MINUTES

SOUTH DAKOTA INVESTMENT COUNCIL
Sioux Falls, South Dakota
June 18 & 19, 2012

AGENDA ITEMS:

1) Roll Call
2) Minutes
3) Investment Update
4) Iran Divestment Update
5) SDRS Funded Status – Update
6) Asset Allocation & Benchmarks Review
7) Joseph Anglin Acknowledgement
8) Compensation Committee Update
9) Executive Board Meeting – 6/11/12
10) Fiscal Year 2014 Budget Request
11) Higher Education Savings Program
12) Audit Committee Update
13) New/Old Business Agenda Items
14) Election of Officers for FY 2013
15) Future Meeting Dates
16) Investment Policies
17) Blackstone Partnerships / Market Update
18) Adjournment

1) Roll Call

The meeting was called to order at 1:30 p.m. on June 18, 2012 by Chair Joseph Anglin. Council members in attendance were Joseph Anglin, Hugh Bartels, Jon Hunter, Jarrod Johnson (on 6/19/12 only), Jim Means, Rich Sattgast, Wesley Tschetter and Rob Wylie.

Others attending all or part of the meeting included Matt Clark, Brett Fligge, Tammy Otten, Chris Nelson, Sherry Nelson, and Laurie Riss of the Investment Office; Senator Larry Tidemann, Representative Charles Turbiville; David Hillard; Steve Myers; Susan Jahraus, Michelle Mikkelsen, Jane Roberts and Jacque Storm of the South Dakota Retirement System; Steven Kohler and Joshua Tidemann from the Bureau of Finance and Management; Jim Fry and Aaron Olson from the Legislative Research Council; and Dan Welker from JP Morgan Asset Management. The Blackstone presentation was attended by several of the Investment Office's portfolio managers.

(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

Jon Hunter noted that the location of the last Council meeting was incorrect on the minutes.

HUGH BARTELS MOVED, SECONDED BY JIM MEANS, TO APPROVE THE MINUTES OF THE APRIL 16 & 17, 2012 COUNCIL MEETING WITH THE CORRECTION OF THE MEETING LOCATION. MOTION PASSED UNANIMOUSLY.

3) Investment Update

Tammy Otten reviewed the Motions and Actions report from the April Council meeting. She stated that the March 31, 2012 Quarterly Investment Update and the Private Equity and Real Estate limited partnership commitments and funding status report for SDRS were sent to the Council in May. The estimated fiscal year to date return of the SDRS portfolio as of 6/15/12 and the trust funds through 5/31/12 were provided.

4) Iran Divestment Update

Otten reviewed a memo sent to the Council that provided an update on the Iran scrutinized companies list. The memo included a comparison of the lists for Colorado and Florida. Based on internal analysis, staff recommended that the Colorado list with the addition of Sinopec, CNOOC Ltd. (China National Offshore Oil Corp) and China Oilfield Services Ltd be adopted as the current Iran scrutinized companies list to comply with South Dakota law.

HUGH BARTELS MOVED, SECONDED BY RICH SATTGAST, TO ADOPT THE COLORADO IRAN SCRUTINIZED COMPANIES LIST EFFECTIVE APRIL 20, 2012, WITH THE LIST AMENDED TO INCLUDE SINOPEC, CNOOC LTD., AND CHINA OILFIELD SERVICES LTD. MOTION PASSED UNANIMOUSLY.

5) SDRS Funded Status

Rob Wylie presented a Funded Status Overview for the South Dakota Retirement System. He reviewed the SDRS funding policy which includes the four major elements of, (1) funding objectives, (2) establishment of reserve, (3) policy regarding consideration of benefit improvements; and (4) statutory conditions that would require corrective action.

Wylie reviewed funded status projections for actuarial value of assets, market value of assets, actuarial accrued liability and the cushion/deficit under different investment return assumptions for the year ended June 30, 2012. He described how the contribution rate is divided among normal cost, expenses, and amortization of unfunded liabilities. He illustrated the funded status projections with 0% return for FY 2012 followed by the 7.75% actuarial assumed rate on market value of assets through 2021.

Wylie discussed the Cement Plant Retirement Fund funded status as of June 30, 2012 under different investment return assumptions. He illustrated the funded status projections for the next 20 years with a 0% FY 2012 return, followed by a 7.75% annual return. The projections were shown under two scenarios; the first including the $1 million contribution in FY 2012, and the second including $1 million annual contributions for 15 years.

Wylie discussed the continuing areas of focus with respect to long-term benefit goals and the fiscal sustainability of the system. He highlighted the importance of identifying and managing the impact of pending changes to actuarial assumptions, potential changes due to alternative plan designs and methodologies to improve sustainability, and the new GASB accounting and disclosure requirements.

6) Asset Allocation & Benchmarks Review

South Dakota Retirement System & Cement Plant Retirement Fund

Matt Clark began the presentation with a review of the asset allocation modeling process. The process estimates fair value for equities (S&P500) similarly to how individual companies are valued using estimated normal earnings, growth rates, dividend payouts, and a risk impacted discount rate.

Normal earnings are estimated using a normal return on equity (ROE) multiplied by book value. This differs from the individual stock valuation process where normal earnings result from a line by line normalization of the income statement. The book value of the index is adjusted for the impact of various items (termed leakages) which may include index constituent changes, mergers, and stock buybacks. The normal ROE is based on historic real ROE plus expected future inflation plus adjustments to reflect the impact on the level of profitability of whether inflation is under control and the degree of contestability of corporate control.

Normal growth is a function of: (1) organic growth resulting from the return on reinvestment applied to the percentage of normal earnings that are reinvested and; (2) acquisition growth resulting from the amount invested in acquisitions and; (3) an assumption of the pass-through to earnings growth of inflation; and (4) an attrition rate to reflect mortality of normal earnings. Buybacks are treated as a form of dividends for asset allocation valuation purposes.

Equilibrium discount rates are based on a building block approach beginning with expected future inflation. A real yield is added to get equilibrium cash yields. A term premium is added to get equilibrium bond yields. A risk premium is added to get the equity discount rate.

The usage of the model would be to overweight undervalued asset categories and to underweight overvalued assets categories. Clark discussed the extensions of this work to include real estate and high yield. He showed the current and historical valuations of each asset class.

Clark discussed the need for discipline and a long term perspective on the part of both the Council and investment team in implementing the asset allocation process. He referenced communications to the Council each previous year during the asset allocation presentation and throughout recent years regarding the difficulty, but necessity, of sticking to our disciplines during challenging periods.

Clark 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 relative to a 60:40 mix was shown. Internal research on Fat Tail Risk was reviewed. Conventional risk measures are adjusted to better explain the frequency of extraordinary negative events that have occurred in the past and that may recur. The adjustment to standard deviation that would be necessary for the statistics to explain down two standard deviation events for the past fifty years was shown. The asset allocation analysis using fat tail adjusted standard deviations and both inflation and deflation crisis correlations with the Investment Office's expected asset category expected returns was reviewed.

Clark presented the SDRS Equity-Like Risk analysis which integrates the risk of equities and the alternative asset classes. The analysis was performed three ways: (1) using conventional standard deviations and correlations; (2) using fat tail adjusted standard deviations and inflation crisis correlations; and (3) using fat tail standard deviations and deflation crisis correlations. He said the asset allocation committee focuses on the second and third measures in judging the risk of the portfolio.

Clark reviewed the SDRS normal asset allocation and minimum and maximum allocations for each category. The capital market benchmark allocations for fiscal years 2002 through 2012 were shown. Clark discussed merits of increasing the private equity benchmark weight by 2% for FY 2013 with a commensurate decrease in global equity to more closely reflect expected long term allocations. He discussed factors that would impact future size of private equity allocations including our ability to identify managers able to earn worthwhile return premiums net of all cost and impact on liquidity. He said that if you can only pick average managers it may not make sense to have much exposure to the area.

Jon Hunter asked about any advantages we may have in identifying value added managers. Clark said that we have substantial successful hands on active equity management experience, whereas most of our peers outsource active or even all equity management. This allows higher level discussions about managers' investments and enhances our ability to judge their skill. Other advantages include a stable experienced investment team which enhances depth of knowledge about a manager over time and facilitates interaction with the key principals of firms. Over time we will gain insight into whether these advantages translate into success in picking managers.

JIM MEANS MOVED, SECONDED BY WESLEY TSCHETTER, TO APPROVE THE PRESENTED FISCAL YEAR 2013 MAXIMUM AND MINIMUM ASSET ALLOCATION POLICY, INDEXES, AND CAPITAL MARKETS BENCHMARK FOR THE SOUTH DAKOTA RETIREMENT SYSTEM AMENDED TO INCREASE PRIVATE EQUITY AND DECREASE GLOBAL EQUITY BY 2%. MOTION PASSED UNANIMOUSLY.

The Council discussed the asset allocation policy for the Cement Plant Retirement Fund. The policy allocation to private equity was discussed, as well as the different cash flow fund needs into the future for this fund.

It was noted that in the presentation, the policy maximum for private equity and real estate were stated incorrectly. There was no change from last year.

ROB WYLIE MOVED, SECONDED BY WESLEY TSCHETTER, TO APPROVE THE FISCAL YEAR 2013 MAXIMUM AND MINIMUM ASSET ALLOCATION POLICIES, INDEXES, AND CAPITAL MARKET BENCHMARKS FOR THE CEMENT PLANT RETIREMENT FUND AS PRESENTED, WITH CORRECTIONS FOR PRIVATE EQUITY AND REAL ESTATE MAXIMUMS. MOTION PASSED UNANIMOUSLY.

Dakota Cement Trust

Otten described the establishment of the Dakota Cement Trust. The Constitution allows "stocks, bonds, mutual funds and other financial instruments as provided by law". Accompanying statutes (SDCL 5-17-42) apply the prudent man standard. She indicated the beginning value of the fund as of April 18, 2001 (the date the Constitutional amendment became effective) was $238 million. The inflation adjusted principal and approximate fair value as of 5/31/12 were presented.

Twelve annual distributions of $12 million ($144 million) have been made from the fund to the General Fund beginning in June of 2001 with the most recent distribution made on June 15, 2012. The Constitution requires a $12 million distribution each year which will be made even if the original $238 million principal is violated. An additional payout for educational purposes can be made per the Constitution if 5% of the 16 quarter moving average market value of the fund exceeds

$12 million as of 6/30 each year and does not violate the original principal of $238 million. In FY 2012, no additional distribution was made for educational purposes as the fair value of the fund was less than the principal value as of 6/30/11. The people of South Dakota will vote on a constitutional amendment in November to change the distribution calculation for the fund.

Otten reviewed the asset allocation analysis which shows the long term mean expected return, expected standard deviation and correlation for conventional and two fat tail adjustments. The incremental return and standard deviation impact of select prior years' asset allocation benchmark weightings were shown.

The proposed investment benchmark for FY 2013 is the same as FY 2012 and represents approximately 85% of the equity-like risk of the South Dakota Retirement System. The asset allocation for all of the trust funds has been gradually adjusted over the years toward that of SDRS. The proposed benchmark allocations and indexes were left the same as the prior year.

Health Care Trust

Otten described the establishment of the Health Care Trust Fund. A Constitutional amendment in April of 2001 created the funds (effective July 1, 2001) and allows investment in "stocks, bonds, mutual funds and other financial instruments as provided by law". Effective FY 2003, legislation applied the prudent man standard (SDCL 28-6-33) to the investments and established the annual distribution of 4% of the four-year average fair value without violating principal. With the codified laws in place, a separate portfolio was established. Details on the inflation adjusted principal, the 5/31/12 estimated fund fair value, and the 7/2/12 distribution amount was provided.

Otten reviewed the asset allocation analysis which shows the long term mean expected return, expected standard deviation and correlation for conventional and two fat tail adjustments. The incremental return and standard deviation impact of select prior years' asset allocation benchmark weightings were shown.

The proposed investment benchmark for FY 2013 is the same as FY 2012 and represents approximately 85% of the equity-like risk of the South Dakota Retirement System. The asset allocation for all of the trust funds has been gradually adjusted over the years toward that of SDRS. The proposed benchmark allocations and indexes were left the same as the prior year.

Education Enhancement Trust

Otten described the establishment of the Education Enhancement Trust fund. A Constitutional amendment in April of 2001 created the funds (effective July 1, 2001) and allows investment in "stocks, bonds, mutual funds and other financial instruments as provided by law". Effective FY 2003, legislation applied the prudent man standard (SDCL 10-50B-11.1) to the investments and established the annual distribution of 4% of the four-year average fair value without violating principal. With the codified laws in place, a separate portfolio was established. The fund was increased in September of 2002 with the securitization of the tobacco settlement payments. Details on the inflation adjusted principal, 5/31/12 estimated fund fair value, and the 7/2/12 distribution amount were provided.

Otten reviewed the asset allocation analysis which shows the long term mean expected return, expected standard deviation and correlation for conventional and two fat tail adjustments. The incremental return and standard deviation impact of select prior years' asset allocation benchmark weightings were shown.

The proposed investment benchmark for FY 2013, which includes tax-exempt fixed income securities as required by the tobacco bond asset-backed securitization, is the same as FY 2012 and represents approximately 85% of the equity-like risk of the South Dakota Retirement System. The proposed benchmark allocations and indexes were left the same as the prior year.

School & Public Lands

Otten discussed the establishment of the School & Public Lands Fund. The Constitution was changed in November of 2000 to allow the investment in "stocks, bonds, mutual funds and other financial instruments as provided by law". SDCL 5-10-18 applies the prudent man standard to the portfolio. The Constitution requires that before investment income is apportioned to the public schools, the principal of the fund is increased by an amount equal to the rate of inflation. Inflation, as measured by the CPI, is applied to the principal of the fund each June 30. The CPI holdback is funded from net realized capital gains (per SDCL 5-10-18.3(4)) and if insufficient, from received investment income. It is anticipated that the CPI adjustment for FY 2012 will be positive and not completely offset by realized capital gains. The estimated fair value as of May 31, after the Board of Regents distribution, was provided.

The Constitution requires that all income be apportioned to the public schools after the principal of the fund is made whole from the effects of inflation. The common school apportionment is based on the number of students in each school to the total number of students. The common school apportionment is made in February and the allocation to the Board of Regents schools is completed in June. The CPI adjustment to each of the accounts that make up the S&PL fund is made annually in February.

Otten reviewed the asset allocation analysis which shows the long term mean expected return, expected standard deviation and correlation for conventional and two fat tail adjustments. The incremental return and standard deviation impact of select prior years' asset allocation benchmark weightings were shown.

The proposed investment benchmark for FY 2013 is the same as FY 2012 to represent approximately 85% of the equity-like risk of the South Dakota Retirement System. The proposed benchmark allocations and indexes were left the same as the prior year.

HUGH BARTELS MOVED, SECONDED BY JIM MEANS, TO APPROVE THE FISCAL YEAR 2013 MAXIMUM AND MINIMUM ASSET ALLOCATION POLICIES, INDEXES, AND CAPITAL MARKET BENCHMARKS FOR THE DAKOTA CEMENT TRUST, HEALTH CARE TRUST, EDUCATION ENHANCEMENT TRUST, AND SCHOOL & PUBLIC LANDS AS PRESENTED. MOTION PASSED UNANIMOUSLY.

JON HUNTER 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 is 60% investment grade corporate bonds, 27% treasury/agency and 13% money market funds. The maximum maturity of any one security is 5 years and position size is limited based on credit rating of the bonds. The total portfolio maximum duration is 2.88 years. The annual payout is outlined in SDCL 4-5-30 and is based on receipted income to the fund. Projected payouts for FY 2012 and FY 2013 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 variation has been within a $50 million band but the composition of the fund could change in the future.

There was no recommended change to the investment policy of the Cash Flow Fund.

The Investment Council recessed at 5:40 p.m. and reconvened at 8 a.m. on June 19, 2012.

7) <u>Joseph Anglin Acknowledgement</u>

Clark stated that Joseph Anglin will be completing his five years on the Investment Council effective June 30, 2012. He thanked Joe for his dedication and contribution during his term. A plaque was presented to Joe on behalf of the Investment Council and Office in recognition and appreciation of his outstanding service.

8) <u>Compensation Committee Update</u>

Clark noted that he had previously supplied the Council with the FY 13 compensation levels for all investment team members. He briefly discussed the long-term plan percentage increases for senior investment positions, transitioning investment positions, accounting positions and the administrative positions.

The Council discussed the next compensation study and the concern about drifting too far from the discount target the Council established for investment positions. Clark discussed potential timing for updating the compensation study with Deloitte and the need for McLagan data to be included.

WESLEY TSCHETTER MOVED, SECONDED BY JARROD JOHNSON, TO AUTHORIZE THE STATE INVESTMENT OFFICER TO PROCEED WITH NEGOTIATIONS FOR THE COMPENSATION STUDY. MOTION PASSED UNANIMOUSLY.

9) Executive Board Meeting – 6/11/12

Joe Anglin and Matt Clark discussed the presentation made to the Executive Board of the LRC on June 11, 2012, which included a preliminary performance update for SDRS and the trust funds and information on compensation levels. The Council's recommendation for the State Investment Officer's FY 2013 compensation was presented and approved unanimously by the Executive Board.

The Council discussed the large turnover that will be taking place on the Executive Board and the need for continuing education and building of relationships with all members.

10) Fiscal Year 2014 Budget Request

Clark reviewed the FY 2012 budget received versus actual expenditures. Any unspent funds will offset next year's budget authorization, so essentially they revert back to the funds under management.

Clark reviewed the FY 2014 budget request. He described the proposed changes in the personal services budget and each segment of the operating budget. He discussed in depth the more significant changes which include funding the investment performance incentive program at 90% versus the two prior years at 85%, the increase for the Department of Legislative Audit to allow certain audit functions to take place on a quarterly basis as opposed to only at year end, and the increase of office space if support appears to be positive for increased staff in the next couple years.

The Council discussed the process for the quarterly audit functions, the office's computer rotation practice, the additional office space, and the eventual addition of office staff. In-depth discussion took place about the need for a compensation study and the building of credibility to current staff, as well as the need for additional staff and the appropriate timing for that to happen.

RICH SATTGAST MOVED, SECONDED BY JARROD JOHNSON, TO APPROVE THE FISCAL YEAR 2014 BUDGET REQUEST AS PRESENTED. MOTION PASSED UNANIMOUSLY.

11) Higher Education Savings Program

Sherry Nelson reviewed the Higher Education Savings Plan summary of accounts and the quarterly compliance schedule that had previously been provided to the Council. She added that approximately $1,000,000 will be transferred to the Dakota Corp scholarship plan which is now being administered by the Board of Regents.

She discussed the proposal by Allianz to remove the RCM Large Cap Growth Fund from the South Dakota CollegeAccess 529 Program in the 0-6, 7-10, 11-14 and Diversified Equity Portfolios and to rebalance the equity allocation for the age-based portfolios to the TIAA-CREF S&P 500

Index Fund and the Allianz AGIC Opportunity Fund, and for the diversified equity portfolio to include the Allianz RCM Disciplined Equity Fund.

RICH SATTGAST MOVED, SECONDED BY WESLEY TSCHETTER, TO APPROVE THE PORTFOLIO CHANGES TO THE COLLEGEACCESS 529 PLAN PROPOSED BY ALLIANZ GLOBAL DISTRIBUTORS 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 PORTFOLIO CHANGES AS PRESENTED. MOTION PASSED UNANIMOUSLY.

12) Audit Committee Update

Hugh Bartels, Chair of the Audit Committee, stated that the Audit Committee had a conference call with the auditors from Legislative Audit to review the scope of the audit. The engagement letter will be executed in July. The auditors will be in the Investment Office to begin the on-site audit the week of August 20, 2012.

13) New/Old Business Agenda Items

The compensation study proposal and further budget discussion will be on the agenda for the next meeting. No other new or old business was brought before the Council.

14) Election of Officers for FY 2013

ROB WYLIE MOVED, SECONDED BY RICH SATTGAST, THAT WESLEY TSCHETTER BE NAMED AS CHAIR OF THE INVESTMENT COUNCIL FOR FISCAL YEAR 2013. MOTION PASSED UNANIMOUSLY.

JON HUNTER MOVED, SECONDED BY JARROD JOHNSON, THAT HUGH BARTELS BE NAMED AS VICE CHAIR OF THE INVESTMENT COUNCIL FOR FISCAL YEAR 2013. MOTION PASSED UNANIMOUSLY.

15) Future Meeting Dates

The next Investment Council meeting will be held in Pierre on August 20, 2012 in conjunction with the investment performance and budget presentation to the LRC Executive Board. It was confirmed that the April 2013 meeting has been changed from April 16 to April 10.

16) Investment Policies

Otten presented the Summary Investment Policies per SD Law/Constitution. SDCL 4-5-28 gives the Council policy making authority. The Summary Investment Policies outline the policy, scope, prudence per SDCL 4-5-27, objectives, authority per constitution and statues 4-5-23 and 4-5-29, ethics, safekeeping per SDCL 4-5-31, investments, internal controls per 4-5-35, performance standards, reporting per SDCL 4-5-32 and 1-27-1.6, and policy overview.

Otten indicated that there were specific objectives for each fund. She highlighted that the Cement Plant Retirement Fund included an objective of liquidity because the fund is frozen and distributing more benefits each year.

The policies are to be used by the Council and staff as a summary of how the funds are to be managed per South Dakota law.

JIM MEANS MOVED, SECONDED BY ROB WYLIE TO APPROVE THE SDIC SUMMARY INVESTMENT POLICIES DATED JUNE, 2012 AS PRESENTED. MOTION PASSED UNANIMOUSLY.

Review of the remaining policies, including the Shareholder Activism Policy related to Federal Divestiture Enactments, the Co-Investment Policy, and the External Manager Hire, Rebalance and Terminate Authorization Policy was deferred to a later meeting.

17) Blackstone Partnerships / Market Update

Steve Schwarzman, Chairman, CEO and Co-Founder of The Blackstone Group, joined the Council to provide an update of the Blackstone funds and to give his views on the current economic environment in the U.S. and around the world. He provided a brief history of Blackstone, their investment platforms and performance since inception. He discussed attractive opportunities within different categories and across asset categories. He discussed economic challenges including the European crisis and implications on the financial system, the impact of changes in bank capital standards, the upcoming U.S. fiscal cliff and long-term deficit problems.

18) Adjournment

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