

MINUTES

SOUTH DAKOTA INVESTMENT COUNCIL June 20, 2023

1) Roll Call

The meeting was called to order at 8:30 a.m. on June 20, 2023 by Chair Greg Kulesa. Council members in attendance were Travis Almond, Brock Greenfield, Josh Haeder, Mary Howard, Loren Koepsell, Greg Kulesa, Kelly Meiners, and Steve Pietila.

Others attending all or part of the meeting included Investment Council staff members Matt Clark, Tammy Otten, Chris Nelson, Sherry Nelson, Jan Zeeck, Darci Haug, Danielle Mourer, Anne Cipperley, Renae Randall, Matthew Carey, Lesyk Voznyuk, Dan Elmer, Jake Wehde, Sami Rains, John Richter, and Sarah Rust; SDRS staff members Jacque Storm, Doug Fiddler, and Michelle Mikkelsen; Derek Johnson and Duncan Koch from BFM; Tim Dwire from SDSU University Foundation; Adam Dentlinger and Devan Schaefer from First Bank and Trust, and Scott Simons.

AGENDA ITEMS:

- 1) Roll Call
- 2) Minutes 4/6/23
- 3) Public Comment
- 4) Greg Kulesa Acknowledgement
- 5) Rules Hearing – Higher Education Savings Program
- 6) SDRS Actuarial Update
- 7) Asset Allocation
- 8) Investment Update – FY 2023
- 9) Iran Divestiture Update
- 10) 529 Higher Education Savings Plan Update
- 11) Audit Committee Update
- 12) Compensation Committee Update
- 13) FY 2025 Budget Request
- 14) Election of Officers – FY 2024
- 15) New/Old Business Agenda Items
- 16) Future Meeting Dates
- 17) Adjournment

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

2) Minutes

JOSH HAEDER MOVED, SECONDED BY TRAVIS ALMOND, TO APPROVE THE MINUTES OF THE APRIL 6, 2023 INVESTMENT COUNCIL MEETING. MOTION PASSED UNANIMOUSLY.

3) Public Comment

There were no public comments.

4) Greg Kulesa Acknowledgment

Greg Kulesa will be completing his five years on the Investment Council effective June 30, 2023. Matt Clark thanked Greg for his contributions to the Council and reviewed some of the performance statistics over the last five years. Kulesa shared his thoughts regarding serving on the Council and thanked the Council members for their service.

5) Rules Hearing – Higher Education Savings Program

The minutes of the Administrative Rules Hearing for the Higher Education Savings Program are attached to these minutes and are made a permanent part hereof.

LOREN KOEPEL MOVED, SECONDED BY MARY HOWARD, TO ADOPT THE PROPOSED CHANGES TO SOUTH DAKOTA'S ADMINISTRATIVE RULES, AS PRESENTED TODAY. MOTION PASSED UNANIMOUSLY ON A ROLL CALL VOTE.

6) SDRS Actuarial Update

Doug Fiddler presented an overview of the South Dakota Retirement System. He provided a breakdown of active members and benefit recipients, as well as member/employer contributions and SDRS disbursements. He discussed the FY 2022 investment return and its impact on the COLA for July of 2023.

Fiddler discussed the statutorily required SDRS contribution rates and corrective actions if SDRS falls below 100% funded. He compared government contributions to pensions in South Dakota versus other states. He outlined how the COLA is calculated and reviewed historical COLA ranges. Fiddler provided an overview of the current and historical inflation rates in comparison to SDRS COLAs for the last several years.

7) Asset Allocation

South Dakota Retirement System

Anne Cipperley and Darci Haug discussed the asset allocation process, importance, and application to SDRS. They discussed the recommended benchmark allocation and ranges, expected return and standard deviations. Renae Randall and Matt Carey discussed valuation of the equity asset category. Lesyk Voznyuk, Dan Elmer, and Jake Wehde discussed valuation of other asset categories. Darci and Danielle Mourer discussed movement of category allocations within ranges based on valuation.

Cipperley discussed the recommended benchmark level of equity-like and bond-like risk to balance long-term potential returns with drawdown risk in difficult markets. She indicated this was for the benchmark which should represent what could be adhered to through thick and thin. Charts of historic returns were shown noting the dominance of equity returns over the very long term and the diversification benefit during market downturns of mixing in some bonds. The recommended range for equity-like risk and bond-like risk was discussed. She 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. She added that after minimums or maximums are reached, markets will typically move further, which can be very painful and that it is essential to be patient for at least another three to five years.

Cipperley discussed the lowering three years ago of the minimum level of equity-like risk and resulting reduction of absolute downside risk during a severe decline, but increased underperformance risk when very expensive markets continue to go up.

Haug discussed equity-like and bond-like risk mapping for all asset categories. She discussed specific asset categories to be included in the benchmark which are those that are significant and passively implementable. She also discussed other niche or skill-based categories which are not in the benchmark but have a permitted range. Haug presented the recommended FY2024 SDRS capital market benchmark allocations and minimum/maximum ranges for each asset category and compared to the benchmark allocations for fiscal years 2016 through 2023. The recommended benchmark was unchanged from the prior year. The real estate and REITs minimums were lowered to zero from 2% previously, the maximum for investment grade fixed income was increased to 60% from 50% and the maximum for cash was lowered from 50% to 45%. Other categories which have not been active in recent years such as TIPS, commodities and arbitrage strategies were consolidated with a max of 5%.

Haug showed SDRS historical levels of equity-like allocation. She 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 a leading investment bank asset management division 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.

Haug discussed additional risk measures and risk control. She reiterated that the focus is on equity-like risk and bond-like risk which includes embedded equity and bond risk for all categories. Statistical measures of risk, such as standard deviation and correlation, are adjusted to reflect higher real-world frequency and magnitude of adverse outlier events. Behavior of some assets in a crisis can vary depending on whether the crisis is rooted in inflation or deflation concerns. She discussed how risk is managed by broad diversification and by reducing amounts invested in expensive assets. Adequate liquidity is maintained to avoid liquidation of depressed assets in a crisis and to allow rebalancing. She 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. She added that strength and determination are important to be able to handle tough markets and that strong funding built up in good markets and a flexible benefit design are very helpful.

Randall gave an overview of asset category valuation. Carey indicated that valuation of the Equity category is based on estimated future cash flows using normal earnings and growth rates and a risk impacted discount rate. Randall reviewed the process for normalizing earnings and invested capital. Carey reviewed charts showing normal earnings back through time. Randall discussed normal growth. Carey showed components of the expected equity return and measure of fair value back through time.

Dan Elmer discussed valuation of the bond category. Lesyk Voznyuk discussed some enhancements to the discount rate process. Jake Wehde showed the resulting valuation of the bond category back through time. Wehde also discussed valuation of the real estate category. Voznyuk discussed valuation of the high yield debt category. Elmer showed a chart including valuation of all the discussed asset categories back through time.

Mourer discussed the plan for adjusting allocations within permitted ranges based on valuation. She showed the asset allocation exposure monitor tool used to track allocations versus targets and limits and rebalancing thresholds. A matrix was shown indicating the process for tracking of valuations versus thresholds where allocation changes are triggered.

Haug discussed historical valuation model suggested allocations and historical added value. She then discussed the flurry of asset allocation changes during 2020 to illustrate implement of the process. Haug, Mourer and Cipperley concluded with a discussion of evolution of implementation of the asset allocation process on time.

Trust Funds

Danielle Mourer and Darci Haug discussed asset allocation for the four trust funds: Dakota Cement Trust, Healthcare Trust, Education Enhancement Trust, and School and Public Lands. The presentation reviewed the establishment of each fund, the Constitution and laws that direct the investment of the assets, and the annual distribution calculation.

The asset allocation analysis was reviewed which shows the long-term mean expected return and standard deviation for each fund. The analysis used the standard deviations and correlations with fat-tail adjustments. The expected return and standard deviation compared to select prior year benchmark allocations were shown.

There were no proposed changes for the FY2024 benchmark from the prior year but there were proposed to minimums and maximums for individual categories were equivalent to those proposed for SDRS. It was recommended that the equity-like risk target for the four trust funds remain at 90% of the equity-like risk for SDRS.

There were questions from the Council and further discussion related to the asset allocation presentations regarding (1) the practicality of the 40% minimum for equity-like risk; (2) minimum physical cash levels to assure adequate liquidity; (3) limitations on use of hedging instruments; (4) the method for measuring equity-like risk for real estate; (5) the measure used to gage inflation; (6) impact of inflation on S&PL distributions; (7) how we assess pricing power for various sectors; and (8) implication of accelerating use of AI tools for companies and markets.

STEVE PIETILA MOVED, SECONDED BY BROCK GREENFIELD, TO APPROVE THE FISCAL YEAR 2024 CAPITAL MARKETS BENCHMARK, INDEXES, EQUITY-LIKE RISK, AND MAXIMUM/MINIMUM RANGES FOR THE SOUTH DAKOTA RETIREMENT SYSTEM AS PRESENTED. MOTION PASSED UNANIMOUSLY.

BROCK GREENFIELD MOVED, SECONDED BY TRAVIS ALMOND, TO APPROVE THE FISCAL YEAR 2024 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.

LOREN KOEPSSELL MOVED, SECONDED BY JOSH HAEDER, TO APPROVE THAT ASSET ALLOCATION ADJUSTMENTS MAY BE IMPLEMENTED IN THE CASH MARKETS AND/OR FINANCIAL DERIVATIVES, INCLUDING INDEX-BASED FUTURES, EXCHANGE TRADED FUNDS, OR OPTIONS. MOTION PASSED UNANIMOUSLY.

8) Investment Update – FY 2023

Danielle Mourer reported the estimated fiscal year-to-date return of the SDRS portfolio and the upcoming distributions and contributions for the various funds. There were no finalized motions and resulting actions to report.

Jan Zeeck discussed the fiscal year-to-date performance of the equity portfolios.

Darci Haug updated the Council on the status of Bristow.

There was a Council question and discussion about exposure to mid-sized banks in relation to the banking turmoil earlier in the year.

9) Iran Divestiture Update

Sami Rains reported that since the last Council meeting, Florida updated the list used to determine the South Dakota list of Iran scrutinized companies. Staff recommended that one company be removed from the list due to it no longer being a publicly traded entity.

JOSH HAEDER MOVED, SECONDED BY KELLY MEINERS, TO APPROVE THE CHANGE(S) TO THE IRAN SCRUTINIZED COMPANIES LIST AS PRESENTED. MOTION PASSED UNANIMOUSLY.

10) 529 Higher Education Savings Plan Update

Sherry Nelson reviewed the CollegeAccess 529 Plan summary of accounts, the HESP Compliance Schedule, and minutes of the quarterly Virtus conference call. She pointed out that 529 account forms can be filled out online but must continue to be printed and mailed in. It was noted that Virtus continues to work on making the enrollment process entirely online. Clark thanked Treasurer Haeder for his ongoing efforts to help with marketing of the program.

11) Audit Committee Update

Loren Koepsell, Chair of the Audit Committee, noted that the quarterly testing is done, and the preliminary report shows no exceptions. He expects to receive the formal report in one week.

12) Compensation Committee Update

Loren Koepsell noted that the Council's recommended total compensation for the State Investment Officer for FY 2024 was approved by the Executive Board at their May 19, 2023 meeting.

The Council discussed salary policy for staff.

13) FY 2025 Budget Request

Matt Clark reviewed the FY 2023 budget authorization 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 2025 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 increases are used. He noted the increase is smaller than typical in the past due to retirements of some senior staff. The budget that will be submitted to the Executive Board, Governor/BFM and Appropriations will not include salary policy, as a 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 2025 budget request. He discussed the changes proposed in the contractual budget for investment and administrative services. He discussed the upgrade to the investment accounting software and the changes among investment research services and investment databases. No changes were proposed for travel or capital assets and there was a slight decrease in supplies due to reduced printing supply costs.

BROCK GREENFIELD MOVED, SECONDED BY MARY HOWARD, TO APPROVE THE FISCAL YEAR 2025 BUDGET REQUEST AS PRESENTED, WITH POTENTIAL MODEST ADJUSTMENTS TO BENEFITS CALCULATIONS ACCORDING TO THE BUREAU OF FINANCE AND MANAGEMENT. MOTION PASSED UNANIMOUSLY.

14) Election of Officers – FY 2024

KELLY MEINERS MOVED, SECONDED BY BROCK GREENFIELD, TO ELECT LOREN KOEPSSELL AS CHAIR AND MARY HOWARD AS VICE CHAIR OF THE INVESTMENT COUNCIL FOR FISCAL YEAR 2024. MOTION PASSED UNANIMOUSLY.

15) New/Old Business Agenda Items

Loren Koepsell provided additional reflection on the Executive Board meeting in Pierre

mentioning their continuing support for the Council and some questions regarding ESG.

16) Future Meeting Dates

The next Investment Council meeting will be held on August 7, 2023 in Pierre.

17) Adjournment

Greg Kulesa declared the meeting adjourned at 3:04 p.m.

FORM 10

MINUTES OF PUBLIC HEARING South Dakota Investment Council

The South Dakota Investment Council convened at 8:43 a.m. on June 20, 2023, in Valhalla I Professional Building Room 301, 4009 West 49th Street, Sioux Falls, South Dakota.

The purpose of the meeting was to conduct a public hearing on the proposed rules of the South Dakota Investment Council numbered §§ 6:01:01:02, 6:01:01:03, 6:01:01:04, 6:01:04:01, 6:01:04:02, 6:01:04:03, 6:01:04:04, 6:01:04:05, 6:01:04:06, 6:01:04:07, 6:01:04:08, 6:01:04:09, 6:01:04:10, 6:01:04:11, 6:01:04:12, 6:01:04:13, 6:01:04:14, 6:01:04:15, 6:01:06:01, 6:01:06:02, 6:01:06:03, and 6:01:06:05, adopted under the authority of SDCL 4-5-28.5.

Hearing Officer: Greg Kulesa, Chair

Members of the Council in Attendance: Greg Kulesa, Chair; Mary Howard, Vice Chair; Brock Greenfield, Loren Koepsell, Kelly Meiners, Josh Haeder, Steve Pietila, and Travis Almond.

Others in Attendance: Jan Zeek, SDIC; Samantha Rains, SDIC; Renae Randall, SDIC; Jake Wehde, SDIC; Matt Carey, SDIC; Michelle Mikkelson, SDRS; Anne Cipperley, SDIC; Danielle Mourer, SDIC; Duncan Koch, BFM; Derek Johnson, BFM; Jacque Storm, SDRS; Chris Nelson, SDIC; Doug Fiddler, SDRS; Tammy Otten, SDIC; Darci Haug, SDIC; Matt Clark, SDIC; Sarah Rust, SDIC; Scott Simons, guest; and Marlene F. Smith, Court Reporter.

Written Testimony

- No written testimony was received.

Oral Testimony

John Richter, General Counsel for the South Dakota Investment Council, provided an overview of the proposed rules. John testified that the rules can be generally lumped into three buckets (1) clean-up; (2) the repeal of rules pertaining to investments in mortgage-backed securities; and (3) the repeal of rules relating to higher education savings plans that were codified two sessions ago.

The proposed changes started with the repeal of rules relating to higher education savings plans (ARSD 6:01:06:01 through ARSD 6:01:06:05) – the reason these are no longer necessary is because they were codified through HB 1009 in the 2022 Legislative Session. The effect will be to remove unnecessary rules.

The Investment Council then looked at its rules pertaining investments in mortgage-backed securities (ARSD 6:01:04:01 through ARSD 6:01:04:15). The rules were initially promulgated in the early 1980s. Over time, portions were codified; however, the Investment Council has no intention of investing in mortgage-backed securities now, nor any time in the future, other than US government agency issued mortgage-backed securities as provided for in codified law. Again, the effect will be to repeal unnecessary and obsolete rules.

After removing the administrative rules pertaining to higher education savings plans and investments in mortgage-backed securities, the remainder is clean-up and clarification. In relation to ARSD §§ 6:01:01:02 through 6:01:01:04, the Investment Council is proposing

to repeal two obsolete rules (:02 and :03) and use :04 as a vehicle to clarify its obligations under SDCL 1-26-15, which requires the Investment Council to promulgate rules for the prompt disposition of declaratory rulings.

As you can see in the information that we provided, we did receive some feedback from LRC, which was mostly incorporated. John noted that our language regarding additional information is consistent with the State Board of Elections (ARSD 5:02:02:02), which has been in effect since 1975 with no issues.

At the conclusion, John stated that he would welcome any comments or questions. There being none, he turned the floor back over to the Chair.

There was no other public testimony. Seeing no further testimony, Chair Greg Kulesa then entertained a motion to adopt the rules as presented. Council member Loren Koepsell moved to adopt the proposed changes to South Dakota's Administrative Rules as presented. Vice Chair Mary Howard seconded the motion. There was no further discussion on the motion, and the motion was adopted unanimously by all eight council members after a roll-call vote.

Summary of Changes to Proposed Rules on Account of the Public Hearing

Aside from incorporating LRC's feedback, which was mentioned while presenting the rules, no other changes were made on account of the Public Hearing.

Adjournment: 8:57 a.m.

Respectfully submitted,



John Richter
General Counsel
South Dakota Investment Council