

The Worldly Investor

Investing abroad requires an understanding of companies, countries and economic cycles. Using quantitative metrics, the Principal Diversified International fund finds companies at the early stage of earnings growth and not yet on investors' radar. The fund spreads its bets across 25 countries. A team of global researchers discover small and large companies in the developed and emerging markets.

Q: What is the investment philosophy of the fund?

A: The fund is composed of allocations to three separately managed funds. It contains an 84% allocation to our mid-large cap developed market international strategy, a 10% allocation to our emerging markets strategy and a 6% allocation to the international small cap strategy. We strongly believe that superior stock selection combined with a disciplined portfolio and risk management strategy is the key to consistent performance.

Q: What are the key elements of the superior stock selection?

A: Superior stock selection is driven by three key characteristics - positive change in the company's business, rising investor expectations and attractive relative valuation.

First, positive change is what drives stock prices so we're looking for an acceleration of growth or profitability. For example, a company we currently own in the fund, Commerzbank, is a leading German bank that as recently

as 2003 was losing money. However, now the bank is likely to earn a return on equity of close to 15% next year. This dramatic turnaround in the business was the result of management focusing the bank and shedding unprofitable ventures. Management focused the bank's lending on the core German middle market and retail banking business and reduced the international lending and trading activities. They also accelerated non-performing loan writeoffs. These actions resulted in a dramatic positive change and return to sustained profits. In contrast, the leading UK banks, Lloyds-TSB and HBOS, for example - have continued to grow their earnings as well. However, rather than seeing a significant positive change, they've been growing EPS in the mid-single digit to 10% range because they've already been well-managed institutions, and the banking environment in the UK has been more benign than in Germany. The companies we invest in will not always be of the highest-quality, however, they will always be seeing positive change.

Second, we look for rising investor expectations or confirmation that this

Principal Inv Diversified International

Fund Facts

| | |
|-----------|--|
| Symbol | PINPX |
| Website | www.principal.com |
| Address | Principal Management Corporation 711 High Street Des Moines, IA 50392-0280 |
| Tel. No. | 800-547-7754 |
| Inception | 12/6/2000 |

Portfolio

| | |
|------------------------------|----------|
| Total Net Assets * | \$ 711 |
| Avg Mkt Cap (\$ Weighted) ** | \$ 44.73 |
| Average Price/Earnings Ratio | 12.63 |
| Average Price/Book Ratio | 2.79 |
| Turnover Ratio | 88 % |

Investment Information

| | |
|----------------------------|------|
| New Investment | Open |
| Min Initial Investment | N/A |
| Min Subsequent Investment | N/A |
| Min Initial IRA Investment | N/A |

Risk (Against MSCI EAFE IX - 3 Years)

| | |
|-------------------|------|
| Alpha | 1.6 |
| Beta | 1.12 |
| R-Squared | 0.94 |
| Ann Std Deviation | 2.90 |
| Sharpe Ratio | 1.89 |

Returns vs. MSCI World X-US IX

| | PINPX | Index |
|---------------|---------|---------|
| 1 Year (Cum.) | 30.55 % | 24.07 % |
| 3 Year (Ann.) | 26.98 % | 23.67 % |
| 5 Year (Ann.) | 11.97 % | 11.00 % |

Returns vs. MSCI EAFE IX

| | PINPX | Index |
|---------------|---------|---------|
| 1 Year (Cum.) | 30.55 % | 24.01 % |
| 3 Year (Ann.) | 26.98 % | 23.34 % |
| 5 Year (Ann.) | 11.97 % | 10.63 % |

Fees and Expenses

| | |
|-----------------------------|--------|
| Max Sales Charge - Front | 0.00 % |
| Max Sales Charge - Deferred | 0.00 % |
| Max Redemption Fee | 0.00 % |
| Total Expense Ratio | 1.16 % |

Portfolio Manager

| | |
|-------------------|------------|
| Paul Blankenhagen | 12/22/2003 |
| Juliet Cohn | 06/14/2004 |

* millions ** billions

Data through: 7/31/06

Source: Company Documents; Lipper



TICKER's Choice

positive change is happening. This can be in the form of stock price-relative strength or positive EPS revisions from the analyst community. Finally, we look for attractive relative valuation. We invest in companies that are trading at a reasonable price on expected cash flow and earnings, preferably at a discount to peer groups.

Q: *How would you describe your investment process?*

A: Our investment process begins with two key resources - our analyst team and what we call 'the global research platform,' which allows us to cover a broad array of securities. We have twenty portfolio managers and analysts that have direct input on investments that go into the diversified international fund. There's a dedicated emerging markets team, a dedicated international small cap team, and a dedicated mid and large-cap team.

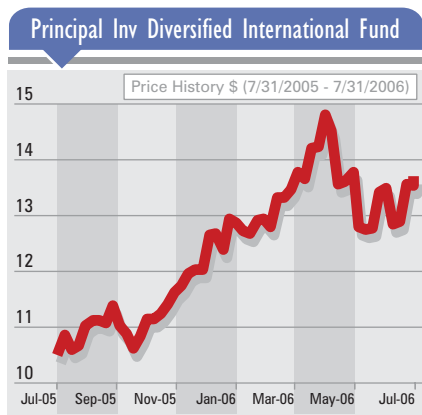
The analysts use the global research platform as a key tool to screen the universe they are responsible for. It focuses them on the most attractive 20% of their universe. Through our proprietary models we have captured the positive change, rising investor expectations, and attractive relative valuation, which is the core of our investment philosophy. The analysts' job is to decide which opportunities are the best. Our analysts talk to company management teams, competitor companies and sell-side analysts to conduct the due diligence. In many cases our team has met with these companies in the past. We meet more than 1,000 companies every year. Our analysts then summarize our research findings in a written document that they pitch to the PMs and the idea is either approved or not approved.

Q: *What kind of benchmark do you follow? How many stocks or companies do you monitor at a time?*

A: We use the Citigroup BMI World ex-US for the core 84% of the fund. The benchmark contains 5,200 companies, we then screen out the companies that don't have the necessary market liquidity. That leaves us with just over 2,000 companies. We then focus on the top 20% of these to research in-depth. These global companies are located in 23 to 25 countries around the world.

Q: *Do you exclude South America and other emerging markets such as Russia and Asia?*

A: We exclude emerging markets and leave those countries to our dedi-



cated team responsible for 10% of the fund. Our developed markets teams focus on the following: Europe, Canada, Australia and countries in Asia such as Singapore, Hong Kong, South Korea and Japan. Europe represents over half of the universe.

Q: *How do you deal with the issues related to accounting and currencies?*

A: Over the last several years we've seen a convergence of accounting standards across the world as European companies have adopted IFRS (International Financial Reporting Standards). We focus on cash flows as part of our valuation work. We have incorporated cash flow valuation models in

our quantitative tools that allow us to compare companies across countries.

In terms of currency, our analysts understand the business and they take into account how currency impacts the forecast for sales and profit within a company. We do not hedge the portfolio's currency exposures, as we believe investors in international funds are willing to invest in the currency of those countries as well.

Q: *How many stocks do you have in the portfolio?*

A: We have around 700 securities in the portfolio. Roughly 400 of those are in the small-cap, about 150 are in the emerging markets, and about 170 are considered core investments in the developed markets. The investment allocation weights in some cases are quite low. However, it's been demonstrated that performance does not suffer due to the number of securities.

Q: *How does that translate into portfolio turnover for you?*

A: Our portfolio turnover is around 100%. It turns into an average holding period of about a year. When we look at companies and do the research, we're looking for that positive change to be sustainable and last for six months to a year.

Q: *Could you discuss one of the companies that highlight your research process? How did you end up selecting it, how long did you hold it, when did you sell it and why?*

A: About a year ago we purchased a technology company called CSR. It's a UK-based semi-conductor designer that specializes in Bluetooth technology. These are the chips that allow electronic devices to communicate in a wireless fashion. For example, they allow a headset to commu-

nicate with the mobile phone. There has to be a chip in the phone and the headset. We see an increase in wireless chip applications - they are found in laptops as well as automobiles, to allow hands free use of your mobile phone. Applications are still in the early stage of development and demand is still coming from handsets and headsets for the most part, and computers. CSR has a competitive advantage in the chip design as they use less power and they're more efficient. They've been winning over 50% of the designs in these devices and their market shares are actually higher than that in some cases. For example, in headsets, they have almost 90% of the market. This share will drift down over time, but still allow them to grow rapidly as the attach rate moves from the mid-20%, up into the mid-30% and beyond for these bluetooth applications.

It's an attractive company, they have built a niche, they're specialists, they have a competitive advantage in the research they've done and designs that they've developed for these chips. They're competing with Broadcom and Texas Instruments, big companies that have a lot of resources, but they've been able to compete successfully with them. The company has done well for us and we continue to hold it because we believe that the investment story continues to be strong. We expect CSR to grow EPS in the 30% range this year and the stock is trading just over 20 times earnings, which is an attractive valuation.

Q: *Most academic studies would lead you to believe that having more than 35 stocks just doesn't add anything to the diversification. I guess your research is something different.*

A: Risk adjusted returns are important to us. This fund is designed to meet the needs of individual and in-

stitutional investors. In other words, the information ratio, which is out-performance divided by volatility of outperformance, is important to us. Our research shows we can generate the risk-adjusted returns that our clients want and our potential investors find interesting. On a volatility-adjusted or risk-adjusted basis, the alpha is not diminished compared to the benefit you derive from the diversification and the reduced volatility.

"Risk adjusted returns are important to us. This fund is designed to meet the needs of individual and institutional investors."



about

Paul Blankenhagen

Paul Blankenhagen is a portfolio manager at Principal Global Investors. He is responsible for developing portfolio strategy and leading the ongoing management of core international equity portfolios including developed markets portfolios and broad market portfolios. Paul is also active in research with an emphasis on the banking sector. He joined the firm in 1992 and has been a member of the international equity team since 1995. Paul was named a portfolio manager in 2000. He received a master's degree from Drake University and a bachelor's degree in finance from Iowa State University. He holds the Chartered Financial Analyst designation, and is a member of the CFA Institute and the CFA Society of Iowa.

Q: *What kind of risks do you perceive? How do you monitor them and what do you do to mitigate them?*

A: The approach we take is to focus on stock selection, picking the best stock in each particular sector and industry group. We limit our over/underweights versus the benchmark for country, currency, sector and industry group weights. We manage our sector weights to be + or -3% versus the index. We also follow that rule for weightings in countries, industry groups and currencies. We actually have a slightly wider band on market capitalization quintiles. We divide the market capitalization of the benchmark into five groups of equal size and seek to have broad representation across all groups within a 5% band. We limit individual stock holdings to + or -1% versus the benchmark. In this respect, we are true to our title of the diversified international fund since we seek to diversify away non-stock specific risks, and focus our efforts on stock selection.

Q: *What is the rationale of not using MSCI EAFE index which is generally what most international funds use?*

A: We do actually look at the MSCI index in addition to the Citigroup index I mentioned earlier, but we include Canada, so we look at the MSCI World ex-U.S. Index which includes Canada. We monitor the portfolio versus the index on a daily and weekly basis. For our initial screening process we use the Citigroup Index, which gives us a much broader starting point than the EAFE index because the EAFE index focuses on only the largest capitalization stocks but excludes many sizable companies in the international landscape that we believe could be attractive investment opportunities. ■

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