

LRC Executive Board

Investment Council Update

June 10, 2019

- Assets managed
 - SDRS – FY 2019 return through 4/30/19 = 4.7%
 - Trust Funds – FY 2019 returns through 4/30/19 range from 5.3% to 5.5%

- 529 Scholarship Update – Transfers to Dakota Corps Scholarship Program
 - Last year (July 2018) transfer \$ 1,205,678
 - Cumulative transfers since Sept 2007 \$14,605,187
 - Estimated transfer for July 2019 \$ 1,200,000

- Council Role & Selection

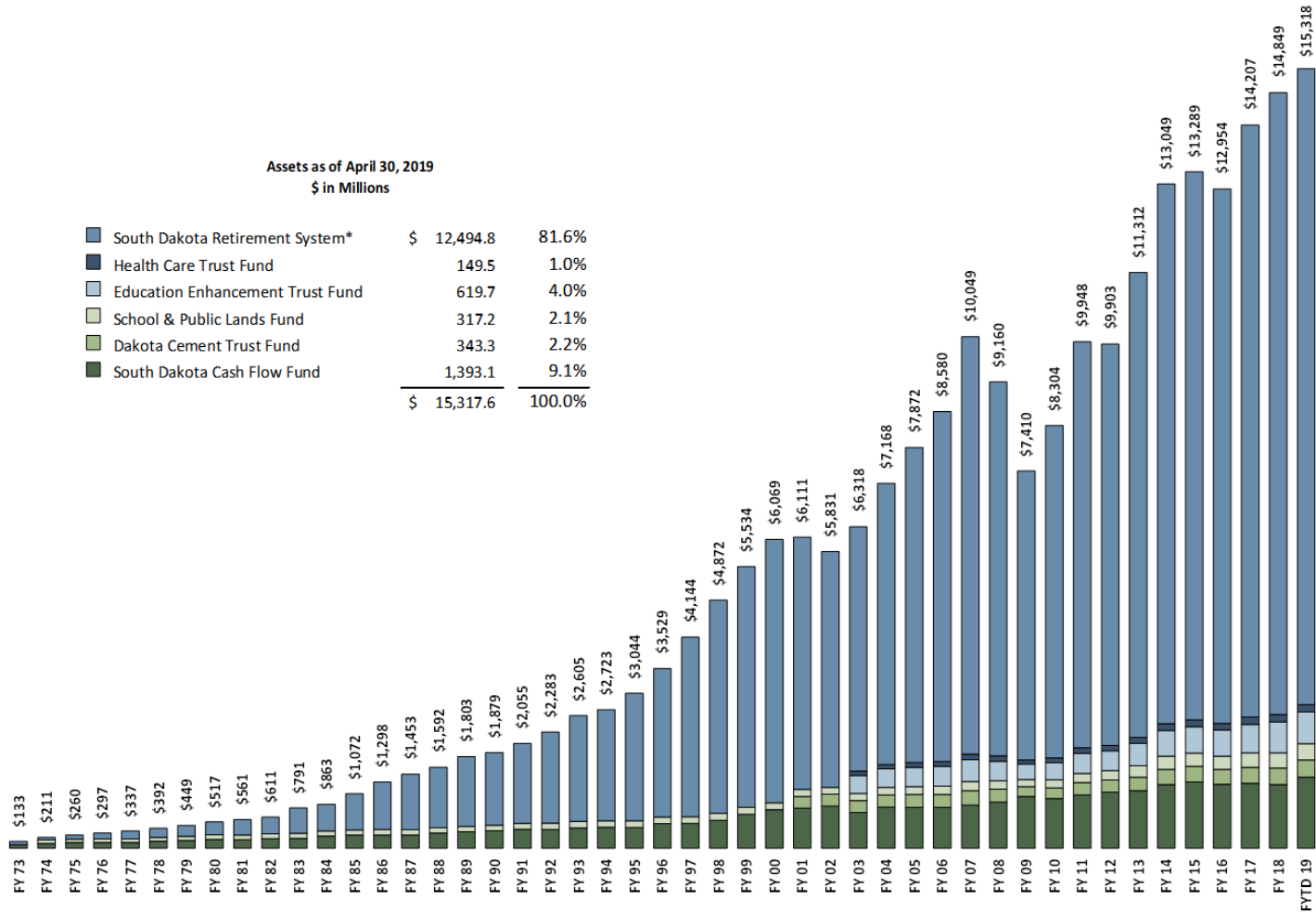
- Investment Officer FY 2020 Compensation

- Compensation Methodology

Assets

Assets as of April 30, 2019
\$ in Millions

South Dakota Retirement System*	\$ 12,494.8	81.6%
Health Care Trust Fund	149.5	1.0%
Education Enhancement Trust Fund	619.7	4.0%
School & Public Lands Fund	317.2	2.1%
Dakota Cement Trust Fund	343.3	2.2%
South Dakota Cash Flow Fund	1,393.1	9.1%
	<u>\$ 15,317.6</u>	<u>100.0%</u>



*The South Dakota Cement Plant Retirement Fund (CPRF) was consolidated into the South Dakota Retirement System (SDRS) on April 1, 2014, per SDCL 3-12-217. For purposes of this exhibit, CPRF Assets for Fiscal Years 1973 - 2013 are included with SDRS.

Trust Funds

As of 4/30/19 (unaudited)

Health Care Trust (established April 2001)

Principal as of 4/30/19	\$ 85,631,024	<u>Asset Allocation</u>	<u>Current</u>	<u>FY 19</u> <u>Benchmark</u>
Principal as of 4/30/19 adjusted for inflation	\$ 120,526,910	Global & Private Equity	39%	51%
Fair Value (FV) as of 4/30/19	\$ 149,543,137	Real Estate	7%	10%
Difference - FV less principal	\$ 63,912,113	Fixed Income-IG	20%	30%
Difference - FV less infl. adj. prin.	\$ 29,016,227	Fixed Income-HY	4%	7%
Fiscal year to date return	5.52%	HY RE Debt	6%	0%
Longterm expected mean return	5.96%	Money Market	<u>23%</u>	<u>2%</u>
Payout of 4% plus expected inflation of 3%	7.00%	Total	100%	100%
Expected return cushion/shortfall	-1.04%			
Distribution for FY 20 (July 1, 2019)	5,520,072			
Distribution for FY 19 (July 2, 2018)	5,414,857			

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.

Education Enhancement Trust (established April 2001)

Principal as of 4/30/19	\$ 403,606,621	<u>Asset Allocation</u>	<u>Current</u>	<u>FY 19</u> <u>Benchmark</u>
Principal as of 4/30/19 adjusted for inflation	\$ 541,749,192	Global & Private Equity	41%	51%
Fair Value (FV) as of 4/30/19	\$ 619,650,988	Real Estate	7%	10%
Difference - FV less principal	\$ 216,044,367	Fixed Income-IG	9%	20%
Difference - FV less infl. adj. prin.	\$ 77,901,796	Fixed Income-tax ex	8%	10%
Fiscal year to date return	5.33%	Fixed Income-HY	4%	7%
Longterm expected return (lower due to tax-exempts)	5.92%	HY RE Debt	5%	0%
Payout of 4% plus expected inflation of 3%	7.00%	Money Market	<u>27%</u>	<u>2%</u>
Expected return cushion/shortfall	-1.08%	Total	100%	100%
Distribution for FY 20 (July 1, 2019)	21,334,593			
Distribution for FY 19 (July 2, 2018)	20,430,222			

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.

Trust Funds

As of 4/30/19 (unaudited)

Dakota Cement Trust (established April 2001)

			FY 19	
		<u>Asset Allocation</u>	<u>Current</u>	<u>Benchmark</u>
Principal as of 4/30/19	\$ 238,000,000	Global & Private Equity	39%	51%
Principal as of 4/30/19 adjusted for inflation	\$ 343,212,692	Real Estate	7%	10%
Fair Value (FV) as of 4/30/19	\$ 343,286,155	Fixed Income-IG	19%	30%
Difference - FV less principal	\$ 105,286,155	Fixed Income-HY	4%	7%
Difference - FV less infl. adj. principal	\$ 73,463	HY RE Debt	6%	0%
		Money Market	<u>24%</u>	<u>2%</u>
Fiscal year to date return	5.48%	Total	100%	100%
Longterm expected mean return	5.96%			
Payout of 4% plus expected inflation of 3%	7.00%			
Expected return cushion/shortfall	-1.04%			
Distribution for FY 19 (June 2019 to GF)	12,682,857			
Distribution for FY 18 (June 2018 to GF)	12,442,947			

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.

School & Public Lands

Inflation protection mandated by Constitutional Amendment -

(payout is reduced by inflation to extent inflation not offset by realized net gains)

			FY 19	
		<u>Asset Allocation</u>	<u>Current</u>	<u>Benchmark</u>
Fair Value as of 4/30/19	\$ 317,148,884	Global & Private Equity	40%	51%
		Real Estate	7%	10%
Fiscal year to date return	5.39%	Fixed Income-IG	17%	30%
Longterm expected mean return	5.96%	Fixed Income-HY	4%	7%
		HY RE Debt	6%	0%
Distribution for FY 19 K-12 (2/7/19)	12,112,218	Money Market	<u>27%</u>	<u>2%</u>
Distribution for FY 19 Board of Regents (6/11/19)	<u>2,290,000</u> est	Total	100%	100%
TOTAL	14,402,218			

Investment Council Role

- Select State Investment Officer
- Maintain a bottom-line oriented non-political environment
- Establish investment policy
 - Benchmarks and asset allocation guidelines
 - Oversight of investment methodology
 - Oversight of external partners
- Monitor compliance
 - Audit committee
 - Conflict of Interest Policy
- Approve annual budget and long-term plan (then goes to Executive Board, Governor, Appropriations)
 - Compensation committee approves compensation framework
 - Recommend Investment Officer compensation to Executive Board of the LRC

Importance of Council Selection

- Council patience and steadfast support is essential to allow the investment team to maintain a long-term focus and persevere through difficult periods
- Essential to select Council members that believe in a long-term approach
- Council success also depends on patience of all South Dakota policy-makers
- Selection of highly respected Council members can help inspire confidence in the Council's oversight of the investment team and budget

Investment Officer FY 2020 Compensation

Investment Council Motion 4/18/19

Recommendation to LRC Executive Board for Investment Officer FY2020 Compensation:

LOREN KOEPELLO MOVED, SECONDED BY PAUL BISSON, THAT THE INVESTMENT COUNCIL RECOMMEND TO THE LRC EXECUTIVE BOARD THAT TOTAL COMPENSATION FOR THE STATE INVESTMENT OFFICER PAYABLE IN FY 2020 BE COMPRISED OF FY 2019 BASE SALARY INCREASED BY STATE SALARY POLICY PLUS 1.75% AND CONTINUATION OF THE INVESTMENT PERFORMANCE INCENTIVE PLAN, WITH ANY EARNED INCENTIVE TO BE PAID FOLLOWING COMPLETION OF THE AUDIT. MOTION PASSED UNANIMOUSLY.

Compensation Overview

- Long-term results have significantly exceeded benchmarks
 - Added ~30% beyond benchmark to SDRS assets in the past 20 years
- Continued success dependent on high caliber team
 - Internal management & internal research aids performance and cost efficiency
- 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
 - Incentives for added value motivate performance and aid retention of successful staff
- Compensation plan updated every 3-4 years, currently in process
 - 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%) including LT and stretch
 - Incentives expected to average 80% with continuation of historical performance

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 after 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
 - No way to know for sure how large discounts can be without 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 impacts sensitivity to financial security
 - Discounts for top SDIC performers may be much larger as industry pay for top quartile performers can be double the median