457 News

Third Quarter • October 2005 • Rod R. Blagojevich, Governor

Illinois Department of Central Management Services

Q&A

Q. I am getting ready to retire and have heard that Deferred Compensation is again accepting deferrals from lump sum sick and vacation pay out. Is this true?

A. The Deferred Compensation Division is very happy to announce that separating participants can once again defer amounts into the Plan from their lump-sum sick and vacation payout amount. The Department of the Treasury released proposed regulations in May 2005 that reversed their previous position that allowed the deferral only if the employee received the pay prior to the end of the day on their last day of service.

Q. How much can I defer?

A. Any amounts contributed to the Deferred Compensation Plan remain subject to the IRS maximum deferral amount for a given year. During 2005, the maximum is $14,000 or 100% of includable compensation, whichever is less. The maximum for the 2006 tax year is the lesser of $15,000 or 100% of includable compensation. For members of the State Employees Retirement System, the December 16 through December 31 pay period will begin the new tax year. Please work closely with your payroll officer to ensure a correct deferral amount and timely submission of the forms. All change forms must be received by this office in the month prior to the expected change in deferral amount.

Q. Can I defer my lump sum under catch-up?

A. As before, a participant cannot defer their lump sum under the special catch-up provision, but may defer extra amounts under the age 50 catch-up provision. See the Maximum Contribution Levels article in this newsletter for more information about allowable limits.

Vanguard Institutional Index Fund

There is good news for participants investing in the Vanguard Institutional Index Fund. The Deferred Compensation Plan assets of the participants investing in the fund have surpassed the minimum dollar amount required by Vanguard to move to the next threshold of share class. The share class the Plan currently offers is the Institutional Class, which has an expense ratio of 0.05%. The next share class is the Institutional Index — Plus Shares, which has an expense ratio of 0.025%. The minimum amount of assets required for the Plan to move to the Plus Shares class is $200 million. Assets in the Vanguard Institutional Index Fund were $205 million as of the close of the third quarter.

On November 30, 2005, the recordkeeper, T. Rowe Price, will officially transfer the Vanguard Institutional Index Fund to the Vanguard Institutional Index — Plus Shares. This transaction will be fairly transparent. Participants will see the transfer to the new share class when viewing their account online, and the transaction will show on the fourth-quarter statement. The change in share class does not affect the underlying investments, it merely lowers the cost to participants in the fund. In turn, this potentially enhances the return.

Watch List Addition

The Illinois State Board of Investment has hired Iron Capital Advisors, an Atlanta, Georgia-based defined contribution consulting firm, to assist the Board and the Illinois Department of Central Management Services in reviewing its deferred compensation plan and investment options on an ongoing basis to ensure the Plan remains competitive in the marketplace. It's our goal 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.

Iron Capital Advisors will provide CMS quarterly communications that we will begin to pass on to you, the participants. These quarterly communications will review how the economy and the markets performed during the preceding quarter, and identify any issues with the current fund lineup, giving special attention to those funds on the "watch list." The back page of this and subsequent editions of the *457* News will contain a new section highlighting the "watch list," along with a brief explanation as to why each fund is on the list. We will explore methods to provide additional information from the quarterly communications in the future.

2005 Maximum Contribution Level

The maximum contribution limit will increase for the 2006 tax year. The new limit will be the lesser of 100% of taxable salary or $15,000. From this point forward, any increase will be tied to the Consumer Price Index (CPI). Remember, if you are participating in a Section 457 along with a 403(b) or 401(k), you have no coordinated deferral limit. That means you may contribute up to the maximum in both plans.

There are also two provisions of catch-up to consider, age 50 and the regular catch-up. The age 50 catch-up is available to participants beginning the tax year they attain age 50 and older. There is no application or approval process to enroll. The maximum additional age 50 catch-up amount is $5,000 for tax year 2006. Therefore, an employee at least 50 years old may defer a total of $20,000 for the new tax year.

A participant must sign up for the regular catch-up provision through an application process with the Deferred Compensation Office. This is to ensure compliance with federal guidelines. First, the participant must have underutilized deferrals from previous years to "catch up." For example, an employee deferring at the maximum rate since 1979, or from the moment of becoming a state employee, would have no amounts to apply toward catch-up. A second condition is that an employee be within four years of normal retirement age. The catch-up period lasts for three years prior to the year that a participant may retire with unreduced benefits. An applicant cannot participate in the year in which they retire.

In order to change your deferral amount for the next tax year, simply fill out a Deferred Compensation Change Form. It is important to note that your tax year may differ from the calendar year when deferring a specific dollar amount within the year. Legislators are paid monthly, in the month earned, and January will be the first pay period of the taxable year. If you are not a legislator, but are paid monthly, the December pay period will be the first of the next taxable year. If you are paid semimonthly, the December 16 through 31 pay period will be your first for the taxable year 2006. If paid biweekly, you will receive either 24 or 26 paychecks each year and need to see your agency liaison for assistance in determining the first pay period of the taxable year.

A Deferred Compensation Change Form is available from your agency liaison, or you can contact this office directly at 217-782-7006. If you have access to our Web site, you may download a form 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:

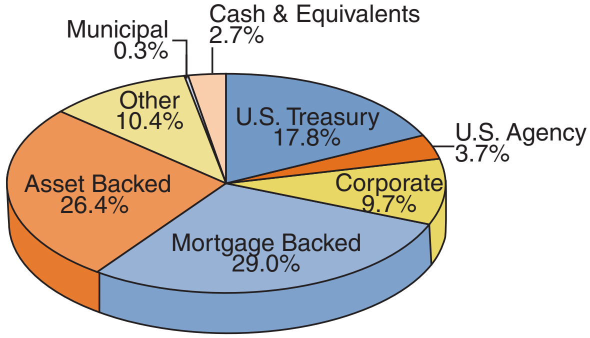
T. Rowe Price Retirement Plan Services
Account Value Information and
Investment Changes: 888-457-5770 or
TDD/TTY 800-521-0325
Internet Access: 800-541-3022
Internet: rps.troweprice.com

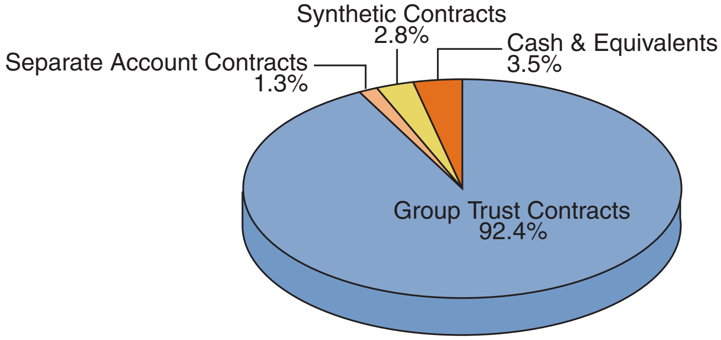
Stable Return Fund Update

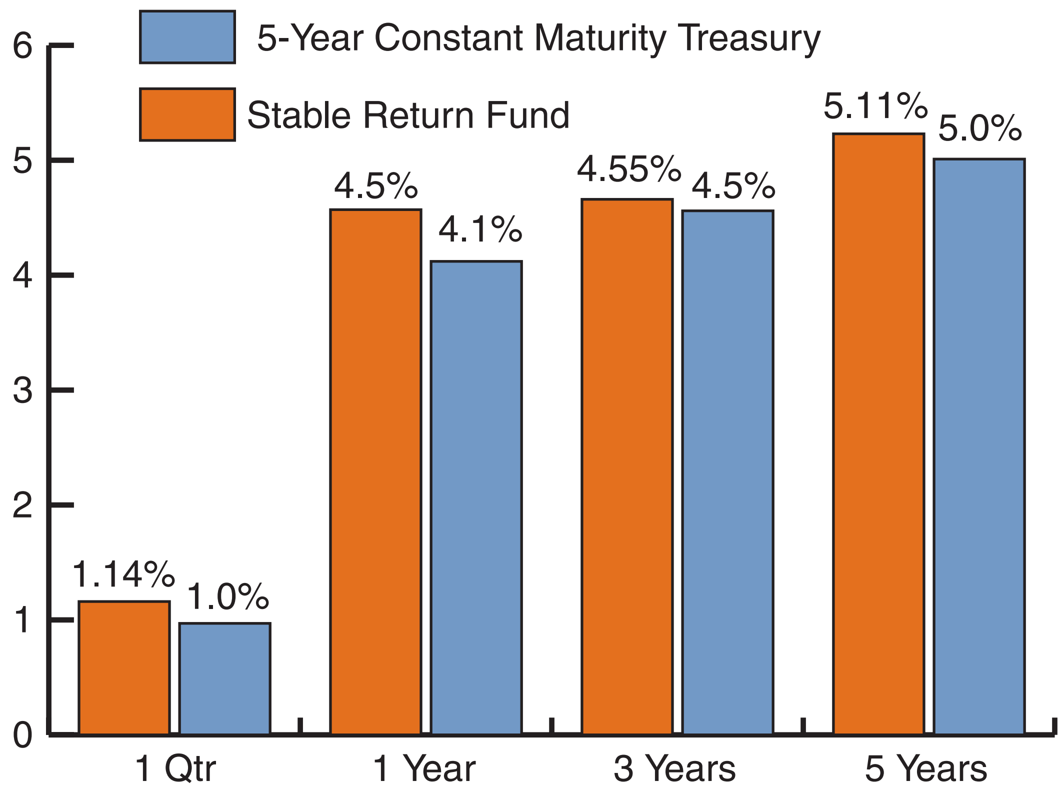
Twenty-two percent of the monies in the Deferred Compensation Plan are invested in the Stable Return Fund, managed by INVESCO. The investment objective of the Stable Return Fund is to seek a steady level of income, while preserving capital. The fund may be appropriate for investors seeking the least fluctuation in principal while earning a competitive market interest rate. Investors with short-term time horizons (less than five years), or those seeking current income, should also consider investing in the fund.

The fund achieves a competitive interest rate by investing in a broadly diversified group of investment contracts issued by high-quality financial institutions, such as insurance companies or banks. Each contract has its own specific terms, including interest rate and maturity date. In some cases, these contracts may be backed by high-quality, fixed-income securities. All investments must be rated AA- or higher.

For additional information regarding these ratings, call INVESCO at 1-800-228-7466.







Past performance cannot guarantee future results.

The income and price information page will no longer be displayed in the quarterly newsletter. This information is available online at the Deferred Compensation Plan's Web site at www.state.il.us/cms/employee/defcom. You will also find links to each investment company's Web site where this information may also be provided. For important information concerning investment options on the "watch list," please read the article below.

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 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 they said they would? If you invest part of your assets in an aggressive fund that is supposed to be investing in the stock 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. First, 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.

   Secondly, there could be firm-level issues. These can include issues such as, involvement in the recent fund scandal, turnover in senior management, or a merger or acquisition. Any of these operational issues will automatically place a fund on the watch list.

The State of Illinois Deferred Compensation Plan

Current Watch List Summary as of 9/30/2005

Ariel Fund has underperformed its index, the Russell 2000 Value index, and its small value peer group for the trailing 3-month, 1-year and 3-year periods. Manager John Rogers avoids investing in energy, utility and technology stocks. He believes they are too volatile and do not represent good long-term investments. Unfortunately, these sectors have performed well, which has caused the fund to lag. On the plus side, Rogers' investment approach has kept the fund's volatility low.

Provident Investment Counsel Small Cap Growth Fund has underperformed its index, the Russell 2000 Growth index, and its small growth peer group for the trailing 3-month, 1-year and 3-year periods. The fund has suffered from a combination of poor sector allocation decisions and poor stock selection. The fund tends to invest in the more risky stocks within a given sector, which has hurt performance. The fund's aggressive style causes its volatility to be significantly higher than average.

T. Rowe Price International Stock Fund is on the watch list due to its relative performance problems a few quarters back. Since that time, the fund's short-term performance has improved. For the 3rd quarter, the fund slightly outperformed its foreign large growth peer group for the trailing 1-month, 1-year and 3-year periods. We will continue to monitor the fund closely for another quarter or two before potentially removing the fund from the watch list.

Wells Fargo Advantage Large Company Growth Fund is on the watch list due to low relative returns and high volatility. For the trailing 1- and 3-year periods, the fund lagged its benchmark index, the Russell 1000 Growth index, and its large growth peers. The fund normally invests little in either energy or utility stocks, two of the best performing sectors in recent periods, which has hurt performance. The fund also focuses on mega-cap stocks, which have underperformed in recent years. On the risk side, the fund's volatility is significantly higher than the large growth peer group average.