M I N U T E S

SOUTH DAKOTA INVESTMENT COUNCIL
Sioux Falls, South Dakota
June 17 & 18, 2013

AGENDA ITEMS:

1) Roll Call
2) Minutes
3) Investment Update
4) Iran Divestment Update
5) SDRS Funded Status – Update
6) Asset Allocation & Benchmarks Review
7) Wesley Tschetter Acknowledgement
8) Jarrod Johnson Acknowledgement
9) Lone Star Real Estate Presentation
10) Lone Star Real Estate Fund III Investment
11) Compensation Committee Update
12) Fiscal Year 2015 Budget Request
13) Investment Incentive Program Changes FY14
14) Audit Committee Update
15) Higher Education Savings Program
16) SDIC Subcommittee Appointments
17) New/Old Business Agenda Items
18) Election of Officers for FY 2014
19) Future Meeting Dates
20) Adjournment

1) Roll Call

The meeting was called to order at 1 p.m. on June 17, 2013 by Chair Wesley Tschetter. Council members in attendance were Hugh Bartels, Jon Hunter, Jarrod Johnson, Jim Means, Rich Sattgast, Wesley Tschetter and Rob Wylie. Council member David Hillard was absent.

Others attending all or part of the meeting included Matt Clark, Brett Fligge, Tammy Otten, Chris Nelson, Sherry Nelson, and Laurie Riss of the Investment Office; Representative Isaac Latterell; Representative Manny Steele; Steve Myers; Susan Jahraus, Michelle Mikkelsen and Jane Roberts of the South Dakota Retirement System; Steven Kohler from the Bureau of Finance and Management; Eric Stroeder from the SDRS Board of Trustees; Dustin Padgett of Reliabank; Heath Rylance of Wells Fargo Advisors; Michael Anderson of Prairie Lakes; and Bob Litz from Minnehaha County. The presentations on SDRS funded status, asset allocation and Lone Star were attended by several of the Investment Office's portfolio managers and the three summer student interns.

(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) Minutes

HUGH BARTELS MOVED, SECONDED BY JARROD JOHNSON, TO APPROVE THE MINUTES OF THE APRIL 29 AND 30, 2013 COUNCIL MEETING. MOTION PASSED UNANIMOUSLY.

3) Investment Update

Tammy Otten reviewed the Motions and Actions report from the April 2013 Council meeting. The estimated fiscal year-to-date return of the SDRS portfolio as of 6/13/13 and the trust funds through 5/31/13 were provided. Upcoming distributions and contributions for the various funds were discussed.

4) Iran Divestment Update

Otten reviewed a memo sent to the Council that outlined compliance with the Iran divestiture law. The memo included the current list utilized by the Council. There were no updates from Florida or Colorado since the April Council meeting. Staff recommended affirming the current company list.

RICH SATTGAST MOVED, SECONDED BY JIM MEANS, TO REAFFIRM THE IRAN SCRUTINIZED COMPANIES LIST AS APPROVED AT THE FEBRUARY 6, 2013 COUNCIL MEETING. MOTION PASSED UNANIMOUSLY.

5) SDRS Funded Status

Rob Wylie presented a Funded Status Update for the South Dakota Retirement System and Cement Plant Retirement Fund. He reviewed the SDRS funding policy which includes funding objectives, establishment of the reserve, policy regarding consideration of benefit improvements, and statutory conditions that would require corrective action. Wylie emphasized the important roles of each of the components of the SDRS funding policy which distinguishes SDRS from other state retirement systems around the country.

Wylie reviewed the funded status projections for the actuarial value of assets and market value of assets under the current tentative investment return for FY 2013. He illustrated the impact the return will have on the cushion that helps to protect SDRS in the event of downturns in the markets. Wylie discussed SDRS funded status projections using an assumed 17.5% return for FY 2013 and the assumed return thereafter.

Wylie discussed the Cement Plant Retirement Fund projected funded status as of June 30, 2013 under the current tentative investment return for FY 2013 and assuming a $4 million contribution. He illustrated the funded status projections for the next 20 years with a 17.5% return for FY 2013, and the assumed rate thereafter, and no future contributions after the $4 million in June/July 2013. He discussed the on-going efforts that are being made on this fund with the support of the legislative and executive branches.

Wylie discussed the continuing areas of focus with respect to the fiscal viability of the current SDRS benefit design, fiscal sustainability, and risk management. He commented on implications of the new GASB accounting and disclosure requirements.

6) Asset Allocation & Benchmarks Review

South Dakota Retirement System & Cement Plant Retirement Fund

Matt Clark began the presentation with a review of the asset allocation modeling process. The process estimates fair value for equities (S&P500) similarly to how individual companies are valued using estimated normal earnings, growth rates, dividend payouts, and a risk impacted discount rate.

Normal earnings are estimated using a normal return on equity (ROE) multiplied by book value. This differs from the individual stock valuation process where normal earnings result from a line by line normalization of the income statement. The book value of the index is adjusted for the impact of various items (termed leakages) which may include index constituent changes, mergers, and stock buybacks. The normal ROE is based on historic real ROE plus expected future inflation plus adjustments to reflect the impact on the level of profitability of whether inflation is under control and the degree of contestability of corporate control.

Normal growth is a function of: (1) organic growth resulting from the return on reinvestment applied to the percentage of normal earnings that are reinvested and; (2) acquisition growth resulting from the amount invested in acquisitions and; (3) an assumption of the pass-through to earnings growth of inflation; and (4) an attrition rate to reflect mortality of normal earnings. Buybacks are treated as a form of dividends for asset allocation valuation purposes.

Equilibrium discount rates are based on a building block approach beginning with expected future inflation. A real yield is added to get equilibrium cash yields. A term premium is added to get equilibrium bond yields. A risk premium is added to get the equity discount rate.

The usage of the model would be to overweight undervalued asset categories and to underweight overvalued assets categories. Clark discussed the extensions of this work to include real estate and high yield. He showed the current and historical valuations of each asset class.

Clark discussed the need for discipline and a long term perspective on the part of both the Council and investment team in implementing the asset allocation process. He referenced communications to the Council each previous year during the asset allocation presentation and throughout recent years regarding the difficulty, but necessity, of sticking to our disciplines during challenging periods.

Clark reviewed the asset allocation risk/return analysis. The first portion focused on long term mean expected returns with conventional expected standard deviation and asset correlations as provided by JP Morgan Asset Management. The incremental return and standard deviation impact of each asset class relative to a 60:40 mix was shown. Internal research on Fat Tail Risk was reviewed. Conventional risk measures are adjusted to better explain the frequency of extraordinary negative events that have occurred in the past and that may recur. The asset allocation analysis using fat tail adjusted standard deviations and both inflation and deflation crisis correlations with the Investment Office's expected asset category expected returns was reviewed.

Clark presented the SDRS Equity-Like Risk analysis which integrates the risk of equities and the alternative asset classes. The analysis was performed three ways: (1) using conventional standard deviations and correlations; (2) using fat tail adjusted standard deviations and inflation crisis correlations; and (3) using fat tail standard deviations and deflation crisis correlations. He said the asset allocation committee focuses on the second and third measures in judging the risk of the portfolio.

Clark reviewed the SDRS normal asset allocation and minimum and maximum allocations for each category. The capital market benchmark allocations for fiscal years 2002 through 2013 were shown.

Clark discussed proposed changes to the Capital Markets Benchmark. He reviewed the reasons for recommending the index changes for private equity from the S&P 500+1.75% to the S&P 500 and for real estate from the NCREIF Property+1.25% to the MSCI REIT index. He described how the proposed benchmark would have differed from the existing benchmark in past periods and how over the last twenty years the combined effect of the changes for private equity and real estate would have essentially washed. There was discussion about the differences between the old and new benchmarks with consideration of the benefits of using implementable benchmarks and how any incremental effect of private equity risk versus the S&P 500 is addressed by the focus on managing equity like risk which takes into account and compensates by adjusting the amount invested in regular equities.

Clark also discussed changing from the use of gross returns to net returns for comparison to the capital markets benchmark. He indicated that this change made it more difficult to outperform the benchmark but made more sense looking forward.

Clark also recommended that prospectively, beginning with FY14 performance, total fund performance incentives be tied solely to the Council's capital market benchmark. He said the Russell Mellon Corporate Universe (Mellon) would be dropped for incentive purposes going forward but that past years gross returns versus the median of the Mellon Universe, which is based on gross returns, would be carried over for multiyear incentive purposes. He said in addition to our desire to shift to net returns which conflicts with the Mellon requirement of gross returns, we have discussed for several years developing difficulties with constituents of the Mellon Universe. This is due to shrinkage in the number of corporate defined benefit funds in favor of defined contribution plans and a shift by those remaining, driven by accounting rules changes, toward asset liability management which favors a mix of fixed income and hedge funds.

Rob Wylie commented that he has been in favor for some time of moving away from using the Mellon Universe due to the changes in corporate plans. He also commented that he thinks switching to net returns is a good change that will fit better with the new accounting standards.

Jim Means asked if we would be able to continue to show return comparisons to the Russell Mellon even though it would not be used for incentive purposes. Clark indicated that we would plan to show the comparison if the data is available, which he expected would be the case for at least the next year or two. He said we traditionally show our return compared to available other major universes for informational purposes and will plan to continue this.

HUGH BARTELS MOVED, SECONDED BY JARROD JOHNSON, THAT BEGINNING WITH THE FY 2014 PERFORMANCE RESULTS, TOTAL FUND PERFORMANCE BE COMPARED SOLELY TO THE SDIC CAPITAL MARKETS BENCHMARK FOR INVESTMENT INCENTIVE PURPOSES. MOTION PASSED UNANIMOUSLY ON A ROLL CALL VOTE.

It was noted that this change for the total fund benchmark for incentive purposes would be need to be communicated to the LRC Executive Board as they approve incentives for the State Investment Officer (see item #13 below).

ROB WYLIE MOVED, SECONDED BY JIM MEANS, TO APPROVE THE CHANGE IN THE PRIVATE EQUITY AND REAL ESTATE INDEXES USED IN THE SDIC CAPITAL MARKETS BENCHMARK, AS PRESENTED, AND USE NET TIME WEIGHTED RATE OF RETURN FOR INVESTMENT COMPARISON AND INCENTIVE PURPOSES. MOTION PASSED UNANIMOUSLY ON A ROLL CALL VOTE.

HUGH BARTELS MOVED, SECONDED BY ROB WYLIE, TO APPROVE THE SOUTH DAKOTA RETIREMENT SYSTEM AND CEMENT PLANT RETIREMENT FUND FISCAL YEAR 2014 CAPITAL MARKETS BENCHMARK AND MAXIMUM/MINIMUM ASSET ALLOCATION POLICY, AS PRESENTED, AND TO APPROVE THE INDEXES, INCLUDING THE CHANGES FOR PRIVATE EQUITY AND REAL ESTATE, AND USE OF NET TIME WEIGHTED RATE OF RETURN. MOTION PASSED UNANIMOUSLY ON A ROLL CALL VOTE.

Health Care Trust

Otten described the establishment of the Health Care Trust Fund by Constitutional amendment in 2001 which allows investment in "stocks, bonds, mutual funds and other financial instruments as provided by law". Annual distributions are 4% of the four-year average fair value without violating principal. Details on the inflation adjusted principal, the 5/31/13 estimated fund fair value, and the 7/1/13 distribution amount was provided.

Otten reviewed the asset allocation analysis which shows the long term mean expected return, expected standard deviation and correlation for conventional and two fat tail adjustments. The incremental return and standard deviation impact of select prior years' asset allocation benchmark weightings were shown.

No change was proposed for the Capital Markets Benchmark weights for FY 2014 from FY 2013 which represents approximately 85% of the equity-like risk of the South Dakota Retirement System. The proposed asset class maximums/minimums were left the same as the prior year. Staff recommended the indexes used in the CMB calculation remain the same except to use the new indexes for real estate and private equity that were approved for SDRS.

JIM MEANS MOVED, SECONDED BY RICH SATTGAST, TO APPROVE THE HEALTHCARE TRUST FISCAL YEAR 2014 CAPITAL MARKETS BENCHMARK AND MAXIMUM/MINIMUM ASSET ALLOCATION POLICY, AS PRESENTED, AND TO APPROVE THE INDEXES, INCLUDING THE CHANGES FOR PRIVATE EQUITY AND REAL ESTATE, AND THE USE OF NET TIME WEIGHTED RATE OF RETURN. MOTION PASSED UNANIMOUSLY.

Education Enhancement Trust

Otten described the establishment of the Education Enhancement Trust fund by Constitutional amendment in 2001 which allows investment in "stocks, bonds, mutual funds and other financial instruments as provided by law". Annual distributions are 4% of the four-year average fair value without violating principal. The fund was increased in 2002 with the securitization of the tobacco settlement payments. The securitized bonds were refinanced in March of 2013. The refinancing removed the majority of the requirement to invest a significant portion of the fund in tax-exempt investments which may be helpful to future returns. The refinancing also altered the pace of debt pay-down which will result in some cash inflows into the fund. To generate income for two new scholarship programs, $3 million was also added this year through appropriation by the Legislature. Details on the inflation adjusted principal, 5/31/13 estimated fund fair value, and the 7/1/13 distribution amount were provided.

Otten reviewed the asset allocation analysis which shows the long term mean expected return, expected standard deviation and correlation for conventional and two fat tail adjustments. The incremental return and standard deviation impact of select prior years' asset allocation benchmark weightings were shown.

The proposed investment benchmark for FY 2014 is different from for FY 2013 due to the impact of the refinancing whereby the allocation to tax-exempt bonds was lowered and the allocations to investment grade fixed income and TIPS were increased. The new allocation represents approximately 85% of the equity-like risk of the South Dakota Retirement System. The proposed asset class maximums/minimums were left the same as the prior year. Staff recommended the indexes used in the CMB calculation remain the same except to use the new indexes for real estate and private equity approved for SDRS.

ROB WYLIE MOVED, SECONDED BY JARROD JOHNSON, TO APPROVE THE EDUCATION ENHANCEMENT TRUST FISCAL YEAR 2014 CAPITAL MARKETS BENCHMARK AND MAXIMUM/MINIMUM ASSET ALLOCATION POLICY, AS PRESENTED, AND TO APPROVE THE INDEXES, INCLUDING THE CHANGES FOR PRIVATE EQUITY AND REAL ESTATE, AND THE USE OF NET TIME WEIGHTED RATE OF RETURN. MOTION PASSED UNANIMOUSLY.

Dakota Cement Trust

Otten described the establishment of the Dakota Cement Trust. The Constitution allows “stocks, bonds, mutual funds and other financial instruments as provided by law” instead of the legal list of fixed income securities. Accompanying statute (SDCL 4-5-47) applies the prudent man standard. She indicated the beginning value of the fund as of April 18, 2001 (the date the Constitutional amendment became effective) was $238 million. The inflation adjusted principal and approximate fair value as of 5/31/13 were presented.

In the past, twelve annual distributions of $12 million ($144 million) were made from the fund to the General Fund beginning in June of 2001 through June 30, 2012. The Constitution required a $12 million distribution each year. Additional payouts totaling $5,120,177 were distributed since 2001 for educational purposes when 5% of the 16 quarter moving average market value of the fund exceeded $12 million and did not violate the original principal of $238 million.

In November of 2012, the people of South Dakota voted to amend the constitution to change the distribution calculation for the fund to 4% of the lesser of the 16 quarter average market value or the calendar year end market value, not limited by principal. This change resulted in the FY 13 distribution to the State General Fund on June 14, 2013 in the amount of $9,356,955 to be used for education purposes.

Otten reviewed the asset allocation analysis which shows the long term mean expected return, expected standard deviation and correlation for conventional and two fat tail adjustments. The incremental return and standard deviation impact of select prior years’ asset allocation benchmark weightings were shown.

No change was proposed for the Capital Markets Benchmark weights for FY 2014 from FY 2013 which represents approximately 85% of the equity-like risk of the South Dakota Retirement System. The proposed asset class maximums/minimums were left the same as the prior year. Staff recommended the indexes used in the CMB calculation remain the same except to use the new indexes for real estate and private equity approved for SDRS.

JIM MEANS MOVED, SECONDED BY RICH SATTGAST, TO APPROVE THE DAKOTA CEMENT TRUST FISCAL YEAR 2014 CAPITAL MARKETS BENCHMARK, MAXIMUM AND MINIMUM ASSET ALLOCATION POLICIES, AS PRESENTED, AND TO APPROVE THE INDEXES, INCLUDING THE CHANGES FOR PRIVATE EQUITY AND REAL ESTATE, AND THE USE OF NET TIME WEIGHTED RATE OF RETURN. MOTION PASSED UNANIMOUSLY.

Otten stated that the Investment Policy for the Dakota Cement Trust was updated to reflect the amendment to the Constitution passed in November of 2012 that changed the distribution from the fund.

HUGH BARTELS MOVED, SECONDED BY RICH SATTGAST, TO APPROVE THE SUMMARY SDIC INVESTMENT POLICY DATED JUNE 2013 FOR DAKOTA CEMENT TRUST ASSETS, AS PRESENTED. MOTION PASSED UNANIMOUSLY.

School & Public Lands

Otten discussed the establishment of the School & Public Lands Fund. The Constitution was changed in November of 2000 to allow the investment in "stocks, bonds, mutual funds and other financial instruments as provided by law" instead of the prior requirement of government fixed income securities. SDCL 5-10-18 applies the prudent man standard to the portfolio. A unique Constitution provision allows the Governor to disapprove any investment made in the fund. The Constitution requires that before investment income is apportioned to the common schools, the principal of the fund be increased by an amount equal to the rate of inflation. Inflation, as measured by the CPI, is applied to the principal of the fund as of June 30. The CPI holdback is funded from net realized capital gains (per SDCL 5-10-18.3(4)) and if insufficient, from received investment income. It is anticipated that the CPI adjustment for FY 2013 will be positive and completely offset by realized capital gains. The estimated fair value as of May 31, after the June Board of Regents distribution, was provided.

The Constitution requires that all income be apportioned to the public schools after the principal of the fund is made whole from the effects of inflation. Land rent and mineral income is distributed without regard to the inflation adjustment. The common school apportionment is based on the number of students in each school to the total number of students. The common school apportionment is made in February and the allocation to the Board of Regents schools is completed in June. The CPI adjustment to each of the accounts that make up the S&PL fund is made annually in February.

Otten reviewed the asset allocation analysis which shows the long term mean expected return, expected standard deviation and correlation for conventional and two fat tail adjustments. The incremental return and standard deviation impact of select prior years' asset allocation benchmark weightings were shown.

The proposed investment benchmark for FY 2014 is the same as FY 2013 which represents approximately 85% of the equity-like risk of the South Dakota Retirement System. The proposed asset class maximums/minimums were left the same as the prior year. Staff recommended the indexes used in the CMB calculation remain the same except to use the new indexes for real estate and private equity approved for SDRS.

JIM MEANS MOVED, SECONDED BY JARROD JOHNSON, TO APPROVE THE SCHOOL & PUBLIC LANDS FUND FISCAL YEAR 2014 CAPITAL MARKETS BENCHMARK AND MAXIMUM/MINIMUM ASSET ALLOCATION POLICY, AS PRESENTED, AND TO APPROVE THE INDEXES, INCLUDING THE CHANGES FOR PRIVATE EQUITY AND REAL ESTATE, AND THE USE OF NET TIME WEIGHTED RATE OF RETURN. MOTION PASSED UNANIMOUSLY.

JON HUNTER MOVED, SECONDED BY RICH SATTGAST, TO APPROVE THAT ASSET ALLOCATION ADJUSTMENTS IN THE RETIREMENT SYSTEMS AND TRUST FUNDS MAY BE IMPLEMENTED IN THE CASH AND/OR DERIVATIVES MARKETS. MOTION PASSED UNANIMOUSLY.

Cash Flow Fund

Sherry Nelson provided an overview of the Cash Flow Fund. The allowed investments are specified in SDCL 4-5-26 legal list. The fund is divided into a short-term money market fund for daily needs of the state, the 1-year CD program with state financial institutions, and the larger duration portfolio. The duration portfolio's asset allocation benchmark is 60% investment grade corporate bonds, 27% treasury/agency and 13% money market funds. The maximum maturity of any one security is 5 years and position size is limited based on credit rating of the bonds. The total portfolio maximum duration is 2.88 years. The annual payout is outlined in SDCL 4-5-30 and is based on receipted income to the fund. Projected payouts for FY 2012 and FY 2013 were provided, and the fund's long-term expected return was discussed.

Nelson reviewed the cash flow fund monthly average balances noting that the balance varies throughout the year. Historically the variation has been within a $50 million band but the composition of the fund could change in the future.

It was proposed to amend the summary SDIC Investment Policy for SD Cash Flow Fund Assets to reflect an increase in the maximum maturity for any one security from 5 years to 5.25 years for new issue securities.

JIM MEANS MOVED, SECONDED BY RICH SATTGAST, TO APPROVE THE SUMMARY SDIC INVESTMENT POLICY DATED JUNE 2013 FOR SD CASH FLOW FUND ASSETS, AS PRESENTED. MOTION PASSED UNANIMOUSLY.

The Investment Council recessed at 5:45 p.m. and reconvened at 8 a.m. on June 18, 2013.

7) Wesley Tschetter Acknowledgement

Wes Tschetter will be completing his five years on the Investment Council effective June 30, 2013. Matt Clark thanked Wes for his dedication and contributions during his term. A plaque was presented to Wes on behalf of the Investment Council and Office in recognition and appreciation of his outstanding service.

8) Jarrod Johnson Acknowledgement

Jarrod Johnson has resigned as Commissioner of School and Public Lands effective August 15, 2013, and will no longer serve on the Investment Council at that time. Matt Clark thanked Jarrod for his over 6.5 years of dedicated service on the Council. A plaque was presented to Jarrod on behalf of the Investment Council and Office in recognition and appreciation of his contributions to the Council during his term as Commissioner of School and Public Lands.

9) Lone Star Real Estate Presentation

Andre Collin and Nick Beevers from Lone Star Funds spoke to the Council about their current real estate funds and their Fund III for which they are currently fundraising. Beevers gave a history of the firm and reviewed Lone Star's organization structure. He described their exclusive arrangement with Hudson Advisors, the management company that performs due diligence and analysis, asset management, special servicing and support services for Lone Star. He reviewed the performance of the prior Lone Star funds, as well as the target return for all of their funds.

Collin gave an overview of their current Lone Star Real Estate Fund II in which the Council is invested. He reviewed projected IRR's and projected cash flows. He provided an overview of several individual transactions in Fund II, describing for each the acquisition and capitalization, financing, projected IRR, and projected disposition date.

Collin discussed Lone Star's views on the investment environment for the U.S., Europe and Japan, as well as the supply and demand and competition in each market.

Beevers provided details on Lone Star Real Estate Fund III for the Council's consideration. He discussed the target fund size, investment strategy, expected investment capital allocations, and the fees.

Tschetter thanked Lone Star for their presentation.

10) Lone Star Real Estate Fund III Investment

Matt Clark and Chris Nelson discussed staff's views of Lone Star and the advantages of their in-house servicing center relationship with Hudson. They reviewed Lone Star's returns, current allocation to overall real estate and Lone Star in particular, as well as projections over the next few years. Nelson described the nature of the investments in Lone Star Fund III relating to actual physical real estate and distressed debt and the anticipated allocation to each.

Clark discussed the Council's other real estate limited partnership relationships and the types of real estate in each. He reviewed staff's recommendation of $100 million to $150 million investment in Lone Star III. Clark recommended that investments with Lonestar be considered 50% real estate and 50% distressed debt for asset allocation guideline purposes. He said adjustments could be made over time as we observe their actual investments. He noted that Lonestar suggested the amount expected to be invested in real estate linked distressed debt may be around 80%. Clark said staff believes some of that represents back door entry into real estate via foreclosure. The rest may act more like distressed debt with the debt being paid off perhaps with discounted payoffs, as opposed to getting to the underlying properties. It was noted that the CARVAL investments were also apportioned to multiple asset categories. Council discussion continued.

JIM MEANS MOVED, SECONDED BY JARROD JOHNSON, TO AUTHORIZE THE STATE INVESTMENT OFFICER TO INVEST UP TO $150 MILLION FOR THE SOUTH DAKOTA RETIREMENT SYSTEM AND UP TO A PROPORTIONATE AMOUNT FOR THE CEMENT PLANT RETIREMENT FUND, THE SCHOOL AND PUBLIC LANDS FUND, THE DAKOTA CEMENT TRUST, THE EDUCATION ENHANCEMENT TRUST, AND THE HEALTH CARE TRUST IN LONE STAR REAL ESTATE FUND III. MOTION PASSED UNANIMOUSLY.

The Council discussed the distressed debt component of the Lone Star funds. After discussion, it was the consensus of the Council that this investment in Lone Star III, as well as the previous Lone Star fund, be split 50/50 to distressed debt and real estate for asset allocation purposes and that the percentage should be reviewed and updated each year.

11) Compensation Committee Update

Hugh Bartels discussed the two recent meeting in Pierre, the first with Lt. Governor Matt Michels and BFM Commissioner Jason Dilges, and the second with the Executive Board of the LRC, where the Council had a chance to discuss the results of the SDIC compensation study. The alternatives to address the issues that arose from the study were also discussed. Both groups were given a heads up that the FY 2015 budget request would be impacted to address the issues.

12) Fiscal Year 2015 Budget Request

Matt Clark reviewed the Personal Services portion of the FY 2015 budget request which included two alternatives to address the issues as a result of the compensation study. Version A included increases in both base compensation and maximum investment incentive potential. Version B included the entire increase in the maximum incentive potential. The Council discussed in depth the importance of addressing compensation issues and the best way to accomplish the goal of getting to appropriate levels for investment positions.

HUGH BARTELS MOVED, SECONDED BY JON HUNTER, TO APPROVE VERSION B OF THE FISCAL YEAR 2015 PERSONAL SERVICES BUDGET REQUEST AS PRESENTED. MOTION PASSED UNANIMOUSLY.

Clark reviewed the FY 2013 budget received versus actual expenditures. Any unspent funds will offset next year's budget authorization, essentially reverting back to the funds under management.

Clark reviewed the FY 2015 operating budget request. He discussed the most significant increase in the contractual budget which includes funding for a new order management system. Such system is for the purpose of preventing error in executing transactions and to prevent transactions that would violate portfolio diversification rules and for other compliance purposes. He said such systems are widely used by most all other large institutional investors. He said we have not had any significant problems in the past but have had a near miss or two. He said as we grow in people and assets and use of electronic trading, it will become crucial to have such a system. The remaining contractual services items included some modest price adjustments. He noted that no changes were being proposed for the travel and office supplies budget, with a small decrease in the capital assets budget.

ROB WYLIE MOVED, SECONDED BY RICH SATTGAST, TO APPROVE THE FISCAL YEAR 2015 OPERATING EXPENSE BUDGET REQUEST AS PRESENTED. MOTION PASSED UNANIMOUSLY.

13) Investment Incentive Program Changes FY 2014

The Council discussed the changes they approved yesterday for total fund comparisons that will go into effect July 1, 2013. (See item #6 above.) It was noted that the change of benchmark on the total fund would impact the State Investment Officer's incentive program, and that the Investment

Council would need to recommend any changes to the LRC Executive Board at their August meeting.

HUGH BARTELS MOVED, SECONDED BY JIM MEANS, TO RECOMMEND TO THE LRC EXECUTIVE BOARD AT THEIR AUGUST 19, 2013 MEETING THAT BEGINNING WITH THE FY 2014 PERFORMANCE RESULTS PAYABLE IN FY 2015, THE INVESTMENT OFFICER'S INCENTIVE PROGRAM BE CHANGED SO THAT TOTAL FUND PERFORMANCE (60% OF INCENTIVE) IS COMPARED SOLELY TO THE CAPITAL MARKETS BENCHMARK AND THAT INVESTMENT RETURN COMPARISONS USE TOTAL NET TIME-WEIGHTED RATES OF RETURN. MOTION PASSED UNANIMOUSLY.

14) <u>Audit Committee Update</u>

Jon Hunter, Chair of the Audit Committee, reviewed the last quarterly procedures audit report and stated that the Audit Committee would have a conference call next week with the auditors from the Department of Legislative Audit to review the scope of the annual audit. The engagement letter would be signed today (June 18). The auditors will be in the Investment Office to begin the on-site audit the week of August 19, 2013.

15) <u>Higher Education Savings Program</u>

Sherry Nelson reviewed the Higher Education Savings Plan summary of accounts, quarterly compliance schedule, and minutes from the quarterly conference call with Allianz that had previously been provided to the Council. She added that approximately $1,300,000 will be transferred to the Dakota Corp scholarship plan which is administered by the Board of Regents.

16) <u>SDIC Subcommittee Appointments</u>

Wes Tschetter recommended a general guideline for appointments to SDIC subcommittees. There may be exceptions, but as a general rule, the Audit Committee would consist of the State Treasurer and/or School & Public Lands Commissioner, and second and third year legislatively appointed members, with the third year member being the chair. The Compensation Committee would consist of the third, fourth and fifth legislatively appointed members, with the fourth year member serving as chair.

Tschetter confirmed Council subcommittees effective July 1, 2013. On the Compensation Committee will be Hugh Bartels as Chair, Jon Hunter and Jim Means. On the Audit Committee will be Jon Hunter as Chair, Jim Means and Rich Sattgast. After the audit cycle is complete this fall, David Hillard will replace Jon Hunter.

17) <u>New/Old Business Agenda Items</u>

No other new or old business was brought before the Council.

18) <u>Election of Officers for FY 2014</u>

JARROD JOHNSON MOVED, SECONDED BY RICH SATTGAST, TO ELECT HUGH BARTELS AS CHAIR OF THE INVESTMENT COUNCIL FOR FISCAL YEAR 2014. MOTION PASSED UNANIMOUSLY.

HUGH BARTELS MOVED, SECONDED BY JARROD JOHNSON, TO ELECT JON HUNTER AS VICE CHAIR OF THE INVESTMENT COUNCIL FOR FISCAL YEAR 2014. MOTION PASSED UNANIMOUSLY.

19) Future Meeting Dates

The next Investment Council meeting will be held in Pierre on August 19, 2013 in conjunction with the investment performance and budget presentation to the LRC Executive Board.

20) Adjournment

Chair Tschetter declared the meeting adjourned at 12 p.m.