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 If we believe the fund no longer represents a suitable investment option, we will remove the fund from the Plan.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.

WATCH LIST—THE STATE OF ILLINOIS DEFERRED COMPENSATION PLAN

Current Watch List Summary

The following funds are on the watch list as of 3/31/2010:

Ariel Fund: The fund's performance for the first two months of 2010 has lagged the benchmark and its peer group. For the year-to-date return, the fund ranked in the 91st percentile as some of the stocks that soared in 2009 retreated in the early part of this year. For example, the fund's largest holding at the end of 2009, Hewitt Associates, posted a 10% loss this year and represented 5% of the fund's assets. However, the fund's one year returns, bolstered by an impressive run last year, ranks in the first percentile with a return of 121%. The fund's longer-term performance, as measured by the five-year annualized return, however, has continued to lag its benchmark and its peer group. Participants also have access to the Northern Small-Cap Value Fund, which invests in a small-cap value equity style. This fund will remain on the watch list due to longer-term underperformance.

Legg Mason Value Trust: The first two months of 2010 proved challenging to the fund's performance relative to the benchmark and its peer groups. Many of the stocks that climbed the highest last year retreated this year. Due to an impressive showing in 2009, this fund's one-year return remains well ahead of the benchmark and peer group at 76% versus 54% for the S&P 500 Index. Technology, financials, and consumer stocks were among their best performers in 2009. However, longer term, this fund's performance continues to lag its peer group and the benchmark. This fund's overall volatility score, a measure of overall risk, is also very high versus its benchmark. An alternative fund for participants to access is the Vanguard S&P 500 Index Fund, as it invests in similar stocks to the Legg Mason Fund. This fund will remain on the watch list due to longer term underperformance with higher risk.

Janus Advisor International Growth: Over the past year and longer-term periods, this fund has produced an impressive performance track record, placing it in the top 5% of all international equity funds. The fund's watch status is a result of organizational changes and not performance. In July of 2009, the Janus Capital Group Board announced the departure of Chief Executive Officer Gary Black. Mr. Black was credited with bringing about several changes to the firm, including a move toward best practices in the investment group. Janus announced a replacement and new chief executive officer, Mr. Richard Weil, earlier this year. Mr. Weil was formerly the global head of PIMCO Advisory, a large investment services organization. He began his new role with Janus on February 1, 2010. As this change is still fairly recent, the fund will remain on the watch list for the near term. An alternative fund for participants to choose is the Invesco International Growth Fund, as it also invests in large-cap international stocks.

FIRST QUARTER 2010 | PAT QUINN, GOVERNOR

Insight

A QUARTERLY PERIODICAL DEDICATED TO HELPING YOU PREPARE FOR TOMORROW

GETTING BACK IN BALANCE

Your asset allocation may change over time because some investments in your portfolio will perform better than others. That's why it's important to review your investments each year and consider rebalancing your account to make sure the investments are still allocated as you had originally intended.

Market changes

Consider an investor in his 50s who has carefully chosen an asset allocation of 60% stocks, 30% bonds, and 10% short-term investments. He based his allocation on the fact that he's a decade away from retirement and has potentially another 30 years beyond that. He'll need the growth potential of stocks to help him keep up with inflation through decades of retirement. But he'll also need the relative stability of bonds and short-term investments.

If the stock market rises substantially, his portfolio could look different from the one he originally planned. Even if bonds had also gone up during the same period, chances are that they didn't increase at the same rate as stocks because investments rise and fall independently of one another. At the end of a year, if stocks have risen faster, they may represent 70% of the portfolio, and bonds and short-term investments would total 30%, instead of the 60/30/10 ratio the asset allocation calls for. Getting off target can be detrimental because he now has less of the stability from bonds needed for his time horizon. To get back on track, he will have to make adjustments to his portfolio.

Getting back in shape

Rebalancing is a way to get your portfolio back to the original allocation of stocks, bonds, and short-term investments you selected. You might sell a portion of those asset classes that have grown to larger percentages than you want and buy more of those that have shrunk. The aim is to keep your allocation in line with your time horizon. If you have 20 or more years before reaching age 65, for example, you might want to consider investing 90% to 100% in stocks. With 10 to 20 years before leaving the workplace, you may want to consider including some bond and short-term investments in your portfolio.

As you enter retirement and beyond, you may want to consider including even more bond and short-term investments. If you don't rebalance every year, your current asset allocation might not reflect your target investment strategy, and it might not deliver the growth or stability appropriate for your stage in life.

Rebalancing requires action. If you prefer not to do the buying and selling yourself, one alternative is to invest in a target-date fund, if available. These funds automatically adjust your investment mix to achieve an appropriate asset allocation as you approach and go through retirement. You only need to select one target-date fund, based on your target year for retirement.

A long-term approach

Rebalancing is part of a well-thought-out, systematic approach to investing, and it can help put you that much closer to reaching your long-term goals. Having too much of your portfolio in one asset class could dampen your returns and ultimately hinder your lifestyle in the decades to come. Your plan may offer an auto-rebalancing service that will automatically rebalance your account for you quarterly, semiannually, or annually.

To learn more about this service and to see if it is available in your plan, visit the ***my***RetirementPlan Web site at **rps.troweprice.com**.

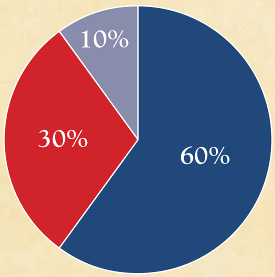
The principal value of target-date funds is not guaranteed at any time, including at or after the target date, which is the approximate date when investors plan to retire. These funds typically invest in a broad range of underlying mutual funds that include stocks, bonds, and short-term investments and are subject to the risks of different areas of the market. In addition, the objectives of target-date funds typically change over time to become more conservative.

Return to your target

Let's say you're 10 years from retirement and choose a mixture of stocks, bonds, and short-term investments that can generate growth to help keep up with cost-of-living increases and minimize the impact of market declines. Having too much of your portfolio in stocks would expose you to declines in a potential downturn. Having too little in stocks can mean less growth in the portfolio overall.

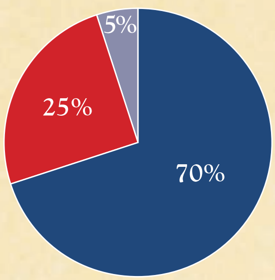
TARGET ALLOCATION

Your asset allocation should provide the right mix of growth and stability for your age and time horizon.



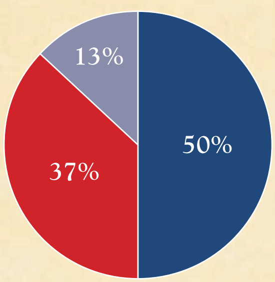
STOCKS SURGE

If stocks surge over the course of a year, the percentage of the portfolio in stocks might be more than the original target allocation.



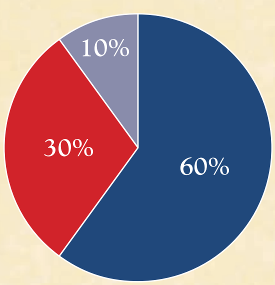
STOCKS DECLINE

If stocks rise less than bonds over the course of the year, the portfolio might look more like this.



AFTER REBALANCING

Buying more of lagging funds and selling a portion of the funds that have performed well will bring your portfolio back into shape.



Stocks | Bonds | Short-Term Investments

To learn more about rebalancing, log in to **rps.troweprice.com**.

MANAGING IN THE MIDDLE

At age 45, Molly has growing children and aging parents who increasingly need her care and attention. As a single parent with a salary of $60,000, her budget is tight. She understands the importance of saving for retirement, but she wonders how she can balance the present-day needs of her family with her own need to save for the future.

Crunching the numbers

To relieve some pressure and put more money in the bank for her current expenses, Molly considers suspending contributions to her employer-sponsored retirement plan for a couple of years. Before taking that step, she calculates the true cost of temporarily stopping her contributions. Currently, she contributes an amount equal to 15% of her salary, or $9,000 per year. By the time she retires, the $18,000 she would have set aside over two years could be worth $80,790, thanks to the power of compounding.[1] That's money she'll need for her own financial independence later on.

Finding peace of mind

Molly decides to keep contributing to her plan and saves $2,000 by exploring local attractions instead of traveling for family vacations and by cutting some nonessential expenses, such as her gym membership. She uses a portion of the money she saves to start tax-advantaged 529 college savings plans for her children—and she gives them an allowance, which helps her to keep spending for them in check. (It also teaches her children the value of budgeting.) Since Molly is putting away money for the cost of college tuition, she tells her parents to devote the savings they had put aside for their grandchildren toward keeping their own nest egg on solid ground. With just a few adjustments to her family's finances and practices, Molly now feels comfortable with her ability to look after those she loves, while keeping her retirement savings plan in place.

[1] *Assumes an annual return rate of 8%, with retirement at age 65. This hypothetical example is for illustrative purposes only and does not reflect the performance of any particular investment.*

Please note the 529 plan's disclosure document includes investment objectives, risks, fees, expenses, and other information that you should read and consider carefully before investing. Please note that the availability of tax or other benefits may be conditioned on meeting certain requirements such as residency, purpose for or timing of distributions, or other factors, as applicable.

To learn more about saving for retirement, visit **rps.troweprice.com** or call **1-888-457-5770** for more information.

KEEPING A LID ON INFLATION

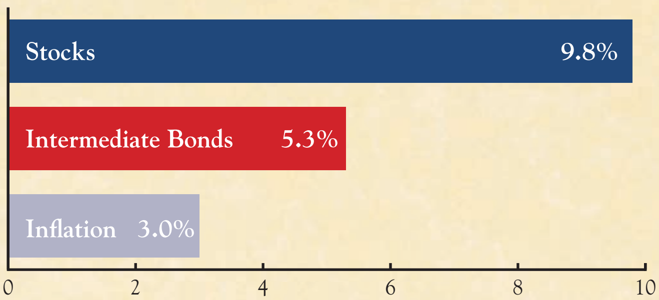
Each year a dollar seems to buy a little less than it did the year before. Some inflation in the cost of goods and services is a natural part of any economy. But will it rise too much in the year ahead?

Some recent news reports have warned that government efforts to stimulate the economy could cause a period of unusually high inflation. To help stabilize the banking system and increase the amount of money available for borrowers, the Federal Reserve added $1.2 trillion to the U.S. economy last March when it purchased government bonds and mortgage-backed securities. And Congress has been borrowing and spending hundreds of billions of dollars in an effort to spur growth. Those two factors combined could make the dollar less valuable simply because having more dollars in circulation can make them worth less.

But there are good reasons why inflation is likely to remain low for at least the next few years. With unemployment at 10% in December, and consumer spending low, factories are producing fewer goods. Since inflation is directly related to demand for products, such conditions make it difficult for prices to increase. In fact, a survey by the Federal Reserve Bank of Philadelphia in late 2009 predicted that inflation would average only 2.14% between 2009 and 2013,[1] compared with average inflation of about 3.00% since 1926.[2]

STOCKS AND BONDS… AND INFLATION

Between the beginning of 1926 and December 31, 2009, the average annualized rate of return for stocks in the Standard & Poor's 500 Index performed well above the average inflation rate for the same period. Intermediate government bonds only fared about half as well and haven't offered the same protection against rising prices.[2]



Source: Ibbotson Associates, a division of Morningstar, Inc.

There's no way of knowing for sure whether or by how much prices will rise, but it's important to be prepared. While the past is no guarantee of future performance, a long-term investment strategy that includes growth-producing stocks (as the chart above shows) may be the best way to help protect your savings from being damaged by rising prices so that you can finance a comfortable retirement.

[1] *Federal Reserve Bank of Philadelphia. "Third Quarter 2009 Survey of Professional Forecasters."*

[2] *Ibottson SBBI Classic Yearbook.*

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EXPAND YOUR INVESTING VOCABULARY FINANCIAL DICTIONARY

Get to know the following terms from this issue of Insight:

Asset Allocation: The mixture of stocks, bonds, and short-term investments selected to create your portfolio. Your asset allocation should depend primarily upon your investment time horizon.

Time Horizon: The period of time you have before and during retirement, which is the driving factor in creating your asset allocation. The percentage of your retirement portfolio invested in stocks should decline as you age, but not so much that you lose the growth potential of stocks during your later years.

529 College Savings Plan: A tax-advantaged savings account that can grow until it is used by you or a beneficiary to meet college expenses, ranging from tuition to books. Withdrawals used for qualified educational expenses are free from federal income tax. The earnings portion of a nonqualified distribution is generally taxable and may be subject to an additional 10% federal penalty.

Call 1-800-922-9945 to request a prospectus, which includes investment objectives, risks, fees, expenses, and other information that you should read and consider carefully before investing.