

STATE OF MINNESOTA

Office of the State Auditor



Patricia Anderson
State Auditor

**ST. PAUL TEACHERS' RETIREMENT
FUND ASSOCIATION
ST. PAUL, MINNESOTA**

FOR THE YEAR ENDED JUNE 30, 2006

Description of the Office of the State Auditor

The Office of the State Auditor serves as a watchdog for Minnesota taxpayers by helping to ensure financial integrity, accountability, and cost-effectiveness in local governments throughout the state.

Through financial, compliance, and special audits, the State Auditor oversees and ensures that local government funds are used for the purposes intended by law and that local governments hold themselves to the highest standards of financial accountability.

The State Auditor performs approximately 250 financial and compliance audits per year and has oversight responsibilities for over 4,300 local units of government throughout the state. The office currently maintains five divisions:

Audit Practice - conducts financial and legal compliance audits for local governments;

Government Information - collects and analyzes financial information for cities, towns, counties, and special districts;

Legal/Special Investigations - provides legal analysis and counsel to the Office and responds to outside inquiries about Minnesota local government law; as well as investigates allegations of misfeasance, malfeasance, and nonfeasance in local government;

Pension - monitors investment, financial, and actuarial reporting for over 700 public pension funds; and

Tax Increment Financing, Investment and Finance - promotes compliance and accountability in local governments' use of tax increment financing through financial and compliance audits.

The State Auditor serves on the State Executive Council, State Board of Investment, Land Exchange Board, Public Employee's Retirement Association Board, Minnesota Housing Finance Agency, and the Rural Finance Authority Board.

Office of the State Auditor
525 Park Street, Suite 500
Saint Paul, Minnesota 55103
(651) 296-2551
state.auditor@state.mn.us
www.auditor.state.mn.us

This document can be made available in alternative formats upon request. Call 651-296-2551 [voice] or 1-800-627-3529 [relay service] for assistance; or visit the State Auditor's web site: www.auditor.state.mn.us.

**ST. PAUL TEACHERS' RETIREMENT
FUND ASSOCIATION
ST. PAUL, MINNESOTA**

For the Year Ended June 30, 2006



**Audit Practice Division
Office of the State Auditor
State of Minnesota**

This page was left blank intentionally.

ST. PAUL TEACHERS' RETIREMENT FUND ASSOCIATION
ST. PAUL, MINNESOTA

TABLE OF CONTENTS

	<u>Reference</u>	<u>Page</u>
Introductory Section		
Board of Trustees		1
Financial Section		
Independent Auditor's Report		2
Management's Discussion and Analysis		3
Basic Financial Statements		
Statement of Plan Net Assets	Exhibit 1	11
Statement of Changes in Plan Net Assets	Exhibit 2	12
Notes to the Basic Financial Statements		14
Required Supplementary Information		
Schedule of Funding Progress	Schedule 1	29
Schedule of Contributions from the Employer and Other Contributing Entities	Schedule 2	29
Notes to Schedule 1 and Schedule 2		30
Management and Compliance Section		
Schedule of Findings and Recommendations	Schedule 3	34
Report on Minnesota Legal Compliance		38

This page was left blank intentionally.

This page was left blank intentionally.

**ST. PAUL TEACHERS' RETIREMENT FUND ASSOCIATION
ST. PAUL, MINNESOTA**

**BOARD OF TRUSTEES
JUNE 30, 2006**

John R. Kunz	President
Erma E. McGuire	Vice President
Eugene R. Waschbusch	Secretary-Treasurer
Carol Adams	Trustee
Matthew Bogenschultz	Trustee
Feryle W. Borgeson	Trustee
Michael McCollor	Trustee
Karen Odegard	Trustee
Chong Thao	Trustee
Al Oertwig	Trustee, ex-officio

This page was left blank intentionally.

This page was left blank intentionally.



STATE OF MINNESOTA
OFFICE OF THE STATE AUDITOR

SUITE 500
525 PARK STREET
SAINT PAUL, MN 55103-2139

(651) 296-2551 (Voice)
(651) 296-4755 (Fax)
state.auditor@state.mn.us (E-mail)
1-800-627-3529 (Relay Service)

PATRICIA ANDERSON
STATE AUDITOR

INDEPENDENT AUDITOR'S REPORT

Board of Trustees
St. Paul Teachers' Retirement Fund Association

We have audited the basic financial statements of the St. Paul Teachers' Retirement Fund Association as of and for the year ended June 30, 2006, 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 basic 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 St. Paul Teachers' Retirement Fund Association as of June 30, 2006, 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.

Our audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The Management's Discussion and Analysis and other required supplementary information referred to in the table of contents are not required parts of the basic financial statements but are 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 supplementary information. However, we did not audit the information and express no opinion on it.

/s/Pat Anderson

PATRICIA ANDERSON
STATE AUDITOR

/s/Greg Hierlinger

GREG HIERLINGER, CPA
DEPUTY STATE AUDITOR

End of Fieldwork: October 5, 2006

This page was left blank intentionally.

MANAGEMENT'S DISCUSSION AND ANALYSIS

This page was left blank intentionally.

ST. PAUL TEACHERS' RETIREMENT FUND ASSOCIATION
ST. PAUL, MINNESOTA

MANAGEMENT'S DISCUSSION AND ANALYSIS
JUNE 30, 2006
(Unaudited)

This section summarizes key information drawn from more detailed sections elsewhere in this report. It includes a brief overview of the financial performance and actuarial status of the St. Paul Teachers' Retirement Fund Association (hereinafter "SPTRFA," "Association," or "Fund") for the fiscal year ended June 30, 2006.

The following principle schedules are referenced throughout:

- (1) Fund basic financial statements
 - (a) Statement of Plan Net Assets
 - (b) Statement of Changes in Plan Net Assets
- (2) Notes to the financial statements
- (3) Required supplementary schedules of contributions and funding progress

ORGANIZATIONAL STRUCTURE

The SPTRFA is a non-profit organization formed in 1909, incorporated under Minn. Stat. ch. 317A. At the direction and oversight of a ten-member Board of Trustees, Association staff manage two tax-qualified, defined benefit pension programs covering licensed personnel for a single employer, Independent School District (ISD) No. 625, central administrative body for public schools within the City of St. Paul.

Basic Plan members do not participate in Social Security through their employment with ISD No. 625. The *Coordinated Plan*, commenced in 1978, provides retirement benefits for members who do participate in Social Security.

Under state law, payroll contributions to the Fund are a direct operating obligation of the school district and members. However, the Association is not a component unit of St. Paul Public Schools; neither are the Fund's assets or liabilities included in District financial statements.

INVESTMENT PERFORMANCE

Contributions provide the initial capital base of any retirement plan, as a lake or pond is often the origin point for a river. However, most of the water that ultimately flows out to sea comes not from the headwaters; rather, its source is the many tributaries on the long and winding voyage toward the sea.

Retirement funds operate in similar fashion. For every dollar ultimately paid out in benefits, about 30 cents will come from employee and employer contributions. Typically, about 70 cents will come from investment earnings on those contributions over time. Clearly, the adequacy of benefits and the long-term health of the Fund rely heavily on the efficient and prudent investment of contributions from members, employers, and taxpayers. In this regard, the Association has performed very well in recent years.

Our statutory, actuarial assumed return is 8.5 percent per year; an *absolute standard* of investment performance. Over any five-year window, annualized returns below this absolute target will cause unfunded liabilities to increase. Excess returns add to the actuarial balance sheet and reduce the unfunded liabilities of the plan, *ceteris paribus*. It is also important to measure how assets are performing in comparison to other public pension funds and to how the assets might have performed if passively invested in index-matching portfolios. To assess *relative* investment performance, we compare returns to those of similar pension funds and the composite benchmark return that would have occurred if the assets had been indexed to matching asset class targets selected by the trustees.

Comparison of Annualized Returns (%)

	1-Year	3-Year	5-Year
Actual performance (net of fees)	12.6	14.7	8.2
Benchmark	13.1	14.1	7.8
Actuarial target	8.5	8.5	8.5
Actual versus benchmark	- 0.5	+ 0.6	+ 0.4
Actual versus actuarial target	+ 4.1	+ 6.2	- 0.3

The 2006 total Fund return (net of fees) rose to 12.6 percent, or about 4.1 percent more than the absolute actuarial target needed to offset “normal cost,” or the annual rate of liability accumulation. This is very positive news, especially on the heels of an 11.8 percent return in 2005. Despite the gains of recent years, the down market years of 2000 through 2003 is manifested in the five-year return relative to the actuarial target of 8.5 percent. That adverse effect is diminishing with each year of excess performance achieved, and the five-year return is now very nearly adequate relative to the long-term absolute target.

When relative returns are considered, our performance was mixed. Data from Callan Associates, our general investment consultant, indicate that on a net-of-fees basis, the Association narrowly missed its composite benchmark (based on asset allocation) by one-half of one percent as of the close of the fiscal year. On a five-year basis, the Fund outperformed the composite by an equally

narrow margin of four-tenths of one percent. However, within the Callan Public Funds Universe, our overall performance in 2005-06 ranked in the top two percent. Together, these statistics reveal that the SPTRFA has an asset allocation that is more aggressive than most public pension funds, which, in absolute terms, served the fund very well. Because one-year return trailed the composite benchmark, it appears that asset allocation, rather than active manager performance, was our strongest ally during the year. When one looks at the three and five-year annualized returns, however, active managers appear to be adding value, (net of fees) even within the more demanding mandates with which they have been assigned.

Compared to most public pension funds, the Association has a large allocation to international equities (25 percent), an overweight to small cap and value-style equity markets, and a real estate allocation that is higher than that for most public plans. The value style tilt of the portfolio will be corrected through rebalancing transactions. The weighting of international equities and real estate reflect long-term commitments that the Trustees and their consultant regard as prudent and necessary strategies. The real estate portfolio is conservative in structure; the goal being to generate equity-like returns with less volatility than stocks. Real estate has supplanted what has, in the past, been a larger allocation to fixed income investments. Bonds (now 19 percent of the targeted allocation overall) are usually employed to dampen portfolio volatility. Substituting real estate is expected to add somewhat to year-over-year volatility.

Each of these strategic allocations is understood to incur more short-term risk (understood as volatility rather than loss of principal). The expectation is that they will also contribute to higher long-term rates of return on fund assets. Recent experience indicates that the strategy is working.

In order of priority, the goals of investing fund assets are:

- to pre-fund promised benefits,
- to maintain the purchasing power of deferred earnings,
- to offset and reduce long-term program costs,
- to satisfy any historical unfunded liabilities,
- to move the fund toward the full-funding target, and
- to enhance future benefits to members.

The purposes for investing all imply measurable outcomes that should manifest themselves as positive effects on the fiscal status of the organization as a business, and from an actuarial viewpoint as a defined benefit pension program. The annual financial statements and the actuarial valuation provide information that helps to better assess whether, and to what extent, the investment program is contributing toward the goals of the Association.

SUMMARY OF THE FUND FINANCIAL STATEMENTS AND ACTUARIAL REPORT

The next two tables summarize data found later in this report. Detailed information can be found in schedules with corresponding names under the Financial Section of this annual report.

Plan Net Assets (In Thousands of Dollars)

	June 30	
	2006	2005
Assets		
Cash	\$ 13,179	\$ 3,179
Receivables	6,396	8,313
Investments at fair value	992,064	933,728
Securities lending collateral	87,924	101,596
Capital assets, less depreciation	27	33
Total Assets	\$ 1,099,590	\$ 1,046,849
Liabilities		
Accounts payable	\$ 1,119	\$ 737
Securities purchases payable	4,802	9,849
Securities lending collateral	87,924	101,596
Total Liabilities	\$ 93,845	\$ 112,182
Net Assets Held in Trust for Pension Benefits	\$ 1,005,745	\$ 934,667

Changes in Plan Net Assets (In Thousands of Dollars)

	Year Ended June 30	
	2006	2005
Additions		
Employer and employee contributions	\$ 34,068	\$ 34,021
State of Minnesota amortization aids	3,400	3,398
Investment activity, less management fees	113,572	99,268
Net securities lending income	196	156
Total Additions	\$ 151,236	\$ 136,843
Deductions		
Benefits, withdrawals, and refunds	\$ 79,567	\$ 73,520
Administrative expenses	591	559
Total Deductions	\$ 80,158	\$ 74,079
Net Increase (Decrease)	\$ 71,078	\$ 62,764
Net Assets in Trust for Benefits - Beginning of the Year	934,667	871,903
Net Assets in Trust for Benefits - End of the Year	\$ 1,005,745	\$ 934,667

(Unaudited)

Page 6

Two important observations can be drawn from the Statement of Changes in Plan Net Assets:

- (1) investment had a very positive effect on the Fund's bottom line, generating approximately \$114 million in additional assets; and
- (2) the SPTRFA manages a mature defined benefit program, for which annual benefit expenditures typically exceed payroll contributions by a significant amount.

These two facts underscore the importance of a sound investment management program. Annual benefit expenditures are about double the level of annual contributions. This is not unusual for a fund such as that administered by the SPTRFA. However, this relationship exposes a certain structural erosion to the asset base. Any year in which the targeted absolute return of 8.5 percent is missed amplifies the effect of this structural budgetary imbalance. The long-term required rate of return then, all else remaining the same, must *exceed* the assumed return by some percentage factor. While we do not know with any precision what that "excess return" is, it most certainly grows by some marginal increment any time the Fund falls short of the actuarial target return. Further, the spread between benefit outlays and contributions must not be allowed to become too large. The importance of monitoring the adequacy of payroll contributions and modifying them when needed is discussed later in this section of the report.

Administrative costs, as can be seen above, are a small part of program expenditures. The Board of Trustees nevertheless must be diligent to monitor and control those costs, since any dollar spent to administer the program affects the total assets available to pay benefits. In a recent report by the Office of the State Auditor¹, the Association's operating expenditures ranked very low compared to other public plans in the state when measured on a per-member basis. Investment expenses, as a percent of assets, were above average, due in part to a relatively larger allocation to active asset management.

Notes to the Basic Financial Statements

The notes provide supplementary information essential to fully understand the data provided in the basic financial statements. Below is a brief description of the notes, listed in numerical order:

- (1) Describes accounting policies applied in the development of the basic financial statements.
- (2) Provides a description of the plans administered by the SPTRFA, including coverage, classes of membership, and benefits.
- (3) Describes the laws and policies governing the deposit and investment of Association assets and also describes other common risks, including concentrations of credit risk, interest rate risk, and foreign currency risk.

¹ "State of Minnesota, Office of the State Auditor, Large Public Pension Plan Investment Report, For the Year Ended December 31, 2004."

- (4) Explains the securities lending program which the SPTRFA participates in through its custodian, the Bank of New York. By state law, securities on loan must be at least 100 percent collateralized at all times.
- (5) Describes how funds are accumulated through contributions.
- (6) Describes the risk management policies of the Association with respect to losses related to torts, loss of assets, injuries to employees, and natural disasters.

Actuarial Valuation Summary

The financial statements can tell the reader whether, on a certain date, a plan is solvent, the general fiscal status of the fund, and how certain elements determining financial health have changed over limited time frames. The reader hoping to assess whether assets and current financing mechanisms are adequate to satisfy long-term liabilities associated with promised plan benefits, however, needs other information; facts about the economy, plan population, investment environment and program features that are, as yet, only known in a probabilistic sense. Hence, an actuarial valuation is needed to supplement accounting-based measures of funded status, and an entire section of this report is dedicated to actuarial measures of the Fund's long-term fiscal health.

The July 1, 2006, valuation is a forecast and, as such, shows the "true" funded status of the defined benefit plans administered by the Association. This picture is reliable if the model, and key assumptions driving the forecast results, are valid. An experience study is conducted every four or five years in order to test whether important assumptions are consistent with real historical data over time. If the demographic and economic assumptions governing the valuation process are relatively consistent with recent history, then policymakers may use the information in the annual valuation in deciding whether the adjustable factors, contribution rates, and investment performance, are sufficient to make or keep the plan healthy.

In 2002, the Fund adopted a number of changes to demographic, mortality, and salary progression assumptions to facilitate more accurate estimation of plan liabilities over time. No other changes have been solicited or adopted since. There were no changes to assumptions governing the valuation methodology or key valuation economic assumptions in the most recent year. Below are summary comparative statistics from the July 1, 2006, valuation:

Summary of 2006 Actuarial Valuation			
Plan Year Beginning July 1, 2006			
	2005	2006	Change
Covered payroll	\$ 223,762,071	\$ 226,350,763	+ 1.16%
Statutory contributions (Ch. 354A)	16.49%	16.33%	- 0.16%
Required (Ch. 356)	23.78%	25.03%	+ 1.25%

(Unaudited)

Sufficiency/(Deficiency) to 2021	- 7.29%	- 8.70%	- 1.41%
Market value of assets	\$ 934,667,364	\$ 1,005,745,229	+ 7.60%
Actuarial value of assets	905,292,514	938,919,005	+ 3.71%
Actuarial accrued liability	1,299,831,584	1,358,619,906	+ 4.52%
Unfunded liability	394,539,070	419,700,901	+ 6.38%
Funded ratio	69.65%	69.11%	- 0.54%

The 2006 actuarial valuation reflects a moderate deterioration in overall funded status compared to the previous year, despite significant excess investment gains of 7.6 percent (net of fees) in the most recent fiscal year. A decline in the funded ratio seems counterintuitive. It occurs because the actuary is required to “smooth out” the effect of investment gains and losses over a five-year window, with each year allowed an additional 20 percent in the weighting formula. Hence, while investment gains for the most recent years have been very strong, less weight is given to those gains, while the relative weight for *negative* years (2002-03) *increased* relative to the previous year valuation. As low-return years move out of the asset equation, the funded ratio should reflect greater influence deriving from recent and more positive years.

Distortions introduced by the valuation methodology and the compression of the amortization target period to 15 years are factors that must be taken into consideration. They do not, however, fully explain the deterioration in measured contribution adequacy in the last two valuations. Continuing to expect investment performance to offset the effects of a slowly growing payroll base and an erosion in the adequacy of the contribution stream does not seem wise. It will be necessary to supplement the plan by a significant amount in order to prevent further deterioration in the funded ratio due to insufficient contributions. This amount grows each year that the contributions continue to be deficient.

The annual contribution deficiency, as measured within a fixed (and diminishing) amortization window through June 2021, worsened by 1.4 percent of payroll, or \$3.3 million. The total difference between actuarial and statutory contributions to the fund was 8.7 percent, or \$20.4 million per year. *Ceteris paribus*, this gap will grow and become more volatile each year that it is not addressed.

Fixed amortization windows are an inferior basis for assessing the funding needs of an open pension fund. If the SPTRFA unfunded liability were amortized over a typical full career service cycle, say 30 years, the deficiency would be 2.8 percent per year. That is still a serious deficiency, but it is a funding problem whose solution is quite within reach.

* * * * *

Collectively, the schedules, accompanying notes, and discussions in this report provide comprehensive information as of June 30, 2006, regarding the benefit plans administered by the Association, the asset and liability structure of the Fund, the financial and actuarial status of the SPTRFA, and key policies and procedures of the Association.

Information compiled for this report is intended to conform with generally accepted accounting principles and Governmental Accounting Standards Board Statements 25, 28, 34, and 40. At all times, the objective has been to provide an accurate and balanced picture of the financial and actuarial condition of the retirement program established and administered on behalf of educators in St. Paul. Questions about the information in this report should be directed to:

Phillip Kapler, Executive Director
St. Paul Teachers' Retirement Fund Association
1619 Dayton Avenue, Room 309
St. Paul, Minnesota 55104-6206

Phone: (651) 642-2550
Facsimile: (651) 642-2553
Website: <http://www.sptrfa.org>
Email: info@sptrfa.org

BASIC FINANCIAL STATEMENTS

This page was left blank intentionally.

**ST. PAUL TEACHERS' RETIREMENT FUND ASSOCIATION
ST. PAUL, MINNESOTA**

EXHIBIT 1

**STATEMENT OF PLAN NET ASSETS
JUNE 30, 2006**

<u>Assets</u>	
Cash	\$ 13,179,150
Receivables	
Employer and employee contributions	\$ 1,597,495
Interest	802,965
Dividends	191,381
Sales of securities	3,804,481
Total receivables	\$ 6,396,322
Investments, at fair value	
Commercial paper	\$ 290,750
U.S. government securities	36,717,587
TBAs	16,574,584
Corporate bonds	33,093,082
Corporate stocks	215,765,996
Commingled investment funds	
Pooled international equity trust	109,461,764
Government/credit bond index fund	80,936,500
Equity index fund	125,676,468
Extended equity index fund	53,894,599
Russell 2000 equity index fund	9,353,081
International emerging markets growth fund	56,830,863
Mutual fund	34,930,699
International corporate stock fund	116,333,653
Money market funds	8,044,258
Limited partnership	4,066,386
Real estate securities	90,093,741
Total investments, at fair value	\$ 992,064,011
Invested securities lending collateral	\$ 87,924,018
Furniture and fixtures (at cost, less accumulated depreciation of \$111,074)	\$ 26,608
Total Assets	\$ 1,099,590,109
<u>Liabilities</u>	
Accounts payable	\$ 1,118,549
Security purchases payable	4,802,313
Securities lending collateral	87,924,018
Total Liabilities	\$ 93,844,880
Net Assets Held in Trust for Pension Benefits	
(A schedule of funding progress is presented on page 29.)	\$ 1,005,745,229

**ST. PAUL TEACHERS' RETIREMENT FUND ASSOCIATION
ST. PAUL, MINNESOTA**

EXHIBIT 2

**STATEMENT OF CHANGES IN PLAN NET ASSETS
JUNE 30, 2006**

Additions	
Contributions	
Employer	\$ 20,615,130
Members	13,453,021
Other sources	
State of Minnesota	3,399,761
	<hr/>
Total contributions	\$ 37,467,912
Investment income (loss)	
From investing activity	
Net appreciation (depreciation) in fair value of investments	\$ 104,544,984
Interest	4,721,758
Dividends	4,023,842
Other	4,891,012
	<hr/>
Total investing activity income (loss)	\$ 118,181,596
Less: investing activity expense	
External	\$ (4,461,854)
Internal	(148,083)
	<hr/>
Total less: investing activity expense	\$ (4,609,937)
Net income (loss) from investing activity	\$ 113,571,659
From securities lending activity	
Securities lending income	\$ 4,214,659
Less: securities lending expense	
Borrower rebates	\$ 3,935,481
Management fees	82,949
	<hr/>
Total securities lending expense	\$ 4,018,430
Net income (loss) from securities lending activity	\$ 196,229
Net investment income (loss)	\$ 113,767,888
Total Additions	\$ 151,235,800

**ST. PAUL TEACHERS' RETIREMENT FUND ASSOCIATION
ST. PAUL, MINNESOTA**

**EXHIBIT 2
(Continued)**

**STATEMENT OF CHANGES IN PLAN NET ASSETS
JUNE 30, 2006**

Deductions	
Benefits to participants	
Retirement	\$ 70,677,567
Disability	870,563
Survivor	6,814,597
Dependent children	57,495
Withdrawals and refunds	<u>1,146,861</u>
Total benefits, withdrawals, and refunds	<u>\$ 79,567,083</u>
Administrative expenses	
Staff compensation	\$ 387,142
Professional services	77,009
Office lease and maintenance	39,648
Communication-related expenses	20,180
Other expense	<u>66,873</u>
Total administrative expenses	<u>\$ 590,852</u>
Total Deductions	<u>\$ 80,157,935</u>
Net Increase (Decrease)	\$ 71,077,865
Net Assets Held in Trust for Pension Benefits	
Beginning of Year	<u>934,667,364</u>
End of Year	<u>\$ 1,005,745,229</u>

This page was left blank intentionally.

ST. PAUL TEACHERS' RETIREMENT FUND ASSOCIATION
ST. PAUL, MINNESOTA

NOTES TO THE BASIC FINANCIAL STATEMENTS
AS OF AND FOR THE YEAR ENDED JUNE 30, 2006

1. Summary of Significant Accounting Policies

Reporting Entity

The St. Paul Teachers' Retirement Fund (Fund) is a single-employer defined benefit pension fund administered by the St. Paul Teachers' Retirement Fund Association (Association), pursuant to the Association's bylaws and Minn. Stat. chs. 354A and 356. The Fund's membership consists of eligible employees of Independent School District No. 625, St. Paul, employees formerly employed by Independent School District No. 625, charter schools, and the employees of the Association. The Association is governed by a ten-member Board of Trustees.

Basis of Presentation

The accompanying financial statements are presented in accordance with Governmental Accounting Standards Board (GASB) Statement No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans*, and with Statement No. 34, *Basic Financial Statements--and Management's Discussion and Analysis--for State and Local Governments*, as amended.

Basis of Accounting

The basis of accounting is the method by which additions and deductions to plan net assets are recognized in the accounts and reported in the financial statements. The Association uses the accrual basis of accounting. Under the accrual basis of accounting, additions are recognized when they are earned, and deductions are recognized when the liability is incurred.

Investments

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. Market values of investments in limited partnerships are determined by reference to published financial information of the partnership. Investments that do not have an established market are reported at estimated fair value.

ST. PAUL TEACHERS' RETIREMENT FUND ASSOCIATION
ST. PAUL, MINNESOTA

1. Summary of Significant Accounting Policies

Investments (Continued)

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.

The Association participates in a securities lending program. In accordance with GASB Statement No. 28, *Accounting and Financial Reporting for Securities Lending Transactions*, investments lent under the program are reported as assets on the balance sheet, and collateral received on those investments is reported as an asset and a liability.

Derivative Investments

The Association may invest in futures contracts using a static asset allocation investment strategy.

Upon entering into a futures contract, each party is required to deposit with the broker an amount, referred to as the initial margin, equal to a percentage of the purchase price indicated by the futures contract. In lieu of a cash initial margin, certain investments are held for the broker as collateral. Subsequent deposits, 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 contract. These amounts are recorded by each party as unrealized gains or losses. When a contract is closed, each party records a realized gain or loss equal to the difference between the value of the contract at the time it was opened and the value at the time it was closed.

Futures contracts involve, to varying degrees, credit and market risks. The Association may enter into contracts only on exchanges or boards of trade where the exchange or board of trade acts as the counterparty to the transactions. Thus, credit risk on such transactions is limited to the failure of the exchange or board of trade. Losses in value may arise from changes in the value of the underlying instruments or if there is an illiquid secondary market for the contracts.

The Association invests in TBA, or "to-be-announced," mortgage-backed securities. TBA mortgage-backed securities transactions are a basic mechanism for trading federal agency mortgage pass-through securities on a delayed delivery and settlement basis. They do not represent a separate type or class of mortgage-backed securities. A TBA transaction is a purchase or sale of mortgage pass-through securities with settlement agreed upon for some future date. The purchase of pass-throughs on a TBA basis creates a long position in the underlying security on the trade date with associated market risk in the position. The securities

ST. PAUL TEACHERS' RETIREMENT FUND ASSOCIATION
ST. PAUL, MINNESOTA

1. Summary of Significant Accounting Policies

Derivative Investments (Continued)

to be delivered are described in general detail at the time of trade but are not specifically identified until shortly prior to settlement. TBA transactions may involve newly-issued or existing agency mortgage pass-throughs.

Investment Income

Interest income is recognized when earned on an accrual basis. Dividend income is recorded on the ex-dividend date.

Contributions

Member employee contributions are recognized when withheld or when paid directly by the member employee. Employer contributions are recognized as a percentage of covered payroll as earned. Direct state-aid and state amortization aid are recognized pursuant to state statute.

Benefits and Refunds

Benefits and refunds are recognized when due and payable in accordance with the terms of the plan.

Furniture and Fixtures

Furniture and fixtures are carried at cost, less accumulated depreciation. Depreciation has been provided using the straight-line method over estimated useful lives of five years.

2. Description of Plans

The following brief description of the plans is provided for general information purposes only. Participants should refer to the plan agreements for more complete information.

The plans are not subject to the provisions of the Employee Retirement Income Security Act of 1974.

ST. PAUL TEACHERS' RETIREMENT FUND ASSOCIATION
ST. PAUL, MINNESOTA

2. Description of Plans (Continued)

General

The Association was created to provide retirement and other specified benefits for its members. The Association maintains two defined benefit pension plans covering teachers in the St. Paul public school system.

Effective July 1, 1978, the Association established a plan, coordinated with Social Security, in accordance with Minnesota statutes (the Coordinated Plan). Teachers who become members of the Association subsequent to June 30, 1978, automatically become members of the Coordinated Plan. Members' contributions and benefits under the Coordinated Plan have been adjusted to reflect contributions to and benefits from Social Security. Teachers who were members of the Association prior to July 1, 1978, are generally covered under the Basic Plan, which provides all retirement benefits for its members.

Membership

At June 30, 2006, the Association's membership consisted of:

Retirees and beneficiaries currently receiving benefits	2,624
Terminated employees entitled to but not yet receiving benefits	1,447
Terminated, non-vested	1,671
Current active plan members (including members on leave)	<u>4,202</u>
Total Membership	<u>9,944</u>

Pension Benefits

Members who satisfy required length-of-service and minimum age requirements are entitled to annual pension benefits equal to a certain percentage of final average salary (as defined in each plan) multiplied by the number of years of accredited service.

Disability Benefits

Active members who become totally and permanently disabled and satisfy required length-of-service requirements are entitled to receive annual disability benefits as calculated under each plan.

ST. PAUL TEACHERS' RETIREMENT FUND ASSOCIATION
ST. PAUL, MINNESOTA

2. Description of Plans (Continued)

Other Benefits

Limited service pensions, deferred pensions, survivor benefits, and family benefits are available to qualifying members and their survivors.

3. Deposits and Investments

A. Deposits

Authority

Minn. Stat. § 356A.06 authorizes the Association to deposit its cash in financial institutions designated by the Board of Trustees.

Custodial Credit Risk

The custodial credit risk for deposits of the Association describes the potential for partial or total loss of cash or near-cash holdings in the event of a depository failure. Minnesota statutes require that assets held in depository accounts be insured by the Federal Deposit Insurance Corporation (FDIC), or exclusively pledged collateral of 110 percent of the uninsured amount on deposit. Balances in the Associations' checking account at US Bank can vary dramatically over short periods of time, as this account holds short-term deposits and transfers necessary to meet not only general operating expenses, but large monthly benefit payments totaling \$6.9 million or more per month. Association deposits at US Bank are collateralized by pledged U.S. Treasury or federal agency notes on deposit with the Federal Reserve Bank of Boston. The Association's deposits at US Bank on June 30, 2006, were under collateralized by \$3,717,510, exposing the Association to custodial credit risk for those deposits.

B. Investments

Authority

The Association's investments are authorized by state law and its own investment policy. Permissible investments include, but are not limited to: government and corporate bonds, foreign and domestic common stock, real property, venture capital investments, and notes.

ST. PAUL TEACHERS' RETIREMENT FUND ASSOCIATION
ST. PAUL, MINNESOTA

3. Deposits and Investments

B. Investments (Continued)

Custodial Credit Risk

Custodial credit risk for investments is generally defined as an assessment of the potential that loaned securities of the Association may be insufficiently collateralized, or that a counterparty to any loan of Association securities might be either undercollateralized or fail to deliver loaned securities in time to satisfy current security trading needs.

According to Association policy, all securities purchased by the Association are held by a third-party safekeeping agent appointed as a custodian who is also the lending agent/counterparty. The securities lending agreement in place between the Association and its custodian is also consistent with this policy.

The Association has no custodial credit risk for investments at June 30, 2006, other than that related to the invested securities lending collateral, as described in Note 4.

Interest Rate Risk

Interest rate risk for investments consists of assessing the potential for adverse effects on the market value of debt securities held as a result of interest rate changes.

The Association participates in fixed income markets through both "active" and "passive" or indexed investment manager accounts, as listed below.

<u>Mandate</u>	<u>Management Firm</u>	<u>Market Value</u>
Active	Voyageur Asset Management	\$ 88,345,019
Indexed	Barclays Global Investors	\$ 80,936,500

The Association has, relative to peers, a small allocation to fixed income assets as part of its investment policy. At June 30, 2006, the targeted allocation was 19 percent of total Fund assets. The actual share of total Fund assets was 17.1 percent.

The active fixed portfolio has a shorter overall weighted duration than the Lehman Aggregate Index benchmark. All else being equal, this would be expected to reduce the account's risk to adverse effects from rising interest rates.

ST. PAUL TEACHERS' RETIREMENT FUND ASSOCIATION
ST. PAUL, MINNESOTA

3. Deposits and Investments

B. Investments

Interest Rate Risk (Continued)

The index account manager, Barclays Global Investors (BGI), has as part of its mandate, the explicit objective of matching, as closely as possible, the overall weighted direction of the Lehman Government/Credit Bond Index. Here, the fixed income strategy is indifferent to changes in the near-term changes in rates of interest.

The following table shows weighted overall durations of each investment account and the associated benchmark as of June 30, 2006:

<u>Account</u>	<u>Average Duration in Years</u>	<u>Average Duration of Benchmark</u>
Voyageur Asset Management	4.76	4.80
Barclays Global Investors	4.98	4.98
Bank of NY - Cash Collateral	0.06	None

Liquidity needs of the Association are not a factor in the structure of the fixed income, or any other asset class in which the Fund participates. The allocation of assets and the structure of investment accounts are optimized relative to long-term investment objectives and capital asset pricing models. The Association attempts to match asset allocations to policy targets and draws down accounts to meet short-term liquidity needs by targeting accounts that are, relative to targets, overfunded. This, in effect, rules out considerations about changes to interest rates, security duration, or portfolio term structures.

Credit Risk

Credit risk is the risk that an issuer or other counterparty to an investment will not fulfill its obligations. Minn. Stat. § 356A.06, subd. 7(c), limits fixed income holdings to investment grade securities. Government-issued debt securities, while broadly defined in law, must be backed by the full faith and credit of the issuing domestic government or agency or rated among the top four quality rating categories by a nationally recognized rating agency, with principal and interest payable in U.S. dollars.

Corporate fixed securities are limited to those either issued by companies domiciled in the United States or the Dominion of Canada. In all cases, securities must be rated among the top four categories of a nationally recognized rating agency.

ST. PAUL TEACHERS' RETIREMENT FUND ASSOCIATION
ST. PAUL, MINNESOTA

3. Deposits and Investments

B. Investments

Credit Risk (Continued)

The following table provides the range of security types and credit ratings (where applicable) for the Association's fixed income holdings.

Debt Investment Type	Market Value	Quality Ratings (Standard and Poors)				
		AAA	AA	A	BBB	Unrated
Asset Backed Securities	\$ 44,778,556	\$ 42,431,128	\$ 1,105,833	\$ 415,025	\$ 826,570	\$ -
Bank Note	13,478,907	-	6,453,885	7,025,022	-	-
BGI - Government/Credit Bond Index Fund	80,936,500	-	-	-	-	80,936,500
Certificate of Deposit Floating Rate Collateralized Mortgage Obligations	15,621,159	-	12,585,705	-	3,035,454	-
Corporate Bonds	16,870,225	16,870,225	-	-	-	-
Corporate Floating Rate	16,864,032	435,952	1,227,381	7,008,115	7,901,654	290,930
Federal Home Loan Mortgage Corporation	16,138,157	2,024,080	4,538,618	7,566,968	2,008,491	-
Federal National Mortgage Association	1,489,292	1,489,292	-	-	-	-
Government Bonds	12,388,123	12,388,123	-	-	-	-
Government National Mortgage Association	11,256,747	11,256,747	-	-	-	-
Other Fixed Income	544,697	544,697	-	-	-	-
Pooled Funds and Mutual Funds	706,085	706,085	-	-	-	-
Repurchase Agreement	8,044,258	-	-	-	-	8,044,258
State and Local Obligations	17,587,060	-	-	-	-	17,587,060
Totals	<u>\$ 264,037,767</u>	<u>\$ 93,062,559</u>	<u>\$ 27,338,742</u>	<u>\$ 23,005,549</u>	<u>\$ 13,772,169</u>	<u>\$ 106,858,748</u>

Concentration of Credit Risk

Concentration of credit risk relates to the adequacy of policy and practice in limiting the risk of loss due to insufficient diversification of holdings and could be measured on the basis of holdings from several aspects, such as asset class, region, sector, industry, or company size. The Investment Policy of the Association incorporates the Modern Portfolio Theory approach to capital market pricing, which holds that risk is inevitable for the institutional investor, but it can be reasonably estimated from historical return dispersion patterns and "budgeted" in allocating assets in a manner most likely to earn a targeted long-term rate of return on the overall portfolio.

ST. PAUL TEACHERS' RETIREMENT FUND ASSOCIATION
ST. PAUL, MINNESOTA

3. Deposits and Investments

B. Investments

Concentration of Credit Risk (Continued)

A good investment policy defines what types of risks will be assumed, how they will be managed, and that each incremental addition to portfolio risk should carry a corresponding and proportional opportunity for gain. The Association's policy is that the standard deviation of quarterly returns should not exceed 120 percent of the same measure for the asset category benchmark. Minn. Stat. § 356A.06, subd. 7, specifies that equity investment holdings may not exceed 5.0 percent of the outstanding shares of any one corporation. Association policy also limits exposure to any one company's securities at 1.5 percent of the total portfolio. Further, no more than 15.0 percent of the Fund assets may be invested in any one sector, and the maximum allocation to any single active investment manager is 12.5 percent of the total Fund.

The following tables indicate these risk control policies were reflected in portfolio holdings as of June 30, 2006.

Total Holdings of the Ten Largest Issuers as of June 30, 2006		
Issuer	Fair Value	Percent of Net Assets (%)
Federal National Mortgage Association	\$ 19,746,649	1.96
U.S. Treasury	15,480,124	1.54
Wellpoint, Inc.	4,562,679	0.45
Government National Mortgage Association	4,250,272	0.42
Small Business Administration	4,108,847	0.41
Cwalt, Inc.	3,356,608	0.33
ConocoPhillips Com	2,699,836	0.27
Merrill Lynch	2,684,977	0.27
Illinois Tool Works, Inc.	2,669,500	0.27
Nokia Corp	2,522,370	0.25
Totals	<u>\$ 62,081,862</u>	

ST. PAUL TEACHERS' RETIREMENT FUND ASSOCIATION
ST. PAUL, MINNESOTA

3. Deposits and Investments

B. Investments

Concentration of Credit Risk (Continued)

Assets by Investment Account as of June 30, 2006		
Investment Manager - Account	Total Assets Under Management (Market Value)	Percent of Total (%)
Advantus	\$ 17,060,397	1.7
Alliance Capital - Large Cap Growth	32,685,899	3.3
Bank of New York - Cash Flow	63,441	-
Barclays - Equity Index Fund	125,676,468	12.7
Barclays - Extended Equity Market Fd	53,894,599	5.4
Barclays - Govt/Credit Bond Index Fd	80,936,500	8.2
Barclays - Russell 2000 Equity Index	9,353,081	0.9
Barrow Hanley - Large Cap Value	65,824,372	6.6
Boston Company - Small Value	38,143,102	3.8
Capital Intl. - Emerging Mkts Gr	56,830,863	5.7
Clifton Group - Index Futures	1,999,483	0.2
Dimensional Fund Advisors	34,930,699	3.5
Fifth Third Advisors - Large Cap	36,934,537	3.7
JP Morgan - International	116,333,653	11.7
Morgan Stanley - Intl. Equity	109,461,764	11.0
RWI Ventures I	3,115,478	0.3
RWI Ventures II	950,908	0.1
Smith Barney	13,194	-
Turin Networks	1,634,260	0.2
UBS Realty Investors	72,741,246	7.3
Voyageur - Fixed Income	88,034,682	8.9
Wellington - Sm/Mid Cap Growth	45,441,899	4.6
Total Assets by Investment Account	\$ 992,060,525	100.0

ST. PAUL TEACHERS' RETIREMENT FUND ASSOCIATION
ST. PAUL, MINNESOTA

3. Deposits and Investments

B. Investments

Concentration of Credit Risk (Continued)

The total assets under management at market value are classified as follows on Exhibit 1.

Receivables		
Interest	\$	802,965
Dividends		191,381
Sales of securities		3,804,481
Investments		992,064,011
Less: securities purchases payable		<u>(4,802,313)</u>
Total Assets Under Management, Market Value	\$	<u>992,060,525</u>

Foreign Currency Risk

Foreign currency risk is the risk that changes in exchange rates of foreign currencies relative to the U.S. dollar adversely affect the fair value of an investment or a deposit.

As the U.S. share of global economic output continues to diminish, and the returns to broad U.S. equity markets continue to deliver among the lowest of those for major developed and developing markets globally, it becomes increasingly difficult for any institutional investing entity to justify a fiduciary posture on investments that does not include a significant international component.

However, because the liabilities of any public pension plan are due and payable in U.S. dollars, it is an inescapable fact that ultimately, all foreign holdings must be converted into U.S. dollar liquidity at some point. Owning securities and currencies of other countries, therefore, adds another level and type of risk, which occurs with each movement in the rate of exchange between the U.S. dollar and the relevant currency of trade.

As of June 30, 2006, the Investment Policy of the Association included a dedication of 25 percent of the total Fund as the international equity component of the total portfolio. International positions are held in pooled or commingled investment funds, which render the exposure to foreign currencies to a derivative risk, as the Fund's interest is limited in all cases to a unit valuation expressed in U.S. dollars. The actual allocation was \$277 million, or 27.9 percent of total invested assets. This allocation resulted in derivative exposures to international markets as detailed in the following chart.

ST. PAUL TEACHERS' RETIREMENT FUND ASSOCIATION
ST. PAUL, MINNESOTA

3. Deposits and Investments

B. Investments

Foreign Currency Risk (Continued)

Assets Held in Non-U.S. Securities by Currency as of June 30, 2006

Country	Currency	Equity	Fixed Income	Cash and Cash Equivalents	Total
Argentina	Argentine Peso	\$ 113,662	\$ 170,492	\$ -	\$ 284,154
Australia	Australian Dollar	2,836,825	-	56,831	2,893,656
Brazil	Brazilian Real	6,879,041	113,662	-	6,992,703
Canada	Canadian Dollar	284,154	-	-	284,154
Chile	Chilean Peso	170,492	-	-	170,492
China	Chinese Yuan	4,091,822	-	-	4,091,822
Croatia	Croatian Kuna	56,831	-	-	56,831
Egypt	Egyptian Pound	1,079,786	-	-	1,079,786
European Union	Euro	73,687,247	-	227,323	73,914,570
Hong Kong	Hong Kong Dollar	6,203,811	-	-	6,203,811
Hungary	Hungarian Forint	56,831	-	-	56,831
India	Indian Rupee	3,125,697	-	-	3,125,697
Indonesia	Indonesian Rupiah	2,386,896	-	-	2,386,896
Israel	Israeli Shekel	1,591,264	-	-	1,591,264
Japan	Japanese Yen	46,858,240	-	-	46,858,240
Kazakhstan	Kazakhstanian Tenge	56,831	-	-	56,831
Korea	Korean Won	11,771,126	-	-	11,771,126
Malaysia	Malaysian Ringgit	1,932,249	-	-	1,932,249
Mexico	Mexican Peso	4,320,872	-	-	4,320,872
Morocco	Moroccan Dirham	56,831	-	-	56,831
New Zealand	New Zealand Dollar	65,677	-	-	65,677
Philippines	Philippine Peso	113,662	-	-	113,662
Republic of Columbia	Columbian Peso	227,323	-	-	227,323
Russian Federation	Russian Ruble	3,182,528	-	-	3,182,528
Singapore	Singapore Dollar	735,494	-	-	735,494
South Africa	South African Rand	5,285,270	-	-	5,285,270
Sultanate of Oman	Omani Rial	56,831	-	-	56,831
Sweden	Swedish Krona	4,824,955	-	-	4,824,955
Switzerland	Swiss Franc	21,980,544	-	-	21,980,544
Taiwan	Taiwanese New Dollar	6,525,049	-	56,831	6,581,880
Thailand	Thai Baht	1,477,602	-	-	1,477,602
Turkey	Turkish New Lira	1,591,264	-	-	1,591,264
United Arab Emirates	Emirati Dirham	56,831	-	-	56,831
United Kingdom	British Pound	61,959,414	-	340,985	62,300,399
Vietnam	Vietnam Dong	113,662	-	-	113,662
Totals		<u>\$ 275,756,614</u>	<u>\$ 284,154</u>	<u>\$ 681,970</u>	<u>\$ 276,722,738</u>

ST. PAUL TEACHERS' RETIREMENT FUND ASSOCIATION
ST. PAUL, MINNESOTA

4. Securities Lending

The Association participates in a securities lending program. On June 30, 2006, 30 percent of its U.S. government securities, corporate bonds, and corporate stocks were loaned out.

Minn. Stat. § 356A.06, subd. 7, permits the Association to enter into securities lending transactions. These are loans of securities to broker-dealers and other entities for collateral with a simultaneous agreement to return the collateral for the same securities in the future. Loans may be made only to pre-approved borrowers. Qualifications of borrowers and the fiscal status of such entities are monitored on a continuing basis. The Association's securities custodian is the agent in lending the Association's securities for collateral of at least 102 percent of the market value of loaned securities. Loaned investments are marked to market daily. If the collateral provided by the borrower falls below 100 percent of the market value of the loaned investment, the borrower is required to provide additional collateral to bring the collateral to 102 percent of the current market value. Collateral may be provided in securities or cash.

In the event of failure by the borrowing party to deliver the securities at all, the Association should be at least 100 percent collateralized in order to recover the market value equivalent of securities not returned.

The Association's contract with the Bank of New York also specifies that the custodian will indemnify the Association for any "fails," or loss of securities by failure of borrowers to return securities.

As of June 30, 2006, the fair value of cash collateral received was \$87,924,018, which is included in the Statement of Plan Net Assets both as an asset and offsetting liability. Of the cash collateral, \$54,711,671 was invested in corporate obligations; \$15,622,697 was invested in certificates of deposit; and \$17,589,650 was invested in repurchase agreements, which have an average weighted maturity of 21 days. The Association also received non-cash collateral of \$4,061,394 in US Treasury securities. The Association has no credit risk exposure to borrowers because the amounts the Association owes borrowers exceed amounts borrowers owe the Association. The contract with the trust company requires the trust company to indemnify the Association if borrowers fail to return the loaned securities, requiring delivery of collateral up to the market value of the loaned securities to the Association. All securities loans may be terminated on demand by either the Association or the borrower.

ST. PAUL TEACHERS' RETIREMENT FUND ASSOCIATION
ST. PAUL, MINNESOTA

5. Contributions

Funding

Benefit and contribution provisions are established by state law and may be amended only by the State of Minnesota Legislature.

Minn. Stat. § 354A.12 sets the rate for employee and employer contributions expressed as a percentage of annual covered payroll. The requirement to reach full funding by the year 2021 is set in Minn. Stat. § 356.215, subd. 11. As part of the annual actuarial valuation, the actuary determines the sufficiency or deficiency 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 by the required date for full funding, and (c) an allowance for administrative expenses. At June 30, 2006, the difference between the statutory and actuarially required contributions is a deficiency of 8.70 percent of payroll.

Employer and Employee Contributions

For the fiscal year ended June 30, 2006, the contribution rates required by statute were as follows:

	<u>Percentage of Members' Salaries</u>	
	<u>Basic Plan</u>	<u>Coordinated Plan</u>
Employee contribution	8.00%	5.50%
Employer contribution	11.64%	8.34%

Other Contributions

Minn. Stat. § 354A.12 requires the state to annually provide the Association with direct aid until it reaches the same funded status as the Minnesota Teachers' Retirement Association (TRA). The direct state-aid contribution was \$2,969,000 for fiscal year 2006.

Minn. Stat. § 423A.02, subd. 3, requires the state to annually provide certain aid to the Association until it is fully funded. The state amortization aid contribution was \$430,761 for fiscal year 2006. Beginning in fiscal year 1998, the School District must make an additional annual contribution to the Association in order for the Association to continue receiving state amortization aid. The School District contributed \$800,000 for fiscal year 2006.

ST. PAUL TEACHERS' RETIREMENT FUND ASSOCIATION
ST. PAUL, MINNESOTA

5. Contributions

Other Contributions (Continued)

Statutes also require active and retired members of the Association to provide contributions for the relative difference (per member) between the administrative expenses incurred by the Association and the state TRA. No additional contributions were required in fiscal year 2006.

Reserve

At June 30, 2006, \$9,353,081 of the net assets is considered reserved as it represents the amount of state amortization aid which, pursuant to legislation, must be separately accounted for and may not be used in determining post-retirement benefit increases. This is considered to be fully funded.

6. 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 liabilities, the Association purchases commercial insurance. There were no significant reductions in insurance coverage from coverage in the prior year. The amount of settlements did not exceed insurance coverage for each of the past three fiscal years.

This page was left blank intentionally.

REQUIRED SUPPLEMENTARY INFORMATION

This page was left blank intentionally.

**ST. PAUL TEACHERS' RETIREMENT FUND ASSOCIATION
ST. PAUL, MINNESOTA**

Schedule 1

**SCHEDULE OF FUNDING PROGRESS
(IN THOUSANDS OF DOLLARS)**

Actuarial Valuation Date	Actuarial Value of Plan Assets (a)	Actuarial Liability (AAL) - Entry Age (b)	Unfunded AAL (UAAL) (b-a)	Funded Ratio (%) (a/b)	Annual Covered Payroll (c)	UAAL as a Percentage of Covered Payroll (%) ((b-a)/c)
2001	\$ 869,045	\$ 1,060,931	\$ 191,886	81.91	\$ 202,915	94.56
2002	899,572	1,141,300	241,728	78.82	201,456	119.99
2003	898,760	1,189,361	290,601	75.57	205,655	141.31
2004	898,860	1,251,460	352,600	71.82	221,685	159.05
2005	905,293	1,299,832	394,539	69.65	223,762	176.32
2006	938,919	1,358,620	419,701	69.11	226,351	185.42

(Unaudited)

**ST. PAUL TEACHERS' RETIREMENT FUND ASSOCIATION
ST. PAUL, MINNESOTA**

Schedule 2

**SCHEDULE OF CONTRIBUTIONS FROM THE EMPLOYER
AND OTHER CONTRIBUTING ENTITIES
(IN THOUSANDS OF DOLLARS)**

Fiscal Year	Annual Required Contributions	Employer Contributions	Employer Percentage Contributed (%)	State Contributions	State Percentage Contributed (%)
2001	\$ 20,444	\$ 19,996	97.81	\$ 3,573	17.48
2002	17,382	20,958	120.58	3,258	18.74
2003	23,948	19,986	83.46	3,384	14.13
2004	30,828	20,378	66.10	3,393	11.01
2005	34,724	20,435	58.85	3,398	9.79
2006	40,373	20,615	51.06	3,400	8.42

Note:

The annual required contributions are actuarially determined. The employer and state are required by statute to make contributions, all of which have been made.

(Unaudited)

This page was left blank intentionally.

ST. PAUL TEACHERS' RETIREMENT FUND ASSOCIATION
ST. PAUL, MINNESOTA

NOTES TO SCHEDULE 1 AND SCHEDULE 2
AS OF AND FOR THE YEAR ENDED JUNE 30, 2006
(Unaudited)

Actuarial Methods and Assumptions

The actuarial accrued liability is determined as part of an annual actuarial valuation on July 1. Significant methods and assumptions are as follows:

- The most recent actuarial valuation date is July 1, 2006.
- Actuarial cost is determined using the Entry Age Normal Actuarial Cost Method.
- The amortization method assumes a level percentage of payroll each year is used to pay the unfunded actuarial accrued liability.
- The amortization period is determined each year by the legislatively-appointed actuary.
- The remaining amortization period at July 1, 2006, is 15 years.
- The actuarial value of assets is determined using market value, adjusted for amortization obligations receivable at the end of each fiscal year, less a percentage of the unrecognized asset return determined at the close of each of the four preceding fiscal years. Unrecognized asset return is the difference between actual net return on market value of assets and the asset return expected during that fiscal year (based on the assumed interest rate employed in the July 1 actuarial valuation of the fiscal year).
- Actuarial Assumptions:
 - Investment rate of return is 8.5 percent.
 - Inflation and projected salary increases are based on a ten-year select and ultimate rate table with rates ranging from 5.0 to 6.9 percent.
 - Two percent annual post-retirement adjustment.
 - Pre-retirement mortality assumptions are based on the 1983 Group Annuity Mortality Table with rates set back seven years for males and five years for females.

**ST. PAUL TEACHERS' RETIREMENT FUND ASSOCIATION
ST. PAUL, MINNESOTA**

Actuarial Methods and Assumptions (Continued)

- Post-retirement mortality assumptions are based on the 1983 Group Annuity Mortality Table with rates set back three years for males and one year for females.
- Post-disability mortality assumptions are based on the 1977 Railroad Retirement Board Mortality Table for Disabled Annuitants.

Significant Plan Provision and Actuarial Methods and Assumption Changes

2000

- Asset valuation method changed to employ a more effective asset-smoothing technique which is market-value based and which eliminates artificial bias related to manager style (effective July 1, 2000).

2001

- The annual lump sum benefits payable to pre-1974 retirees will be paid as monthly installments (effective January 1, 2002).

2002

The following actuarial assumptions changed:

<u>Assumptions</u>	<u>Prior</u>	<u>Revised</u>
Salary increases	Merit table that ranges from 7.25% at age 20 down to 5.25% at age 70	Ten-year select and ultimate table. During the select period, 0.3% x (10-T) where T is completed years of service is added to the ultimate rate. Ultimate table ranges from 6.9% at age 20 down to 5.0% at age 60 and over.
Male Pre-Retirement Mortality	1983 GAM (Male - 5)	1983 GAM (Male - 7)
Female Pre-Retirement Mortality	1983 GAM (Female - 3)	1983 GAM (Female - 5)
Separation Decrement	Graded rates	Select and ultimate table. Ultimate rates are generally lower than prior rates.

**ST. PAUL TEACHERS' RETIREMENT FUND ASSOCIATION
ST. PAUL, MINNESOTA**

Significant Plan Provision and Actuarial Methods and Assumption Changes

2002 (Continued)

<u>Assumptions</u>	<u>Prior</u>	<u>Revised</u>
Disability Decrement	Graded rates	Graded rates. Revised rates are lower than prior rates.
Form of Annuity Selected - Male	85% married 15% elect 50% J&S option 50% elect 100% J&S option	85% married 10% elect 50% J&S option 45% elect 100% J&S option
Form of Annuity Selected - Female	60% married 10% elect 50% J&S option 10% elect 100% J&S option	60% married 10% elect 50% J&S option 10% elect 100% J&S option
Combined Service Annuity Load Factor	None assumed	7.0% load on liabilities for active members and 30% load on liabilities for former members.

The following plan provisions changed:

- Effective July 1, 2002, 359 charter school teachers are no longer covered by this Fund. Active charter school teachers retain their rights to benefits earned in this Fund through June 30, 2002, as if they were former members with a termination of employment on June 30, 2002. They may not, however, draw a refund of contributions as long as they remain employed by the same school they were employed with on June 30, 2002. Effective July 1, 2002, these 359 charter school members were transferred to the Minnesota Teachers' Retirement Association.
- An administrative expense assessment otherwise payable under law will not be assessed if the administrative expenses of the Fund do not exceed the July 1, 2001, administrative expense amount adjusted for inflation.
- While not a formal change in provisions, a change in the expected amount of state-aid has occurred with the Fund. Since the Duluth Teachers' Retirement Fund accrued liability funding ratio exceeded the Minnesota Teachers' Retirement Fund accrued liability funding ratio as of July 1, 2001, the state-aid normally provided to Duluth shall be re-allocated to the other first class city teachers' funds. This results in a marginal increase in the amount of state-aid for this Fund.

ST. PAUL TEACHERS' RETIREMENT FUND ASSOCIATION
ST. PAUL, MINNESOTA

Significant Plan Provision and Actuarial Methods and Assumption Changes (Continued)

2006

- While not impacting the results of the July 1, 2006, actuarial valuation, two changes in plan provisions were made since the prior valuation. One change is the cap on the post-retirement benefit increases, such that the combination of the guaranteed 2 percent and excess rate of return factors cannot exceed 5 percent, effective July 1, 2010. The other change is the deferred augmentation rate for post-June 30, 2006, hires, which is 2.5 percent for all years.

This page was left blank intentionally.

**ST. PAUL TEACHERS' RETIREMENT FUND ASSOCIATION
ST. PAUL, MINNESOTA**

Schedule 3

**SCHEDULE OF FINDINGS AND RECOMMENDATIONS
FOR THE YEAR ENDED JUNE 30, 2006**

MINNESOTA LEGAL COMPLIANCE

ITEM ARISING THIS YEAR

06-1 Deposits in Excess of Coverage

At June 30, 2006, the Saint Paul Teachers' Retirement Fund Association's deposits with a financial institution exceeded the amount of insurance and collateral pledged. Minn. Stat. § 118A.03, subd. 3, requires that, "... the collateral computed at its market value should be at least ten percent more than the amount on deposit plus accrued interest at the close of the financial institution's banking day." Unsecured Association deposits expose the Association to a loss if the financial association develops difficulties. The Association's deposits with financial institutions should be closely monitored to ensure that the required amount of collateral is pledged.

We recommend the Association obtain adequate levels of collateral from its designated depositories as required by statute. The Association should monitor the collateral on a regular basis and maintain complete records of the types and amounts of collateral pledged. The collateral should be compared to balances held at the financial institutions.

Client's Response:

The Association acknowledges that at the close of business on the last day of the fiscal year, collateral pledged at our local depository, US Bank, was insufficient. There was a spike in our account balance because a large wire transfer needed to pay benefits on the next business day settled on June 30, 2006.

Our bank is normally notified of any scheduled incoming wire transfer, and is generally diligent about adjusting pledged collateral accordingly. End-of-year transactions sometimes necessitate timing and volume adjustments that make this more difficult. It is worth noting that our exposure was very limited in this instance, as the adjustment was effected and collateral was sufficient by the next day.

The Association concurs with the Auditor's recommendation, and we will endeavor to assure that timely notice is provided to our depository institution to better ensure that adequate collateral is pledged at all times.

PREVIOUSLY REPORTED ITEMS RESOLVED

Compliance with Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) of 1989 (04-1)

The Saint Paul Teachers' Retirement Fund Association did not have documentation demonstrating that it had a perfected security interest in pledged collateral in compliance with FIRREA, 12. U.S.C. § 1823(e). A 1992 U.S. Court of Appeals decision stated that, if a municipality fails to perfect a security interest under federal law, its right to such collateral in the event of default is not enforceable. To obtain an enforceable security interest in the collateral, FIRREA requires the pledging institution's security agreement or pledge of collateral to meet certain requirements.

Resolution

The Association obtained documentation demonstrating that it had a perfected security interest in pledged collateral in compliance with FIRREA, 12. U.S.C. § 1823(e). The Association had its depository institution provide proof of compliance in the form of a copy of the depository's board of directors or loan committee resolution.

Holdings in Authorized Investments (05-1)

The total of investments authorized under "Other investments" must not exceed 35 percent of the Association's investment portfolio. When index funds were added to the Association's investments held as authorized under Minn. Stat. § 356A.06, subd. 7(h), the Association exceeded the 35 percent limitation for investments held under this clause.

Resolution

Legislation was passed that modified Minnesota statutes by reclassifying index funds from "Other investments," resulting in compliance by the Association.

OTHER ITEM FOR CONSIDERATION

Long-Term Financial Solvency

According to the Association's actuarial valuation and review for June 30, 2006, the unfunded actuarial accrued liability is \$419.7 million. This amount has increased 119 percent since June 30, 2001, when the unfunded actuarial accrued liability was \$191.9 million. During this same period, the funded ratio has fallen from 81.91 percent to 69.11 percent.

Minn. Stat. § 354A.29, subd. 3, provides for an annual two percent post-retirement adjustment. In addition, Minn. Stat. § 354A.29, subd. 4, requires an additional benefit increase be paid when the amount of the five-year annualized rate of return is in excess of the pre-retirement interest assumption of 8.5 percent. Both of these post-retirement adjustments are permanent increases to the benefit base. However, since no permanent funding mechanism exists to offset or compensate for the benefit increases resulting from the temporary investment gains, the Association must rely on investment earnings to fund them.

Between 2001 and 2006, actual contributions rose two percent, from \$36.7 million to \$37.5 million. During this same period, total deductions for benefits increased 47 percent, from \$54.2 million to \$79.6 million.

The actuarially determined required contribution rate consists of amounts needed to cover (a) normal costs, (b) administrative costs, and (c) amortization of unfunded actuarial accrued liabilities. These financial requirements have exceeded actual statutory contributions made to the Association since June 30, 2001, when there was a contribution sufficiency of 1.26 percent. This difference between the statutory and actuarially required contributions at June 30, 2006, is a deficiency of 8.70 percent of payroll. The actuary's report for June 30, 2006 states: "Each year there is a contribution deficiency leads to an increased deficiency in all future years."

While there were different proposals for changes during the 2006 Minnesota Legislative Session, including some supported by the Association, ultimately a law was passed to limit the Association's benefit increases. Minn. Laws ch. 277 Art. 1, sec. 2, states the Association may not pay a post-retirement adjustment of more than five percent in any year, effective July 1, 2010. This law does not, however, require investment losses from prior periods be recovered before triggering further investment-based increases.

Under the current statutory guidelines, between now and the July 1, 2010, effective date, there is no limit on post-retirement benefit increases. Current projections anticipate that the five-year annualized rate of return calculated as of June 30, 2007, may exceed the statutory threshold of 8.5 percent. This could result in benefit increases greater than five percent. Subsequent years could have similar results. This means that a series of permanent benefit increases, in excess of five percent, without a permanent funding mechanism have the potential to be granted until the limit on post-retirement benefit increases becomes effective in 2010.

Schedule 3
(Continued)

As part of its fiduciary duty to maintain the integrity of the fund for the long-term, the Association must continue to develop and act on plans to improve the present financial condition of the fund. Benefit formulas and funding mechanisms must be structurally sound to achieve a contribution sufficiency and to prevent the fund's financial condition from stagnating and deteriorating despite good investment returns. We recommend the Association initiate and actively pursue all courses of legislative action which will ensure a reliable means of recovering and funding its unfunded actuarial accrued liability in addition to including alternatives for restructuring contribution rate formulas and further limiting future benefit increase amounts.



STATE OF MINNESOTA OFFICE OF THE STATE AUDITOR

SUITE 500
525 PARK STREET
SAINT PAUL, MN 55103-2139

(651) 296-2551 (Voice)
(651) 296-4755 (Fax)
state.auditor@state.mn.us (E-mail)
1-800-627-3529 (Relay Service)

PATRICIA ANDERSON
STATE AUDITOR

REPORT ON MINNESOTA LEGAL COMPLIANCE

Board of Trustees
St. Paul Teachers' Retirement Fund Association

We have audited the basic financial statements of the St. Paul Teachers' Retirement Fund Association as of and for the year ended June 30, 2006, and have issued our report thereon dated October 5, 2006.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the provisions of the *Minnesota Legal Compliance Audit Guide for Local Government*, promulgated by the State Auditor pursuant to Minn. Stat. § 6.65. Accordingly, the audit included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

The *Minnesota Legal Compliance Audit Guide for Local Government* contains five categories of compliance to be tested: contracting and bidding, deposits and investments, conflicts of interest, public indebtedness, and claims and disbursements. Our study included all of the listed categories, except that we did not test for compliance in contracting and bidding, public indebtedness, and claims and disbursements, because these areas do not apply to the St. Paul Teachers' Retirement Fund Association.

The results of our tests indicate that, for the items tested, the St. Paul Teachers' Retirement Fund Association complied with the material terms and conditions of applicable legal provisions, except as described in the Schedule of Findings and Recommendations as item 06-1.

This report is intended solely for the information and use of the Board of Trustees and management and is not intended to be, and should not be, used by anyone other than those specified parties.

We would like to express our appreciation to the Board of Trustees of the Association and the staff for their cooperation and assistance during the audit.

/s/Pat Anderson

PATRICIA ANDERSON
STATE AUDITOR

/s/Greg Hierlinger

GREG HIERLINGER, CPA
DEPUTY STATE AUDITOR

End of Fieldwork: October 5, 2006