

# MINUTES

## SOUTH DAKOTA INVESTMENT COUNCIL

Sioux Falls, South Dakota

June 21 & 22, 2016

### 1) Roll Call

The meeting was called to order at 1 p.m. on June 21, 2016 by Vice Chair David Hillard. Council members in attendance were Lorin Brass, Ryan Brunner, David Hillard, Steve Kirby, Laura McNally, Rich Sattgast and Rob Wylie. Jim Means was absent.

Others attending all or part of the meeting included Matt Clark, Brett Fligge, Chris Nelson, Tammy Otten, Sherry Nelson and Laurie Riss from the Investment Office; Jeff Nelson; Doug Fiddler, Jane Beer, Michelle Mikkelsen, Susan Jahraus and Travis Almond from the South Dakota Retirement System; Paul Schrader; Jim Terwilliger, Conrad Adam and Matt Svendsen from the Bureau of Finance & Management; and Jeff Mehlhaff from the Legislative Research Council.

(Note: For sake of continuity, the following minutes are not necessarily in chronological order. Documents referenced are on file in the Investment Office, and public access is subject to the provisions of SDCL 1-27.)

#### AGENDA ITEMS:

- 1) Roll Call
- 2) Introduction of New Council Member
- 3) Minutes
- 4) Starwood Global Opportunity Fund XI
- 5) Investment Update – FY 2016
- 6) Iran Divestiture – Update
- 7) Higher Education Savings Program Update
- 8) Compensation Committee Update
- 9) Audit Committee Update
- 10) Lone Star Distressed Real Estate
- 11) Asset Allocation – Cash Flow Fund
- 12) Fiscal Year 2018 Budget Request
- 13) Investment Incentive Program Changes FY2017
- 14) SDRS Funded Status Update
- 15) Asset Allocation – SDRS & Trust Funds
- 16) Election of Officers – FY 2017
- 17) New/Old Business
- 18) Future Meeting Dates
- 19) Adjournment

### 2) Introduction of New Council Member

Vice Chair Hillard welcomed Jeff Nelson to the Investment Council effective July 1, 2016. Mr. Nelson stated he was from the Madison area and worked for the East River Electric Power Cooperative for 40 years prior to his retirement as General Manager/CEO in 2014. Mr. Nelson was appointed to the Investment Council by the LRC Executive Board for a five-year term beginning fiscal year 2017.

### 3) Minutes

ROB WYLIE MOVED, SECONDED BY LORIN BRASS, TO APPROVE THE MINUTES OF THE APRIL 19, 2016 AND MAY 12, 2016 INVESTMENT COUNCIL MEETINGS. MOTION PASSED UNANIMOUSLY.

### 4) Starwood Global Opportunity Fund XI

Christopher Graham, Senior Managing Director and Head of U.S. Acquisitions, and Lanhee Yung, Managing Director and Global Head of Investor Relations, joined the Council meeting to discuss their distressed real estate funds.

Chris Graham briefly discussed the two funds the Investment Council is currently invested in, including Starwood Distressed Opportunity Fund IX and Starwood Global Opportunity Fund X. They are currently fundraising for Global Opportunity Fund XI.

Lanhee Yung discussed their overall gross return since inception in 1991, the target fund size and target return for the recently launched Starwood Global Opportunity Fund XI, and their post-recession general opportunity funds. She reviewed their global organizational structure and their primary and symbiotic business lines. She discussed Starwood's competitive advantages, highlighting their experience, scale and creativity, and operational and capital markets expertise.

Graham reviewed the asset classes that are currently in Fund X and those that will constitute their next fund, all with a focus on opportunistic investing in U.S. and European real estate. He contrasted Starwood's investment strategy with those of their primary competitors.

RYAN BRUNNER MOVED, SECONDED BY ROB WYLIE, TO GO INTO EXECUTIVE SESSION PER SDCL 1-25-10 FOR THE PURPOSE OF DISCUSSING STARWOOD INFORMATION CONTAINING FINANCIAL AND COMMERCIAL INFORMATION THAT IS CONFIDENTIAL UNDER SDCL 1-27-1.6(5). MOTION PASSED UNANIMOUSLY.

The Council went into executive session from 1:35 p.m. to 2:20 p.m.

Matt Clark reviewed current real estate allocations and projections and the impact of a Starwood investment to the total real estate amount now and going forward. He then reviewed the staff's recommendation for an investment in Starwood Global Opportunity Fund XI.

Council discussion continued.

STEVE KIRBY MOVED, SECONDED BY RICH SATTGAST, TO INVEST UP TO \$150 MILLION IN AGGREGATE IN ADJUSTED PROPORTIONATE AMOUNTS FOR THE SOUTH DAKOTA RETIREMENT SYSTEM, THE SCHOOL AND PUBLIC LANDS FUND, THE DAKOTA CEMENT TRUST, THE EDUCATION ENHANCEMENT TRUST, AND THE HEALTH CARE TRUST IN STARWOOD GLOBAL OPPORTUNITY FUND XI L.P. MOTION PASSED UNANIMOUSLY.

5) Investment Update – FY 2016

Tammy Otten reviewed the Motions and Actions Notes from the April 2016 Council meeting and a correction to the February 2016 notes. The estimated fiscal year-to-date return of the SDRS portfolio as of 6/17/15 was provided. Upcoming distributions and contributions for the various funds were discussed.

6) Iran Divestiture - 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.

7) Higher Education Savings Program - Update

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.

8) Compensation Committee Update

David Hillard, Chair of the Compensation Committee, noted that the Council's recommended total compensation for the Investment Officer for FY 2017 was approved by the Executive Board at their June 13, 2016 meeting.

9) Audit Committee Update

Steve Kirby, Chair of the Audit Committee, reported that Legislative Audit had completed their interim report for the quarter ended March 31, 2016. There were no exceptions reported as a result of the procedures.

10) Lone Star Distressed Real Estate

John Grayken, Founder; Nick Beevers, Senior Managing Director-Investor Relations & Fundraising; and Ben Sarly, Managing Director-Investor Relations & Fundraising; joined the Council to discuss Lone Star funds and their investment outlook.

John Grayken gave a history on the formation of the firm, their progression over the years, their implementation of a global platform, and the cyclicity of the business. He reviewed their investment strategies, focus of their funds, type and size of investments, and amount of capital commitments since inception.

Grayken discussed Lone Star's strategies and views on the investment environment for the U.S., Europe, Japan and Latin America, as well as the complexities and competitors in each market.

RICH SATTGAST MOVED, SECONDED BY RYAN BRUNNER, TO GO INTO EXECUTIVE SESSION PER SDCL 1-25-10 FOR THE PURPOSE OF DISCUSSING LONE STAR INFORMATION CONTAINING FINANCIAL AND COMMERCIAL INFORMATION THAT IS CONFIDENTIAL UNDER SDCL 1-27-1.6(5). MOTION PASSED UNANIMOUSLY.

The Council went into executive session from 3:45 p.m. to 4:15 p.m.

11) Asset Allocation – 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 portfolio for daily needs of the state, the 1-year CD program with state financial institutions, an Intermediate-term portfolio and the larger short-term portfolio. Asset allocation benchmarks, maturity and duration ranges, and position size and portfolio ranges were reviewed for the short-term and intermediate-term portfolios.

The annual payout is outlined in SDCL 4-5-30 and is based on receipted income to the fund. The projected payout for FY 2016 was provided.

Nelson reviewed the cash flow fund monthly average balances. She discussed how the variation throughout the year is taken into account in determining how to allocate the fund across the various components.

Nelson discussed the implementation of the plan for the intermediate-term portfolio and the change being sought to the investments law to allow the portfolio to hold agency-backed mortgage securities beyond those backed by GNMA which are already allowed.

LAURA McNALLY MOVED, SECONDED BY RYAN BRUNNER, TO APPROVE THE PORTFOLIO GUIDELINES FOR THE CASH FLOW FUND SHORT-TERM AND INTERMEDIATE-TERM FIXED INCOME PORTFOLIOS AS PRESENTED. MOTION PASSED UNANIMOUSLY.

12) Fiscal Year 2018 Budget Request

Matt Clark reviewed the FY 2016 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. He noted that the budget is funded a couple times a year so that amounts expected to be unexpended, especially from unearned incentives which are known early in the fiscal year, can remain in the assets under management.

Clark reviewed the budget request for FY 2018 and the unit cost summary. He noted that the personal services budget includes increases for 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 budget also includes two new FTEs as the final of three steps in filling staff levels according to the long-term plan. The budget that will be 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. To reflect a total picture of expenditures, the unit cost summary does include an assumed salary policy.

Clark reviewed the operating portion of the FY 2018 budget request and described the changes proposed for the contractual and capital asset budgets. No changes were proposed for travel and supplies. Brett Fligge reviewed some of the newer services included in the investment services area.

STEVE KIRBY MOVED, SECONDED BY ROB WYLIE, TO APPROVE THE FISCAL YEAR 2018 BUDGET REQUEST AS PRESENTED. MOTION PASSED UNANIMOUSLY.

13) Investment Incentive Program Changes – FY 2017

Clark discussed the changes in the incentive program for FY 2017, payable in FY 2018, relating to research analysts Zach Nipp, Lesyk Voznyuk, Daniel Elmer, Matthew Carey and Makenzie Zomers. He reviewed the memorandum outlining the plans for FY 2017. He noted that three of the five analysts have been assigned to permanent asset classes. He said their incentive plans will be updated to match the structures of others in their area subsequent to receiving their own portfolios in the next year or two.

LORIN BRASS MOVED, SECONDED BY LAURA McNALLY, TO APPROVE THE FY 2017 INVESTMENT PERFORMANCE INCENTIVE PLANS AS DETAILED IN THE MAY 20, 2016 MEMO, "INVESTMENT PERFORMANCE INCENTIVE PLAN CHANGE EFFECTIVE FY17." MOTION PASSED UNANIMOUSLY.

*The Investment Council recessed at 5:15 p.m. and reconvened at 8 a.m. on June 22, 2016.*

14) SDRS Funded Status Update

Rob Wylie, Executive Director; Doug Fiddler, Actuary; and Paul Schrader, Consultant; provided an overview of the actuarial condition for SDRS and highlighted the changes in the generational benefit plan.

Rob Wylie described the statutorily defined contribution rates for both employee and employer as an important factor that differentiates South Dakota from the rest of the country. He reviewed the mission statement for SDRS and discussed the goals for income replacement between SDRS, Social Security and personal savings. He provided background information on SDRS including its creation and consolidation, total membership and trust fund assets. He emphasized the statutorily defined funding thresholds that require the SDRS Board to initiate corrective action recommendations if not met.

Paul Schrader discussed the funding of SDRS and the SDRS funding policy. He described the cushion and reserve to protect the system during unfavorable economic periods, as well as the standards defining conditions for considering benefit improvements or corrective actions. Schrader reviewed actuarial methodologies, as well as the design features in place to improve sustainability of the system and mitigate risk.

Doug Fiddler reviewed the actuarial value funded ratio, fair value funded ratio (FVFR), cushion and contributions as of June 30, 2015. He described the projected funded status for the fiscal year ending June 30, 2016 based on 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 the hybrid plan design, benefit policies, and GASB accounting and disclosure requirements.

Wylie concluded the presentation with an overview of the newly created Generational Member plan design for new employees joining SDRS after June 30, 2017.

15) Asset Allocation – SDRS & Trust Funds

***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 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 2008 through 2016 were shown. The staff's recommended benchmark for FY 2017 was also 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. Staff proposed splitting high yield real estate debt from the high yield category into its own category. The new real estate high yield debt category would have no weight in the benchmark but would have a permitted range. The benchmark weight and ranges for the former high yield category would remain the same but would apply only to high yield corporate debt.

Clark discussed equity-like and bond-like risk mapping for all asset categories. 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 internal asset category expected returns and internal adjusted risk measures were used.

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 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 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.

RYAN BRUNNER MOVED, SECONDED BY LORIN BRASS, TO APPROVE THE FISCAL YEAR 2017 CAPITAL MARKETS BENCHMARK, INDEXES, EQUITY-LIKE RISK, AND MAXIMUM/MINIMUM RANGES FOR THE SOUTH DAKOTA RETIREMENT SYSTEM AS PRESENTED. MOTION PASSED UNANIMOUSLY.

### **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 Constitution and laws that direct the investment of the assets, the annual distribution calculation for each fund, the 5/31/16 estimated fund fair value, and the 2016 distribution amounts.

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

Staff proposed no change to the trust funds' Capital Markets Benchmark weights or indexes for FY 2017 from FY 2016. Staff proposed splitting high yield real estate debt from the high yield category into its own category, similar to the change for SDRS, with the new real estate high yield debt category having no weight in the benchmark but a permitted range for the actual portfolio. It was recommended that the equity-like risk target for the trust funds remain at 90% of the equity-like risk for SDRS.

STEVE KIRBY MOVED, SECONDED BY LAURA McNALLY, TO APPROVE THE FISCAL YEAR 2017 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.

LAURA McNALLY MOVED, SECONDED BY LORIN BRASS, 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.

16) Election of Officers – FY 2017

RYAN BRUNNER MOVED, SECONDED BY LORIN BRASS, TO ELECT DAVID HILLARD AS CHAIR AND STEVE KIRBY AS VICE CHAIR OF THE INVESTMENT COUNCIL FOR FISCAL YEAR 2017. MOTION PASSED UNANIMOUSLY.

17) New/Old Business Agenda Items

There were no new or old agenda items brought before the Council.

18) Future Meeting Dates

The next Investment Council meeting will be held in Pierre on August 29, 2016, in conjunction with the LRC Executive Board meeting.

19) Adjournment

Vice Chair Hillard declared the meeting adjourned at 12:30 p.m.