



TO: Members of the Legislative Commission on Pensions and Retirement

FROM: Ed Burek, Deputy Director *EB*

RE: Amendment S2239-A16: Junk Bond Authority Extended to First Class City Teacher Plans and Police and Paid Fire Relief Associations by Amendment to S.F. 2239 (Pogemiller); H.F. 2362 (Smith), Omnibus Retirement Bill I, in House and Senate Committees

DATE: March 23, 2006

Summary of Amendment S2239-A16

S.F. 2239 (Pogemiller); H.F. 2362 (Smith), the Commission's Omnibus Retirement Bill I, was amended in the House Governmental Operations and Veterans Affairs Committee and in the Senate Finance Committee, by explicitly including language to allow first class city teacher fund associations and police and paid fire relief associations to invest in junk bonds.

The applicable language, as now found in S.F. 2239, the second engrossment, specifies on page 54, lines 25 to 31, that a police or paid fire relief association may invest in junk bonds (domestic government and corporate debt obligations not rated in the top four quality categories by a nationally recognized rating agency) if the percentage of these securities does not exceed five percent of the total portfolio or 15 percent of the non-equity assets, whichever is less, and the association may not buy or hold more than 50 percent of a single offering or more than 25 percent of any issuer's junk bond debt. Nearly identical language appears on page 55, lines 17 to 23, for first class city teacher plan associations, except that the junk bonds may not exceed ten percent of the non-equity assets, rather than 15 percent.

Background on Permissible Investments under Section 356A.06, Subdivision 7

Currently, only the State Board of Investment (SBI) and the Minneapolis Teachers Retirement Fund Association (MTRFA) are explicitly authorized to invest a portion of its portfolio in junk bonds. The SBI permissible investment provision is Minnesota Statutes, Section 11A.24. The MTRFA has that authority due to an inadvertent cross-reference to Section 11A.24 found in the MTRFA post-retirement adjustment provision, which passed in the same year, 1994, that the Legislature took action to keep non-SBI pension funds out of the junk bond market.

For non-SBI plans, the principle investment authority provision is Section 356A.06, Subdivision 7. This provision applies to all non-SBI public pension funds with \$1 million or more in assets, and to many with less than \$1 million in assets they use SBI or an investment advisor to invest most of their portfolio. The assets currently permitted in the portfolio of any of these non-SBI plans under Section 356A.06, Subdivision 7, are as follows:

- a. Types of Permissible Investments. Permissible investments may be owned directly or through commingled trusts and are of the following types:
 1. Government debt obligations, including debt obligations of the United States Government and its agencies, government sponsored organizations of which the United States is a member, state and local governments, and Canada and its provinces. All obligations must be backed by the full faith and credit of the issuing organization or be rated as an investment-grade security by a nationally recognized rating agency, and principal and interest must be payable in United States dollars. (An investment-grade debt security is one rated in the top four quality categories.)
 2. Investment-grade corporate debt of companies organized under the laws of the United States and Canada, including bond notes, debentures, providing the securities are investment-grade and are payable in United States dollars.
 3. Miscellaneous debt and cash equivalent securities, including bankers acceptances, certificates of deposit, commercial paper, mortgage participation securities and asset backed securities, guaranteed investment contracts, providing that securities of a cash equivalent nature are fully backed by insurance, and securities of a longer term debt nature are investment-grade. The SBI may also purchase Minnesota Housing Finance agency mortgage pools providing none of the mortgages are in default.
 4. Stock or convertible securities of any United States or Canadian company, or of any company listed on domestic stock exchanges. The pension fund may not own more than five percent of the outstanding shares of any given company.
 5. International securities. While not further defined or specified in law, "international securities" presumably refers to foreign stocks and bonds.

6. Puts, calls, futures. A covered pension fund may use puts, calls, and future contracts purchased and sold through regulated markets. Puts and calls are options giving the right to sell (put) or buy (call) a fixed amount of a security at a specified price. Puts can be used if one believes the market price of the security will go down by the contract settlement date; calls could be used if one believes the price may rise. A futures contract is an agreement to exchange securities or currencies at an agreed upon rate.
 7. Exchange traded funds. A covered pension fund may choose to invest in any of the various permissible assets authorized under this provision in the form of exchange traded funds.
 8. Various miscellaneous investments, including venture capital investments, regional funds, mutual funds, limited partnerships, real estate investment trusts, and resource investments. For any of these investments, there must be at least four other owners in addition to the covered pension fund, and that pension fund may not own more than 20 percent of the investment or act as a general partner or engage in any activity that creates general liability.
- b. Asset Mix Restrictions. In addition to specifying legal investments, the section also puts some minimal limits on the proportion of equity investments that a covered pension fund must hold. *The total of all forms of equity investments [the domestic stock in (4) above, international securities in (5), and miscellaneous equity investments in (8)] cannot exceed 85 percent of the total portfolio's value. Furthermore, the miscellaneous equity investments in (8) above, considered separately, may not exceed 35 percent of the portfolio's value.*

Background Information on the Origin of Larger Non-SBI Plan Investment Authority Provision, and Current Law MTRFA Junk Bond Authority

Section 356A.06, Subdivision 7, was created by the Legislature to keep public pension funds other than the SBI out of the junk bond market. Any effort now to provide access by some non-SBI funds to the junk bond market is a reversal of prior legislative policy and should not be undertaken without careful consideration.

In 1994, the SBI asked for junk bond investment authority and the Legislature granted that authority, adding specific language to the SBI's bond investment authority, Section 11A.24, Subdivision 3, "Corporate Obligations." The language, now found in paragraph (b) of that subdivision, states that the SBI may invest in unrated and below-investment grade debt not to exceed five percent of any portfolio. Until 1994, most other large Minnesota pension fund investment authority was created by cross-reference to this section of SBI law. The 1994 Legislature willfully acted to keep the non-SBI funds out of the below-investment-grade market by revising these cross-references to a new provision, Section 356A.06, Subdivision 7, and removing the references to SBI's provision, Section 11A.24. These changes appeared as Laws 1994, Chapter 604, Article 2, entitled "Limit on Investment Authority for other Public Funds." The new Section 356A.06, Subdivision 7, was created largely by copying the SBI law (Minnesota Statutes, Section 11A.24) as it existed *prior* to adding the junk bond authority.

One pension fund association other than the SBI remained tied to the revised SBI investment authority provision, and that was the MTRFA. It is doubtful that this was intended. What happened is that in that same year, 1994, a new post-retirement provision was enacted for the MTRFA, coded as Section 354A.28. That legislation included language stating that the assets of the MTRFA retirees (which the MTRFA refers to as the annuity reserve fund) are to be invested according to the SBI provision, Section 11A.24. When the Legislature changed all the references in *existing* law for non-SBI plans from Section 11A.24 to the new Section 356A.06, Subdivision 7, it failed to catch this new reference to the SBI provision in the new 1994 bill containing the MTRFA post fund language.

The SBI request to revise its investment authority in 1994 was inconsistent with its policy statements. SBI annual reports include a discussion of its asset mix and the policy justification for each of the asset classes it uses. For years those reports included a statement that SBI invests in bonds as a deflation hedge. In very weak market conditions where deflation rather than inflation is occurring, the reports noted that bonds would be one of the most secure investments and would more than maintain their real value in purchasing power. In other words, bonds were the bedrock or safety net for the portfolio. When SBI decided to invest in junk bonds, it failed to consider that this move was inconsistent with its safety net. Junk bonds are not a sound investment in deflationary markets because of the weakened ability of these companies to cover their debt payments.

Discussion and Analysis

S.F. 2239 (Pogemiller); H.F. 2362 (Smith), the Commission's Omnibus Pension Bill I, was amended in the House Governmental Operations and Veterans Affairs Committee and in the Senate Finance Committee, by explicitly including language to allow first class city teacher fund associations and police and paid fire relief associations to invest in junk bonds. Several restrictions would apply, including a requirement that the investments not exceed five percent of the total portfolio.

Several years ago, the MTRFA invested a considerable portion of its assets in junk bonds, with very harmful results. The MTRFA invested in junk bonds at the start of a period when junk bonds were under performing investment-grade bonds, and unfortunately, they also selected a manager who under performed the junk bond market. Due to the large junk bond exposure, the bond portfolio as a whole had returns over a several-year period well below that of investment-grade bond benchmarks. About two years ago, the MTRFA abandoned using junk bonds. SBI and MERF, in recent years, have not been noticeably impacted, but they invest differently than MTRFA did, and in much lower percentages. MERF did have considerable problems with junk bonds back in the late 1980s and early 1990s. (MERF and various other pension funds have contended that they have junk bond investment authority if they invest through a mutual fund arrangement, under an interpretation of Section 356A.06, Subdivision 7, paragraph (g).)

Two common arguments are made for having some portion of a total portfolio invested in junk bonds, at least on an opportunistic basis. One is that they provide diversification, while the other is that these investments enhance returns.

- a Diversification Argument. One common argument for adding junk bond authority is that junk bonds are an effective diversification element because they behave neither like stocks nor investment-grade bonds (their returns are not well correlated with stocks or investment-grade bonds). It is a troublesome argument, particularly if it is the sole basis for adding junk bonds. Any new form of investment can be justified under this argument since the new investment type will not be perfectly correlated with the existing asset classes. Furthermore, any investment form which ought to be no more than a small fraction of the total portfolio because holding more would not be prudent cannot add effective diversification. The allocation is too small to have any meaningful diversification impact.

When the economy is strong, junk bonds tend to behave similar to investment-grade bonds. Junk bonds provide a somewhat higher return than investment-grade bonds in these periods to compensate for the greater default risk, although that risk premium is reduced in strong economic periods. However, they are likely to provide noticeably lower returns than equity investments. When the economy is weak and investors become somewhat concerned about the ability of companies to make their interest payments on bonds, junk bond returns plummet, since these are the companies most at risk of default. In weak markets investment-grade debt provides much better returns than junk bonds. Therefore, junk bonds are an asset class which when used prudently will be too insignificant to provide any effective diversification, and where the investor, when viewing the impact on the total portfolio, is likely to wish those assets were allocated elsewhere (in investment-grade bonds during a down market, and in stock during an up market).

- b Rate of Return Argument. The second argument is that junk bonds will enhance return. This argument has no merit. Overtime, junk bonds tend to have higher returns than investment-grade bonds, so some allocation to junk bonds may increase a fund's bond return, but it lowers the pension fund's total return. Assets are not needed in the investment-grade bond portfolio would be better placed in equity investments.

The junk bond language recently added to the House and Senate versions of S.F. 2239 (Pogemiller); H.F. 2362 (Smith) raises the following pension and related public policy issues:

1. Implications of Junk Bond Exposure. The Commission and the Legislature may wish to consider that junk bonds will not provide meaningful diversification at the percentages proposed, because the allocation is too small to have much impact, and will somewhat reduce long-term returns. Allowing a larger allocation sufficient to create a meaningful diversification effect would require junk bond holdings at a level which nearly all investment professionals consider to be imprudent and a breach of fiduciary responsibilities as institutional investors. Over the long term, junk bond holdings, whatever the proportion, will lower the total portfolio rate of return compared to results from devoting those assets to equity investments.
2. Divergent Interests of Pension Fund versus Investment Advisors. In recent years, many investment advisors have advocated having a small allocation of junk bonds. The Commission and the Legislature may wish to consider that the primary interests of the pension fund administration and the pension fund advisor are not perfectly aligned. Junk bond exposure is advantageous to an investment advisor. It may not be in the best interest of the pension fund, however. The pension fund has an interest in developing a fundamentally sound investment program to ensure that retiree pensions are well funded, and to minimize the need for contributions and aid. The investment advisor shares these interests, in part due to language in law which makes these advisors plan fiduciaries, but the advisor also has self-interest. The advising firm has an interest expanding its client base, maintaining existing clients, and making the

pension fund administration increasingly dependent upon the investment advisor. While the pension fund administration has an interest in keeping the investment program simple to maintain adequate control, the investment advisor has an interest in creating complexity. The pension fund administration that accepts an advisor's advice to include some junk bond investments will need the advisor's help in all the subsequent decisions. The board will need advice about whether to invest in junk bonds on an opportunistic basis or whether to hire a manager or managers to invest solely in junk bonds. If these investments are to be undertaken on an opportunistic basis, the board will need the advisor's help in determining which existing bond managers have sufficient experience in that area. If a new manager is to be hired, the board typically depends on the advisor to recommend a group of managers to consider, and to assist in evaluating those managers that the board decides to interview. The investment advisor should also be asked to develop criteria and procedures to evaluate the results of the junk bond exposure.

The board should also be concerned about any connection or relationship between the investment advisor and the asset management firms that the advisor recommends to the board. A recent Securities and Exchange Commission (SEC) study found what it considered to be an alarming level of conflict of interest in these relationships. A chief concern the SEC noted was various "pay-to-play" relationships. Investment management firms may buy services from an investment advisor firm which are of little value or which duplicates services the investment manager already receives. These purchases are made because if the investment management firm does not buy these services it is unlikely to be recommended by the investment advisor to the advisor's pension fund clients.

3. Lack of Demonstrated Need for Diversification. Pension plan investment advisors tend to recommend to their clients that they should consider investing in additional forms of assets because of the diversifying effect this can provide. Junk bonds are one of the asset forms typically mentioned. However, often the advisor fails to provide evidence that the recommendation makes sense for that particular investment organization, and the boards fail to require that evidence. The advisor's recommendations are based on market values and the obvious observation that diversification can add more stability to the growth of assets over time, and more stability to computed contribution requirements. However, the advisor and the board may fail to fully consider that for the first class city teacher fund associations, contribution rates are set by law and do not change unless the applicable law is amended. Variable returns will not trigger any automatic changes in contribution rates. For local police and paid fire plans, contribution needs are influenced by the actuarial value of assets, not market value. These actuarial value of asset methodologies are intended as smoothing methodologies. Furthermore, the investment performance-based post-retirement adjustment mechanisms in place for the first class city teacher plans and local Minneapolis police and fire plans are based on forms of five-year averaging of performance, which again is a smoothing methodology. It is not possible to determine whether additional diversification is appropriate for a pension fund without considering the impact of these smoothing elements that are already in place.
4. Amount of Junk Bond Permissible Exposure. The issue is whether the proposed maximum proportion of junk bonds in a portfolio for the applicable plans is appropriate, or whether it should be lower or higher.
5. Included Funds. The issue is whether to revise the pension funds to granted junk bond authority. The MTRFA, which a few years ago considerably damaged its investment performance due to junk bond exposure, will be granted authority to again invest in those assets. On the other hand, MERF was not included in the amendments that would provide this authority.
6. Possible Required Reporting. The issue is whether the Commission and the Legislature wish to have the pension funds that decide to use this new authority report to the Commission and the Legislature on the impact of that exposure. The Commission and the Legislature may wish to include language in law requiring these pension fund administrations report on how they have used this authority, including the portion of total assets and bond portfolio assets invested in these assets. The Commission and the Legislature may also wish to have the funds report the total portfolio return the fund received, the total portfolio return that would have occurred if the assets had been invested in investment-grade bonds, and the total portfolio return that would have occurred if the assets were invested in the domestic (or foreign) stock markets rather than in junk bonds. It would also be appropriate to have the plan administrations report on the performance benchmarks they intend to use, and how, in quarterly and annual performance reviews, the administration intends to evaluate its junk bond program.

54.1 rate, but not to exceed an employer contribution of ~~\$2,000~~ \$5,000 per year per employee;

54.2 ~~or~~

54.3 (11) to a supplemental plan organized and operated under the federal Internal
54.4 Revenue Code, as amended, that is wholly and solely funded by the employee's
54.5 accumulated sick leave, accumulated vacation leave, and accumulated severance pay; or

54.6 (12) to the International Association of Machinists national pension fund for the
54.7 employees of a governmental subdivision who are covered by a collective bargaining
54.8 agreement that provides for coverage by that fund and that sets forth a fund contribution
54.9 rate, but not to exceed an employer contribution of \$5,000 per year per employee.

54.10 Sec. 2. **EFFECTIVE DATE.**

54.11 Section 1 is effective the day following final enactment.

54.12 ARTICLE 8

54.13 RETIREMENT FUND INVESTMENT AUTHORITY CHANGES

54.14 Section 1. Minnesota Statutes 2004, section 69.77, subdivision 9, is amended to read:

54.15 Subd. 9. **Local police and paid fire relief association investment authority.**

54.16 (a) The funds of the association must be invested in securities that are authorized
54.17 investments under section 356A.06, subdivision 6 or 7, whichever applies. ~~Up to 75~~
54.18 ~~percent of the market value of the assets of~~ Notwithstanding any provision of section
54.19 356A.06, subdivision 6 or 7 to the contrary, the special fund of the relief association
54.20 may be additionally invested in:

54.21 (1) open-end investment companies registered under the federal Investment
54.22 Company Act of 1940, if the portfolio investments of the investment companies comply
54.23 with the type of securities authorized for investment under section 356A.06, subdivision
54.24 7, up to 75 percent of the market value of the assets of the fund; and

54.25 (2) domestic government and corporate debt obligations that are not rated in the top
54.26 four quality categories by a nationally recognized rating agency, and comparable unrated
54.27 securities if the percentage of these assets does not exceed five percent of the total assets
54.28 of the special fund or 15 percent of the special fund's non-equity assets, whichever is less,
54.29 the special fund's participation is limited to 50 percent of a single offering of the debt
54.30 obligations, and the special fund's participation is limited to 25 percent of an issuer's debt
54.31 obligations that are not rated in the top four quality categories. Securities held by the
54.32 association before June 2, 1989, that do not meet the requirements of this subdivision may
54.33 be retained after that date if they were proper investments for the association on that date.

55.1 (b) The governing board of the association may select and appoint investment
 55.2 agencies to act for and in its behalf or may certify special fund assets for investment by the
 55.3 State Board of Investment under section 11A.17. The governing board of the association
 55.4 may certify general fund assets of the relief association for investment by the State Board
 55.5 of Investment in fixed income pools or in a separately managed account at the discretion
 55.6 of the State Board of Investment as provided in section 11A.14. The governing board of
 55.7 the association may select and appoint a qualified private firm to measure management
 55.8 performance and return on investment, and the firm shall use the formula or formulas
 55.9 developed by the state board under section 11A.04, clause (11).

55.10 Sec. 2. Minnesota Statutes 2004, section 354A.08, is amended to read:

55.11 **354A.08 AUTHORIZED INVESTMENTS.**

55.12 In addition to investments authorized under section 356A.06, subdivision 7, a
 55.13 teachers retirement fund association may receive, hold, and dispose of:

55.14 (1) real estate or personal property acquired by it, whether the acquisition was by
 55.15 purchase, or any other lawful means, as provided in this chapter or in the association's
 55.16 articles of incorporation; and

55.17 (2) domestic government and corporate debt obligations that are not rated in the top
 55.18 four quality categories by a nationally recognized rating agency, and comparable unrated
 55.19 securities if the percentage of these assets does not exceed five percent of the total assets
 55.20 of the pension plan or ten percent of the pension plan's non-equity assets, whichever is
 55.21 less, the pension plan's participation is limited to 50 percent of a single offering of the
 55.22 debt obligations, and the pension plan's participation is limited to 25 percent of an issuer's
 55.23 debt obligations that are not rated in the top four quality categories.

55.24 In addition to other authorized real estate investments, an association may also
 55.25 invest funds in Minnesota situs nonfarm real estate ownership interests or loan secured by
 55.26 mortgages or deeds of trust. The board may also certify assets for investment by the State
 55.27 Board of Investment as provided under section 11A.17.

55.28 Sec. 3. Minnesota Statutes 2004, section 354A.28, subdivision 5, is amended to read:

55.29 Subd. 5. **Investment.** The assets of the annuity reserve fund must be invested,
 55.30 reinvested, and retained ~~in the discretion of~~ by the board of trustees of the Minneapolis
 55.31 Teachers Retirement Fund Association in authorized investments under section ~~11A.24~~
 55.32 356A.06, subdivision 7.

55.33 Sec. 4. Minnesota Statutes 2004, section 356.219, subdivision 3, is amended to read:

1.1 Senator moves to amend S.F. No. 2239, the first engrossment, as
1.2 follows:

1.3 Page 54, after line 3, insert:

1.4 "Section 1. Minnesota Statutes 2004, section 69.77, subdivision 9, is amended to
1.5 read:

1.6 Subd. 9. **Local police and paid fire relief association investment authority.**

1.7 (a) The funds of the association must be invested in securities that are authorized
1.8 investments under section 356A.06, subdivision 6 or 7, whichever applies. ~~Up to 75~~
1.9 ~~percent of the market value of the assets of~~ Notwithstanding any provision of section
1.10 356A.06, subdivision 6 or 7 to the contrary, the special fund of the relief association
1.11 may be additionally invested in:

1.12 (1) open-end investment companies registered under the federal Investment
1.13 Company Act of 1940, if the portfolio investments of the investment companies comply
1.14 with the type of securities authorized for investment under section 356A.06, subdivision
1.15 7, up to 75 percent of the market value of the assets of the fund; and

1.16 (2) domestic government and corporate debt obligations that are not rated in the top
1.17 four quality categories by a nationally recognized rating agency, and comparable unrated
1.18 securities if the percentage of these assets does not exceed five percent of the total assets
1.19 of the special fund or 15 percent of the special fund's non-equity assets, whichever is less,
1.20 the special fund's participation is limited to 50 percent of a single offering of the debt
1.21 obligations, and the special fund's participation is limited to 25 percent of an issuer's debt
1.22 obligations that are not rated in the top four quality categories. Securities held by the
1.23 association before June 2, 1989, that do not meet the requirements of this subdivision may
1.24 be retained after that date if they were proper investments for the association on that date.

1.25 (b) The governing board of the association may select and appoint investment
1.26 agencies to act for and in its behalf or may certify special fund assets for investment by the
1.27 State Board of Investment under section 11A.17. The governing board of the association

2.1 may certify general fund assets of the relief association for investment by the State Board
2.2 of Investment in fixed income pools or in a separately managed account at the discretion
2.3 of the State Board of Investment as provided in section 11A.14. The governing board of
2.4 the association may select and appoint a qualified private firm to measure management
2.5 performance and return on investment, and the firm shall use the formula or formulas
2.6 developed by the state board under section 11A.04, clause (11)."

2.7 Page 54, line 6, after "of" insert ":

2.8 (1)"

2.9 Page 54, line 8, before the period, insert " and

2.10 (2) domestic government and corporate debt obligations that are not rated in the top
2.11 four quality categories by a nationally recognized rating agency, and comparable unrated
2.12 securities if the percentage of these assets does not exceed five percent of the total assets
2.13 of the pension plan or ten percent of the pension plan's non-equity assets, whichever is
2.14 less, the pension plan's participation is limited to 50 percent of a single offering of the
2.15 debt obligations, and the pension plan's participation is limited to 25 percent of an issuer's
2.16 debt obligations that are not rated in the top four quality categories"

2.17 Renumber the sections in sequence and correct the internal references

2.18 Amend the title accordingly