

**SOUTH DAKOTA INVESTMENT COUNCIL**

**AUDIT REPORT**

**Fiscal Year Ended June 30, 2012**



**State of South Dakota  
Department of Legislative Audit  
427 South Chapelle  
c/o 500 East Capitol  
Pierre, SD 57501-5070**

**SOUTH DAKOTA INVESTMENT COUNCIL  
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MARTIN L. GUINDON, CPA  
AUDITOR GENERAL

REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND  
ON COMPLIANCE AND OTHER MATTERS BASED ON AN AUDIT OF  
FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH  
GOVERNMENT AUDITING STANDARDS

Executive Board  
Legislative Research Council

and

Investment Council  
State of South Dakota

We have audited the financial statements of the Cash Flow, School and Public Lands, Dakota Cement Trust, Cement Plant Retirement, Education Enhancement Trust and Health Care Trust portfolios as of and for the fiscal year ended June 30, 2012 and have issued our report thereon dated September 28, 2012. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the South Dakota Investment Council's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the South Dakota Investment Council's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the South Dakota Investment Council's internal control over financial reporting.

*A deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. A *material weakness* is a deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis.

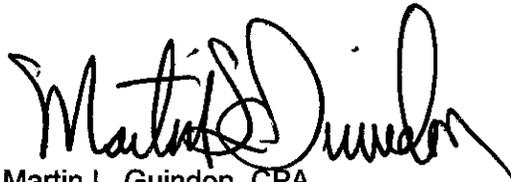
Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies

in internal control over financial reporting that might be deficiencies, significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined above.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the South Dakota Investment Council's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, and contracts, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

This report is intended solely for the information and use of management and members of the South Dakota Legislature and is not intended to be and should not be used by anyone other than those specified. However, this report is a matter of public record and its distribution is not limited.

A handwritten signature in black ink, appearing to read "Martin L. Guindon". The signature is stylized with large, flowing letters and a prominent loop at the end.

Martin L. Guindon, CPA  
Auditor General

September 28, 2012



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MARTIN L. GUINDON, CPA  
AUDITOR GENERAL

## INDEPENDENT AUDITOR'S REPORT

Executive Board  
Legislative Research Council

and

Investment Council  
State of South Dakota

We have audited the accompanying financial statements of the Cash Flow, School and Public Lands, Dakota Cement Trust, Cement Plant Retirement, Education Enhancement Trust and Health Care Trust portfolios as of and for the fiscal year ended June 30, 2012, as listed in the table of contents. These financial statements are the responsibility of the South Dakota Investment Council (SDIC). Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

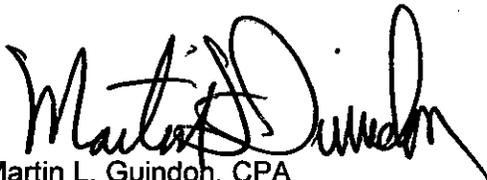
The financial statements present only the above referenced investment portfolios managed by the SDIC and do not purport to, and do not, present fairly the financial position of the State of South Dakota as of June 30, 2012 and the changes in its financial position and its cash flows, where applicable, for the fiscal year then ended in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the net assets of the portfolios listed above as of June 30, 2012, and the changes in net assets for the fiscal year then ended in conformity with accounting principles generally accepted in the United States of America.

As explained in the following table and in Note 2 to the financial statements, the financial statements include investments whose carrying values have been estimated by management in the absence of readily determinable fair values. Management's estimates are based on information provided by the fund managers or the general partners:

<u>Portfolio</u>	<u>Amount</u>	<u>Percent of Net Assets</u>
School and Public Lands	\$ 31,771,469	17%
Dakota Cement Trust	\$ 48,911,053	21%
Cement Plant Retirement	\$ 16,922,511	36%
Education Enhancement Trust	\$ 71,687,797	19%
Health Care Trust	\$ 18,748,563	18%

In accordance with *Government Auditing Standards*, we have also issued our report dated September 28, 2012, on our consideration of the SDIC's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.



Martin L. Guindoh, CPA  
Auditor General

September 28, 2012

South Dakota Investment Council  
Statement of Net Assets  
As of June 30, 2012

	Cash Flow Portfolio	School and Public Lands Portfolio	Dakota Cement Trust Portfolio	Cement Plant Retirement Portfolio	Education Enhancement Trust Portfolio	Health Care Trust Portfolio
<b>Assets</b>						
Cash and cash equivalents	\$ 95,462,094	\$ 3,061,470	\$ 5,165,884	\$ 1,842,886	\$ 18,999,513	\$ 5,793,717
<b>Receivables</b>						
Investment income receivable	3,902,776	655,186	807,148	104,489	1,692,257	351,038
Unsettled investment sales	-	2,415	3,166	36,472	5,151	1,395
Forward foreign exchange contracts	-	-	-	9,237	-	-
<b>Total receivables</b>	<b>3,902,776</b>	<b>657,601</b>	<b>810,314</b>	<b>150,198</b>	<b>1,697,408</b>	<b>352,433</b>
<b>Investments, at fair value</b>						
Fixed income	1,008,361,829	60,597,900	75,842,796	10,124,979	131,074,433	33,324,975
Equities	-	96,705,214	114,550,747	22,418,415	176,480,340	52,054,290
Real estate	-	20,486,292	31,784,126	7,324,451	46,175,460	12,081,003
Private equity	-	5,341,423	8,605,820	5,775,396	12,483,055	3,199,119
Commodities	-	-	-	121,311	-	-
<b>Total investments</b>	<b>1,008,361,829</b>	<b>183,130,829</b>	<b>230,783,499</b>	<b>45,764,552</b>	<b>366,213,288</b>	<b>100,659,387</b>
<b>Other assets</b>	<b>-</b>	<b>1,541,737</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>
<b>Total assets</b>	<b>1,107,726,699</b>	<b>188,391,637</b>	<b>236,759,687</b>	<b>47,757,636</b>	<b>386,910,209</b>	<b>106,805,537</b>
<b>Liabilities</b>						
Unsettled investment purchases	-	26,822	34,660	179,686	55,291	15,267
Due to brokers - futures transactions	-	-	-	3,281	-	-
Earnings distribution - declared	17,325,551	-	-	-	14,052,700	3,825,385
<b>Total liabilities</b>	<b>17,325,551</b>	<b>26,822</b>	<b>34,660</b>	<b>182,967</b>	<b>14,107,991</b>	<b>3,840,652</b>
<b>Net assets</b>	<b>\$ 1,090,401,148</b>	<b>\$ 188,364,815</b>	<b>\$ 236,725,027</b>	<b>\$ 47,574,669</b>	<b>\$ 372,802,218</b>	<b>\$ 102,964,885</b>

The accompanying notes are an integral part of the financial statements.

South Dakota Investment Council  
Statement of Changes in Net Assets  
For the fiscal year ended June 30, 2012

	Cash Flow Portfolio	School and Public Lands Portfolio	Dakota Cement Trust Portfolio	Cement Plant Retirement Portfolio	Education Enhancement Trust Portfolio	Health Care Trust Portfolio
Additions:						
Contributions	\$ 65,854,702	\$ 9,040,789	\$ -	\$ 1,034,892	\$ -	\$ -
Investment income (loss):						
<i>From investing activities:</i>						
Net appreciation (depreciation) in fair value of investments*	(377,778)	(303,222)	(192,028)	(211,314)	62,410	20,255
Interest	20,244,295	2,640,673	3,514,817	553,419	5,741,685	1,514,151
Dividends	-	2,458,088	3,137,656	654,636	4,846,240	1,384,234
Real estate income	-	78,050	123,266	45,745	180,495	47,420
Investment income	19,866,517	4,873,589	6,583,710	1,042,486	10,830,830	2,966,060
Less investment activity expense	(769,329)	(280,532)	(579,603)	(223,524)	(1,163,105)	(236,633)
Net investment activity income	19,097,188	4,593,057	6,004,107	818,962	9,667,725	2,729,427
<i>From security lending activities:</i>						
Security lending income	-	28,837	33,190	9,123	76,154	13,644
Security lending expenses	-	(8,651)	(9,957)	(2,736)	(22,846)	(4,093)
Net security lending activity income	-	20,186	23,233	6,387	53,308	9,551
Total investment income	19,097,188	4,613,243	6,027,340	825,349	9,721,033	2,738,978
Total additions	84,951,890	13,654,032	6,027,340	1,860,241	9,721,033	2,738,978
Deductions:						
Withdrawals	-	-	-	3,732,000	-	-
Statutorily Required Distributions	25,829,546	9,413,665	12,000,000	-	14,052,700	3,825,385
Total deductions	25,829,546	9,413,665	12,000,000	3,732,000	14,052,700	3,825,385
Net increase (decrease) in net assets	59,122,344	4,240,367	(5,972,660)	(1,871,759)	(4,331,667)	(1,086,407)
Net assets - beginning of year	1,031,278,804	184,124,448	242,697,687	49,448,428	377,133,885	104,051,292
Net assets - end of year	\$ 1,090,401,148	\$ 188,364,815	\$ 236,725,027	\$ 47,576,669	\$ 372,802,218	\$ 102,964,885

The accompanying notes are an integral part of the financial statements.

SOUTH DAKOTA INVESTMENT COUNCIL  
INVESTMENT PORTFOLIOS  
NOTES TO THE FINANCIAL STATEMENTS

1. Reporting Entity:

The South Dakota Investment Council (SDIC) is a principal, functional sub-unit of state government. The SDIC is responsible for the investment of the state's monies in the state treasury. The SDIC provides investment management services on a prefunded cost recovery basis as authorized by South Dakota Codified Laws (SDCL) 4-5-30.

The statements represent the financial activity of the Cash Flow, School and Public Lands, Dakota Cement Trust, Cement Plant Retirement, Education Enhancement Trust, and Health Care Trust portfolios. The statements report investments by each portfolio. The Cash Flow portfolio represents the state's aggregate idle fund monies for all state funds, except for certain funds for which separate portfolios have been established. The School and Public Lands portfolio represents assets held in permanent school funds. The Dakota Cement Trust portfolio represents proceeds from the sale of the South Dakota Cement Plant. The Cement Plant Retirement portfolio pays retirement benefits to former employees of the previously owned State Cement Plant. The Education Enhancement Trust portfolio represents assets held in trust from the master settlement agreement between the State of South Dakota and major United States tobacco product manufacturers. The Health Care Trust portfolio represents assets held in trust from federal reimbursement for Medicaid and Medicare costs associated with publicly owned and operated nursing facilities.

2. Summary of Significant Accounting Policies:

a. Basis of Presentation:

The accompanying financial statements of the investment activity of the SDIC are prepared in accordance with generally accepted accounting principles (GAAP) for governments as prescribed by the Governmental Accounting Standards Board (GASB).

b. Basis of Accounting:

The statements on the portfolios are reported on the full accrual basis of accounting. Under the accrual basis of accounting, revenues are recognized in the accounting period in which they are earned and expenses are recognized in the period incurred. Security transactions and the related gains and losses are recorded on a trade date basis using the average cost method. Purchases and sales of foreign investments and the related income are translated at the rate of exchange on the respective transaction dates. Realized and unrealized gains and losses resulting from foreign currency changes are included in the Statement of Changes in Net Assets. Dividend income is recorded on the ex-dividend date and interest income is accrued as earned.

c. Cash and Cash Equivalents:

Cash includes demand deposits and foreign currency cash balances. Cash equivalents include short-term investments with original maturities of three months or less. Foreign currency cash balances are translated into U.S. dollars using the year-end spot foreign currency exchange rates. Other cash equivalents are valued at cost plus accrued interest.

d. Valuation of Securities:

Investments are reported at fair value, which approximates market value, in accordance with GASB Statement No. 31. Fair value is the amount at which a financial instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale.

Certificates of deposit are reported at cost and U.S. Treasury bills at cost plus accrued interest, which is a reasonable estimate of fair value. Fair values for the fixed income securities are index prices obtained from Bank of America Merrill Lynch for investment-grade and high-yield securities, Citigroup Global Markets for agency mortgage-backed securities, and Bloomberg Financial Markets for short-term (less than one year) fixed income securities. Domestic and Canadian equity security fair values are obtained from FT Interactive Data and are based on the composite price which is the last price transmitted for a security. Non-Canadian foreign equity security values are obtained from Exshare and are based on an exchange-specific closing price for a security. Spot foreign currency exchange rates are obtained from Reuters. Investments denominated in foreign currencies are translated into U.S. dollars using the year-end spot foreign currency exchange rates. Fair values of foreign currency forward contracts are calculated based on rates obtained from Bloomberg Financial Markets.

Alternative investments consist of investments in a variety of markets and industries through limited partnerships, corporate entities, co-investments, and other investment vehicles. For investments where no readily determinable fair value exists, the SDIC valuation estimates are based on valuations of the underlying companies as determined and reported by the fund manager or general partner. For all of these alternative investments, the SDIC has determined that the net asset value reported by the underlying fund approximates the fair value of the investment. These fair values estimates are subjective and based on judgment. The alternative investments fair values as of percentage of net assets on June 30, 2012 for Cash Flow, School and Public Lands, Dakota Cement Trust, Cement Plant Retirement, Education Enhancement Trust and Health Care Trust portfolios were 0%, 17%, 21%, 36%, 19% and 18%, respectively.

Foreign exchange rate gains and losses are included with the net appreciation in fair value of investments. Futures contracts are marked to market based on quoted futures prices with changes in fair value reflected in the current period.

e. Use of Estimates:

The preparation of financial statements in accordance with GAAP requires management to make estimates that affect the reported amounts of net assets on June 30, 2012. Actual results could differ from those estimates.

### 3. Deposits, Investments and Securities Lending:

The State Investment Officer is responsible for the investment of state public funds. State public funds in the Cash Flow portfolio are invested using the pooled deposit and investment concept which preserves the integrity of the fund cash balances of each state fund while simultaneously allowing the deposit and investment of aggregate idle fund monies. The Cash Flow portfolio may be invested in the following classes of securities and investments and not otherwise:

- (1) Direct and indirect obligations of the United States government.
- (2) Agencies and instrumentalities of the United States government.
- (3) Direct obligations of the State of South Dakota and any of its political subdivisions.
- (4) Obligations consisting of notes, bonds, debentures, and certificates which are direct obligations of a solvent corporation or trust existing under the laws of the United States or any state thereof, if such investments are rated in the four highest classifications established by at least two standard rating services; or
- (5) Savings accounts, share accounts, certificates of deposit of banks, savings and loan associations, building and loan associations and bankers' acceptances.
- (6) In addition to the investments authorized by subdivisions (1) to (5) of this section, inclusive, the investment council may also allocate a sum certain of state public funds for investment in the accounts and certificates of South Dakota banks and associations. This sum shall initially be offered to South Dakota banks and associations, and if not initially fully subscribed, the investment officer shall immediately reoffer the unsubscribed sum to other qualified public depositories. "Qualified public depository" is a state bank and loan association or federally chartered credit union located in this state which receives or holds public deposits and segregates eligible collateral for public deposits.

The remaining portfolios are governed by the prudent man rule; that is, the SDIC should use the same degree of care as a prudent man. The SDIC dictates the limits on the percent the portfolios invest in various asset classes.

#### Deposits:

*Custodial Credit Risk.* The custodial credit risk for deposits is the risk that, in the event of the failure of a depository institution, a government will not be able to recover deposits or will not be able to recover collateral securities that are in the possession of an outside party. The Cash Flow portfolio's certificates of deposit and other deposits in state financial institutions in excess of depository insurance must be 100% collateralized. Collateral is valued at the lower of cost or market as reported in the quarterly call reports prepared by the qualified public depositories pursuant to SDCL 4-6A-7. Collateral is required to be segregated by each depository as approved by the South Dakota Public Deposit Protection Commission. Collateral may not be held in any safety deposit vault owned or controlled either directly or indirectly by the pledging financial institution but must be deposited for safekeeping in a financial institution that is a member of the Federal Reserve. On June 30, 2012, pledged collateral for all depositories equaled at least 100 percent of the total public deposits in excess of depository insurance. As a result, none of the Cash Flow portfolio's certificates of deposit was exposed to custodial credit risk.

The SDIC has no formal deposit policy specific to custodial credit risk for the School and Public Lands, Dakota Cement Trust, Cement Plant Retirement, Education Enhancement Trust, and Health Care Trust portfolios. On June 30, 2012, these portfolios had bank balances in various foreign currencies. These deposits are not collateralized or covered by depository insurance. As a result, the following amounts were exposed to custodial credit risk:

	School & Public Lands Portfolio	Dakota Cement Trust Portfolio	Cement Plant Retirement Portfolio	Education Enhancement Trust Portfolio	Health Care Trust Portfolio
Foreign Currency Balances	\$81,903	\$660,935	\$112,282	\$934,241	\$159,160

#### Investments:

**Securities Lending.** State statutes and the SDIC policies permit the use of investments for securities lending transactions. These transactions involve the lending of corporate debt, foreign equity securities, and domestic equity securities to broker-dealers for collateral in the form of securities, with the simultaneous agreement to return the collateral for the same securities in the future. The SDIC's securities custodian is an agent in lending securities and shall accept only U.S. Government securities or its agencies as collateral for any loan or loaned securities. The collateral required must equal 102% of fair value plus accrued interest for corporate debt securities, 102% of fair value for U.S. equity securities and 105% of fair value for foreign securities except in the case of loans of foreign securities which are denominated and payable in US Dollars, in which event the collateral required is 102% of fair value. The earnings generated from the collateral investments results in the gross earnings from lending activities, which is then split on a percentage basis with the lending agent.

At year-end, the SDIC has no credit risk exposure to borrowers because the amounts the SDIC owes the borrowers exceed the amounts the borrowers owe the SDIC. The contract with the lending agent requires the agent to indemnify the SDIC if the borrowers fail to return the loaned securities and the collateral is inadequate to replace the securities lent.

All securities loans can be terminated on demand by either the SDIC or the borrower. The SDIC does not have the ability to pledge or sell collateral securities unless the borrower defaults, therefore no asset and corresponding liability for the collateral value of securities received has been established on the Statement of Net Assets. Regarding restrictions on loans, the securities lending agreement does limit the total value of securities that can be out on loan on any given day.

**Custodial Credit Risk.** The custodial credit risk for investments is the risk that, in the event of the failure of the counterparty to a transaction, a government will not be able to recover the value of investment or collateral securities that are in the possession of an outside party. The SDIC's securities lending policies are detailed in the preceding Securities Lending section. As of June 30, 2012, the SDIC does not have custodial credit risk with regard to the security lending collateral.

**Interest Rate Risk.** Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of an investment. SDIC policy limits or establishes ranges for the durations of the fixed income portfolios held by the various funds. Modified duration estimates the sensitivity of a bond's price to interest rate changes. The Cash Flow duration portfolio policy limits average portfolio duration to 2.88 years, and no holding's

maturity can exceed 5 years. The Cement Plant Retirement investment grade fixed income portfolio's duration must fall between 70% and 130% of the duration of the Citigroup Broad Investment Grade (BIG) Index. The investment grade fixed income portfolios of Dakota Cement Trust, Health Care Trust, Education Enhancement Trust, and School and Public Lands are benchmarked to the duration of the Citigroup Broad Investment Grade (BIG) Index. The internally-managed high yield fixed income portfolios have a duration range of 85% to 115% of the Citigroup High-Yield Cash Pay Capped Index duration. The trust funds' Treasury Inflation Protected Securities (TIPS) investments have a range of 5 to 10 years to maturity at purchase. The weighted modified durations (in years) of the various funds are listed in the following table.

Investment Type	Cash Flow Portfolio		School & Public Lands Portfolio		Dakota Cement Trust Portfolio	
	Fair Value	Wgtd. Mod. Dur.	Fair Value	Wgtd. Mod. Dur.	Fair Value	Wgtd. Mod. Dur.
U.S. Treasuries	\$10,051,499	0.58	\$6,803,772	7.18	\$8,415,474	7.19
U.S. Treasury Inflation Protected Securities			9,131,139	2.07	11,452,416	2.08
U.S. Agencies	246,688,492	1.83	4,656,460	8.07	6,182,860	8.23
U.S. Agency Discount Notes			34,994	0.16	64,989	0.16
FDIC's Temporary Liquidity Guarantee Program	35,352,504	0.46				
U.S. Government-Backed Loans			1,545,817	9.96		
Investment Grade Corporates	697,612,145	2.19	16,674,663	4.55	20,507,382	4.55
High Yield Corporates			2,095,005	3.88	2,831,227	3.88
Agency Mortgage-Backed Securities			16,726,905	3.39	20,088,398	3.16
Non-Agency Mortgage-Backed Securities			3,357,492	0.09	4,313,418	0.09
<b>Total</b>	<b>\$989,704,640</b>		<b>\$61,026,247</b>		<b>\$73,856,164</b>	
Portfolio modified duration		2.02		4.29		4.11

Investment Type	Cement Plant Retirement Portfolio		Education Enhancement Trust Portfolio		Health Care Trust Portfolio	
	Fair Value	Wgtd. Mod. Dur.	Fair Value	Wgtd. Mod. Dur.	Fair Value	Wgtd. Mod. Dur.
U.S. Treasuries	\$952,082	7.07			\$3,734,943	7.19
U.S. Treasury Bills	22,996	0.21				
U.S. Treasury STRIPS	374,467	11.01				
U.S. Treasury Inflation Protected Securities					4,983,764	2.08
U.S. Agencies	421,992	3.82			2,755,900	8.24
U.S. Agency Discount Notes			\$94,983	0.16	14,997	0.16
FDIC's Temporary Liquidity Guarantee Program	38,379	0.03				
Investment Grade Corporates	2,670,220	4.51			9,093,628	4.54
High Yield Corporates	635,718	3.87	4,476,142	3.88	1,227,034	3.88
Agency Mortgage-Backed Securities	2,433,047	3.18	260,013	(1.32)	8,908,820	3.13
Non-Agency Mortgage-Backed Securities			6,886,379	0.09	1,918,149	0.09
Municipal Bonds			116,996,765	4.31		
<b>Total</b>	<b>\$7,548,901</b>		<b>\$128,714,282</b>		<b>\$32,637,235</b>	
Portfolio modified duration		4.60		4.05		4.11

The School and Public Lands, Cement Plant Retirement, Dakota Cement Trust, Education Enhancement Trust, and Health Care Trust fixed income portfolios invest in mortgage-backed securities. These securities are sensitive to prepayments by mortgagees, which is likely in declining interest rate environments, thereby reducing the value of these securities. The SDIC invests in mortgage-backed securities to diversify the portfolio and increase the return while minimizing the extent of risk.

**Credit Risk.** Credit risk is the risk that an issuer or other counterparty to an investment will not fulfill its obligations. SDIC policy establishes a percentage range and a normal allocation to various credit risk categories. The Cash Flow duration portfolio can invest 4% of the portfolio into each corporate security rated Aaa or Aa, 2% in A-rated, 1% in Baa1 or Baa2, and 0.5% in individual holdings of corporate securities rated Baa3. The maximum overweight of Baa3 rated holdings versus the benchmark is 5% of the Cash Flow duration portfolio. The SDIC sets the investment policy annually for the Dakota Cement Trust, School and Public Lands, Cement Plant Retirement, Education Enhancement Trust, and Health Care Trust portfolios. This policy establishes the benchmark percentage invested in each asset category and the minimum and maximum range that each asset category can vary during the fiscal year. On June 30, 2012, the portfolios held the following investments, excluding those issued by or explicitly guaranteed by the U.S. Government, which are not considered to have credit risk. The investments are grouped as rated by Moody's Investors Service.

	Cash Flow Portfolio	School & Public Lands Portfolio	Dakota Cement Trust Portfolio	Cement Plant Retirement Portfolio	Education Enhancement Trust Portfolio	Health Care Trust Portfolio
Moody's rating:	Fair Value	Fair Value	Fair Value	Fair Value	Fair Value	Fair Value
Aaa	\$351,464,048	\$14,517,633	\$27,420,199	\$4,263,261	\$17,526,864	\$15,994,928
Aa	176,958,926	2,175,698	2,674,432	329,405	71,069,815	1,187,484
A	402,389,510	5,591,339	6,883,434	827,553	28,633,649	3,052,118
Baa	92,875,876	8,533,931	10,494,924	1,442,694	3,662,077	4,652,668
Ba		666,659	882,761	141,087	1,403,106	387,362
B		1,398,383	1,876,268	336,703	2,966,711	816,156
Caa		1,821,110	2,367,368	142,566	3,772,830	1,045,571
Ca		919,059	1,185,461	9,276	1,891,507	528,377
C		51,055	66,071		105,112	30,032
P-1		34,994	64,989		94,983	14,998
Unrated		500,534	643,923	6,085	11,213,034	283,496
Total	\$1,023,698,360	\$38,210,395	\$54,559,830	\$7,498,630	\$142,339,688	\$27,993,190

**Concentration of Credit Risk.** Concentration of credit risk is the risk of loss that may be attributed to the magnitude of a government's investment in a single issuer. The Cash Flow portfolio has a policy in place limiting its investments in individual holdings. Information regarding the Cash Flow portfolio policy is located in the Credit Risk section. The SDIC does not have a formal policy in place to limit investments in any particular issuer for the Dakota Cement Trust, School and Public Lands, Cement Plant Retirement, Education Enhancement Trust, and Health Care Trust portfolios. Additionally, there are no single issuer exposures (excluding those issued by or explicitly guaranteed by the U.S. Government, or involving mutual funds or investment pools) within the portfolios that comprise 5% of the overall portfolios on June 30, 2012.

**Foreign Currency Risk.** Foreign currency risk is the risk that changes in exchange rates will adversely affect the fair value of an investment or deposit. The School and Public Lands, Dakota Cement Trust, Cement Plant Retirement, Education Enhancement Trust, and Health Care Trust portfolios' exposure to foreign currency risk derives from their positions in foreign currency and foreign currency-denominated equity investments. To match the unhedged benchmark, the SDIC's normal policy is not to hedge foreign currency back to U.S. dollars. SDIC's policy does allow hedging under certain

circumstances when deemed appropriate by the State Investment Officer and portfolio manager. The portfolios' exposure to foreign currency risk on June 30, 2012, was as follows (in U.S. dollar fair values):

Currency	School & Public Lands Portfolio		Dakota Cement Trust Portfolio		Cement Plant Retirement Portfolio	
	Equities	Cash	Equities	Cash	Equities	Cash
Australian Dollar					\$13,798	\$224
British Pound	\$4,043,377	\$2,988	\$6,609,333	\$142,390	1,141,927	31,375
Canadian Dollar	626,719	1,629	441,549	6,899	192,129	399
Euro	5,749,065	13,305	7,777,748	332,293	1,293,533	42,766
Japanese Yen	5,256,263	52,387	5,381,388	63,433	1,101,996	21,001
Norwegian Krone	114,539				25,387	732
Swiss Franc	5,150,563	11,594	5,851,166	115,920	1,114,408	15,785
<b>Total</b>	<b>\$20,940,526</b>	<b>\$81,903</b>	<b>\$26,061,184</b>	<b>\$660,935</b>	<b>\$4,883,178</b>	<b>\$112,282</b>

Currency	Education Enhancement Trust Portfolio		Health Care Trust Portfolio	
	Equities	Cash	Equities	Cash
British Pound	\$10,150,926	\$280,868	\$2,927,215	\$117,471
Canadian Dollar	713,006	11,141	312,541	992
Euro	11,658,531	1,084	3,437,778	3,792
Japanese Yen	7,602,885	486,448	2,205,811	26,366
Swiss Franc	8,584,524	154,700	2,581,203	10,539
<b>Total</b>	<b>\$38,709,872</b>	<b>\$934,241</b>	<b>\$11,464,548</b>	<b>\$159,160</b>

Investments with external managers, which are not included in the table above, may expose the portfolios to additional foreign currency risk. The fair values of externally-managed global equity, hedge fund, commodities, distressed, real estate, and private equity investments were as follows (in U.S. dollar fair values):

	School & Public Lands Portfolio	Dakota Cement Trust Portfolio	Cement Plant Retirement Portfolio	Education Enhancement Trust Portfolio	Health Care Trust Portfolio
Global Equity			\$851,054		
Hedge Fund			438,378		
Commodities			121,311		
Distressed	\$1,581,156	\$2,568,937	2,636,181	\$3,716,157	\$944,427
Real Estate	20,486,292	31,784,126	7,324,451	46,175,460	12,081,003
Private Equity	5,341,423	8,605,820	5,775,396	12,483,055	3,199,119
<b>Total</b>	<b>\$27,408,871</b>	<b>\$42,958,883</b>	<b>\$17,146,771</b>	<b>\$62,374,672</b>	<b>\$16,224,549</b>

#### 4. Rate of Return:

The percentage rates of return for fiscal year 2012 for the Cash Flow, School and Public Lands, Dakota Cement Trust, Cement Plant Retirement, Education Enhancement Trust and Health Care Trust portfolios were 2.3%, 2.6%, 2.8%, 2.4%, 2.9% and 2.9%, respectively. The Cash Flow percentage was derived by dividing the total investment income by the average daily investment balances. The other percentages were derived using the time-weighted rate of return calculation and the geometric linking of those returns.

5. Derivatives:

Derivatives are generally defined as contracts whose values depend on, or derive from, the value of an underlying asset, reference rate, or index. The SDIC's portfolios are exposed to various derivative products through the investment management of the SDIC and its external managers. The following notes detail the derivatives instruments used in the SDIC's internally-managed portfolios. All of the SDIC's derivatives are classified as investment derivatives.

**Futures Contracts:**

A futures contract is a contract to buy or sell units of an index or financial instrument at a specified future date at a price agreed upon when the contract is originated. The SDIC purchases and sells futures contracts as a means of adjusting the Cement Plant Retirement portfolio mix at a lower transaction cost than the transactions which would otherwise occur in the underlying portfolios. During the fiscal year ended June 30, 2012, S&P 500 futures and 10-year U.S. Treasury Note futures were utilized in the Cement Plant Retirement portfolio. Upon entering into such a contract, the Cement Plant Retirement portfolio pledges to the broker cash or U.S. Government securities equal to the minimum initial margin requirement of the futures exchange. Additionally, the Cement Plant Retirement portfolio receives or pays a daily variation margin, which is an amount of cash equal to the daily fluctuation in value of the contract. The pending variation margin on June 30, 2012, of (\$3,281) is presented in the Statement of Net Assets as "Due to brokers – futures transactions." The change in fair value of the futures contracts is presented in the Statement of Changes in Net Assets as "Net appreciation in fair value of investments." The net change in fair value from futures contracts for the fiscal year ended June 30, 2012, was \$107,818. Futures contract position on June 30, 2012 was as follows:

<u>Description</u>	<u>Expiration Date</u>	<u>Open Position</u>	<u>Number of contracts</u>	<u>Contract Size</u>	<u>Fair Value (Exposure)</u>
10-Year US Treasury Note future	September 2012	Long	6	100,000 par value 6% US Tsy Note	\$800,250

**Foreign Currency Forward Contracts:**

The SDIC enters into foreign exchange forward contracts for the Cement Plant Retirement portfolio to manage foreign currency exposure, as permitted by portfolio policies. The fair values of the contracts are presented in the Statement of Net Assets as "Forward foreign exchange contracts." The change in fair value of the forward contracts is presented in the Statement of Changes in Net Assets as "Net appreciation in fair value of investments." The net change in fair value from foreign currency forward contracts for the fiscal year ended June 30, 2012, was \$91,282. On June 30, 2012, the foreign currency forward contracts outstanding were as follows:

<u>Description</u>	<u>Notional Amount</u>	<u>Value Date</u>	<u>Fair Value</u>
Forward sale	282,573 Euros	8/10/2012	\$9,237

*Credit Risk.* The SDIC is exposed to credit risk on derivative instruments that are in asset positions. The SDIC attempts to minimize credit risk by entering into derivatives contracts with major financial institutions. On June 30, 2012, the aggregate fair value of foreign currency forward contracts in asset positions was \$9,237. This represents the maximum loss that would be recognized at the reporting date if all counterparties failed to perform as contracted. The credit ratings of the counterparties are as follows:

<u>Moody's Credit Rating</u>	<u>Number of Counterparties</u>	<u>Fair Value</u>
Aa3	1	\$9,237

*Interest Rate Risk.* The SDIC is exposed to interest rate risk on its 10-year U.S. Treasury Note futures contract. As interest rates increase, the value of the futures contract decreases.

*Foreign Currency Risk.* The Cement Plant Retirement portfolio is exposed to foreign currency risk on its foreign currency forward contracts because they are denominated in foreign currencies. The net fair value of the foreign currency forward contracts in U.S. dollars is \$9,237.

6. Proration of Investment Income:

The cash income received from pooled investments in the Cash Flow portfolio is prorated to state funds which have been certified as participating funds by the Legislative Appropriations Committee. The cash income is prorated to each individual participating fund using the ratio of its average daily cash balance to the total average daily cash balance of all funds. The income is distributed to the participating funds, except the General Fund, in the next fiscal year. The General Fund is credited 90% of the estimated proration in June and the remaining portion in the following fiscal year as provided by SDCL 4-5-30.1.

The cash income received from investments in the School and Public Lands portfolio is received and deposited into the trust fund. Annual distributions of the receipted income are distributed to the permanent school and other educational and charitable funds administered by the commissioner of School and Public Lands.

The cash income from investments in the Dakota Cement Trust portfolio is received and deposited into the trust fund. Annual distributions of twelve million dollars or five percent of the average fair value of the sixteen most recent calendar quarter ends as of June 30<sup>th</sup> are made from the Dakota Cement Trust to the State General Fund.

The cash income from investments in the Cement Plant Retirement portfolio is received and deposited into the fund. Monthly distributions are made from the Cement Plant Retirement Fund to former Cement Plant employees for retirement benefits.

The cash income from investments in the Education Enhancement Trust and Health Care Trust portfolios is received and deposited into the respective trust funds. At the beginning of each fiscal year, amounts equal to four percent of the average fair value at the end of the sixteen most recent calendar quarter ends as of the prior December 31<sup>st</sup> are transferred from the Education Enhancement Trust and the Health Care Trust portfolios to the State General Fund. The transfer amount cannot invade the principal of either trust.

Per SDCL 4-5-30, amounts equal to the Cement Plant Retirement, Dakota Cement Trust, Education Enhancement Trust, and Health Care Trust portfolios' pro rata shares of the SDIC fiscal year budgeted expenditures are transferred to the SDIC Operating Expense Fund. An amount equal to the Cash Flow and School and Public Lands portfolios' pro rata share of the SDIC fiscal year budgeted expenditures is deducted from the Cash Flow portfolio income and transferred to the SDIC Operating Expense Fund.

7. Commitments:

On June 30, 2012, the SDIC had uncalled capital commitments to private equity and real estate limited partnerships funds. The commitments may be called at the discretion of the general partner or may never be called. As capital is called, it is funded from capital and earnings returned by the limited partnerships or from other assets. Approximate uncalled capital commitments on June 30, 2012, were as follows:

	School & Public Lands Portfolio	Dakota Cement Trust Portfolio	Cement Plant Retirement Portfolio	Education Enhancement Trust Portfolio	Health Care Trust Portfolio
Private Equity	\$2,349,012	\$2,938,193	\$1,901,048	\$4,521,164	\$1,344,594
Real Estate	5,586,624	6,609,759	1,943,388	10,216,083	3,132,396
Total	\$7,935,636	\$9,547,952	\$3,844,436	\$14,737,247	\$4,476,990