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The Principal® Perspective

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Searching for a Solution to the Recession: Do Government Actions Help or Hinder?

Flip through a magazine or a newspaper, go online, or watch CNBC and you'll find wall-to-wall recession coverage. The public has been bombarded with messages of an economy in dire shape. And it hasn't let up.

It's been that way for several months, ever since mid-September of last year when Lehman Brothers went bankrupt and Federal Reserve Chairman Ben Bernanke and former U.S. Treasury Secretary Henry Paulson went to Congress with a message: pass a $700 billion bailout bill or the country will fall into an economic depression.

Of course, it's not just our 24/7 media at fault. According to Bob Baur, Ph.D, chief global economist for Principal Global Investors, the current recession was caused by a "severe drop in consumer spending, coupled with an enormous credit crunch" and a "housing bust that came about because the Federal Reserve (the Fed) was raising interest rates" in 2004–2006. But one prominent economist, Dr. Lee Ohanian, professor of economics at UCLA, says that our current economic straits were also caused by questionable government actions and relentlessly negative media coverage. "In my opinion, this is the first recession in the history of the United States in which a crisis of confidence caused the recession," says Ohanian. True, the subprime mortgage mess was eroding the stability of the banking industry for many months prior to September 2008. But Ohanian says that the consumer was still spending in the third quarter. Auto sales were reasonably strong up until mid-September. "It wasn't until we heard these pronouncements of ominous economic consequences that you saw consumers suddenly stop buying," he says.

Dr. Ohanian's view of what caused the current recession is probably a minority opinion. It turns out that economists

Continued on back page

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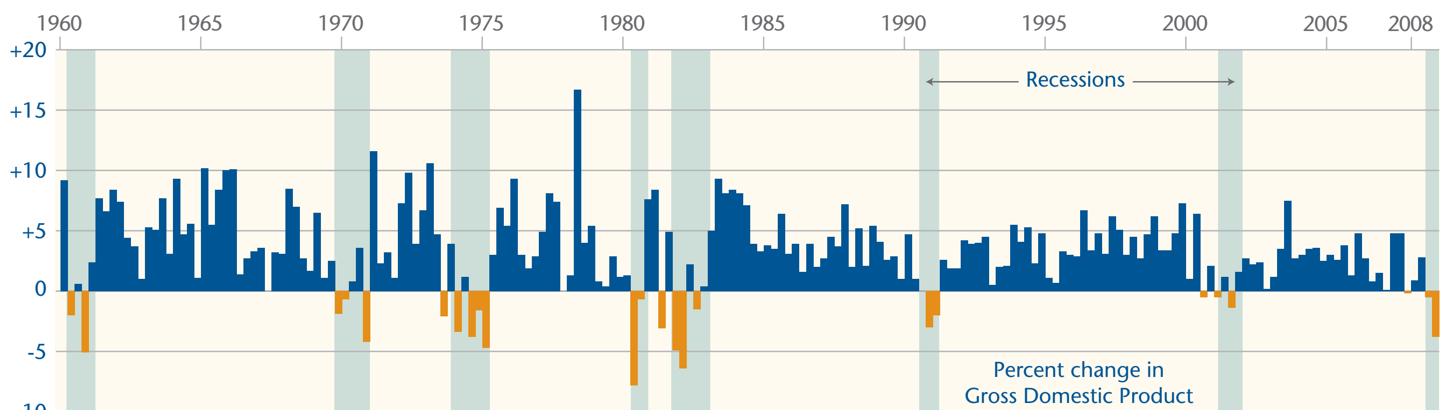
Boom and Bust: Recessions Across the Decades



Source: Bureau of Economic Analysis

Time for a Portfolio Check-up?

During these past several months, the thought of opening your financial statements has undoubtedly been painful. Maybe they've piled up unopened on your desk. But the truth is, you should open those envelopes, and probably make an appointment to see your financial professional.

Most likely your portfolio is worse for wear. But there are steps to take with your financial professional's help.

For one thing, your portfolio may be out of balance. With markets performing so poorly in 2008 and into 2009, your total allocation to equity funds versus fixed-income funds, cash equivalents, and other asset classes may have declined. You and your financial professional will want to have a discussion about whether to continue your allocation at the same level as before the stock market decline.

Getting Past the Current Crisis

Because stocks have historically rebounded from bear markets to reach new highs, one strategy might be to discuss boosting your allocation to equity funds to your portfolio's previous level. On the other hand, you might decide that given your time horizon and your current attitude about risk, you want to keep your equity allocation at a lower level than before.

Perhaps you've shied away from fixed income. However, as you get older, it makes sense to have a higher percentage of securities that offer income. Ask your financial professional if corporate bonds or government securities make sense — or both, and at what allocation.

It's also possible that you have moved a significant amount of your assets into lower-risk investments such as money markets or U.S. Treasury securities. While these holdings are less risky, they don't keep up with inflation. And historically, a preponderance of cash in a portfolio may have been too conservative for investors to reap the rewards of an eventual market recovery.

Take a Hard Look

Within your portfolio, you may have noticed that your allocations to various industries or parts of the world are no longer the same as when you started out due to variations in performance. For example, your allocations to finance and insurance may have declined markedly in relation to groups such as consumer staples — food, beverage, and the like. You should discuss with your financial professional whether you want to shift your portfolio toward those sectors that have underperformed.

Another good reason to meet is to clear the air. By now, you've read a dozen expert forecasts. Your financial professional can remind you that no one has a crystal ball, and the way to deal with uncertainty is to be diversified. In addition, you may be tempted to chase performance, by investing in funds that performed relatively well in the recent past, even though past performance doesn't reflect the future.

Another good thing about meeting with your financial professional is that unlike meeting with your lawyer or your accountant, the session is probably free. If they manage your affairs on a percentage of assets under management, there may be no charge for the time.

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

Federal Income Taxes: Some Relief in Sight for 2009

Every year, there are built-in changes in the tax law – and 2009 is no exception. They might be inflation adjustments, or other changes determined years ago to take affect now.

First, your tax bracket possibly changed as a result of an inflation adjustment, for the better.

There are six tax brackets — 10, 15, 25, 28, 33, and 35%. In 2009, it takes more income to reach a given tax bracket than it did in 2008. For example, in 2009, married people hit the 25% tax bracket with taxable income of $67,900. In comparison, a married couple filing jointly hit that bracket with income of $65,100 in 2008.

Standard deductions and exemptions were also adjusted for inflation. The standard deduction is a write-off that everyone gets if they don't have many itemized deductions. In 2009, the standard deduction for married taxpayers rises to $11,400, up from $10,900 in 2008.

Personal exemptions, which are deductions that you get for having dependents, rise to $3,650 in 2009, up from $3,500 in 2008.

Gift and estate tax changes in 2009. You can make annual gifts up to $13,000 ($26,000 for a married couple filing jointly) without worrying about triggering the gift tax. That's up from $12,000 ($24,000 if married) in 2008. You also get a lifetime exemption on gifts of $1 million, an amount that hasn't changed.

Federal estate tax exemption rises to $3.5 million in 2009, up from $2 million in 2008. So, a person who died with an estate worth $3 million in 2008 would pay an estate tax on $1 million. If that person died in 2009, there would be no estate tax due.

So far, all of these pre-programmed adjustments may be favorable to you, with one conspicuous exception: Social Security. In 2009, the maximum amount of earnings subject to the tax rises to $106,800 from $102,000 in 2008.

For more information on tax law changes, it's always a good idea to consult with a professional tax advisor.

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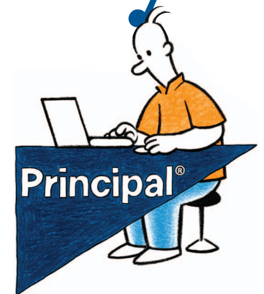

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"Searching for a Solution to the Recession" *Continued from Page 1*

disagree on a lot of things, including the timing of a recession, what causes economic downturns, and how best to get out of one. Many economists, including Dr. Baur, believe that the current recession was sparked by the failure of the U.S. government to save Lehman Brothers from bankruptcy, which in turn triggered a cascading crisis in the global financial system, leading to millions of lost jobs abroad and at home.

The Current Crisis

All of this was preceded by a housing boom in the early part of this decade, and the growth of the mortgage-backed securities market. Indeed, most recessions have historically been preceded by a period of booming growth when interest rates were very low and gross domestic product was strong. The previous recession, which began in March 2001 and ended in November of that year, was preceded by the technology boom of the late 1990s. Investors poured money into technology stocks, particularly Internet companies with no earnings. (Remember "irrational exuberance?") And as computer orders began to decline in early 2000, the NASDAQ plummeted. Eventually, the Fed lowered interest rates dramatically and the economy recovered.

Not Your Father's (or Grandfather's) Recession

More typically, recessions occur as a result of a build-up of inventories. Consumer spending slows, too many people are on the payroll, production slows, capital spending slows, and jobs are lost. This type of recession happened in the **1950s and 1960s**. Inventory recessions tend to work themselves out, since eventually inventories are depleted and need to be replenished, at which time businesses start hiring people again. Another cause for a recession is inflation, which plagued the **1970s and early 1980s** due to energy shortages. The Fed would raise interest rates to combat inflation, which caused sales declines in interest-sensitive goods such as cars and houses. These parts of the economy shed jobs and a recession would ensue. The **1973 recession** coincided with Watergate and uncertainty over the stability of the U.S. government. In addition, Americans were confronted with an energy crisis for the first time. Meanwhile, the stock market declined 40%.

Forty-five years earlier, the Great Depression was caused in part by a large number of bank failures that took place within a short period before and after the stock market crash of 1929. To combat the Depression, when unemployment exceeded 20%, Franklin Delano Roosevelt instituted government policies such as establishing Social Security, unemployment benefits, and deposit insurance, widely believed to have helped end the crisis. Still other economists believe that parts of the intervention, such as setting prices and wages in certain sectors like agriculture, interfered with market forces to drag out the hard times.

The Great Debate

That debate continues to this day. Does government intervention help or hurt? It clearly helped us out of the inflation-induced recessions of the 1970s and 1980s. And lowering interest rates dramatically in 2001 and 2002 pulled us out of the 2001 recession. But some would argue that the Fed kept interest rates low for too long and sowed the seeds of the current downturn. Economists really don't know for sure. "Every recession in the history of the U.S. has been followed by a very robust recovery," observes Ohanian. "We don't know why it happens, but it happens. The restorative forces of the American economy are remarkable."

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