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Principal® Global Equities

The Best of Both Worlds: Opportunities in U.S. Mid-Cap Equities

Principal Global Equities offers clients focused exposure to the universe of U.S. mid-cap stocks through its dedicated Mid-Cap Equity team. The group focuses on creating well-rounded portfolios of mid-sized companies that have sustainable competitive advantages and attractive valuations.

Why Mid-Cap?

Imagine you were able to invest in only one sector of the U.S. equity market. Which one would you pick? If you go with large-cap stocks, you miss out on the swiftness and growth that small-caps can offer. If you choose small-cap stocks, you give up the strength and stability of large-caps. Mid-cap stocks can offer the best of both worlds. Not only a strong contender in its own right, mid-cap equities also offer a distinct mix of benefits that we believe are complementary to both large-cap and small-cap stocks. However, despite their powerful attributes, mid-cap stocks are often underrepresented in investor portfolios.

Mid-cap companies can offer the higher growth potential of smaller companies, with the strength and stability generally offered by larger companies. Similar to small-cap companies, mid-cap companies often have an entrepreneurial approach to doing business and, because of their size, are able to respond swiftly to change and capitalize on unfolding opportunities more readily than large-cap companies. They tend to have stronger balance sheets and have often weathered many of the growing pains that can disrupt small-cap companies. With proven management teams and well-established products, mid-caps may even be globally diversified – similar to large-cap companies. However, unlike their large-cap peers, mid-cap firms are not usually tempted to engage in dilutive acquisitions to boost their growth rates. Thus, in our view, mid-cap stocks offer an excellent balance between strong growth and a demonstrable history of management success.

January 2013

Quotes from famed investor, Warren Buffett, whose philosophy of investing we share:

“Only buy something that you’d be perfectly happy to hold if the market shut down for 10 years.”

Overlooked by Investors

Although mid-cap indices, such as the Russell Midcap Index, are widely recognized, most investors focus greater attention on investing in small-cap and large-cap styles. We believe this is a missed opportunity for investors to take advantage of the growth potential and stability that mid-cap companies can offer. Most mid-cap stocks started as something else, either as small-cap stocks that grew into the mid-cap category ("up-and-comers"), large-cap companies that declined in size ("fallen angels"), or spin-offs from larger organizations. Ironically, the fact that mid-cap stocks are often overlooked can prove a benefit to those investors who have dedicated allocations to this universe.

Superior Risk-Adjusted Returns

As **Exhibit 1** demonstrates, historically mid-cap stocks have delivered higher risk-adjusted returns than large-cap stocks over full market cycles, and lower volatility than small-cap stocks. Another important contributor to potential returns is that mid-cap stocks have tended to be prime targets for acquisition by deep-pocketed large-cap companies and often command take-out premiums. Just a few notable past examples include:

- Aetna's proposed $5.7 billion acquisition of Coventry Health Care at a 20% premium in August 2012
- Kinder Morgan's proposed $21.1 billion acquisition of El Paso Corporation at a 37% premium in October 2011
- Teva Pharmaceutical Industries $6.8 billion acquisition of Cephalon for a 39% premium in October 2011

Exhibit 1: Comparative Risk-Adjusted Returns and Volatility

10-year period ending December 31, 2012

Index	Return (annualized)	Volatility (standard deviation)
Russell 2000	9.71%	20.02%
Russell Midcap	10.64%	17.80%
S&P 500	7.09%	14.71%

Source: Sylvan

"It's far better to buy a wonderful company at a fair price than a fair company at a wonderful price."

Too Big to Ignore

According to Russell, mid-cap stocks (market capitalization range of $1 to $12 billion) represent approximately 27% of the total U.S. equity market capitalization as of December 31, 2012 – a universe far too big to ignore.

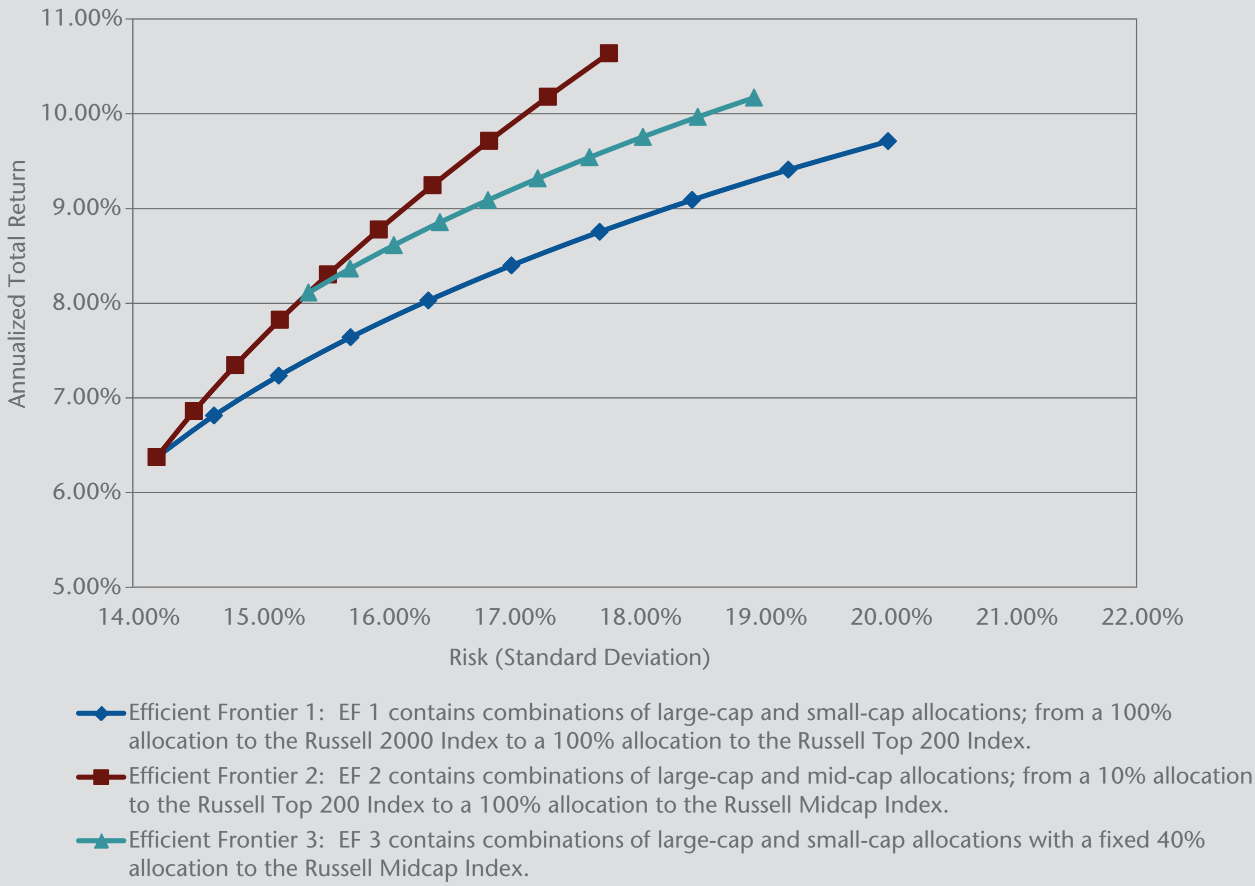
We feel many mid-cap companies are in the "sweet spot" of their business cycle; typically having evolved from the traditional small-cap start-up phase, they have likely endured a full market cycle. Yet, we look for plenty of room to enjoy substantial continued growth for investors. The mid-cap equity universe offers a broad selection of companies, combining the aspects of growth, value, quality, and liquidity. As such, we believe every equity investor is a potential mid-cap investor.

Dispelling the Myth

We feel an allocation in mid-cap stocks should be a long-term, stand-alone investment. Investors often presume they will achieve the same return, diversification, and growth benefits through the use of dedicated large-cap and small-cap allocations. However, this is a common misperception among even the most sophisticated of investors. As can be seen in **Exhibit 2**, the risk-adjusted returns of a hypothetical portfolio with allocations to mid-cap equities are higher than those containing only large- and small-cap stocks.

Exhibit 2: Efficient Frontier - Hypothetical Analysis

10 years ended December 31, 2012



The efficient frontier shown is generally representative of the potential long-term risk/return relationship of hypothetical equity index-based allocations. This doesn't profess to show all risk/return scenarios and there is no guarantee that future risk/return performance will be consistent, especially over shorter time periods. No portfolio allocation has zero risk and none guarantees any specific return.

Source: Sylvan

Why Now?

While an investment in mid-cap stocks should be a strategic, long-term allocation, we believe that now is a good time for investors to consider adding a new allocation or expanding their existing investments. With interest rates currently at a level that makes industry consolidation ever more attractive, mid-cap companies are expected to be the strongest beneficiaries of continued strong merger-and-acquisition activity.

We also believe recent market conditions are especially compelling for strategies that focus on owning high-quality companies at attractive valuations. Those companies with competitive advantages and owner/operator management teams can take advantage of current economic conditions to create value for their shareholders. Additionally, our analysis finds quality companies to be relatively cheap across the full capitalization spectrum. Over the last 12 months, low quality companies have outperformed high quality companies. We believe that companies with strong business models that are profitable and deliver strong earnings consistently continue to be attractively priced.

Why Principal Mid-Cap?

Continuity of people and process; robust resources

Not only does our Mid-Cap Equity strategy have a strong continuity of philosophy and process, our focused five-member team has also been very stable, under the same leadership since 1999. While completely autonomous from an investment perspective, the Mid-Cap team enjoys the full support and extensive resources of the broader Principal Global Equities group.

Focus on superior risk-adjusted return potential

We are long-term investors that approach the investment process with a time horizon spanning full market cycles. We focus on owning established, high-quality companies with sustainable competitive advantages at attractive valuations. A company's management team is an important consideration in our investment process. We seek companies with either an owner/operator leading the company or a culture of such throughout the organization.

We focus one hundred percent of our efforts on fundamental research. We seek to invest in companies that possess sustainable competitive advantages that manifest in forms such as market dominance and scale, low-cost production, high switching costs, and barriers to entry. We also focus on the management team as they can be responsible for significant shareholder value creation or destruction. We believe companies with a founder or second generation family member running the company, or an owner/operator culture, tend to manage expenses more closely and allocate capital more effectively than other "cash paid for" CEO's. Our valuation process is centered on a discounted-cash flow analysis. We use our fundamental knowledge of a company to formulate assumptions about future growth in order to produce an estimate of the cash flow that the company will generate going forward.

Crucial to our process is a focus on risk reduction at each stage of the investment process. We approach risk in the context of company fundamentals, overall portfolio volatility and downside protection, without respect to a benchmark. We believe risk can be reduced by owning companies with sustainable competitive advantages (i.e., lower business risk, less financial risk, and less accounting risk). Risk can also be reduced by the management team of the individual companies that we own. While we cannot participate in the multitude of decisions made by a company every year, we can reduce our risk by having management aligned with our goal of creating long-term shareholder value. Valuation is also an important component in our risk reduction process. We use our buy-and-sell discipline to ensure we have a sufficient margin of safety between where the company is trading and our estimate of intrinsic value. Beyond these processes, we also continually monitor the companies we own, the industries they are in, and their competitors for any changes that could impact our view of the business.

Core diversification and style consistency

Our Mid-Cap Equity strategy has a rational and sensible exposure to the mid-cap universe without style extremes or excessive concentration in any one sector. This is in contrast to the vast tech exposure of mid-growth portfolios in the late 1990s, or the heavy financial services exposure of mid-value portfolios in the mid-2000s. We focus on fundamental stock picking and do not speculate on macro events or investment themes.

We begin the security-selection process by surveying 800-850 companies to identify those that demonstrate above-average levels of profitability. This narrows the universe to approximately 300 companies. From there, we conduct a fundamental review to determine if a company's profitability arises from a competitive advantage that is sustainable. This results in a more focused universe of roughly 200 companies, on which we complete in-depth analysis to identify those stocks selling at a discount to their intrinsic value. This leads us to a diversified portfolio of 80-120 companies that we believe have sustainable competitive advantages, and trade at attractive valuations.

Long-term perspective

We believe our strategy is appropriate for long term investors that measure success over a market cycle. While our approach may lag during euphoric markets, which are typically anchored to macro events or themes, our high quality companies tend to do very well in both distressed and stable markets. By investing for the long-term, we are able to maintain a relatively low turnover (20%-30%), which is beneficial for both retirement and tax-sensitive investors.

Demonstrated history of success

Our Mid-Cap Equity strategy has delivered long-term risk-adjusted returns that has historically exceeded the overall U.S. equity market, as well as large-cap, mid-cap, and small-cap benchmarks, as shown in **Exhibit 3**.

Exhibit 3: Performance Comparison

Periods as of December 31, 2012

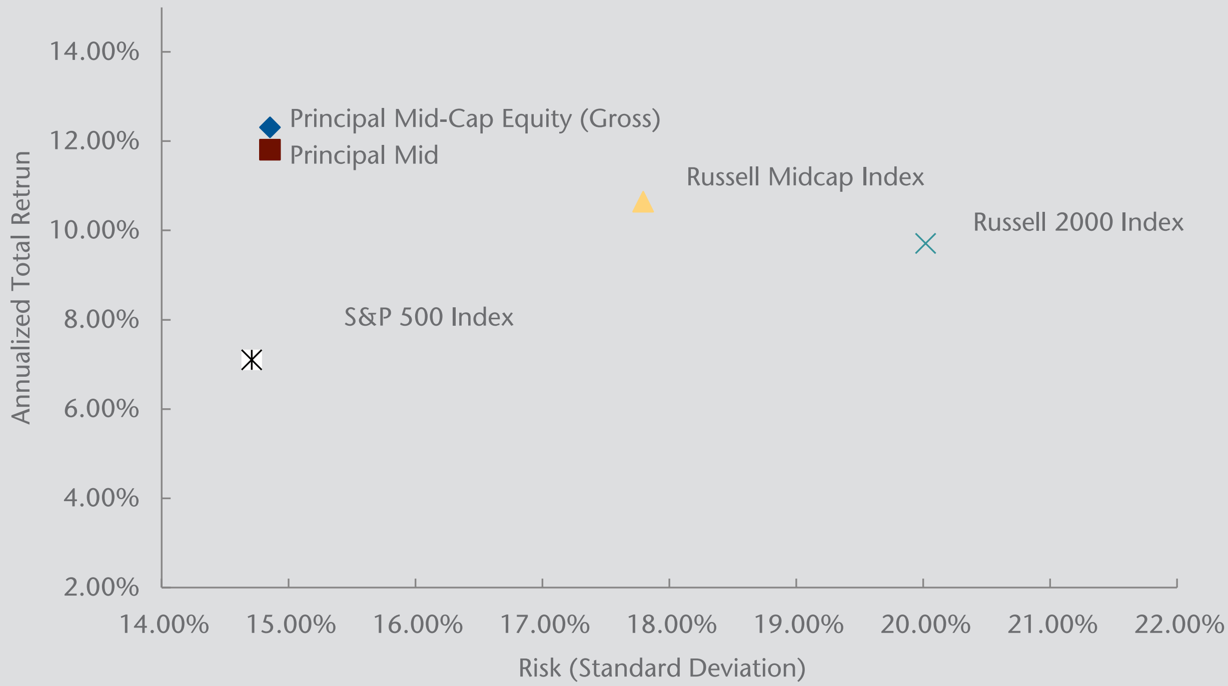
			Annualized		
	Three Months	One Year	Three Years	Five Years	Ten Years
U.S. Mid-Cap Equity (Gross)	3.49%	19.99%	17.60%	7.71%	12.30%
U.S. Mid-Cap Equity (Net)	3.37%	19.44%	17.06%	7.21%	11.81%
Russell Midcap Index	2.88%	17.28%	13.14%	3.56%	10.64%
Russell 2000 Index	1.85%	16.35%	12.24%	3.55%	9.71%
S&P 500 Index	0.38%	16.00%	10.86%	1.66%	7.09%

Periods over one year are annualized. Past performance is not a reliable indicator of future performance and should not be relied upon to make investment decisions. Due to rounding, figures and percentages shown may not add to the totals or equal 100%. Composite performance results are based on fully discretionary accounts under management, including those accounts no longer with the firm. Gross performance results reflect time weighted rates of returns, include income and market value changes, are shown net of commissions and other transaction costs incurred in the management of the accounts and include the reinvestment of net realized gains and income. Net performance results reflect a reduction of investment advisory fees based on the Principal Global Investors applicable asset management fee schedule. Information regarding Principal Global Investor's advisor fees is available in its Form ADV which is available on request. Actual investment advisory fees charged to clients may vary.

Source: Sylvan

Exhibit 4: Mid-Cap Equity Risk/Return

10-year period ending December 31, 2012



Benchmarks: The Russell Midcap Index measures the performance of the mid-cap segment of the U.S. equity universe. The Russell Midcap Index is a subset of the Russell 1000 Index. It includes approximately 800 of the smallest securities based on a combination of their market cap and current index membership. The Russell Midcap Index represents approximately 30% of the total market capitalization of the Russell 1000 companies. The Russell Midcap Index is constructed to provide a comprehensive and unbiased barometer for the mid-cap segment. The Index is completely reconstituted annually to ensure larger stocks do not distort the performance and characteristics of the true mid-cap opportunity set.

Past performance is not a reliable indicator of future performance and should not be relied upon to make investment decisions.

Source: Sylvan

Conclusion

In our view, the mid-cap universe offers a wealth of companies that combine the finest aspects of growth, value, quality, and liquidity. Mid-cap equities can offer strength and stability similar to large-cap stocks, but with potentially higher returns, and lower levels of risk than small-cap equities. Since mid-cap stocks are often underrepresented, we believe they present further diversification benefits for investors. As investors contemplate an allocation to the mid-cap universe, they should choose an Adviser with experience, resources, and a strong performance track record such as Principal Global Equities.

About Principal Global Equities

Principal Global Equities, a specialized investment management group within Principal Global Investors provides client-focused investment solutions spanning equity markets worldwide. We are fundamental investors focused on bottom-up stock selection within a sophisticated comparative framework. Our research universe encompasses over 10,000 companies, large and small, in emerging and developed markets. We provide expertise in active-core and specialty strategies, with risk profiles aligned to distinct client objectives and preferences.

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The Principal Financial Group

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