

MINUTES

SOUTH DAKOTA INVESTMENT COUNCIL

Teleconference

June 4, 2020

1) Roll Call

The meeting was called to order at 9 a.m. on June 4, 2020 by Chair Loren Koepsell. Council members in attendance were Travis Almond, Paul Bisson, Ryan Brunner, Josh Haeder, Mary Howard, Loren Koepsell, Greg Kulesa, and Jeff Nelson.

Others attending all or part of the meeting included Investment Council staff members Matt Clark, Tammy Otten, Chris Nelson, Brett Fligge, Jeff Hallem, Sherry Nelson, and Laurie Riss; SDRS staff members Jacque Storm, Doug Fiddler, and Jane Beer; SDRS Board members Louise Loban, Kevin Merrill, Justice Mark Salter, Eric Stroeder, and Glen Vilhauer; Rob Wylie; Paul Schraeder; and Ashlee Keyes and Amy Macy from DLA.

AGENDA ITEMS:

- 1) Roll Call
- 2) Minutes
- 3) Public Comment
- 4) Loren Koepsell Acknowledgement
- 5) Investment Update – FY 2020
- 6) Iran Divestiture Update
- 7) Compensation Committee Update
- 8) Audit Committee Update
- 9) Investment Incentive Plan Changes-FY2021
- 10) Asset Allocation – SDRS & Trust Funds
- 11) 529 Higher Education Savings Plan Update
- 12) Election of Officers – FY 2021
- 13) New/Old Business Agenda Items
- 14) Future Meeting Dates
- 15) 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

JEFF NELSON MOVED, SECONDED BY PAUL BISSON, TO APPROVE THE MINUTES OF THE APRIL 16/17, 2020 INVESTMENT COUNCIL MEETING. MOTION PASSED UNANIMOUSLY ON A ROLL CALL VOTE.

3) Public Comment

There were no public comments.

4) Loren Koepsell Acknowledgement

Matt Clark stated that Loren Koepsell's appointment to the Investment Council expires on June 30, 2020. He noted that Koepsell was appointed in August of 2017 to complete the term of a Council member who resigned. Clark indicated that he anticipated the LRC Executive Board will reappoint Koepsell for a full term, and that Koepsell has indicated he would be interested. The Executive Board will act on the reappointment formally at their June meeting.

5) Investment Update – FY 2020

Tammy Otten reported the estimated fiscal year-to-date return of the SDRS portfolio and the upcoming distributions and contributions for the various funds.

Matt Clark reviewed asset allocation moves. He updated the Council on the Bristow merger.

Brett Fligge discussed the equity markets, the discipline needed through tough times for underperforming areas and the importance of sticking to the process.

NOTE: The State's network server went down at 9:20 a.m. and the Council could not continue the conference call. A Skype meeting was set up, and an invite was sent to everybody who had been on the call and to those that had previously requested dial-in instructions. The meeting resumed at 10:10 a.m.

6) Iran Divestiture Update

Otten reported that since the last Council meeting, Florida had not updated the list used to determine the South Dakota list of Iran scrutinized companies. As a result, staff recommended no change to the current South Dakota scrutinized companies' list.

7) Compensation Committee Update

Jeff Nelson reminded the Council that action on the State Investment Officer's compensation for FY 2021 was deferred from the last meeting in the hope of having a clearer picture of the state's possible budget issues due to the Coronavirus pandemic. He noted that there has been no further definitive action taken regarding state agency budgets and recommended that the Council's recommendation to the Executive Board for the State Investment Officer's salary have flexibility for potentially changing conditions.

JEFF NELSON MOVED, SECONDED BY PAUL BISSON, THAT THE INVESTMENT COUNCIL INFORM THE LRC EXECUTIVE BOARD THAT, BUT FOR THE CURRENT CORONAVIRUS PANDEMIC, THE COUNCIL WOULD RECOMMEND TOTAL COMPENSATION FOR THE STATE INVESTMENT OFFICER PAYABLE IN FY 2021 BE COMPRISED OF FY 2020 BASE SALARY INCREASED BY STATE SALARY POLICY PLUS 1.75% ACCORDING TO THE COUNCIL'S LONG-TERM PLAN, AND CONTINUATION OF THE INVESTMENT PERFORMANCE INCENTIVE PLAN, WITH ANY EARNED INCENTIVE TO BE PAID FOLLOWING COMPLETION OF THE AUDIT; FURTHER, THE COUNCIL RECOGNIZES THAT DEPENDING UPON THE LEGISLATURE'S EXPECTATION FOR POTENTIAL CHANGES IN THE BUDGET DUE TO THE CURRENT CORONAVIRUS PANDEMIC, IT MAY BE APPROPRIATE TO LOWER OR ELIMINATE THE INCREASE OR TO DEFER CONSIDERATION OF AN INCREASE. MOTION PASSED UNANIMOUSLY ON A ROLL CALL VOTE.

8) Audit Committee Update

Paul Bisson, Chair of the Audit Committee, reported that the Agreed Upon Procedures work was completed for the quarter ended 3/31/20, and the Audit Committee has received and reviewed Legislative Audit's report. He noted that the Audit Committee is currently working out a schedule for the upcoming fiscal year end audit.

9) Investment Incentive Plan Changes – FY 2021

Matt Clark discussed the changes to the incentive plan for the three newer investment team members. He noted that Taylor Gubbrud and Peyton Larsen are working in the equity area, and it is expected they will be assigned portfolio responsibility for FY 2022. Clark reviewed the 5/19/2020 memorandum outlining the calculation details for their plans for

FY 2021 and noted the plans will be updated and re-approved prior to the beginning of FY 2022. He added that once they are assigned a portfolio, the plans will not need to be approved each year.

Clark stated that Eliason has been assigned a high yield portfolio, and her incentive plan is outlined in the 5/20/2020 memorandum entitled, "Investment Performance Incentive Plan Changes Effective Fiscal Year 2021."

MARY HOWARD MOVED, SECONDED BY GREG KULESA, TO APPROVE THE INCENTIVE PLAN CHANGES AS DETAILED IN THE MAY 19, 2020 AND MAY 20, 2020 MEMORANDUMS ENTITLED, "*INVESTMENT PERFORMANCE INCENTIVE PLAN CHANGES EFFECTIVE FISCAL YEAR 2021*". MOTION PASSED UNANIMOUSLY ON ROLL CALL VOTE.

10) Asset Allocation

South Dakota Retirement System

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

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

Clark discussed equity-like and bond-like risk mapping for all asset categories. He discussed specific asset categories to be included in the benchmark which are those that are significant and passively implementable. He discussed other niche or skill-based categories which are not in the benchmark but that have a permitted range. He presented the SDRS capital market benchmark allocations and minimum/maximum ranges for each asset category. The capital markets benchmark allocations for fiscal years 2010 through 2020 were shown. The staff's recommended benchmark for FY 2021 was presented.

Clark showed SDRS historical levels of equity-like allocation. He reviewed the asset allocation risk/return analysis. The first portion focused on long-term mean expected returns, expected standard deviations, and asset correlations provided by JP Morgan Asset Management as a proxy for conventional expectations. The incremental return and

standard deviation impact of each asset class was shown. The analysis was shown again using internal asset category expected returns and internal adjusted risk measures.

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

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

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

Trust Funds

Tammy Otten discussed asset allocation for the four trust funds; Dakota Cement Trust, Healthcare Trust, Education Enhancement Trust, and School and Public Lands. The presentation provided reviewed the establishment of each fund, the Constitution and laws that direct the investment of the assets, and the annual distribution calculation for the Council's information.

Otten reviewed the asset allocation analysis 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.

Staff proposed no changes to the FY 2021 capital markets benchmark weights or benchmark indexes for the Dakota Cement Trust, Education Enhancement Trust, Healthcare Trust or School and Public Lands Fund. It was recommended that the equity-like risk target for the four trust funds remain at 90% of the equity-like risk for SDRS.

GREG KULESA MOVED, SECONDED BY JEFF NELSON TO APPROVE THE FISCAL YEAR 2021 CAPITAL MARKETS BENCHMARK, INDEXES, EQUITY-LIKE RISK, AND MAXIMUM/MINIMUM RANGES FOR THE SOUTH DAKOTA RETIREMENT SYSTEM AS PRESENTED. MOTION PASSED UNANIMOUSLY ON A ROLL CALL VOTE.

GREG KULESA MOVED, SECONDED BY MARY HOWARD, TO APPROVE THE FISCAL YEAR 2020 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 FUND AS PRESENTED. MOTION PASSED UNANIMOUSLY ON A ROLL CALL VOTE.

JEFF NELSON MOVED, SECONDED BY PAUL BISSON, TO APPROVE THAT ASSET ALLOCATION ADJUSTMENTS IN THE RETIREMENT AND TRUST FUNDS MAY BE IMPLEMENTED IN THE CASH AND/OR DERIVATIVES MARKETS. MOTION PASSED UNANIMOUSLY ON A ROLL CALL VOTE.

11) 529 Higher Education Savings Plan Update

Sherry Nelson reviewed the CollegeAccess 529 Plan summary of accounts, the compliance schedule, and minutes of the quarterly Allianz conference call. She discussed the estimated amount that would be contributed in July to the Dakota Corps Scholarship Program.

12) Election of Officers – FY 2021

GREG KULESA MOVED, SECONDED BY TRAVIS ALMOND, TO ELECT JEFF NELSON AS CHAIR AND PAUL BISSON AS VICE CHAIR OF THE INVESTMENT COUNCIL FOR FISCAL YEAR 2021. MOTION PASSED SIX TO ZERO ON A ROLL CALL VOTE WITH ALMOND, BRUNNER, HAEDER, HOWARD, KOEPSSELL AND KULESA VOTING IN FAVOR AND NELSON AND BISSON ABSTAINING.

13) New/Old Business Agenda Items

Upcoming Council meetings being held via video conference because of the COVID-19 pandemic was discussed. It was acknowledged that the long-term goal will be to get back to in-person meetings for most regular meetings.

14) Future Meeting Dates

It was noted that the Executive Board will be meeting on August 31. Historically, the Investment Council held its August meeting in Pierre to coincide with the Executive Board meeting. This year, it was suggested the August Council meeting be held virtually and be rescheduled for the week prior to the Executive Board meeting. The Council will be polled for a suitable date.

15) Adjournment

Chair Koepsell declared the meeting adjourned at 12:10 p.m.