

MINUTES

SOUTH DAKOTA INVESTMENT COUNCIL Sioux Falls, South Dakota June 15 & 16, 2015

1) Roll Call

The Investment Council meeting was called to order at 1 p.m. on June 15, 2015 by Chair Jon Hunter. Council members in attendance were Lorin Brass, Ryan Brunner, David Hillard, Jon Hunter, Steve Kirby (6/15/15 only), Jim Means, Rich Sattgast and Rob Wylie.

Others attending all or part of the meeting included Matt Clark, Brett Fligge, Tammy Otten, Chris Nelson, Sherry Nelson, Lee Mielke, Renae Randall, and Laurie Riss of the Investment Office; Jeff Hallem; Doug Fiddler, Susan Jahraus, Michelle Mikkelsen, Jane Roberts, Jacque Storm, and Travis Almond of the South Dakota Retirement System; Eric Stroeder of the SDRS Board of Trustees; Mike Lauritsen of School & Public Lands; Jim Terwilliger and Austin Wagner from the Bureau of Finance and Management; Aaron Olson from the Legislative Research Council; and Ashlee Keyes of Legislative Audit. The internal equity presentation was attended by three of the newer Investment Office staff and six summer student interns.

AGENDA ITEMS:

- 1) Roll Call
- 2) Minutes
- 3) Investment Update
- 4) Iran Divestment Update
- 5) SDRS Funded Status – Update
- 6) Asset Allocation – SDRS
- 7) Jon Hunter Acknowledgement
- 8) Asset Allocation – Trust Funds & CFF
- 9) Compensation Committee Update
- 10) Investment Incentive Program Changes FY16
- 11) Fiscal Year 2017 Budget Request
- 12) Audit Committee Update
- 13) Higher Education Savings Program
- 14) Internal Global Equity Presentation
- 15) State Conflict of Interest Law & Policy
- 16) Election of Officers for FY 2016
- 17) New/Old Business Agenda Items
- 18) Future Meeting Dates
- 19) Adjournment

(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

STEVE KIRBY MOVED, SECONDED BY DAVID HILLARD, TO APPROVE THE MINUTES OF THE APRIL 8, 2015 COUNCIL MEETING. MOTION PASSED UNANIMOUSLY.

3) Investment Update

Tammy Otten reviewed the Motions and Actions report from the April 2015 Council meeting. The estimated fiscal year-to-date return of the SDRS portfolio as of 6/12/15 and the trust funds through 5/31/15 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 no changes to the current list.

5) SDRS Funded Status Update

Rob Wylie and Doug Fiddler, Senior Actuary for the South Dakota Retirement System (SDRS), presented a review of the SDRS Funded Status and Plan Design. Wylie began the presentation

with a review of the SDRS mission statement. He provided background information on SDRS including its history, total membership, total annuitants, and trust fund assets. He described the fiscally conservative nature of SDRS, the statutorily fixed and matching contribution rates, and the statutorily defined funding thresholds that require the Board to initiate corrective action if not met.

Doug Fiddler reviewed the actuarial value funded ratio, market value funded ratio, cushion and contributions as of June 30, 2014. He described the projected funded status for the fiscal year ending June 30, 2015, for several different investment return assumptions. Fiddler reviewed the returns that would be required to maintain a market value funded ratio of 100% and 80% over one, five and ten year time periods, as well as the likelihood of being able to achieve those returns.

Fiddler discussed funding of SDRS and the SDRS comprehensive funding policy, which includes target funding standards, establishment of a cushion and reserve to protect the system during unfavorable economic periods and to fund future benefit improvements. He also discussed funding standards for benefit improvements and funding standards for corrective actions and benefit reductions.

Wylie described the hybrid plan design that includes features of both defined benefit and defined contribution plans. He reviewed the mortality assumption update adopted by the SDRS Board effective 6/30/14 and the impact to accrued liability, cost and risk management. He commented on the new GASB accounting and disclosure requirements.

Wylie discussed several issues the SDRS Board is studying, primarily involving sustainability.

6) Asset Allocation

South Dakota Retirement System – Benchmarks & Ranges, Risk Analysis & Asset Category Valuation

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

Clark said that risk management focuses on equity like risk and bond like risk which includes embedded equity and bond risk of all categories. He said statistical measures of risk such as standard deviation and correlation are also calculated but 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. He said adequate liquidity is maintained to avoid liquidations of depressed assets and to allow rebalancing. He stated that participation in the economic system is necessary to get the highest long term rewards but short term ebbs and flows must be endured. He added that strength and determination is important to be able to handle tough markets, which is helped by strong funding built up in good markets.

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 also highlighted the diversification benefit during market downturns of mixing in some bonds. He showed the SDRS historical levels of equity-like allocation. 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 3 to 5 years.

Clark presented the SDRS Capital Market Benchmark allocations and minimum/maximum ranges for each asset category. The capital markets benchmark allocations for fiscal years 2006 through 2015 were shown. He discussed the specific asset categories to be included in the benchmark which 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 discussed equity-like and bond-like risk mapping for each category. He 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 was shown. The second portion was the same except that internal asset category expected returns and internal adjusted risk measures were used.

Clark then discussed asset category valuation. The modeling process for equities (S&P500) is similar to how individual companies are valued using estimated future cash flows, based on normal earnings and growth rates, and a risk impacted discount rate. 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 and discussed the plan for adjusting allocations within permitted ranges based on valuation.

There were questions and discussions about the source of valuation inputs, the mapping of equity-like risk to various asset categories, comparison of benchmarks to peers, and impact of benchmark changes for incentive plans.

JIM MEANS MOVED, SECONDED BY LORIN BRASS, TO APPROVE THE FISCAL YEAR 2016 CAPITAL MARKETS BENCHMARK, INDEXES, EQUITY-LIKE RISK, AND MAXIMUM/MINIMUM RANGES FOR THE SOUTH DAKOTA RETIREMENT SYSTEM AS PRESENTED. MOTION PASSED UNANIMOUSLY.

The Investment Council recessed at 5:35 p.m. and reconvened at 8 a.m. on June 16, 2015.

7) Jon Hunter Acknowledgement

Jon Hunter will be completing his five years on the Investment Council effective June 30, 2015. Matt Clark expressed his gratitude to Jon for his passion, knowledge, dedication and contributions during his term and for his leadership as Chair. He reviewed some of the performance results over the last five years. A plaque was presented to Jon on behalf of the Investment Council and Office in recognition and appreciation of his outstanding service.

8) Asset Allocation, continued

Trust Funds

Otten provided a presentation handout that combined the four trust funds; Dakota Cement Trust, Healthcare Trust, Education Enhancement Trust, and School and Public Lands. The presentation described the establishment of each fund, the laws that allow for investment in "stocks, bonds,

mutual funds and other financial instruments as provided by law”, the annual distribution calculation, the inflation adjusted principal, the 5/31/15 estimated fund fair value, and the June & July 2015 distribution amounts.

Otten reviewed the asset allocation analysis which shows the long term mean expected return, expected standard deviation and correlation for conventional and fat tail adjustment. The expected return and standard deviation compared to select prior year benchmark allocations were shown.

Staff proposed similar changes for the various trust fund Capital Markets Benchmark weights for FY 2016 as were made for the SDRS CMB. Staff recommended the indexes used in the CMB calculation be the same as approved for SDRS. The only exception would be the tax-exempt fixed income asset allocation for the Education Enhancement Trust.

Following a discussion on the risk level of the trust funds, it was decided that the equity-like risk level stay at approximately 90% of the equity-like risk for SDRS.

JIM MEANS MOVED, SECONDED BY ROB WYLIE, TO APPROVE THE FISCAL YEAR 2016 CAPITAL MARKETS BENCHMARK, INDEXES, EQUITY-LIKE RISK, AND MAXIMUM/MINIMUM RANGES FOR THE DAKOTA CEMENT TRUST, HEALTH CARE TRUST, EDUCATION ENHANCEMENT TRUST, AND SCHOOL & PUBLIC LANDS AS PRESENTED. MOTION PASSED UNANIMOUSLY.

ROB WYLIE MOVED, SECONDED BY RICH SATTGAST, 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.

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, maximum maturity, and position sizes were reviewed. Nelson noted that the portfolio limits have been updated to apportion investments under 1 year to either the investment grade corporate or the treasury/agency category. Previously, short-term investments were a separate category.

The annual payout is outlined in SDCL 4-5-30 and is based on receipted income to the fund. Projected payouts for FY 2015 and FY 2016 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 monthly variation has been within a \$50 million band, but that could change in the future.

Nelson discussed the Cash Flow Fund project. She review changes that have already occurred and others that are expected to be proposed. SDCL 4-5-30.1 was repealed effective March 13, 2015 to eliminate the 90% distribution of expected income to the General Fund that occurs each June 15. A law change, effective July 1, 2015, changed the legal list to apply investment grade requirements to time of purchase only. For FY '16, the management fee will be .02% rather than the previous pro rata approach to fee determination. Meetings with the Governor, Lt. Governor, and BFM explored ways to better manage and increase returns for the Cash Flow Fund including better communication between SDIO/BFM and agencies and potentially investing a portion of the

CFF longer term. Meetings with the largest agencies to determine the funds likely to remain in the CFF longer term are being conducted.

DAVID HILLARD MOVED, SECONDED BY RYAN BRUNNER, TO APPROVE THE CASH FLOW FUND INVESTMENT POLICY AS PRESENTED. MOTION PASSED UNANIMOUSLY.

9) Compensation Committee Update

Jim Means reviewed the recent meetings with the LRC Executive Board Subcommittee on the Investment Council and the full Executive Board. The Council's recommended total compensation for the Investment Officer for FY 2016 was approved by the Executive Board.

10) Investment Incentive Program Changes – FY 2016

Clark stated that Zach Nipp is eligible to be included in the investment incentive program effective with FY 2016 performance payable in FY 2017. Clark reviewed the memorandum outlining the calculation details for the plan. It was noted that the decision on the area of Zach's portfolio management responsibilities will be made over the next year. As a result, his incentive plan will be updated and re-approved prior to the beginning of FY 2017.

ROB WYLIE MOVED, SECONDED BY JIM MEANS, TO APPROVE THE INCLUSION OF ZACH NIPP IN THE INVESTMENT PERFORMANCE INCENTIVE PROGRAM EFFECTIVE FOR THE PERFORMANCE PERIOD BEGINNING FY 2016, AS DETAILED IN THE JUNE 8, 2015 MEMO, "*INVESTMENT PERFORMANCE INCENTIVE PLAN CHANGE EFFECTIVE FY16.*" MOTION PASSED UNANIMOUSLY.

11) Fiscal Year 2017 Budget Request

Clark reviewed the FY 2015 budget received versus actual expenditures. He pointed out the areas making up the available cash balance and noted that any unspent funds will offset next year's budget authorization, essentially reverting back to the funds under management.

Clark reviewed the budget request for FY 2017 and the unit cost summary. In discussing the personal services budget, he noted that an assumed salary policy of 3% was applied to base salaries to give the Council a total picture of potential costs. The budget submitted to the Executive Board, Governor/BFM and Appropriations will not include salary policy as general salary policy for the state will be applied at the end of the process. The budget includes increases for the investment positions transitioning over 18 to 20 years from entry level to senior portfolio managers after which time the long-term plan increase is used. The incentive fund is budgeted at the maximum level, and any unearned incentive money is not used for any other purpose.

Clark reviewed the operating portion of the FY 2017 budget request and described the changes proposed for the contractual, travel, supplies and capital asset budgets.

Clark reviewed a change in the process of funding the budget from the assets under management. SDCL 4-5-30 was changed effective 7/1/15 so that the entire budget is not funded at the beginning of each year. Rather, amounts will be taken from the funds under management a few times a year, more on an as-needed basis.

RICH SATTGAST MOVED, SECONDED BY RYAN BRUNNER, TO APPROVE THE FISCAL YEAR 2017 BUDGET REQUEST AS PRESENTED. MOTION PASSED UNANIMOUSLY.

12) Audit Committee Update

David Hillard, Chair of the Audit Committee, discussed some of the items that will be added to the procedures for the quarterly audits, as well as a couple items that will rotate out. He thanked Ashlee Keyes for the work on the quarterly procedural audits and the annual audit and discussed the important role performed by Legislative Audit.

13) Higher Education Savings Program

Sherry Nelson reviewed the Higher Education Savings Plan summary of accounts, quarterly compliance schedule, and minutes from the quarterly conference call with Allianz. She added that over \$1 million will be transferred to the Dakota Corp scholarship plan in July. The program is administered by the Board of Regents.

Rich Sattgast discussed the ABLE Act which amends section 529 of the IRS Code to create tax-free savings accounts to cover qualified expenses for individuals with disabilities. Nelson and Sattgast discussed the administrative challenges to this program. Clark noted that this issue will continue to be monitored and the Council kept up to date.

14) Internal Global Equity Presentation

Renae Randall and Lee Mielke gave a presentation on the Global Equity modeling process. Mielke began with an overview of the modeling process and listed each step: company research, competitive advantage, management, risk rating, normalized earnings, long term growth, and valuation.

Mielke described the company research that goes into the modeling process. He then described Michael Porter's 5 Forces model and how those forces affect the profitability and attractiveness of an industry. He concluded by discussing the factors used in determining a risk rating and a normalized sales growth rate.

Randall presented the normalized earnings process. She showed the adjustments that are made to the income statement to better reflect the economic profitability of a company. Randall further discussed adjustments related to R&D and amortization of finite intangibles. She then examined the invested capital portion of the model and described the adjustments made to gain a clearer picture of a firm's capital position. She also reviewed the return on assets and discussed incremental returns. Next, normalized earnings were defined, and the different ways that a firm can grow earnings per share were examined. Finally, the discussion of firm valuation and relative attractiveness were analyzed.

Randall and Mielke next jointly discussed the agriculture and chemicals company CF Industries. CF Industries is a North American producer of nitrogen fertilizer. Profitability and growth considerations of the firm were discussed at length and a complete example of the equity valuation process was provided.

There were questions and further discussion regarding R&D and advertising amortization, how frequently the employees do research updates on portfolio holdings, and how the discount rate for a company is determined. Additionally, processes including OneNote, company update e-mails, and trade emails were discussed.

15) State Conflict of Interest Law & Policy

Jeff Hallem, legal counsel for the Investment Council, reviewed the new state law regarding employee conflict of interest. He noted the law covers any state employee, as well as his/her supervisor, who recommends, approves, awards or administers contracts. A covered employee cannot derive a direct benefit from a contract that is within the scope of his/her state duties. The prohibitions in the conflict law continue for a period of one year after employment.

Hallem discussed the draft SDIC Conflict Waiver Policy which outlines prohibited transactions and waiver requirements. He noted that the law establishes the Investment Council as the governing body to review and approve any waiver requests for the three ex-officio Council members and the Investment Office staff for Council related conflicts. He recommended blanket waivers be executed by the Council for small transactions and for any employee who, as part of their official state duties, serves on a board of a purchased investment, such as an advisory board of a limited partnership.

Council review and discussion continued.

DAVID HILLARD MOVED, SECONDED BY ROB WYLIE, TO GRANT A BLANKET WAIVER WITH RESPECT TO THE STATE CONFLICT LAW ON ALL TRANSACTIONS OF \$1,000 OR LESS OR THE DISCRETIONARY SMALL PURCHASE PROVISION AMOUNT PER SDCL 5-18A-11(2), WHICHEVER IS HIGHER, AND TO AUTHORIZE THE CHAIR OF THE INVESTMENT COUNCIL TO SIGN THE BLANKET WAIVER FORM TO BE FILED WITH THE BUREAU OF HUMAN RESOURCES. MOTION PASSED UNANIMOUSLY.

JIM MEANS MOVED, SECONDED BY RICH SATTGAST, TO APPROVE THE PROPOSED SDIC CONFLICT WAIVER POLICY AS AMENDED AND TO ALLOW FOR NON-SUBSTANTIVE CHANGES THAT MAY BE MADE BY LEGAL COUNSEL. MOTION PASSED UNANIMOUSLY.

LORIN BRASS MOVED, SECONDED BY ROB WYLIE, TO GRANT A BLANKET WAIVER WITH RESPECT TO THE STATE CONFLICT LAW TO THE STATE INVESTMENT OFFICER AND ANY EMPLOYEE OF THE DIVISION OF INVESTMENT WHO, AS PART OF THEIR OFFICIAL STATE DUTIES, HAVE A SEAT ON A BOARD OF A PURCHASED INVESTMENT, AND TO AUTHORIZE THE CHAIR OF THE INVESTMENT COUNCIL TO SIGN THE BLANKET WAIVER FORM TO BE FILED WITH THE BUREAU OF HUMAN RESOURCES. MOTION PASSED UNANIMOUSLY.

RICH SATTGAST MOVED, SECONDED BY RYAN BRUNNER, THAT INDIVIDUAL WAIVER REQUESTS BE SUBMITTED TO THE SDIC COMPENSATION COMMITTEE FOR REVIEW AND APPROVAL CONSISTENT WITH THE SDIC CONFLICT WAIVER POLICY. MOTION PASSED UNANIMOUSLY.

16) Election of Officers for FY 2016

Chair Hunter opened the floor for nominations for the Chair and Vice Chair of the Investment Council for fiscal year 2016.

DAVID HILLARD MOVED THAT JIM MEANS BE ELECTED AS CHAIR OF THE INVESTMENT COUNCIL FOR FISCAL YEAR 2016. RICH SATTGAST SECONDED THE MOTION. MOTION PASSED UNANIMOUSLY.

LORIN BRASS MOVED THAT DAVID HILLARD BE ELECTED AS VICE CHAIR OF THE INVESTMENT COUNCIL. RYAN BRUNNER SECONDED THE MOTION. MOTION PASSED UNANIMOUSLY.

17) New/Old Business Agenda Items

Rob Wylie addressed the potential for a change to the law regarding SDRS representation on the Investment Council. This issue will be discussed at an upcoming Council meeting.

18) Future Meeting Dates

The next Investment Council meeting will be held in Pierre on August 24, 2015 in conjunction with the investment performance and budget presentation to the LRC Executive Board.

The April 13, 2016 meeting date has been changed to April 19, 2016.

19) Adjournment

Chair Hunter declared the meeting adjourned at 1:05 p.m.