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EDITED TRANSCRIPT

PFG - Q4 2011 THE PRINCIPAL FINANCIAL GROUP EARNINGS CONFERENCE CALL

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OVERVIEW:

PFG reported 2011 total Co. net income of \$682m. 4Q11 operating earnings were \$217m.



CORPORATE PARTICIPANTS

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Larry Zimpleman *Principal Financial Group Inc - CEO*

Terry Lillis *Principal Financial Group Inc - CFO*

Dan Houston *The Principal Financial Group - Retirement Investor Services, US Insurance Solutions*

Norman Sorensen *Principal Financial Group Inc - Chairman Principal International*

CONFERENCE CALL PARTICIPANTS

Randy Binner *FBR & Co. - Analyst*

Ed Spehar *BofA Merrill Lynch - Analyst*

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PRESENTATION

Operator

Good morning and welcome to The Principal Financial Group fourth-quarter 2011 financial results conference call. There will be a question and answer period after the speakers have completed their prepared remarks. (Operator Instructions) I would now like to turn the call over to John Egan, Vice President of Investor Relations.

John Egan - *Principal Financial Group Inc - IR*

Thank you, and good morning. Welcome to The Principal Financial Group's fourth-quarter and full-year earnings conference call. As always, our earnings release, financial supplement, and additional investment portfolio detail are available on our website at www.principal.com/investor. Slides related to today's call are also on the website. Following a reading of the Safe Harbor provision, CEO Larry Zimpleman, and CFO, Terry Lillis will deliver some prepared remarks then we will open up the call for questions. Others available for the Q&A are Dan Houston, Retirement Investor Services and US Insurance Solutions; Jim McCaughan, Principal Global Investors, Norman Sorensen and Luis Valdez, Principal International; and Julia Lawler, Chief Investment Officer.

Some of the comments made during this conference call may contain Forward-looking statements within the meaning of the Private Securities Litigation Reform Act. The Company does not revise or update them to reflect new information, subsequent events, or change in strategy. Risk and uncertainties that could cause actual results to differ materially from those expressed or implied are discussed in the Company's most recent annual report on Form 10-K and quarterly report on Form 10-Q filed by the Company with the Securities and Exchange Commission. Now, I would like to turn the call over to Larry.

Larry Zimpleman - *Principal Financial Group Inc - CEO*

Thanks, John. And welcome to everyone on the call. As usual, I'll comment on three areas. First, I'll discuss fourth-quarter and full-year 2011 results. Second, I'll provide an update on the continued successful implementation and execution of our strategy, and I'll close with some comments on the financial strength of the Company and our capital management plans.



The fourth quarter saw a continuation of a challenging external environment that had a negative impact on quarterly operating earnings. This includes continued volatility of credit spreads, especially on financials, low interest rates, and the strengthening of the US dollar against emerging market currencies. Terry will discuss all of these in more detail. Despite these external challenges in the fourth quarter, the diversified nature of our business model allows us to weather these difficult periods without any significant degradation of the strength of our financial position caused by having significant long-term equity or interest-rate guarantees. This is a significant differentiator for many of our insurance competitors. Despite these external challenges, good momentum continued to build across our businesses in the fourth quarter, demonstrating our competitive advantage and the strength of our distribution relationships and product leadership.

Some of the growth metrics from the quarter include strong quarterly sales of \$3.3 billion for Full Service Accumulation, the third highest on record, contributing to strong net cash flows of \$1.6 billion in the quarter. Record quarterly sales of \$3.1 billion in Principal Funds contributing to record net cash flows of \$900 million in the quarter. Strong net cash flows for Principal International of \$1.7 billion. And strong sales in US Insurance Solutions, including \$55 million in Individual Life sales in the quarter. These strong results will lead to improved earnings and continued growth in 2012 and beyond. Turning now to the full year, as outlined on slide 4, overall results were solid, despite the external challenges. Total Company assets under management were \$335 billion at the end of the year, up 5% over year end 2010. Total Company earnings for 2011 improved 4% over 2010 to \$878 million, the second highest operating earnings on record driven by strong sales and enhanced efforts around client retention.

Let me highlight some of the outstanding growth metrics from 2011. Full Service Accumulation full-year sales of \$8.4 billion were the second highest ever, and were 27% higher than 2010 sales. We saw sales growth across all distribution channels and across all plan sizes. Full-year net cash flows and Full Service Accumulation were \$3.8 billion compared to \$600 million for full year 2010. This means net cash flow was 3.5% of beginning-of-year account value, which is close to flows prior to the financial crisis. Additionally, the pipeline has returned to pre-crisis levels and is up 25% compared to the same period in 2010. Principal Funds once again had record sales of \$11.2 billion for the year, up 20%, resulting in record net cash flows of \$2.2 billion for the year against industry flows, which were neutral.

Principal Global Investors had \$11 billion in mandates awarded in 2011. As of year end, \$3 billion had yet to fund, giving us the opportunity for strong net flows in 2012. Despite the currency headwinds and an equity market decline in emerging markets, reported assets under management in Principal International were \$53 billion for the year, up 15% over 2010, driven by strong organic growth, as well as assets from the HSBC Afore acquisition. This growth is in spite of roughly a 10% drag from unfavorable foreign exchange rates. Full-year net cash flows in Principal International were a record \$5.5 billion, a 17% increase over 2010.

In US Insurance solutions, Individual Life full-year sales of \$186 million were up 13% compared to 2010, and year-over-year premiums and deposits increased 9% over last year. The non-qualified and business-owner markets continue to drive sales in this segment, leading to significantly higher growth than the Life industry overall. Full-year Specialty Benefit sales were \$285 million, up 18% over 2010, with all products showing growth and record sales in individual disability. As we think about 2011 and how that positions us going forward, we have a focused set of strategically aligned businesses that are performing well, have good momentum, and have exceptional long-term growth potential.

Now I'll provide an update on the continued successful execution of our strategy, as well as the key differentiators that make our strategy the right one for long-term growth. We remain committed to providing comprehensive solutions to small and medium-size businesses. In Full Service Accumulation, Principal total retirement suite continues to be a differentiator for us, driving 61% of 2011 sales. Plan sponsors and plan participants like the convenience of having all of their retirement plans from one top-tier provider, driving better close ratios and better persistency for this block. Client retention efforts in Full Service Accumulation over the past few years have resulted in lower withdrawals, contributing to improved lapse rates overall.

Our focus on the alliance distribution channel continues to drive strong Full Service Accumulation sales, with over 44% of total sales coming from alliance firms. We continue to build out these relationships by adding more products to their platforms and creating more ways to win. Our alliance distribution relationships were recently strengthened with the addition of another national broker dealer Edward Jones. Edward Jones is one of the largest and most recognized broker dealers in the US and focuses on small and medium-size clients, like we do. We're excited about the opportunity to build upon this multi-product relationship in the coming years.



Moving now to our efforts to capture and retain more baby-boomer assets, our growth in Principal Funds is driven by an outcome-oriented multi-manager product strategy. We offer mutual funds that meet specific investor needs, such as providing income strategies for helping to protect against inflation and market volatility, especially for investors nearing and in retirement. The most recent fund launch was the Global Multi-Strategy Fund, which seeks to achieve long-term capital appreciation, with an emphasis on positive total returns and relatively low volatility. Our product innovation and distribution model continue to be differentiators for Principal Funds. Four funds had more than \$1 billion in sales in 2011. The Global Diversified Income Fund, High Yield Fund, Preferred Securities Fund, and Strategic Asset Management portfolios. Additionally, our broad suite of investment and income solutions, which allows us to capture and retain assets as plan participants retire, contributed more than \$1 billion in Principal Fund sales in 2011.

The single-best leading indicator of future sales is investment performance. Investment performance continues to be strong across asset classes, and is a differentiator for The Principal. The strong performance includes particular strength in asset allocation, where at quarter end, 94% of our target date and target risk funds were in the top half on a one-year basis, 84% on a three-year basis, and 69% on a five-year basis. 2011 was a very successful year in terms of executing our Global Investment Management strategy. During the year, we announced and closed on three acquisitions that were exactly the right fit for our strategy. In Principal Global Investors, we acquired a majority stake in Finisterre Capital and Origin Asset Management, both based in London, and both focused internationally with an emphasis on emerging markets. These fit perfectly within our successful multi-boutique strategy and through our global distribution platform, we expect to grow assets under management by three to five times in the next five years for each acquired boutique.

In the last week, we received approval to launch a qualified foreign institutional investor, or QFII fund, which allows foreign investors to invest in China. This further positions us as a leading global investment manager. In Principal International, we announced and closed on the acquisition of HSBC Afore, which is the mandatory defined contribution business in Mexico. This acquisition added scale to grow our operations in Mexico, making The Principal the seventh largest Afore in Mexico, and giving us an important five-year exclusive distribution agreement with HSBC Mexico, which has the fourth largest bank distribution platform. This deal complements our existing infrastructure, is already accretive, and a meaningful contributor to Principal International's earnings. This acquisition is just one example of the tremendous growth and success we've seen in Principal International.

That's thanks in large part to the contributions from the Chairman of Principal International Norman Sorensen. As we announced several weeks ago, Norman will retire at the end of this month. We thank him for his tremendous contribution during his 14 years at The Principal and look forward to his continued involvement on our International Advisory Council in 2012. As a successful head of our Latin American operations for the past decade, Luis Valdez, President and CEO of Principal International, will continue to lead this division. This transition is part of a planned succession that we announced last year. Norman and Luis have been working closely together and we look forward to additional global growth under Luis' leadership. Overall, I am very pleased with the continued execution of our strategy across the businesses. With a strategy that is focused on businesses that offer potential for significant long-term growth, our outlook remains positive going into 2012 and beyond. As a global investment management leader, our business mix is the right one, we're in the right growth markets, and we know what it takes to stay competitive.

Moving now to some comments on the strength and flexibility of our financial position, as shown on slide 5, our business model has shifted to a more fee-based investment management model, which means we need less capital to support organic growth. And with realized capital losses now down to their lowest level since the financial crisis, we can put even more capital to work to build long-term shareholder value. This enables us to deploy more capital toward strategic acquisitions, and return more capital to shareholders. As evidence of that, we strategically deployed more than \$1.1 billion of capital throughout 2011, while starting and ending the year at the same level of excess capital in what remains a challenging environment. We are very pleased with the combination of capital deployment actions we took this year, and we will use this model as a template going forward.

Further evidence of our commitment to building long-term value for shareholders is our recent announcement that we will move to a quarterly common stock dividend schedule, starting in first quarter 2012. This action reflects the migration of our business model to more fee-based businesses, and the absence of a significant exposure to products with long-term guarantees that can negatively impact our financial strength. The solid performance in 2011 is the result of our employees' dedication and focus on successfully executing on our strategy. Despite ongoing market challenges, our employees continue to work hard to serve advisors and clients. I'm proud of the work they do and look forward to our future as a leading global investment manager. Terry?



Terry Lillis - Principal Financial Group Inc - CFO

Thanks, Larry. As Larry mentioned, fourth-quarter earnings were negatively impacted by headwinds. However, business fundamentals remain strong. This morning, I'll focus my comments on operating earnings for the quarter and full year, net income, including continued solid performance of our investment portfolio, and the strength of our capital position and strong balance sheet as we entered 2012.

Fourth-quarter 2011 operating earnings of \$217 million were up 1% from a year-ago quarter on 5% higher average assets under management. There were a few notable items impacting fourth-quarter 2011 operating earnings. Fourth quarter 2011 had positive DAC amortization true-ups due to the equity market performance, which benefited Full Service Accumulation, Individual Annuities, and Individual Life by \$0.01 each. Principal International benefited by \$0.03 from foreign tax credits and the removal of a one-month reporting lag in BrazilPrev, thus reporting four months of earnings from that operation in the fourth quarter. Full Service Accumulation was dampened by \$0.04 from lower spread and higher expenses in the quarter, and the corporate segment was negatively impacted by \$0.04 from lower variable investment income on excess capital held at the holding company from an active credit strategy. Adjusting for these items, we consider the earnings per share run rate for the fourth quarter to be \$0.73 and fourth-quarter 2011 earnings down 2% on a 5% increase in average assets under management compared to adjusted fourth quarter 2010.

Now, let me discuss the business unit results. Full Service Accumulation operating earnings at \$64 million were down 16% from a year-ago quarter on a 3% increase in average account values. The earnings drop was driven by higher quarterly costs for pension and other post-retirement benefits, which we refer to as Security Benefit costs, higher non-deferrable sales compensation expense, and less variable investment income. A more normalized earnings for this quarter would have been \$72 million. In 2012, new regulations for plan sponsor and participant fee disclosures are scheduled to take effect. The Principal has been well positioned for this regulatory change and we were an early adopter of the proposed disclosure regulations in fall of 2011. Advisors and plan sponsors place business with us because of our compelling value proposition, not because we're the cheapest provider. The retirement industry is fragmented and we expect to see the industry consolidate to the top players such as The Principal.

Let me make a couple comments related to Full Service Accumulation margins. Slide 6 summarizes the leading drivers of the return on assets since 2004. Factor one, which has been the largest impact, is a consumer-driven shift in business mix, which I'll give more detail on in a moment. The second factor is the current market environment, which has reduced recurring deposits. The third factor listed, growth, retention, and efficiency, is one we have and will continue to influence through scale and focused execution.

As depicted on slide 7, the mix of business is shifting away from general and separate account investments into mutual funds and employer securities, reducing return on assets, but improving free cash flow generation. As this business mix continues to shift and more business is written on our mutual fund platform, and in non-domestic equity investments, fewer dividends are eligible for the dividend received deduction benefit, which also reduces the return on assets. Despite this, we continued to deliver industry-leading return on assets. When we measure results for Full Service Accumulation, we also look at other profit metrics, such as pretax margins and pretax return on net revenue, which are better indicators of the financial performance of the business.

Slide 8 illustrates our stable track record of driving revenues to the bottom line, even as customer preferences migrate to different asset types. Return on revenue margins continues to be a key focus. 2011 Full Service Accumulation sales of \$8.4 billion was very strong, up 27% over 2010. The underlying fundamentals within Full Service Accumulation continue to improve. The sales pipeline continues to build across all market sizes and distribution channels, and the close ratios continue to improve. We are actively executing on our strategy to win more business and gain market share, despite the shift in business mix and environmental headwinds. Strong transfer deposits combined with excellent client retention drove full-year net cash flow of \$3.8 billion, or 3.5% of beginning-of-year account value against an industry that ended the year flat, as estimated by Cerulli.

We also saw modest growth in recurring deposits year-over-year, reflecting improvement in employer matches and salary deferral's. While unemployment rates remain elevated, these trends increase our optimism about improvement in the US economy in 2012. Principal Funds continues to deliver strong operating results. Operating earnings at \$11 million in the fourth quarter were in line with a year-ago quarter. On a full-year basis, 2011 operating earnings of \$48 million were up 22% on 12% increase in average account values. Full-year 2011 sales were \$11.2 billion, up 20% over 2010, driving full-year net cash flows to a record \$2.2 billion.



Individual annuities, operating earnings, in fourth quarter 2011 were \$30 million, down \$3 million from a year-ago quarter. As the low interest rate environment persists, individual annuities will continue to experience spread compression. Fourth-quarter 2011 earnings from Principal Global Investors were \$18 million, down 9% from a year-ago quarter on a 2% increase in average assets under management, primarily due to higher compensation costs and the acquisition costs related with our purchase of Origin Asset Management. In fourth quarter 2011, we earned performance fees on our hedge funds at Columbus Circle Investors, one of our investment boutiques. As is common in the industry, a substantial portion of those fees is shared with the investment managers.

On a full-year basis, earnings were up 26% on a 5% increase in average assets under management, as pretax margins expanded to 21.4%, another step in our road back to the target of over 30% pretax margin. Unaffiliated net cash flow for the quarter was a negative \$900 million, due to market volatility causing some delay in the funding of mandates awarded until after year end. Principal Global Investors had \$11 billion in mandates awarded in 2011, double the amount awarded in 2010. As Larry mentioned, as of yearend, \$3 billion of the 2011 total awarded had yet to fund. We remain optimistic about the likely institutional net flows for Principal Global Investors in 2012. We base this optimism on a high level of client interest in awarding new mandates for our capabilities and also on a generally good client appreciation of our investment performance and service.

Additional activities that bode well for the long-term growth are the 2012 launch of the QFII fund, as well as the expanded series of Islamic investments. However, market volatility continues to feed uncertainty about client plans, so we see this as a risk. As we continue to monitor the global economy and focus on things we can control, such as execution and fund performance, we remain cautiously optimistic as we begin 2012.

Moving to Principal International, operating earnings at \$51 million include one-time benefits of approximately \$10 million. Of this, \$7 million results from an additional month of earnings in current quarter results from BrazilPrev, as we close the one-month reporting lag for that business. This also impacts assets under management and net cash flow. After this change, we will no longer have any material operations in Principal International on a one-month reporting lag. The remaining \$3 million benefit came from some foreign tax credits we were able to recognize. Assets under management were \$53 billion at year end, down 3% from third quarter 2011. Net cash flow of \$1.7 billion and positive investment performance of \$1.3 billion was more than offset by the negative \$4.8 billion effective exchange rates from the strengthening dollar.

While the underlying growth of the companies on a local basis at approximately 15% remains strong, 2012 began with operating earnings weighted foreign exchange rates roughly 10% less favorable than the 2011 average rates providing a headwind to US dollar reported earnings. Our financial supplement now includes foreign exchange information used for financial reporting to help you better analyze the impact of exchange rates on Principal International. A quick comment on an item that will impact Principal International in first quarter 2012. In the Mexican Afore pension market participants who did not select an Afore are assigned to various providers. The regulator of the Mexican Afore pension market has initiated a program to reassign these participants to providers with higher net investment returns. Principal will both gain and lose participants from this recent reassignment. A reassignment of participants out of The Principal Afore will result in an after-tax write-down of present value of future profits, while participants that transfer in will not generate capitalized expenses.

In January 2012, participants were transferred out of The Principal Afore, generating an after-tax present-value future-profits write-off of approximately \$5 million. Future revenue lost on these accounts will be partially offset by revenues from any future participants assigned to us. Individual Life fourth-quarter operating earnings were \$33 million. This was in line with a year-ago quarter after adjusting fourth quarter 2010 for the impact of a one-time increase in net reserves following a periodic long-term interest rate assumption review. On a full-year basis, Individual Life had record operating earnings of \$119 million. Full-year Life sales of \$186 million were up 13%, driven by non-qualified product offerings, as well as continued success in the business owner and executive solutions market.

Turning to Specialty Benefits, fourth-quarter operating earnings were \$26 million, down \$4 million from a favorable year-ago quarter. Premium growth and stable claim experience were more than offset by lower variable investment income and higher security benefit costs in the current quarter. On a full-year basis, Specialty Benefit earnings were up 5% on a 6% increase in premium and fees. Additionally on a full-year basis, loss ratios remain very stable and at a midpoint of our targeted range. Our Specialty Benefit business continues to perform very well.

The corporate segment reported an operating loss of \$43 million, driven by a shortfall in performance on an active credit strategy of approximately \$13 million. The loss was primarily driven by the write-down of an MF global bond. The active credit strategy provided a 4.25% annualized return since inception. However, we have completely wound this strategy down as of January 2012, due to the added volatility and continued deployment



of excess capital at the holding company in 2011. As we communicated on our guidance call, we expect full-year 2012 operating losses for the corporate segment of \$120 million to \$130 million. For the year, total Company net income was \$682 million, an increase of 2% over 2010. We also experienced \$147 million of credit-related investment losses for the year, a continued downward trend to a multi-year low.

The evolution of our business model means we now have a much higher portion of our earnings coming from less capital intensive, more fee-based businesses. As the low interest rate environment persists, our earnings will grow, but at a slower rate, as shown in slide 9. In addition to the items I previously mentioned that will impact 2012 results in Principal International and the corporate segment, let me provide a brief update on the impact of deferred acquisition cost guidance that went into effect in January. We continue to refine our modeled impacts from the new guidance, and slide 10 summarizes our updated estimates. While the 2012 total Company earnings impact estimate remains at \$35 million to \$45 million, there is a slight shift in the business segment split.

Moving to our balance sheet, our net unrealized capital gain position of \$1.6 billion was unchanged from third quarter 2011. As a reminder, because of our strong asset liability management, changes in net unrealized gain or loss due to interest rate movement do not result in economic impact and do not force us to sell assets. In the fourth quarter, we completed a \$100 million share buyback authorization, paid \$215 million for our common stock dividend, and closed on the Origin acquisition for approximately \$60 million. Looking at capital adequacy, we estimate our year-end risk-based capital ratio to be 445%. Relative to a 350% RBC ratio, we have approximately \$1.6 billion of total excess capital with approximately \$600 million of the excess capital at the holding company. As outlined in slide 11, in 2011, we deployed more than \$1.1 billion of capital. This includes \$350 million for strategic acquisitions, \$550 million for opportunistic share repurchase, and the common stock dividend I previously mentioned.

We expect our 2012 capital deployment strategy to be very similar to 2011. We believe our decision to move to a quarterly common stock dividend and our overall capital deployment actions demonstrate our commitment to creating long-term value for shareholders. In closing, we are very pleased with the strong underlying fundamentals of our businesses, as we look into 2012 and beyond. This concludes our prepared remarks. Operator, please open the call to questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Randy Binner, FBR.

Randy Binner - FBR & Co. - Analyst

Just a question on ROA -- and the slides are helpful, and the guides a little bit lower, the 24 to 26 basis points. I'm just trying to get perspective on how that might get better or get worse in 2013. It seems like of the three bullets you laid out in your presentation, the consumer shift, as well as a lot of your initiatives on retention and efficiency -- those probably don't change as much, but maybe the market would get better. Just trying to think about how we want to think about that ROA a little bit longer term.

Larry Zimpleman - Principal Financial Group Inc - CEO

Hi, Randy. This is Larry.

I think what you said makes a lot of sense. I don't think we'll see quite as dramatic shift in some of those consumer-driven components. Probably the one that will have a little bit more impact -- and it's a good news event -- and that's the reality that we are writing on a relative basis more and more of the business on the mutual fund platform. And it has two impacts. One would be, of course, the difference in DRD on the mutual fund platform. And the second is -- which is a little bit muted because of the EITF change -- but the second one is that we don't DAC anything on the

mutual fund platform. So in the short term, in the short term, that might look like a little less ROA; but obviously in the longer term, assuming again we can continue the client retention we've had, it should contribute to actually improved ROAs over time as that new business becomes less as a percentage of the total.

Randy Binner - *FBR & Co. - Analyst*

Thanks. Just a quick one on FSA as well.

The number of cases, it keeps falling. I think this has been a topic on previous calls. But the cases are larger. Is that something we can expect to continue? Is that a function of less new business creation? Or is that something you're intentionally doing, maybe to take advantages of scale?

Larry Zimpleman - *Principal Financial Group Inc - CEO*

Yes, there's -- our intention, Randy, is to write small-, medium-, and large-size plans, write them in all categories. If you actually look at the number of cases written in 2011, they were up 30% over 2010. And you remember, the assets that were written in 2011 were up 27%. So, obviously, we're continuing to focus on the small plan. But I'll let Dan comment on the trend overall for the platform.

Dan Houston - *The Principal Financial Group - Retirement Investor Services, US Insurance Solutions*

Yes, Randy, it's certainly our intention to sell across the entire platform, small, medium and large. With an 80%-plus increase in TPA sales, that gives you some indication of our re-emphasizing on the small-case market. But a couple of stats relative to the start-up plans and plan terminations -- and again, this is that differentiation between not going to another service provider, but the plan terminated itself. What we've seen, the startups themselves are down by about 500 contracts on an annualized basis. If we look at plan terms, those plan terms are still up by over 10% from a year ago. So most of the shrinkage has occurred in that small -- less than 500-life employer market, and until we start seeing the economy turn around and we see new startup plans and we see fewer plans terminating, we probably won't see a significant increase in that space.

Randy Binner - *FBR & Co. - Analyst*

That's great. Thanks.

Operator

Ed Spehar, Bank of America.

Ed Spehar - *BofA Merrill Lynch - Analyst*

The question I have is on the FSA ROA roll-forward from 2004. And, could you give us some numbers around the pieces here? Like the general account shift. I would guess that might be maybe 3 or 4 basis points of ROA. But could you give us some sense of each of those pieces?

And then a related question is -- you mention the greater use of nonproprietary options as a factor behind the ROA decline. I thought that the impact to FSA margins was zero, regardless of whether it was a proprietary or non-proprietary fund, and that the benefit of that was -- where you would see the benefit of a proprietary fund was in the PGI segment. So maybe help us understand that.

Larry Zimpleman - *Principal Financial Group Inc - CEO*

Yes, Ed, this is Larry.



I'm going to make a couple of comments and then I'll let Terry deal with that greater bucket about consumer-driven. My comment on the non-proprietary, Ed, is really more focused around the issue on new business. The reality is that most of the time when you write new business -- and the good news is, we've been writing more than our fair share of new business -- you're not going to drive as much proprietary assets into that new business initially. That's just the way it's worked for decades; and so as you write new business and you write greater volumes of new business on the non-proprietary platform, that will have some negative impact. It will have some degradation in the ROA. Now, what happens over time, because of the expertise of our service staff and our relationship managers, we basically convert a lot of that non-proprietary money over to proprietary assets in years two, three, four, five, six, as the investment lineup is reviewed and changed. As I said in my comment, the great thing here is that our investment performance across the proprietary platform, and particularly on PGI, is exceptionally strong. It's exceptionally strong. So we do believe that we'll see that help us and become more of a tailwind as we go forward.

I'll have Terry comment on the consumer-driven component.

Terry Lillis - *Principal Financial Group Inc - CFO*

Yes, this is Terry.

As we look at the roll-down of the ROA since 2004 to 2011, there's a lot of components to come into it. But mix of businesses, as the slides indicated, is probably our biggest driver of it. Now, I'm going to give you some metrics associated with each of these types of investment, but you have to realize that these are revenues that are generated, expenses are allocated to it, the equity market and the DAC amortization and all of that stuff comes into play. But in general, the general account is probably the more profitable business, because there's more risk associated with that type of investment and more capital associated with that as well. But that's probably in that 70, 75 basis points range would be profitability.

Separate accounts also have profitability associated with them of around 30 to 35 basis points. Now, it is where most of the DRD, or the dividend received deduction benefit comes into play. And so that's why we separated that out. As that rolls down, that tax credit will probably be a little bit less, but 30 to 35 basis points would probably a good profitability measure there. The proprietary funds and the non-proprietary funds may, as you mentioned before, have similar profitability metrics. It also comes into play as to what types of investments that they are making, whether they are passive or active, or international; fixed income, equity -- all that comes into play. But roughly we're talking 15 to 20 basis points of profitability for those types of businesses; and then the employer securities, which is more of a consulting relationship, where we'll be able to benefit as those participants cash out of their plan and retain them in other markets -- that's probably in that 5 basis points.

So if you weight those, you'll get roughly what we reported in terms of the ROA rolldown in our slide deck as well. Now, once again, as I mentioned, you got to take into consideration some noise. The equity market improvement or decline has some play as to how much DAC amortization. But that will get you roughly those numbers.

Ed Spehar - *BofA Merrill Lynch - Analyst*

Yes, that's extremely helpful. Just one -- did you say 15 to 20, or 15 to 25 on proprietary?

Larry Zimpleman - *Principal Financial Group Inc - CEO*

15 to 20.

Ed Spehar - *BofA Merrill Lynch - Analyst*

15 to 20. And the number that you -- I can't recall if you had said when you gave your outlook. I think maybe you did -- about expected capital deployment of \$800 million to \$900 million for this year. Did you comment on how much of that you considered to be just the free cash flow generated versus how much of it is working down any on balance sheet?



Larry Zimpleman - *Principal Financial Group Inc - CEO*

Well, I would say, Ed, that the vast majority is really just coming, if you will, it's basically net income. So the vast majority of that -- again, we have an excess capital level of about \$1.6 billion. But we want to hold an internal cushion probably around \$1.1 billion or \$1.2 billion. So we would have what we would consider to be somewhere around \$400 million, \$450 million of sort of truly excess cash. We'll work that down, but that will be done over multiple years. So for the most part, that represents the net income that we expect in 2012.

Ed Spehar - *BofA Merrill Lynch - Analyst*

Thank you.

Operator

Mark Finkelstein, Evercore Partners.

Mark Finkelstein - *Evercore Partners - Analyst*

I've got a few. Firstly, just to follow up on Ed's question -- the difference between the annuity structure and the trust structure of 30 to 35 on the annuity and the 15 to 20 on the mutual fund structure -- is that purely the DRD, or are there any other factors that's driving that change in profitability?

Terry Lillis - *Principal Financial Group Inc - CFO*

Mark, this is Terry. I would say that's entirely the DRD at this point in time.

Mark Finkelstein - *Evercore Partners - Analyst*

Okay, and then a few other clarifications.

I think you stated in the presentation, but the 22 to 26 that you're looking at for 2015 -- that compares to the 27? That doesn't compare to the 24 to 26 that you're assuming for 2012 due to the DAC, correct?

Terry Lillis - *Principal Financial Group Inc - CFO*

The lower number, the 22 to 26 is on a post-EITF basis. That's a reduction. So that would be down from that 27 basis points that we are saying at this point in time, is probably a good run rate.

Mark Finkelstein - *Evercore Partners - Analyst*

Sorry. Just to clarify -- so, the 22 to 26 is assuming that the EITF-9G is implemented. So it does compare to the 24 to 26 that you're assuming for 2012?

Terry Lillis - *Principal Financial Group Inc - CFO*

The 22 to 26 is on an after-DAC changes.



Larry Zimpleman - *Principal Financial Group Inc - CEO*

No.No.The 22 to 26,Mark, is done on the same consistent basis as the 27 in 2011.

Mark Finkelstein - *Evercore Partners - Analyst*

Okay.

Larry Zimpleman - *Principal Financial Group Inc - CEO*

You can see from the slide, the slide says all years on a pre-DAC change basis.

Mark Finkelstein - *Evercore Partners - Analyst*

Yes.That was my interpretation. I just want to understand.

Terry Lillis - *Principal Financial Group Inc - CFO*

I apologize.

Mark Finkelstein - *Evercore Partners - Analyst*

Couple questions on that.

Firstly, in the explanations, you have the market impacts, which I think was a negative 3 basis points. In your 22 to 26, are you assuming any recovery in some of those factors -- plan terminations, et cetera? Or are you assuming that where we are today is what we're going to look like three years from now, with no recovery from market factors?

Larry Zimpleman - *Principal Financial Group Inc - CEO*

I would say -- Mark, this is Larry.

It would be our best guess that whatever trends we see through operating in the market today -- which would be, again, generally speaking, a slow economic recovery -- those are the trends that we would be looking at between now and 2015. So we're not assuming any particular rapid recovery. We're not assuming any particular significant fall in the economy. We're assuming it looks more like it does today.

Mark Finkelstein - *Evercore Partners - Analyst*

Okay.And then, on the capital deployment -- picking up something you actually said in your opening remarks -- is there any change in your thinking between M&A and buybacks in the \$800 million to \$900 million that's not allocated to dividends?

Larry Zimpleman - *Principal Financial Group Inc - CEO*

I wouldn't say there's any change in thinking, Randy. But the one thing that I always say is that M&A is very difficult to forecast. It's just very difficult to forecast. So when you'd say to anybody who sits in my seat -- how much do you expect to deploy of that \$800 million to \$900 million, how much



do you expect to deploy in M&A for the year -- that would literally just be throwing a dart at the wall, because you really don't know. What I would say is that we have a strategy that has probably the highest level of organic growth embedded into it of anybody, any of our competitors, whether it's on the insurance side or the asset management side.

So for us, M&A needs to be the right M&A. It needs to be accretive. It needs to further augment our growth capability. And I would just say, again, the real success for us in 2011, among other things, were the three acquisitions that we did. And if we could do that every year, I would be a very happy CEO.

Mark Finkelstein - *Evercore Partners - Analyst*

Okay. Actually, one final, quick question.

In the expectations around 2015 of 22 to 26, what's the assumed AUM growth annually?

Larry Zimpleman - *Principal Financial Group Inc - CEO*

Well, you would have, again -- generally, Randy, what you would have there would be about 8% equity market growth. You've got some of it in fixed income, so it's not going to grow as fast. You got a little bit of it in international. It might grow at 9%. Then again, we would probably be looking at net cash flow of about 4% of beginning account value. So that would get you to your total AUM growth.

Mark Finkelstein - *Evercore Partners - Analyst*

All right. Thank you.

Operator

Suneet Kamath, Sanford Bernstein.

Suneet Kamath - *Sanford C. Bernstein & Co. - Analyst*

One quick follow-up to Mark's question, and then I'll have another one.

So looking at slide 8 in the illustration for 20 to 25, as well as the title that says pre-DAC -- given there seems to be this 2-basis point reduction from the DAC accounting change, if we did it on a post-DAC basis, is the 22 to 26 really 20 to 24?

Larry Zimpleman - *Principal Financial Group Inc - CEO*

Correct.

Suneet Kamath - *Sanford C. Bernstein & Co. - Analyst*

Okay, and then, I guess the other thing that I'm sort of struggling with -- and I appreciate the detail on the slides. But the other thing I'm struggling with is, if you look at this business from 2004 to 2011, you had -- I don't know, 84% growth in average account values, just using the numbers that are on your slide? So I'm just wondering why this business, why we're not seeing, in addition to all the issues that you laid out that are resulting in a decline in the ROA, why we're not seeing massive positive operating leverage.



Larry Zimpleman - *Principal Financial Group Inc - CEO*

Yes, this is Larry. I'll ask Dan to comment as well.

We are driving positive operating leverage into the business. As we've shown you on the slide, we think that we've driven somewhere around 4 basis points net, 4 basis points net of efficiency, that there are truly scale advantages to this Business; and we've commented before about how, in the recent years, we've added very -- actually the net employee count is actually down a little bit. But we've obviously been adding business.

The one thing I would say here though, just to temper that enthusiasm, because there are economies of scale. But at the same time, Suneet, it is absolutely critical that we continue to invest in this business. That means investing in distribution, it means investing in the IT platform, it means investing to make sure we have the right asset management things in place. So we will continue to invest in this business, because it is critical for the long-term success. So we have to balance that. We have to balance the need to drive operational efficiencies and scale, but we also have to invest in the business. And I think, again, net-net, on a 4 basis points over the last seven years, that's actually a pretty good record.

Maybe I'll let Dan comment.

Dan Houston - *The Principal Financial Group - Retirement Investor Services, US Insurance Solutions*

Well said.

As you set aside those consumer-driven issues and the market impact, I'm very optimistic that as the economy continues to recover here, we'll get those market environmental components back into our operating earnings leverage. If you just looked at the overall contribution that investments would have contributed to net cash flow this past year, it was -- or to our account values, it was zero. That was the overall contribution that we derived from the investment from this \$100 billion-plus platform.

The other piece of what I would call very good news comes from Chatham, and it's -- all right, you've reduced your expense structure, you've made some investments. Are your clients satisfied? Among our emerging clients that we've surveyed recently, we've got 96% satisfaction. We look at our Dynamic, where Principal is 42% above the industry benchmark. When you look at Institutional, we were 36% above the industry benchmark. Overall satisfaction is 97% for Institutional and Dynamic. So not only are we becoming more efficient, not only are we launching new products, but we're retaining customers at a very record level. So I feel as if we are establishing a very solid base here for our ability to continue to be truly one of the nation's leading providers of these retirement services, small- to medium-size businesses.

Hopefully that helps.

Suneet Kamath - *Sanford C. Bernstein & Co. - Analyst*

Yes, that's great. Just one last quick follow-up on slide 8 again.

On this ROA versus ROE trade-off for FSA -- given your commentary, what was the rough ROE of this business in 2004 versus where it is today?

Larry Zimpleman - *Principal Financial Group Inc - CEO*

I'll ask Terry.

Terry Lillis - *Principal Financial Group Inc - CFO*

Yes, Suneet, this is Terry.



In 2004, that business had a much more capital-intensive -- because of the general account mix -- so it was probably just slightly below the net 20% range. And so it's now 25% plus. So as that ROA has declined, it's freed up capital, less capital intensive businesses, and you've seen the ROE increase significantly as well.

Suneet Kamath - *Sanford C. Bernstein & Co. - Analyst*

Great. Thank you.

Operator

Stephen Schwartz, Raymond James.

Steven Schwartz - *Raymond James & Associates - Analyst*

One more on page 8.

Given what we're looking at here in terms of the return on assets, and particularly after post-DAC, I don't think this was touched upon -- maybe I missed it -- but the ability to take cash out. You've been at 60%, 65% for a while, you've gone up to around 70% now. If you're looking at this 2015 and this works out the way that you think, how much money do you think you could get out, what kind of percent?

Larry Zimpleman - *Principal Financial Group Inc - CEO*

Oh, are you talking -- I'm sorry, Steve. This is Larry.

You're talking about the percent of the earnings that can be passed through to free cash flow.

Steven Schwartz - *Raymond James & Associates - Analyst*

Yes, that's exactly right.

Larry Zimpleman - *Principal Financial Group Inc - CEO*

Yes, yes. So I'm sorry.

So, again, today -- well, my guess is that we'll continue to be able to increase that. I mean, maybe it's in the range of 1 to 2 percentage points every year, so that's sort of 65% becomes 67% in a couple years, becomes 70% in a couple of years, that sort of rate.

Steven Schwartz - *Raymond James & Associates - Analyst*

Okay, great.

And then if I can, just on a comment -- I think, Larry, you mentioned that FSA pipeline was up 25% year-over-year. Does that imply that we could be looking at a 25% increase in sales for the first quarter?



Larry Zimpleman - *Principal Financial Group Inc - CEO*

I'll let Dan take that one, Steve.

Dan Houston - *The Principal Financial Group - Retirement Investor Services, US Insurance Solutions*

Yes, knowing that many of our members of the sales force are listening to the call, yes, absolutely. We, we do like to think that we can convert our pipeline to sales. But you know how this goes. We aren't 100% successful. We feel good about the pipeline for a couple of different reasons. One is, it isn't filled with just large cases. This isn't just an institutional place. We've got really great traction going on for small, medium, and large. Our close rates are up from where they were a year ago and we feel optimistic about delivering a solid sales result for 2012, and we're off to a good start so far.

Steven Schwartz - *Raymond James & Associates - Analyst*

Okay.

Larry Zimpleman - *Principal Financial Group Inc - CEO*

I would just say, Steve, it isn't like that, to get a very solid sales result in Q4 we had to clean out the pipeline. Let's just say it that way.

Steven Schwartz - *Raymond James & Associates - Analyst*

Okay, good. And then, if I may, one kind of out of the blue.

There was -- I think it was A.M. Best; it was one of the trade rags. China -- is something going on in the pension market in China? It looked like they might be going to some voluntary individual type of pension plan. Could you comment on that?

Larry Zimpleman - *Principal Financial Group Inc - CEO*

I'm going to let Norman comment on that one. He's been Mr. China here for several years. So Norman, take that one.

Norman Sorensen - *Principal Financial Group Inc - Chairman Principal International*

Good morning.

Basically, what's been happening since 2005 is the Chinese government has established something called enterprise annuity, which is a clone of 401(k), but it doesn't have the tax advantages that 401(k) has in the US. So they have been perfecting this. So far, foreign companies have not been allowed. We are first in line for this, and our application spans back to about 2007. So we're very hopeful that sooner than later, we'll get approval to enter that market with a license for the enterprise annuity.

By the way, it's not an annuity. It's a misnomer. It is really a 401(k)-type plan. We have enormous confidence in that, that market will be very large, and not only us, but a lot of American companies will benefit from it.

Steven Schwartz - *Raymond James & Associates - Analyst*

Okay. So there's nothing new going on. It's just the same process that's been going on now for quite a while.



Larry Zimpleman - *Principal Financial Group Inc - CEO*

That's correct.

Norman Sorensen - *Principal Financial Group Inc - Chairman Principal International*

The process is under way, but they are perfecting it. For example, they are beginning to add some tax advantages to the thing. They see that employees will not contribute as much unless they have tax advantages. So the tax department is working on this. It's a whole roundabout of various ministries that are trying to perfect this system.

The key to it, obviously, is our entry. We need to get entry first, since no foreign companies have yet been allowed.

Steven Schwartz - *Raymond James & Associates - Analyst*

Okay. Thank you, guys.

Operator

Chris Giovanni, Goldman Sachs.

Chris Giovanni - *Goldman Sachs - Analyst*

First question -- in terms of we're seeing some better payroll data as small-, medium-size business data is finally showing a bit more momentum, at least the best since '08. Curious in terms of how we should think about the potential benefit to sales and flows if this persists. Then ultimately what that should imply from an ROA and ROE standpoint, and things flowing through to the bottom line.

Larry Zimpleman - *Principal Financial Group Inc - CEO*

Okay. Well, I'll make a few comments on that.

I think we've said going into 2011, Chris, as you remember, we expected to have a muted economic recovery. And we talked, for example, for Full Service Accum, we talked about net cash flow that was in the 3% to 5% range. I would say, as you know, when things are hitting on all cylinders relative to the economy and small-medium employers and we get the startup plans that Dan was talking about before, we would expect that net cash flow to be more in that 4% to 6% of beginning account value range.

We're two-thirds, three-quarters of the way back towards what might be normal under the old conditions. I don't know if we'll get there exactly in 2012. It does look like we're inching closer to that. But whether we'll see that consistent growth in 2012, I don't know. My own personal view is that we've got to deal with some of the longer term and more systemic budget issues, and we maybe need to think more about tax reform before we finally see that uncertainty which has been hanging over the American economy for some time.

In terms of ROAs and ROEs and all of that -- again, what I would just caution you about there is that, again, with the change in EITF, you're going to see some negative impact on those ROAs. And the other thing, again -- we're writing more and more of the business on the mutual fund platform that doesn't allow any sort of DAC. So it looks less profitable in the early years, and more and more of the business is going on that platform. So that one's a little bit harder to predict.

But anything else, Dan?



Dan Houston - *The Principal Financial Group - Retirement Investor Services, US Insurance Solutions*

No. The only thing I was going to throw out is, if we're just trying to test the markets for the economic recovery, we know that we track in our Specialty Benefits division the number of workers covered in our Life and Disability and Dental Businesses. And for the first time, now, we have a full trailing 12 months positive growth. It's not up to where it had historically been at that 1.5% growth per year. But it's now turning positive. So we, again, we feel good that there is employment growth returning to the small- to medium-size marketplace.

Chris Giovanni - *Goldman Sachs - Analyst*

Okay, and then just a follow-up to that in terms of the competitive landscape.

There's been the finalization of the fee disclosure act that came out yesterday. There's been a lot basically saying that if you're a small business, now's the time to really be shopping 401(k) plans, because you're seeing a lot of new entries, Vanguard is coming out with another low-cost feature. So there's been a lot of pressure around continued shopping. So curious in terms of what you guys are seeing there, potential opportunities and risks from the recent environment.

Larry Zimpleman - *Principal Financial Group Inc - CEO*

Sure. That's a good question. I'll let Dan comment.

Dan Houston - *The Principal Financial Group - Retirement Investor Services, US Insurance Solutions*

Chris, this isn't something that happened just this week or just this year. This has been going on for the last several years. All the advisors are out there doing their jobs with their respective companies, and they have put these plans out to bid. We see the fee disclosure, frankly, as a very positive move overall. It gives us an opportunity to clearly articulate our value proposition; it resonates with the advisors, it resonates with the plan sponsors. And then another note, relative to an article earlier in the week about passive investment options, and what's the implication on Principal -- we have already in excess of \$15 billion of passive investment options on our platform.

About 24,500 of our plans -- call it mid-some-odd-30,000 plans -- already have a passive investment option. And we have six passive options available to our clients. So we don't see that this is a pivotal event, that all of a sudden the money migrates towards passive.

And frankly, investment return for active managers like Principal Global Investors has really improved here in the last 12 months, and we feel very good about getting out and not only talking about fee disclosure, but talking about TRS, talking about TPA as an option; and profiling, again, so many of these new investment options that we have available to our customers through our relationship managers and our customer service associates that are deployed locally.

Chris Giovanni - *Goldman Sachs - Analyst*

Okay. Thanks. That's very helpful.

Operator

We have reached the end of our Q&A. Mr. Zimpleman, your closing comments, please.



Larry Zimpleman - *Principal Financial Group Inc - CEO*

Well, thanks again to all of you for joining us today. We're excited about 2012 and we enter the year with good momentum across all our businesses. Our financial position remains very strong, and with excess capital of \$1.6 billion, we look forward to the opportunities that are in front of us.

Hope everybody has a great day. Thanks for listening.

Operator

Thank you for participating in today's conference call. This call will be available for replay beginning approximately 8.00 PM Eastern time until the end of day February 10, 2012. 39011663 is the access code for the replay. The number to dial for the replay is 855-859-2056. That's for US and Canada callers. Or 404-537-3406 for international callers.

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