

To : Local retirement Fund Investment Study Group
From : Office of the State Auditor
Re: Mutual Fund Investment Issues
Date : September 8, 2010

There are several statutes that permit relief associations and other public pension plans to invest in mutual funds:

Minnesota Statutes, Section 356A.06 Subd. 6 (b)(5) – permits reliefs using the short list to invest 100% investment in mutual funds provided that the mutual funds only invest in investments authorized on the short list.

Minnesota Statutes, Section 356A.06 Subd. 7 (h) permits reliefs and plans using the long list to invest 100% in mutual funds provided that the mutual funds only invest in investments authorized on the long list sections (c) to (j).

Minnesota Statutes, Section. 356A.06 Subd. 7(k) (iii) provides additional authority to users of the long list to invest in any mutual funds not authorized in Minn. Stat. Section 356A.07 (h) subject to the limitation of the “other investments” section.

Minnesota Statutes, Section 69.775 (b) available to all relief associations permits up to 75% of the funds assets to be invested in mutual funds that restrict their investment to the long list.

Minnesota Statutes, Section 69.77 Subd. 9(a)(1) applicable to local police and paid fire relief associations contains the same authorization as Minn. Stat. Section 69.775(b) with slightly different language.

1. Issues related to Minn. Stat. Section 69.775:

Minnesota Statutes, Section 69.775 (b), available to all relief associations, states:

Notwithstanding the foregoing, up to 75 percent of the market value of the assets of the special fund, not including any money market mutual funds, may be invested in open-end investment companies registered under the federal Investment Company Act of 1940, if the portfolio investments of the investment companies comply with the type of securities authorized for investment under section 356A.06, subdivision 7

With the recent changes to the mutual fund provisions on the long list, this provision does not appear to grant any additional authority to long list users. Paid fire and police relief

associations have the same authority under Minn. Stat. Section 69.77 Subd. 9 (a)(1). Both of these statutes include the entire long list as the restriction on the eligible mutual fund's investment portfolio. The entire long list includes the "other investment" section. It is not clear whether these statutes are authorizing the relief associations to invest up to 75% of their portfolios in mutual funds that invest in resource investments, venture capital investment businesses, international debt securities or other mutual funds, all authorized under the "other investment" section of the long list. Further, it is not clear how the "other investment" restrictions would apply to this grant of authority to invest in mutual funds.

For short list users Minn. Stat. Section 69.775 (b) does provide additional options, since the short list itself restricts investment to mutual funds that invest only in investments authorized on the short list, which is limited to certificates of deposit, and certain government and corporate obligations. There are probably very few mutual funds that meet these criteria.

Additionally there are language problems with this Minn. Stat. Section 69.775 (b). The phrase "not including money market funds" was added to this statute to exclude money market mutual funds from the 75% cap. Since this statute authorizes and limits mutual fund investment, this phrase causes some confusion as to whether it is excluding money market funds from the additional authorization or excluding them from the 75% cap.

Option One:

Delete paragraph (b) of Minn. Stat. Section 69.775 and subdivision 9 (a)(1) of Minn. Stat. Section 69.77.

Option Two:

In addition to Option One, the language of 69.775 (b) could be put into the short list. This would allow short list reliefs to invest in a larger group of mutual funds as long as the mutual funds restricted their investments to a portion of the long list or were rated money market mutual funds. Note, the rating requirement is not currently in Minn. Stat. 69.775. The following language was taken from the public investment law, Minn. Stat. Section 118A.05 Subd. 4 (3).

The new language could look like this:

(6) shares of an open-ended investment company which is registered under the Federal Investment Company Act of 1940 and which holds itself out as a money market fund meeting the conditions of rule 2a-7 of the Securities and Exchange Commission and is rated in one of the two highest rating categories for money market funds by at least one nationally recognized statistical rating organization;
or

(7) up to 75% of plan assets may be in open-end investment companies registered under the federal Investment Company Act of 1940, if the portfolio investments of the investment companies comply with the type of securities authorized for investment under section 356A.06, subdivision 7 (c) to (j).

2. Mutual Fund investment authorized by Minn. Stat. Section 356A.06 Subd.7 (k).

Provisions on the long list allowing restricted investment in mutual funds (h) and then unrestricted investment in mutual funds (k (iii)) were meant to address the situations where a mutual fund, otherwise eligible for investment by a relief association, was made ineligible due to small amount of below investment grade debt, international debt or emerging market equity. Under the current approach those portions of the mutual fund portfolio not authorized by section (h) would be allocated to the “other investment” section for the purposes of calculating the “other investment” plan portfolio cap of 20%.

A number of relief associations have invested in short and double short mutual funds under the authority provided in the “other investment” section. These mutual funds configure their portfolios so that their value moves the opposite direction as an identified index. For instance, if the fund is using the Russell 3000 index, when that index goes up one point then the mutual fund should decline in value one point. With the double short or ultra short mutual funds the fund will decline two points if the index goes up one point and visa versa.

One way to prevent investment in short and double short mutual funds would be to restrict the mutual funds authorized in the “other investment” section to those with small amounts of below investment grade debt, international debt or emerging market equity.

The new language might look like this:

(iii) mutual funds through bank sponsored collective funds and open-end investment companies registered under the Federal Investment Company Act of 1940 to the extent that a fund or a portion of the fund does not qualify under paragraph (h) because it invests in below investment grade debt, international debt or emerging market equity. The total amount of the mutual fund's investment in below investment grade debt, international debt or emerging market equity, individually and in the aggregate, cannot exceed 5 % of value of the mutual fund's portfolio.

Exchange Traded Funds (ETFs)

A number of financial advisors have stated that ETFs should receive the same treatment as mutual funds on the long list. Like mutual funds, ETFs represent an investment in a pool of securities. The pool does not expand or contract like an open-ended mutual fund.

ETF shares are traded on stock exchanges like stock. Generally, investors buy ETF shares through a broker.

Currently there is explicit authority to invest in ETFs on the long list. Minnesota Statutes Section 356A.06 Subd. 7 (j) states:

(j) **Exchange traded funds.** The covered pension plan may invest funds in exchange traded funds, subject to the maximums, the requirements, and the limitations set forth in paragraphs (c) to (i), as applicable.

Unlike mutual funds there is no similar provision in the “other investment” section permitting limited investment in ETFs whose pool of investments is inconsistent with (c) to (j) on the long list.

Just like mutual funds there are short and ultra short ETFs.

One option would be to include ETFs with mutual funds in the “other investment” section with whatever restrictions are applicable to mutual funds.