

# MINUTES

## SOUTH DAKOTA INVESTMENT COUNCIL Watertown, South Dakota April 9, 2014

### 1) Roll Call

The Investment Council meeting was called to order at 8 a.m. on April 9, 2014 by Chair Hugh Bartels. Council members in attendance were Hugh Bartels, David Hillard, Jon Hunter, Steve Kirby, Jim Means, Rich Sattgast, and Rob Wylie. Council member Vern Larson 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; Susan Jahraus from the South Dakota Retirement System; Aaron Olson from the Legislative Research Council; Ryan Brunner from the Office of School & Public Lands; Senator Ried Holien; Representative Roger Solum; and Michael Anderson, Dustin Padgett and Heath Rylance from Watertown.

(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

DAVID HILLARD MOVED, SECONDED BY ROB WYLIE, TO APPROVE THE MINUTES OF THE FEBRUARY 6, 2014 AND MARCH 13, 2014 COUNCIL MEETINGS. MOTION PASSED UNANIMOUSLY.

### 3) Starwood Opportunity Fund X Global, L.P.

Jerry Silvey, Executive Vice President & Chief Financial Officer, Mark Deason, Senior Vice President, and Lanhee Yung, Manager Director, of Starwood Capital Group joined the Council to discuss Starwood real estate, and in particular, the Starwood Global Opportunity Fund X for which they are currently fundraising.

Silvey gave a history of the firm, total assets under management, and their investment performance since inception. He discussed the gross IRR projections for Starwood Opportunity Funds (SOF) VIII and IX, as well as the launching of SOF X. He described their global organization and reviewed their senior management team. Silvey discussed Starwood's competitive advantages which include deep hands-on real estate perspective, scale and reputation, operational expertise, capital markets expertise, and distressed investing expertise. He described the synergistic business lines that also help investment teams gather market data. Silvey discussed Starwood's expertise across all major real estate asset classes and reviewed the percentage of assets in each class.

Lanhee Yung provided an overview of SOF IX, its portfolio composition, cash flow and portfolio asset level returns. She also discussed the fund's diversification by location, product type and theme.

#### AGENDA ITEMS:

- 1) Roll Call
- 2) Minutes
- 3) Starwood Opportunity Fund X Global, LP
- 4) Investment Update
- 5) Iran Divestiture Update
- 6) Asset Allocation Update
- 7) Rules Hearing – Higher Education Savings Program
- 8) Higher Education Savings Program Update
- 9) Rules Hearing – CD Program
- 10) Real Estate Review & Starwood Investment
- 11) Audit Committee Update
- 12) SDRS/CPRF Consolidation
- 13) Legislative Wrap-Up Review
- 14) Compensation Committee Update
- 15) Incentive Program
- 16) Bank Custodian Fee Schedule
- 17) Convertible Arbitrage Program Update
- 18) Interns/Open Positions Update
- 19) Future Meeting Dates
- 20) New/Old Business Agenda Items
- 21) Adjournment

Mark Deason provided an overview of several individual transactions in SOF IX, describing for each the investment description, investment thesis and game plan/status.

Silvey discussed Starwood's views on current market opportunities. He provided details on SOF X for the Council's consideration. He discussed the target fund size, the investment themes, target gross IRRs, fees and anticipated closings.

Bartels thanked Starwood for their presentation.

Discussion on overall real estate and the Starwood Global Opportunity Fund X continued under agenda item #10.

4) Investment Update – FY 2014

The Motions and Actions report from the February 6, 2014 and March 13, 2014 meetings were reviewed by Tammy Otten. The 3/31/14 quarterly investment update will be provided to the Council the first part of June after final details are in for consolidation of the CPRF into SDRS. Assets and estimated returns for funds under management as of 3/31/14 were presented.

An overview of the Education Enhancement Trust Fund's receipt of the annual tobacco company payment was provided. The additional contribution into the Cement Plant Retirement Fund to bring it to full funding was discussed.

5) Iran Divestiture Update

Otten reviewed the March 31, 2014 memo provided to the Council which included the updated scrutinized companies list for Iran based on the most recent Colorado and Florida public lists.

ROB WYLIE MOVED, SECONDED BY RICH SATTGAST TO APPROVE THE UPDATED IRAN SCRUTINIZED COMPANIES LIST DATED APRIL 9, 2014, AS PRESENTED. MOTION PASSED UNANIMOUSLY.

6) Asset Allocation Update

Matt Clark discussed the asset allocation strategy and the market valuation levels that would likely trigger a reduction of equity-like risk.

7) Rules Hearing – Higher Education Savings Program

The minutes of the Administrative Rules Hearing for the Higher Education Savings Program are attached to these minutes and are made a permanent part hereof.

JIM MEANS MOVED, SECONDED BY STEVE KIRBY, TO ADOPT THE AMENDED RULES FOR THE HIGHER EDUCATION SAVINGS PROGRAM. MOTION PASSED UNANIMOUSLY ON A ROLL CALL VOTE.

8) Higher Education Savings Program Update

Sherry Nelson reviewed the compliance schedule and the Summary of Shareholder Positions and Accounts for the CollegeAccess529 Plan through February 28, 2014. She noted a letter has been sent to Allianz regarding the Council's intentions to renew the HESP Program Management Agreement and that a reply has not yet been received. Allianz has until April 17, 2014 to propose changes, otherwise, the contract will automatically renew under the same terms.

9) Rules Hearing – CD Program

The minutes of the Administrative Rules Hearing for the CD Program are attached to these minutes and are made a permanent part hereof.

JIM MEANS MOVED, SECONDED BY DAVID HILLARD, TO ADOPT THE AMENDED RULES FOR THE INVESTMENT IN CERTIFICATES OF DEPOSIT IN SOUTH DAKOTA QUALIFIED PUBLIC DEPOSITORIES. MOTION PASSED UNANIMOUSLY ON A ROLL CALL VOTE.

10) Real Estate Review & Starwood Investment

Chris Nelson reviewed the current allocation to real estate limited partnerships, along with projections for capital calls and capital returns. He discussed the maximum allowed allocation to real estate, both with and without all committed capital. He described the need to continue to make new investments to maintain allocations as existing partnership investments return capital.

Clark and senior staff reviewed their views on Starwood and discussed the recommendation of a total of \$150 million investment in Starwood Global Opportunity Fund X.

The Council discussed the overall exposure to real estate, opportunities in U.S. and Europe, inflation protection and cash flow yield of real estate, and Starwood's investment strategy.

STEVE KIRBY MOVED, SECONDED BY ROB WYLIE, TO AUTHORIZE THE STATE INVESTMENT OFFICER TO INVEST UP TO \$150 MILLION IN TOTAL FOR THE SOUTH DAKOTA RETIREMENT SYSTEM AND THE TRUST FUNDS IN STARWOOD GLOBAL OPPORTUNITY FUND X, L.P., TO BE COMPRISED OF APPROXIMATELY \$135 MILLION FOR THE SOUTH DAKOTA RETIREMENT SYSTEM AND APPROXIMATELY \$15 MILLION IN TOTAL AMONG THE SCHOOL AND PUBLIC LANDS FUND, DAKOTA CEMENT TRUST, EDUCATION ENHANCEMENT TRUST, AND HEALTH CARE TRUST. MOTION PASSED UNANIMOUSLY ON A ROLL CALL VOTE.

11) Audit Committee Update

Jim Means, Chair of the Audit Committee, stated that the Audit Committee reviewed the quarterly procedures audit report through 12/31/13 provided by the Department of Legislative Audit (DLA). He said the audit went well and there were no adverse findings. He added that he discussed with Ashlee Keys from DLA any recommended changes to the procedures audit and she provided a few items for the Committee's consideration. Means also reviewed the updated fraud risk assessment report.

12) SDRS/CPRF Consolidation

Otten reviewed the steps taken to consolidate the assets of the CPRF into SDRS at the custodian bank, external managers and limited partnerships. One external manager for CPRF was liquidated. Three small tag end limited partnerships will be held as separate pieces by SDRS rather than being consolidated due to cost relative to the size of the liquidating investments. March quarter end books will remain open until the end of May to allow March quarter valuations from limited partners to be included in the CPRF fair value transferred to SDRS on April 1.

13) Legislative Wrap-Up Review

Otten reviewed the final legislative report. The four bills sponsored by the SDRS Board of Trustees passed and were signed by the Governor. SB 152 consolidated the Cement Plant

Retirement Fund into the South Dakota Retirement System on April 1, 2014. SB 1 changed the membership of the Executive Board of the Legislature. SB 187 included the Investment Council budget as recommended by the Governor. HB 1099 to increase the Investment Council membership failed.

14) Compensation Committee Update

Jon Hunter, Chair of the Compensation Committee, spoke about the lengthy process that has been involved to improve compensation. This included an independent consultant compensation study which concluded that total compensation had fallen substantially below the Council's target for investment positions. The Council decided to use the incentive program to move back closer to the target. The fiscal year 2015 budget, which includes additional funding in the incentive program, has now been approved.

Hunter stated the Compensation Committee had met to discuss two issues. The first was the State Investment Officer's FY 2015 compensation which will be recommended to the LRC Executive Board at their June meeting. The FY 2015 budget includes a 4.8% increase in base salary, and the Compensation Committee is recommending that increase be implemented. The second issue was the next stage of increasing overall compensation by implementing the new incentive structure. The Compensation Committee's recommendation is that the revised incentive program be implemented immediately (see item #15 for motion).

The Council discussed the Compensation Committee's recommendations. They discussed the implications of last year's large outperformance on this year's incentives. It was noted that immediate implementation was the intent in including the additional incentives in the FY15 budget.

Hunter reviewed the old structure of the incentive program which included a range of 0% to 100% with a 50% expected average over time. The new structure includes a range of 0% to 200% with an expected average of 80% over time.

Clark discussed the focus on long-term investing and reviewed the focus of the additional incentives on stretch and longer term performance.

JON HUNTER MOVED, SECONDED BY JIM MEANS, THAT THE INVESTMENT COUNCIL RECOMMEND TO THE LRC EXECUTIVE BOARD TOTAL COMPENSATION FOR THE STATE INVESTMENT OFFICER PAYABLE IN FY 2015 BE COMPRISED OF A 4.8% INCREASE IN BASE SALARY AND CONTINUATION OF THE INVESTMENT PERFORMANCE INCENTIVE PLAN INCORPORATING THE NEW INCENTIVE PAY STRUCTURE, WITH ANY EARNED INCENTIVES TO BE PAID FOLLOWING COMPLETION OF THE AUDIT. MOTION PASSED UNANIMOUSLY.

15) Incentive Program

JON HUNTER MOVED, SECONDED BY JIM MEANS, TO APPROVE, EFFECTIVE BEGINNING WITH FISCAL YEAR 2014 INVESTMENT PERFORMANCE, THE NEW INCENTIVE PROGRAM PERCENTAGE STRUCTURE INCORPORATING THE CURRENT 1-YEAR AND 4-YEAR REGULAR INCENTIVES FOR UP TO 100% OF BASE PAY, AND THE ADDITION OF 10-YEAR REGULAR, 4-YEAR STRETCH, AND 10-YEAR STRETCH INCENTIVES FOR UP TO AN ADDITIONAL 100% OF BASE PAY. MOTION PASSED UNANIMOUSLY.

16) Bank Custodian Fee Schedule

Otten provided an update on continuing fee schedule negotiations for the bank custodian contract with BNY/Mellon. The current fee schedule expires 5/31/14.

17) Convertible Arbitrage Update

Brett Fligge updated the Council on the recent suspension of the internal convertible arbitrage program. He stated the wind-down process went smoothly, and the entire portfolio was liquidated by the end of the March quarter.

18) Intern/Open Positions Update

Clark stated that five students have been hired for summer internships.

19) Future Meeting Dates

The next Investment Council meeting is scheduled for June 16 & 17, 2014 in Sioux Falls.

20) New/Old Business Agenda Items

No new or old business agenda items were brought before the Council.

21) Adjournment

Chair Bartels declared the meeting adjourned at 2:10 p.m.

SOUTH DAKOTA INVESTMENT COUNCIL

MINUTES OF PUBLIC HEARING

The South Dakota Investment Council convened at 11 a.m. on Wednesday, April 9, 2014, in Room 433 of the Student Center at Lake Area Technical Institute in Watertown, South Dakota.

The purpose of the meeting was to conduct a public hearing on the proposed rules of the Council numbered 06:01:06:01, adopted under the authority of SDCL 13-63-2.

**Hearing Officer:** Hugh Bartels, Chair of the South Dakota Investment Council, Watertown, South Dakota.

**Members of the Investment Council in Attendance:** Hugh Bartels, David Hillard, Jon Hunter, Steve Kirby, Jim Means, Rich Sattgast, and Rob Wylie.

**Members of the Investment Office in Attendance:** Matthew Clark, Brett Fligge, Sherry Nelson, Chris Nelson, Tammy Otten, and Laurie Riss.

**Others in Attendance:** Senator Ried Holien, Watertown; Representative Roger Solum, Watertown; Susan Jahraus, Pierre; Aaron Olson, Pierre; Ryan Brunner, Pierre.

**Written Testimony**

No written testimony was submitted.

**Oral Testimony**

Oral testimony in favor of the proposed rules was presented by Sherry Nelson.

**Sherry Nelson** stated that the proposed rule change is to update the program management agreement for the higher education savings plan to refer to the most recent amendment to the IRS code that affects all higher education savings plans.

There being no further testimony, Mr. Bartels thanked everyone for attending and concluded the public hearing.

Respectfully submitted,

Laurie Riss  
Secretary  
South Dakota Investment Council

**Rules Hearing Adjournment:** 11:05 a.m.

SOUTH DAKOTA INVESTMENT COUNCIL  
MINUTES OF PUBLIC HEARING

The South Dakota Investment Council convened at 11:10 a.m. on Wednesday, April 9, 2014, in Room 433 of the Student Center at Lake Area Technical Institute in Watertown, South Dakota.

The purpose of the meeting was to conduct a public hearing on the proposed rules of the Council numbered 06:01:02:01 to 6:01:02:04, inclusive; 6:01:03:01 to 6:01:03:03, inclusive; and 6:01:07:01 to 6:01:07:03, inclusive, adopted under the authority of SDCL 4-5-28.

**Hearing Officer:** Hugh Bartels, Chair of the South Dakota Investment Council, Watertown, South Dakota.

**Members of the Investment Council in Attendance:** Hugh Bartels, David Hillard, Jon Hunter, Steve Kirby, Jim Means, Rich Sattgast, and Rob Wylie.

**Members of the Investment Office in Attendance:** Matthew Clark, Brett Fligge, Sherry Nelson, Chris Nelson, Tammy Otten, and Laurie Riss.

**Others in Attendance:** Senator Ried Holien, Watertown; Representative Roger Solum; Watertown; Susan Jahraus, Pierre; Aaron Olson, Pierre; Ryan Brunner, Pierre.

**Written Testimony**

No written testimony was submitted.

**Oral Testimony**

Oral testimony in favor of the proposed rules was presented by Sherry Nelson.

**Sherry Nelson** stated that the proposed rule changes would combine three sections of rules for banks, associations, and other qualified public depositories into one section. She stated that the following changes would be included: The minimum allocation would be updated from \$100,000 to equal the current FDIC deposit insurance limit; a sentence would be added that clarifies that collateralization is required for the allocation amount in excess of deposit insurance; the requirements that allocations will be determined from the summer call report and be completed by December 1 would be removed; and, Savings and Loan associations would be referred to as associations.

**Matt Clark** discussed how the proposed rules would impact how allocations are determined. He stated that it would give the Investment Council increased flexibility surrounding the program's implementation.

There being no further testimony, Mr. Bartels thanked everyone for attending and concluded the public hearing.

Respectfully submitted,

Laurie Riss  
Secretary  
South Dakota Investment Council

**Rules Hearing Adjournment:** 11:25 a.m.