457 News
2nd Quarter • July 2007 • Rod R. Blagojevich, Governor
Illinois Department of Central Management Services

Beneficiary Distribution Options

Once an account has been established in the name of the beneficiary(ies), he or she gains control of the account and has the ability to change the investment mix to their preferred investment strategy. In addition, the distribution of the account can—or sometimes must—occur, depending on the relationship to the deceased. In either case, there is no penalty for withdrawal of the account prior to age 59½.

A spousal beneficiary has the same distribution options as the participant. They may start, stop, or change their distribution election at any time, beginning with the next month's distribution schedule. The spousal beneficiary may receive partial distribution amounts or set up monthly, quarterly, semiannual, or annual distributions of a fixed-dollar amount or over a specified time period. A spousal beneficiary may also choose to delay the start of a distribution up to age 70½, the age when Required Minimum Distributions (RMDs) must begin and may be calculated over the beneficiary's life expectancy.

A nonspousal beneficiary with a balance over $5,000 may elect to receive a lump-sum distribution, installments paid over five years, or installments paid over the life expectancy of the nonspouse beneficiary. Nonspousal beneficiaries can not elect to delay the distribution of the account, and payout must begin by the year following the date of death. Payments to estates or trusts can not exceed a five-year payout period.

Both spousal and nonspousal beneficiaries have the ability to roll over the account to a Traditional IRA. All money transferred out of the Plan will assume the characteristics of the receiving plan.

If you need to update your beneficiaries, a Beneficiary Election Form can be obtained at the Deferred Compensation Web site or by contacting the Deferred Compensation Office.

T. Rowe Price Retained as Recordkeeper

The contract for recordkeeping services with T. Rowe Price will expire on December 31, 2007. The Illinois State Board of Investment (ISBI) released a Request for Proposal (RFP) for recordkeeping services in February of this year. Recordkeeping finalists presented to the Board at their July 13, 2007, meeting and the decision was made to retain T. Rowe Price as the plan's recordkeeper. A contract is being finalized for a three-year term. The decision of adopting a new investment platform, as discussed in the previous quarter's 457 News, will be made subsequently and phased in at a later date if adopted. You will be kept abreast of any developments in the 457 News.

Distribution Elections

For participants in payout, the policy regarding the frequency at which one can change their distribution method of election has been revised. Participants may restart, stop, or change their current distribution method at any time. The change will occur in the next month's regular distribution schedule. Payments or direct deposits are initiated on the Friday following the second Thursday of each month. Distribution Method Election Forms can be obtained from our Web site or by contacting this office.

Columbia Wanger Shareholder Information Meeting

On September 25, 2007, Columbia Wanger Asset Management, L.P., will conduct their annual shareholders' meeting in Chicago. State of Illinois participants currently invested in the Columbia Acorn Fund are invited to attend and participate in the meeting to be held at Chase Bank Auditorium, Plaza Level, 38 South Dearborn Street, from noon until 1 p.m. CT. A buffet lunch will be served prior to the meeting. Reservations may be made by calling 1-800-922-6769 prior to September 18, 2007.

For those outside the Chicago area, a live Web cast of the meeting will be offered at the same time and can be accessed at www.columbiafunds.com.

IRRATIONAL BEHAVIOR

Article provided by Iron Capital Advisors

I was sitting at home the other night with my wife and we rented a movie I had not seen in a long time. It was the 1997 hit "Men in Black" featuring Tommy Lee Jones and Will Smith as secret agents policing alien activity here on earth. The existence of these aliens here on earth of course had to be kept top secret to avoid a panic. Agent J (Will Smith) thought the MIB should just let everyone know about the aliens - after all, as he said, "People are smart, they can handle it." Agent K (Tommy Lee Jones), who was older and perhaps wiser, responded, "A person is smart. People are dumb, panicky, dangerous animals, and you know it." How profound. Agent K could have had a very lucrative career on Wall Street.

When it comes to investing, the individual investor may be intelligent, but the market? The market is a dumb, panicky, dangerous animal, and you should know that. This year has been a classic example. In the first quarter, the market went on a rollercoaster ride due to so called sub-prime loans going default. Sub-prime loans are loans to people with poor credit. Well, the market shook that off and rebounded in March, April and May only to struggle again in June. Once again they are afraid of sub-prime loans and the possibility of inflation. Wall Street acts as if it is shocked to find out that people with poor credit don't always pay their loans back. Isn't that how they got the poor credit to begin with? Surely, not even the gurus of Wall Street could be so surprised. So, what is really going on?

Unfortunately, the market is just irrational, at least in the short-term. The market tends to overreact, and then correct. This is the essence of the "market cycle". The irrational behavior of the market is not new. Robert Shiller, the Yale professor and best selling author of "Irrational Exuberance", wrote extensively about how irrational the market can be. The famous economist John Maynard Keynes once warned, "The market can stay irrational much longer than you can stay solvent."

So what is an investor to do? I believe we should hold on to the knowledge that eventually the market does get it right. In the long-term the market does a good job of valuing assets fairly. In the short-term we should always remember Keynes' warning. This is why having a well-defined investment discipline is so crucial.

One of the most common mistakes we find when we look at participant portfolios, is that often there is no discernable investment strategy in place. We usually find a random hodgepodge of holdings with no evidence that anyone ever thought about overall portfolio construction and/or risk management. Individual investors tend to make investment decisions in a vacuum. For example, they may ask if they should buy a particular fund that has performed well recently. Of course, that answer depends on what the rest of your portfolio looks like, and you have to decide not only whether to buy, but also how much to buy, and what to sell in order to buy. However, I have found that usually this is when the client's eyes start to glaze over, not wanting to delve into details when they just wanted to buy the latest, hottest fund.

Portfolio management is much more than just making decisions on investing in this asset and/or that asset. Portfolio management involves creating a whole portfolio where every part has its function and making decisions is based on a sound investment philosophy and controlling risk. Controlling risk is arguably the most important element in portfolio management, yet most investors do not really understand what it means. When you talk to most investors about controlling risk, they start talking about buying investments that are zconservative when considered on an individual basis, but what we are talking about is much more dynamic than that. Controlling risk entails thinking about each investment in terms of your overall portfolio.

The portfolio management process should begin with a declaration. You should put in writing a carefully considered investment policy statement, which should include your objective. Where are we going? People do not invest for the sake of investing. They are investing to fund their retirement or their children's education, or in some cases just to have more money than their neighbors. Whatever the motivation there is a goal, and that goal greatly impacts how the portfolio should be managed.

Once we know what the goal is, we can determine the return required to achieve that goal and the amount of risk we are both able and willing to take in order to achieve that return. Then, and only then, can we build a strategic asset allocation that gives you the highest likelihood of achieving your return objective based on long-term relationships of various assets. While constructing this long-term strategy, you must do something that is incredibly difficult: you must completely ignore what is happening in the market today. Don't worry, we will eventually get around to today's environment, but not yet. First we have to look at long-term market relationships and the big picture questions like how much equity exposure should I have long term, how much international, and how much in bonds. Only once we have made these decisions can we intelligently look at what is going on today.

Once you know how much equity exposure you want in the long-term, then you can review what is going on today and decide if right now you should be over-weighted, have more exposure than your long-term strategy calls for, or underweighted. If you are not sure, then go back to your long-term strategy. This structure gives us a framework from which to make rational decisions in an irrational market. We can then control the amount of risk you take by asking one simple question: what happens if we are wrong?

That is the key to controlling risk. It sounds so simple, yet most investors just are not willing to consider the possibility that they could be wrong. It's too painful. Yet if you invest money long enough, you will eventually be wrong, but that doesn't have to be a bad thing. If you consider your mortal nature before pulling the trigger, make sure that the odds are in your favor for being correct and that if you do happen to be wrong, then it won't hurt your overall portfolio too badly; then you will be okay in the long-term.

Note: Need to develop an investment strategy? Iron Capital Advisors provided an article on asset allocation in the Second Quarter 2006 457 News. Also, the T. Rowe Price Retirement Funds manage the investment strategy for you based on your intended retirement date. You can find copies of the 457 News and the fund descriptions at the Deferred Compensation Web site at www.state.il.us/cms/employee/defcom.

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

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
as of 6/30/2007:

Ariel Fund outperformed for the quarter placing in the 21st percentile for its peer group. The fund has drifted out of the small value space and into the mid-cap blend category. The fund continues to lag dramatically for the longer term periods. The fund ranks in the 90th percentile for mid-cap blend funds over the three-year period that ended June 30, 2007. The fund returned 10.85% for that period versus 17.16% for the Russell Mid Cap Index. For those participants who bought this fund for small value exposure, the plan has added a new small value option, the Northern Small Cap Value Fund.

Wells Fargo Advantage Large Company Growth Fund slightly outperformed for the quarter with a gain of 6.93% versus the Russell 1000 Growth Index, which posted a 6.86% gain. 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. We are concerned that the fund does not seem to be able to put together two good quarters in a row, and we expected it to do better as growth managers in general have done better.

Legg Mason Value Trust outperformed during the quarter returning 6.67%, versus the S&P 500, which was up 6.28%. The fund had outperformed the S&P 500 15 straight calendar years, but it is in the 78th percentile for the one-year period ending June 30, 2007. 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. The fund will remain on the watch list until it puts a few more good quarters together.

T. Rowe Price International Stock underperformed for the quarter posting a 5.91% gain versus the 6.67% gain posted by the international index, MSCI EAFE. The fund has bounced on and off the watch list due to long-term mediocre performance. T. Rowe Price has announced that they will be changing the manager in October, which has us concerned.

Stable Return Fund has been added to the watch list. I know this sounds surprising, but there have been several personnel changes within INVESCO's Fixed Income Department, which automatically places the fund on the watch list. We are not overly concerned, but we will monitor the situation. So far the returns have remained competitive, and the insurance contracts that allow for the stability in stable value remain in place.