State of Illinois Deferred Compensation Plan

Insight

Fourth Quarter 2015 | Bruce Rauner, Governor

The Ins and Outs of Retirement Budgeting

How to make a retirement budget that works for you.

Inflation, taxes, income from a part-time job, and Social Security benefits are just a few of the factors that could affect your retirement cash flow. So getting a good handle on your spending patterns today will go a long way toward understanding how much you will need to save to maintain a comfortable lifestyle after you retire. It can also help you avoid overspending early in a retirement that could last decades.

To figure out how much you're likely to spend in retirement, use your current budget as a baseline and estimate how much each category will decrease or increase after you leave the workforce. For example, some current expenses—such as commuting costs—will go down or disappear after you retire, while others—like health care—may increase.

Draft a Budget

Start with the basics: how much you spend on food, both at home and away; housing expenses, including mortgage or rent, utilities, and repairs; and insurance, including residential, car, health care, life, and long-term care.

After your fixed costs, add in discretionary spending on things like clothes and furniture, replacing your car, travel and entertainment, personal care (such as haircuts or manicures), education, or charitable giving. Do-it-yourselfers who usually handle the routine chores, such as mowing the lawn, cleaning the house, and fixing gutters, should also think about how long they will be able to keep up with that work. As you age, you may need to outsource some of these tasks, which could also affect your budget.

If you're still not sure about how much to budget for some of these expenses, T. Rowe Price has a retirement budget calculator that can help. Visit **www3.troweprice.com/rws/public/apps/components/calculators/budget/index.jsp**.

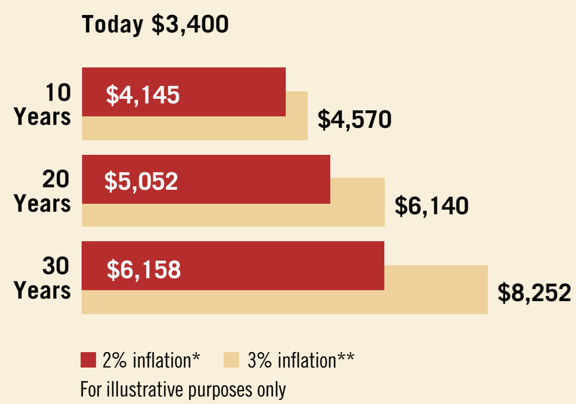
Accounting for Inflation

Once you have a grasp on how much income you'll need that first year or two of retirement, project that amount over the next 30 years and measure the impact inflation will have on your money. For example, the average person age 65 or older spent $3,400 on groceries in 2014, according to the Consumer Expenditure Survey from the Bureau of Labor Statistics. Here's a look at how that cost could rise with inflation.

*5-year average through 2014

**The historical average since 1914

Source: Buyupside.com, http://buyupside.com/calculators/inflationjan08.htm



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Resist the Urge to Overspend

If you have a long list of retirement goals, like joining a golf club or finally seeing Europe, it's tempting to try to do everything at once. For a retirement portfolio to last 30 years or more, T. Rowe Price analysis confirms that a 4% initial withdrawal amount from your retirement savings is a useful guideline for most retirees. That amount can support inflation over time, which has averaged around 3% a year since 1914, according to the U.S. Bureau of Labor Statistics.[1]

Using this strategy, 4% of $500,000 translates into a first-year withdrawal of $20,000. Assuming 3% inflation, the second year's withdrawal would be $20,600, $21,218 the next, and so on, and you'd still have a high probability of not outliving your savings. (Please see the chart on page 1.) Of course, you need to reevaluate your withdrawal strategy on a regular basis, perhaps annually, to account for changes in personal circumstances.

Project, Plan, Repeat

By going through this exercise long before you're ready to retire, you'll have a good idea how your expenses in retirement will compare with your income, and you'll have time to make any necessary adjustments. For example, if you're on a trajectory to spend more than you expect to bring in, look for opportunities to trim discretionary spending or consider taking a part-time job to boost your income.

Remember, spending patterns tend to change over the course of retirement, so it's likely you'll have to repeat this exercise more than once. Retirement should be an enjoyable time in your life. Proper budgeting can help ensure that you're in a good position to make the most of your golden years.

[1]Bureau of Labor Statistics, http://www.bls.gov/data/inflation_calculator.htm

Retirement Savings vs. Emergency Reserves

Keep saving for retirement while continuing to prepare for the unexpected.

Nothing can derail even the most carefully crafted budget faster than an unexpected bill or loss of income. That's why an emergency fund plays a central role in every retirement plan. An emergency fund could help you avoid raiding your retirement savings should something unexpected occur, and with a little planning, you can build up your emergency reserves while still saving for your retirement.

> If you have questions, you can contact a retirement specialist on business days between 6 a.m. and 9 p.m. central time at **1-888-457-5770**, or visit **rps.troweprice.com**.

Ideally, you should have enough in reserve to cover three to six months' worth of living costs. Of course, as you build up your reserves, you should always be contributing as much as possible to your retirement plan. Plan to have your reserves fully funded within one to two years.

Once you have reached your goal for the emergency fund, turn your attention toward paying off any high-interest debt, such as credit cards, as quickly as possible. Set a goal of one to three years to get out of debt, and resist accumulating any more.

With your emergency fund in place and your debt under control, you can focus on building your retirement plan contributions up to at least 15% of your salary each year, including any employer match. Consider increasing your contributions by 2% each January until you hit that target, or sign up for your plan's automatic increase program, if offered.

Even if your current financial situation isn't ideal, retirement savings should remain a top priority. The more you can stick to a workable plan to increase your savings, the less likely it is you'll have to sacrifice the retirement you've always dreamed of.

> T. Rowe Price offers many tools and resources to help you plan for retirement. For more information, visit **rps.troweprice.com**.

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 2015 deferrals and any other tax-deferred and tax-exempt deductions.

Your W-2 statement will reflect contributions to the Deferred Compensation Plan (457 Plan). If the "Deferred Compensation" box in the lower right-hand corner of the W-2 form is marked "X," it means you contributed to the Deferred Compensation Plan in 2015; 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 2015

If you received a payment from your account during the 2015 tax year, you will receive a separate Form 1099-R from our recordkeeper, T. Rowe Price, by January 31, 2016. Box 2a of your 1099-R will list the taxable amount of the distribution(s) you received during 2015 and should be entered on line 16b of your Form 1040. 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.

Distributions from your Deferred Compensation Plan account, plus any earnings, are taxable as ordinary income for federal income tax purposes. These same distributions are not, however, subject to State of Illinois income tax. Line 1 of your Illinois return (IL 1040) is taken directly from your federal adjusted gross income, which includes any deferred compensation distributions. These distributions should also then be listed (and consequently deducted from income) on line 5 of your IL 1040.

IRS Limits for 2016

To help you better prepare for the upcoming year, below is a summary of the 2016 salary deferral contributions you can make to your State of Illinois 457 Plan:

- The IRS annual salary deferral dollar limit for before-tax contributions is $18,000.
- For participants who will be age 50 and older, the age 50 catch-up provision allows you to defer up to $24,000 in before-tax contributions. (This includes the $18,000 maximum before-tax contribution allowed by the IRS plus an additional $6,000.)
- The 457 special catch-up provision is $36,000. (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 for 2015 distributions will be mailed by January 31, 2016.

Required Minimum Distributions

If you turn age 70½ in 2016 and have left state service, you must receive your 2016 required minimum distribution (RMD) by April 1, 2017. To calculate your RMD, divide your account balance as of December 31, 2015, by 27.4 if you turn age 70, or 26.5 if you turn age 71, in 2016. This is the minimum amount that you must withdraw from your account.

Each year thereafter (including 2017), you must receive your RMD for that year by December 31.

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 investment option more closely. Being on the watch list does not mean you should immediately sell your shares in the investment option. It is not unusual for an investment option to appear on the list from time to time, and it does not mean it is necessarily a bad investment. If we believe the investment no longer represents a suitable investment option, we will remove the investment option from the DCP.

Why are investment options placed on the watch list?

Investment options can be placed on the watch list for several reasons. Why an investment option 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 an investment option 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 an investment option on the watch list.
2. **Risk**—Less obvious to many participants is the risk that an investment manager incurs. If an investment option becomes too volatile, we will place it on the watch list.
3. **Risk-Adjusted Returns**—What returns has the investment manager been able to deliver relative to the risk the investment has incurred? If the manager is unable to deliver adequate returns for the risk taken, we will place the investment option on the watch list.
4. **Portfolio Construction/Style Drift**—Is the investment manager investing the money in the way he or she said? If you invest part of your assets in an aggressive investment option 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 investment option on the watch list.
5. **Operations**—There are many operational reasons for placing an investment option on the watch list. For example, the manager of the investment could leave. Remember, when you purchase shares of an investment option, what you are really doing is hiring a professional portfolio manager to invest your money. If that manager leaves, you should watch the investment option 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 an investment option on the watch list.

Current Watch List as of December 2015

Wellington Diversified Growth Fund

The Wellington Diversified Growth Fund has lagged its respective benchmark, the Russell 1000 Growth, over the three- and five-year annualized periods and ranked in the bottom quartile of its peer group universe. The Fund has also lagged its benchmark over the last four consecutive calendar years. The calendar year 2011 posted the greatest underperformance versus the benchmark. The Fund did not have as much exposure to higher-priced defensive stocks, which performed best. The Fund's technology holdings also didn't keep pace with the benchmark over recent periods. Participants seeking a similar investment strategy have access to the Vanguard Institutional Index Fund, which also invests in domestic large-cap stocks.

TELEPHONE NUMBERS

DEFERRED COMPENSATION
Plan Rules/Options Information
800-442-1300/217-782-7006

TDD/TTY: 800-526-0844

Internet: 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**