Second Quarter • July 2006 • Rod R. Blagojevich, Governor

457 News

Illinois Department of Central Management Services

Asset Allocation—Managing Your Retirement Portfolio for a Secure Retirement

This article provided by Iron Capital Advisors

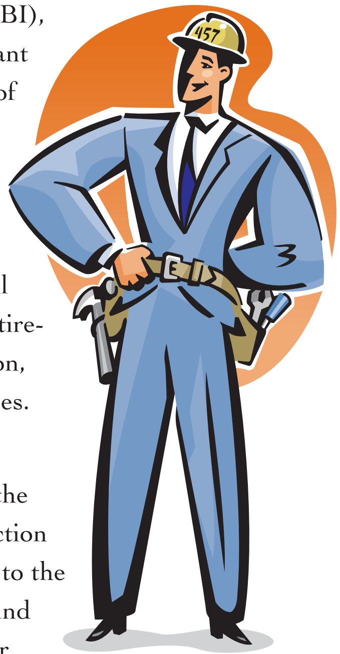
The topic today is asset allocation. What does it mean to you? If you are like most, it doesn't mean a thing. It is a fancy term investment people throw out when they talk about retirement planning, but you should know what it is because you are practicing asset allocation in your Deferred Compensation Plan.

Asset allocation is how you allocate your investments across the various options in the Plan. Properly done, asset allocation can maximize your odds of having enough money to retire securely. Improperly done, it can eliminate any opportunity to make money in the market. An industry research group named DALBAR researches how investors allocate their assets and when they decide to make changes to their allocations. They claim that the average investor has achieved a mere 3.51% average annual return on his or her portfolio over the last 20 years—while the market has achieved a 12.98% average annual return over the same time period.

How can that be? Many investors use an asset allocation method known in the industry as "chasing the return." They look to see what asset has had the best return lately and invest in that asset, after it has already gone up. They hold on to that asset while it may continue to go up a little, but then it starts to go down, or at least go up slower than some other asset. Then, they move their money to that asset again—after it has gone up. In other words, most investors buy high and sell low. Unfortunately, trying to predict what is going to be the best asset class in the year ahead is just about impossible. Although it is usually safe to bet that it will not be the same as last year, which is why "chasing the return" never works.

(continued on page 3)

Investment Option Changes



The Illinois State Board of Investment (ISBI), with the help of their independent consultant Iron Capital Advisors, monitors the State of Illinois Deferred Compensation Plan and its investment options to ensure that the Plan remains competitive in the marketplace. The goal is to provide you with a wide variety of investment choices that will enable you to invest effectively for your retirement, based on your individual time horizon, risk, philosophy, and personal circumstances.

In June, the recent and continued market volatility predicated a closer look at all of the investments. At that time, ISBI, in conjunction with Iron Capital Advisors, made changes to the Plan's investment lineup in an effort to round out the fund offerings and continue to offer quality options in each asset class. As a result of the review, the Department of Central Management Services is adding one new fund, the Northern Small Cap Value Fund, and is phasing out one of the current fund options, the Provident Investment Counsel Small Cap Growth Fund, beginning in October. More information about these changes is on page 2 of this newsletter.

Questions?

If you have any questions regarding these changes, you may call the Deferred Compensation Office at 1-217-782-7006, 1-800-442-1300, or at 1-800-526-0844 for TDD/TYY. Retirement account representatives at T. Rowe Price are also available to assist you—if you have any questions about the funds, if you want to make an exchange into or out of the funds, or if you would like a prospectus to view additional information about the funds—by calling toll-free at 1-888-457-5770.

Please take this time to review your current investment strategy to determine if you have to make a change in how you invest your future contributions and existing account balances.

New Fund Added

Northern Small Cap Value Fund (ticker symbol NOSGX)

This fund is managed by Robert Bergson, CFA. The fund seeks long-term capital appreciation. The fund normally invests at least 80% of net assets in equity securities of small-capitalization companies with market capitalizations that are, at the time of purchase, within the range of the Russell 2000 Index.

The Northern Small Cap Value investment approach:

- Invests primarily in small-capitalization stocks selling at discounts to the manager's assessment of their intrinsic value.
- Focuses on companies who show positive momentum in earnings and stock price to avoid value traps.
- Avoid companies that the manager believes are distressed.

Why add Northern Small Cap Value?

- The fund is a true small value fund that will not drift out of that space.
- The fund has outperformed in four of the last five years since Robert Bergson took over management.
- The fund tracks very closely to the Russell 2000 Value Index and can provide better diversification to participants building their portfolios.

Key Dates to Remember

September 29, 2006 — At 3 p.m. CT, Northern Small Cap Value Fund will be added as an investment option, and the Provident Investment Counsel Small Cap Growth Fund will be frozen.

November 29, 2006 — You will have until 3 p.m. CT on this day to move your current balance out of the Provident Investment Counsel Small Cap Growth Fund and into one or more of the other available options.

Fund Frozen October 1, 2006

Provident Investment Counsel Small Cap Growth Fund

This fund has been on the watch list for over a year and has underperformed for some time. The fund's performance has bounced up lately, but based on the long-term performance, ISBI and Iron Capital Advisors are not confident that this will continue.

On September 29, 2006, at 3 p.m. CT, this fund will no longer accept incoming transfers or new contributions. This means that if you are currently directing money into this fund, you must execute a change. Changes to the elections for future contributions to this fund must be made to T. Rowe Price by September 29, 2006. If you do not make this change to your future investment election, this election will automatically be allocated on October 1, 2006, to the Columbia Acorn Fund, which is the closest substitute in the Plan.

Account balances may remain in this frozen fund until 3 p.m. CT on November 29, 2006, to allow you plenty of time to move your account balances to the appropriate investment option(s) of your choice. Any remaining fund balances after December 1, 2006, will automatically be transferred to the Columbia Acorn Fund.

Telephone Numbers

Deferred Compensation:

Plan Rules/Options Information
800-442-1300
217-782-7006
TDD/TTY: 800-526-0844
Internet: 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: rps.troweprice.com

Asset Allocation (continued from page 1)

There is another option. You can build a prudent asset allocation that will perform well over time. But how do you do that? Ideally, you start by calculating how much money you need in order to retire, how much you have now, and what rate of return you need in order to get from here to there. Once you have that information, you can use a computer program to construct an asset allocation that will maximize your odds of achieving that required return over time. You can find these tools online by accessing your account through the ***my***RetirementPlan Web site at **rps.troweprice.com**.

There is a simpler way of going about it, if you don't like going through those steps. The easiest thing to do is to select the T. Rowe Price Retirement Fund that most closely matches your goal retirement date. These funds are preset allocations managed by T. Rowe Price. Their major advantage is their ease of use. You simply pick the fund with a target date closest to the year you plan to retire and everything else is done for you (Retirement Funds assume a retirement age of 65 as a guideline). However, you can't take advantage of the expertise of some of the other managers in the plan, and you may need to verify this is the right asset allocation based on your needs. For many, the ease of use makes this option a good choice.

There is a third option that allows you to have your own allocation and use the different managers in the plan without going through a computer program. You can follow this simple five-step asset allocation process.

Step 1 — Decide how much to invest in stocks versus bonds.
This is the most important decision of all and will have the greatest impact on your long-term rate of return and risk level. If you consider yourself an average risktaker, we usually recommend an asset allocation of 60% stocks and 40% bonds. If you are more aggressive, you can allocate more of your portfolio to stocks, even 100% if you have the stomach for it. If you are more conservative than the average investor, you should have more in bonds and the stable value option; however, we would not recommend having more than 80% of your money in bonds and/or stable value under any circumstances. You should have at least 20% invested in stocks.

Step 2 — Within your stock allocation, decide how much to invest in small-cap stocks versus large-cap stocks and domestic stocks versus foreign stocks.
The next decision is how much you put in small-cap versus large-cap stocks and how much international exposure you would like. Large-cap stocks represent roughly 70% of the invested capital in the stock market, while small-cap stocks represent 30%. Most investors probably want to look a lot like the market. Therefore, you should have 70% of your stock investments in large-cap stocks and 30% in small-cap stocks. If you are more aggressive, you could have as much as 50% in small-cap, but we would not recommend any more than that.

You also have to decide how much international exposure you want to put into your portfolio. Since roughly half of the invested capital in the world is outside of the U.S., you may want to have exposure there. Some people don't like investing outside of the U.S. and that is okay—although you are sacrificing some investment opportunities. We generally recommend anywhere from 0% to 30% of the equity portfolio be invested internationally.

Step 3 — Within your stock allocation, decide how much to invest in growth versus value.
In your plan, you also have some equity options that are value-oriented and some that are growth-oriented. The market, by definition, is 50% value and 50% growth. We recommend you do the same.

Step 4 — Within your bond or fixed-income allocation, decide how much to invest in cash versus core bonds.
In your plan, you can invest in core bond funds (the Vanguard Index or the T. Rowe Price New Income Fund) or in the T. Rowe Price Stable Value Fund. We generally recommend 50% of the bond portion of your portfolio in core bond funds and 50% in stable value.

Step 5 — Reevaluate annually.
Finally, you have to review this periodically. Your circumstances will change over the years and you'll need to adjust your portfolio accordingly. We recommend annual reviews.

To summarize, asset allocation is critically important to your investment success. In your plan, you can use the online tools to create a custom asset allocation, choose one of the T. Rowe Price Retirement Funds, or use our process to do it yourself. The one thing you don't want to do is "chase the return." Select a prudent long-term asset allocation and stay the course.

The State of Illinois Deferred Compensation Plan

Current Watch List Summary

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.

The following funds are on the watch list as of 6/30/2006:

The Ariel Fund continues to underperform. The fund has drifted out of the small value space and into the mid-cap blend category. However, even compared to this group, the fund continues to lag dramatically. The fund ranks in the 99th percentile for mid-cap blend funds over the 12-month period ending June 30, 2006. The fund returned 0.97% for that period versus 13.66% for the Russell Mid Cap Index. For those participants who bought this fund for small value exposure, the Plan will be adding a new small value option on October 1. Look for that information.

The Provident Investment Counsel Small Cap Growth Fund outperformed the Russell 2000 Growth Index during the second quarter but remains on the watch list due to its longer-term underperformance. The fund has underperformed its index on a one-, three- and five-year basis. For the quarter, the fund was down -5.27% versus -7.25% for its index. The fund is among the most volatile in the small growth category. While the fund has rebounded somewhat this year, the long-term performance and volatility have made us recommend the removal of this fund from the lineup. Columbia Acorn is the closest alternative available within the Plan.

The Wells Fargo Advantage Large Company Growth Fund was originally placed on the watch list due to its low relative returns and high volatility, and the fund remains on the watch list due to its continued underperformance. The fund is more growth oriented than the index and most of its peers. As a result, it posted strong numbers in the last six months of 2005 when growth was in favor and has struggled in 2006 as the market has reverted back to value names. The fund is well positioned to take advantage of a market dominated by growth, with a high weighting to technology, and eventually the market will cycle in that direction. The question is simply when.

The Legg Mason Value Trust is being placed on the watch list due to underperformance year to date. This has been a very strange year so far in the markets. The market has been led by the lowest quality, overvalued sectors, such as small value, that have been in favor now longer than ever before in market history. This environment does not bode well for quality managers like Bill Miller. This fund has outperformed the S&P 500 15 straight calendar years, but it is in the 99th percentile year to date. This fund is highly concentrated and therefore volatile. For those wishing for a more stable large-cap blend option, there is the Vanguard Index Fund in the Plan. We are confident that the fund will bounce back as it has many times in the past, but this fund is volatile and participants should be prepared for that.

The T. Rowe Price International Stock Fund had been removed from the watch list due to improved performance, but the fund has struggled again this year. The fund’s largest country allocation is Japan, which has lagged other international markets year to date. The outlook for Japan is strong, and their economy is growing faster than it has in many years, which has caused their central bank to start raising interest rates. This has been a major cause of all the market panic in the last few months. We are not overly concerned, but must place the fund back on the watch list until performance improves. The fund is up 3.79% for the first six months of the year, versus 10.50% for the MSCI EAFE International Index.

I-02542-2Q06

7/06

2Q06-ILLNEWS-250901