ANNUAL REPORT OF THE FUNDED STATUS OF THE SOUTH DAKOTA RETIREMENT SYSTEM TO THE GOVERNOR AND LEGISLATURE OF THE STATE OF SOUTH DAKOTA

JANUARY 2015

South Dakota Retirement System
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South Dakota Retirement System

January 13, 2015

To the Governor and the Legislature of the State of South Dakota

Re: Annual Report of the Funded Status of the South Dakota Retirement System

As SDRS celebrated its 40th anniversary, continuing strong investment returns during fiscal year 2014 allowed the SDRS Fair (Market) Value Funded Ratio to remain over 100 percent while mortality assumptions were significantly strengthened.

For fiscal year 2014, the SDRS Trust Fund, under the management of the South Dakota Investment Council, produced investment returns of 18.9 percent net of investment fees. The returns for the year exceeded the investment benchmark and generated over $1 billion in earnings above expectations. When 2014 results are released for all statewide plans, we anticipate that SDRS will remain among the best funded public plans nationally with a funded ratio approximately 25 percentage points higher than the averages for all statewide plans. This is more impressive considering that the SDRS investment return assumption is among the most conservative used by statewide plans. In addition, the SDRS Board of Trustees adopted new mortality assumptions effective for the June 30, 2014 actuarial valuation that are also among the most conservative assumptions in use by statewide plans.

For the second consecutive year, SDRS is fully funded on both a fair (market) value basis and an actuarial value basis at 107.3 percent and 100.0 percent, respectively. This exceptional achievement was realized as a result of the conservative oversight of the Board of Trustees, the outstanding long-term success of the South Dakota Investment Council, and the ongoing support of the Executive and Legislative branches of state government and the SDRS membership. SDRS continues to be one of the most financially sound public employee retirement systems in the nation and is well-positioned to confront challenges in the future.

During fiscal year 2014, the South Dakota Cement Plant Retirement Fund was merged into SDRS. Because of appropriations to fully fund the Cement Plant Retirement Fund, the merger had no adverse impact on the funded status of SDRS.

The enclosed information highlights the SDRS Mission Statement and provides an in-depth summary of the current funded status, investment and actuarial experience, comparative data, and initiatives of SDRS. Supplemental information is included in the appendices.

Throughout 2015, the SDRS Board of Trustees will continue to analyze risks and anticipated future experience, study long-term sustainability, and evaluate long-term benefit goals. SDRS remains fully committed to the fiscally responsible designs inherent in the SDRS hybrid defined benefit plan and strives to provide outstanding service to our membership at the lowest cost possible.

We welcome your comments and questions.

Sincerely,

Robert A. Wylie
Executive Director/Administrator

Elmer P. Brinkman
Chair of the Board of Trustees

SDRS MISSION STATEMENT

To plan, implement, and administer income replacement programs, and to encourage additional savings for retirement, all of which offer SDRS members and their families the resources and the opportunity to achieve financial security at retirement, death or disability by providing an outstanding, appropriate and equitable level of benefits.

The Board of Trustees believes this mission is achievable with the resources available in a progressive working environment, by sound and efficient management, through superior investment performance and by exercising the fiduciary responsibility associated with the proper stewardship of member assets.

LONG-TERM INCOME REPLACEMENT GOALS

SDRS INCOME REPLACEMENT GOAL:
Lifetime income replacement from SDRS resources of at least 55 percent of final average compensation for career employees in each membership class.

RECOMMENDED MEMBER TOTAL INCOME REPLACEMENT GOAL:
Lifetime income replacement of at least 85 percent of final average compensation, including income from SDRS, Social Security, and personal retirement savings of at least one time annual compensation at retirement.

FUNDING POLICY OBJECTIVES

The SDRS Board of Trustees' Funding Policy includes the following Funding Objectives:

- Funded Ratios of 100% or greater for the Fair (Market) Value Funded Ratio and 100% for the Actuarial Value Funded Ratio.
- Ratio of Fair Value of Assets to Actuarial Value of Assets that exceeds 100%, resulting in a Cushion.
- Maintaining a fully funded system with no Unfunded Liabilities.
- Statutorily fixed contributions that meet or exceed the Normal Cost, expenses and payment of Unfunded Liabilities over a period not to exceed 20 years when Unfunded Liabilities exist.

As of the June 30, 2014 actuarial valuation, SDRS continues to meet all of these objectives.

FUNDING AND ACTUARIAL METHOD CHANGES

During 2014, the SDRS Board of Trustees approved a change in the actuarial assumptions regarding mortality. The mortality assumption was revised to a fully generational application of the RP-2000 Mortality Tables using Scale BB. The use of fully generational tables means that SDRS liabilities reflect an estimate of all future mortality improvements expected to occur throughout the lifetimes of all current SDRS members. The change in mortality assumption increased the Actuarial Accrued Liabilities of SDRS by $604 million. The updated mortality assumption is one of the most conservative mortality assumptions used by statewide retirement systems.

As of June 30, 2014, a transfer of $599 million was made from the Cushion to the Actuarial Value of Assets in order to fund the net impact of the mortality assumption change and the changes to disability and certain survivor benefits that were adopted during the 2014 Legislative Session and will be effective July 1, 2015. As a result, the Actuarial Value Funded Ratio is 100% and meets the Funding Policy Objective, and the Risk Management Contribution, the amount by which statutorily required Employer and Member Contributions exceed the actuarially required contributions, will build the Cushion and Reserve for Funding Long-Term Benefit Goals (Reserve) to protect the System against future unfavorable experience.

SDRS FUNDED STATUS REPORT

JUNE 30, 2014 MEASURES OF ACTUARIAL SOUNDNESS

In the 2014 actuarial valuation, three important measures of actuarial soundness have been calculated in evaluating the actuarial soundness and funding progress of SDRS. They are the Funded Ratio, the Funding Period when the Unfunded Actuarial Accrued Liability is greater than $0, and the Risk Management Contribution when the Unfunded Actuarial Accrued Liability is equal to $0.

The Actuarial Accrued Liability (AAL) is the present value of all benefits currently being paid and expected to be paid in the future, to all members, less the present value of future Normal Cost contributions. The Actuarial Value Funded Ratio is equal to the Actuarial Value of Assets divided by the AAL. The Actuarial Value Funded Ratio is 100.0% as of June 30, 2014. The Fair (Market) Value Funded Ratio is equal to the Fair (Market) Value divided by the AAL. The Fair (Market) Value Funded Ratio is 107.3% as of June 30, 2014.

The Funding Period measures the length of time required to amortize Unfunded Actuarial Accrued Liabilities as well as pay the ongoing Normal Costs, interest charges, and expenses considering the fixed statutory contributions. A shorter Funding Period results in a more favorable actuarial measure. As of June 30, 2014, the Unfunded Actuarial Accrued Liability is $0 and no Funding Period is applicable.

The Risk Management Contribution is the amount that statutory contributions exceed the Normal Cost and amortization payment on the Unfunded Actuarial Accrued Liability. When it exists, the Risk Management Contribution will increase the Cushion and Reserve, thereby better protect SDRS against future unfavorable experience. For fiscal 2014, the Risk Management Contribution increased the Cushion and Reserve by $37.7 million. As a result of the mortality assumption change described

above, the Risk Management Contribution is expected to decrease to approximately $30 million for fiscal 2015.

The SDRS Actuarial Value Funded Ratio:

- Was 40% in 1973.
- Has been over 90% each year since 1988.
- Had consistently been over 95% since 1997.
- Dropped from 97% in 2008 to 92% in 2009 as a result of the significant asset losses suffered in 2008 and 2009 due to the Great Recession; however, asset gains in 2010 and 2011 and corrective actions in 2010 restored the Funded Ratio to over 95% in 2010 and 2011.
- Decreased to 93% due to the demographic and economic assumption changes in 2012.
- Increased to 100% due to the change in funding method in 2013.
- Remains at 100% in 2014

The SDRS Fair (Market) Value Funded Ratio:

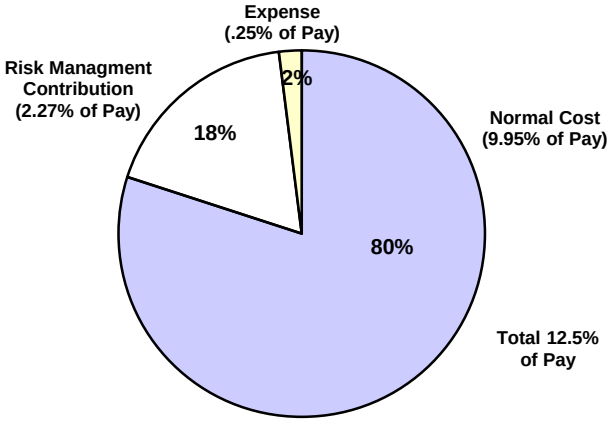
- Was 40% in 1973.
- Has been over 75% each year since 1984.
- Has been over 100% in 20 of the last 24 actuarial valuations.
- Decreased to 76% as a result of the significant asset losses suffered in 2008 and 2009 due to the Great Recession; however, asset gains in 2010, 2011, 2013 and 2014 and corrective actions in 2010 helped to increase the Funded Ratio to 107% as of June 30, 2014 despite significant increases in liabilities as a result of strengthened actuarial assumptions.

DISTRIBUTION OF FUNDING REQUIREMENTS

As a result of the change in funding method adopted by the SDRS Board of Trustees in fiscal 2013, SDRS has no Unfunded Actuarial Accrued Liability as of June 30, 2013 or June 30, 2014. Current statutorily required Employer and Member Contributions fund the Normal Cost and expenses of the system and provide a Risk Management Contribution that will build the Cushion and Reserve to protect the System against future unfavorable experience.

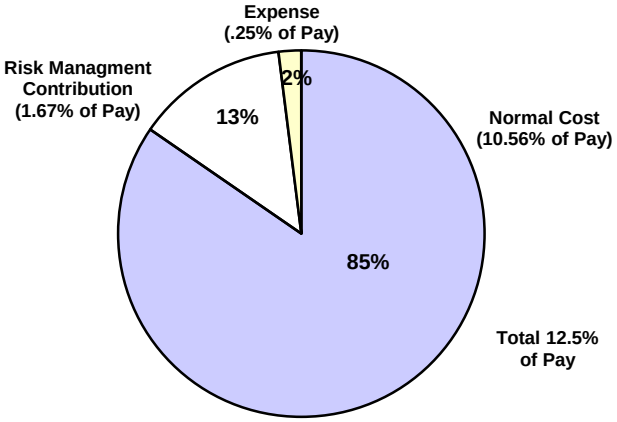
For fiscal year 2014, fixed statutory contributions were sufficient to pay the Normal Cost and expenses and provide a Risk Management Contribution of approximately 2.24% of pay to the Cushion and Reserve. For fiscal year 2015, fixed statutory contributions are expected to pay the Normal Cost and expenses and provide a Risk Management Contribution of approximately 1.67% of pay to the cushion and Reserve.

June 30, 2013



Funding Policy Contribution Rate: 10.2% of Pay
Total Anticipated Contribution Rate: 12.5% of Pay

June 30, 2014



Funding Policy Contribution Rate: 10.8% of Pay
Total Anticipated Contribution Rate: 12.5% of Pay

FISCAL YEAR 2014 SDRS EXPERIENCE

The SDRS money-weighted investment return based on the Fair (Market) Value of Assets was 18.9% after investment expense (also 18.9% on a time-weighted basis after investment expense). This return was significantly more than the assumed annual rate of return of 7.25%, resulting in an actuarial investment gain of $1,067M.

Actual Investment Return	$ 1,696M
Less Expected Return	(628)M
Actuarial Investment Gain/(Loss)[1]	$ 1,067M

All SDRS investment gains and liability gains and losses are allocated to the Reserve for Funding of Long-Term Benefit Goals over five years. SDRS investment losses are allocated to the Reserve immediately.

[1] Sum adjusted by $1 million due to rounding

FUNDED STATUS COMPARISONS

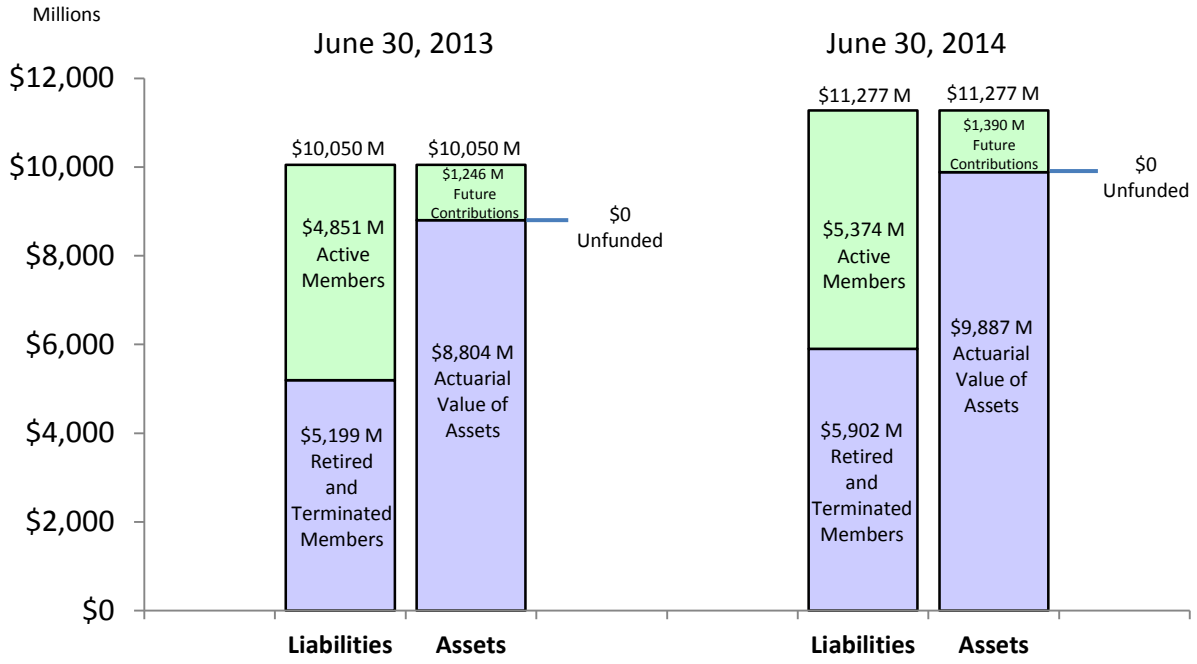
The long-term experience of SDRS has been very favorable, resulting in a funded status that exceeds virtually all other statewide public retirement systems.

	June 30, 2013		June 30, 2014	
	SDRS	Average[2]	SDRS	Average[2]
Funded Ratio (Actuarial Value of Assets)	100%	72%	100%	72%
Funded Ratio (Fair Value of Assets)	103%	73%	107%	81%

[2] 2013 averages from Wilshire Associates State Retirement Plan Funding Report for statewide public systems. 2014 averages estimated by Buck Consultants.

SDRS LIABILITIES AND RESOURCES

Current SDRS members are projected to receive future benefits from SDRS that have a present value of $11.3B. Of that amount, 52% is attributed to current retirees and terminated vested members and 48% is attributed to current active members. SDRS has existing assets of $9.9B at Actuarial Value and also $10.6B at Fair (Market) Value to offset those future costs.



The Unfunded Actuarial Accrued Liability was $0 at June 30, 2013 and remains at $0 at June 30, 2014. The changes in mortality assumptions increased both the Actuarial Accrued Liability and the Normal Cost rate. The fixed statutory contributions are sufficient to pay the Normal Cost (the cost of benefits accruing during the current year) and expenses and will contribute to the Risk Management Contribution to build the Cushion and Reserve. The Risk Management Contribution was approximately 2.24% of pay for fiscal year 2014 and is anticipated to be approximately 1.67% of pay for fiscal year 2015.

The volatile investment climate over the last several years has impacted the SDRS Cushion, which has varied from $2.1 billion in 2007 to negative $1.1 billion in 2009. As of June 30, 2014, $599 million was transferred from the Cushion to the Actuarial Value of Assets to fund the net increase in Actuarial Accrued Liability for the change in mortality assumption and the change in disability and certain survivor benefit provisions in accordance with the Board of Trustees' Funding Policy Objectives. As of June 30, 2014, the Cushion is $720 million.

FUNDED STATUS SUMMARY

The prudent management of SDRS combined with the outstanding investment performance of recent years has allowed SDRS to emerge from the Great Recession in a very strong position. As of June 30, 2014, the Actuarial Value Funded Ratio is 100.0% and the Fair (Market) Value Funded Ratio is 107.3%. In addition, because the Unfunded Actuarial Accrued Liability is $0, statutorily fixed Member and Employer Contributions are sufficient to fund the Normal Cost and expenses of the System and provide the Risk Management Contribution that will build the Cushion and Reserve to protect the System against future unfavorable experience. If future adverse experience generates a new Unfunded Actuarial Accrued Liability, the Risk Management Contribution will be available to amortize the Unfunded Liability.

This is particularly remarkable considering the Board of Trustees has adopted actuarial assumption changes in recent years that have increased the Actuarial Accrued Liability by approximately $870 million. SDRS's actuarial assumptions are among the most conservative in use by statewide plans.

With a Fair (Market) Value Funded Ratio of 107.3% and a Fair (Market) Value of Assets of $10.6 billion, SDRS remains in actuarial balance and is a financially solid retirement system.

SDRS INITIATIVES

During fiscal year 2014, SDRS and the Board of Trustees celebrated its 40th anniversary. From consolidation in 1974, countless Trustees, Investment Council members, staff and System members have worked tirelessly to ensure the ongoing success of SDRS. SDRS was recognized this past fiscal year by numerous organizations as a well-funded, efficient model statewide retirement system. Such success is only possible with the on-going dedication of all SDRS stakeholders.

During fiscal year 2014, the Board of Trustees continued its comprehensive review of SDRS including:

- Consideration of long-term benefit goals and fiscally sustainable benefit designs
- Comprehensive review of economic and demographic actuarial assumptions
- Long-term modeling of asset and liability experience under anticipated as well as unanticipated conditions
- Analysis and assessment of risks facing SDRS and its stakeholders

The reviews of recent investment performance, actuarial assumptions, and anticipated asset and liability experience resulted in significant changes to the actuarial assumptions regarding mortality to more accurately reflect increasing longevity. The review of benefit designs led to legislation enacted

in 2014 and effective July 1, 2015 regarding disability benefits and certain survivor benefits. The consideration of long-term benefit goals, fiscally sustainable benefit designs, and the analysis of risks facing SDRS and its stakeholders will continue in 2015.

SDRS 2015 LEGISLATION

The SDRS Board of Trustees will submit the following bills for consideration during the 2015 legislative session:

- HB 1007: An Act to revise and update certain provisions relating to the South Dakota Retirement System.
- HB 1008: An Act to provide for a consistent refund methodology for members of the South Dakota Retirement System and their beneficiaries.
- HB 1009: An Act to limit the recovery of certain overpayments made by the South Dakota Retirement System.
- HB 1010: An Act to revise certain provisions relating to disability and surviving spouse benefits for members of the South Dakota Retirement System.
- HB 1011: An Act to provide for automatic increases in the accounts of automatically-enrolled participants of the deferred compensation plan of the South Dakota Retirement System.

Appendix A

SDRS BENEFITS

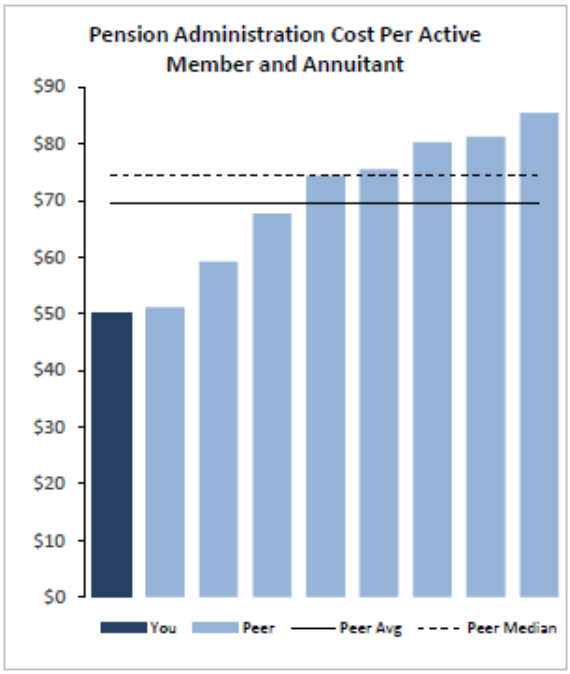
The following exhibit presents a schedule of the annualized benefits payable as of July 1, 2014, by SDRS on a county-by-county basis.

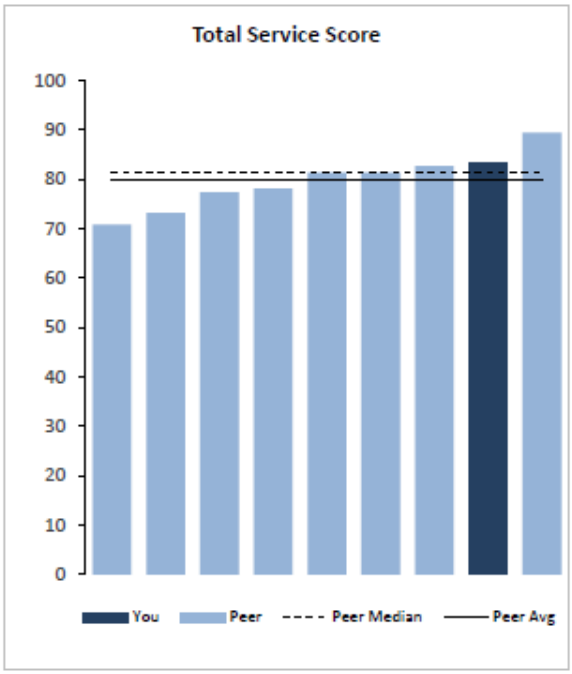
County	Annual Benefits	County	Annual Benefits	County	Annual Benefits
Aurora	$ 1,483,592	Fall River	$ 3,356,216	McPherson	$ 761,578
Beadle	$ 8,053,370	Faulk	$ 1,284,968	Meade	$ 8,998,384
Bennett	$ 573,216	Grant	$ 2,770,280	Mellette	$ 514,838
Bon Homme	$ 4,056,139	Gregory	$ 1,978,994	Miner	$ 1,140,713
Brookings	$ 29,146,218	Haakon	$ 612,850	Minnehaha	$ 64,155,206
Brown	$ 19,735,576	Hamlin	$ 2,139,105	Moody	$ 2,351,951
Brule	$ 1,939,914	Hand	$ 1,453,008	Pennington	$ 55,458,025
Buffalo	$ 29,643	Hanson	$ 623,802	Perkins	$ 1,166,369
Butte	$ 3,775,563	Harding	$ 322,297	Potter	$ 1,477,959
Campbell	$ 751,394	Hughes	$ 29,486,383	Roberts	$ 3,367,792
Charles Mix	$ 3,773,304	Hutchinson	$ 3,536,672	Sanborn	$ 986,585
Clark	$ 1,522,384	Hyde	$ 531,692	Shannon	$ 244,254
Clay	$ 12,990,410	Jackson	$ 834,913	Spink	$ 5,301,195
Codington	$ 13,961,709	Jerauld	$ 736,684	Stanley	$ 3,650,783
Corson	$ 559,946	Jones	$ 544,140	Sully	$ 601,877
Custer	$ 5,072,398	Kingsbury	$ 2,260,811	Todd	$ 1,044,475
Davison	$ 9,729,207	Lake	$ 7,191,062	Tripp	$ 2,614,887
Day	$ 3,041,712	Lawrence	$ 15,401,214	Turner	$ 2,891,632
Deuel	$ 1,242,341	Lincoln	$ 5,270,786	Union	$ 4,808,317
Dewey	$ 1,088,577	Lyman	$ 1,290,551	Walworth	$ 3,432,440
Douglas	$ 1,170,682	Marshall	$ 2,342,299	Yankton	$ 13,301,425
Edmunds	$ 1,635,181	McCook	$ 1,892,839	Ziebach	$ 237,058

Total SDRS Benefits Paid in South Dakota	**$ 389,701,785**
Total SDRS Benefits Paid Outside of South Dakota	**$ 50,647,152**
Total SDRS Benefits	**$ 440,348,937**
Total Cement Plant Benefits Paid in South Dakota	**$3,805,954**
Total Cement Plant Benefits Paid Outside South Dakota	**$318,061**
Total Cement Plant Benefits Paid	**$4,124,015**
Total SDRS and Cement Plant Benefits Paid	**$ 444,472,952**

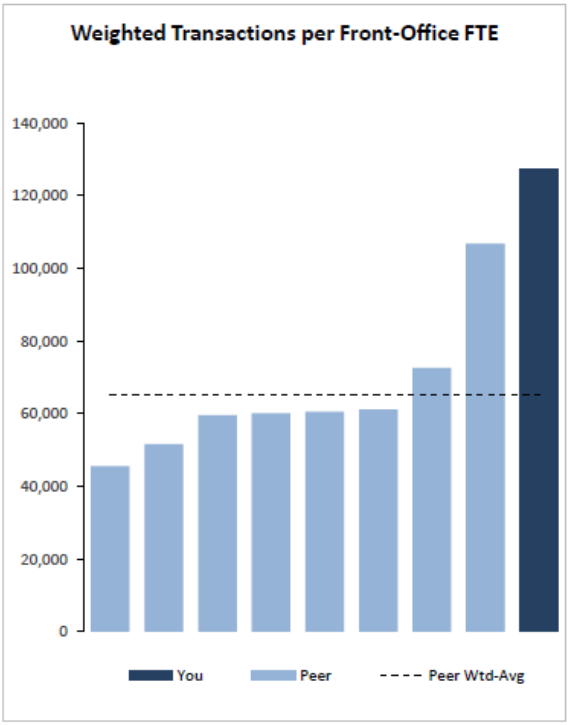
Appendix B

The international benchmarking firm, CEM, annually measures and compares the costs and quality of services provided by public employee retirement systems. The graphics below, from CEM's report issued in January 2014, show the comparison of costs and service for SDRS and a peer universe of statewide retirement systems with less than 100,000 members. Based on the CEM information, SDRS administrative costs are the lowest in the peer group while providing above average service to the membership.





In measuring FTE productivity, SDRS' weighted transactions per front-office FTE were 95% above the adjusted peer average. Higher transaction volumes per FTE decreased SDRS' total cost per member. Front-office FTE work includes activities involving contact with members or employers, such as paying pensions, member calls, and presentations.



Appendix C

SDRS FUNDING POLICY

Elements			
Funding Objectives (Discussed at the Quadrennial Funding Study presentations in 1999 and 2002, and formally adopted April 2006 and revised September 2013)	**Establishment of Cushion and Reserve** (The Reserve for Funding of Long-Term Benefit Goals, adopted in 1995 and later revised in 1998, 2001 and 2013)	**Policy Regarding Consideration of Benefit Improvements** (Adopted in 2004 and revised in 2013)	**Statutory Conditions That Would Require Corrective Action** (SDCL 3-12-122, refined during 2004 Legislative Session)
• Funded Ratios (Assets ÷ Actuarial Accrued Liabilities) o Based on Fair Value of Assets – 100% or greater o Based on Actuarial Value of Assets – 100% • Ratio of Fair Value of Assets to Actuarial Value of Assets o Exceeds 100%, which results in a Cushion • Maintain a fully funded system o No Unfunded Liabilities under Entry Age Normal Cost method o If future Unfunded Liabilities created because of unfavorable experience, fully fund over a period not to exceed 20 years • Statutorily fixed contributions meet or exceed the actuarially required contribution each year o Normal Cost plus expenses when System is fully funded o Includes payment of Unfunded Liabilities over a period not to exceed 20 years if System not fully funded	• Cushion o Excess of Fair Value of Assets over Actuarial Value o Captures all net favorable experience • Actuarial Value of Assets o asset value if all assumptions met o minimizes volatility in actuarial measures o limited to 80-120% of market value of assets o set to market value if no Cushion for five consecutive years • Reserve o Delays recognition of asset gains (and liability experience gains/losses) over five years, but recognizes asset losses immediately • Both Cushion and Reserve provide resources to: o Protect SDRS during times of unfavorable experience, and o Pre-fund benefit improvements	• After consideration of the expense of the benefit improvement the Fair Value Funded Ratio must be at least 120% • In addition, the following guidelines must be satisfied: o Reserve is sufficient to fully fund the present value of the benefit improvement o After consideration of the recommended benefit improvement all funding objectives must still be met • Proposed benefit improvement must be consistent with both the Board's long-term benefit goals and public policy with regard to retirement practices	• Funded status report to Governor and Retirement Laws Committee (RLC) if any of the following exists: o Contributions not sufficient to fund current benefit structure o Funded Ratio (based on Fair or Actuarial Value) less than 80% o Fair Value of Assets less than 90% of the Actuarial Value of Assets The report shall include an analysis of the conditions required for an improvement of the funded status of the system and recommendations for the circumstances and timing for any future benefit changes, contribution changes, or changes in actuarial assumptions • If any of the above conditions exist for three consecutive actuarial valuations, the following recommendations shall be made by the Board to the Governor and RLC, effective as soon as possible to improve the SDRS funded status o Benefit reductions o Contribution changes o Combination of the two

Appendix D - From the November 2014 SDRS Outlook newsletter

SOUTH DAKOTA RECEIVES RECOGNITION FOR SDRS ACCOMPLISHMENTS

The South Dakota Retirement System (SDRS) has quickly rebounded since the Great Recession, thanks to the Board of Trustees' diligent work to protect the system and the outstanding investment returns of recent years. SDRS' accomplishments have not gone unnoticed. Recently, South Dakota received national recognition for SDRS' stature as an exceptional public pension plan.

NIRS Pensionomics 2014 Study
The National Institute on Retirement Security (NIRS) conducted a study to assess the overall state and national economic impact of the benefits paid to retirees under public pension plans. The study found that SDRS benefit payments provided a significant economic contribution to South Dakota and the state's economy.

In 2012, 26,000 residents of South Dakota received over $450 million in public pension benefits. The benefits distributed were estimated to support 6,450 jobs in the state and $887 million in total economic output. The study recognized South Dakota for having the highest total economic output per dollar of pension benefits paid, as well as the highest total economic output per dollar of taxpayer contributions to the plan. In short, the study showed South Dakota received the biggest bang for the buck.

For the complete NIRS Pensionomics 2014 study report, visit the NIRS website at www.nirsonline.org.

iiSEARCHES 2014 Public Pension Plan Awards for Excellence
The editors of iiSEARCHES recently announced SDRS and the South Dakota Investment Council as U.S. Mid-Sized Public Fund of the Year. This award recognizes pension funds that have excelled in their investment strategy, implementation, and performance. Low fees and strong investment returns supported South Dakota's place as the best mid-sized public fund based on fiscal year 2013 results.

For the complete article highlighting SDRS, as published in the Trends & Insights for Investors—2014 Global Money Management Report, visit the Institutional Investor Corporate website, Money Management Intelligence, at www.moneymanagementintelligence.com.

Loop Capital Markets 2014 Annual Report
The Loop Capital Markets completed an in-depth review of 247 public pension plans across the United States. The report, which is based on fiscal year 2013 data, recognizes South Dakota as one of only two states having a funded level for pension assets versus liabilities at 100 percent. South Dakota has no unfunded actuarial accrued liability (UAAL), which is an important measure in evaluating the actuarial soundness of a pension plan.

The Twelfth Annual Public Pension Funding Review provides an extensive comparison of pension plans and funded levels for fiscal year 2013. A summary of the report is available at www.loopcap.com.

For more information, including direct links to each respective group's report, visit the "News and Info" section of the SDRS website at www.sdrs.sd.gov.