Insight

A QUARTERLY PERIODICAL DEDICATED TO HELPING YOU PREPARE FOR TOMORROW

IRS LIMITS FOR THE 2011 PLAN YEAR

To help you better prepare for the upcoming year, below is a summary of the 2011 salary deferral contributions you can make to your State of Illinois Deferred Compensation Plan (457 Plan):

- The IRS annual salary deferral dollar limit for before-tax contributions is $16,500.
- For participants who will be age 50 and older, the age 50 catch-up provision allows you to defer up to $22,000 in before-tax contributions. (This includes the $16,500 maximum before-tax contribution allowed by the IRS plus an additional $5,500.)
- The 457 special catch-up provision is $33,000. (This provision can only be elected during the three years (consecutive) prior to, but not including, the year the participant attains normal retirement age, as defined by the 457 Plan.)

1099-Rs will be mailed by January 31, 2011.

REQUIRED MINIMUM DISTRIBUTIONS

If you turn age 70½ in 2011 and have left state service, you must receive your 2011 required minimum distribution (RMD) by April 1, 2012. To calculate your RMD, divide your account balance as of December 31, 2010, by 27.4 if you turn age 70 in 2011 or 26.5 if you turn age 71. This is the minimum amount that you must withdraw from your account.

Each year thereafter, you must receive your RMD by December 31.

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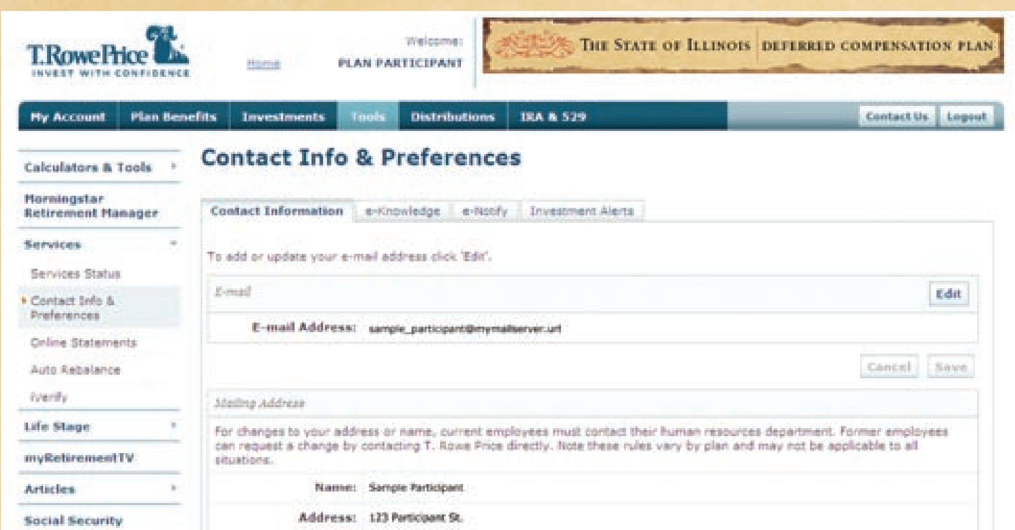

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MAKING THE MOST OF TIME

Investing for retirement is about acquiring enough savings to be comfortable financially after you no longer draw a regular paycheck. To invest successfully for the future, you need to put money aside consistently in order to benefit from the power of compounding and make the most of tax-advantaged retirement accounts.

Two Powerful Tools

Living the retirement you envision will require more than a few years' worth of savings. Given that people today are healthier and living longer than ever before, you should plan on building a nest egg capable of providing regular income until at least age 95. Keep in mind that financial experts suggest that you may need to replace 75% of your preretirement income—half of it from your investments and the remaining 25% from Social Security, a pension, or a part-time job—in order to maintain your lifestyle in retirement. This means your balance at retirement should be 12.5 times your final salary. For example, assuming a 4% initial withdrawal amount, an investor earning $50,000 at age 65 would need about $625,000 to generate $25,000 annually, half of preretirement income.

That may sound like a high mountain to climb, but you have two key tools to help you on your way: compounding and tax-advantaged investments. In order to get the maximum benefit from them, and to give yourself the best chance to reach your goals, you'll need to contribute consistently over a long period, with an annual target of 15% of your income. If that's too much for you today, save what you can now, but know that increasing your contributions by just 1% to 2% each year can have a big impact on your retirement income potential.

Compounding

Compounding occurs when your investments generate earnings, which in turn can generate more earnings as your savings potentially build. (See the example at right.) Say you invest $10,000 and earn an 8% return the first year. You now have a $10,800 balance. Over the next year, the same 8% return will produce more—$864—since your previous year's earnings are also earning that return.[1]

The results of compounding can be significant over time—and even more impressive if you contribute consistently to an account.

Tax-Advantaged Investing

To help you reach your goals, the government allows you to contribute before-tax income to the Deferred Compensation Plan, which enables you to reduce your taxable income and may lower your current tax obligation.

Contributing consistently over time (without stopping) significantly increases the growth potential of your retirement plan account. And the earlier you start, the more you'll be able to benefit from compounded, tax-deferred returns.

[1] *This example is for illustrative purposes only and is not meant to represent the performance of any specific investment option.*

GAINING SAVINGS MOMENTUM

To see the importance of starting to save early, consider three investors—Carol, Bill, and John—who each contribute $250 per month to a retirement plan at different stages of their careers and with varying consistency. Carol, who keeps contributing and remains in the market for 30 years, ends up with significantly more savings than the other two. And note the power of starting early: Bill stops contributing after only 10 years, but his savings compound over the full 30 years, resulting in more money than John's 20 years of contributions (started 10 years later).

The Advantage of Tax-Deferred Compounding

This example is for illustrative purposes only and is not meant to represent the performance of any specific investment option.

* *Assumes an 8% average annual rate of return.*

INCOME TAX INFORMATION

Currently Deferring Participants

If you are actively deferring into the Plan, your taxable income was reduced thanks to your participation in the Deferred Compensation Plan. You will only report the wages shown in Box 1 of your W-2 statement on your income tax form. Your wages reported in Box 1 show your gross wages reduced by the total amount of your 2010 deferrals and any other tax-deferred and tax-exempt deductions.

Your W-2 statement will reflect contributions to the Deferred Compensation Plan (457). If the "Deferred Compensation" box in the lower right-hand corner of the W-2 is marked "X" it means you contributed to the Deferred Compensation Plan in 2010; the amount of your deferral is indicated in Box 12 with a "G" coding. Remember, you do not report your deferred compensation anywhere on your income tax form.

For Participants who took a distribution in 2010

If you received a payment from your account during the 2010 tax year, you will receive a separate 1099-R from our recordkeeper, T. Rowe Price, by January 31, 2011. Box 2a of your 1099-R will list the taxable amount of your distribution(s) you received during 2010 and should be entered on line 16b of your 1040 form. Box 7 of your 1099-R shows the distribution code for the type of distribution received. A code of "7" in this box indicates a normal distribution for a participant age 59½ or over. If you were under age 59½, box 7 will be coded with a "2" to indicate that your 457 plan distributions are not subject to the 10% additional tax on early distributions.

For federal income tax purposes, your deferred compensation, plus any earnings, is taxable as ordinary income when it is distributed. Deferred compensation distributions are reported along with other earnings on line 7 of your income tax Form 1040. Deferred compensation distributions are not subject to State of Illinois income tax. Report the distribution in the "federally taxed retirement and Social Security" subtraction section, line 5 of your Illinois return.

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

MANAGE YOUR DEBT

Getting control of credit card and other debts can make you feel better and have a lasting impact by freeing more money to put toward your retirement. The key is to eliminate your most costly debts first—by cutting back on your spending.

UNDERSTAND INTEREST RATES

Not all debt is created equal. The interest rate is an important factor. Let's say you owe $5,000 on each of two credit cards: Both require a $200 minimum monthly payment, but one charges 11% interest while the other charges 18%. At $200 per month, you'd retire the debt on the first card in almost two-and-a-half years, paying $700 in interest. The second card would take three more months to pay off, with $1,300 in interest—about a quarter of the amount you borrowed.

PAY MORE, SPEND LESS

To begin, write down all your debts. Then approach the one with the highest interest rate first. Pay as much above the minimum as your budget allows, while covering the minimum on the others. The more you reduce the balance, the less time it will take to eliminate the debt and the less interest you'll pay. By cutting back on your spending (but not your retirement plan contributions), you can free up extra money to pay down higher-rate credit cards more quickly.

KEEP CONTRIBUTING TO YOUR PLAN

When faced with debt, you may be tempted to suspend contributions to the Deferred Compensation Plan or to borrow money from your plan to pay off the debt. But remember that every dollar you put into your plan has the potential to help build security for your future, so keep contributing while you eliminate debt. As you get your debt under control, you can save more toward the retirement you envision.

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 12/31/2010:

Ariel Fund: The fund's performance in 2009 was impressive, outperforming 95% of its peer group with a total gain of +63% versus a benchmark return of +34%. The fund's results in 2010 have been closer to the median mid-cap manager with a year-to-date gain of 16%, matching the return of the benchmark. Over the course of 2010, positive contributors to performance have been stock picks and an overweight in the consumer sector. The portfolio manager's strategy of investing in beaten-down luxury brands like Royal Caribbean Cruises (+39%) and Sothebys Holdings (+39%) added value to results. The fund's longer-term performance as measured by the five-year annualized return, however, continues to lag its benchmark and its peer group coupled with higher risk as measured by standard deviation and beta. Participants also have access to the Northern Small-Cap Value Fund, which invests in a small-cap value equity style. This fund will remain on the watch list due to longer-term underperformance but the recent outperformance is noteworthy.

Columbia Acorn Fund: The fund was recently placed on watch-list status due to a significant short-term change in the lead portfolio management of the fund option. Columbia Acorn announced the lead portfolio manager, Chuck McQuaid, is taking a three-month sabbatical beginning on January 14, 2011. He has served as Columbia Acorn's portfolio manager for over 30 years and has publicly communicated that he will resume all investment management responsibilities on April 1, 2011. Upon his departure, the fund's current co-portfolio manager Rob Mohn, who also serves as the firm's director of research, will assume lead portfolio manager responsibilities. He has served as co-portfolio manager for seven years. Due to the significant change in investment management over the short term, the fund will be closely monitored over the next few months. An alternative fund for participants to choose is the Northern Small-Cap Value Fund as it also invests in small-cap stocks.

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