THE DUE DILIGENCE PROCESS FOR SUB-ADVISED INVESTMENT OPTIONS

Our proprietary due diligence process provides a rigorous and disciplined framework for identifying, hiring, and retaining premier investment managers[1] within each asset class and investment style for our platform of Sub-Advised Investment Options. The process is characterized by a comprehensive and continuous review of all investment managers using a proprietary performance methodology and advanced analytical tools.

I. Investment Manager Selection Policy

Purpose

The purpose of the *Investment Manager Selection Policy* is to define a disciplined process for identifying and engaging premier investment management firms. There are a variety of reasons why the member companies of the Principal Financial Group® (The Principal®) might choose to hire a new investment manager. In most cases, it will be to replace a recently terminated manager, take advantage of a new investment approach, or to add an additional sub-advisor to an existing portfolio.

Manager Screening

Each manager search is unique depending upon the asset class and investment style targeted and other factors such as whether we are replacing a manager, starting a new investment option, or adding an additional manager to an investment option. Based upon need, the Investment Services Group (ISG) may start with a review of the entire universe of institutional managers in an asset class, or narrow the focus, for example, to include only firms that are complementary to an existing manager of an investment option. In some cases such as corporate acquisitions or new product development, our investment professionals are validating proposed managers rather than conducting a full search. In all cases, however, managers are evaluated based upon a large number of in-depth qualitative and performance-oriented factors.

Our initial screening process relies heavily on objective measures such as the firm and product track record and performance, but also incorporates many subjective judgments such as the consistency of the investment process.

[1] The term "manager" or "investment manager" used in this document may refer to an investment advisor or sub-advisor of a Separate Account, or an investment advisor or sub-advisor of an underlying mutual fund.

We typically review each of the following criteria. The weight given to each of these criteria varies from search to search, but our goal is to focus on investment managers with strong overall profiles.

1. *Firm Track Record* – length of time firm has been in existence. In addition, the firm should have a strong reputation of integrity.
2. *Product Track Record* – length of time the investment strategy has been in existence.
3. *Assets under Management* – the size of our portfolio relative to the investment strategy's total assets should be reasonable.
4. *Style* – each investment strategy should meet our needs in regards to investment style, sector, region or asset class.
5. *Open/Minimum Account Size* – investment strategy shall be open for new business and firm must be able to provide significant capacity.
6. *Performance* – the investment strategy's long- and near-term return and risk relative to passive indexes and appropriate peer universes will be evaluated.
7. *Investment Philosophy/Process Characteristics* – the degree to which an investment manager's strategy complements our other Sub-Advisors in our multi-manager Sub-Advised Investment Options or fills a space on our platform. The goal is to ensure that our clients can choose from a balanced selection of investment philosophies and portfolio construction techniques (e.g. top-down vs. bottom-up, fundamental research vs. quantitative inputs, etc). Additions to multi-manager investment strategies are made after considering the style and performance characteristics of existing managers.
8. *Management Fees* – investment strategies must have a competitive fee structure.
9. *Client Service:* The firm should have the capabilities and track record of supporting similar investment strategies with the member companies of The Principal or similar firms. The firm should also have experience with Investment Company Act of 1940 products.

The goal of this initial search process is to identify a short list of firms with many of the characteristics that we are seeking. These firms are then asked to complete a questionnaire for further evaluation. We do not have a specific goal for the number of firms that receive a questionnaire since we focus more on the quality of the managers, not the quantity. In recent years anywhere from three to 10 firms make it to this stage.

The Manager Selection Questionnaire

The manager selection questionnaire is a tool for gathering detailed information about each candidate firm in a consistent format. In each search, the questionnaire is adapted for the specifics of the particular asset class. The questionnaire focuses on four key aspects of the firm and investment option: organization, investment philosophy and process, resources, and performance.

A description of the key characteristics evaluated within each of the four areas is given below:

> ***Organization*** – Stability of the firm's ownership, sound capital structure and financial condition, clear business objectives, capable leadership, well-defined lines

of decision-making authority and responsibility, employee compensation structure, industry reputation, clear succession planning, regulatory record, future asset capacity, trading capabilities, and experienced and talented investment staff.

Investment Philosophy and Process – Evidence of a valid and well-defined investment approach including a clearly identified, rational and persistent market anomaly or inefficiency, unique sources of information or proprietary information processing models, disciplined buy/sell decisions, systematic portfolio construction, and adequate risk controls.

Resources – The state of current and proposed resources supporting the investment process including the quality and depth of fundamental and/or quantitative research, the level of client service and marketing support, and the adequacy of information management, compliance and trading systems.

Performance – The candidate's historical excess returns and risks relative to a suitable peer universe, a passive index, and competing firms over near- and long-term time horizons.

It is important to note that three of the four key areas— *organization*, *investment philosophy and process*, and *resources*— are analyzed subjectively with a long term perspective. In other words, we believe the evaluation should reflect the focus in these areas of a firm's ability to add value given the state of its existing organization, the soundness of its investment philosophy and process, and the depth and quality of its resources.

In contrast, evaluations of performance are based on ***historical*** levels of excess return and risk relative to passive indexes and suitable peer universes. The purpose of analyzing historic investment performance is to objectively measure whether the firm has delivered strong investment results and is, indeed, skillful. Investment management skill is defined as the investment manager's ability to ***consistently outperform*** a passive index and the peer group over time. Accordingly, an investment manager must accomplish three things to be classified as skillful. First, their product should produce a positive excess return, on average, over the measurement period. Second, the risk that a product has taken is considered. Finally, the results should be significant from a statistical point of view. These goals are all achieved through the use of *Information Ratios*.

Manager Selection and Implementation

The senior members of the ISG are responsible for reviewing the questionnaires and evaluating each candidate. Manager performance is evaluated separately based upon the Quantitative criteria described previously. The ideal manager will have demonstrated consistent outperformance versus both a passive index and its peer group. It will have done so without taking a high level of risk and the strong performance will have been achieved on a consistent basis.

The role of the committee is to select several candidates as finalists. A thorough and lengthy discussion takes place where each candidate's strengths and weaknesses are compared. Typically, two to four firms emerge as unanimous choices as finalists.

Finalists are typically interviewed in person, either in Des Moines, Iowa or the manager's office. Upon completion of the finalist interviews, the committee meets to finalize the recommendation on which firm to select, subject to the successful negotiation of the management and fee agreements. The ISG then presents the final hiring recommendation to the mutual fund board of directors for registered funds and the Investment Committee of Principal Life Insurance Company for unregistered separate accounts. If the recommendation is approved, the ISG is then responsible for the agreements, managing the transition process, and developing detailed investment guidelines for the new portfolio.

II. Investment Manager Monitoring Policy

Purpose

The purpose of the *Investment Manager Monitoring and Retention Policy* is to establish a rational and disciplined framework for managing the ***existing*** investment sub-advisor relationships. By designing and implementing a systematic decision-making process, The Principal can improve the quality and timeliness of its manager retention and termination decisions. This should help reduce the high costs associated with reactionary or ad hoc actions.

This policy embodies certain principles that are crucial to successful, long-term asset management relationships. These principles include:

- *Clear Mandates* – performance goals and objectives are clearly identified and agreed to by staff and the investment manager in advance;
- *Active and Timely Communication* – regular communication between our staff and the investment manager is essential. Responses to performance or organizational issues must be timely, appropriate and consistent;
- *Long Time Horizon* – performance evaluations are conducted over multi-year time horizons, which we believe provide a more accurate depiction of investment manager skill; and,
- *Flexibility* – the ISG has the flexibility under the policy to use its discretion and reasoned judgment to address unique events and circumstances.

Investment Manager Monitoring Program

The *Investment Manager Monitoring and Retention Policy* sets forth the parameters, objectives and responsibilities for monitoring the investment sub-advisor relationships with both affiliated and unaffiliated investment management firms.

The objective of the monitoring program is to identify on a timely basis any adverse changes in the investment manager's organization, investment process, or performance results. Once adverse changes have been identified, the monitoring program also dictates the timing and manner of the response from member companies of The Principal. Responsibility for implementing the monitoring program rests with the ISG, with input and assistance provided by senior management and other affiliated business units.

Investment Guidelines

The ISG, with input from product managers from The Principal, develops investment guidelines for each investment manager, typically when the manager is hired. The guidelines summarize the sub-advisor's investment strategy, provide a description of eligible investments, and outline other portfolio restrictions and constraints. Each investment manager's guidelines also include specific return and risk objectives relative to passive style indexes, Morningstar peer groups, or both. Finally, the guidelines specify reporting requirements and deadlines for performance data, portfolio or market commentary, and compliance information.

Quarterly Reviews

We believe a successful monitoring program requires ongoing qualitative and quantitative assessments. The manager selection decision relies heavily on the subjective review of qualitative factors relating to the firm's organization, investment philosophy and process, and resources. The objective of the monitoring process is to ensure that the investment manager retains the organizational traits and investment process characteristics that served as the basis for the original hiring decision. (A description of key elements for each area was provided in the *Investment Manager Search Policy*.) The monitoring of qualitative factors is perhaps the most critical aspect of the monitoring program because we believe that *qualitative factors determine the investment manager's ability to add value in the future*.

In contrast, quantitative assessments focus on those elements of the investment manager's product or process that can be measured objectively and compared to certain targets or goals. The most common and important form of quantitative assessment is the periodic review of historical investment performance. Quantitative tools can also be used to analyze such items as the level of active management risk, style/sector consistency, up market/down market performance, and sources of value-add (via attribution analysis). This detailed level of analysis provides a double-check that a manager's investment process is being applied consistently over time.

Quantitative assessments are necessary because they validate a firm's investment approach and provide valuable insights into the firm's level of investment management skill. The information obtained from our quantitative assessment is also helpful in providing detailed and accurate communications to current and prospective clients of The Principal.

Face-to-Face Meetings

In addition to quantitative and qualitative assessments, the ISG meets in-person with each sub-advisor not less than once every twelve months. The agenda for these meetings includes discussions of business issues, investment strategy and performance results. In addition, members of the ISG visit the investment manager at its office not less than once every twenty-four months.

Courses of Action

Depending on the significance of an adverse event, the ISG can choose one of three possible courses of action:

- No Action – Circumstances or events resulting in this course of action are generally not considered serious. There is no significant adverse impact on the firm or its investment process. Examples include the loss of a single large client, the loss of staff not deemed to be critical to the investment process, or minor violations of compliance guidelines that have been resolved.

- Watch List – Investment Options may be placed on the Watch List for Qualitative reasons (firm or process), Quantitative reasons (performance) or both. The Watch List reflects a Cautionary Status that has triggered a more in-depth review of an investment option based on the actions of one or more of its managers. This action signifies that our diligence process has uncovered a concern with the investment option that requires further monitoring. We further define the triggers for Qualitative and Quantitative Watch List immediately below.

    - Qualitative – Qualitative concerns that trigger Watch List status typically arise from a significant event that is a major change in the organization, the investment process, or a compliance issue. Examples of reasons a manager may be placed on the Qualitative Watch List include replacement of the portfolio management team, a sudden change in investment process, or significant compliance and ethical concerns at the firm or strategy level.

    - Quantitative – Watch List Status will result if long-term performance is significantly below our expectations. Performance results of the investment option are used to determine Quantitative Watch List status.

      If the investment option was on the Watch List for quantitative or performance concerns and the due diligence process determines removal from the Watch List is appropriate, the investment option may be placed on Probation until such time that the performance of the relevant manager(s) improves. The cautionary status of Probation may be assigned to an investment option for the following reasons:

        - An investment option has been removed from the Watch List because the due diligence process has determined that the manager(s) has made improvements in the short term that have the potential to be sustainable over the long term. However, long-term performance is still below our expectations and requires additional monitoring.
        - An investment option has been removed from the Watch List because the due diligence process has determined that the underperformance that led to Watch List status is explainable in light of the process used by the manager(s) based on the market environment at the time. However, long-term performance is still below our expectations and requires additional monitoring.

- A manager(s) is removed from an investment option due to performance reasons but the investment option's long-term performance is still below our expectations and requires additional monitoring. In this situation, the due diligence process recognizes that while removal of the underperforming manager(s) has the potential to improve performance, the long-term performance history still contains the manager(s) that have led to the underperformance.

The status of Probation is conferred on an investment option for an indefinite period of time. However, at any time while a manager is on Probation, the due diligence process may remove a manager(s). Probation status is lifted only after the investment option scores "Favorable" for one quarter based on the quantitative scoring criteria of the due diligence process, which focuses on three- and five-year results.

Being placed on the Watch List (or Probation) does not necessarily mean that the investment option is no longer an appropriate investment option. Instead, this status is meant to communicate to the investment manager the ISG's increased level of concern about a particular issue or event, which if left unresolved, could endanger the relationship.

An investment option is placed on the Watch List for a length of time that normally will not exceed twelve months. Within thirty days of being placed on the Watch List, the ISG will communicate with the relevant manager(s) to discuss the triggering issue or event. Specific steps that need to be followed to resolve the matter will be agreed upon with the manager.

3. <u>Immediate Termination</u> – Under extraordinary circumstances, the ISG may choose to recommend termination of the investment sub-advisor relationship immediately *without* placing the firm on the Watch List. This course of action would only occur in situations where the survivability of the firm is in question, where the firm has materially deviated from its obligations, or in instances of company fraud, willful misconduct, or a violation of fiduciary duty that may or may not be directly related to its obligations to any of the member companies of the Principal Financial Group.

ISG recommendations to hire or terminate an investment manager are subject to review and approval of mutual fund board of directors and/or the Investment Committee of Principal Life Insurance Company. Watch List events are communicated to plan sponsors through an Investment Bulletin. Multi-manager products are evaluated as follows: The Quantitative review focuses on the <u>overall product</u> that clients receive. Underperformance of one of several managers may result in additional scrutiny of that manager, but will not result in a Watch List event if the overall product performance meets or exceeds our goals. In contrast, a significant Qualitative event for any single manager may result in a multi-manager product being placed on the Watch List.

Decision Rules

Qualitative Signals

There are a variety of organizational or investment process-related events that may cause the ISG to place the investment manager on the Watch List. Watch List action is not automatic and depends on the severity of the triggering issue or event. The most common issue and events include:

- A change in the investment manager's ownership structure
- Deteriorating financial condition of the firm
- Failure to meet business objectives
- A loss of key investment personnel
- A major shift in the advisor's investment philosophy
- Significant changes in key aspects of the investment process (i.e., source of process inputs, style profile, risk control, sources of value added etc.)
- Client losses and/or declining assets under management
- Poor client service
- Compliance, trading and investment guideline violations

Quantitative Signals

Quantitative decision rules focus on historical measures of investment performance. Historical performance results serve to validate (or reject) an investment manager's investment approach and thereby confirm (or refute) their investment management abilities.

Because short-term performance figures are potentially subject to a lot of random 'noise', the monitoring program uses long time horizons, typically three and five years, to evaluate investment Sub-Advisor performance. If the investment manager's tenure with the Principal Financial Group is less than three years, the firm's actual performance may be combined with the manager's performance history in managing other mutual funds or portfolios which have substantially similar mandates and were identified by our team of investment analysts in the selection and retention process.

In general, the ISG expects managers to achieve second quartile or better peer performance over three- and five-year periods using data from third parties such as Morningstar®. Relative to a passive index, managers are expected to achieve positive excess returns over a five-year time period and to be within an acceptable range of the index over a three-year time period. Gross performance figures relative to a passive index are used so we can evaluate the skill of the manager without expenses that are included at the product level. Performance should ideally be consistently generated on a monthly basis.

An active investment product will be placed on the Watch list if the overall score of an investment product's Investment Option Quantitative Rating is "Less Favorable" for two of three consecutive quarters. Note: To make sure we provide an accurate picture of a "newly" hired investment manager, they will be given an appropriate time frame (approximately two to three years) before placing the investment option on the Watch List for quantitative reasons. This will help to prevent unnecessary action immediately after hiring a new investment manager, and allow for evaluation over longer periods.

Passive index strategies must be evaluated differently because they do not have excess return expectations. Instead, their performance objectives relate to closely tracking a specific index over time within a predetermined range.

Notwithstanding these rules, the ISG reserves the right to recommend any course of action deemed prudent, at any time, in response to investment manager performance. Furthermore, judgments as to whether an investment manager has achieved specific performance goals rest solely with the staff and members of senior management.

III. Investment Manager Evaluation Methodology

Each quarter, the ISG prepares a *Due Diligence Quarterly Review* summarizing product and sub-advisor performance, other portfolio attributes, and Due Diligence actions and scores for the quarter. The purpose of the Quarterly Review is to provide audiences with a clear and consistent method for reviewing periodic manager performance and keeps them informed of significant firm events.

In addition, the Quarterly Review provides a current view of Qualitative and Quantitative Scores. For multi-manager products, the Qualitative Score is based on a weighted average of scores for all managers. End of quarter market values are used to derive the appropriate advisor weights. The Quantitative Score is based on the performance of the overall investment option.

Qualitative Methodology

The qualitative methodology independently ranks each investment manager on the basis of its perceived strengths and weaknesses in three key areas: *organization, investment philosophy and process, and resources.* All three of the key qualitative areas are analyzed subjectively with a forward-looking perspective.

All three areas are scored on a scale of 1.0 to 4.0 (with 1.0 being the best score). The weightings are:

Organization:	30%
Investment Philosophy and Process:	50%
People:	20%
Total Qualitative Score:	100%

Each area's score is based upon a thorough analysis of many different components. All of these components are combined into one qualitative score.

Qualitative Score

The interpretation of the numerical scores is as follows:

Score	Evaluation
1.00 – 2.50	**Favorable:** No current or foreseeable major changes to the organization, investment philosophy and process, or resources.
2.51 – 3.00	**Neutral:** No current or foreseeable major changes to the organization, investment philosophy and process, or resources, but some modest changes have occurred.
3.01 – 4.00	**Less Favorable:** One or more changes have occurred to the organization, investment philosophy and process, or resources. There may also be an actual or possible major change to these three elements.

Quantitative Score

For active investment strategies, the ISG evaluates the following performance statistics on a **quarterly** basis to determine whether Watch List status is appropriate:

1. Three-Year Risk-Adjusted Passive Index Performance (Information Ratio)
2. Five-Year Risk-Adjusted Passive Index Performance (Information Ratio)
3. Three-Year Peer Performance based on Morningstar® Percentile Rankings
4. Five-Year Peer Performance based on Morningstar® Percentile Rankings
5. Three-Year Consistency of Monthly Performance vs. Index based on number of months outperforming (Consistency)

See the following chart below for weighting information:

Quantitative Score

Quantitative Score				
35% Risk-Adjusted Passive Index Performance		50% Peer Performance		15% Consistency
50% Three-year Returns	50% Five-year Returns	50% Three-year Returns	50% Five-year Returns	100% Three-year Returns

These five factors are combined into one quantitative score. The Investment Option numerical score is interpreted as follows:

Score	Evaluation
1.00 – 2.50	**Favorable:** Performance is meeting or exceeding our expectations.
2.51 – 3.00	**Neutral:** Performance is not exceeding expectations, but still in good standing.
3.01 – 4.00	**Less Favorable:** Performance is significantly below our expectations.

Key Terms

Consistency Ratio – The consistency ratio measures how consistently the manager is able to exhibit positive excess returns. To calculate the consistency ratio, the number of months the manager had positive excess returns is divided by the total number of months. The higher the number, the better.

Excess Return – The difference between an investment option's return and the return of an external standard such as a passive index.

Excess Risk – Also known as "tracking error" or "excess standard deviation", defined as the standard deviation or volatility of excess returns.

Information Ratio – The information ratio is a risk-adjusted measure commonly used to evaluate an active manager's investment skill. It is defined as the manager's excess return divided by the variability or standard deviation of the excess return. Information ratio is an excellent tool for evaluating a manager's level of skill because it simultaneously considers both the level of excess return as well as consistency in which the excess return was delivered to investors. Managers should strive for a positive information ratio, with higher numbers representing better results.

Morningstar Percentile Rankings – Each investment's total returns are compared to other investments in the same Morningstar category for various time periods. Total returns are ranked on a scale from 1 to 100 where 1 represents the highest-returning 1% of investments and 100 represents the lowest-returning investments.

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