

MINUTES

SOUTH DAKOTA INVESTMENT COUNCIL

Sioux Falls, South Dakota

June 14 & 15, 2017

1) Roll Call

The meeting was called to order at 10:30 a.m. on June 14, 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 SDRS Board of Trustees members Karl Alberts, Penny Brunken, Jilena Faith, Laurie Gill, Kathy Greenway, Laurie Gustafson, James Hansen, James Johnson, Myron Johnson, Louise Loban, Matt Michels, KJ Peterson, and Erik Stroeder; Investment Council staff Matt Clark, Brett Fligge, Chris Nelson, Tammy Otten, Sherry Nelson, Laurie Riss and Christa Sites; SDRS staff Jane Beer, Michelle Mikkelsen; Ryan Mikkelsen, Doug Fiddler, and Jacque Storm; Paul Schrader; June Larson from Nationwide; Lowell Slyter; Liza Clark, Jim Terwilliger, and Mark Quasney from the Bureau of Finance & Management; Ashlee Keyes from the Department of Legislative Audit; and Deene Dayton.

AGENDA ITEMS:

- 1) Roll Call
- 2) SDRS – South Dakota Perspective, Looking Back & Planning Forward, Investment Update, Projected Funding Status
- 3) Asset Allocation – SDRS & Trust Funds
- 4) Investment Incentive Program Changes FY2018
- 5) Fiscal Year 2019 Budget Request
- 6) Blackstone Real Estate Partners-Asia
- 7) Real Estate Review & BREP Asia II Investment
- 8) Minutes (4-20-17)
- 9) David Hillard Acknowledgement
- 10) Investment Update – FY 2017
- 11) Iran Divestiture – Update
- 12) Compensation Committee Update
- 13) LRC Executive Board Meeting & Appropriations Committee Tour – Reviews
- 14) Audit Committee Update
- 15) Higher Education Savings Program Update
- 16) Election of Officers – FY 2018
- 17) New/Old Business
- 18) Future Meeting Dates
- 19) Executive Session – Personnel Discussion
- 20) 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) SDRS – SD Perspective, Looking Back & Planning Forward, Investment Update & Projected Funding Status

The South Dakota Perspective on Public Employee Retirement Benefits and the South Dakota Retirement System

Rob Wylie discussed benefit policy positions for SDRS which include the defined benefit nature of the plan along with hybrid features and variable benefits to assure sustainability and sharing of risks and rewards by the membership. Wylie reviewed plan governance emphasizing the SDRS Board of Trustees' role as fiduciaries and importance of fixed contributions. He noted a realistic planning horizon for mature systems like SDRS is 10-20 years because of the duration of its liabilities compared to longer timeframes for less mature systems.

Wylie discussed the minimum funding standards which dictate when changes are required or should be considered. He emphasized that recommendations for corrective actions are required by state law unless both the fixed, statutory contributions are sufficient to meet the actuarial requirement and the fair value funded ratio is 100% or more. Wylie concluded by stating that a well-funded defined benefit plan with fixed, shared member and employer contributions and hybrid, variable benefit features is the most efficient and advantageous design for members, employers and taxpayers.

Looking Back and Planning Forward

Paul Schrader further discussed the unique nature of SDRS relating to fixed, statutory contributions, the requirement that benefits adjust to resources and economic realities, and recent past and future planning for sustainability of the system.

Doug Fiddler reviewed the fair value funded ratios of SDRS from 2012 to 2016 compared to peer statewide plans from Wilshire and Milliman studies. He noted that SDRS will focus exclusively on fair value of assets going forward and that actuarial smoothed asset values will no longer be used.

Schrader reviewed recent initiatives regarding the funding policy, expanded variable benefits, changes to actuarial assumptions, GASB requirements, and addressing subsidies and inequities. He discussed an alternate approach in the industry of looking at pension liabilities measured using risk-free rates as opposed to using estimated returns for plan assets. He reviewed sources of SDRS asset growth including contributions, benefits/expenses and investment income. He compared historical revenue sources for SDRS peer plans. A chart of historical net cash flow as a percent of assets was also shown.

Schrader described SDRS synergy with SDIC. He reviewed future planning issues, some of which include updating SDRS policies and goals, refining risk measures, and establishing a plan for future benefit changes.

Investment Update

Matt Clark provided an investment performance update fiscal year to date for SDRS assets and discussed individual areas that contributed to the performance. He reviewed the current asset allocation and market conditions.

Projected Funded Status as of June 30, 2017

Doug Fiddler discussed the projected funded status as of 6/30/17. He discussed the automatic adjustments to the COLA that will vary with both inflation and long-term affordability, which is expected to keep the fair value funded ratio at 100% in most circumstances. He discussed current and historical inflation rates in comparison to SDRS COLA's for the last several years.

Fiddler reviewed the impact of the FY 2017 investment return on the 2018 maximum COLA. He discussed the projected future COLA ranges and likelihood of additional required corrective actions after one and five years based on an assumed 12% net investment return in FY 2017.

3) 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 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 equity-like and bond-like risk mapping for all asset categories. 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 presented the SDRS capital market benchmark allocations and minimum/maximum ranges for each asset category. The capital markets benchmark allocations for fiscal years 2009 through 2017 were shown. The staff's recommended benchmark for FY 2018 was also shown.

Clark showed the SDRS historical levels of equity-like allocation back to 1987. 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.

There was discussion about the use of valuation of the S&P500 to adjust equity-like risk. It was noted that valuations of non U.S. markets or small caps can be different than for the S&P500. Clark indicated large cap U.S. stocks represented the majority of the internal equity universes and further non U.S. securities are half-weighted to create a home country bias. He added that historical data for the S&P500 is more robust, enhancing confidence in the process. He said

smaller and non U.S. stocks are valued one stock at a time through the internal equity portfolio management process, and those areas can be over-weighted in the equity portfolios when attractively valued. He said research projects were underway to value non U.S. and smaller company at the index level which could help broaden valuation inputs used to set the equity-like risk.

LORIN BRASS MOVED, SECONDED BY JEFF NELSON, TO APPROVE THE FISCAL YEAR 2018 CAPITAL MARKETS BENCHMARK, INDEXES, EQUITY-LIKE RISK, AND MAXIMUM/MINIMUM RANGES FOR THE SOUTH DAKOTA RETIREMENT SYSTEM AS PRESENTED. MOTION PASSED UNANIMOUSLY.

Trust Funds

Tammy 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 information provided 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 5/31/17 estimated fund fair value, and the 2017 distribution amounts.

Otten reviewed the asset allocation analysis which shows the long-term mean expected return and standard deviation for each portfolio. The analysis was shown using conventional standard deviations and correlations 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 2018 from FY 2017. It was recommended that the equity-like risk target for the trust funds remain at 90% of the equity-like risk for SDRS.

RYAN BRUNNER MOVED, SECONDED BY RICH SATTGAST, TO APPROVE THE FISCAL YEAR 2018 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 RYAN BRUNNER, 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.

4) Investment Incentive Program Changes FY 2018

Clark discussed changes in the incentive program for FY 2018, payable in FY 2019, relating to research analysts Zachary Nipp, Oless (Lesyk) Voznyuk, Daniel Elmer, Matthew Carey and Makenzie Smook and Senior Portfolio Manager Jan Zeeck. He reviewed the memorandums outlining the plans. He discussed Jan Zeeck's transition to the global core equity portfolio and related changes to her incentive plan. He noted that three of the five analysts have been assigned to asset classes and individual portfolios. Incentive plans for them have been updated to match the structures of others in their assigned area. Incentive plans for the other two analysts will be based on the area they are working in currently and on the total fund and will be updated once assigned an individual portfolio.

JEFF NELSON MOVED, SECONDED BY LORIN BRASS, TO APPROVE THE INCENTIVE PLAN CHANGES AS OUTLINED IN THE MAY 25, 2017 AND MAY 26, 2017 MEMORANDUMS ENTITLED, "INVESTMENT PERFORMANCE INCENTIVE PLAN CHANGES EFFECTIVE FY 2018." MOTION PASSED UNANIMOUSLY.

5) Fiscal Year 2019 Budget Request

Matt Clark reviewed the FY 2017 budget received versus actual expenditures. He discussed the areas that made up the unexpended budget noting that those funds will offset next year's budget authorization, essentially reverting back to the funds under management. He added 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 approval process for the SDIC budget which first includes approval by the Investment Council, followed by the LRC Executive Board, the Governor/Bureau of Finance & Management, and finally the Appropriations Committee during the next legislative session.

Clark reviewed the budget request for FY 2019 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. He described the salary increase percentages incorporated into the long-term plan for investment positions. He added 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 2019 budget request and described the changes proposed in the contractual budget for investment and administrative services. A small decrease was proposed for supplies and no changes for travel and capital assets.

ROB WYLIE MOVED, SECONDED BY STEVE KIRBY, TO APPROVE THE FISCAL YEAR 2019 BUDGET REQUEST AS PRESENTED. MOTION PASSED UNANIMOUSLY.

The Investment Council recessed at 4:45 p.m. and reconvened at 8 a.m. on June 15, 2017.

6) Blackstone Real Estate Partners-Asia

Alan Miyasaki, Senior Managing Director of Blackstone Real Estate Partners-Asia, presented information on their Asia real estate funds, and in particular, BREP Asia II for which they are currently fundraising. He reviewed Blackstone's global real estate business and discussed the amount of assets in their opportunistic, debt and core real estate funds and their net returns since inception. Miyasaki discussed their investment strategy as being the same in the U.S. but highlighted the differences. He discussed the importance of having a local presence in Asia and reviewed their offices and number of professionals around the region.

In reviewing BREP Asia I, Miyasaki reviewed the fund size, percent of capital deployed, percent of invested capital returned, the net IRRs, and the sector and geographic allocations. He discussed Blackstone's view of the current market environment in Asia and reviewed the GDP growth of Asia countries, and in comparison to the Euro Area and the U.S.

Miyasaki reviewed the investment themes Blackstone pursues when making investment decisions. He described the real estate macro trends, key metrics and opportunities in India, China, Australia and Japan.

ROB WYLIE MOVED, SECONDED BY RICH SATTGAST, TO GO INTO EXECUTIVE SESSION PER SDCL 1-25-10 FOR THE PURPOSE OF DISCUSSING BLACKSTONE 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 8:40 a.m. General session reconvened at 9:15 a.m.

Chair Hillard thanked Alan Miyasaki for his presentation. Discussion continued under next agenda item.

7) Real Estate Review & BREP Asia II Investment

Chris Nelson reviewed the current exposure to real estate limited partnerships and projections for the next several years. He reviewed each real estate limited partner and in particular the Blackstone Real Estate funds. The established cap for Blackstone overall was discussed.

Matt Clark discussed Blackstone's relationships in China and outlined his comfort level with investing in the Asia fund at this time. He reviewed senior staff's recommendation of an investment of up to \$300 million in aggregate in SDRS and the trust funds.

Council discussion continued on SDIC's overall Blackstone commitment, the BREP Asia fund weight of total BREP funds, China investment opportunities, and the recommended investment for BREP Asia II.

STEVE KIRBY MOVED, SECONDED BY LORIN BRASS, TO AUTHORIZE THE STATE INVESTMENT OFFICER TO INVEST UP TO \$300 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 BLACKSTONE REAL ESTATE PARTNERS ASIA II L.P. MOTION PASSED UNANIMOUSLY.

8) Minutes – 4/20/17

JEFF NELSON MOVED, SECONDED BY RYAN BRUNNER TO APPROVE THE MINUTES OF THE APRIL 20, 2017 INVESTMENT COUNCIL MEETING. MOTION PASSED UNANIMOUSLY.

9) David Hillard Acknowledgement

David Hillard will be completing his five years on the Investment Council effective June 30, 2017. Matt Clark expressed his gratitude to David for his 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 David in recognition of his outstanding service.

10) Investment Update – FY 2017

Tammy Otten reported on the Motions and Actions Notes and staff actions from prior Council meetings. The estimated fiscal year-to-date return of the SDRS portfolio as of 6/12/17 was provided. Upcoming distributions and contributions for the various funds were discussed. Otten then reviewed the new SDRS total fund attribution table for the first 10 months of the fiscal year.

Matt Clark discussed the new attribution analysis approach which will be included in the quarterly investment update going forward. The Council suggested that the prior quarter be included in the quarterly investment update for comparison purposes.

11) 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 of scrutinized companies utilized by the Council. Since the last Council meeting, there were no updates to the Florida or Colorado lists which are used as sources. Staff recommended no changes to the current list.

12) Compensation Committee Update

There was no report from the Compensation Committee at this time.

13) LRC Executive Board Meeting & Appropriations Committee Tour - Review

The LRC Executive Board held their June 6, 2017 meeting in the conference room at the Investment Council office. Clark noted that he and Chair Hillard provided an update on returns and Allianz scholarship amounts. The Executive Board appointed Paul Bisson to a five-year term on the Investment Council effective 7/1/17. Rob Wylie also gave an update on SDRS.

The Appropriations Committee toured the Investment Council office as part of their East River Tour on June 8, 2017. Following the tour, Clark gave an overview presentation on the Investment Council.

14) Audit Committee Update

Lorin Brass, Chair of the Audit Committee, reported that the Department of Legislative Audit had completed their interim report for the quarter ended March 31, 2017. There were no exceptions reported as a result of the procedures.

Ashlee Keyes from the Department of Legislative Audit reviewed the updated Agreed Upon Procedures guidelines. Changes were made in the guidelines to comply with new audit industry standards that went into effect with the quarter ended March 31, 2017.

15) 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 approximately \$1.5 million will be transferred to the Dakota Corp scholarship plan in July. The plan is administered by the Board of Regents. She noted that the agreement between Allianz and the State of Michigan for 529 services will be terminated in August. This will result in a reduced contribution to the Dakota Corps Scholarship Fund in July of 2018 of about \$400,000. She noted this information has been communicated with the Governor's Office and the Executive Board.

16) Election of Officers – FY 2018

JEFF NELSON MOVED, SECONDED BY RYAN BRUNNER, TO ELECT STEVE KIRBY AS CHAIR AND LORIN BRASS AS VICE CHAIR OF THE INVESTMENT COUNCIL FOR FISCAL YEAR 2018. MOTION PASSED UNANIMOUSLY.

Subcommittee appointments for the upcoming year were discussed and will be confirmed at the next Council meeting.

17) New/Old Business Agenda Items

The Council discussed the format of this joint meeting with the SDRS Retirement Board and felt that periodic joint meetings in the future would be beneficial.

18) Future Meeting Dates

The next Investment Council meeting will be held in Pierre on August 28, 2017, in conjunction with the LRC Executive Board meeting.

19) Executive Session

LORIN BRASS MOVED, SECONDED BY RYAN BRUNNER TO GO INTO EXECUTIVE SESSION TO DISCUSS PERSONNEL ISSUES PER SDCL 1-25-2(1). MOTION PASSED UNANIMOUSLY.

The Council went into executive session at 10:50 a.m. General session reconvened at 11:35 a.m.

20) Adjournment

Chair Hillard declared the meeting adjourned at 11:35 a.m.