



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, 2011, as listed in the table of contents. These basic financial statements are the responsibility of the Association's management. Our responsibility is to express an opinion on these basic 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 basic 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, 2011, 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.

Accounting principles generally accepted in the United States of America require that the Management's Discussion and Analysis and Required Supplementary Information as listed in the table of contents be presented to supplement the basic financial statements. Such information, although not part of the basic financial statements, is required by the Governmental Accounting Standards Board, who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. In accordance with auditing standards generally accepted in the United States of America, we have applied certain limited procedures to the required supplementary information, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

Our audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The introductory section, the other supplementary information, the investment section, the actuarial section, and the statistical section listed in the table of contents are presented for purposes of additional analysis and are not a required part of the basic financial statements. The other supplementary information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the basic financial statements. This information has been subjected to the auditing procedures applied in the audit of the basic financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the basic financial statements or to the basic financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the information is fairly stated in all material respects in relation to the basic financial statements as a whole. The introductory, investment, actuarial, and statistical sections have not been subjected to the auditing procedures applied in the audit of the basic financial statements and, accordingly, we do not express an opinion or provide any assurance on them.

REBECCA OTTO  
STATE AUDITOR

GREG HIERLINGER, CPA  
DEPUTY STATE AUDITOR

December 19, 2011

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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, 2011. 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, increased by \$21 million during the fiscal year to \$213 million. This 10.9% increase in net assets was primarily due to investment performance. Net assets in the defined contribution plan also rose by \$6.6 million, an increase of 16.9%.
- Total additions in the defined benefit pension plan were \$45.7 million which was 24.7% higher than the amount in the previous fiscal year. The increase was primarily due to investment experience. In fiscal year 2011 net investment return was +21.7% compared to a return last year of +17.0%. Similarly, due primarily to investments, total additions in the defined contribution plan were \$14.7 million, compared to \$12.7 million last fiscal year, an increase of 14.9%.
- The defined benefit plan recorded a +21.7% rate of return for the year, net of fees. For longer periods of time, the DTRFA annualized returns over 20 and 25 years of +8.4% and +8.6% respectively provide some additional perspective about the returns of the plan. For the defined contribution plan, net returns for the last fiscal year were +6.9% in the Bond Fund, +37.1% in the Equity Fund, and +0.5% in the Money Market Fund.
- The actuarial funding ratio of the defined benefit plan, a comparison of actuarial value of assets to actuarial accrued liability, was 73% at June 30, 2011. The funding ratio decreased from the 82% level of the previous year mainly because of the actuarial technique

used to smooth investment gains and losses. A portion of investment losses in fiscal years 2008 and 2009 were realized in fiscal year 2011.

## 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:

	Plan Net Assets			
	2011	2010	Change	Percent
Cash & Investments	\$268,715,426	\$235,249,774	\$33,465,652	14.2%
Receivables	10,764,346	7,607,691	3,156,655	41.5%
Securities Lending Collateral	5,381,363	4,996,116	385,247	7.7%
Capital Assets	297,766	294,654	3,112	1.1%
Total Assets	285,158,901	248,148,235	37,010,666	14.9%
Liabilities	(26,107,069)	(16,660,437)	(9,446,632)	56.7%
<b>Plan Net Assets</b>	<b>\$259,051,832</b>	<b>\$231,487,798</b>	<b>\$27,564,034</b>	<b>11.9%</b>

The value of plan net assets increased by \$27.6 million during fiscal year 2011. This was primarily a result of investment experience - positive returns in the equity and bond markets. There were also strong positive returns in the real estate holdings during the year, but that comprised a very small portion of the total portfolio. As a result, additions to plan net assets increased significantly.

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

	Additions to Plan Net Assets			
	2011	2010	Change	Percent
Member & Employer Contributions	\$12,634,942	\$12,887,414	\$(252,472)	-2.0%
Total Investment Income (Loss)	47,744,387	36,490,878	11,253,509	30.8%
Other	12,404	58,082	(45,678)	-78.6%
<b>Total Additions</b>	<b>\$60,391,733</b>	<b>\$49,436,374</b>	<b>\$10,955,359</b>	<b>22.2%</b>

Employee and employer contribution rates in the defined benefit plan remain unchanged. However, in fiscal year 2009, the State of Minnesota began making a fixed \$346,000 payment to the plan each year and an additional payment that varies each year. The small decrease in total contributions compared to the previous year was due to fewer active members in the pension plan therefore lower total contributions. The investment rate of return for the defined benefit plan of 21.7% in fiscal year 2011 was higher than the 8.5% actuarially assumed return, and higher than the return of 17.0% in fiscal year 2010.

	Deductions from Plan Net Assets			
	2011	2010	Change	Percent
Benefit Payments	\$24,067,915	\$23,596,191	\$471,724	2.0%
Withdrawals & Transfers	7,970,966	7,610,976	359,990	4.7%
Contribution Refunds	210,819	116,127	94,692	81.5%
Administrative Expense	577,999	588,358	(10,359)	(1.8)%
<b>Total Deductions</b>	<b>\$32,827,699</b>	<b>\$31,911,652</b>	<b>\$916,047</b>	<b>2.9%</b>
<b>Increase (Decrease) in Plan Net Assets</b>	<b>\$27,564,034</b>	<b>\$17,524,722</b>	<b>\$10,039,312</b>	<b>57.3%</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 (but no cost-of-living-adjustment for benefit recipients on January 1, 2011) and higher withdrawals in the defined contribution plan. Total administrative expenses decreased for the second consecutive year, by 1.8% in fiscal year 2011 and by 1.0% in fiscal year 2010.

### **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, 2011, the funded ratio of the defined benefit plan was 73%, a decrease from the 82% level a year earlier. The funded ratio is derived by comparing the "actuarial value" of plan assets to the actuarial accrued 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 2011, this smoothing technique resulted in the recognition of \$30.9 million in deferred investment losses from fiscal years 2008 and 2009. The recognition of the deferred losses from those years was offset by the recognition of a portion of the gains during fiscal years 2007 and 2010. In fiscal year 2011, the fund experienced an actual investment gain of \$23.9 million, of which \$4.8 million was allocated to the current year. That same amount will be allocated to each of the next four years. At June 30, 2011, deferred investment losses totaled \$17.3 million, which will be recognized during the next four years.

During fiscal year 2011, the fund experienced a net actuarial loss of \$3.8 million due to demographic and other economic factors. Of this amount, there was a \$2.5 million gain due to member salaries that

increased at a lower rate than assumed by the plan. This resulted in an actuarial gain since the liability for future benefits, based on a formula using high-5 average salary, thereby accrued at a lower rate than assumed. The remaining \$6.2 million actuarial loss was attributed to post-retirement mortality and a combination of several other immaterial factors not separately identified by the actuaries.

As reported last year significant legislation was enacted in 2010. After the negative market returns in fiscal years 2008 and 2009, legislative action was taken to address a declining funding ratio. Major provisions signed into law include a one percent increase to both employee and employer contribution rates phased in over two years beginning on July 1, 2011, and a revised cost of living adjustment method based on the funding ratio of the pension plan.

The actuarial valuation report for the fiscal year notes that contribution rates are not sufficient for the plan to achieve 100% funding by the year 2035, the date required in law for the plan to be fully funded. Based on contribution rates in effect on July 1, 2011, the total rate of 13.5% (6.0% employee, 6.29% employer, and 1.21% State payment) is 3.7% lower than the actuarially required rate of 17.23%. However, another one-half percent increase to both employee and employer contribution rates are scheduled to occur on July 1, 2012.

In summary, although the pension fund is less than 100% funded and has a contribution deficiency, the fund has a healthy reserve of assets. Investment markets have made dramatic improvement over the last two fiscal years. The legislative solutions passed in 2010 have yet to be fully implemented. We are optimistic that the pension fund is on track and sustainable for all members well into the future.

### **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 the staff of the Association.

# Statement of Plan Net Assets

June 30, 2011

	Pension Trust Funds				Total
	Defined Benefit Plan	Defined Contribution Plan			
	Pension Fund	Bond Fund	Equity Fund	Money Mkt Fund	
<b>Assets</b>					
Cash	\$64,469	\$69,414	\$111,127	\$50,250	\$295,260
Short-term investments	19,069,464		303,001	6,821,076	26,193,541
Total cash and equivalents	19,133,933	69,414	414,128	6,871,326	26,488,801
Receivables					
Member contributions	459,389				459,389
Employer contributions	483,610				483,610
Interest and dividends	310,956		60	2,932	313,948
Stock and bond sales	9,502,466				9,502,466
Other	4,933				4,933
Total receivables	10,761,354		60	2,932	10,764,346
Investments, at fair value					
U.S. Government obligations	21,956,650				21,956,650
Corporate and other bonds	29,014,694	12,285,720			41,300,414
Equities	123,651,435		26,392,201		150,043,636
Private equity and limited partnerships	27,463,195				27,463,195
Real assets	1,462,730				1,462,730
Total investments	203,548,704	12,285,720	26,392,201		242,226,625
Invested securities lending collateral	4,857,528		523,835		5,381,363
Properties, at cost, net of accumulated depreciation of \$392,227	294,616	1,008	1,575	567	297,766
Total assets	238,596,135	12,356,142	27,331,799	6,874,825	285,158,901
<b>Liabilities</b>					
Accounts payable	228,322				228,322
Securities lending liabilities	6,227,360		671,294		6,898,654
Stock and bond purchases	18,772,458				18,772,458
Deferred contributions		47,797	118,958	40,880	207,635
Total liabilities	25,228,140	47,797	790,252	40,880	26,107,069
<b>Net assets held in trust for pension benefits</b>	<b>\$213,367,995</b>	<b>\$12,308,345</b>	<b>\$26,541,547</b>	<b>\$6,833,945</b>	<b>\$259,051,832</b>

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

# Statement of Changes in Plan Net Assets

For the Year Ended June 30, 2011

	Pension Trust Funds				Total
	Defined Benefit Plan	Defined Contribution Plan			
	Pension Fund	Bond Fund	Equity Fund	Money Mkt Fund	
<b>Additions</b>					
Contributions					
Employer	\$2,798,027				\$2,798,027
Plan members' deposits & transfers	2,779,703	\$1,641,639	\$2,469,437	\$2,287,601	9,178,380
State funding	658,535				658,535
Total contributions	<u>6,236,265</u>	<u>1,641,639</u>	<u>2,469,437</u>	<u>2,287,601</u>	<u>12,634,942</u>
Investment activities income					
Net appreciation in fair value of investments	38,244,338	302,765	6,683,521		45,230,624
Interest	1,867,108	18	565	49,781	1,917,472
Dividends	527,182	566,880	783,548		1,877,610
Rental income (net)	198,622				198,622
Total investment activities income	<u>40,837,250</u>	<u>869,663</u>	<u>7,467,634</u>	<u>49,781</u>	<u>49,224,328</u>
Less investment expense	<u>(1,359,608)</u>	<u>(9,227)</u>	<u>(127,253)</u>	<u>(2,571)</u>	<u>(1,498,659)</u>
Net investment activities income	<u>39,477,642</u>	<u>860,436</u>	<u>7,340,381</u>	<u>47,210</u>	<u>47,725,669</u>
Securities lending					
Securities lending income	21,245		5,479		26,724
Less securities lending expense	(6,364)		(1,642)		(8,006)
Net income from securities lending	<u>14,881</u>		<u>3,837</u>		<u>18,718</u>
Total net investment income	<u>39,492,523</u>	<u>860,436</u>	<u>7,344,218</u>	<u>47,210</u>	<u>47,744,387</u>
Other income	12,404				12,404
Total Additions	<u>45,741,192</u>	<u>2,502,075</u>	<u>9,813,655</u>	<u>2,334,811</u>	<u>60,391,733</u>
<b>Deductions</b>					
Benefits to participants					
Retirement	22,185,946				22,185,946
Disability	162,188				162,188
Survivor	1,719,781				1,719,781
Contribution refunds	210,819				210,819
Plan members' withdrawals & transfers		2,628,170	3,478,754	1,864,042	7,970,966
Total benefits, refunds & withdrawals	<u>24,278,734</u>	<u>2,628,170</u>	<u>3,478,754</u>	<u>1,864,042</u>	<u>32,249,700</u>
Administrative expenses	497,009	25,282	40,520	15,188	577,999
Total Deductions	<u>24,775,743</u>	<u>2,653,452</u>	<u>3,519,274</u>	<u>1,879,230</u>	<u>32,827,699</u>
Net increase (decrease)	20,965,449	(151,377)	6,294,381	455,581	27,564,034
Net assets held in trust for pension benefits					
- Beginning of year	<u>192,402,546</u>	<u>12,459,722</u>	<u>20,247,166</u>	<u>6,378,364</u>	<u>231,487,798</u>
- End of year	<u>\$213,367,995</u>	<u>\$12,308,345</u>	<u>\$26,541,547</u>	<u>\$6,833,945</u>	<u>\$259,051,832</u>

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 Pension 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. 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, 2011, receivables consisted of contributions owed by members and employers, interest and dividends from investments, and amounts due from the sales of investments where the trade was initiated prior to June 30, 2011, 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, 2011, 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, and obligations for the purchase of investments where the trade was initiated prior to June 30, 2011, but settled at a later date.

### 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, 2011, is as follows:

Class	Useful Life-Yrs.	Carrying Value	Accumulated Depreciation	Net
Land	N/A	\$35,540	N/A	\$35,540
Land Improvement	7-15	68,414	\$46,964	21,450
Building	15-30	397,388	186,168	211,220
Furniture, fixtures	5-7	<u>188,651</u>	<u>159,095</u>	<u>29,556</u>
Totals		<u>\$689,993</u>	<u>\$392,227</u>	<u>\$297,766</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 interest-bearing account balances up to \$250,000 insured by the Federal Deposit Insurance Corporation (FDIC) and non-interest bearing accounts fully insured by the 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 \$316,243 all of which were covered by insurance.

### Investments

The following table shows the investments of the Association by type at June 30, 2011:

#### Short-term investments

Commingled investment funds	\$19,888,919
Certificates of deposit	4,000,000
Government Agency Discounted Notes	2,304,622

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

Commingled international equity fund	38,992,166
Commingled domestic equity fund	14,692,557
Domestic equity mutual fund	38,036,698
Domestic equities	53,555,521
Asset backed securities	1,062,227
Commercial mortgage backed	2,034,079
Corporate bonds	15,624,380
Government bonds	1,688,072
Government agency bonds	18,381,889
Mortgage backed securities	8,980,431
Municipal bonds	383,895
Commingled bond fund	13,164,533
Real estate	1,462,730
Limited partnership investments	10,065,081
Private equity investments	17,398,114

#### Invested collateral on securities loaned

Money market funds	3,912,876
Mortgage backed securities	367,850
Asset backed securities	334,608
Corporate bonds	766,029

#### Investments held by broker-dealers under securities lending program

Corporate bonds	50,869
Government bonds	1,881,091
Government agency bonds	5,598
Domestic equities	<u>4,766,694</u>
Total investments	<u>\$273,801,529</u>

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

Short-term investments	\$26,193,541
Investments	242,226,625
Invested securities lending collateral	<u>5,381,363</u>
Total investments	<u>\$273,801,529</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 \$8,319,448 or 13.2% of the debt portfolio.

Quality Rating	
AAA	\$23,342,269
AA+	1,624,392
AA	760,632
AA-	397,975
A+	1,356,249
A	3,372,304
A-	2,691,681
BBB+	2,216,550
BBB	1,496,242
BBB-	1,568,127
BB+	1,047,980
BB	324,186
BB-	227,188
B+	1,432,334
B	411,215
B-	871,166
CCC	3,580,462
CC	70,943
D	353,974
Not rated	<u>12,542,032</u>
Total credit risk debt securities	\$59,687,901
U.S. Government bonds	<u>3,569,163</u>
Total debt securities	<u>\$63,257,064</u>



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# Notes - Continued

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## 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, 2011 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.

### 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 Statement of Investment Objectives and Policies (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 Barclays Capital U.S. Aggregate Index.
- The average effective modified duration of each bond portfolio must be between 75% and 125% of the effective duration of the Barclays Capital U.S. Aggregate 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, 2011 the index range required by the Association for bond managers is 3.9 years to 6.5 years based on a Barclays Capital U.S. Aggregate Index of 5.2 years at June 30, 2011.

The Association's bond portfolios were within the required range. The Pension Fund bond portfolio had a duration of 4.0 and the Bond Fund portfolio had a duration of 5.07 at June 30, 2011. The overall effective weighted duration for all fixed income investments is shown below.

<u>Investment</u>	<u>Fair Value</u>	<u>Duration (Years)</u>
Asset backed securities	\$1,062,227	(.42)
Commercial mortgage backed	2,034,079	2.26
Corporate bonds	15,675,249	5.09
Government bonds	3,569,163	12.68
Government agency bonds	18,387,487	4.21
Municipal bonds	383,895	10.98
Mortgage backed securities	8,980,431	(.85)
Commingled bond fund	<u>13,164,533</u>	<u>4.78</u>
Total debt securities	<u>\$63,257,064</u>	<u>4.21</u>

### 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.
- No purchase of non-agency mortgage obligations or non-agency mortgage backed pass-throughs will be permitted unless exposure falls below 15%.
- No purchases of real estate related asset backed securities are permitted.
- 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, 2011 there were no single issuer investments that exceeded the above guidelines.

### 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).

# Notes - Continued

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

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

<u>Currency</u>	<u>Debt</u>	<u>Equity</u>	<u>Total</u>
Australian Dollar	\$1	\$937,579	\$937,580
Brazilian Real	180,909	382,902	563,811
Bulgarian Lev		147,349	147,349
Canadian Dollar		2,545,315	2,545,315
Swiss Franc		1,478,566	1,478,566
Czech Koruna		282,421	282,421
Danish Kroner		868,547	868,547
Egyptian Pound	53		53
European Union Euro	554,741	11,929,639	12,484,380
British Pound	4,462	6,150,326	6,154,788
Hong Kong Dollar		4,235,671	4,235,671
Iceland Krona	85,441		85,441
Japanese Yen	1,865	3,679,929	3,681,794
Indonesian Rupiah		3,550	3,550
Malaysian Ringgit	40,882		40,882
Mexican Peso	72,726	143,717	216,443
Norwegian Krone		122,632	122,632
Polish Zloty	63,844	13,838	77,682
Russian Ruble		1,004	1,004
South African Rand		203,154	203,154
Turkish Lira		1	1
Swedish Krona		588,728	588,728
Total securities subject to currency risk	<u>\$1,004,924</u>	<u>\$33,714,868</u>	<u>\$34,719,792</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 collateral amounts received exceeded amounts out on loan.

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, asset backed securities, and corporate bonds.

The securities on loan at year-end had a market value of \$6,704,252. The Association had received collateral of \$6,898,654 on these loans and the market value of the invested collateral received for the securities on loan was \$5,381,363. If all the loans were terminated at June 30, 2011, the Association would have needed to make up the \$1.5 million difference between the market value of the invested collateral and the collateral liability.

### Derivative Investments

The Pension Fund invests in a domestic equity fund which uses derivative investments to enhance returns and hedge losses. The strategies employed by the domestic equity fund include short sales, use of puts and options, and the use of futures contracts. The domestic equity fund may use leverage to take positions in derivatives up to 150% of the value of the fund's net assets. The Pension Fund's risk related to this investment is limited to the amount invested in this fund. At June 30, 2011 the value of this investment was \$9,561,633.

### Commitments and Contingencies

At June 30, 2011 the Pension Fund had commitments for future purchases of private equity investments amounting to approximately \$12,400,000.

## NOTE 3. DEFINED BENEFIT PLAN

The following brief description of the Pension 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, 2011 membership consisted of:

• Retirees and beneficiaries receiving benefits	1,344
• Terminated plan members entitled to, but not yet receiving benefits	1,025
• Active plan members	<u>1,006</u>
Total	3,375

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# Notes - Continued

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

#### 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 for members hired prior to July 1, 2010 and after 5 years for members hired after June 30, 2010 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 4% 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

Effective July 1, 2010 a cost of living adjustment (COLA) equal to the consumer price index (up to 5%) is payable when the funding ratio using actuarial value of assets equals or exceeds 90%. Until the 90% threshold is met, there is a transitional COLA which provides for an adjustment based on the funding ratio using the market value of assets: 2% when greater than 90%, 1% when greater than 80%, otherwise 0%.

For the fiscal year ended June 30, 2011 there was no cost of living adjustment because the funding ratio using the market value of assets was less than 80%.

#### 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 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, 2011, members were required to contribute 5.5% of their salaries to the Association. Employer contributions were 5.79% of the members' salaries.

# Notes - Continued

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

For the fiscal year beginning July 1, 2011 members will be required to contribute 6.0% of their salaries and employers will be required to contribute 6.29% of members' salaries.

#### Funded Status and Funding Progress

The funded status as of July 1, 2011, the most recent actuarial date is as follows:

Actuarial value of assets	\$235,071,975
Actuarial accrual liability (AAL)	321,065,000
Unfunded AAL (UAAL)	85,993,025
Funded ratio	73.2%
Annual covered payroll	\$44,483,736
UAAL as a percentage of payroll	193.3%

The funded ratio decreased 8.5% 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 the independent actuary retained by the DTRFA.

Additional information as of the latest valuation follows:

- Valuation date..... July 1, 2011
- 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%.
- No annual post-retirement adjustment.
- 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, 2011, there were 407 participants in the Bond Fund, 541 participants in the Equity Fund, and 297 participants in the Money Market Fund.

A summary of the unit values in the tax deferred program at June 30, 2011, is as follows:

	<u>Bond Fund</u>	<u>Equity Fund</u>	<u>Money Mkt. Fund</u>
Net assets	\$12,308,345	\$26,541,547	\$6,833,945
Number of units	911,786	2,639,618	2,531,258
Net asset value per unit	\$13.4992	\$10.0551	\$2.6998

# 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)
7/1/06	\$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
7/1/09	279,256	364,811	85,555	76.6	51,019	167.7
7/1/10	255,309	312,650	57,341	81.7	49,502	115.8
7/1/11	235,072	321,065	85,993	73.2	44,484	193.3

(unaudited)

## Schedule of Contributions From Employers and the State of Minnesota

(Dollars in Thousands)

Year Ended June 30	Annual Required Employer Contributions	Actual Employer Contributions	Employer Percentage Contributed	Additional State Contributions	State Percentage Contributed
2006	\$ 3,982	\$ 2,867	72.0%	-	-
2007	4,736	2,941	62.1	-	-
2008	4,560	2,994	65.7	-	-
2009	5,170	2,954	57.1	\$346	6.7%
2010	5,922	2,866	48.4	760	12.8
2011	3,101	2,798	90.2	659	21.3

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 Pension Fund. Beginning in 2009, the State of Minnesota began making additional payments directly to the Pension Fund. The employer and the State 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:

- The most recent actuarial valuation date is July 1, 2011.
- 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%.
- No post-retirement adjustment.
- 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 Changes to Plan Provisions and Actuarial Methods & Assumptions - Last 6 Years

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 was paid 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.

2010 - Changes to Plan Provisions:

- Employee contribution rate scheduled to change from 5.5% to 6.0% on July 1, 2011, then to 6.5% on July 1, 2012.
- Employer contribution rate scheduled to change from 5.79% to 6.29% on July 1, 2011, then to 6.79% July 1, 2012.
- Automatic cost of living adjustment replaced with one based on the funding ratio of the plan, effective July 1, 2010.
- Vesting will increase from 3 years to five years for employees hired after June 30, 2010.
- Interest paid on refunds will be reduced from 6.0% to 4.0%, effective July 1, 2010.
- The rate of augmentation for all deferred accounts will be lowered to 2.0%, effective July 1, 2012.

(Unaudited)

# Schedule of Investment & Administrative Expenses

For the Year Ended June 30, 2011

	Pension Trust Funds				Total
	Defined	Defined Contribution Plan			
	Benefit Plan	Bond	Equity	Money Mkt	
	Pension Fund	Fund	Fund	Fund	
<b>Investment Expenses</b>					
Salaries	\$30,912				\$30,912
Payroll taxes	2,136				2,136
Group insurance	3,906				3,906
Legal and professional	8,532				8,532
Investment management	1,165,858		\$108,147		1,274,005
Investment advisor	89,088	\$5,476	10,365	\$2,571	107,500
Custodial bank fees	59,176	3,751	8,741		71,668
<b>Total investment expenses</b>	<b>\$1,359,608</b>	<b>\$9,227</b>	<b>\$127,253</b>	<b>\$2,571</b>	<b>\$1,498,659</b>
<b>Administrative Expenses</b>					
Personnel					
Salaries	\$226,793	\$17,442	\$27,254	\$9,811	\$281,300
Payroll taxes	18,593	1,309	2,046	737	22,685
Group insurance	29,463	2,186	3,415	1,229	36,293
Total personnel expenses	274,849	20,937	32,715	11,777	340,278
General expenses					
Bank charges	10,902			65	10,967
Data processing	6,236	264	413	149	7,062
Depreciation	24,079	504	788	284	25,655
Dues and periodicals	4,431				4,431
Insurance	3,337				3,337
Meetings, conventions & travel	33,636				33,636
Printing, postage & office supplies	13,870	361	499	298	15,028
Real estate taxes	15,568				15,568
Repairs and service contracts	8,925				8,925
Supplies - building	10,534				10,534
Utilities and telephone	12,597				12,597
Other	2,453				2,453
Total general expense	146,568	1,129	1,700	796	150,193
Professional fees					
Actuarial	28,000				28,000
Auditing and accounting	43,703	3,216	6,105	2,615	55,639
Legal	3,889				3,889
Total professional fees	75,592	3,216	6,105	2,615	87,528
<b>Total administrative expenses</b>	<b>\$497,009</b>	<b>\$25,282</b>	<b>\$40,520</b>	<b>\$15,188</b>	<b>\$577,999</b>