

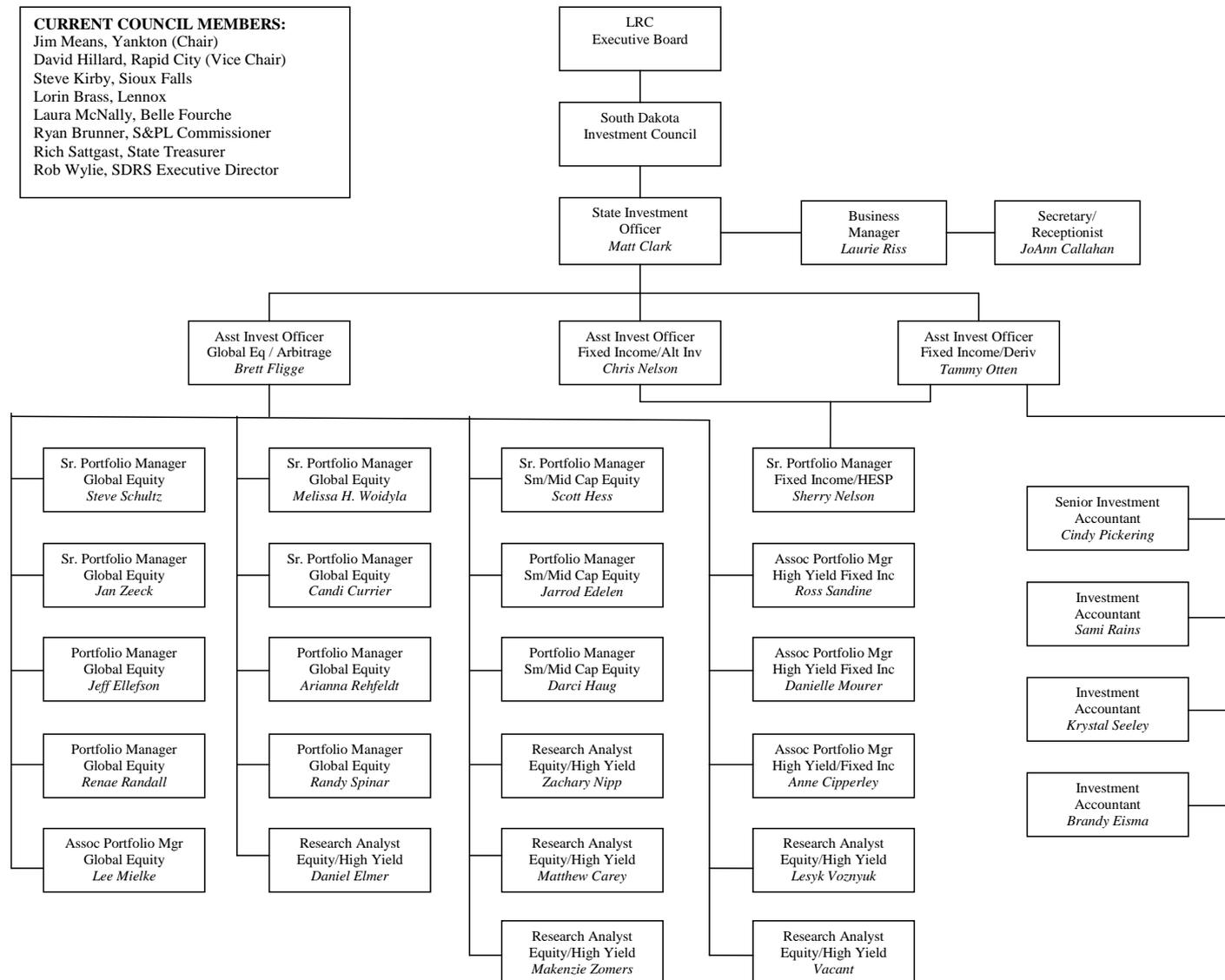
# **SDIC FY 2015 Performance & FY 2017 Budget Presented to LRC Executive Board**

August 24, 2015

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# Organization Chart

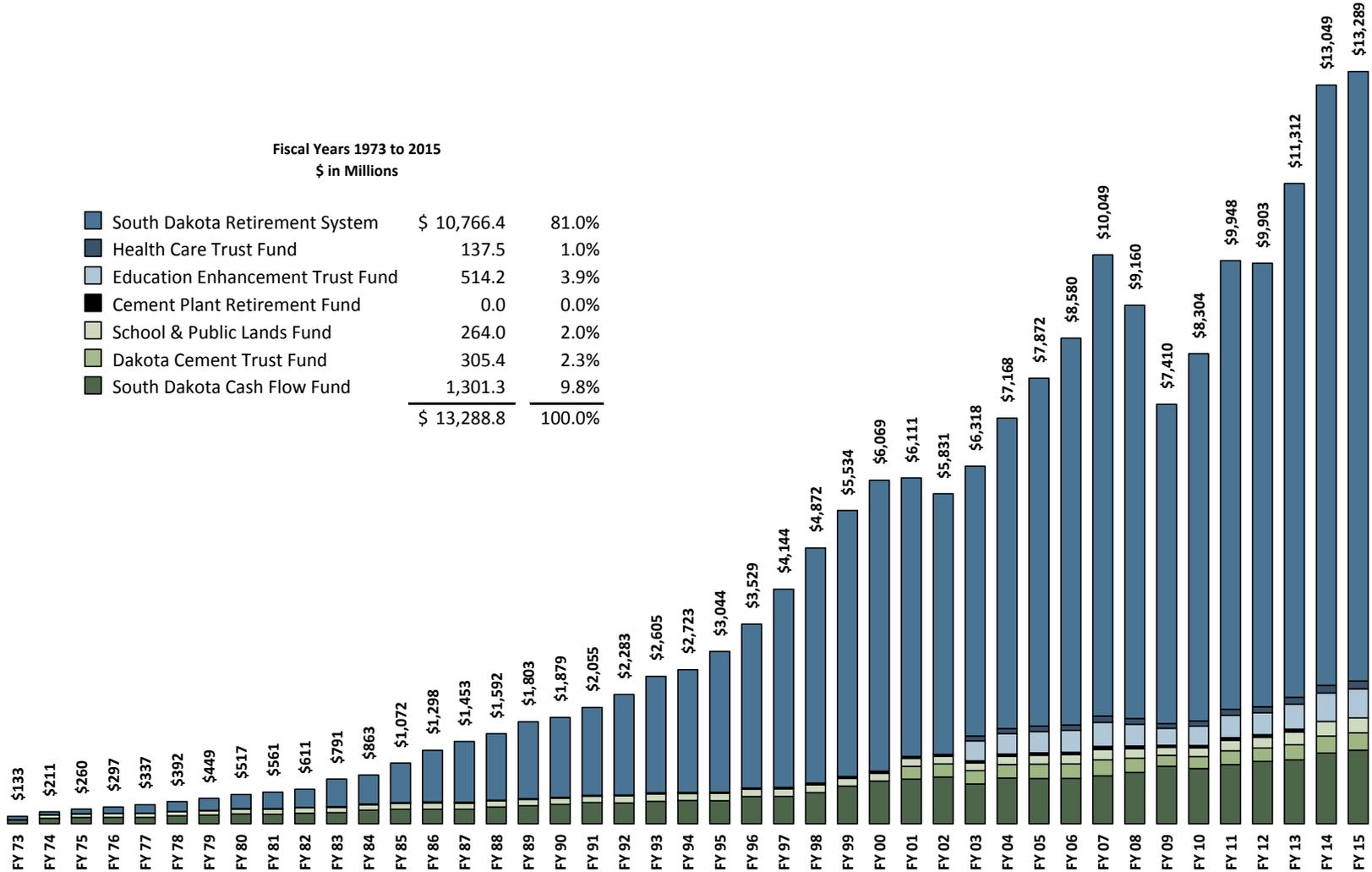
**CURRENT COUNCIL MEMBERS:**  
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 Lorin Brass, Lennox  
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 Ryan Brunner, S&PL Commissioner  
 Rich Sattgast, State Treasurer  
 Rob Wylie, SDRS Executive Director



# Assets

Fiscal Years 1973 to 2015  
\$ in Millions

South Dakota Retirement System	\$ 10,766.4	81.0%
Health Care Trust Fund	137.5	1.0%
Education Enhancement Trust Fund	514.2	3.9%
Cement Plant Retirement Fund	0.0	0.0%
School & Public Lands Fund	264.0	2.0%
Dakota Cement Trust Fund	305.4	2.3%
South Dakota Cash Flow Fund	1,301.3	9.8%
	<hr/>	
	\$ 13,288.8	100.0%



# Investment Performance

## Returns vs. Benchmarks (unaudited)

	<u>FY 2015</u>	<u>4 Years Annualized FY 12 – 15</u>	<u>10 Years Annualized FY 06 – 15</u>
▪ SDRS Total Fund	4.18%	10.83%	8.46%
▪ Capital Market Benchmark	2.09%	8.38%	6.71%
Added Value	<b>2.09%</b>	<b>2.46%</b>	<b>1.75%</b>
▪ State Fund Universe	3.87%	8.42%	6.85%
Added Value	<b>.31%</b>	<b>2.41%</b>	<b>1.61%</b>
▪ SDRS Beginning FY15 Assets		\$10.602 billion	
▪ SDRS Ending 6/30/15 Assets		\$10.766 billion	

# Investment Performance

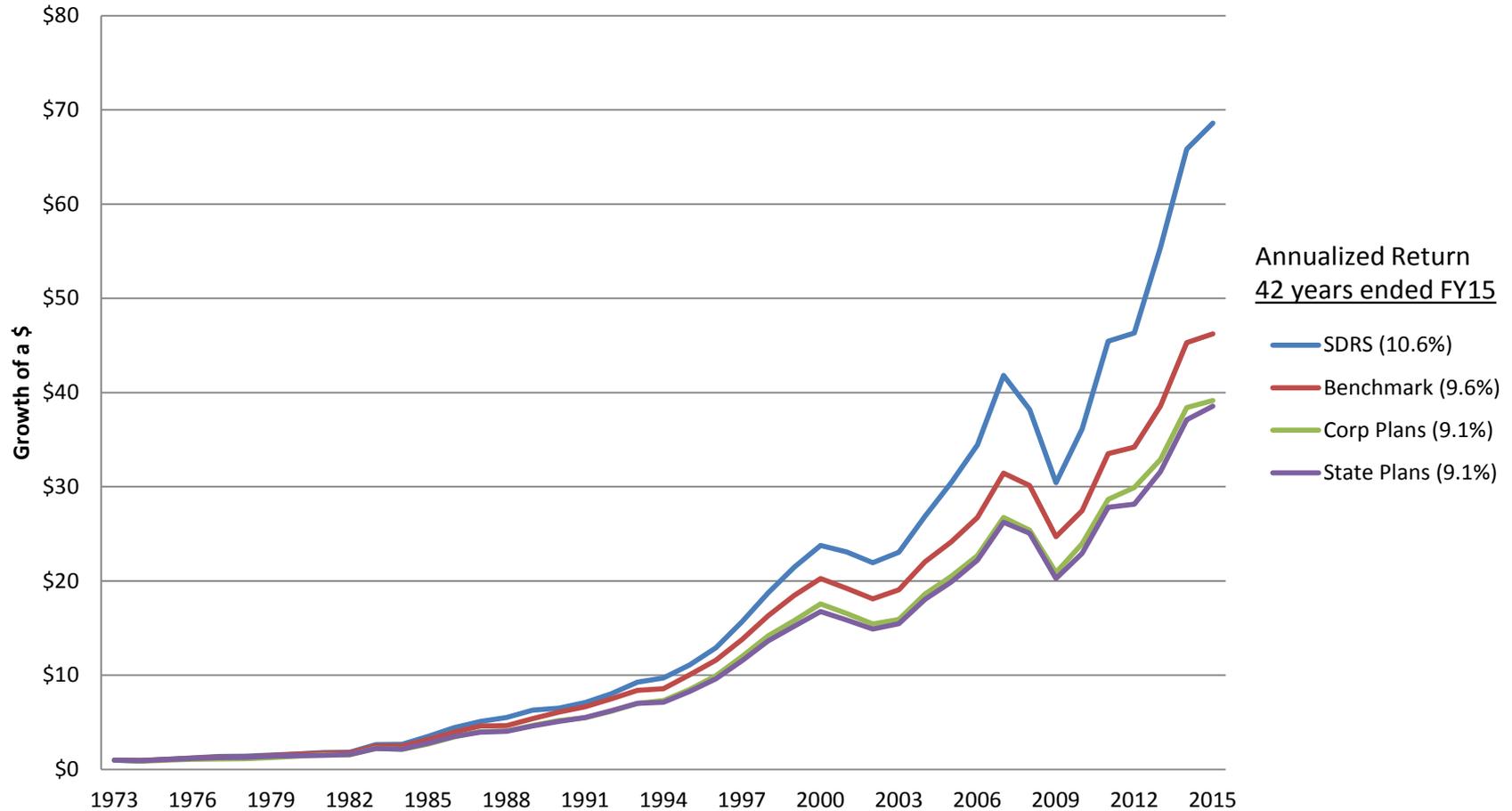
## Earnings vs. Benchmarks (unaudited)

- Total SDRS dollars earned Fiscal Year 2015 \$ .457 billion
- Total SDRS dollars earned last 4 years \$3.832 billion
- Total SDRS dollars earned last 10 years \$6.610 billion
- **Extra earnings** resulting from last 1, 4 and 10 years of performance over benchmark (not including compounding)

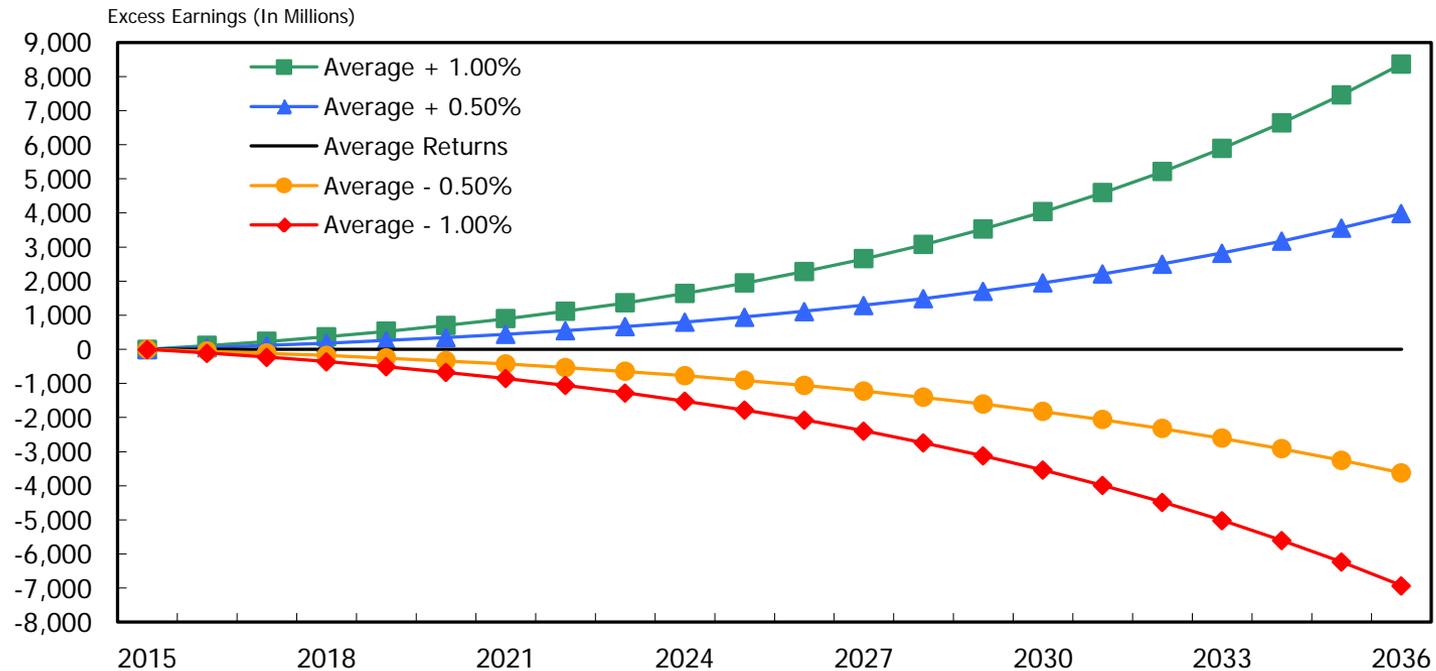
	<u>1 year</u>	<u>4 years</u>	<u>10 years</u>
○ vs. Capital Markets Benchmark	\$221 million	\$873 million	\$1.42 billion
○ vs. State Funds	\$ 33 million	\$827 million	\$1.31 billion

# Superior returns add up over time

Cumulative returns for SDRS, Benchmark, Corporate plans, and other States



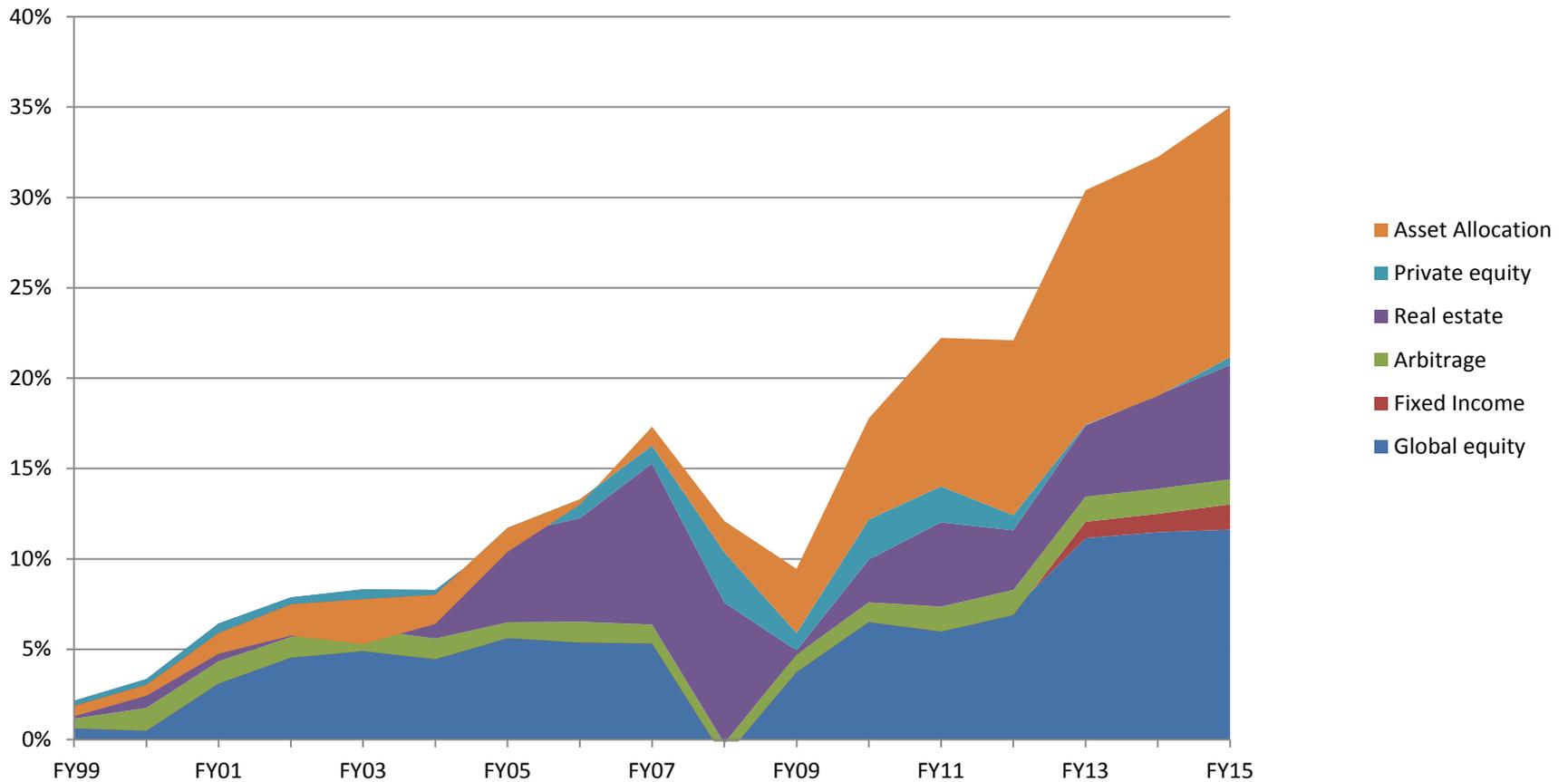
# Potential Excess Earnings



- SDIC 42-year outperformance = 1% annualized vs. benchmark
- If 1% outperformance continues next 20 years = extra \$8 billion
- Outperformance of even half that amount = extra \$4 billion
- Underperformance of 1% = cost to retirement system of \$6.9 billion.

# Many pistons contribute

Cumulative added value by source FY99 to FY15



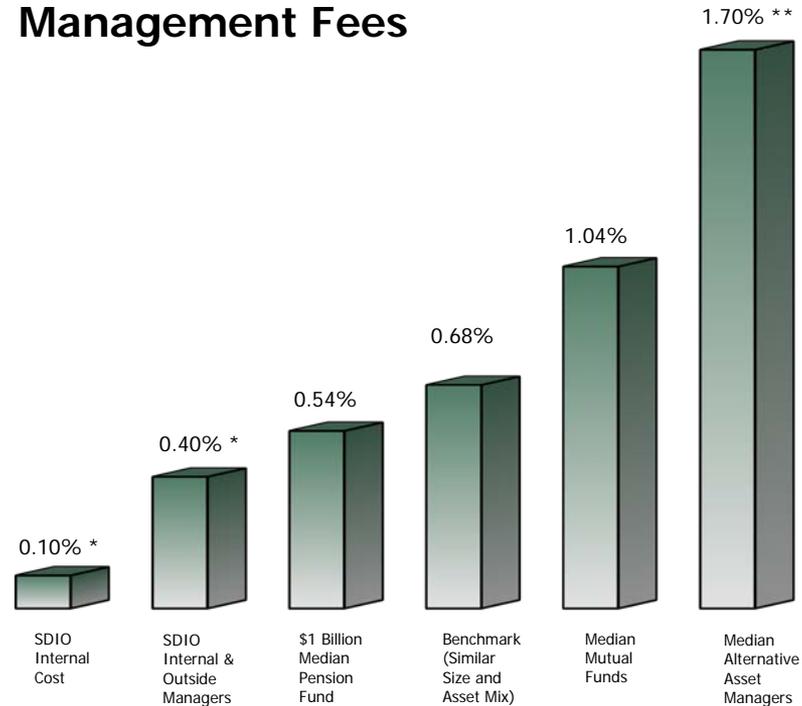
# Every asset category has good and bad years

## Annual added or detracted value by source

Asset Class	FY99	FY00	FY01	FY02	FY03	FY04	FY05	FY06	FY07	FY08	FY09	FY10	FY11	FY12	FY13	FY14	FY15
Global equity	0.8%	-0.1%	2.9%	1.9%	0.0%	-0.4%	0.8%	-0.3%	-0.1%	-6.2%	5.6%	2.1%	-0.8%	1.1%	3.7%	0.3%	0.1%
Fixed Income	-0.1%	-0.1%	-0.3%	-0.6%	0.3%	0.0%	0.3%	0.1%	0.0%	0.2%	-0.9%	0.6%	0.4%	-0.3%	1.2%	0.1%	0.4%
Arbitrage	0.5%	0.7%	0.0%	-0.1%	0.1%	-0.1%	-0.3%	0.3%	-0.1%	-0.2%	0.2%	0.1%	0.3%	0.0%	0.0%	0.0%	0.0%
Real estate	1.0%	0.6%	0.5%	0.1%	0.0%	0.5%	2.1%	0.9%	3.0%	-1.0%	-7.0%	2.1%	2.3%	-1.3%	0.6%	1.2%	1.1%
Private equity	-0.3%	0.0%	-0.2%	0.2%	-0.2%	0.3%	0.7%	0.6%	-0.1%	1.8%	-1.8%	1.2%	-0.2%	-1.1%	-0.8%	-0.1%	0.5%
Asset Allocation	-0.6%	0.0%	-0.6%	-0.6%	-0.7%	0.8%	0.1%	0.8%	1.0%	1.0%	1.5%	1.4%	1.9%	1.5%	2.1%	-0.1%	0.0%
<b>Total</b>	<b>1.3%</b>	<b>1.1%</b>	<b>2.3%</b>	<b>1.0%</b>	<b>-0.4%</b>	<b>1.1%</b>	<b>3.7%</b>	<b>2.4%</b>	<b>3.8%</b>	<b>-4.5%</b>	<b>-2.4%</b>	<b>7.6%</b>	<b>3.8%</b>	<b>-0.1%</b>	<b>6.8%</b>	<b>1.4%</b>	<b>2.1%</b>

# Cost Efficiency

## Management Fees



Difference between SDIC cost of .40% and benchmark cost of .68% is \$37 million per year

\* SDIC projected expenses for FY 2017 using adjusted assets and expected average performance incentives

\*\* Plus 20% profit participation after preferred return

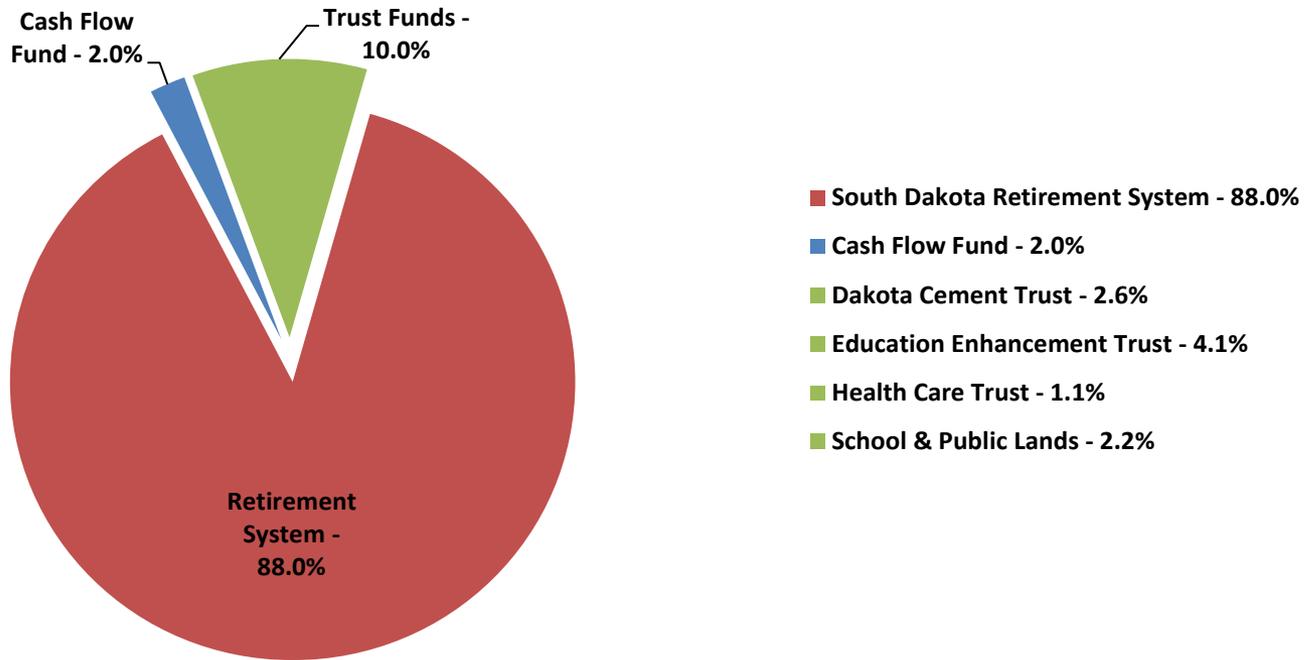
# Compensation Overview

- Long term results have significantly exceeded benchmarks
  - Added 35% beyond benchmark to SDRS assets in the past 17 years
- Continued success dependent on high caliber team
  - Internally manage most assets using internally generated research
- Future team depends on retention of talent pipeline and trainers
  - Develop internally as cannot compete for top tier experienced talent
- Compensation plan aligned with goal of adding value over long term
  - Motivate superior long-term performance and retain successful staff
- Compensation plan revised in 2006, updated in 2010 and 2013
  - Council target is 70% of cost of living adjusted median industry pay to balance getting a good deal for South Dakota without losing the good deal if we cannot keep our people
  - Incorporates performance incentives (range of 0% to 200%) which are expected to average 80% with continuation of SDIC historic level of superior performance
  - Pay was increased to 70% target after 2006 study and by 2013 study had fallen to 55%

# Compensation Overview, continued

- Council changes implemented in 2014 to get back to target
  - Expanded incentive compensation plan as opposed to adjusting base compensation
  - Incentives expanded to include longer term and stretch incentives and expected to average 80% (0% to 200%)
  - Incentives aligned with the goal of adding value and only paid if add value
- Cost efficient due to internal management capabilities
  - Securing team to preserve internal capabilities best chance to remain cost efficient
  - Internal cost .1% with expected average incentives

# Budget Funding Sources



Budget funded by assets under management  
0% General Fund appropriation

Note: S&PL share of SDIC expenses paid from earnings of Cash Flow Fund

# Long Term Plan Executive Summary

## Projected LTP Budget

	<u>FY 2017</u>	<u>FY 2022</u>	<u>FY 2027</u>
<b>INVESTMENT OFFICE BUDGET</b>			
<b>Personal Services</b>			
Number of Employees	32.25	34.25	34.25
Base Compensation - Total Staff	5,159,034.69	7,008,828.39	9,562,501.07
Staff Attorney (1/4 FTE) & Interns	62,501.43	72,456.29	83,996.70
Investment Council	6,246.00	7,875.00	7,875.00
Flexibility funds-Retirements & Resignations	155,552.66	180,328.17	209,049.77
Investment Incentive Maximum	8,921,549.99	12,924,527.37	16,605,918.22
Benefits	2,236,520.09	3,110,937.18	4,028,638.14
Total Personal Services	16,541,404.86	23,304,952.40	30,497,978.89
<b>Operating Expenses</b>			
Contractual Services	1,656,796	1,954,202	2,237,572
Travel	85,000	103,558	120,052
Office Supplies & Postage	12,733	15,684	18,182
Capital Assets	44,400	51,472	59,670
Total Operating Expenses	1,798,929	2,124,916	2,435,476
<b>Total Investment Council Budget</b>	<b>18,340,334</b>	<b>25,429,868</b>	<b>32,933,455</b>
<b>ASSET SUMMARY *</b>			
Internal Assets	11,003,988,519	13,912,008,222	17,690,114,826
External Assets	3,474,943,743	4,393,265,754	5,586,352,050
Total Assets	14,478,932,261	18,305,273,976	23,276,466,877
<b>EXPENSE SUMMARY</b>			
Internal Expenses	18,340,334	25,429,868	32,933,455
External Manager Fees	38,224,381	48,325,923	61,449,873
Total Expenses	56,564,715	73,755,792	94,383,327
<b>UNIT COST SUMMARY **</b>			
Internal Expenses as % of Total Adjusted Assets	0.094%	0.101%	0.103%
Total Expenses as % of Total Adjusted Assets	0.398%	0.404%	0.407%

\* Projections based on long-term assumed returns applied to 6/30/15 assets. Updated each June 30.

\*\*Unit Cost Summary based on total assets adjusted to long-term value & expenses using assumed avg inv perf incentives

Note: FY 17 amounts differ from actual budget request. The LTP includes an assumed 3% salary policy

# FY15 Budget and Actual

## Unexpended credited against FY16

	<u>Actual Exp</u> <u>FY 2015</u>	<u>Budget Rec'd</u> <u>FY 2015</u>	<u>Unexpended</u>
<b>PERSONAL SERVICES</b>			
<b>BASE COMPENSATION</b>			
Base Compensation - Investment Staff	3,633,121.86	4,017,261	384,139.14 *
Base Comp - Accounting, Admin & Longevity	384,381.00	392,595	8,214.00
<b>TOTAL STAFF - FULL TIME</b>	<b>4,017,502.86</b>	<b>4,409,856</b>	<b>392,353.14</b>
P/T Staff Attorney & Interns	28,571.50	22,065	(6,506.50)
Investment Council	2,700.00	5,946	3,246.00
Retirement & resignation flexibility funds	-	148,061	148,061.00
Benefits	814,552.24	868,082	53,529.76
<b>Total Base Compensation</b>	<b>4,863,326.60</b>	<b>5,454,010</b>	<b>590,683.40</b>
<b>Investment Performance Incentives</b>			
Maximum Potential Investment Perf Incentive	4,788,671.52	7,323,946	2,535,274.48
Benefits	590,861.53	1,022,536	431,674.47
<b>Total Investment Performance Incentives</b>	<b>5,379,533.05</b>	<b>8,346,482</b>	<b>2,966,948.95</b>
<b>Total Personal Services</b>	<b>10,242,859.65</b>	<b>13,800,492</b>	<b>3,557,632.35</b>
<b>OPERATING EXPENSES</b>			
Contractual Total (see appendix for further details)	1,275,525.86	1,557,693	282,167.14
Travel	61,097.94	85,000	23,902.06
Office Supplies & Postage	6,310.72	12,733	6,422.28
Capital Assets	47,881.93	43,000	(4,881.93)
<b>Total Operating Expenses</b>	<b>1,390,816.45</b>	<b>1,698,426</b>	<b>307,609.55</b>
<b>TOTAL BUDGET</b>	<b>11,633,676.10</b>	<b>15,498,918</b>	<b>3,865,241.90</b>

\* Includes \$52,541 Allianz reimbursement & unused compensation due to turnover

# FY17 Budget Request Summary

	<u>Received FY 2016</u>	<u>Request FY 2017</u>	<u>% chng</u>
<b>PERSONAL SERVICES</b>			
<b>BASE COMPENSATION</b>			
Base Compensation - Investment Staff	4,460,775	4,605,874	3.25%
Base Comp - Accounting, Admin & Longevity	403,477	409,701	1.54%
<b>TOTAL STAFF - FULL TIME</b>	<b>4,864,252</b>	<b>5,015,574</b>	<b>3.11%</b>
P/T Staff Attorney & Interns	53,891	60,884	12.98%
Investment Council	6,064	6,064	0.00%
Retirement & resignation flexibility funds	151,022	151,022	0.00%
Benefits	955,550	985,055	3.09%
<b>Total Base Compensation</b>	<b>6,030,779</b>	<b>6,218,599</b>	<b>3.11%</b>
<b>Investment Performance Incentives</b>			
Maximum Potential Investment Perf Incentive	8,034,522	8,921,550	11.04%
Benefits	1,117,494	1,231,174	10.17%
<b>Total Investment Performance Incentives</b>	<b>9,152,016</b>	<b>10,152,724</b>	<b>10.93%</b>
<b>Total Personal Services</b>	<b>15,182,795</b>	<b>16,371,324</b>	<b>7.83%</b>
<b>OPERATING EXPENSES</b>			
Contractual Total (see next page for further details)	1,605,892	1,656,796	3.17%
Travel	85,000	85,000	0.00%
Office Supplies & Postage	12,733	12,733	0.00%
Capital Assets	47,192	44,400	-5.92%
<b>Total Operating Expenses</b>	<b>1,750,817</b>	<b>1,798,929</b>	<b>2.75%</b>
<b>TOTAL BUDGET</b>	<b>16,933,612</b>	<b>18,170,253</b>	<b>7.30%</b>
<b>UNIT COST SUMMARY *</b>			
Internal Expenses as % of Total Adjusted Assets	0.092%	0.093%	
Total Expenses as % of Total Adjusted Assets	0.395%	0.396%	

\* Based on total assets adjusted to long-term value and expenses using assumed average investment performance incentives

# FY17 Budget Request

## Contractual services detail

	<b>Received</b>	<b>Request</b>	
	<b><u>FY 2016</u></b>	<b><u>FY 2017</u></b>	<b><u>% chng</u></b>
<b>CONTRACTUAL SERVICES</b>			
<b>Investment Services</b>			
Consulting Services	30,000	30,000	0.00%
Investment Accounting, Performance Benchmarking	181,000	96,000	-46.96%
Investment Databases, Newsfeeds & Quote Fees	471,765	507,336	7.54%
Investment Research Services	256,782	288,185	12.23%
Flexibility - From Brokerage to Independent Research	83,139	145,000	74.41%
<b>Total Investment Services</b>	<b><u>1,022,686</u></b>	<b><u>1,066,521</u></b>	<b><u>4.29%</u></b>
<b>Administrative Expenses</b>			
Office Rent	120,554	125,069	3.75%
Bond/Liability Insurance	7,800	7,800	0.00%
Telephone	12,000	14,000	16.67%
Office Equip Rental/Maintenance	6,000	6,000	0.00%
Bureau of Info & Telecommunications (BIT)	56,232	56,232	0.00%
State Central Services	11,086	11,640	5.00%
Legislative Audit	51,500	51,500	0.00%
Attorney General's Office - Legal Services	18,509	18,509	0.00%
Custodial Fees - Global	263,025	263,025	0.00%
Seminars/Educational Programs	33,500	33,500	0.00%
Business Publications	3,000	3,000	0.00%
<b>Total Administrative Expenses</b>	<b><u>583,206</u></b>	<b><u>590,275</u></b>	<b><u>1.21%</u></b>
<b>TOTAL CONTRACTUAL SERVICES</b>	<b><u>1,605,892</u></b>	<b><u>1,656,796</u></b>	<b><u>3.17%</u></b>

# Trust Funds (unaudited)

## Health Care Trust (established April 2001)

Principal as of 6/30/15	\$ 85,631,024
Principal as of 6/30/15 adjusted for inflation	\$ 112,409,149
Fair Value (FV) as of 6/30/15	\$ 137,528,097
Difference - FV less principal	\$ 51,897,073
Difference - FV less infl. adj. prin.	\$ 25,118,948
Fiscal year to date return	4.43%
Longterm expected mean return	6.03%
Payout of 4% plus expected inflation of 3%	7.00%
Expected return cushion/shortfall	-0.97%

Distribution for FY 16 (July 1, 2015)	<b>4,674,130</b>
Distribution for FY 15 (July 1, 2014)	4,322,835

## Education Enhancement Trust (established April 2001)

Principal as of 6/30/15	\$ 347,253,008
Principal as of 6/30/15 adjusted for inflation	\$ 451,089,124
Fair Value (FV) as of 6/30/15	\$ 514,166,745
Difference - FV less principal	\$ 166,913,737
Difference - FV less infl. adj. prin.	\$ 63,077,621
Fiscal year to date return	4.31%
Longterm expected return (lower due to tax exempt)	5.95%
Payout of 4% plus expected inflation of 3%	7.00%
Expected return cushion/shortfall	-1.05%

Distribution for FY 16 (July 1, 2015)	<b>17,038,734</b>
Distribution for FY 15 (July 1, 2014)	15,699,869

	FY 15	
<u>Asset Allocation</u>	<u>Current</u>	<u>Benchmark</u>
Global Equity	39%	53%
Private Equity	3%	0%
Real Estate	8%	10%
Fixed Income-IG	19%	26%
Fixed Income-HY	7%	7%
Fixed Income-Tips	3%	2%
Money Market	<u>20%</u>	<u>2%</u>
Total	100%	100%

Law allows up to 4% of the 16 quarter average to be distributed as long as principal is not violated as of December 31 each year. Avg = \$116.8mm

	FY 15	
<u>Asset Allocation</u>	<u>Current</u>	<u>Benchmark</u>
Global Equity	39%	53%
Private Equity	3%	0%
Real Estate	8%	10%
Fixed Income-IG	10%	16%
Fixed Income-tax e:	9%	10%
Fixed Income-HY	7%	7%
Fixed Income-Tips	3%	2%
Money Market	<u>21%</u>	<u>2%</u>
Total	100%	100%

Law allows up to 4% of the 16 quarter average to be distributed as long as principal is not violated as of December 31 each year. Avg = \$425.8mm

# Trust Funds (unaudited)

## Dakota Cement Trust (established April 2001)

Principal as of 6/30/15	\$ 238,000,000	<u>Asset Allocation</u>	<u>Current</u>	<u>FY 15 Benchmark</u>
Principal as of 6/30/15 adjusted for inflation	\$ 320,096,538	Global Equity	39%	53%
Fair Value (FV) as of 6/30/15	\$ 305,394,373	Private Equity	3%	0%
		Real Estate	9%	10%
Difference - FV less principal	\$ 67,394,373	Fixed Income-IG	20%	26%
Difference - FV less infl. adj. principal	\$ (14,702,165)	Fixed Income-HY	7%	7%
		Fixed Income-Tips	4%	2%
Fiscal year to date return	4.56%	Money Market	<u>18%</u>	<u>2%</u>
Longterm expected mean return	6.03%	Total	100%	100%
Payout of 4% plus expected inflation of 3%	7.00%			
Expected return cushion/shortfall	-0.97%			

Distribution for FY 15 (June 12, 2015 to GF)	<b>10,803,626</b>
Distribution for FY 14 (June 14, 2014 to GF)	10,063,456

Constitution allows 4% of the lesser of 1) the 16 quarter average balance or 2) the current December 31 fair value, be distributed by June of the following year. Avg = \$270 mm

## School & Public Lands

Inflation protection mandated by Constitutional Amendment -  
(payout is reduced by inflation to extent inflation not offset by realized gains)

Fair Value as of 6/30/15	\$ 264,009,889	<u>Asset Allocation</u>	<u>Current</u>	<u>FY 15 Benchmark</u>
		Global Equity	42%	53%
Fiscal year to date return	4.20%	Private Equity	3%	0%
Longterm expected mean return	6.03%	Real Estate	8%	10%
		Fixed Income-IG	19%	26%
Distribution for FY 15 K-12 (2/2/15)	9,969,231	Fixed Income-non-r	1%	
Distribution for FY 15 Board of Regents (6/8/15)	<u>2,092,161</u>	Fixed Income-HY	7%	7%
		Fixed Income-Tips	3%	2%
TOTAL	<b>12,061,393</b>	Money Market	<u>19%</u>	<u>2%</u>
		Total	100%	100%

# Appendix

- Investment performance incentives
- Target discount rationale
- FY15 Budget and Actual - Contractual Services details

# Investment performance incentives

Aligns compensation with goal of adding value

- Encourage superior performance
  - Counters underperformance career risk that can discourage efforts to add value
  - Multiyear timeframes encourage investing for the long term
- Encourage retention of successful staff
  - Team is most attractive to other organizations when winning
  - Shifts compensation higher when people more sought and down when losing
- Incentives paid only for added value
- Important to encourage adding value in good and bad markets
  - Added value in down markets more important than in up markets
  - Encourages adding value by reducing risk when markets expensive

# Target discount rationale

- Need top caliber people long term
  - Unsuccessful people or job hoppers always available but no bargain, even if free
  - Compensation is too low to recruit veteran high-performers from elsewhere
  - Must develop team internally by training cream of crop local University graduates
  - Takes 15 to 20 years to fully develop seasoned talent
  - If lose talent pipeline or trainers, will jeopardized handoff to next generation
- Our past history and observation of others suggest 70% target
  - Only way to know for sure how large discounts can work is to risk damaging team
  - 50% discount levels in past led to difficulties
  - 30% discount believed significant relative to other high-end professionals
  - Industry subject to intense performance measurement with significant consequences for winning and losing which intensifies desire for financial security
  - Discounts for top SDIC performers may be much larger as industry pay for top quartile performers can be double the median

# FY15 Budget and Actual

## Contractual services detail

	<u>Actual</u> <u>FY 2015</u>	<u>Budget Rec'd</u> <u>FY 2015</u>	<u>Unexpended</u>
<b>CONTRACTUAL SERVICES</b>			
<b>Investment Services</b>			
Consulting Services	0.00	30,000	30,000.00
Investment Accounting, Performance Benchmarking	83,096.51	191,000	107,903.49
Investment Databases, Newsfeeds & Quote Fees	439,133.05	435,189	(3,944.05)
Investment Research Services	224,581.84	254,232	29,650.16
Flexibility - From Brokerage to Independent Research	0.00	83,139	83,139.00
<b>Total Investment Services</b>	<u>746,811.40</u>	<u>993,560</u>	<u>246,748.60</u>
<b>Administrative Expenses</b>			
Office Rent	116,841.40	115,148	(1,693.40)
Bond/Liability Insurance	5,733.50	7,410	1,676.50
Telephone	16,968.34	10,000	(6,968.34)
Office Equip Rental/Maintenance	2,557.46	6,000	3,442.54
Bureau of Info & Telecommunications (BIT)	45,416.07	48,028	2,611.93
State Central Services	10,170.22	9,513	(657.22)
Legislative Audit	35,975.10	50,000	14,024.90
Attorney General's Office - Legal Services	17,445.00	18,509	1,064.00
Custodial Fees - Global	251,034.22	263,025	11,990.78
Seminars/Educational Programs	25,291.31	33,500	8,208.69
Business Publications	1,281.84	3,000	1,718.16
<b>Total Administrative Expenses</b>	<u>528,714.46</u>	<u>564,133</u>	<u>35,418.54</u>
<b>TOTAL CONTRACTUAL SERVICES</b>	<u>1,275,525.86</u>	<u>1,557,693</u>	<u>282,167.14</u>