

MINUTES

SOUTH DAKOTA INVESTMENT COUNCIL Rapid City, South Dakota April 20, 2017

1) Roll Call

The meeting was called to order at 8 a.m. on April 20, 2017 by Chair David Hillard. Council members in attendance were Lorin Brass, Ryan Brunner, David Hillard, Steve Kirby, Laura McNally, Jeff Nelson, Rich Sattgast and Rob Wylie.

Others attending all or part of the meeting included Matt Clark, Brett Fligge, Chris Nelson, Tammy Otten, Sherry Nelson, Jeff Hallem, and Laurie Riss from the Investment Office; and Jane Beer, Michelle Mikkelsen and Travis Almond from the South Dakota Retirement System.

(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) Minutes
- 3) CVC Capital Partners – Fund VII
- 4) Private Equity Review & CVC Investment
- 5) Allianz Global Investors – HESP Program
- 6) Higher Education Savings Program Update
- 7) Investment Update – FY 2017
- 8) Iran Divestiture – Update
- 9) Compensation Committee Update
- 10) Legislative Wrap-Up
- 11) Audit Committee Update
- 12) Interns & Staffing Update
- 13) Equity Structure/Core presentation
- 14) Cash Flow Fund presentation
- 15) New/Old Business
- 16) Future Meeting Dates
- 17) Adjournment

2) Minutes

JEFF NELSON MOVED, SECONDED BY RYAN BRUNNER, TO APPROVE THE MINUTES OF THE FEBRUARY 2, 2017 AND MARCH 8, 2017 INVESTMENT COUNCIL MEETINGS. MOTION PASSED UNANIMOUSLY.

3) CVC Capital Partners – Fund VII

Rob Squire, Partner, and Kamil Salame, Partner, of CVC Capital Partners presented information on their private equity funds and in particular Fund VII for which they are currently fundraising. Salame discussed the key features of CVC Capital Partners which include a global investment platform with an emphasis on local teams, deep and established senior leadership, a disciplined investment philosophy, and consistent value creation.

Salame discussed investment strategy reviewing their geographic focus, type and size of investments, number of companies per fund, due diligence process, and approach to creating and adding value. He described their proactive ownership which includes working with top-quality management teams, focusing on operational efficiency, and investing for growth. Salame reviewed some examples of their proactive ownership throughout the investment for several of the investments in CVC Fund.

STEVE KIRBY MOVED, SECONDED BY RICH SATTGAST, TO GO INTO EXECUTIVE SESSION PER SDCL 1-25-10 FOR THE PURPOSE OF DISCUSSING CVC CAPITAL PARTNERS 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 at 8:45 a.m. General session reconvened at 9:15 a.m.

Chair Hillard thanked CVC for their presentation.

4) Private Equity Review & CVC Investment

Chris Nelson reviewed current private equity investments and projections for the next several years. He reviewed each private equity firm and the invested levels and returns to date for each fund. Matt Clark discussed some of the better and lesser-performing funds.

Clark reviewed staff's recommendation for an investment with CVC. Council discussion continued.

STEVE KIRBY MOVED, SECONDED BY JEFF NELSON TO AUTHORIZE THE STATE INVESTMENT OFFICER TO INVEST UP TO \$200 MILLION FOR THE SOUTH DAKOTA RETIREMENT SYSTEM PLUS UP TO AN ADJUSTED PROPORTIONATE AMOUNT FOR THE SCHOOL AND PUBLIC LANDS FUND, THE DAKOTA CEMENT TRUST, THE EDUCATION ENHANCEMENT TRUST, AND THE HEALTH CARE TRUST IN CVC CAPITAL PARTNERS VII. MOTION PASSED UNANIMOUSLY.

5) Allianz Global Investors – HESP Program

Heather Bergman, Portfolio Manager/Vice President, and Steve Piekara, Product Manager/529 College Savings Plans, from Allianz Global Investors, joined the Council to discuss 529 plans in general and specifically the South Dakota CollegeAccess 529 Plan.

Steve Piekara provided an update on the 529 industry, including the total number of 529 plans in the country made up of 60 direct savings plans, 32 advisor savings plans, 18 prepaid plans and 1 private label plan. He reviewed total assets, growth from 1996 through 2016, and average account size.

Piekara reviewed the history of the CollegeAccess 529 Plan. He provided a Plan overview discussing the mutual funds offered, contribution limit, types of investment options, and number of portfolios. He reviewed current Plan statistics regarding assets under management, number of accounts and average account balances.

Piekara discussed the challenges that Allianz faces as an active plan manager. He discussed the DOL regulation, as well as Allianz's efforts to make pricing more attractive. He reviewed the top 529 plan managers in the country showing asset size and market share. Piekara discussed the Morningstar ratings and the criteria used to determine the ratings. He addressed steps Allianz has taken to attempt to improve the rating.

Piekara reviewed industry trends regarding active versus passive management, contributions into and distributions from 529 plans, and consolidation of plans.

Heather Bergman provided an overview of Allianz Global Investors. She discussed their total assets under management by asset class, client segment and region. She discussed their global breadth with local expertise and resources.

Bergman discussed the five building blocks of the 529 investment process, including the research-based theoretical glide path, strategic asset allocation, active asset allocation, portfolio construction and continuous monitoring. She noted that the glide path, which was approved by the Investment Council in August of 2010, is designed to capture the tradeoff between the need for returns that match and exceed tuition inflation and the need to help safeguard college savings balances when the beneficiary is near or at college age. She reviewed the strategic asset allocation profile which is consistent with the existing glide path and the average historical asset allocations for the program.

Bergman discussed the portfolio changes implemented in February of 2016, which focused on using fewer funds while remaining diversified, as well as the overall reduction of fees. Also added was a dynamic core strategy to allow exposure changes through the year to adapt to short-to-medium term market conditions.

Bergman reviewed Allianz's proposal to add more age bands to age-based portfolios to smooth the glide path and help reduce the risk profile of the program in the middle portfolios. The proposal increases the number of age-based portfolios, constrains the step-size in terms of risk assets of each band, and remains generally aligned with the current research-based glide path and strategic asset allocation.

Chair Hillard thanked Steve Piekara and Heather Bergman for their presentations.

6) Higher Education Savings Program – Update

Sherry Nelson reviewed the changes to the glide path as proposed and reviewed by Allianz in their presentation. Council discussion continued.

LAURA McNALLY MOVED, SECONDED BY RICH SATTGAST, TO APPROVE THE CHANGES TO THE AGE-BASED PORTFOLIOS IN THE COLLEGEACCESS 529 PLAN PROPOSED BY ALLIANZ GLOBAL INVESTORS AND PRESENTED TO THE INVESTMENT COUNCIL ON THIS DAY AND TO AUTHORIZE THE STATE INVESTMENT OFFICER TO EXECUTE THE NECESSARY DOCUMENTS AND TAKE ANY OTHER ACTIONS DEEMED NECESSARY TO CARRY OUT THE CHANGES AS PRESENTED. MOTION PASSED UNANIMOUSLY.

Nelson reviewed the Summary of Positions and Accounts, as well as the compliance schedule.

7) Investment Update – FY 2017

The Motions and Actions notes were reviewed by Tammy Otten. Assets and estimated returns for SDRS and the trust funds under management as of 4/17/16 were reported.

Otten reported that the Education Enhancement Trust was receiving the annual tobacco company payment, and the net amount remaining after bond principal and interest payments would be deposited into the EET fund.

Jeff Hallem updated the Council on the 2004 Tobacco Arbitration Proceeding currently taking place and in the discovery phase.

8) Iran Divestiture – Update

Otten reviewed the Iran memo dated April 3, 2017 and staff recommendations for updates to the South Dakota Iran scrutinized companies list.

BRUNNER MOVED, SECONDED BY LORIN BRASS, TO APPROVE THE CHANGES TO THE IRAN SCRUTINIZED LIST AS PRESENTED. MOTION PASSED UNANIMOUSLY.

9) Compensation Committee Update

Steve Kirby, Chair of the Compensation Committee, reviewed the recommendation that was made by the Committee to the Investment Council at the most recent Council meeting for the FY 2018 compensation for the State Investment Officer.

STEVE KIRBY MOVED, SECONDED BY LAURA McNALLY, THAT THE INVESTMENT COUNCIL RECOMMEND TO THE LRC EXECUTIVE BOARD THAT TOTAL COMPENSATION FOR THE STATE INVESTMENT OFFICER PAYABLE IN FY 2018 BE COMPRISED OF THE CURRENT FY 2017 BASE SALARY AND CONTINUATION OF THE INVESTMENT PERFORMANCE INCENTIVE PLAN, WITH ANY EARNED INCENTIVES TO BE PAID FOLLOWING COMPLETION OF THE AUDIT. MOTION PASSED UNANIMOUSLY.

The approved motion will be presented to the Executive Board of the LRC at their June meeting.

10) Legislative Wrap-Up

Otten reviewed the final legislative report. SB 178, the fiscal year 2018 appropriations bill, included the Council's requested budget. The passage of SB 36 affects the timing of sales tax receipts into the Cash Flow Fund. SB 116 will include Council information on a specific state website, and HB 1006 changed the requirements for public notice of board meetings. Rob Wylie talked about the four bills sponsored by the SDRS Board of Trustees that passed the Legislature and were signed by the Governor. Jeff Hallem reviewed with the Council the potential effects of SB 27, SB 151, SB 171, HB 1073 and HB 1076.

11) Audit Committee Update

Lorin Brass, Chair of the Audit Committee, advised that he received the report from Legislative Audit on the Agreed Upon Procedures for the quarter ended December 31, 2016. He noted the audit procedures identified a violation of a portfolio management policy for the Cash Flow Fund relating to limits on individual company holdings. He noted that he has discussed the issue with Ashlee Keyes from Legislative Audit, as well as with staff.

Matt Clark and Sherry Nelson discussed the issue which involved a purchase which caused a security weight to increase into a buffer where positions are allowed to be retained if caused by market value changes or portfolio size changes but are not allowed to be caused by additional purchases other than on a temporary basis in relation to a swap from one security of a company to another of the same company. The excess amount was not noticed initially due to a spreadsheet formula error and because the holding did not exceed the buffer limit with subsequent portfolio size changes having been thought to be the reason for being in the buffer. They described the steps in relation to guideline clarifications, internal notifications, and spreadsheet design that have been taken to avoid it happening in the future.

There was Council discussion of the validation of the audit process to help identify areas to improve processes.

Brass referenced upcoming new audit industry standards for Agreed Upon Procedures. Legislative Audit and SDIC staff are currently reviewing those standards.

12) Interns & Staffing Update

Clark advised that six student interns have been hired for a summer internship. From these interns, there is the potential to fill the one current open position as well as the two open positions beginning fiscal year 2018. Clark discussed current portfolio manager staffing in the SMID, global equity, and high yield areas and described some of the changes that are being considered, as well as where the potential new staff members would be assigned. He also discussed the movement of Jan Zeeck from a global sector portfolio to the Core Portfolio to help provide more interaction with global sector portfolio managers.

13) Equity Structure/Core Presentation

Brett Fligge provided a review of equity portfolios, which include global large cap, small/mid cap, high quality, emerging markets ETF, and external equity managers.

Fligge reviewed two reports included in the quarterly investment update that provide information on the core portfolio, including minimums/maximums by country and industry, comparisons to benchmark, the largest 40 overweight positions, and the largest 20 underweight positions. Clark added comments on reasons why some stocks would be over or underweight relative to benchmark.

Fligge reviewed a chart showing changes in the weighting of energy companies in the high yield portfolios and impact on performance. There was discussion of the distress that unfolded in the energy/coal sector and of restructuring that resulted for certain companies.

14) Cash Flow Fund Presentation

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 money market portfolio for daily needs of the state, the 1-year CD program with state financial institutions, an intermediate-term fixed income portfolio and the larger short-term fixed income portfolio. Asset allocation benchmarks, maturity and duration ranges, and individual position and portfolio limits 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. Projected payout for FY 2017 was provided.

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 phased in implementation plan for the intermediate-term portfolio.

15) New/Old Business Agenda Items

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

16) Future Meeting Dates

The next Investment Council meeting will be held in Sioux Falls on June 14 and 15, 2017 in conjunction with the SDRS Board of Trustees meeting. It was noted that the LRC Executive Board set their interim schedule, and their June 6, 2017 meeting will take place in the Investment Council Office. The Appropriations Committee's East River Tour is also scheduled, and they will be visiting the Investment Council Office on June 8, 2017.

17) Adjournment

Chair Hillard declared the meeting adjourned at 3 p.m.