THIRD QUARTER 2011 | PAT QUINN, GOVERNOR

Insight

A QUARTERLY PERIODICAL DEDICATED TO HELPING YOU PREPARE FOR TOMORROW

OVERCOMING YOUR FEAR OF THE MARKET

Some investors are wary of the stock market and keep too much of their portfolio in bonds and money market/stable value investments. This approach can lower your ability to continue growing your savings so you'll have enough for retirement.

Beating the Effects of Rising Costs?

When you are investing over the long term, swings in stock prices are less important than how well your investments perform over years and decades. Because prices for goods and services tend to steadily rise over the years (inflation), your investments should grow at a rate that keeps pace with those costs. Think of having $100 in a bank account, paying 2% interest. After a year, you have $102. But if inflation were 3%, you'd need $103 just to buy what $100 bought a year ago. This effect is even more dramatic when planning for a retirement that could last for decades. For example, a movie ticket costing $9.75 today will likely be about $24 in 30 years. (For more examples, use the Inflation Estimator on the T. Rowe Price website at **rps.troweprice.com**. To access the calculator, click on Tools, then Calculators & Tools.)

Now consider that over the past 50 calendar years, the average annual gain of the S&P 500 stock index was 9.45%, which easily outpaced the 4% inflation rate over that same period. Intermediate bonds, meanwhile, grew an average of 7.12%, beating inflation by just 3.12%.[1] So without stocks in your portfolio, your savings might have significantly less buying power than you anticipate.

Market Timing Doesn't Work

Over the past several years, inflation has remained lower than the historic average and stocks have not performed as well as they have in the past. This leads some investors to think they can wait until the markets return to normal before investing in stocks again. But efforts to time the market (buying and selling according to how the market is performing right now) usually hurt performance. If you continue to invest through a temporary lull in stock values, you may be able to purchase stocks at attractive prices and benefit when the market rebounds.

Although the past is no guarantee of future performance, history suggests that taking a long-term view of stocks works best. Consider a woman who invested $10,000 in stocks in April 1995. Assuming she reinvested her dividends, she would have accumulated $30,652 by March 2010.[2]

Sticking with Stocks

All investments include some market or inflation risk. The way to manage those factors is to consider your time horizon and adjust your allocation to stocks, bonds, and money market/stable value investments. As you approach retirement and the need to access your money, you may want to increase your allocation to bonds and stable value investments, so that your portfolio is better positioned in the event of market volatility. An investor with 15 years until retirement might keep nearly 80% invested in stocks. By retirement, the mix may be adjusted so that stocks represent 60% of the portfolio. Stocks should remain an important part of your portfolio because they can provide the growth potential needed to sustain your income stream throughout your retirement.

[1,2] *Ibbotson Associates, a division of Morningstar, Inc. This example uses the performance of the S&P 500. It is for illustrative purposes only and not meant to represent the performance of any investment option in your Plan. It is not possible to invest directly in an index.*

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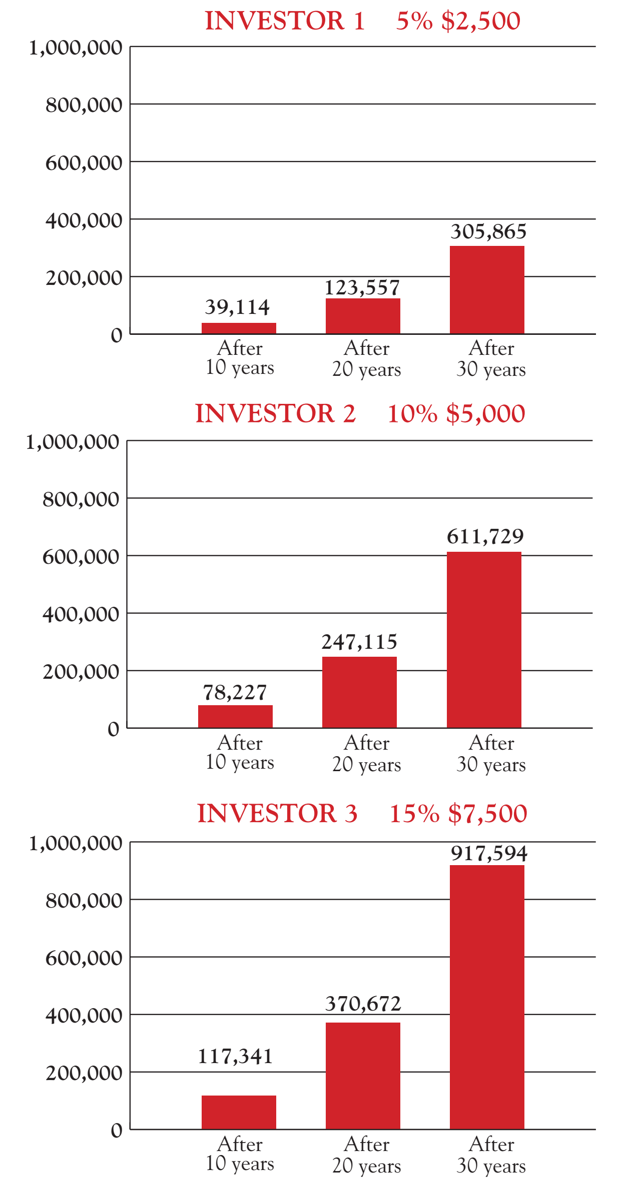
THE BENEFITS OF SAVING MORE

Increasing the percentage of salary you save may have a significant impact on the amount you accumulate for retirement. Consider three investors earning $50,000 per year and contributing to a workplace retirement plan. The first saves 5%, or $2,500 per year. The second puts away a total of 10%, or $5,000. The third finds ways to cut expenses and puts away 15%, or $7,500 per year.*



** Assumes an annual compounded growth rate of 8% and a starting balance of zero. This example is for illustrative purposes only and not meant to represent the performance of any specific investment.*

WHEN TO TAKE SOCIAL SECURITY

Though he's still at the height of his career at age 55, Andrew is already looking ahead to a fulfilling retirement of travel, hobbies, and time with his grandkids. Managing his Social Security benefits can help him realize those goals.

An empty nester, Andrew always assumed he would stop working at age 62, when he'll become eligible to start collecting $1,480 per month in Social Security payments (an annual benefit of $17,760). But after calculating his overall expected income, he realized the numbers don't reach the level he'll need to retire with peace of mind. Financial experts suggest that most people will need 75% of their preretirement income to start off, with a cushion of continued growth to absorb the rising cost of goods and services.

Maximizing Benefits

To boost his retirement income, Andrew plans to delay taking Social Security benefits for a few years. The Social Security Administration increases the amount you can receive by 7% to 8% for each year you wait, up until age 70. Based on today's numbers, if he holds off until age 70, his benefits will rise to $2,782 per month, or $33,384 per year.

Minimizing Financial Cares

To make sure he has sufficient income after he stops working, Andrew realized he'll also have to postpone his retirement. Those extra years of work after age 62 will enable Andrew to continue contributing to his employer-sponsored savings plan, allowing savings to potentially grow along with expected Social Security benefits. This strategy gives Andrew more confidence and security because he knows he'll be able to enjoy his retirement with fewer concerns about meeting his expenses.

To calculate your expected benefits, use the Social Security Calculator on the T. Rowe Price website at **rps.troweprice.com**. To access the calculator, click Tools, then Calculators & Tools.

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

THE HEALTH CARE LAW AND YOUR CHILDREN

Extending insurance benefits and college loan opportunities for families.

Coverage for More Kids

Part of the new Health Care and Education Reconciliation Act, passed in March, increases access to health care and education for children. Though much of the law won't take effect for years, some changes designed to help parents extend health coverage for their children will happen much sooner. About 30% of young adults ages 19 to 29 in the United States lack health insurance, often because they no longer qualify for their parents' plans and don't yet have jobs that provide them with their own coverage.[1] Starting this September, they can remain covered under their parents' plans until age 26, even if they are married. To qualify, they can't have jobs that offer insurance, and they must be claimed on their parents' tax return as dependents.

Another major hurdle for many families has been finding coverage for children who already have medical issues. Starting in September, insurance companies won't be able to deny coverage to children under age 19, regardless of any pre-existing condition. After 2014, adults will get the same protection.

Help Pay for College

While saving is the best way to prepare for the rising cost of higher education, loans can provide additional help. Under the new law, the Department of Education will have direct control over all federal student loans, eliminating the fees that went to banks. Among the changes, no matter how much a student owes, repayment will be capped at 10% (instead of 15%) of his or her discretionary income. And the outstanding amount of the loan will be forgiven after 20 years, instead of the current 25. The law also provides for an increase in educational Pell Grants available to students from low-income families—to a maximum of $5,975 (as opposed to the current $5,550)—by 2017.

If you have children, be sure to consider what the new law means for their health coverage and education.

[1]*The National Conference of State Legislatures.*

FINANCIAL UPDATE: TEST YOUR KNOWLEDGE OF BONDS

1. When you buy a bond you are:

   A. Buying part ownership in a company.

   B. Lending money.

   C. Putting money in a savings account.

2. When a bond matures, it means:

   A. It becomes more sophisticated and complex.

   B. The entity you lent your money to repays it to you.

   C. It is converted into a stock investment.

3. As you age, you should consider:

   A. Keeping your investment mix as it is.

   B. Decreasing your percentage of bonds.

   C. Increasing your percentage of bonds.

Answers

1. B. A bond is an IOU from a government agency or company. You lend the entity money that is needed for a project or to meet expenses. In return, the government agency or company makes periodic payments, known as interest. When the bond matures, you receive the full amount of your investment, known as the principal.

2. B. When a bond matures, the investor gets back the principal. Most retirement plans offer bond funds, in which the principal of each individual bond is automatically reinvested when a bond matures.

3. C. Because bonds tend to offer steadier returns, it makes sense to start increasing the ratio of bonds to stocks once you're within 10 years of retiring. Keep in mind, however, that it's still important to maintain your portfolio's growth potential throughout retirement with a significant allocation of stock funds.

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 9/30/2011:

The State of Illinois Deferred Compensation Plan Current Watch List

Ariel Fund—Ariel recently announced that Kenneth Kuhrt will join John Miller as portfolio managers of their small and mid-cap strategies including the Ariel Fund, with John Rogers maintaining the lead portfolio manager position. This change was announced in their separate accounts and will most likely change in the mutual funds early next year. Mr. Khurt has accumulated a 7 year working history at Ariel and is being promoted due to his contributions to the investment process. Kenneth also serves as portfolio manager on the micro-cap product and Ariel Discovery Fund. From a performance perspective, over the five year trailing period the Fund's return underperforms the benchmark and ranks in the 80th percentile of its peer group as of August 31, 2011. The Fund's performance improved significantly in 2009, ranking in the 5th percentile of its peer group as well as a strong showing in the fourth quarter of 2010. The risk scores however are significantly higher than the peer group on a longer term basis. This fund will remain on the watch list due to longer term underperformance. Participants also have access to the Northern Small-Cap Value Fund which invests in a small-cap value equity style.

Invesco International Growth Fund—The fund remains on watch list status due to a recent change in portfolio management. On Friday, June 10, 2011, Invesco announced the departure of long-term co-lead portfolio manager, Barrett Sides. Mr. Sides had worked along-side his counterpart co-lead portfolio manager, Clas Olson, since 1994. Mr. Olson assumed full lead portfolio manager responsibilities and will maintain this structure going forward. Over the years, Invesco has added investment professionals to the team which now has 9 portfolio managers and 4 analysts. The only investment professional that changed their coverage responsibilities was Clas Olson. He has final decision making authority on investing activities in the Asia/Pacific region. They do plan to hire an additional analyst for this specific region in the next year. Although the investment team lost a senior investment team member, the current team has extensive experience. The performance track record over the long term is also favorable. Due to the recent change in investment management however, the fund will be closely monitored over the next year. An alternative fund for participants to select is the Janus Overseas Fund as it also invests in large-cap international stocks