

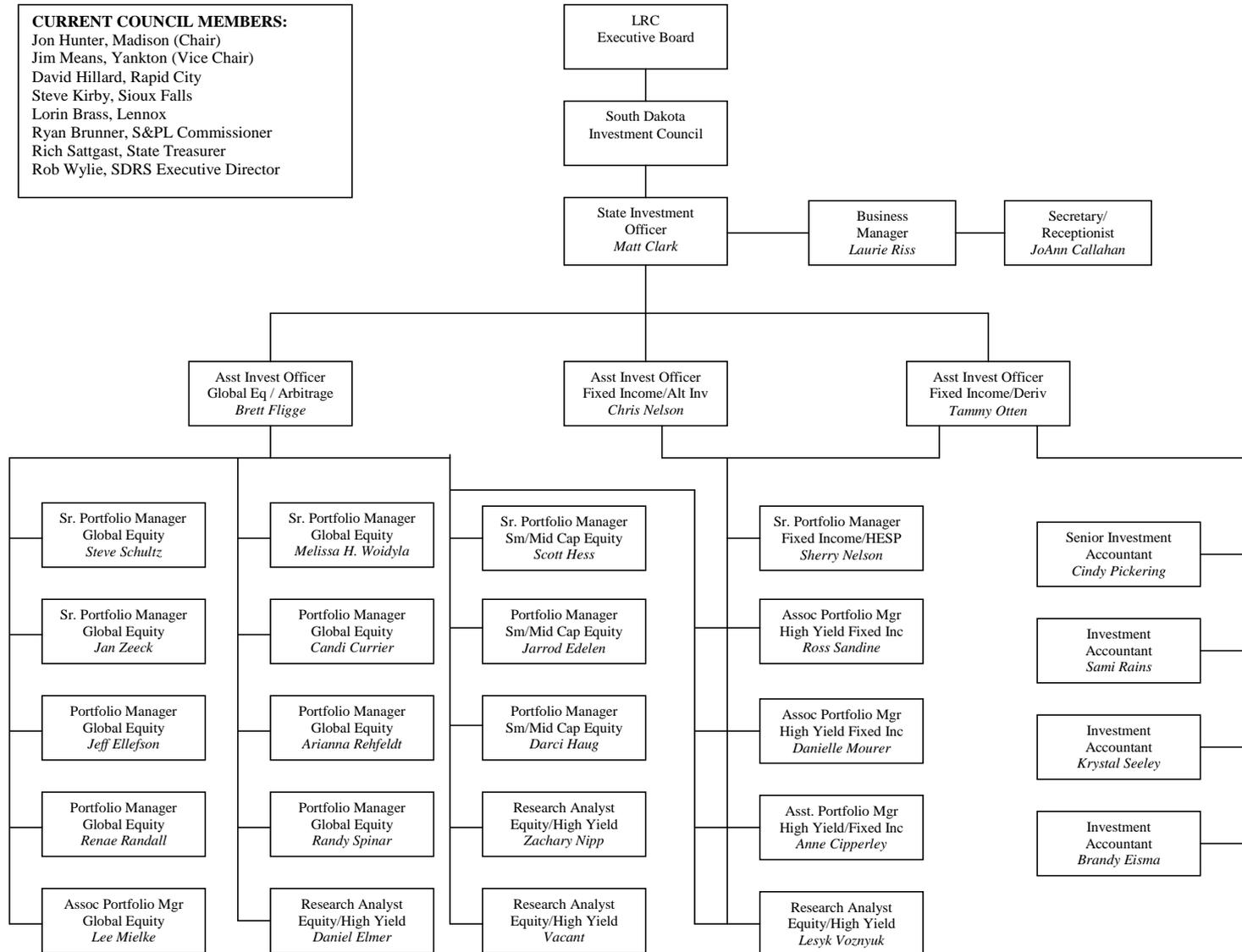
SDIC FY 2016 Budget & Investment Performance Presented to Appropriations Committee February 5, 2015

- Organization Chart
- Assets
- Cost Efficiency
- Long Term Plan
- Budget Process & Funding Sources
- Compensation Overview
- FY 2014 Budget Review
- FY 2016 Budget Request
- Investment Performance
- Trust Fund Summaries
- Appendix

Organization Chart

CURRENT COUNCIL MEMBERS:

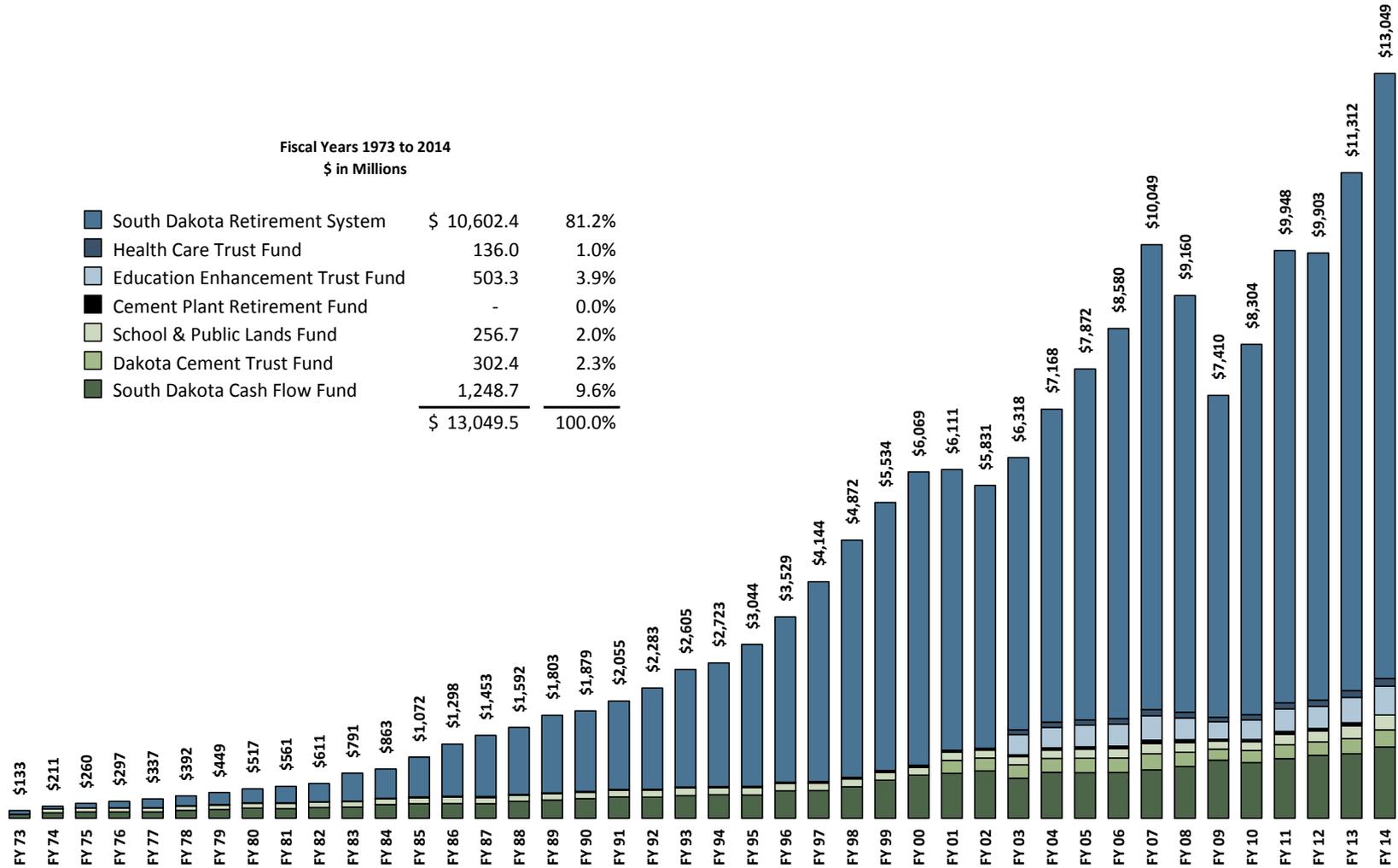
Jon Hunter, Madison (Chair)
 Jim Means, Yankton (Vice Chair)
 David Hillard, Rapid City
 Steve Kirby, Sioux Falls
 Lorin Brass, Lennox
 Ryan Brunner, S&PL Commissioner
 Rich Sattgast, State Treasurer
 Rob Wylie, SDRS Executive Director



Assets

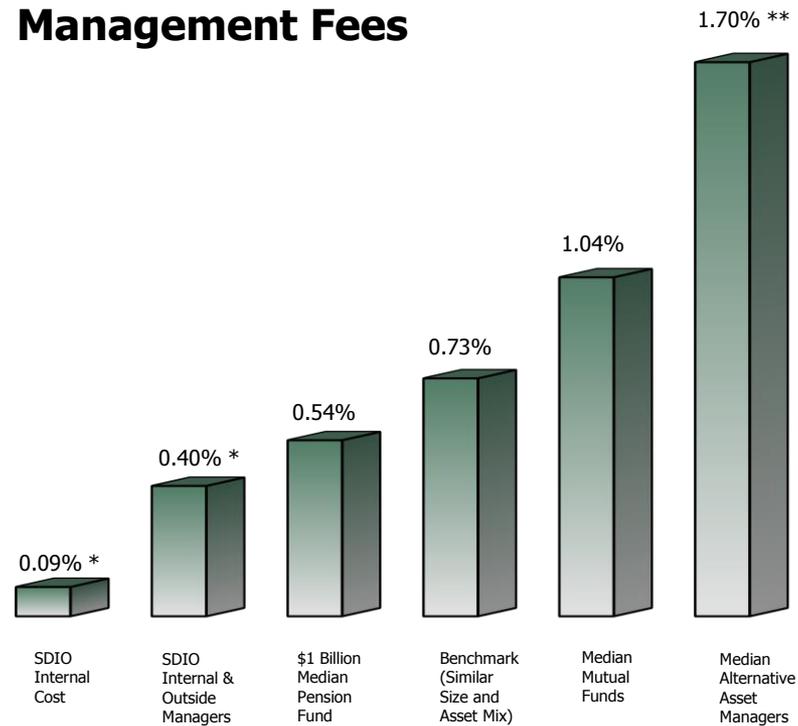
Fiscal Years 1973 to 2014
\$ in Millions

South Dakota Retirement System	\$ 10,602.4	81.2%
Health Care Trust Fund	136.0	1.0%
Education Enhancement Trust Fund	503.3	3.9%
Cement Plant Retirement Fund	-	0.0%
School & Public Lands Fund	256.7	2.0%
Dakota Cement Trust Fund	302.4	2.3%
South Dakota Cash Flow Fund	1,248.7	9.6%
	<hr/>	
	\$ 13,049.5	100.0%



Cost Efficiency

Management Fees



Difference between SDIC cost of .40% and benchmark cost of .73% is \$43 million per year

* SDIC projected expenses for FY 2016 using adjusted assets and expected average performance incentives

** Plus 20% profit participation after preferred return

Long-Term Plan

- Developed Plan in 1987 – has helped guide operations for 27 years
- Recommended by Appropriations Committee and Executive Board
- Key to development and retention of high-quality internal investment team

Long Term Plan Executive Summary

Projected LTP Budget

	<u>FY 2016</u>	<u>FY 2021</u>	<u>FY 2026</u>
INVESTMENT OFFICE BUDGET			
Personal Services			
Number of Employees	32.25	34.25	34.25
Base Compensation - Total Staff	4,900,887	6,823,768	8,586,546
Intern, Council members, Longevity	28,673	34,221	38,418
Flexibility funds-Retirements & Resignations	148,061	171,643	198,982
Investment Incentive Maximum	8,034,521	11,940,847	14,978,995
Benefits	2,077,124	2,945,413	3,664,528
Total Personal Services	15,189,266	21,915,894	27,467,468
Operating Expenses			
Contractual Services	1,599,548	1,885,462	2,155,654
Travel	85,000	103,558	120,052
Office Supplies & Postage	12,733	15,684	18,182
Capital Assets	47,192	57,159	66,262
Total Operating Expenses	1,744,473	2,061,862	2,360,151
Total Investment Council Budget	16,933,739	23,977,756	29,827,619
ASSET SUMMARY *			
Internal Assets	10,319,735,736	13,025,807,991	16,567,729,964
External Assets	3,934,042,905	4,965,639,510	6,315,874,959
Total Assets	14,253,778,641	17,991,447,502	22,883,604,923
EXPENSE SUMMARY			
Internal Expenses	16,933,739	23,977,756	29,827,619
External Manager Fees	43,274,472	54,622,035	69,474,625
Total Expenses	60,208,211	78,599,791	99,302,243
UNIT COST SUMMARY **			
Internal Expenses as % of Total Adjusted Assets	0.089%	0.098%	0.095%
Total Expenses as % of Total Adjusted Assets	0.393%	0.402%	0.399%

* Projections based on long-term assumed returns applied to 6/30/14 assets. Updated each June 30.

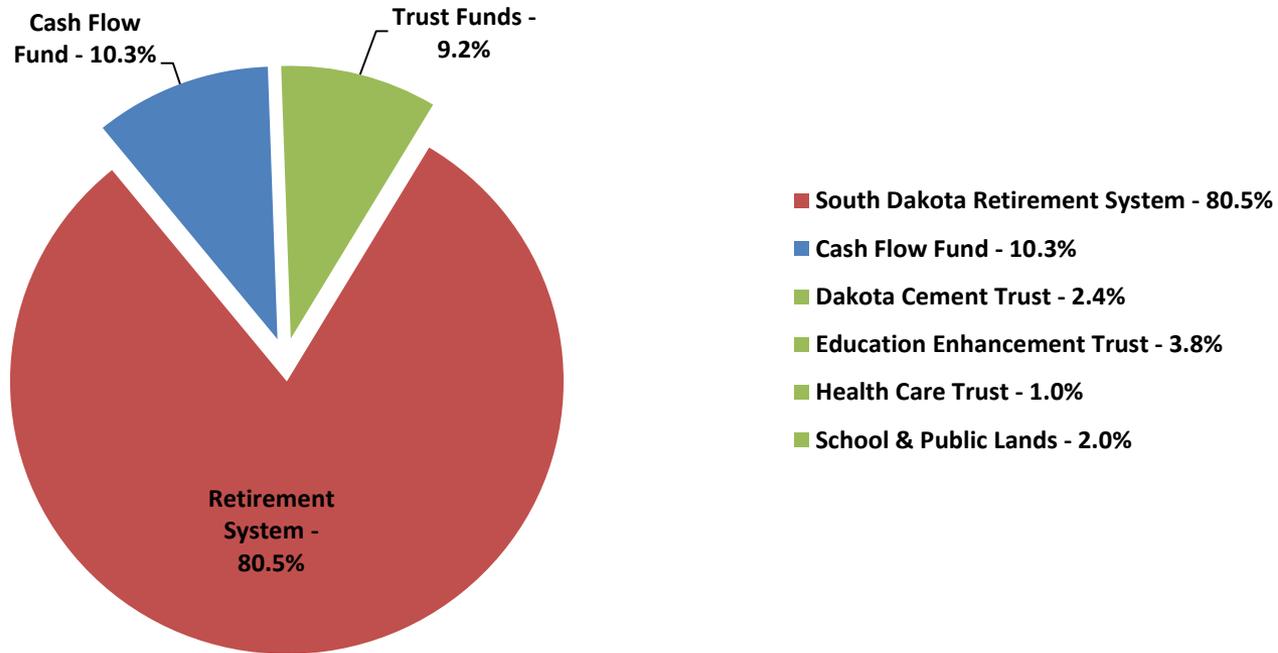
**Unit Cost Summary based on total assets adjusted to long-term value & expenses using assumed avg inv perf incentives

Note: FY 16 amounts differ from actual budget request. The LTP includes an assumed 3% salary policy

Budget Process & Funding Sources

- Budget approved by Investment Council before presenting to LRC Executive Board, then submitted to Bureau of Finance and Management for Governor's recommendation, with final approval by Appropriations Committee (SDCL 4-5-22)
- Budget deducted from assets under management, no general fund appropriations (SDCL 4-5-30)

Budget Funding Sources



Budget funded by assets under management
0% General Fund appropriation

Notes: S&PL share of SDIC expenses paid from earnings of Cash Flow Fund
CFF share of SDIC expenses would change if SB9 becomes law

Compensation Overview

- Long term results have significantly exceeded benchmarks
 - Added over 30% beyond benchmark to SDRS assets in the past 16 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
 - Expected internal costs under .1% even with increased incentives

FY14 Budget and Actual

Unexpended credited against FY15

	<u>Actual Exp</u> <u>FY 2014</u>	<u>Budget Rec'd</u> <u>FY 2014</u>	<u>Unexpended</u>
PERSONAL SERVICES			
Base Compensation			
Base Compensation - Investment Staff	3,343,512.56	3,661,973	318,460.44 *
Base Compensation - Accounting & Administrative	348,855.88	353,941	5,085.12
TOTAL STAFF	3,692,368.44	4,015,914	323,545.56
Retirement & resignation flexibility funds	0.00	140,431	140,431.00
Total Intern, Council, Longevity	26,156.00	35,582	9,426.00
Benefits	803,608.65	792,397	(11,211.65)
Total Base Compensation	4,522,133.09	4,984,324	462,190.91
Investment Performance Incentives			
Maximum Potential Investment Perf Incentive	2,813,172.93	3,261,124	447,951.07
Benefits	338,218.96	448,582	110,363.04
Total Investment Performance Incentives	3,151,391.89	3,709,706	558,314.11
Total Personal Services	7,673,524.98	8,694,030	1,020,505.02
OPERATING EXPENSES			
Contractual Total (see appendix for further details)	1,228,596.41	1,434,815	206,218.59
Travel	70,870.91	85,000	14,129.09
Office Supplies & Postage	8,566.85	12,733	4,166.15
Capital Assets	46,338.47	48,500	2,161.53
Total Operating Expenses	1,354,372.64	1,581,048	226,675.36
TOTAL BUDGET	9,027,897.62	10,275,078	1,247,180.38

* Includes \$51,231 Allianz reimbursement & unused compensation due to turnover

FY16 Budget Request Summary

	<u>Received FY 2015</u>	<u>Request FY 2016</u>	<u>% Change</u>
PERSONAL SERVICES			
Base Compensation			
Base Compensation - Investment Staff	4,017,261	4,373,255	8.86%
Base Compensation - Accounting, Admin & Longevity	392,595	395,623	0.77%
TOTAL STAFF - FULL TIME	4,409,856	4,768,878	8.14%
Staff Attorney - Part Time	0	30,108	new
Interns & Investment Council	28,011	28,673	2.36%
Retirement & resignation flexibility funds	148,061	148,061	0.00%
Benefits	868,082	950,143	9.45%
Total Base Compensation	5,454,010	5,925,863	8.65%
Investment Performance Incentives			
Maximum Potential Investment Perf Incentive	7,323,946	8,034,522	9.70%
Benefits	1,022,536	1,108,764	8.43%
Total Investment Performance Incentives	8,346,482	9,143,286	9.55%
Total Personal Services	13,800,492	15,069,149	9.19%
OPERATING EXPENSES			
Contractual Total (see next page for further details)	1,557,693	1,599,548	2.69%
Travel	85,000	85,000	0.00%
Office Supplies & Postage	12,733	12,733	0.00%
Capital Assets	43,000	47,192	9.75%
Total Operating Expenses	1,698,426	1,744,473	2.71%
TOTAL BUDGET	15,498,918	16,813,622	8.48%
UNIT COST SUMMARY *			
Internal Expenses as % of Total Adjusted Assets	0.086%	0.089%	
Total Expenses as % of Total Adjusted Assets	0.389%	0.393%	

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

FY16 Budget Request

Contractual services detail

	<u>Received</u> <u>FY 2015</u>	<u>Request</u> <u>FY 2016</u>	<u>% Change</u>
CONTRACTUAL SERVICES			
Investment Services			
Consulting Services	30,000	30,000	0.00%
Investment Accounting, Performance Benchmarking	191,000	181,000	-5.24%
Investment Databases, Newsfeeds & Quote Fees	435,189	471,765	8.40%
Investment Research Services	254,232	256,782	1.00%
Flexibility - From Brokerage to Independent Research	83,139	83,139	0.00%
Total Investment Services (see Appendix for further details)	<u>993,560</u>	<u>1,022,686</u>	<u>2.93%</u>
Administrative Expenses			
Office Rent	115,148	120,554	4.69%
Bond/Liability Insurance	7,410	7,800	5.26%
Telephone	10,000	12,000	20.00%
Office Equip Rental/Maintenance	6,000	6,000	0.00%
Bureau of Info & Telecommunications (BIT)	48,028	50,430	5.00%
State Central Services	9,513	10,544	10.84%
Legislative Audit	50,000	51,500	3.00%
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%
Total Administrative Expenses	<u>564,133</u>	<u>576,862</u>	<u>2.26%</u>
TOTAL CONTRACTUAL SERVICES	<u>1,557,693</u>	<u>1,599,548</u>	<u>2.69%</u>

Investment Performance

Returns vs. Benchmarks

	<u>FY 2014</u>	<u>4 Years Annualized FY 11 – 14</u>	<u>10 Years Annualized FY 05 – 14</u>
▪ SDRS Total Fund	18.90%	16.19%	9.37%
▪ Capital Market Benchmark	17.49%	13.33%	7.47%
Added Value	1.41%	2.86%	1.90%
▪ State Fund Universe	16.87%	12.92%	7.41%
Added Value	2.03%	3.27%	1.96%
▪ SDRS Beginning FY14 Assets		\$ 9.08 billion	
▪ SDRS Ending 6/30/14 Assets		\$ 10.60 billion	

Investment Performance

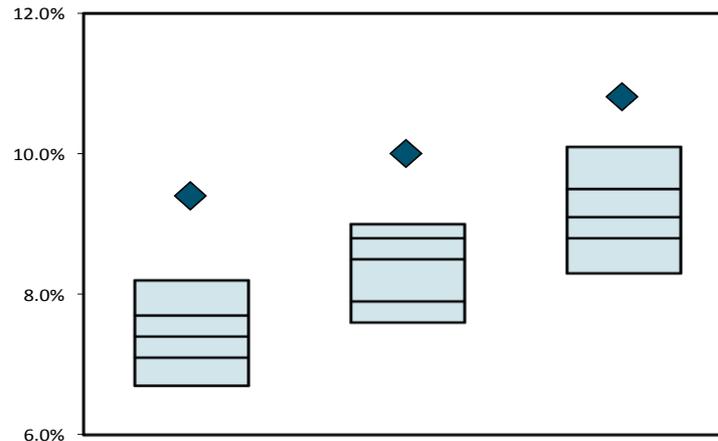
Earnings vs. Benchmarks

- Total SDRS dollars earned Fiscal Year 2014 \$1.73 billion
- Total SDRS dollars earned last 4 years \$5.03 billion
- Total SDRS dollars earned last 10 years \$6.88 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	\$128 million	\$897 million	\$1.40 billion
○ vs. State Funds	\$184 million	\$1.06 billion	\$1.44 billion

State Fund Comparison

**STATE FUND UNIVERSE
ANNUALIZED RATES OF RETURN**

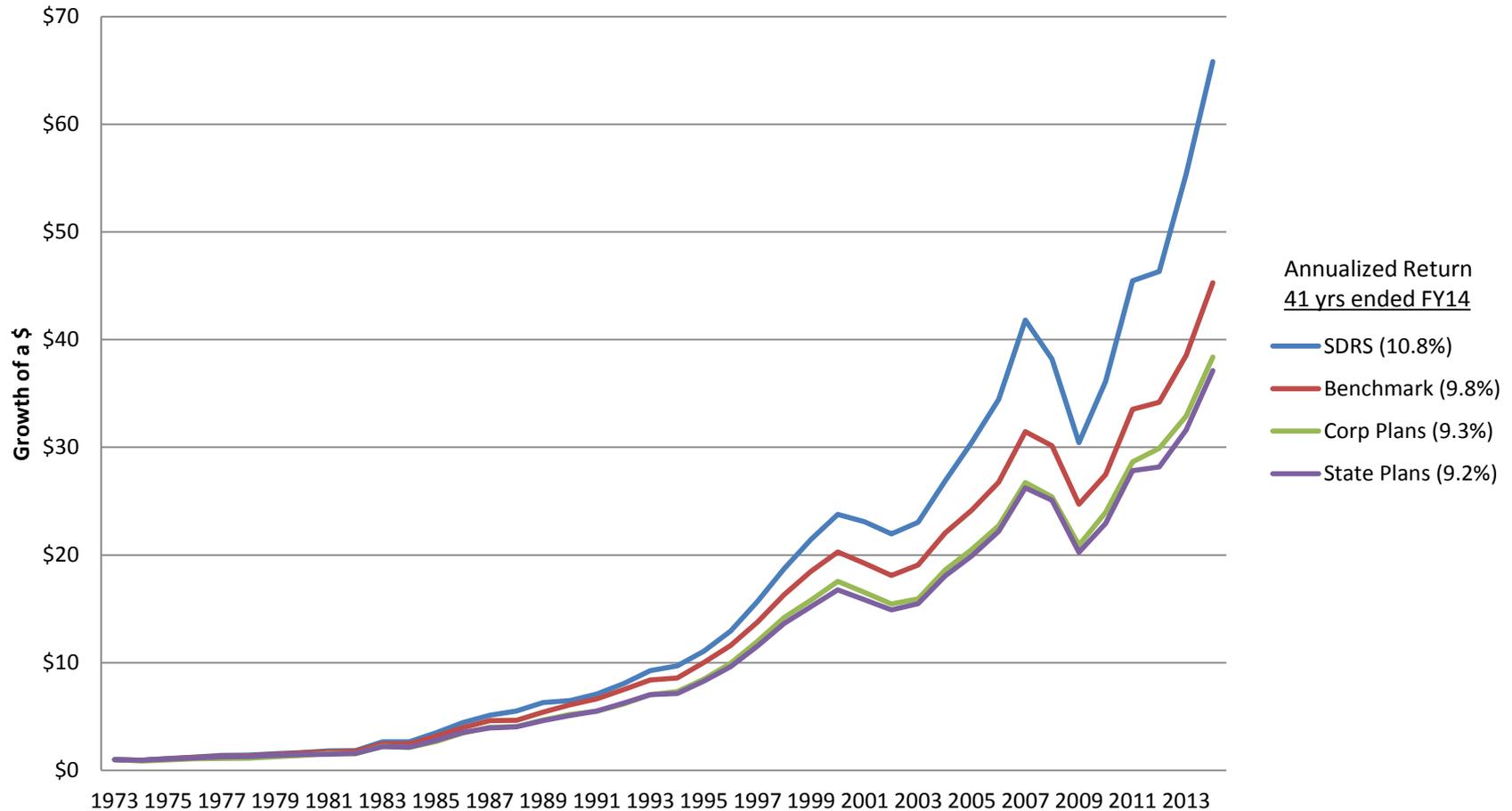


ANNUALIZED RETURNS

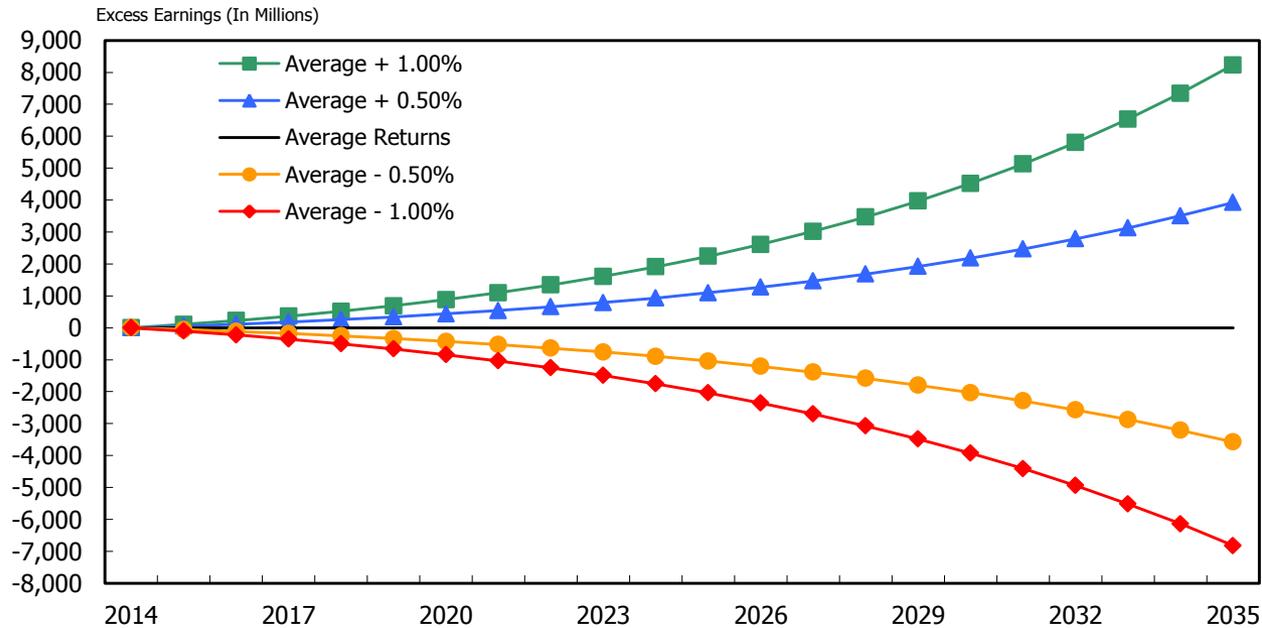
	10 Years <u>2005-2014</u>	20 Years <u>1995-2014</u>	41 Years <u>1974-2014</u>
10th %tile	8.2	9.0	10.1
25th %tile	7.7	8.8	9.5
Median	7.4	8.5	9.1
75th %tile	7.1	7.9	8.8
90th %tile	6.7	7.6	8.3
◆ SDRS Fund	9.4	10.0	10.8
SDRS %tile Rank	1	1	1

Superior returns add up over time

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



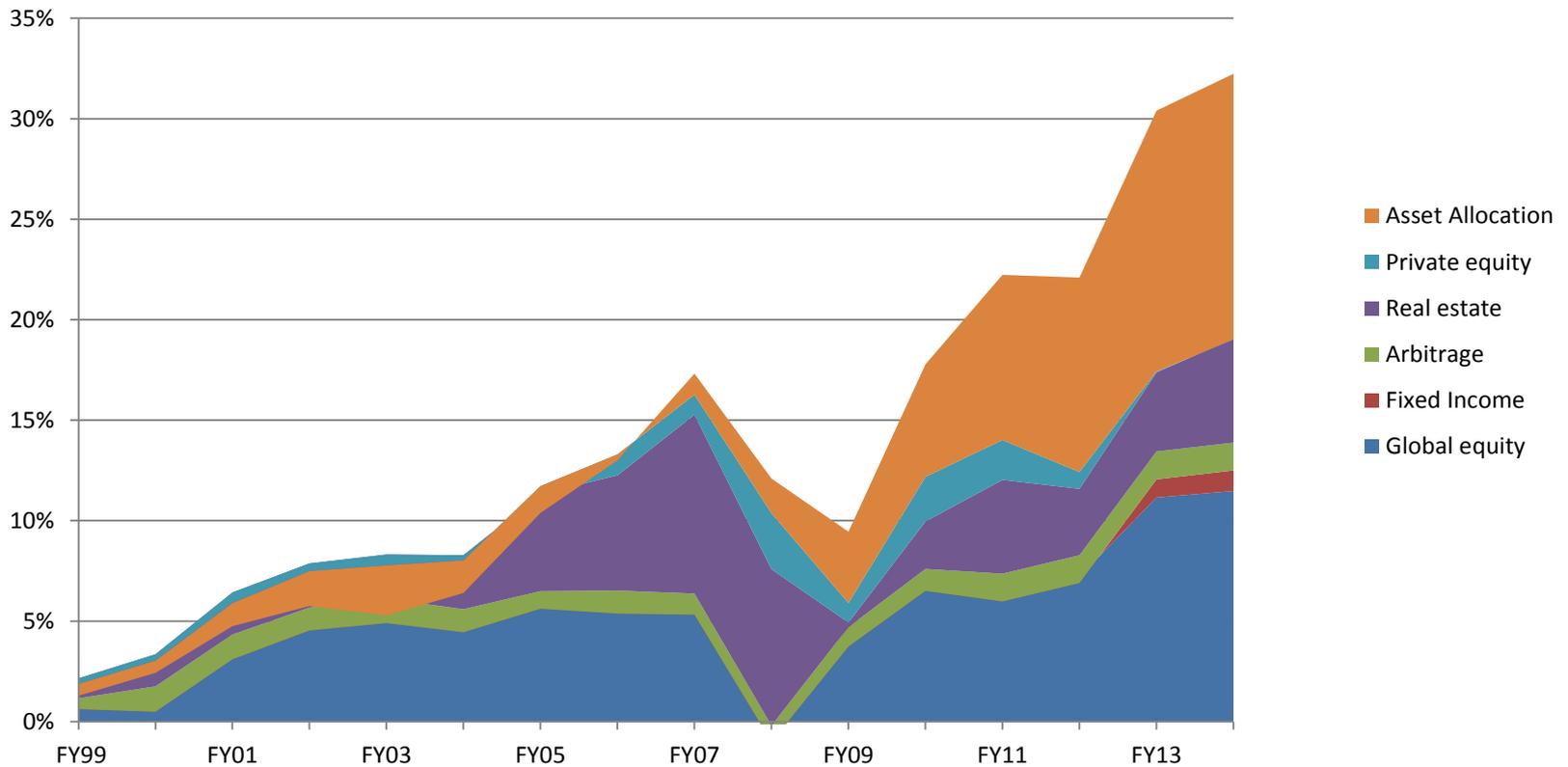
Potential Excess Earnings



- SDIC 41-year outperformance = 1% annualized vs. benchmark
- If 1% outperformance continues next 20 years = extra \$8 billion
- Outperformance of even half that amount = extra \$3.9 billion
- Underperformance of 1% = cost to retirement system of \$6.8 billion.

Many pistons contribute

Cumulative added value by source FY99 to FY14



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
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%
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%
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%
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%
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%
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%
Total	1.3%	1.1%	2.3%	1.0%	-0.4%	1.1%	3.7%	2.4%	3.8%	-4.5%	-2.4%	7.6%	3.8%	-0.1%	6.8%	1.4%

Trust Funds (preliminary estimates)

Health Care Trust (established April 2001)

Principal as of 12/31/14	\$ 85,631,024
Principal as of 12/31/14 adjusted for inflation	\$ 111,635,286
Fair Value (FV) as of 12/31/14	\$ 133,310,000
Difference - FV less principal	\$ 47,678,976
Difference - FV less infl. adj. prin.	\$ 21,674,714
Fiscal year to date return	1.30%
Longterm expected mean return	6.58%
Payout of 4% plus expected inflation of 3%	7.00%
Expected return cushion/shortfall	-0.42%

Distribution for FY 16 (July 1, 2015) EST	4,670,000
Distribution for FY 15 (July 1, 2014)	4,322,835

<u>Asset Allocation</u>	FY 15	
	<u>Current</u>	<u>Benchmark</u>
Global Equity	46%	53%
Private Equity	3%	0%
Real Estate	10%	10%
Fixed Income-IG	20%	26%
Fixed Income-HY	7%	7%
Fixed Income-Tips	4%	2%
Money Market	<u>12%</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

Education Enhancement Trust (established April 2001)

Principal as of 12/31/14	\$ 341,732,154
Principal as of 12/31/14 adjusted for inflation	\$ 442,458,912
Fair Value (FV) as of 12/31/14	\$ 493,040,000
Difference - FV less principal	\$ 151,307,846
Difference - FV less infl. adj. prin.	\$ 50,581,088
Fiscal year to date return	1.10%
Longterm expected return (lower due to tax exempts)	6.50%
Payout of 4% plus expected inflation of 3%	7.00%
Expected return cushion/shortfall	-0.50%

Distribution for FY 16 (July 1, 2015) EST	17,000,000
Distribution for FY 15 (July 1, 2014)	15,699,869

<u>Asset Allocation</u>	FY 15	
	<u>Current</u>	<u>Benchmark</u>
Global Equity	46%	53%
Private Equity	3%	0%
Real Estate	10%	10%
Fixed Income-IG	10%	16%
Fixed Income-tax ex	10%	10%
Fixed Income-HY	6%	7%
Fixed Income-Tips	3%	2%
Money Market	<u>12%</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 (preliminary estimates)

Dakota Cement Trust (established April 2001)

Principal as of 12/31/14	\$ 238,000,000	<u>Asset Allocation</u>	<u>Current</u>	<u>FY 15 Benchmark</u>
Principal as of 12/31/14 adjusted for inflation	\$ 317,892,885	Global Equity	44%	53%
Fair Value (FV) as of 12/31/14	\$ 306,240,000	Private Equity	3%	0%
		Real Estate	10%	10%
Difference - FV less principal	\$ 68,240,000	Fixed Income-IG	20%	26%
Difference - FV less infl. adj. principal	\$ (11,652,885)	Fixed Income-HY	7%	7%
		Fixed Income-Tips	4%	2%
Fiscal year to date return	1.20%	Money Market	<u>13%</u>	<u>2%</u>
Longterm expected mean return	6.58%	Total	100%	100%
Payout of 4% plus expected inflation of 3%	7.00%			
Expected return cushion/shortfall	-0.42%			
Distribution for FY 15 EST (June 2015 to GF)	10,800,000			
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 12/31/14	\$ 263,140,000	<u>Asset Allocation</u>	<u>Current</u>	<u>FY 15 Benchmark</u>
		Global Equity	47%	53%
Fiscal year to date return	1.20%	Private Equity	3%	0%
Longterm expected mean return	6.58%	Real Estate	8%	10%
		Fixed Income-IG	19%	26%
Distribution for FY 14 K-12 (2/2/15)	9,969,231	Fixed Income-non-m	1%	
Distribution for FY 14 Board of Regents (6/16/14)	<u>2,043,790</u>	Fixed Income-HY	6%	7%
		Fixed Income-Tips	3%	2%
TOTAL	12,013,021	Money Market	<u>13%</u>	<u>2%</u>
		Total	100%	100%

Appendix

- Investment performance incentives
- Target discount rationale
- FY14 Budget and Actual – Contractual Services details
- FY16 Budget – Investment 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
 - No way to know for sure how large discounts can be without damaging team
 - Had difficulties in the past when discount got too close to 50%
 - Less opportunity than in past to design own approach may increase sensitivity
 - 30% discount believed large 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
 - Industry pay for top quartile performers can be double the median. SDIC performance is better than top quartile, discount versus top quartile is large

FY14 Budget and Actual

Contractual services detail

	Actual Exp <u>FY 2014</u>	Budget Rec'd <u>FY 2014</u>	<u>Unexpended</u>
CONTRACTUAL SERVICES			
Investment Services			
Consulting Services	0.00	30,000	30,000.00
Investment Accounting, Performance Benchmarking	90,014.53	94,000	3,985.47
Investment Databases, Newsfeeds & Quote Fees	403,244.95	415,213	11,968.05
Investment Research Services	212,985.84	247,572	34,586.16
Flexibility - From Brokerage to Independent Research	0.00	83,139	83,139.00
Total Investment Services	<u>706,245.32</u>	<u>869,924</u>	<u>163,678.68</u>
Administrative Expenses			
Office Rent	115,147.80	129,125	13,977.20
Bond/Liability Insurance	5,700.00	7,410	1,710.00
Telephone	16,161.97	10,000	(6,161.97)
Office Equip Rental/Maintenance	2,190.22	6,000	3,809.78
Bureau of Info & Telecommunications (BIT)	39,945.74	43,335	3,389.26
State Central Services	9,841.68	8,351	(1,490.68)
Legislative Audit	46,069.75	55,700	9,630.25
Attorney General's Office - Legal Services	17,445.00	17,970	525.00
Custodial Fees - Global	250,499.84	250,500	0.16
Seminars/Educational Programs	17,542.25	33,500	15,957.75
Business Publications	1,806.84	3,000	1,193.16
Total Administrative Expenses	<u>522,351.09</u>	<u>564,891</u>	<u>42,539.91</u>
TOTAL CONTRACTUAL SERVICES	<u>1,228,596.41</u>	<u>1,434,815</u>	<u>206,218.59</u>

FY16 Budget

Investment services detail

	Received FY 2015	Request FY 2016	% Change
<u>Investment Services-Detailed</u>			
Consulting Services			
Consulting/Comp Analysis/Asset Alloc/etc.	30,000	30,000	0.00%
Subtotal	30,000	30,000	0.00%
Investment Accounting, Performance, Benchmarking			
BNY/Mellon Performance & Risk Analysis	20,000	10,000	-50.00%
S&P 1200	12,000	12,000	0.00%
S&P 1000	2,000	2,000	0.00%
S&P USA	10,000	10,000	0.00%
Trade Order Mgmt System	85,000	85,000	0.00%
Portia	62,000	62,000	0.00%
Subtotal	191,000	181,000	-5.24%
Investment Databases, Newsfeeds & Quote Fees			
Bloomberg	112,800	122,311	8.43%
Factset	205,700	215,985	5.00%
Reuters Fundamental Index	28,580	45,360	58.71%
Quote Fees (incl. Bloomberg/Factset)	45,125	45,125	0.00%
Dow Jones News Service	42,984	42,984	0.00%
Subtotal	435,189	471,765	8.40%
Investment Research Services			
KDP High Yield	20,000	20,000	0.00%
Stone McCarthy	0	0	0.00%
Gimme Credit FI Research	25,000	25,000	0.00%
Citigroup Yield Book / BB Index	10,000	10,000	0.00%
Credit Sights	77,500	79,825	3.00%
Indie Research-Insider Score	26,525	26,525	0.00%
Morningstar Equity	75,000	75,000	0.00%
The Markets.com	15,692	15,692	0.00%
Value Line	4,515	4,740	4.98%
Global Purchasing Companies Research Calls	0	0	0.00%
Flexibility - From Brokerage to Independent Research	83,139	83,139	0.00%
Subtotal	337,371	339,921	0.76%
Total Contractual - Investment	993,560	1,022,686	2.93%