457 News

Third Quarter • October 2006 • Rod R. Blagojevich, Governor

Illinois Department of Central Management Services

Investment Option Changes Reminder

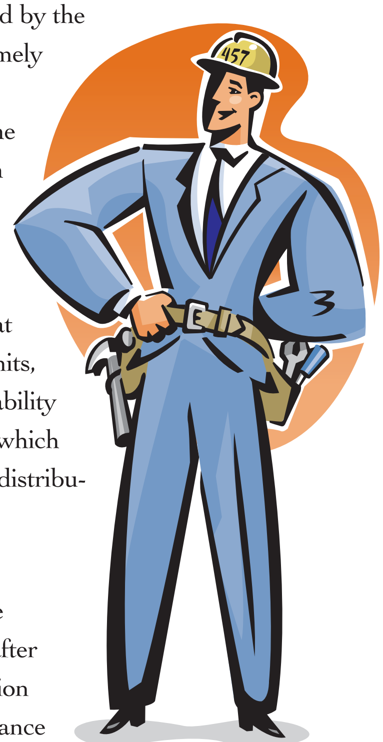
The Illinois State Board of Investment (ISBI), with the help of its independent consultant Iron Capital Advisors, made changes to the Plan's investment lineup in an effort to round out the fund offerings and continue to offer quality options in each asset class. The Deferred Compensation Plan has added one new fund, the Northern Small Cap Value Fund, and began the process of phasing out the Provident Investment Counsel Small Cap Growth Fund.

The Provident Small Cap Growth Fund is being removed from the fund lineup. As of September 29, 2006, at 3 p.m. CT, the fund closed to any new contributions or transfers. Any participant that is deferring a percentage allocation into Provident who did not make a change automatically had those allocations attributed toward the Columbia Acorn Fund, the closest substitute in the Plan. If you do not want your allocations to continue to invest in the Columbia Acorn Fund, you may still make any allocation change to the appropriate investment option(s) of your choice. This can be done anytime, and there is no charge or fee to make a change to your future deferral allocations.

Account balances may then remain in this fund until 3 p.m. CT on December 1, 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. This balance transfer will not count toward your one exchange per calendar quarter at no charge.

The Northern Small Cap Value fund became available for deferrals and transfers on September 29, 2006, after 3 p.m. CT. The fund invests primarily in small-capitalization stocks that the manager believes are selling at a discount to their intrinsic value. This fund may provide an opportunity for participants to further diversify their portfolio in the small-cap value style arena. The Russell 2000 Value Index is the benchmark for the fund.

Federal Legislation



The Pension Protection Act of 2006 was signed by the President on August 17, 2006. This was extremely important for governmental 457(b) plans like Deferred Compensation because it included the permanent extension of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) provisions. This law contained provisions that were set to expire on December 31, 2010. Among the provisions that are now permanent: increased contribution limits, age-50 catch-up contributions, enhanced portability including rollovers, and flexible distributions, which ended irrevocable elections and fixed delayed distribution dates.

Other provisions of the law that may impact participants include the ability of a non-spouse beneficiary to roll over to a Traditional IRA (after 2006) and the potential for Roth IRA conversion upon distribution eligibility (after 2007). Guidance from the Department of Labor is expected to be released to clarify these and other provisions over the next year.

New Trade Policy–Acorn Fund

The Columbia Acorn Fund has requested that the Deferred Compensation Plan adopt a new restrictive trading policy to deter frequent trading within the fund. On November 1, 2006, participants making an exchange out of the Columbia Acorn Fund will not be allowed to exchange account balances back into the fund for a period of 30 days. The Securities and Exchange Commission (SEC) unanimously passed a rule that requires mutual fund intermediaries to identify and restrict the trading of market timers or face potential penalties.

Frequent trading is recognized as when an individual buys and sells shares of a mutual fund for short-term gains. The practice of market timing does not serve the interests of long-term shareholders because it may increase the expenses of a mutual fund and impact the manager's ability to manage cash flow. Because there is no set definition of frequent trading, it is the responsible company's obligation to suppress the activity. Therefore, the Plan may have several trading policies with restrictions that differ. Other fund companies in the Plan that currently utilize trading policies include T. Rowe Price and Legg Mason.

2007 Maximum Contribution Level Increases

The maximum contribution limit will increase $500 for the 2007 tax year. The new limit will be the lesser of 100% of taxable salary or $15,500. The $500 increase was 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 will remain unchanged at $5,000 for tax year 2007. Therefore, an employee at least 50 years old may defer a total of $20,500 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. Applicants 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 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 16-31 pay period will be your first for the taxable year 2007. 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 1-217-782-7006. If you have access to our Web site, you may download a form at www.state.il.us/cms/employee/defcom.

457 News Online

The 457 News that accompanies your quarterly statement can be educational, informative and provide a valuable resource to you as you continue to plan and save for retirement. Articles on portfolio design, asset allocation, and risk and the fund descriptions have hopefully allowed you to select an investment mix that is right for you. In addition, many of the Plan's procedures, rules, and changes are regularly printed to keep you abreast of important factors to consider as well. For your convenience, the 457 News dating back several quarters is available to you on 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

Required Minimum Distributions (RMDs)

If you turn age 70½ in 2006 and have left state service, you must receive your required minimum distribution (RMD) by April 1 of 2007. To calculate your RMD, divide your account balance as of December 31, 2005, by 27.4 if you turn age 70 in 2006, or 26.5 if you turn age 71. This is the minimum amount you must withdraw under the Internal Revenue Code, and you can always choose to receive a larger distribution amount during the year.

If you would like to take only the required minimum distribution amount each year, you can choose the "recalculated life expectancy" option under "Installments" on the Participant Distribution Method Election Form. You may now choose to elect to receive your annual RMD in December of each year. Previously, RMDs were distributed in January or July. Contact the Deferred Compensation Office to change your annual distribution to December. Your minimum will be calculated and distributed to you each year automatically.

Overdeferring Participants

Internal Revenue Service regulations do not allow any deferrals over the maximum to remain invested. It is your responsibility to revoke participation or change the amount of your deferral so you will not exceed your maximum. If you, at any time, have deferred in excess of your maximum, and the overage cannot be corrected through the payroll process, we will not invest the excess and will return it to you as taxable income.

Tax Form 1099-R

If you have received or will receive a distribution from your Deferred Compensation Account during the 2006 tax year, you will receive an Internal Revenue Service 1099-R from T. Rowe Price, the Plan's recordkeeper. The form will be mailed to you at the end of January to comply with the federal requirement that it must be mailed on or before January 31, 2007. You will use this form to file your federal taxes.

Questions?

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

Moving?

If you have recently moved or are planning to move, please notify the Deferred Compensation Office. The notification must be in writing. Just contact the office for a Change Form or mail or fax the information with your signature and Social Security number.

If this change affects any beneficiary, or if a beneficiary's address has changed, you will also need to complete a new Beneficiary Election Form. These forms may also be downloaded from our Web site at http://www.state.il.us/cms/employee/defcom.

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 he or she said he or she 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 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.

The State of Illinois Deferred Compensation Plan

Current Watch List Summary

The following funds are on the watch list as of 9/30/2006:

Ariel Fund performed adequately for the quarter beating the Russell Mid Cap Index and placing it in the 42nd 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 95th percentile for Mid Cap Blend funds over the 12-month period ending September 30, 2006. The fund returned 2.16% for that period versus 9.57% 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 was originally placed on the watch list due to its low relative returns and high volatility. However, the fund had a strong quarter with a 4.54% return versus the Russell 1000 Growth Index, which posted a 3.94% 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. The fund needs to put together a few more solid quarters in a row before being removed from the watch list.

Legg Mason Value Trust remains on the watch list due to underperformance year-to-date. The current market 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.

T. Rowe Price International Stock has been removed from the watch list due to improved performance, but the fund has struggled again this year. The fund underperformed for the quarter posting a 3.45% gain versus the 3.99% gain posted by the international index, MSCI EAFE. The fund has been hurt this year by an overweight to Japan. Japan's future is looking brighter than it has in some time, so the fund's position makes sense; however, it has yet to pay off. The fund performed slightly better than the average Foreign Large Growth Fund ranking in the 48th percentile for the quarter. We will continue to monitor this fund closely.

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