

MINUTES

SOUTH DAKOTA INVESTMENT COUNCIL Sioux Falls, South Dakota June 13 & 14, 2018

1) Roll Call

The joint meeting of the Investment Council and the SDRS Board of Trustees was called to order at 10:30 a.m. on June 13, 2018 by Chair Steve Kirby. Council members in attendance were Paul Bisson, Lorin Brass, Ryan Brunner, Steve Kirby, Loren Koepsell, Jeff Nelson, Rich Sattgast and Rob Wylie.

SDRS Board of Trustees members attending all of part of the meeting included Karl Alberts, James Appl, Penny Brunken, Jilena Faith, Laurie Gill, Laurie Gustafson, James Hanson, James Johns, Myron Johnson, Louise Loban, Matt Michels, K.J. Peterson, and Eric Stroder.

Others attending all or part of the meeting included Matt Clark, Brett Fligge, Chris Nelson, Tammy Otten, and Laurie Riss from the Investment Council Office; Jane Beer, Travis Almond, Jacquee Storm, Doug Fiddler, Dawn Smith, Stephanie Gruba, and Brittnie Adamson from the South Dakota Retirement System; Paul Schrader, actuary; Liza Clark, Jim Terwilliger, Lara Williams, Jacob Harris and Michael Jost from the Bureau of Finance & Management; Ashlee Keyes from the Department of Legislative Audit; Jeff Mehlhaff from the Legislative Research Council; Greg Kulesa; Jon Hunter; Josh Haeder; and Kevin Merrill.

(Note: For sake of continuity, the following minutes are not necessarily in chronological order. Documents referenced are on file in the Investment Office, and public access is subject to the provisions of SDCL 1-27.)

2) SDRS Presentations

Society of Actuaries Retirement 20/20 Call for Models for Public Pension Plans

Rob Wylie discussed the Society of Actuaries' call for papers on public sector retirement plan design models better suited for today's challenges. He noted that SDRS submitted a paper on the SDRS generational design and was one of four winning designs. He added that Doug Fiddler and Paul Schrader were the architects of the paper with input from the Investment Council staff.

Investment Update

Matt Clark provided an investment performance update fiscal year to date for SDRS assets.

AGENDA ITEMS:

- 1) Roll Call
- 2) SDRS
 - a. Society of Actuaries Retirement 20/20 Call for Models for Public Pension Plans
 - b. Investment Update FY 2018
 - c. SDRS Projected Funded Status
 - d. Comparisons with Other Systems and Lessons Learned
- 3) Asset Allocation – SDRS & Trust Funds
- 4) Fiscal Year 2020 Budget Request
- 5) Minutes (4-19-19)
- 6) Steve Kirby Acknowledgement
- 7) Bridgewater Associates
- 8) Investment Incentive Program Changes FY2019
- 9) Asset Allocation Discussion
- 10) Investment Update – FY 2018
- 11) Iran Divestiture – Update
- 12) Compensation Committee Update
- 13) Audit Committee Update
- 14) Audit Committee Charter
- 15) Higher Education Savings Program Update
- 16) Election of Officers – FY 2019
- 17) New/Old Business
- 18) Future Meeting Date
- 19) Adjournment

Review of SDRS Projected Funded Status

Doug Fiddler presented estimated funding status results for June 30, 2018. He reviewed the average inflation from 2010 to 2018 compared to the SDRS COLA average over the same time period. He discussed the impact of the fiscal year 2018 investment return on the 2019 maximum COLA, the projected future COLA ranges, and the likelihood of additional required corrective actions based on different investment return assumptions.

Comparisons with Other Systems and Lessons Learned

Doug Fiddler compared the SDRS funded status, contribution levels, plan maturity, investment returns, cash flows, funding requirements, and payroll growth to other median public sector plans.

Paul Schrader presented a case study of the problems faced by another pension system. He described the mistakes that were made over many years which resulted in steadily declining funded ratios, increasing funding periods and increasing unfunded liabilities. He discussed the pension reform efforts, including COLA reductions, higher member contributions, higher state funding and automatic adjustment features.

Schrader discussed lessons learned from that fund's experience and emphasized the importance of transparency, prompt recognition of problems, sound governance, a strategic long-term approach, administrative and benefit efficiencies, and an established framework for future benefit changes due to meeting or exceeding funding goals.

3) Asset Allocation

South Dakota Retirement System

Matt Clark discussed the asset allocation process, importance, and application to SDRS. He discussed the recommended benchmark allocation and ranges, expected return and standard deviations, asset category valuation, and the movement of category allocations within ranges based on valuation.

Clark discussed the recommended benchmark level of equity-like and bond-like risk to balance long-term potential returns with drawdown risk in difficult markets. He indicated this was for the benchmark which should represent what could be adhered to through thick and thin. He showed charts of historic returns noting the dominance of equity returns over the very long term and the diversification benefit during market downturns of mixing in some bonds. He discussed the recommended range for equity-like risk and bond-like risk. He said the goal is to enter market downturns with below benchmark risk and increase toward maximum during the downturn to benefit from an eventual rebound. He added that after getting to minimums and maximums, markets will typically move further, which can be very painful. It is essential to be patient for at least another three to five years.

Clark discussed equity-like and bond-like risk mapping for all asset categories. He discussed specific asset categories to be included in the benchmark which are those that are significant and passively implementable. He discussed other niche or skill-based categories which are not in the benchmark but that have a permitted range. He presented the SDRS capital market benchmark allocations and minimum/maximum ranges for each asset category. The capital markets benchmark allocations for fiscal years 2010 through 2018 were shown. The staff's recommended benchmark for FY 2019 was also shown.

Clark showed the SDRS historical levels of equity-like allocation back to 1987. He reviewed the asset allocation risk/return analysis. The first portion focused on long-term mean expected returns, expected standard deviations, and asset correlations provided by JP Morgan Asset Management as a proxy for conventional expectations. The incremental return and standard deviation impact of each asset class was shown. The analysis was shown again using internal asset category expected returns and internal adjusted risk measures.

Clark discussed additional risk measures and risk control. He reiterated that the focus is on equity-like risk and bond-like risk which includes embedded equity and bond risk for all categories. He said statistical measures of risk such as standard deviation and correlation are adjusted to reflect higher real-world frequency and magnitude of adverse outlier events. He said that behavior of some assets in a crisis can vary depending on whether the crisis is rooted in inflation or deflation concerns. Clark discussed how risk is managed by broad diversification and by reducing amounts invested in expensive assets. He said adequate liquidity is maintained to avoid liquidations of depressed assets in a crisis and to allow rebalancing. He stated that participation in the economic system is necessary to get the highest long-term rewards and that short-term ebbs and flows must be endured. He added that strength and determination is important to be able to handle tough markets, which is helped by strong funding built up in good markets and a flexible benefit design.

Clark then discussed asset category valuation. Equity category valuation is based on estimated future cash flows based on normal earnings and growth rates and a risk impacted discount rate. The model is similar to the model used to value individual companies. He discussed adjustments to fair value based on monetary conditions and corporate earnings strength. He discussed valuation processes for bonds, real estate and high yield.

Clark showed the current and historical valuations of each asset class and historical efficacy of the valuation process. He discussed the plan for adjusting allocations within permitted ranges based on valuation.

There was discussion about the use of valuation of the S&P500 to adjust equity-like risk. It was noted that valuations of non U.S. markets or small caps can be different than for the S&P500. Clark indicated large cap U.S. stocks represented the majority of the internal equity universes and further non U.S. securities are half-weighted to create a home country bias. He added that historical data for the S&P500 is more robust, enhancing confidence in the process. He said smaller and non U.S. stocks are valued one stock at a time through the internal equity portfolio management process, and those areas can be over-weighted in the equity portfolios when attractively valued. He said research projects were underway to value non U.S. and smaller companies at the index level which could broaden valuation inputs used to set equity-like risk.

Trust Funds

Tammy Otten discussed asset allocation for the four trust funds; Dakota Cement Trust, Healthcare Trust, Education Enhancement Trust, and School and Public Lands. She described the establishment of each fund, the Constitution and laws that direct the investment of the assets, the annual distribution calculation for each fund, the 5/31/18 estimated fund fair value, and the 2018 distribution amounts.

Otten reviewed the asset allocation analysis which shows the long-term mean expected return and standard deviation for each portfolio. The analysis was shown standard deviations and

correlations with fat tail adjustments. The expected return and standard deviation compared to select prior year benchmark allocations were shown.

Staff proposed no changes to the Dakota Cement Trust, Healthcare Trust or School and Public Lands trust funds' capital markets benchmark weights or indexes for FY 2019 from FY 2018. Staff recommended a change to the Education Enhancement Trust to reflect a decline in the mandated allocation to tax-exempt fixed income securities. It was recommended that the equity-like risk target for the four trust funds remain at 90% of the equity-like risk for SDRS.

Note – Motions on asset allocation issues are included under item #9.

4) Fiscal Year 2020 Budget Request

Matt Clark reviewed the FY 2018 budget received versus actual expenditures estimated through the rest of the fiscal year. He discussed the areas that made up the unexpended budget noting that those funds will offset next year's budget authorization, essentially reverting to the funds under management.

Clark reviewed the budget request for FY 2020 and the unit cost summary. He noted that the personal services budget includes increases for investment positions transitioning over 18 to 20 years from entry level to senior portfolio managers after which time the long-term plan increase is used. He described the salary increase percentages incorporated into the long-term plan for investment positions. The budget that will be submitted to the Executive Board, Governor/BFM and Appropriations will not include salary policy, as general salary policy for the state will be applied at the end of the process. To reflect a total picture of expenditures, the unit cost summary does include an assumed salary policy.

Clark reviewed the operating portion of the FY 2020 budget request. He discussed the changes proposed in the contractual budget for investment and administrative services and described in detail the two major increases relating to a trade order management system and legal consulting fees. A small decrease was proposed for supplies and no changes for travel and capital assets.

Brett Fligge discussed the research flexibility needed in the operating budget to pay for research services as they continue to become unbundled from trading commissions.

ROB WYLIE MOVED, SECONDED BY RYAN BRUNNER, TO APPROVE THE FISCAL YEAR 2020 BUDGET REQUEST AS PRESENTED. MOTION PASSED UNANIMOUSLY.

The Investment Council recessed at 4:40 p.m. and reconvened at 8 a.m. on June 14, 2018.

5) Minutes – 4/19/18

LORIN BRASS MOVED, SECONDED BY PAUL BISSON TO APPROVE THE MINUTES OF THE APRIL 19, 2018 INVESTMENT COUNCIL MEETING. MOTION PASSED UNANIMOUSLY.

6) Steve Kirby Acknowledgement

Steve Kirby will be completing his five years on the Investment Council effective June 30, 2018. Matt Clark expressed his gratitude to Steve for his dedication and contributions during his term and for his leadership as Chair. He reviewed some of the performance results over the last five years. A plaque was presented to Steve in recognition of his outstanding service.

7) Bridgewater Associates

Jeff Gardner, Portfolio Strategist, from Bridgewater Associates joined the Council to discuss their investment strategies and economic views.

ROB WYLIE MOVED, SECONDED BY RYAN BRUNNER, TO GO INTO EXECUTIVE SESSION PER SDCL 1-25-10 FOR THE PURPOSE OF RECEIVING AND DISCUSSING INVESTMENT STRATEGY INFORMATION THAT IS CONFIDENTIAL UNDER SDCL 1-27-1.6(5). MOTION PASSED UNANIMOUSLY.

Staff remaining to participate in and/or facilitate the discussion included Matt Clark, Chris Nelson, Tammy Otten, and Brett Fligge.

Open session reconvened at 10 a.m.

8) Investment Incentive Program Changes FY 2019

Matt Clark noted that beginning FY 2019, Matthew Carey and Makenzie Smook have been assigned to asset classes and individual portfolios. He reviewed the memorandum outlining the plans, noting that the incentive plans have been updated to match the structures of others in their assigned area.

PAUL BISSON MOVED, SECONDED BY LOREN KOEPEL, TO APPROVE THE INCENTIVE PLAN CHANGES AS DETAILED IN THE MAY 29, 2018 MEMORANDUM ENTITLED, "INVESTMENT PERFORMANCE INCENTIVE PLAN CHANGES EFFECTIVE FY 2019." MOTION PASSED UNANIMOUSLY.

9) Asset Allocation Discussion

Council discussion continued regarding the asset allocation process and internal research to understand drivers of changes in corporate profitability and reconciliation to aggregated inputs from the internal modelling of individual companies.

JEFF NELSON MOVED, SECONDED BY RICH SATTGAST, TO APPROVE THE FISCAL YEAR 2019 CAPITAL MARKETS BENCHMARK, INDEXES, EQUITY-LIKE RISK, AND MAXIMUM/MINIMUM RANGES FOR THE SOUTH DAKOTA RETIREMENT SYSTEM AS PRESENTED. MOTION PASSED UNANIMOUSLY.

ROB WYLIE MOVED, SECONDED BY RYAN BRUNNER, TO APPROVE THE FISCAL YEAR 2019 CAPITAL MARKETS BENCHMARK, INDEXES, EQUITY-LIKE RISK, AND MAXIMUM/MINIMUM RANGES FOR THE DAKOTA CEMENT TRUST, HEALTH CARE TRUST, EDUCATION ENHANCEMENT TRUST, AND SCHOOL & PUBLIC LANDS AS PRESENTED. MOTION PASSED UNANIMOUSLY.

LORIN BRASS MOVED, SECONDED BY PAUL BISSON, TO APPROVE THAT ASSET ALLOCATION ADJUSTMENTS IN THE RETIREMENT AND TRUST FUNDS MAY BE IMPLEMENTED IN THE CASH AND/OR DERIVATIVES MARKETS. MOTION PASSED UNANIMOUSLY.

10) Investment Update – FY 2018

Tammy Otten stated that there were no completed motions to report. The estimated fiscal year-to-date return of the SDRS portfolio as of 6/11/18 was provided. Upcoming distributions and contributions for the various funds were discussed.

Matt Clark updated the Council on the current equity allocation. He discussed consideration by staff of a possible recommendation to lower the minimum equity-like risk. He said that any contemplated change would not result in a change to the actual allocation at current valuations. He said any change to the range would require Council approval.

11) Iran Divestiture - Update

Otten reported that since the last Council meeting, there were no updates to the Florida or Colorado lists which are used as sources. Staff recommended no changes to the current list.

12) Compensation Committee Update

Lorin Brass, Chair of the Compensation Committee, noted that the LRC Executive Board approved the Council's recommendation for the State Investment Officer's FY 2019 compensation at their May 21, 2018 meeting.

13) Audit Committee Update

Jeff Nelson, Chair of the Audit Committee, stated that the Committee met with Legislative Audit and approved the engagement letter for the annual audit. He added that at their meeting they discussed areas of focus for the Agreed Upon Procedures that will be incorporated into the AUP.

The Audit Committee suggested that Auditor General Marty Guindon be invited to a future Council meeting to discuss their practices and procedures.

14) Audit Committee Charter

Jeff Nelson discussed the changes to the Audit Committee Charter. Most of the changes were to improve the clarity of the responsibilities relating to the Agreed Upon Procedures. The composition of the membership was also discussed.

The Audit Committee recommended the approval of the proposed changes with a potential modification to the composition of membership to retain Council Chair flexibility in selecting members.

15) Higher Education Savings Program - Update

Tammy Otten reviewed the CollegeAccess 529 Plan summary of accounts, along with the minutes from the quarterly conference call with Allianz and the compliance schedule.

The Council briefly discussed Able program communications.

16) Election of Officers – FY 2019

RICH SATTGAST MOVED, SECONDED BY RYAN BRUNNER, TO ELECT LORIN BRASS AS CHAIR AND LOREN KOEPESELL AS VICE CHAIR OF THE INVESTMENT COUNCIL FOR FISCAL YEAR 2019. MOTION PASSED UNANIMOUSLY.

17) New/Old Business Agenda Items

No new or old business was brought before the Council.

18) Future Meeting Dates

The next Investment Council meeting will be held in Pierre on August 27, 2018, in conjunction with the LRC Executive Board meeting.

19) Adjournment

RYAN BRUNNER MOVED, SECONDED BY RICH SATTGAST, FOR ADJOURNMENT. MOTION PASSED UNANIMOUSLY. Chair Kirby declared the meeting adjourned at 11 a.m.