

MINUTES

SOUTH DAKOTA INVESTMENT COUNCIL Sioux Falls, South Dakota November 14, 2013

1) Roll Call

The Investment Council meeting was called to order at 9 a.m. on November 14, 2013 by Chair Hugh Bartels. Council members in attendance were Hugh Bartels, David Hillard, Jon Hunter, Steve Kirby, Vern Larson, Jim Means, and Rob Wylie. Council member Rich Sattgast was absent.

Others attending all or part of the meeting included Matt Clark, Brett Fligge, Chris Nelson, Tammy Otten, Jarrod Edelen, Adam Schwab, Anne Cipperley, Danielle Mourer, Ross Sandine, Lee Mielke, Randy Spinar, Brandy Eisma, Sami Kangas, Krystal Seeley, and Laurie Riss from the Investment Office; Jane Roberts, Michelle Mikkelsen, and Susan Jahraus from the South Dakota Retirement System; Aaron Olson from the Legislative Research Council, Ashlee Keyes from Legislative Audit; and Bob Litz.

(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.)

AGENDA ITEMS:

- 1) Roll Call
- 2) Welcome to New Council Member
- 3) Minutes
- 4) Investment Update – FY 2014
- 5) Iran Divestiture – Update
- 6) Riverstone Co-Investment Update
- 7) Compensation Committee Update
- 8) Incentive Program Changes
- 9) Small/Mid Cap Portfolio Presentation
- 10) SDIC FY 2013 Annual Report
- 11) Audit Committee Update
- 12) Sarbanes Oxley – Compliance Checklist
- 13) High Yield Portfolio & Modeling Process Overview
- 14) Potential Management of External Funds
- 15) Higher Education Savings Program
- 16) CD Program – Update
- 17) New/Old Business
- 18) Future Meeting Dates
- 19) Adjournment

2) Welcome to New Council Member

Chair Bartels welcomed Steve Kirby to the Council. Mr. Kirby is the President and Founding Partner of Bluestem Capital Company in Sioux Falls. He was appointed by the LRC Executive Board to a five-year term on the Investment Council beginning July 1, 2013.

3) Minutes

JIM MEANS MOVED, SECONDED BY DAVID HILLARD, TO APPROVE THE MINUTES OF THE AUGUST 19, 2013 COUNCIL MEETING. MOTION PASSED UNANIMOUSLY.

4) Investment Update – FY 2014

Otten presented the Motions and Actions report from the August 19, 2013 Council meeting. She noted that since the last Council meeting, one new co-investment was made in accordance with the Council's Co-Investment Policy. One outside managed portfolio in distressed mortgages had been liquidated per contract at the end of the September quarter. Estimated total asset values as of October 31, 2013 and net total rate of returns as of November 12, 2013 were provided.

Chris Nelson provided an update on the limited partnership investments. Otten gave an update of the asset allocation model, and Clark provided scenarios on asset allocation moves under different market conditions.

5) Iran Divestiture - Update

Otten discussed the Iran Scrutinized Companies List memo dated October 31, 2013 that had been previously provided to the Council. Florida had updated their list as of 9/24/13 and included two new names on the list. Staff recommended that these names be added to the South Dakota list. A report will be provided to the Executive Board of the Legislature in January as required by law.

ROB WYLIE MOVED, SECONDED BY VERN LARSON, TO APPROVE THE UPDATED IRAN SCRUTINIZED COMPANIES LIST DATED NOVEMBER 14, 2013, AS PRESENTED. MOTION PASSED UNANIMOUSLY.

6) Riverstone Co-Investment Update

Matt Clark updated the Council on the recent \$7.5 million co-investment with Riverstone V. Jarrod Edelen and Randy Spinar discussed the valuation of the opportunity in comparison to public energy companies and sensitivity to changes in oil prices.

7) Compensation Committee Update

Hugh Bartels discussed the recent Compensation Committee conference call regarding the proposed changes to the investment incentive program.

8) Incentive Program Changes

The Compensation Subcommittee and Matt Clark discussed with the rest of the Council the changes being proposed for the investment performance incentive program. Clark reviewed details of the proposed plan and showed how it would have worked applied to historical performance.

After discussion, it was the consensus of the Council to continue working toward implementation of the additional incentive plan which focuses on longer term and stretch incentives.

9) Small/Mid Cap Portfolio Presentation

Jarro Edelen and Adam Schwab presented the Small & Mid Cap (SMID) equity modeling process and discussed one of the SMID investments, Winnebago Industries.

Edelen began with an overview of the SMID portfolios and the market cap ranges and benchmarks. Schwab followed with a discussion of a sample of SMID companies and the breakdown of the sector coverage. Edelen described the overlap of company holdings between Global Equity and the SMID portfolios. He mentioned the company presentations the SMID team has done. He described the use of OneNote which organizes the notes and research on each company. Schwab then discussed the responsibility of each SMID portfolio and the general equity process.

Edelen explained the research process behind the SMID portfolios. He discussed the income statement and invested capital research. Schwab described the risk rating approach and sales growth research. He detailed the ROIC page and capital allocation in the SMID process. He also explained the dividend discount model and the SMID approach to valuation.

Edelen began the discussion of Winnebago and highlighted the business mix of WGO. He described the due diligence conducted on WGO and described the trends in unit sales, profitability,

and return on assets. Schwab discussed the manufacturing process and customer demographics and reviewed the risk rating. He discussed the buying decision and valuation over time for Winnebago.

The Council asked questions on a number of issues, including the out-of-benchmark policy, the benefits from the policy, and the research process for forming assumptions and projections on individual companies.

10) SDIC FY 2013 Annual Report

Clark stated that the Investment Accounting department compiles and produces the annual report each year. The investment accountants were introduced, including Sami Kangas, Krystal Seeley and Brandy Eisma. The fourth investment accountant, Cindy Pickering, was not in attendance. Otten provided an overview of the FY 2013 Annual Report stating that there were no major changes in the format from last year. Clark reviewed the report's transmittal letter.

Clark noted that the FY 2013 annual report and audit report are posted on the SDIC website. As a result of the on-line access, only a limited number of reports were printed at a cost of \$1.50 per copy and provided to Council members, legislators, various Pierre offices, the SDRS Board of Trustees, and past Council members.

11) Audit Committee Update

Jon Hunter, Chair of the Audit Committee, reported that the fiscal year 2013 audit was complete. He stated that the Audit Committee had talked with Department of Legislative Audit (DLA) and Ashlee Keyes from DLA was present at the meeting. Hunter discussed the *Emphasis of Matter* section of the auditor's report. This section listed the percentage of financial position for which carrying values have been estimated by management in the absence of readily determinable fair values. Hunter stated the audit went well, and thanked staff.

Discussion continued regarding DLA performance of quarterly procedures audits. Hunter stated that these audits had been completed during fiscal year 2013 and would continue in 2014. He and Jim Means had discussed the current procedures and asked the other Council members and staff to let the audit committee know if there were areas they would like covered. Bartels stated that three areas should continue to be covered during the quarterly audits, those being, 1) policy, 2) reputational risk and 3) fraud risk.

12) Sarbanes Oxley – Compliance Checklist – Annual Review

Otten reviewed the Sarbanes-Oxley compliance checklist. As a government agency, the Investment Council does not need to comply with Sarbanes Oxley, but the report outlines how we would compare if required. She highlighted the inclusion of the quarterly procedures audits and other updates done by Krystal Seeley, Investment Accountant.

13) High Yield Portfolio & Modeling Process Overview

Ross Sandine, Danielle Mourer, and Anne Cipperley gave a presentation on High Yield. Sandine began with an overview of how high yield has been managed within the office before the inception of the current high yield portfolio. He discussed various characteristics of the high yield universe and the size of the universe covered. He described how the universe is screened down to a manageable set of companies. He reviewed how the high yield asset class has evolved and touched on some of the significant events that caused the high yield market to react. He

highlighted how a high yield bond is “capped” on the upside due to call features that are incorporated within the structure.

Sandine discussed various rules they are required to abide by in managing the high yield portfolio and emphasized reasons the maximum cash level is higher than internal equity portfolios. He also discussed the reason for having different over/under weight ranges for ratings and the “buffer zone” that exists before position sizes must be corrected.

Cipperley discussed the high yield modeling process. She highlighted how the high yield managers use a cash flow model. She discussed in detail three of the main inputs used in the model: normalized cash flow EBITDA, volatility of cash flow EBITDA, and leverageable assets. The company JC Penney was used as an example. Cipperley explained how the cash flow scenario model works, including the company’s starting liquidity position and the required cash outflows the company must make in a given year. She then elaborated on how the model tests for bankruptcy, highlighting that a company can go bankrupt due to liquidity or solvency issues.

Mourer discussed the discretionary cash uses in the model, explaining how they are divided into three priorities. She elaborated on three additional considerations in the model: feedback loops, net operating loss carry-forwards, and pension underfunding. The coupon discount model was discussed, including how cash flows are discounted back to calculate a present value and the manner in which the inputs are derived. A JC Penney bond was used as an example.

Sandine concluded the presentation with an overview of the current portfolio, touching on the largest/smallest industry over/under weights, price to value ranges, why the views on a company or industry may differ from those of the equity portfolio managers, and performance since inception.

14) Potential Management of External Funds

Clark stated that at the last Council meeting, the Council asked senior staff to come back with their thoughts on the potential for management of external funds. Following Clark’s recap of senior staff’s thoughts, it was the Council’s consensus that it did not make sense at present to pursue further discussions in this area.

15) Higher Education Saving Program

Sherry Nelson reviewed the Higher Education Savings Plan summary of accounts, the quarterly compliance schedule, and the minutes for the Allianz third quarter conference call that had previously been provided to the Council. She noted that the Program Management Agreement requires Council approval of the auditor selected by Allianz.

JIM MEANS MOVED, SECONDED BY STEVE KIRBY, TO APPROVE PRICEWATERHOUSECOOPERS AS THE AUDITOR FOR THE COLLEGEACCESS 529 PLAN FOR THE YEAR ENDING DECEMBER 31, 2013. MOTION PASSED UNANIMOUSLY.

Nelson discussed the proposal by Allianz that included several asset allocation and underlying fund changes within the age-based and static portfolios that would further diversify and lower the duration of the portfolios. Allianz recommended adding two funds: the PIMCO Senior Floating Rate Fund and the Morgan Stanley Institutional Emerging Markets Fund. They also suggested removal of the AllianzGI Disciplined Equity Fund.

DAVID HILLARD MOVED, SECONDED BY VERN LARSON, TO APPROVE THE PORTFOLIO CHANGES TO THE COLLEGEACCESS529 PLAN AS PROPOSED BY ALLIANZ GLOBAL DISTRIBUTORS AND PRESENTED TO THE INVESTMENT COUNCIL ON THIS DAY AND TO AUTHORIZE THE STATE INVESTMENT OFFICER TO EXECUTE

THE NECESSARY DOCUMENTS AND TAKE ANY OTHER ACTIONS DEEMED NECESSARY TO CARRY OUT THE PORTFOLIO CHANGES AS PRESENTED. MOTION PASSED UNANIMOUSLY.

16) CD Program - Update

Sherry Nelson reviewed her memo summarizing the results of the CD Program. Forty-seven banks, two savings banks and four credit unions participated this year, the same number as last year. The total accepted was \$23.657 million, an increase of \$2.68 million. The rate of .37% was based on the one-year Treasury note yield of .12% on 9/26/13 plus a liquidity premium of .25%. A listing of the participating financial institutions and a report on program statistics were provided.

17) New/Old Business

No new or old business was brought before the Council for future agenda items.

18) Future Meeting Dates

The next Investment Council meeting will be held in Pierre in conjunction with the Appropriations budget hearing. The date is tentatively set for February 5, 2014, (subsequently changed to February 6) and will be confirmed with the Council as soon as a final schedule is set by the Appropriations Committee.

19) Adjournment

Chair Bartels declared the meeting adjourned at 3:40 p.m.