FOURTH QUARTER 2013 | PAT QUINN, GOVERNOR

Insight

A QUARTERLY PERIODICAL DEDICATED TO HELPING YOU PREPARE FOR TOMORROW

DIVERSIFYING YOUR PORTFOLIO

Mutual funds offer diversification you don't easily get from investing in individual stocks or bonds.

The stock and bond market extremes of the past several years have been of great concern to retirees and those who are saving for retirement. While sudden shifts in performance are usually shortlived, they can have a greater impact on portfolios that are too concentrated in a particular sector, or area of the market.

If, for example, you held just one stock in your portfolio, or just one mutual fund that focused on a single sector, you would be exposed to an enormous amount of business or sector risk. Some mutual funds can offer built-in diversification by holding a wide variety of securities across different sectors. Others invest in line with a specific theme—large company stocks, small company stocks, or investment-grade bonds, for example.

HOW TO DIVERSIFY

To benefit as much as possible from diversification, the stock portion of your portfolio should include investments in the following areas:

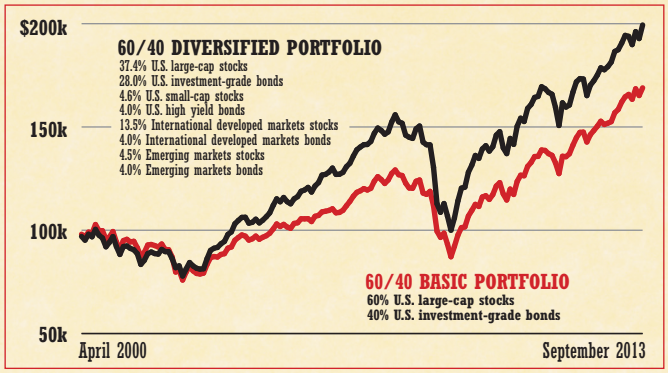
Sectors and businesses. Broad exposure to an array of sectors and businesses limits the possibility that a downturn in any one industry might reduce the long-term growth potential of your portfolio and helps to ensure you'll benefit from strong performance in any one sector.

Global regions. Many of the world's companies are based outside the U.S. Exposure to multiple regions can put your portfolio in a position to benefit from those economies that are performing well. It also spreads out the sector risk of being too heavily concentrated in one area of the world.

Capitalization. Diversifying across small, medium, and large companies can help your portfolio benefit from shifts in business and economic cycles.

THE BENEFITS OF DIVERSIFICATION

Of two portfolios with the same overall allocations to stocks and bonds—and the same initial investment of $100,000—the portfolio with greater diversification produced a 5.25% return from April 2000 through September 2013, compared with a 4.30% return for the more basic portfolio. While past performance cannot guarantee future results, the takeaway is this: how you invest within asset classes can make a difference in how your overall portfolio performs. Diversification cannot assure a profit or protect against loss in a declining market.



Note: The starting date of the beginning of April 2000 was chosen because it was the nearest whole month to the start of the first bear market since 1999. The indexes used for the more diversified portfolio include the Russell 1000 Index, the Barclays U.S. Aggregate Bond Index, the Russell 2000 Index, the Credit Suisse High Yield Index, the MSCI EAFE Index, the Barclays Global Aggregate ex USD Bond Index, the MSCI Emerging Markets Index, and the J.P. Morgan Emerging Markets Bond Index Global. The indexes used for the basic portfolio include the S&P 500 Index and the Barclays U.S. Aggregate Bond Index. Russell Investment Group is the source and owner of the trademarks, service marks, and copyrights related to the Russell Indexes. Russell® is a trademark of Russell Investment Group. This chart is for illustrative purposes only and is not meant to represent the performance of any specific investment in your Plan. It is not possible to invest directly in an index. Source: T. Rowe Price.

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DETERMINING AN APPROPRIATE ASSET ALLOCATION

In addition to diversifying the holdings in your portfolio, make sure you also establish a mix of stocks, bonds, and short-term/stable investments that is appropriate for your time horizon—how many years you have until you retire—and your tolerance for risk. This mix is known as your asset allocation. How much stock you hold is a big factor in determining the magnitude of your returns. People who are not yet retired should hold the majority of their portfolio in stocks so they have the growth potential to help stay ahead of inflation. It is important to review your asset allocation and diversification at least yearly to make sure it is still in line with your goals. There are mutual funds that adjust their asset mixes to become more conservative as you get closer to retirement while maintaining appropriate diversification within those asset classes. If you have such an option in your Plan, it may be a good choice to help you maintain your portfolio over time.

Think of your investment portfolio like the food pyramid: A healthy mix of nutrients is more beneficial to your health than eating just grains or fruits. While having an appropriately diversified and allocated portfolio cannot assure a profit or protect against loss in a declining market, it can go a long way toward putting you on track for a successful retirement.

HOW DO I ENCOURAGE MY CHILDREN TO START SAVING?

Judith Ward, CFP®, a senior financial planner with T. Rowe Price, explains how to teach children sound habits about money at an early age. If your children are like mine, they don't miss a thing! They will learn financial habits by observing how you use, talk about, and interact with money—so it's important for parents and mentors to demonstrate good financial behaviors.

Don't hold back. Start teaching your children about the importance of saving by opening a college savings plan for them when they are very young, and then, once they are older, open a Roth IRA on their behalf, if they are eligible.

College Savings Plans. Opening this type of account for your child is one of the first things you can do to financially help her (and you) pay for college. For certain types of college savings plans, any earnings are tax-deferred and distributions are free from federal tax and, in most cases, state tax, provided you use the money for qualified higher education expenses. Accruing money in this type of account may help lessen your child's need to borrow money for college expenses and accumulate significant debt.

Roth IRA. Opening and contributing to a Roth IRA is a practical way to get children thinking about their future, while helping them to see the potential benefits of saving. You can open an account for your child as soon as he has earned income of his own, such as wages from a part-time job. You can make contributions on his behalf—so he doesn't need to deplete his savings to get started—up to the amount of his earnings, with a maximum of $5,500 for tax year 2014. Eventually, you should encourage your child to begin contributing on his own.

PARENTS

42% think they strongly encourage their children to talk about money.

KIDS

19% strongly agree their parents encourage them to talk about money.*

* T. Rowe Price 5th Annual Parents, Kids & Money Survey, 2013

Learning about money can be fun. Visit moneyconfidentkids.com with your children to play the award-winning Great Piggy Bank Adventure, or download The Great Piggy Bank Adventure app to your smartphone.

INCOME TAX INFORMATION

CURRENTLY DEFERRING PARTICIPANTS

If you are actively deferring into the Plan, your taxable income was reduced thanks to your participation in the Deferred Compensation Plan. You will only report the wages shown in Box 1 of your W-2 statement on your income tax form. Your wages reported in Box 1 show your gross wages reduced by the total amount of your 2013 deferrals and any other tax-deferred and tax-exempt deductions.

Your W-2 statement will reflect contributions to the Deferred Compensation Plan (457 Plan). If the "Deferred Compensation" box in the lower right-hand corner of the W-2 form is marked "X," it means you contributed to the Deferred Compensation Plan in 2013; the amount of your deferral is indicated in Box 12 with a "G" coding. Remember, you do not report your deferred compensation anywhere on your income tax form.

FOR PARTICIPANTS WHO TOOK A DISTRIBUTION IN 2013

If you received a payment from your account during the 2013 tax year, you will receive a separate Form 1099-R from our recordkeeper, T. Rowe Price, by January 31, 2014. Box 2a of your 1099-R will list the taxable amount of your distribution(s) you received during 2013 and should be entered on line 16b of your Form 1040. Box 7 of your 1099-R shows the distribution code for the type of distribution received. A code of "7" in this box indicates a normal distribution for a participant age 59½ or over. If you were under age 59½, box 7 will be coded with a "2" to indicate that your 457 Plan distributions are not subject to the 10% additional tax on early distributions.

TELEPHONE NUMBERS

Deferred Compensation
Plan Rules/Options Information
800-442-1300/217-782-7006
TDD/TTY: 800-526-0844
Internet: http://www.state.il.us/cms/employee/defcom

Recordkeeper
T. Rowe Price Retirement Plan Services, Inc.
Account Value Information and
Investment Changes: 888-457-5770 or
TDD/TTY: 800-521-0325
Internet Access: 800-541-3022
Internet: http://rps.troweprice.com

Distributions from your deferred compensation, plus any earnings, are taxable as ordinary income for federal income tax purposes. These same distributions are not, however, subject to State of Illinois income tax. Line 1 of your IL 1040 is taken directly from your federal adjusted gross income, which includes any deferred compensation distributions. These distributions should also then be listed (and consequently deducted from income) on line 5 of your Illinois return (IL 1040).

IRS LIMITS FOR 2014

To help you better prepare for the upcoming year, below is a summary of the 2014 salary deferral contributions you can make to your State of Illinois Deferred Compensation Plan (457 Plan):

- The IRS annual salary deferral dollar limit for before-tax contributions is $17,500.
- For participants who will be age 50 and older, the age 50 catchup provision allows you to defer up to $23,000 in before-tax contributions. (This includes the $17,500 maximum before-tax contribution allowed by the IRS plus an additional $5,500.)
- The 457 special catch-up provision is $35,000. (This provision can only be elected during the three years (consecutive) prior to, but not including, the year the participant attains normal retirement age, as defined by the 457 Plan.)

1099-Rs for 2012 distributions will be mailed by January 31, 2014.

REQUIRED MINIMUM DISTRIBUTIONS

If you turn age 70½ in 2014 and have left state service, you must receive your 2014 required minimum distribution (RMD) by April 1, 2015. To calculate your RMD, divide your account balance as of December 31, 2013, by 27.4 if you turn age 70, or 26.5 if you turn age 71, in 2014. This is the minimum amount that you must withdraw from your account.

Each year thereafter (including 2015), you must receive your RMD for that year by December

WHAT DOES BEING ON THE "WATCH LIST" MEAN?

It is important that you understand what it means to be on the watch list and, perhaps more importantly, what it does not mean. Being on the watch list, as the name would imply, simply means we believe there is good reason to watch this fund more closely. Being on the watch list does not mean you should immediately sell your fund shares. It is not unusual for a fund to appear on the list from time to time. It does not mean the fund is necessarily a bad investment. If we believe the fund no longer represents a suitable investment option, we will remove the fund from the 457 Plan.

Why are funds placed on the watch list?

Funds can be placed on the watch list for several reasons. Why a fund is on the watch list is more important than the mere fact that it is on the watch list. The most typical reasons are as follows:

1. **Performance**—The most common reason a fund is placed on the watch list is poor performance relative to its appropriate market benchmark and/or peer group. When signs of relative underperformance appear, we place a fund on the watch list.
2. **Risk**—Less obvious to many participants is the risk that a fund manager incurs. If a fund becomes too volatile, we will place it on the watch list.
3. **Risk-Adjusted Returns**—What returns has the fund manager been able to deliver relative to the risk the fund has incurred? If the manager is unable to deliver adequate returns for the risk taken, we will place the fund on the watch list.
4. **Portfolio Construction/Style Drift**—Is the fund manager investing the money in the way he or she said? If you invest part of your assets in an aggressive fund that is supposed to be investing in the stocks of small, growth-oriented companies, then you want the manager to do just that. We monitor the manager's portfolio, and if the security holdings do not reflect what has been communicated, we place the fund on the watch list.
5. **Operations**—There are many operational reasons for placing a fund on the watch list. For example, the manager of the fund could leave. Remember, when you purchase shares of a mutual fund, what you are really doing is hiring a professional portfolio manager to invest your money. If that manager leaves, you should watch the fund closely. There could also be firm-level issues. These can include issues such as regulatory violations, turnover in senior management, or a merger or acquisition. Any of these operational issues will automatically place a fund on the watch list.

Log in to your Plan's website at **rps.troweprice.com**.

WATCH LIST—THE STATE OF ILLINOIS DEFERRED COMPENSATION PLAN

Current Watch List Summary

The following fund is on the watch list as of 12/31/13

Janus Overseas Fund ("Overseas Fund")—The Overseas Fund was placed on watch list status due to underperformance of the benchmark and peer group. European financial issues detracted from returns in recent years and a higher weighting in emerging markets has detracted in 2013. The Fund's investment strategy is a high conviction approach that has led to higher overall volatility of returns. The Fund's returns are now lagging the benchmark over the three- and five-year trailing periods. In addition to underperformance, Janus has also experienced planned changes in senior leadership. Janus made a change in their Chief Investment Officer that oversees the investment strategies managed by the firm. However the lead portfolio manager responsible for directly managing the assets of the Overseas Fund has not changed. Participants seeking a similar investment strategy have access to the Northern Trust ACWI ex-US Fund which also invests in large-cap international stocks in both developed and emerging markets.

Columbia Acorn Fund, Z ("Acorn Fund")—The Acorn Fund was placed on "Alert" status due to a change in the lead portfolio manager. Columbia recently announced that the long-term lead portfolio manager and Columbia Wagner Asset Management Chief Investment Officer Chuck McQuaid, will retire effective April 1, 2014. Mr. McQuaid has been managing the fund since 1995. Assuming his responsibilities will be Robert Mohn who has been worked on the fund since 1992 and assumed co-portfolio manager responsibilities in 2003. In addition, Mr. Mohn is also the Director of Domestic Equity Research since 2004. Adding to the oversight of the Fund, David Frank will become co-portfolio manager on January 1, 2014. Mr. Frank is currently co-portfolio manager on Wagner Asset Domestic Equity and an analyst in financial stocks. He has been with Wagner Asset Management since 2002. Participants seeking a similar investment strategy have access to the Northern Trust Small Cap Separate Acct which also invests in domestic small-cap stocks.

Lord Abbett LGCP Core Strategy—Lord Abbett was placed on "Alert" status due to underperformance of the benchmark and peer group. Performance over the past three and five year periods has been poor. Specifically, performance in the calendar year of 2011 acted as the largest drag on returns. Lord Abbett focused on cyclical companies where their earnings were lower than normal. As a result of underperformance in 2011, Lord Abbett added to its risk management. Over the past three calendar years however, the fund has ranked in the top half of its peer group for 2012 and 2010. Participants seeking a similar investment strategy have access to the Vanguard Institutional Index, Plus Fund which also invests in both domestic growth and value large-cap stocks.

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