



REBECCA OTTO  
STATE AUDITOR

# STATE OF MINNESOTA

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### INDEPENDENT AUDITOR'S REPORT

Board of Trustees  
Duluth Teachers' Retirement Fund Association

We have audited the basic financial statements of the Duluth Teachers' Retirement Fund Association as of and for the year ended June 30, 2008, as listed in the table of contents. These financial statements are the responsibility of the Association's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the basic financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the basic financial statements referred to above present fairly, in all material respects, the plan net assets of the Duluth Teachers' Retirement Fund Association as of June 30, 2008, and the changes in plan net assets for the year then ended in conformity with accounting principles generally accepted in the United States of America.

The Management's Discussion and Analysis and accompanying financial information listed as required supplementary information in the table of contents are not required parts of the basic financial statements but are supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures to this information, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Our audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The accompanying financial information listed as other supplementary information in the table of contents is presented for additional analysis and is not a required part of the basic financial statements of the Duluth Teachers' Retirement Fund Association. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly presented in all material respects in relation to the basic financial statements taken as a whole. The introductory section, investment section, actuarial section, and statistical section have not been subjected to the auditing procedures applied in the audit of the basic financial statements and, accordingly, we express no opinion on them.

REBECCA OTTO  
STATE AUDITOR

GREG HIERLINGER, CPA  
DEPUTY STATE AUDITOR

December 17, 2008

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# Management's Discussion & Analysis

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The following overview is a discussion and analysis of the financial activities of the Duluth Teachers' Retirement Fund Association (DTRFA) for the fiscal year ended June 30, 2008. Its purpose is to provide explanations and insights into the information presented in the financial statements, notes to the financial statements, and required supplementary information.

## Financial Highlights

- Net assets in the defined benefit plan, which represent funds available to pay current and future pension benefits, decreased by \$47.4 million during the fiscal year to \$272 million. This 14.9% decrease in net assets was primarily due to investment performance. Net assets in the defined contribution plan fell by \$6.8 million, a decrease of 13.8%.
- Total additions in the defined benefit pension plan were -\$25.2 million which was 144% lower than the amount in the previous fiscal year. The decrease was primarily due to investment experience. In fiscal year 2008 investment return was -10.6% compared to a return in fiscal year 2007 of 19.2%. The negative investment return increases the unfunded actuarial accrued liability. Similarly, due primarily to investments, total additions in the defined contribution plan decreased by \$15.8 million, compared to an increase of \$16.5 million last fiscal year.
- The defined benefit plan recorded a -10.6% rate of return for the year, net of fees. For longer periods of time, the DTRFA annualized returns over five and ten years of 8.7% and 6.3% respectively are in the top third of all public pension funds in the nation. For the defined contribution plan, net returns for the last fiscal year were -1.9% in the Bond Fund, -18.8% in the Equity Fund, and +3.6% in the Money Market Fund.
- The actuarial funding ratio, a comparison of the actuarial value of assets to the actuarial accrued liability, was 82% at June 30, 2008. The funding ratio decreased from the 87% level of the previous year.

## Overview of the Financial Statements

The discussion and analysis below is intended to assist the reader in better understanding the purpose and meaning of each of the key components of the financial statements, which are comprised of the following:

1. The *Statement of Plan Net Assets* presents information about assets and liabilities, with the difference between the two reported as *net assets held in trust for pension benefits*. The level of net assets reflects the resources available to pay benefits to members when due. Over time, increases and decreases in net assets measure whether the financial position of the DTRFA is improving or deteriorating.
2. The *Statement of Changes in Plan Net Assets* presents the results of fund operations during the year and discloses the additions and deductions from plan net assets. It supports the net change that has occurred to the prior year's net asset value on the statement of plan net assets.
3. The *Notes to the Financial Statements* provide additional information that is essential to gain a full understanding of the data provided in the basic financial statements. The notes provide important and detail information about the DTRFA, the various pension trust funds, and the statements themselves.
4. The *Required Supplementary Information* consists of data on the funded status of the plan, the status of contributions from the employers and the State of Minnesota, and information pertaining to actuarial methods and assumptions. Also included as *Other Supplementary Information* are schedules of investment and administrative expenses, and information about cash receipts and disbursements.

## Management's Discussion and Analysis - Continued

### Financial Analysis

The following table shows condensed information from the Statement of Plan Net Assets:

	<b>Plan Net Assets</b>			
	<b>2008</b>	<b>2007</b>	<b>Change</b>	<b>Percent</b>
Cash & Investments	\$337,565,622	\$400,998,661	\$(63,433,039)	(15.8)%
Receivables	13,686,975	11,015,220	2,671,755	24.3%
Securities Lending Collateral	48,231,546	69,996,115	(21,764,569)	(31.1)%
Capital Assets	348,580	353,550	(4,970)	(1.4)%
<b>Total Assets</b>	<b>399,832,723</b>	<b>482,363,546</b>	<b>(82,530,823)</b>	<b>(17.1)%</b>
Liabilities	(85,790,967)	(114,154,513)	28,363,546	(24.9)%
<b>Plan Net Assets</b>	<b>\$314,041,756</b>	<b>\$368,209,033</b>	<b>\$(54,167,277)</b>	<b>(14.7)%</b>

The value of plan net assets decreased by \$54.2 million during fiscal year 2008. This was primarily a result of investment experience - negative returns in the equity markets and very low returns in the bond markets. The only portions of the portfolio generating positive returns during the year were real estate and commodities. As a result, additions to plan net assets decreased significantly.

The following two tables show condensed information from the Statement of Changes in Plan Net Assets:

	<b>Additions to Plan Net Assets</b>			
	<b>2008</b>	<b>2007</b>	<b>Change</b>	<b>Percent</b>
Member & Employer Contributions	\$12,268,006	\$14,728,864	\$(2,460,858)	(16.7)%
Total Investment Income	(36,806,218)	59,458,277	(96,264,495)	(161.9)%
Other	36,975	50,439	(13,464)	(26.7)%
<b>Total Additions</b>	<b>\$(24,501,237)</b>	<b>\$74,237,580</b>	<b>\$(98,738,817)</b>	<b>(133.0)%</b>

Employee and employer contribution rates in the defined benefit plan remained the same as the previous year. The decrease in contributions compared to the previous year was due to lower voluntary contributions and transfer into the defined contribution plan. The investment rate of return of -10.6% in fiscal year 2008 was lower than the 8.5% actuarially assumed return, and lower than the return of 19.2% in fiscal year 2007.

	<b>Deductions from Plan Net Assets</b>			
	<b>2008</b>	<b>2007</b>	<b>Change</b>	<b>Percent</b>
Benefit Payments	\$21,579,521	\$20,065,048	\$1,514,473	7.6%
Withdrawals & Transfers	7,455,945	8,785,148	(1,329,203)	(15.1)%
Contribution Refunds	59,144	201,525	(142,381)	(70.7)%
Administrative Expense	571,430	533,668	37,762	7.1%
<b>Total Deductions</b>	<b>\$29,666,040</b>	<b>\$29,585,389</b>	<b>\$80,651</b>	<b>0.3%</b>
<b>Increase in Plan Net Assets</b>	<b>\$(54,167,277)</b>	<b>\$44,652,191</b>	<b>\$(98,819,468)</b>	<b>(221.3)%</b>

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## Management's Discussion and Analysis - Continued

The primary factor for higher total deductions compared to the previous year: higher benefit payments in the defined benefit plan due to a greater number of retirees and because benefit payments to eligible retirees were increased by a 5.3% cost of living adjustment on January 1, 2008. Administrative expenses increased in fiscal year 2008 after decreasing or remaining the same during the previous four years, but over the last five fiscal years, these expenses have increased on average by only 2% per year.

### **Actuarial Funded Status, Financial Position, and Economic Factors**

The funding objective of the DTRFA defined benefit plan is to meet long-term benefit promises through prudent investment of fund assets, and contributions which remain approximately level as a percent of member payroll over decades of time. Historical information relating to progress in meeting this objective is presented on pages 21-22. The DTRFA continues to maintain a long-term investment approach consistent with the long-term nature of plan obligations.

As of June 30, 2008, the funded ratio of the defined benefit plan was 82%, a decrease from the 87% level a year earlier. The funded ratio is derived by comparing the "actuarial value" of plan assets to the total liabilities of the plan. State law requires that a five-year smoothing method be used to determine actuarial value of plan assets. Most public pension funds use a smoothing technique to value their assets for actuarial purposes. This is done to avoid significant swings in the value of assets from one year to the next. During fiscal year 2008, this smoothing technique resulted in the recognition of \$11.1 million in deferred investment gains from fiscal years 2004-2007. The recognition of the deferred gains from prior years helped to offset the loss recognized for the current year. In fiscal year 2008, the fund experienced an actual investment loss of \$57.6 million, of which \$11.5 million was

allocated to the current year. That same amount will be allocated to each of the next four fiscal years. At June 30, 2008, total deferred investment losses totaling \$26.5 million and will be recognized in the next four fiscal years.

During fiscal 2008, the fund also experienced actuarial gains due to demographic and other economic factors, but the net experience variation is less than 1% of the actuarial accrued liability. In addition, several actuarial assumptions were changed including assumptions related to salary increases, payroll growth, and pre- and post-retirement mortality. The net impact of all assumption changes was an increase in the actuarial accrued liability of \$15.6 million.

The actuarial valuation report for the fiscal year also notes that current contribution rates are not sufficient for the plan to achieve full, 100% funding by the year 2035, the date required in law for the plan to be fully funded. The total current contribution rate of 11.87% (5.5% employee, 5.79% employer, and 0.58% State payment) is 4.0% lower than the actuarially required contribution rate of 15.87%.

In summary, although the pension fund is less than 100% funded and has a contribution deficiency, the DTRFA has a healthy reserve of assets. We look forward with optimism for more stable investment markets and a better economy.

### **Requests for Information**

This financial report is designed to provide the Board of Trustees, members, retirees, employers, and other users with a general overview of the financial activities of the DTRFA and to demonstrate the Association's accountability for the funds under its control. Questions concerning any information provided in this report, or requests for additional financial information should be addressed to Duluth Teachers' Retirement Fund Association, 625 East Central Entrance, Duluth, MN 55811.

# Statement of Plan Net Assets

June 30, 2008

	Pension Trust Funds				Total
	Defined	Defined Contribution Plan			
	Benefit Plan	Bond	Equity	Money Mkt	
	Basic Fund	Fund	Fund	Fund	
<b>Assets</b>					
Cash	\$65,584	\$53,337	\$71,747	\$47,004	\$237,672
Short-term investments	21,569,257	126	1,074,942	8,247,138	30,891,463
Total cash and equivalents	<u>21,634,841</u>	<u>53,463</u>	<u>1,146,689</u>	<u>8,294,142</u>	<u>31,129,135</u>
Receivables					
Member contributions	385,428				385,428
Employer contributions	405,753				405,753
Interest and dividends	870,220		35,751		905,971
Stock and bond sales	11,963,367		8,734		11,972,101
Other	17,722				17,722
Total receivables	<u>13,642,490</u>		<u>44,485</u>		<u>13,686,975</u>
Investments, at fair value					
U.S. Government obligations	57,016,837		1,133,279		58,150,116
Corporate and other bonds	87,026,811	9,642,130	6,590,382		103,259,323
Equities	102,172,718		15,848,546		118,021,264
Private equity	7,888,844				7,888,844
Real assets	19,116,940				19,116,940
Total investments	<u>273,222,150</u>	<u>9,642,130</u>	<u>23,572,207</u>		<u>306,436,487</u>
Invested securities lending collateral	44,213,053		4,018,493		48,231,546
Properties, at cost, net of accumulated depreciation of \$326,849	342,105	2,072	3,237	1,166	348,580
Total assets	<u>353,054,639</u>	<u>9,697,665</u>	<u>28,785,111</u>	<u>8,295,308</u>	<u>399,832,723</u>
<b>Liabilities</b>					
Accounts payable	360,119				360,119
Securities lending liabilities	44,213,053		4,018,493		48,231,546
Stock and bond purchases	36,864,623		230,772		37,095,395
Deferred contributions		24,361	64,364	15,182	103,907
Total liabilities	<u>81,437,795</u>	<u>24,361</u>	<u>4,313,629</u>	<u>15,182</u>	<u>85,790,967</u>
<b>Net assets held in trust for pension benefits (a schedule of funding progress is presented on page 21)</b>	<u>\$271,616,844</u>	<u>\$9,673,304</u>	<u>\$24,471,482</u>	<u>\$8,280,126</u>	<u>\$314,041,756</u>

The accompanying notes are an integral part of these financial statements.

# Statement of Changes in Plan Net Assets

For the Year Ended June 30, 2008

	Pension Trust Funds				Total
	Defined	Defined Contribution Plan			
	Benefit Plan	Bond	Equity	Money Mkt	
	Basic Fund	Fund	Fund	Fund	
<b>Additions</b>					
Contributions					
Employer	\$2,994,086				\$2,994,086
Plan members' deposits & transfers	2,954,062	\$1,404,260	\$1,758,193	\$3,157,405	9,273,920
Total contributions	5,948,148	1,404,260	1,758,193	3,157,405	12,268,006
Investment activities income					
Net appreciation (depreciation) in fair value of investments	(39,957,251)	(666,112)	(7,383,557)		(48,006,920)
Interest	8,753,014	227	645,480	271,990	9,670,711
Dividends	1,092,297	521,913	1,179,611		2,793,821
Rental income (net)	182,534				182,534
Total investment activities income (loss)	(29,929,406)	(143,972)	(5,558,466)	271,990	(35,359,854)
Less investment expense	(1,566,292)	(7,298)	(186,355)	(1,551)	(1,761,496)
Net investment activities income (loss)	(31,495,698)	(151,270)	(5,744,821)	270,439	(37,121,350)
Securities lending					
Securities lending income	311,872		32,176		344,048
Less securities lending expense	(25,572)		(3,344)		(28,916)
Net income from securities lending	286,300		28,832		315,132
Total net investment income (loss)	(31,209,398)	(151,270)	(5,715,989)	270,439	(36,806,218)
Other income	31,173		5,802		36,975
Total Additions	(25,230,077)	1,252,990	(3,951,994)	3,427,844	(24,501,237)
<b>Deductions</b>					
Benefits to participants					
Retirement	19,934,499				19,934,499
Disability	218,783				218,783
Survivor	1,426,239				1,426,239
Contribution refunds	59,144				59,144
Plan members' withdrawals & transfers		1,789,752	3,786,341	1,879,852	7,455,945
Total benefits, refunds & withdrawals	21,638,665	1,789,752	3,786,341	1,879,852	29,094,610
Administrative expenses	487,944	26,890	41,023	15,573	571,430
Total Deductions	22,126,609	1,816,642	3,827,364	1,895,425	29,666,040
<b>Net increase (decrease)</b>	(47,356,686)	(563,652)	(7,779,358)	1,532,419	(54,167,277)
<b>Net assets held in trust for pension benefits</b>					
- Beginning of year	318,973,530	10,236,956	32,250,840	6,747,707	368,209,033
- End of year	\$271,616,844	\$9,673,304	\$24,471,482	\$8,280,126	\$314,041,756

The accompanying notes are an integral part of these financial statements.



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# Notes to the Financial Statements

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## NOTE 1. SUMMARY OF ACCOUNTING POLICIES

### Organization

The Duluth Teachers' Retirement Fund Association (Association) was created in 1910 to provide retirement and other specified benefits for its members pursuant to Minnesota Statutes Chapters 354A and 356. Association membership consists of eligible employees of Independent School District 709, eligible staff of Lake Superior College and the employees of the Association. The Association is governed by a nine-member board of trustees.

### Financial Reporting Entity

The Association's financial statements include the Basic Fund, a defined benefit plan, and three funds in the defined contribution plan - the Bond Fund, Equity Fund, and Money Market Fund. These plans are presented as pension trust funds in the financial statements. The Association's financial statements include all plans for which it is financially accountable. The Association is not included as a component unit of another reporting entity.

### Basis of Accounting

The Association's financial statements are prepared using the accrual basis of accounting. Additions are recorded in the accounting period when they are earned and become measurable and deductions are recorded when the liability is incurred. Member and employer contributions are recorded as revenues when due, pursuant to formal commitments, as well as statutory or contractual requirements. Benefits and refunds are recognized when due and payable in accordance with the terms of the plan.

### Deposits and Investments

#### Deposits

Minnesota Statutes, Section 356A.06, Subd. 8a authorizes the Association to deposit its cash and to invest in money market accounts and certificates of deposit in financial institutions designated by the Association's Board of Trustees. Minnesota statutes require that all of the Association's deposits be covered by insurance, surety bond, or collateral.

#### Investments

Minnesota Statutes, Sections 354A.08, 356A.06, Subd. 7 and the Association's Articles of Incorporation and Bylaws designate authorized investment types and limitations. Minnesota Statutes, Section 356A.04, Subd. 2 specifies that investments are governed by the "prudent person standard." The prudent person standard pertains to all fiduciaries, and includes anyone who has authority with respect to the Association.

Investments are reported at fair value. Short-term investments are reported at cost, which approximates fair value. Securities traded on an exchange are valued at the last reported sales price at current exchange rates. Mortgages are valued on the basis of future principal and interest payments, and are discounted at prevailing interest rates for similar instruments. Investments that do not have an established market are reported at estimated fair value. Net appreciation (depreciation) in fair value of investments includes net unrealized and realized gains and losses. Purchases and sales of securities are recorded on a trade-date basis. Dividends are recorded on the ex-dividend date.

There are no investments in, loans to, or leases with parties related to the Association.

### Receivables

Receivables are recognized in the period in which amounts are due pursuant to formal commitments as well as contractual requirements. At June 30, 2008, receivables consisted of contributions owed by members and employers, interest and dividends from investments, and amounts due from the sales of stocks and bonds where the trade was initiated prior to June 30, 2008, but settled at a later date.

### Liabilities

Liabilities for benefits and refunds are recognized when due and payable in accordance with the terms of the plan. At June 30, 2008, liabilities consisted principally of investment management fees, obligations to return securities lending collateral, member deposits in the defined contribution plan which will be credited to the members' accounts after the computation of the monthly unit value, obligations for the purchase of investments where the trade was initiated prior to June 30, 2008, but settled at a later date, and variation margins from futures contracts.

### Risk Management

The Association is exposed to various risks of loss related to torts; theft of, damage to, or destruction of assets; errors or omissions; injuries to employees; and natural disasters. To cover its potential liabilities, the Association purchases commercial insurance. There were no significant reductions in insurance coverage from coverage in the prior year, and there were no insurance claims or settlements in the past three fiscal years.

### Properties

Land, land improvements, building, and furniture and fixtures are stated at cost. Depreciation is computed over the estimated useful lives of the properties using the straight-line method.

# Notes - Continued

## 1. Summary of Accounting Policies (cont.)

A summary of properties at June 30, 2008, is as follows:

<u>Class</u>	<u>Useful Life-Yrs.</u>	<u>Carrying Value</u>	<u>Accumulated Depreciation</u>	<u>Net</u>
Land	N/A	\$35,540	N/A	\$35,540
Land Improvement	7-15	68,414	\$33,401	35,013
Buildings	15-30	397,388	146,440	250,948
Furniture, fixtures	5-7	<u>174,087</u>	<u>147,008</u>	<u>27,079</u>
Totals		<u>\$675,429</u>	<u>\$326,849</u>	<u>\$348,580</u>

## NOTE 2. DEPOSIT & INVESTMENT RISK DISCLOSURES

### Deposits

Custodial credit risk for deposits is the risk that in the event of a bank failure, the Association's deposits may not be returned. The deposits are held in one institution with a balance of up to \$100,000 insured by the Federal Deposit Insurance Corporation (FDIC). As required by Minnesota statutes, the Association's deposits in excess of the FDIC limit are covered by collateral. At year end the Association had cash deposits totaling \$259,108 all of which were covered by insurance.

### Investments

The following table shows the investments of the Association by type at June 30, 2008:

#### **Short-term investments**

Commercial paper	\$1,322,054
Commingled investment funds	24,537,924
Certificates of deposit	165,750
Government agency discounted notes	4,437,730

#### **Investments held by the Association or its agent**

Commingled international stock fund	45,130,812
Commingled domestic equity fund	5,219,282
Commingled commodities fund	16,717,847
Domestic equities	31,367,249
Domestic preferred stock	400,589
Asset backed securities	23,738,723
Commercial mortgage backed	3,314,395
Corporate bonds	34,661,398
Government bonds	4,246,470
Government agency bonds	44,533,169
Mortgage backed securities	29,253,144
Commingled bond fund	11,182,111
Real estate	1,466,875
Mortgage loans	932,218
Private equity investments	7,888,844

#### **Invested collateral on securities loaned**

Commingled investment funds	48,231,546
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#### **Investments held by broker-dealers under securities lending program**

Corporate bonds	1,109,552
Government bonds	4,604,468
Government bonds – stripped	107,458
Government agency bonds	4,658,551
Government agency discounted notes	428,005
Domestic equities	<u>35,903,332</u>
Total investments	<u>\$385,559,496</u>

#### Amounts from Statement of Plan Net Assets:

Short-term investments	\$30,891,463
Investments	306,436,487
Invested securities lending collateral	<u>48,231,546</u>
Total investments	<u>\$385,559,496</u>

#### Credit Risk – Debt Securities

Credit risk is the risk that an issuer or other counterparty to an investment will not fulfill its obligations to the Association. The Association limits credit risk by requiring investment managers to meet the following requirements:

- Total portfolio quality must be maintained at a minimum overall rating of “A”.
- Securities that have a rating of “BBB” or lower may not exceed 15% of an investment manager's portfolio.
- The average quality rating of commercial paper and money market securities in the portfolio will be at least “A1/P1”.

As shown below, the value of below investment grade debt securities is \$5,661,542 or 3.4% of the debt portfolio.

#### Quality Rating

AAA	\$48,333,328
AA+	12,993,497
AA	2,144,434
AA-	3,423,355
A+	2,387,773
A	5,882,353
A-	1,915,088
BBB+	4,476,246
BBB	8,008,060
BBB-	1,628,113
BB+	1,720,990
BB	832,297
B	2,607,305
B-	175,658
CCC+	145,075
CCC	171,401
CC	8,816
Not rated	<u>6,405,534</u>
Total credit risk debt securities	<u>\$103,259,323</u>
U.S. Government & agencies	<u>63,015,851</u>
Total debt securities	<u>\$166,275,174</u>



# Notes - Continued

## 2. Deposit & Investment Risk Disclosures (cont.)

### Custodial Credit Risk

Custodial credit risk for investments is the risk that, in the event of a failure of the counterparty, the Association will not be able to recover the value of the investment or collateral securities that are in the possession of an outside party. At June 30, 2008 the Association had no custodial credit risk because all investment securities were registered in the name of the Association and were held in the possession of the Association's custodial bank.

### Concentration of Credit Risk

Concentration of credit risk is the risk of loss that may be attributed to the magnitude of investments in a single holding. The Association limits this risk by maintaining diversified portfolios. The following guidelines are from the Statement of Investment Objectives & Policies (SIOP):

- No more than 6% of any portfolio may be invested in any one corporate issuer.
- Mortgage obligations and non-agency mortgage backed pass-through securities are limited to 35% of the total market value of the portfolio.
- Rule 144a securities are limited to 20% of a portfolio.
- Foreign bonds are limited to 20% of the portfolio.
- No equity investment may exceed 5% of the total outstanding shares of any company.

At June 30, 2008 there were no single issuer investments that exceeded the above guidelines.

### Interest Rate Risk

Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of an investment. The Association limits this risk by including the following guidelines in the SIOP:

- The market value weighted average expected maturity of the bond portfolio shall not exceed 15 years.
- The volatility of returns for the fixed income component should be controlled so that the annualized standard deviation of quarterly returns does not exceed 130% of the same measure for the Lehman Brothers Aggregate Bond Index.
- The average effective modified duration of each bond portfolio must be between 75% and 125% of the effective duration of the Lehman Brothers Aggregate Bond Index.
- Asset-backed or collateralized mortgage obligations will be classified as having a "high risk" if they have an average life greater than 10 years and duration greater than 5.6 years. Asset-backed or collateralized mortgage backed securities meeting the definition of high risk will be limited to no more than 10%, at market value, of the manager's portfolio.

Duration is a measure of a debt investment's exposure to fair value changes arising from changes in interest rates. Effective duration uses the present value of cash flows, weighted for those cash flows as a percentage of the investment's full price.

At June 30, 2008 the index range required by the Association for bond managers is 3.5 years to 5.9 years based on a Lehman Brothers Aggregate Bond Index of 4.7 years at June 30, 2008.

The Association's bond portfolios were within the required range. The Basic Fund bond portfolio had a duration of 5.0 and the Bond Fund portfolio had a duration of 5.6 at June 30, 2008. The overall effective weighted duration for all fixed income investments is shown below. The overall duration is lower than the range specified above because the Association's S&P 500 enhanced index portfolios contain securities that have an average duration of less than one year.

<u>Investment</u>	<u>Fair Value</u>	<u>Duration (Years)</u>
Asset backed securities	\$23,738,723	0.12
Commercial mortgage backed	3,314,395	4.55
Corporate bonds	35,770,950	2.60
Government bonds	8,850,938	6.13
Government bonds – stripped	107,458	13.71
Government agency bonds	49,191,720	3.83
Government agency disc. notes	4,865,735	0.06
Mortgage backed securities	29,253,144	0.31
Commingled bond fund	<u>11,182,111</u>	<u>5.40</u>
Total debt securities	<u>\$166,275,174</u>	<u>2.56</u>

### Foreign Currency Risk

Foreign currency risk is the risk that changes in currency exchange rates will adversely affect the fair value of an investment.

State law limits certain investments to a total portfolio limit of no more than 20% of the market value of the portfolio. Emerging market equities and international bonds are included in this category.

The Association's investment policies require non-U.S. equity managers to invest at least 80% of the portfolio in large capitalization stocks and no more than 20% in small capitalization stocks. The policies also require bond managers to invest no more than 20% of the portfolio in issues of the foreign bond sector (defined as securities whose payments are based on foreign interest rates).

The Association's exposure to foreign currency risk is presented in the following table (in U.S. Dollars):

# Notes - Continued

## 2. Deposit and Investment Risk Disclosure (cont'd.)

<u>Currency</u>	<u>Debt</u>	<u>Equity</u>	<u>Total</u>
Australian Dollar	\$7,441	\$1,449,168	\$1,456,609
Brazilian Real	93,124	307,292	400,416
Bulgarian Lev		487,234	487,234
Canadian Dollar	483,275	1,280,002	1,763,277
Swiss Franc		2,486,609	2,486,609
Czech Koruna		65,280	65,280
Danish Kroner		145,211	145,211
Egyptian Pound	10		10
European Union Euro	209,141	23,387,083	23,596,224
British Pound	9,334	9,900,805	9,910,139
Hong Kong Dollar		95,294	95,294
Hungarian Forint		9,516	9,516
Iceland Krona	21,235		21,235
Japanese Yen	1,655	36,884	38,539
Indonesian Rupiah		3	3
Malaysian Ringgit	39,764		39,764
Mexican Peso	212	32,966	33,178
Norwegian Kroner		231,366	231,366
New Zealand Dollar		53,771	53,771
Polish Zloty	24,138	843,323	867,461
Romanian Leu		163,007	163,007
Russian Rouble	19,689		19,689
Swedish Kronor	<u>22</u>	<u>93,601</u>	<u>93,623</u>
Total securities subject to currency risk	<u>\$909,040</u>	<u>\$41,068,415</u>	<u>\$41,977,455</u>

### Securities Lending

Minnesota Statutes and the investment policies of the Association permit securities lending transactions – loans of securities to broker-dealers and other approved entities for collateral with a simultaneous agreement to return the collateral for the same securities in the future. Securities on loan include U.S. Government securities, corporate and other bonds, and common stocks. The Association's investment custodian acts as its agent in lending securities for cash collateral at 102% of the value of the securities loaned plus accrued income. The contract with the custodian requires them to indemnify the Association if the borrowers fail to return the securities. Securities on loan are recorded as investments on the Statement of Plan Net Assets and the corresponding liability is recorded for the market value of the collateral received. At year-end, the Association had no credit risk exposure to borrowers because the amounts the Association owes the borrowers exceeds the amounts the borrowers owe the Association. The securities on loan at year-end had a market value of \$46,811,366 and the market value of the collateral received for the securities on loan was \$48,231,546.

All securities loans can be terminated on demand by either the Association or the borrower. Loan terms are open-ended and are negotiated on a daily basis. Collateral

received is invested in various types of short-term securities and short-term investment pools. Short-term investment pools have a daily weighted-average maturity of six to twenty days. In addition to open-ended loans, loans with a stated term to maturity may be made, in which case the maturity of securities loaned is matched with the term to maturity of the investment of the cash collateral.

### Derivative Investments

The Association utilizes futures contracts as part of an S&P 500 enhanced indexing strategy. That strategy is designed to provide excess returns relative to the index utilizing a combination of S&P 500 futures contracts that provide near perfect tracking to the S&P 500, along with a short-term, low duration fixed income portfolio. The actual dollars invested in the enhanced cash portfolio approximately equal the notional value of the S&P 500 futures contracts held (i.e. no leverage is employed).

Upon entering into a futures contract, each party is required to deposit with the broker an amount, referred to as an initial margin, equal to a fixed dollar amount per futures contract, as determined by the Chicago Mercantile Exchange. In lieu of a cash initial margin, the broker holds U.S. Government securities with a value of approximately 6% of the face value of the futures contracts on behalf of the Association as collateral. Subsequent cash flows, referred to as variation margins, are received or paid each day by each party equal to the daily fluctuations in the fair value of the contracts. The contract value is based on quoted market prices, which will equal the value of the S&P 500 Index at the expiration of the contract. At June 30, 2008, the Basic Fund held a long position in 218 S&P 500 futures contracts and the Equity Fund held a long position in 30 S&P 500 futures contracts. Although these contracts are scheduled to mature on a given date, the strategy "rolls" the contracts to maintain exposure to the S&P 500 Index. The total face value of the contracts at June 30, 2008 was \$69,819,950 for the Basic Fund and \$8,583,370 for the Equity Fund.

S&P 500 futures contracts are traded on a large well-capitalized exchange that has limited counterparty risk. This is because the futures exchange and the exchange's clearing corporation act as the counterparty for each trade. If an investor defaults on his obligation to the futures exchange, several layers of protection exist for the other investors, including: the initial margin deposit; the capital of the clearing broker (or clearing member) who opened the defaulted position; and the clearing corporation which maintains surplus funds, additional capital in the form of security deposits from the clearing members, and guaranteed bank lines. Finally, if these protections fail, the primary capital of all 80 clearing members totaling almost \$31 billion is pledged to support the exchange.

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# Notes - Continued

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## 2. Deposit and Investment Risk Disclosures (cont.)

### Commitments and Contingencies

At June 30, 2008 the Basic Fund plan had commitments for future purchases of private equity investments amounting to \$13,990,405.

### NOTE 3. DEFINED BENEFIT PLAN

The following brief description of the Basic Fund plan is provided for general information purposes only.

There are three participating employers in the plan. The plan is not subject to the provisions of the Employee Retirement Income Security Act of 1974.

### General

The Association administers a cost-sharing multiple employer defined benefit pension plan covering all licensed educators of Independent School District 709, certain staff of Lake Superior College hired prior to July 1, 1995 who elected coverage by the Association, and the employees of the Association. At June 30, 2008, membership consisted of:

• Retirees and beneficiaries receiving benefits	1,243
• Terminated plan members entitled to, but not yet receiving benefits	986
• Active plan members	<u>1,140</u>
Total	3,369

### Pension Benefits

Association members may be eligible for benefits under three different plans depending on year of hire. Members in all three plans are covered by Social Security.

Old Plan – Covers members hired prior to July 1, 1981. Normal retirement benefits are earned at age 60, or if age plus service totals 90. Benefits vest after 10 years or at age 60. The annual normal retirement benefit is equal to 1.45% of a member's high five-year average salary multiplied by the total years of credited service. Early benefits are available as early as age 55 with 10 or more years of credited service with a .25% per month early retirement deduction under age 60. Old Plan members receive a benefit under Tier I or Tier II if that benefit is greater.

Tier I Plan – Covers all members hired before July 1, 1989. Normal retirement benefits are earned at age 65 or with 30 plus years of service over age 62, or if age plus service totals 90. Retirement benefits vest after 3 years of service or at age 65. The annual retirement benefit is equal to 1.2% for each of the first ten years of service credit and

1.7% for each subsequent year of service credit multiplied by the high five years average salary. Early benefits are available as early as age 55 with three or more years of credited service or at any age with 30 or more years of credited service with a .25% per month early retirement deduction under the normal retirement age. Tier I Plan members receive a benefit under the Tier II Plan if that benefit is greater.

Tier II Plan – Covers Association members hired after June 30, 1989. Normal retirement benefits are tied to the Social Security normal retirement age but cannot exceed age 66. Retirement benefits vest after 3 years or age 65. The annual normal retirement benefit is equal to 1.70% for all years of credited service multiplied by the high five successive years average salary. Benefits are available as early as age 55 with three or more years of credited service with an actuarial equivalence early retirement reduction under full retirement age.

Under all plans, members may elect to receive their pension benefits in the form of a single-life annuity, a joint and survivor annuity, or a life and term certain annuity, and have the option of electing Social Security actuarial income leveling. Terminating members may receive a refund of their contributions with interest computed at 6% or may elect an augmented deferred retirement benefit if retirement benefits have vested.

### Death and Disability Benefits

If active members die prior to the receipt of their first retirement allowance payment, death benefits are payable under each of the three plans. Active members who have not reached normal retirement age and have at least three years of credited service may receive a disability benefit upon becoming permanently disabled.

### Cost of Living Adjustment

A guaranteed 2% cost-of-living adjustment (COLA) is payable to eligible benefit recipients each January 1. An additional percentage increase is added to the guaranteed 2% COLA to the extent that five-year annualized investment returns exceed the plan's 8.5% actuarially assumed rate of interest, and to the extent that contribution rates are determined to be actuarially sufficient.

### Funding

Benefit and contribution provisions are established by state law and may be amended only by the Minnesota Legislature. Minnesota Statutes, Section 354A.12 set the rates for employee and employer contributions that, expressed as a percentage of annual covered payroll, are sufficient to cover administrative expense and to fully fund the pension plan by the year 2035. The requirement to

# Notes - Continued

### 3. Defined Benefit Plan (cont.)

reach full funding by the year 2035 is set in Minnesota Statutes, Section 356.215, Subd. 11. That statute also requires that assets in excess of the actuarial accrued liability be amortized as a level percentage of covered payroll over a rolling 30-year period. As part of the annual actuarial valuation, the actuary determines the sufficiency of the statutory contribution rates toward meeting the required full funding deadline. The actuary compares the actual contribution rate to a "required" contribution rate. The required contribution rate consists of: (a) normal costs based on entry age normal cost methods, (b) a supplemental contribution for amortizing any unfunded actuarial accrued liability (UAAL) by the required date for full funding, and (c) an allowance for administrative expenses. Administrative expenses are financed by employee and employer contributions.

For the fiscal year ended June 30, 2008, members were required to contribute 5.5% of their salaries to the Association. Employer contributions were 5.79% of the members' salaries.

#### Funded Status and Funding Progress

Effective June 30, 2008, the DTRFA implemented the provisions of Governmental Accounting Standards Board Statement No. 50, *Pension Disclosures*. The disclosures are amendments to GASB Statement No. 25 and present the disclosures of the actuarial methods, assumptions and funded status of the plan in the financial notes. The funded status as of July 1, 2008, the most recent actuarial date is as follows:

Actuarial value of assets	\$298,067,085
Actuarial accrual liability (AAL)	<u>363,044,284</u>
Unfunded AAL (UAAL)	64,977,199
Funded ratio	82.1%
Annual covered payroll	\$51,711,330
UAAL as a percentage of payroll	125.7%

The funded ratio decreased 4.7% from the previous year. The schedule of funding progress, presented as required supplementary information following the notes to the financial statements, presents similar information but uses a multi-year format to show trend information. These trends indicate whether the actuarial value of plan assets are increasing or decreasing over time relative to the actuarial accrued liability for benefits. The trend information was obtained from the annual valuation report of independent actuary retained by the DTRFA.

Additional information as of the latest valuation follows:

- Valuation date..... July 1, 2008
- Actuarial cost method..... Entry age normal
- Amortization method..... Level percent of payroll
- Amortization period..... Closed, to June 30, 2035
- Inflation rate..... 4.5%
- Asset valuation method: Actuarial value of assets is determined using the market value of assets adjusted by spreading over a five-year period the difference between the actual return on investments and the 8.5% assumed rate of return.
- Investment return: 8.5%. The annual 2.0% post-retirement adjustment is accounted for by using a 6.5% post-retirement investment return.
- Projected salary increase: Total reported pay for the current fiscal year is increased annually for each future year according to an ultimate rate table which includes a 10-year select period.

### NOTE 4. DEFINED CONTRIBUTION PLAN

The Bond Fund, Equity Fund, and Money Market Fund were established to account for a voluntary tax deferred program which meets the requirements of section 403(b) of the Internal Revenue Code. Each fund has different investment objectives. Voluntary contributions may be made by eligible employees of Independent School District 709, subject to plan and Internal Revenue Code limitations. There are no employer contributions to these funds. Income tax on employee contributions and on associated earnings are deferred until amounts are withdrawn. Benefits are paid as lump-sum, or as periodic benefit payments, at the option of the participant based on the value of participant's account balance at the time of withdrawal. At June 30, 2008, there were 395 participants in the Bond Fund, 598 participants in the Equity Fund, and 276 participants in the Money Market Fund.

A summary of the unit values in the tax deferred program at June 30, 2008, is as follows:

	<u>Bond Fund</u>	<u>Equity Fund</u>	<u>Money Mkt. Fund</u>
Net assets	\$9,673,303	\$24,471,482	\$8,280,126
Number of Units	970,070	2,843,199	3,103,233
Net asset value per unit	\$9.9718	\$8.6070	\$2.6682

# Required Supplementary Information

## Schedule of Funding Progress

(Dollars in Thousands)

Actuarial Valuation Date	Actuarial Value of Assets (a)	Actuarial Accrued Liability (AAL) Entry Age (b)	Unfunded AAL (UAAL) (b-a)	Funded Ratio (a/b)	Covered Payroll (c)	UAAL as a Percentage of Covered Payroll ((b-a)/c)
7/1/03	\$278,467	\$291,109	\$12,642	95.7%	\$50,656	25.0%
7/1/04	276,949	301,704	24,755	91.8	48,821	50.7
7/1/05	268,481	310,924	42,443	86.4	49,148	86.4
7/1/06	270,926	322,229	51,303	84.1	49,522	103.6
7/1/07	288,265	332,217	43,952	86.8	50,789	86.5
7/1/08	298,067	363,044	64,977	82.1	51,711	125.7

(unaudited)

## Schedule of Contributions From Employers

(Dollars in Thousands)

Year Ended June 30	Annual Required Employer Contributions	Actual Employer Contributions	Employer Percentage Contributed
2003	\$ 1,691	\$ 2,933	173.5%
2004	2,510	2,827	112.6
2005	3,028	2,846	94.0
2006	3,982	2,867	72.0
2007	4,736	2,941	62.1
2008	4,560	2,994	65.7

Note: Annual required contribution is actuarially determined based on projected payroll. The employer is required by statute to contribute 5.79% of payroll to the fund. The employer made all the contributions required by statute.

(unaudited)

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# Other Required Supplementary Information

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## ACTUARIAL METHODS AND ASSUMPTIONS

The actuarial accrued liability is determined as part of an annual actuarial valuation. Significant methods and assumptions are as follows:

- The most recent actuarial valuation date is July 1, 2008.
- Actuarial cost is determined using the Entry Age Normal Actuarial Cost Method.
- The amortization method assumes a level percentage of an increasing payroll using a payroll growth assumption of 4.5%.
- The amortization period is closed. The date to amortize an unfunded actuarial accrued liability is June 30, 2035. Assets in excess of the actuarial accrued liability will reduce current contribution requirements as a level percent of pay over a rolling 30-year period.
- The investment rate of return is 8.5%. The annual 2% post-retirement adjustment is accounted for by using a 6.5% post-retirement rate of return.
- Actuarial value of assets is determined using the market value of assets adjusted by spreading over a five-year period the difference between the actual return on investments and the 8.5% assumed rate of return.
- A rate of inflation of 4.5%.
- Salary increases are based on a select and ultimate table, with a ten-year select period. For service from hire through 7 completed years, an 8.0% salary increase is assumed. With 8 completed years, a 7.25% increase is assumed. With 9 completed years, a 6.5% increase is assumed.
- Mortality rates using the 1994 Group Annuity Mortality Table, set back 2 years for pre and post-retirement.

## SIGNIFICANT PLAN PROVISION AND ACTUARIAL METHODS AND ASSUMPTION CHANGES

2008 - Actuarial Assumption Changes:

- Payroll growth assumption changed from 5.0% to 4.5%.
- Salary assumptions, based on a select and ultimate table, were changed after age 50. Ultimate rates at age 55 changed from 5.0% to 4.5%; at age 60 changed from 5.0% to 4.0%; at age 65 changed from 5.0% to 3.5%.
- Direct state funding restored. First payment of \$346,000 is due October 1, 2008.
- Mortality table changed to *1994 Group Annuity Mortality Table*, set back 2 years.
- Disabled lives mortality table changed to the Disabled Eligible for Social Security Disability-ERISA Sec. 4044 for 2006 for ages 54 and younger, graded between ages 55 and 64, and the Group Annuity Mortality Table set back two years for ages 65 and older.
- Retirement rates changed: from 10% at age 55 to age 60, to 15%; from 20% at age 65 to 45%; from graded rates at age 70 to age 80, to 100%.
- Withdrawal select period rates changed: first year from 40% to 60%; second year from 10% to 20%; third year from 6% to 15%.
- Form of annuity selected, male: 30% elect 50% joint & survivor option; 40% elect 100% joint & survivor option.
- Form of annuity selected, female: 15% elect 50% joint & survivor option; 15% elect 100% joint & survivor option.

*(Unaudited)*

# Schedule of Investment & Administrative Expenses

For the Year Ended June 30, 2008

	Pension Trust Funds				Total
	Defined	Defined Contribution Plan			
	Benefit Plan	Bond	Equity	Money Mkt	
	Basic Fund	Fund	Fund	Fund	
<b>Investment Expenses</b>					
Salaries	\$29,338				\$29,338
Payroll taxes	1,969				1,969
Group insurance	3,041				3,041
Legal					0
Investment management	1,397,315		\$160,973		1,558,288
Investment advisor	67,874	\$2,295	6,657	\$1,551	78,377
Custodial bank fees	66,755	5,003	18,725		90,483
<b>Total investment expenses</b>	<b>\$1,566,292</b>	<b>\$7,298</b>	<b>\$186,355</b>	<b>\$1,551</b>	<b>\$1,761,496</b>
<b>Administrative Expenses</b>					
Personnel					
Salaries	\$209,698	\$16,499	\$25,788	\$9,277	\$261,262
Payroll taxes	15,759	1,234	1,929	694	19,616
Group insurance	25,004	1,707	2,668	960	30,339
Total personnel expenses	250,461	19,440	30,385	10,931	311,217
General expenses					
Bank charges	888	982		171	2,041
Data processing	8,159	375	375	375	9,284
Depreciation	24,057	1,184	1,850	666	27,757
Dues and periodicals	3,626				3,626
Insurance	3,408				3,408
Meetings, conventions & travel	49,417				49,417
Printing, postage & office supplies	15,060	481	655	352	16,548
Real estate taxes	15,901				15,901
Repairs and service contracts	1,865				1,865
Supplies - building	12,105				12,105
Utilities and telephone	11,802				11,802
Other	2,245				2,245
Total general expense	148,533	3,022	2,880	1,564	155,999
Professional fees					
Actuarial	41,084				41,084
Auditing and accounting	37,987	4,095	7,425	2,745	52,252
Legal	9,879	333	333	333	10,878
Total professional fees	88,950	4,428	7,758	3,078	104,214
<b>Total administrative expenses</b>	<b>\$487,944</b>	<b>\$26,890</b>	<b>\$41,023</b>	<b>\$15,573</b>	<b>\$571,430</b>