SouthDakota Legislative Research Council

MINUTES
Retirement Laws Committee

Second Meeting
2009 Interim
September 16, 2009

South Dakota Investment Council Office
4009 West 49th, Suite 300
Sioux Falls, South Dakota

Wednesday, September 16, 2009

The second meeting of the Retirement Laws Committee was called to order by Chair, Representative Tim Rounds, at 9:00 a.m. (CDT) at the South Dakota Investment office in Sioux Falls, South Dakota following a brief tour of the offices.

The meeting was held with the following members present: Senators Corey Brown, Sandy Jerstad, Tom Nelson (Vice Chair), and Kathy Miles; and Representatives Marc Feinstein, Patrick Kirschman, Tim Rounds (Chair), and Manny Steele. Senator Gene Abdallah and Representative Noel Hamiel were excused.

Others in attendance were Representative Bill Thompson; Jarred Johnson, Commissioner of School and Public Lands; Rob Wylie, South Dakota Retirement System Administrator; Jan Coleman, SDRS Board of Trustees; Chuck Holmstrom, SDRS Board of Trustees; Sam Wilson, South Dakota AARP; Matt Clark, South Dakota Investment Officer; Brett Fligge, Assistant Investment Officer; Tammy Otten, Assistant Investment Officer; Chris Nelson, Assistant Investment Officer; Laurie Riss, SDIC Business Manager; and Bob Mercer, journalist.

(NOTE: For purpose of continuity, the following minutes are not necessarily in chronological order. Also, all referenced documents distributed at the meeting are attached to the original minutes on file in the Legislative Research Council (LRC)).

Approval of Minutes

REPRESENTATIVE MANY STEELE MOVED, SECONDED BY SENATOR COREY BROWN, TO APPROVE THE JUNE 4TH MINUTES. The motion prevailed on a voice vote.

FY2009 Investment Summary and FY2010 Investment Update

Matt Clark, South Dakota Investment Officer, distributed a handout detailing the mission, goal, and policies of the South Dakota Investment Council (SDIC). South Dakota is the only state that internally manages the majority of its investments. Typically, states have external managers for most or even all of their investments.

A question was asked regarding the possibility of a conflict of interest when SDIC employees invest in the same companies researched by the Council. Mr. Clark said that there were strict conflict of interest rules requiring that the interest of the State come first. He then distributed a copy of the "Personal Investing Guidelines" that were established in 1995 and updated in 2001. (**Document #1**)

Matt Clark said the Council hires the "best of the crop" from South Dakota higher education institutes. His philosophy, as well as that of his predecessor, is if you hire people with strong ties to South Dakota, they are less likely to leave South Dakota. He said this begins with the student intern program. This philosophy has paid off through very low turnover rates.

Mr. Clark reported that the SDRS assets managed by his office increased by 13 percent since the beginning of FY2010. The makeup of managed assets are: South Dakota Retirement System, Healthcare Trust Fund, Education Enhancement Trust Fund, Cement Plant Retirement Fund, School and Public Lands Fund, Dakota Cement Trust Fund, and the South Dakota Cash Flow fund. The estimated value on September 15, 2009, was approximately $8.1 billion, which was up from $6.4 billion, when the market was the lowest it had been in years.

Representative Tim Rounds asked if the added cash from the trust funds positively affected the SDIC's ability to invest. Mr. Clark said that the trust funds added in the last decade are not a large portion of the total portfolio. He said that the South Dakota Retirement Fund is by far the largest part of the portfolio and that fund drives the investment models created and used by the SDIC.

Representative Marc Feinstein asked how the trust funds are invested vs. how the SDRS funds are invested. Mr. Clark said the trust funds are being phased in to be managed like the SDRS fund. The trust funds have about 80% as much equity-like risk as SDRS. The Council's estimate as of September 14, 2009, indicates the Health Care Trust Fund and the Education Enhancement Trust Fund will have sufficient growth above the principal amount to transfer a portion of the earnings to the State General Fund in FY2011. The transfer amounts, if any, are dependent upon the markets between now and December 31.

Senator Sandy Jerstad reported that she recently returned from a meeting hosted by the National Council of State Legislators and was pleased to learn that our investment office is the envy of the entire nation. Mr. Clark said that most states don't have continuity in the leadership of their investment offices. South Dakota has benefited from longevity and stability throughout the investment organization.

Mr. Clark was asked if, because the Council is the envy of other states, he has ever been approached by other states to manage their investments. It was discussed years ago, but was dismissed because it is hard to keep all stakeholders happy. Many states want our long-term success, but they aren't willing to devote the resources and the patience that our long-term strategy requires.

The goal at SDIC is to add value to the portfolio over the long-term – more than what could be earned by market indexes and other retirement plans. The SDIC wants to do better than other investment offices.

Mr. Clark said it is important to focus on the long-term value. You need to buy when prices are below long-term value and sell when prices exceed long-term value. But you must have a method to determine long-term value. It is important for the staff and the Council to be patient and let their forecasting models work. Everyone – the staff, Mr. Clark, the Council, the Legislature, and the Governor – must stay strong for this long-term strategy to succeed.

To succeed in their mission, the SDIC has a long-term value measure, experience in many previous difficult periods, and a track record of success in prior difficult periods while continuously preparing for tough times.

Mr. Clark described the benefits of internal investment management. The costs are lower, but earnings are higher. Many other states hire outside firms to manage their investments – SDIC is competing against New York and Los Angeles Firms.

Brett Fligge, Assistant Investment Officer, reviewed the SDIC's approach to global equity management. The reason SDIC has a global focus is to gain knowledge and understand the global market place for all industries and to take advantage of opportunities wherever they appear.

The process for equity valuation that the council uses includes background research, an estimate of normal earnings, determination of the return on the current level of invested capital, an estimate of normal growth, calculation of a normalized dividend stream, and a calculation of the discounted value of a normalized dividend stream.

Mr. Fligge detailed the Council's internally developed equity valuation model. He used data from the Lowe's Company to show the calculation of measures that drive their decisions to buy or sell.

Exposure to risk is inherently part of investing. SDIC recognizes this, but also understands that risk allows the return on investments that is needed to pay the desired benefits. SDIC manages risk through diversification and by reducing investments in assets believed to be overvalued.

Tammy Otten, Assistant Investment Officer, reviewed the asset allocation policies and benchmarks for the Council. The "asset allocation" of the SDIC can be described as follows: the process of dividing investments among different kinds of assets, such as stocks, bonds, real estate and cash, to optimize the risk/reward tradeoff based on SDIC's goals. Ms. Otten explained SDIC's minimum, normal, and maximum level of holdings in the various investment categories.

Chris Nelson, Assistant Investment Officer, reviewed the Council's use of external investment managers. The SDIC does not internally manage investments in real estate due to the need for specialized real estate management expertise. Nor does the SDIC internally manage the private equity investment category because it requires hands-on business management expertise. The final investment category the SDIC does not handle internally is distressed residential mortgage securities because of the level of data that is needed to succeed in that investing environment. Mr. Nelson gave an overview of Blackstone Real Estate Group, which is one of the SDIC's external investment managers. Blackstone looks for opportunities by "going where the other investors are not". Blackstone manages approximately 5% to 10% of the SDIC's assets.

Possible Corrective Actions by the SDRS Board of Trustees

Rob Wylie, Executive Director of the South Dakota Retirement System, (**Document #2** and **Document #3**) presented possible changes to the retirement system that would eliminate

$240M in future costs. He presented several options that will be discussed further at the next meeting of the South Dakota Retirement System Board of Trustees on December 1st and 2nd. The options presented to the committee included:

- Make the return to work provisions cost neutral (could include a 90-day separation period, 15% reduction in retirement benefits upon reemployment, no additional retirement benefits earned upon reemployment);
- Eliminate first-year pro-rated cost of living adjustments (COLA) for retirees and all other pro-rated COLAs;
- Reduce the refund amount if the employee leaves the system;
- Index the COLA and base it on the SDRS Funded Status (if the system is doing well, the COLA will be 3.1%, whereas if the market value funded ratio is less than 100%, the COLA would be reduced on a sliding scale, but never lower than 2.1%); and
- Reduce or eliminate the current deficit in the optional spouse benefit.

Representative Rounds asked how long the reemployed remained on staff. Mr. Wylie said 75% of those employees who were reemployed after retirement stayed more than three years and accrued additional benefits. Mr. Wylie explained the proposed changes would eliminate that additional benefit. Members who terminate employment and are reemployed by the same employer within 90 days would be treated as not having terminated employment and therefore, would not be eligible for benefits.

Representative Feinstein asked when the employer would be required to pay for some of the costs of the retire/rehire. Mr. Wylie explained that under the proposed changes, effectively there would be an employer cost because when the employee is reemployed, none of the employer contributions are paid to the employee. Mr. Wylie said employers are desperate to keep baby-boomers on staff, and while SDRS understands the workforce issues, they must reduce the cost to the system and get the plan back into actuarial balance.

Representative Feinstein asked what "new employer" meant. Does the proposed change prevent a state employee from working another state entity? Mr. Wylie said that detail is yet to be worked out but that part of the new law would be the hardest to draft because the IRS Code isn't clear on this issue.

Representative Manny Steele suggested hiring critical people back on short-term contracts instead of entering into full-time employment-with-benefits situations.

Another piece of legislation is being considered by the SDRS for the 2010 legislative session. Currently, SDCL 12-27-20 prevents organizations who expend public funds from communicating with their members to inform them of the impact of ballot questions. This prohibition has prevented the SDRS from being able to notify its members regarding the effects of certain ballot measures on their funds.

Next Meeting

The next meeting of the Retirement Laws Committee will be on December 8th in Pierre when the committee will receive a briefing on the 2010 legislative package from the South Dakota Retirement System Board of Trustees.

Adjourn

REPRESENTATIVE STEELE MOVED, SECONDED BY SENATOR MILES, THAT THE COMMITTEE ADJOURN. The motion passed unanimously by a voice vote.

The meeting adjourned at 12:40 p.m.

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