

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 If we believe the fund no longer represents a suitable investment option, we will remove the fund from the Plan.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 09/30/2008:

Ariel Fund The fund has underperformed year-to-date and continues to lag for the longer term periods. The fund ranks in the 99th percentile for Small-Mid Cap Value funds year-to-date through August 31, 2008. However, the fund has rebounded somewhat posting a positive 4.4% return in August. The fund has moved up in market cap and therefore we have reclassified it as a Small-Mid Value fund benchmarked to the Russell 2500 Value 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. We are keeping the fund on the watch list due to the poor performance.

Legg Mason Value Trust continues to be hurt by exposure to financial firms. The fund is in the 99th percentile year-to-date through August 31, 2008. The fund is positioned for the rebound from the credit crunch and housing crisis and should do very well when that happens, but it will continue to underperform as long as the crisis continues. The proposed federal takeover of bad debt should help this fund, but only time will tell. For those wishing for a more stable large cap blend option there is the Vanguard Index fund in the Plan.

Fidelity Puritan remains on the watch list due to a manager change. The fund has underperformed its benchmark but was in the top half of its peer group for the three-month period. The recent issues are primarily due to an overweight of corporate bonds and an underweight to treasury securities within the fixed-income portion of the portfolio. We are not overly concerned about the short-term performance, but any time there is a change in the portfolio management we automatically place the fund on the watch list. We will continue to monitor the new managers closely.

LSV Value Equity has been placed on the watch list due to recent performance. The fund has underperformed its benchmark and is in the 67th percentile year-to-date through August 31, 2008. It has been a rough environment for value oriented managers such as LSV. Most of the pain in the market has come from financials and consumer driven stocks typically favored by value managers. The LSV fund runs a quantitative model that identifies stocks selling at a deep discount. This strategy works well over time but it has not been working over the last year. As long as LSV sticks to their strategy they should rebound when the market shifts back toward value. In the meantime we will continue to monitor them closely.

APPROVED

By Dana Marquette at 12:29 pm, Oct 03, 2008

Insight



A QUARTERLY PERIODICAL DEDICATED TO HELPING YOU PREPARE FOR TOMORROW

WHEN THE MARKET GETS ROUGH, KEEP YOUR EYE ON THE HORIZON

With the economy and stock market extremes all over the news right now, it's understandable how investors' nerves may be frayed. But for those who are investing for a long-term goal—such as retirement—here's some good news: Relax—time is probably on your side.

T. Rowe Price Financial Planner Stuart Ritter suggests that you keep these thoughts in mind when you think about recent market activity:

- **The stock market goes up and down.**

While stocks may be volatile in the short term, the picture over long periods of time is very different. It helps to look at the returns earned during each 20-year period over the last 50 years (1957-1976, 1958-1977, etc.). While a one-year return may look bad, the worst average 20-year return was a 6.5% gain—and that included a year that had a 26.5% loss.*

- **You're in it for the long term.**

If your retirement is still years in the future, keep a long-term perspective. The current market volatility is likely not your personal volatility. The media tends to focus primarily on the extremes of the stock market. That doesn't necessarily represent your portfolio's mix of investments.

Think about your investments as a plant growing in a garden. If you dig them all up in an attempt to avoid exposing them to frost, they won't be there to grow when the sun comes back. Better to leave them alone and weather the storm.

- **Don't try to beat the market.**

When markets are falling, some investors might think it makes sense to protect their assets by moving their money out of an investment. When the market goes up again, they will put their money back where it was. Unfortunately, what they are actually doing is "selling low" and "buying high." That's the opposite of what you want to do. Volatile markets can climb as quickly as they fall.

* This example is meant for illustrative purposes only and is not meant to represent the performance of any investment options offered in your plan. The market index used is the S&P 500. The returns are based on historical information from the last five decades and may perform differently in the future. Evaluation period: 12/31/56–12/31/06. Source: Ibbotson Associates.

- **Dollar cost averaging helps smooth the way.**

Remember, when you are investing for retirement through your retirement plan, you are investing the same amount of money each month so your money buys more shares when prices fall (and fewer shares when prices rise). Over time, you average out the cost of your mutual fund shares.

Rising Market			Falling Market	
Investment Amount	Share Price	Number of Shares Purchased	Share Price	Number of Shares Purchased
\$150	\$10	15	\$10	15
150	12	12.5	8	19
150	14	11	6	25
150	16	9	4	37.5
\$600 Invested		47.5 Shares Purchased	96.5 Shares Purchased	
\$600 invested/47.5 shares purchased = \$12.63 average price paid per share			\$600 invested/96.5 shares purchased = \$6.22 average price paid per share	

For illustrative purposes only. This is not meant to represent any specific investment. Your results will vary. Dollar cost averaging does not assure a profit or protect against loss in declining markets. Since the program's benefits are realized over time, you should be prepared to stay the course during periods of low and high prices.

- **Control what you can control.**

You can't control how the stock market behaves (and you certainly can't undo any losses you might have already experienced). What you can control is how much you save and how well you maintain your investment strategy through all market conditions.

Retirement saving is a long-term commitment

Once you have a strategy in place, the best thing you can do for your future is to keep saving in your tax-deferred retirement account for as long as possible. When you resist temptations to tap into your account for any reason, you increase your potential to enjoy the retirement you deserve.

For more articles on saving and investing strategies, go to the **myRetirementPlan** Web site at rps.troweprice.com and click on the Money® tab.

UPDATE ON STABLE RETURN FUND

There have been many questions about the Stable Return Fund within the plan and its continued safety in this current market environment. Let me start by saying the stable return option is completely safe. If you take my word for it please feel free to skip on to more interesting sections of the quarterly newsletter.

For those who need more convincing and/or comfort let me explain why I can make that statement so confidently even in this environment. To understand the safety of the stable return option one must understand what it is and perhaps more importantly what it isn't.

The stable return option is what we refer to in the industry as a stable value fund. It is managed solely for the State of Illinois Deferred Compensation Plan by INVESCO. It is not a money market fund. This is important because there have been some very well publicized issues with money market funds, funds where you are never supposed to lose money and yet some people have lost money. There has never been a failure of a stable value fund.

Money market funds invest in highly liquid debt securities issued mostly by the treasury but also by corporations. These securities represent very short-term loans that must be paid back in no more than one year, and often as quickly as the next day. Because these securities are highly liquid under most circumstances, and generally considered to be extremely safe the funds are allowed to carry a constant price or net asset value of \$1. So if you put \$100 in one of these funds you get one hundred shares at \$1 per share. You will then receive interest payments that are usually used to purchase additional shares. The constant \$1 share price is maintained by accounting rules and accounting rules alone. Of course under normal circumstances the underlying investments make money and it is not an issue. However, we are not living in normal circumstances. Securities which are normally extremely liquid have proven not to be, and companies that seemed strong have been proven otherwise. As a result some money market funds, which were not carefully managed have lost money or as they say in the business, "broken the buck". This has participants concerned about the safety of their "safe" investments.

Stable value funds, like money market funds, promise a stable value for your money, hence the very creative name. As a result they are often lumped in with money market funds even though they are very different. They are only offered in retirement plans and do not exist elsewhere, which just adds to the confusion.

Because stable value funds are only in retirement plans, they are able to invest in securities with longer maturities that represent loans which are paid back in two or three years. This allows for a much bigger universe of securities and greater diversification. Your stable return option has over 2000 underlying securities. That is a lot of diversification, and of course diversification adds to safety. This also allows stable value funds to avoid many of the areas of the market that have been caught up in this credit crisis. It is not always the case, but in today's market the stable value investable universe is actually safer than the money market fund's investable universe.

Another basic difference between stable value funds and money markets is how they get their stable price. Stable value funds achieve their stable price through insurance contracts on the underlying portfolio. If a stable value fund ever "breaks the buck" these insurance contracts kick in and must pay the difference. Your fund is covered by eight different insurance companies. No company can cover more than 25% of the total portfolio. So not only is the portfolio diversified, but the protection of the insurance contracts are diversified as well. It is also important to note that the insurance industry as a whole is in much stronger shape than other financial institutions. This is largely due to the more conservative standards they must abide by in investing their assets.

Finally, some of you have probably heard that the government is going to offer insurance similar to FDIC insurance for money market funds. This obviously has increased the interest in moving to a money market fund and away from a stable value fund. Well, there is a catch. The proposal before congress only covers moneys already in money market funds. Deposits made after September 19, 2008 will not be covered.

We know that this market environment has been rough, and the faith in our financial institutions has been shaken. It is only made worse by the 24/7 media that sensationalizes every situation including this one. People are scared, and who can blame them? But, you should take comfort in knowing your stable return option is still safe. It is well diversified among high quality securities and the promise of a stable value is backed by eight insurance companies that are in solid financial shape. The money in the stable return option will be there when you need it.

Chuck Osborne, CFA

Managing Director
Iron Capital Advisors

TELEPHONE NUMBERS

Deferred Compensation

Plan Rules/Options Information

800-442-1300/ 217-782-7006

TDD/TTY: 800-526-0844

Internet: <http://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: <http://rps.troweprice.com>

IS YOUR RETIREMENT AROUND THE CORNER?

As retirement approaches, you'll want to reevaluate your priorities.

You've invested for the long term and now your goal is in sight. As your retirement date draws near, you may want to reconsider your goals and investment strategy. No longer will growth and asset accumulation be your primary goal. The spotlight will be on providing stable, sustainable income. This brief article can help you prepare for the big day.

Get pre-retiree tips from T. Rowe Price and state benefit system representatives at local onsite meetings. Check the [web site address] for dates and times of upcoming Pre-Retiree Meetings.

Ready? Five Years Before Retirement.

You're on the final countdown! It's a good time to make sure you're on track to reach your goals. Begin by comparing your current assets to your savings goal. If there is a shortfall, you can make adjustments to your savings rate or your investment strategy.

Next, review the sources of income that will be available to you during retirement, including Social Security, employer pensions, part-time employment, and personal savings and investments. This will help you calculate the amount of income you can expect during retirement. Use the Retirement Income Estimator tool on the **myRetirementPlan** Web site at **rps.troweprice.com** to estimate how much you may receive each month in retirement based on your current 457 balance, savings rate, age, and Social Security estimates.

MANAGING FUNDS: IT'S ALL IN THE DETAILS

Have you ever wondered how mutual fund managers select the investments in their portfolios? Here is an overview of some of their common decision-making practices.

Information gathering and evaluation

A typical day in the life of a portfolio manager starts early. Before most people have hit the snooze button, portfolio managers are in the office reviewing economic data, reading about world events, and gathering other information that could have an impact on the investments in your mutual fund portfolios. Whether they're watching news reports, reading financial publications, or reviewing research, portfolio managers are constantly evaluating information that may influence markets and ultimately affect the performance of your funds.

There is so much information in the marketplace that most managers rely on research analysts to help them forecast economic changes and interpret the impact these changes may have on fund holdings. Analysts also work to identify new investment opportunities and track the performance of current holdings. In general, research analysts specialize in one or more industries or sectors. For example, an analyst may cover manufacturing or beverages and restaurants. Some are responsible for geographic areas, such as Europe or Japan.

A disciplined approach to investing

Every portfolio manager works to meet his or her mutual fund's objective, which is defined in the prospectus. Some of the most common objectives are pursuing capital appreciation, generating income, or providing stability of principal. Every investment must support the portfolio's "buy discipline." Buy disciplines are guidelines, established by portfolio managers, that help determine which investments may be appropriate for a particular fund.

You should also make sure your portfolio is invested appropriately. If you invest too aggressively, a market downturn could significantly affect your savings. If you invest too conservatively, your savings may not keep pace with inflation. For help developing and tracking your investment strategy, log in to the **myRetirementPlan** Web site at **rps.troweprice.com** and use the free Morningstar¹ tools available there.

Get set. One year before retirement.

This is it! You need to think about the distribution of assets from your retirement plan. Do you want to take your savings in a lump sum and pay taxes? Or would you rather roll over your savings into an IRA and make withdrawals as you need the money? A T. Rowe Price retirement specialist can help you with these decisions. Just call **1-888-445-4226**.

Go! It's time to retire.

When you reach your retirement date, you'll be ready to enjoy a new stage of life. You'll probably have lots of questions, too. T. Rowe Price has a variety of resources available to help you ease into retirement. You can request personal assistance, informational kits and guides, online tools, and other resources by calling **1-888-445-4226**. Our retirement specialists are available business days between 8 a.m. and 10 p.m. eastern time.

¹ Morningstar, an independent provider of research and analysis for investors, is based in Chicago and supplies investment information on mutual funds, stocks, and variable annuities.

For example, a bond fund's prospectus may state that its manager may generate income by investing in cash equivalents and investment-grade bonds, which are generally higher-quality, lower-risk bonds with moderate return potential.

Once a list of potential new investments is developed, managers carefully review each opportunity. They evaluate a company's products, customers, and finances; talk with managers and employees to better understand the culture; and determine whether the company's established goals are being met. If a company measures up to the manager's expectations, its stock or bonds may be added to your fund's portfolio.

A disciplined approach to selling

The decision to sell is just as important as the decision to buy. As a result, many managers have "sell disciplines." These are guidelines, established by portfolio managers, which help determine when an investment should be removed from a portfolio. For instance, a mutual fund that invests in small companies may have a size limitation. Once a company no longer meets the size criteria for inclusion in the fund, it may need to be removed from the portfolio.

When portfolio managers and research analysts head home, they rarely leave their work behind. Even outside of the office, they are always looking for the next "best" idea. These professionals are working to help you pursue your financial goals by uncovering investment opportunities, evaluating potential, and buying and selling investments in a timely way, every day.

Call 1-800-457-5770 to request a prospectus, which contains complete information, including investment objectives, risks, fees, and expenses, that you should read and consider carefully before investing.

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