk characteristics by analyzing valuation, income statement, balance sheet, industry and market-related factors.



*The MSCI ACWI Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed and emerging markets. The MSCI ACWI consists of 45 country indices comprising 24 developed and 21 emerging market country indices.

On a weekly basis, the investment team identifies the target portfolio that maximizes expected return while maintaining a risk profile similar to the Russell 2000 Value Index. The portfolio is diversified across industries, common risk factors and securities. Portfolio risks and implementation costs are tightly controlled and minimized through a proprietary optimization process. The investment team monitors portfolio returns and risks on a daily basis. Each month, LA Capital's Portfolio Review Committee formally reviews the portfolio for compliance with investment objectives and guidelines.

LA Capital's investment team is highly dedicated to the research process with more than half of the firm's resources dedicated to various areas of research — including Factor Research, Model Development, Risk Management and Information Technology, which combine to form an integrated global research platform. The goal of the investment research process is to enhance returns, control risk and reduce trading costs. Accordingly, the investment team focuses on four areas of research:

1. Identification of new risk factors that explain security returns
2. Improved statistical techniques to more accurately price risk factors
3. Enhancements to the risk management and portfolio construction process
4. Low-cost trading strategies

Each research project is evaluated for its ability to add value to the investment process. The firm believes the distinguishing feature of the research process is its ability to identify and adapt to changing market conditions.

Portfolio management team

Hal W. Reynolds co-founded LA Capital in 2002. He earned a B.A. from the University of Virginia and an M.B.A. from the University of Pittsburgh. Mr. Reynolds has earned the right to use the Chartered Financial Analyst designation.

Thomas D. Stevens co-founded LA Capital in 2002. He earned a B.B.A. and an M.B.A. from the University of Wisconsin. Mr. Stevens has earned the right to use the Chartered Financial Analyst designation.

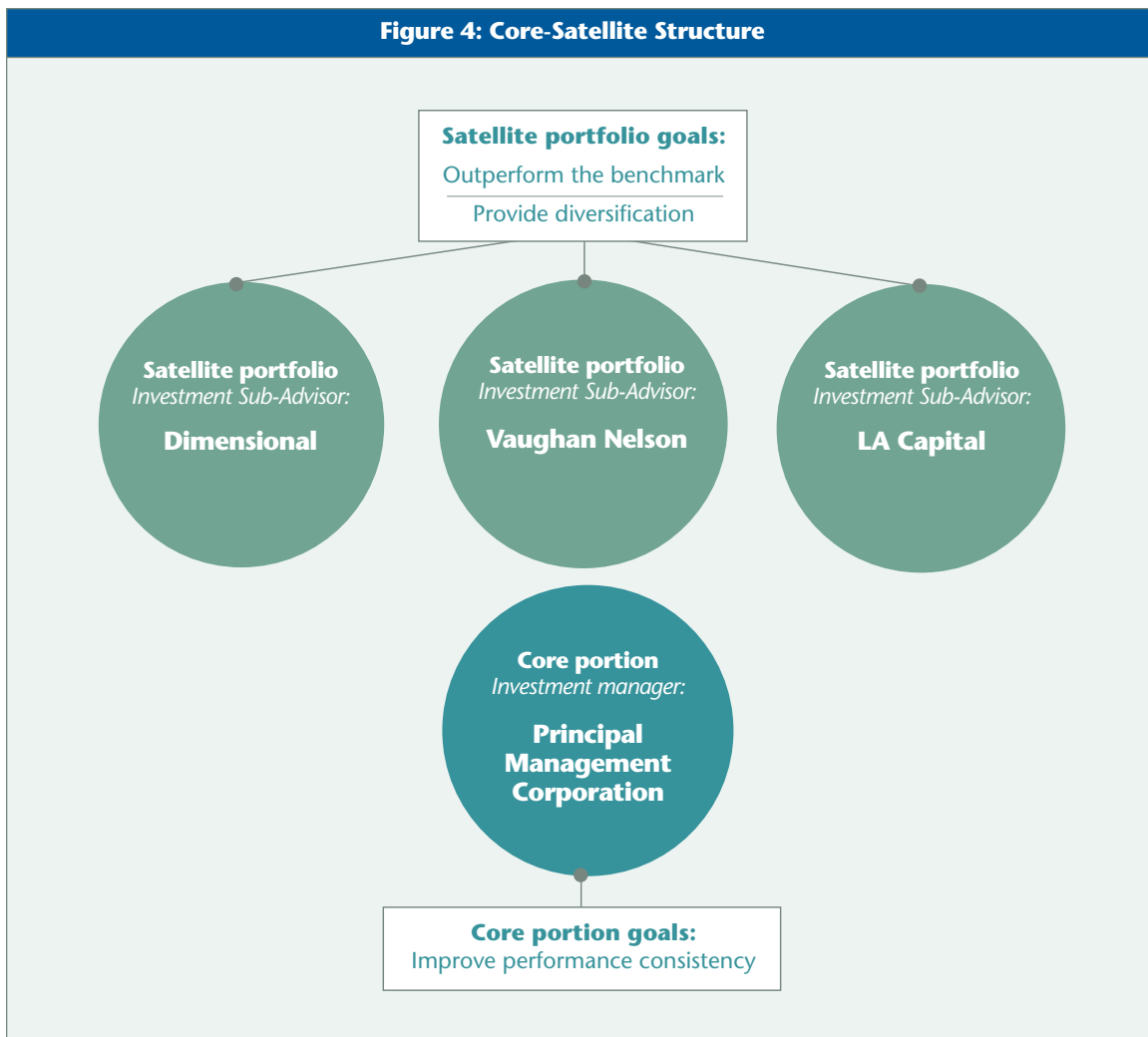
Daniel E. Allen joined Los Angeles Capital in 2009. Previously, he was with Wilshire Associates Incorporated and Wilshire Consulting Division. He earned a B.B.A. from Pacific Lutheran University and an M.B.A. from University of Chicago Booth School of Business. Mr. Allen has earned the right to use the Chartered Financial Analyst Designation.

SmallCap Value II Core-Satellite Structure

Dimensional, Vaughan Nelson and LA Capital 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 Value II, we combined these investment managers 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, Dimensional, Vaughan Nelson and LA Capital are the satellite sub-advisors for Principal SmallCap Value II, and the core portfolio manager is Principal Management Corporation.¹



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

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 Value II 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.

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.

No investment strategy, such as asset allocation or diversification, can guarantee a profit or protect against loss in periods of declining values.

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

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.

Sub-Advised Investment Options include separate accounts available through a group annuity contract with Principal Life Insurance Company and mutual funds available through Principal Funds, Inc.



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.