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 If we believe the fund no longer represents a suitable investment option, we will remove the fund from the Plan.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 9/30/2009:

Ariel Fund: The fund's performance for the year-to-date period ending August 31 has shown much improvement as it posted an impressive +40% return versus +21% for the benchmark. Individual holdings, such as CB Richard Ellis and Royal Caribbean, have been the source of the fund's second-quarter success. The fund's longer-term performance however, has lagged its benchmark and its peer group. This fund will remain on the watch list due to longer-term underperformance but more recent performance has been notable.

Legg Mason Value Trust: This fund has also recently shown signs of improvement as it handily outpaced its benchmark and peer group over the month of August and the year-to-date period. However, longer term this fund's performance continues to lag its peer group and the benchmark. This fund's overall volatility score, a measure of overall risk, is also very high versus its benchmark. This fund will remain on the watch list due to longer-term underperformance.

Fidelity Puritan Fund: This fund had a change to its underlying lead portfolio manager, which occurred in February of 2007. As a result of this change, the fund was placed on the watch list. Since that change, the fund has performed close to the median of its peer group. Over the one-year period the fund lags its benchmark, but for the year-to-date period the fund posted a gain of +17% versus +11% for the benchmark. The fund keeps the allocation of stocks to bonds fairly tight to the target of 60% stocks and 40% bonds. A slight underweight to equities detracted over the second quarter as equities posted significant gains, but an overweight to financial issues in the equity portfolio added value as many banks were rewarded for improved credit markets. This fund will remain on the watch list due to the short investment manager tenure.

Janus Adviser International Growth Fund: Although this fund's performance has been stellar with significant outperformance of its benchmark and peer group, this fund was recently placed on the watch list due to organizational changes at Janus. In July of 2009, the Janus Capital Group Board announced the departure of Chief Executive Officer Gary Black. Mr. Black was credited with bringing about several changes to the firm including a move towards best practices in the investment group. Janus is currently searching for a replacement. As a result of organizational changes at the firm, this fund was placed on watch status. An alternative fund for participants to choose is the Invesco International Growth Fund as it also invests in large-cap international stocks.

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DISTRIBUTION SERVICES MOVING TO T. ROWE PRICE

Effective Immediately

T. Rowe Price Retirement Plan Services, Inc.—your Deferred Compensation Plan recordkeeper—will begin to provide distribution services **directly** to participants who are eligible to receive distributions from the Plan. Rather than submitting your distribution request or your request for installment schedule changes through the Department of Central Management Services (CMS), eligible Plan participants will be able to conduct distribution transactions and changes over the phone directly with T. Rowe Price.

What you can expect:

- **IMPORTANT! Regularly scheduled distribution payments will continue without interruption.** If you are currently receiving installment payments from your account, these payments will continue to be made on the scheduled day.
- **Payment options remain the same.** The Plan continues to offer total and partial distributions, including Total Lump Sum, Partial Lump Sum, Installments, Fixed Dollar Installments, and Rollovers. Or, you may leave your money in your Deferred Compensation account until you are required by law to begin receiving it.
- **NEW! Streamlined, *paperless* transactions!** Forms are no longer needed to request a distribution or to request a change to an existing installment schedule. Simply call T. Rowe Price at **1-888-457-5770** to discuss your options with a Distribution Services Specialist. Eligible participants who request a distribution prior to 4 p.m. eastern time will have their transaction processed *that day*, providing everything is in good order.

To learn more about your distribution options, call T. Rowe Price at **1-888-457-5770**, or visit the ***my*RetirementPlan** Web site at **rps.troweprice.com** and click the **Distributions** tab.

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

YOUR RETIREMENT READINESS GUIDE

As we make the announcement that your distribution services are moving to T. Rowe Price, we thought it also appropriate to discuss one of the primary reasons participants take distributions from the Deferred Compensation Plan—to begin, and hopefully enjoy, retirement!

These are the bedrock requirements to enjoying your retirement years:

1. Have sufficient income to maintain your lifestyle in retirement
2. Ensure that you will not run out of money
3. Maintain your purchasing power over the course of a lengthy retirement
4. Have a financial cushion for unexpected expenses
5. Pass on what you want to your heirs

(Continued on next page)

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There is no shortage of other potential retirement goals, but we recommend focusing on strategies that put you in the best position to achieve these five targets. Once these bases are covered, you can approach your other ambitions from a position of financial strength.

At the least, you'll want to establish a set of priorities going into retirement. But you can add more substance to your visualizations by sketching out a retirement budget. Anticipate what your everyday expenses will be in retirement and consider what kind of bigger-ticket items will need to be factored in as well.

Determine Your Retirement Budget

Your everyday expenses in the early years of your retirement may be relatively easy to estimate. But the most effective expense planning anticipates every contingency—including some that may not come about for another 20 years or more, such as a move to be nearer to your children, a major illness, or the need for assisted living.

The expense projection checklist shown below will help provide a more specific picture of your financial requirements. If you maintain a budget, you already have most of the information you need. If you don't, the checklist is a good way to get started.

Projecting Your Expenses for One Year

You may want to begin with an inventory of current expenses, both essential and discretionary, as a basis for projecting your in-retirement costs. Or go directly to the "Projected" column if you have a good sense for what you're spending now, but do take into consideration changes in your spending patterns that may occur in retirement. For example, you won't be commuting to work each day, and you may need less dry cleaning. Note that income taxes are not included in these projections.

What About Taxes?

Taxes in retirement can vary dramatically, depending on both the amount of income you have and the source of that income. Many retirees find that their taxes drop sharply because their earned income declines. Others may be surprised at how large a bite Uncle Sam takes.

Before retiring, you should at least review the kinds of taxes you'll probably have to pay during retirement. In addition to quarterly estimated taxes on your income, you'll at minimum need to understand tax treatment of retirement account withdrawals or distributions, early withdrawal penalties, and gift and estate taxes. By familiarizing yourself with them now, you can possibly avoid some tax surprises later on.

EXPENSES

Category	Current	Projected	Have you considered?
Housing (Mortgage, utilities, telephone, cable, maintenance)	$	$	
Food	$	$	Will you be eating at home for more or fewer meals?
Transportation (Fuel, loan payments, maintenance, etc.)	$	$	
Clothing, personal care	$	$	Will your clothing expenses be lower if you're not dressing for the office each weekday?
Professional, educational	$	$	
Insurance (Medical, dental, vision, hearing, prescription drug, life, disability, property/casualty, auto)	$	$	Medical insurance and expenses, like those for prescription drugs, tend to increase over time. While the general population in America spends about 5% of annual income on health care, those age 65 and over spend about 12% and those over 75 about 14%. (Medicare benefits are not available until age 65, regardless of when you retire.)
Uninsured health care (Out-of-pocket expenditures for office visits not covered by medical insurance, the portion of prescription costs not covered, vision and/or dental if not included in your medical plan.)	$	$	
Dependent care/support	$	$	If you currently support dependents, do you anticipate continuing that support into retirement?
Professional services (Lawn care, housecleaning, maintenance, accounting, tax preparation, attorney fees, etc.)	$	$	
Property taxes (Income taxes are considered elsewhere in the guide)	$	$	
Other	$	$	
Total	$	$	

A tax professional can assist you with estimating your liabilities in the first few years of retirement. Tax-estimating software programs may also prove to be helpful and informative.

Tax-Wise Withdrawal Strategies

A tax advisor can also help you navigate tax laws that apply to withdrawals from your retirement accounts. However, there are several rules of thumb you can use as a starting point.

It is generally more advantageous to withdraw assets from taxable accounts before tapping into those that are tax-deferred. However, note that there are generally minimum distribution amounts you must take from your tax-deferred retirement account assets once you attain age 70½ (some exceptions apply if you are still employed). These are called required minimum distributions (RMDs), and they are discussed further in the next section.

If you are married, the older spouse should begin taking withdrawals first. Tap any Roth IRA assets last since any growth in Roth IRAs is not subject to further taxation (assuming several rules are met). Roth IRAs are also not subject to RMDs while the IRA account owner is still alive. As your estate planning attorney will inform you, they can be excellent tools for leaving a legacy to your youngest heirs because they may provide decades of tax-deferred growth as well as tax-free distributions to your heirs.

What You Need to Know About Required Minimum Distributions

Many types of tax-advantaged retirement plans are subject to required minimum distributions (RMDs), which require you to take a minimum amount out of each account for the year you reach age 70½ and for each year thereafter (although some exceptions apply if you are still employed). Assets you withdraw generally qualify as income and are subject to income tax. RMDs apply to the following types of accounts:

- IRAs (Traditional, Rollover, SEP, SIMPLE, and SAR-SEP)
- IRA certificates of deposit (CDs)
- 403(b)s
- Certain other employer retirement plans, such as your State of Illinois Deferred Compensation Plan

RMD rules do not apply to Roth IRA owners or to spousal beneficiaries who elect to treat the Roth IRA as their own.

You usually must take your first RMD by April 1 of the year after you turn 70½. For each year after the year in which you turn 70½, you must take an RMD by December 31.

Your RMD is based on your current age and your year-end account balance for the prior year. Since both of these factors change each year, your RMD must be recalculated each year. If you have multiple retirement accounts, you must calculate the appropriate RMD for each one. It is important to know that RMDs are not optional—even if you don't need the money. Any year that you don't take your RMD, or take too little, the IRS may assess a penalty equal to 50% of the required amount not distributed by the deadline.

DETERMINE YOUR RETIREMENT READINESS

How do you know when the right moment has come to retire? Determining when to retire doesn't have to be strictly a financial decision. Many people find that they prefer the activity and social interaction of working, and if that's the case, there's no reason to rush into retirement. But often, the answer rests largely on whether you have the financial wherewithal to get by without a regular paycheck.

A good rule of thumb is that you may need to replace approximately 75% of your pretax income when you retire. This percentage reflects the fact that everyday expenses typically decline in retirement (you are no longer saving for retirement) and assumes that you wish to continue the standard of living you enjoyed before retirement.

That 75% should ideally be composed of the following income sources:

- 50% from your investments
- 20% from Social Security
- 5% from other sources (such as pension income or a part-time job)

These rules of thumb are not set in stone. You may decide that you want to simplify your life in retirement and don't need to replace as much income. Or you may want the ability to spend more in retirement than you did when you were working, now that you'll have more time to enjoy it.

The choice is up to you, but you should be as realistic as possible about how much income you'll need and whether your assets can produce it. To determine that, you must gauge how much income you can plan to take from your investments.

Determining the Size of Withdrawals From Your Investments

Gauging the correct amount to withdraw and spend annually from investments has always been a difficult decision for near-retirees. Withdraw too little annually and you limit your options in the near term; withdraw too much and you could face an empty nest egg in your later years.

There are thousands of potential market scenarios to determine which withdrawal strategies generate the greatest probability of not running out of assets before the end of a 30-year retirement, lasting to age 95. Research has demonstrated that an appropriate initial withdrawal amount is approximately 4% of your total retirement investments. Thereafter, the strategy assumes you will increase your withdrawal dollar amount by 3% each year to combat inflation.

Example. An initial withdrawal amount of 4% from a $500,000 asset base establishes $20,000 as the first year's withdrawal (i.e., $500,000 x .04). In the second year of retirement, this initial amount is increased by 3%, or $600, for a total second-year withdrawal of $20,600 (i.e., $20,000 x 1.03). In the third year, the new amount is increased by 3% to $21,218 (i.e., $20,600 x 1.03).

This initial withdrawal amount may seem conservative, but research shows that it will give your nest egg a better chance of lasting in retirement. Additionally, this conservative approach may limit the loss of principal if there is a market downturn early in your retirement, as well as provide a much greater chance that you will not outlive your assets, regardless of market volatility.