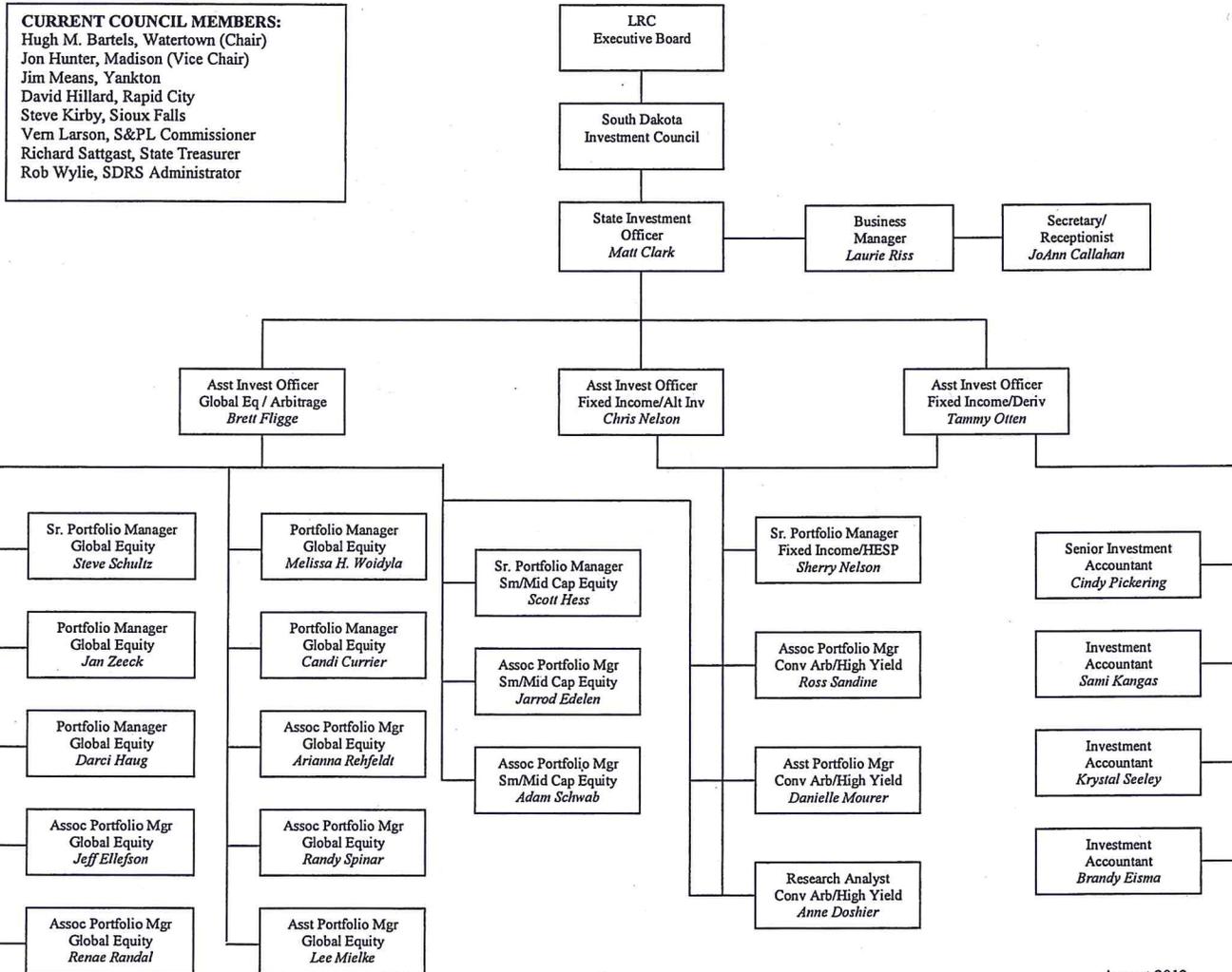


SDIC FY 2013 Performance & FY 2015 Budget Presented to LRC Executive Board August 19, 2013

- Organization Chart
- Assets
- Investment Performance
- Cost Efficiency
- Compensation Overview
- Budget Funding Sources
- Long-Term Plan
- FY 2013 Budget Review
- FY 2015 Budget Request
- Incentive Plan Benchmark Change
- Trust Fund Summary
- Appendix

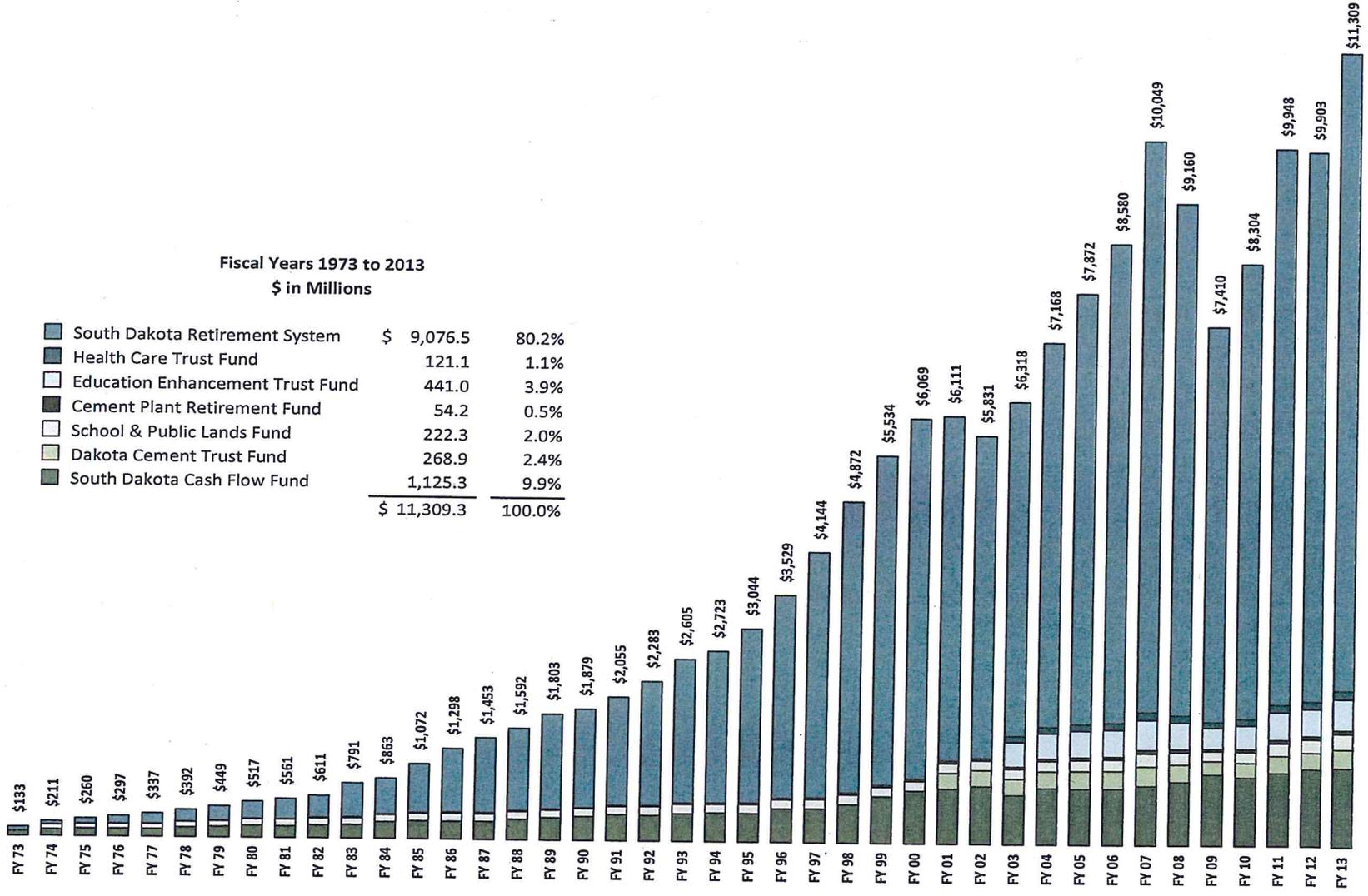
Organization Chart



August 2013

Assets

Fiscal Years 1973 to 2013
\$ in Millions



Investment Performance

Returns vs. Benchmarks (unaudited)

	<u>FY 2013</u>	<u>4 Years Annualized FY 10 – 13</u>	<u>10 Years Annualized FY 04 – 13</u>
▪ SDRS Total Fund	19.53%	16.15%	9.16%
▪ Capital Market Benchmark	12.73%	11.76%	7.29%
Added Value	6.8%	4.39%	1.87%
▪ Mellon Total Billion \$ Funds-Corp	9.98%	12.13%	7.71%
Added Value	9.55%	4.02%	1.45%
▪ State Fund Universe (est)	12.25%	12.00%	7.22%
Added Value	7.28%	4.15%	1.94%
▪ SDRS Beginning FY13 Assets		\$7.835 billion	
▪ SDRS Ending 6/30/13 Assets		\$9.076 billion	

Investment Performance

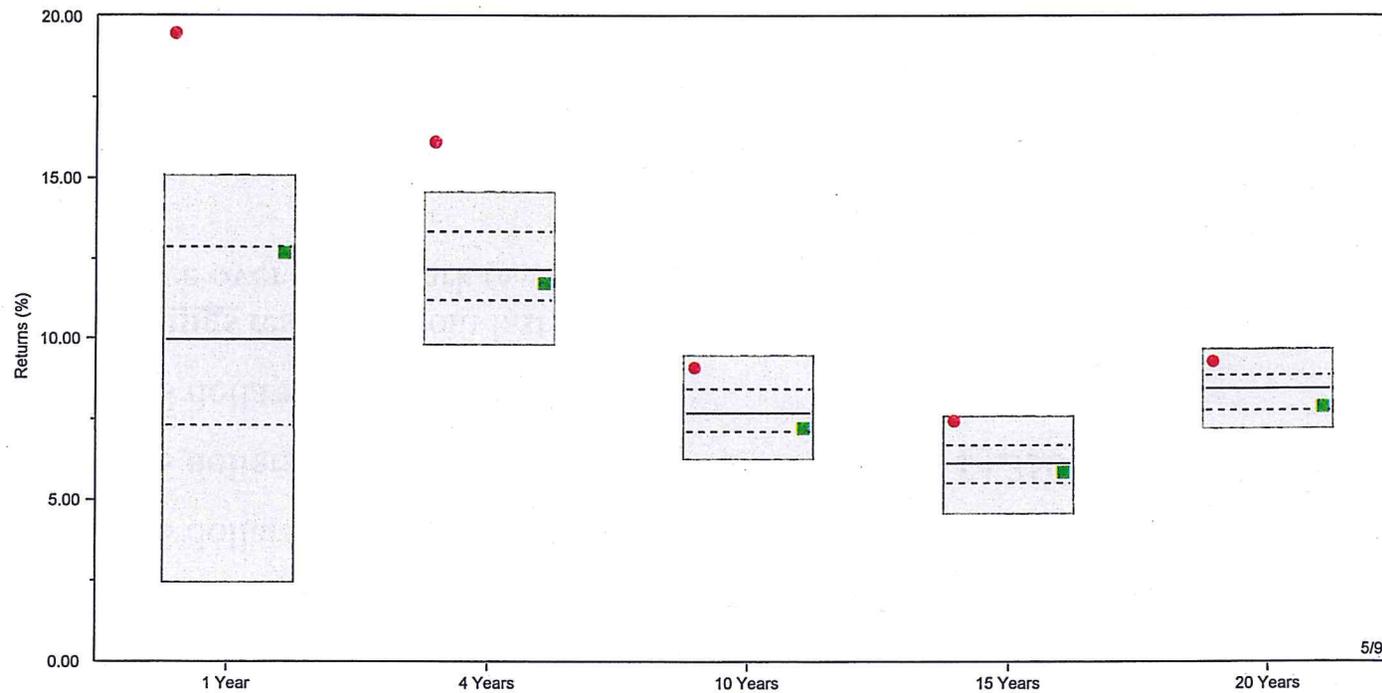
Earnings vs. Benchmarks (unaudited)

- Total SDRS dollars earned Fiscal Year 2013 \$1.503 billion
- Total SDRS dollars earned last 4 years \$4.350 billion
- Total SDRS dollars earned last 10 years \$5.937 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	\$532 million	\$1.20 billion	\$1.33 billion
○ vs. Mellon Total Billion \$ Corp	\$748 million	\$1.19 billion	\$1.25 billion
○ vs. State Funds	\$570 million	\$1.19 billion	\$1.25 billion

Corporate Funds Comparison

Annualized Total Fund TOTAL BILLION DOLLAR FUNDS - CORPORATE Ending June 30, 2013 Quartile

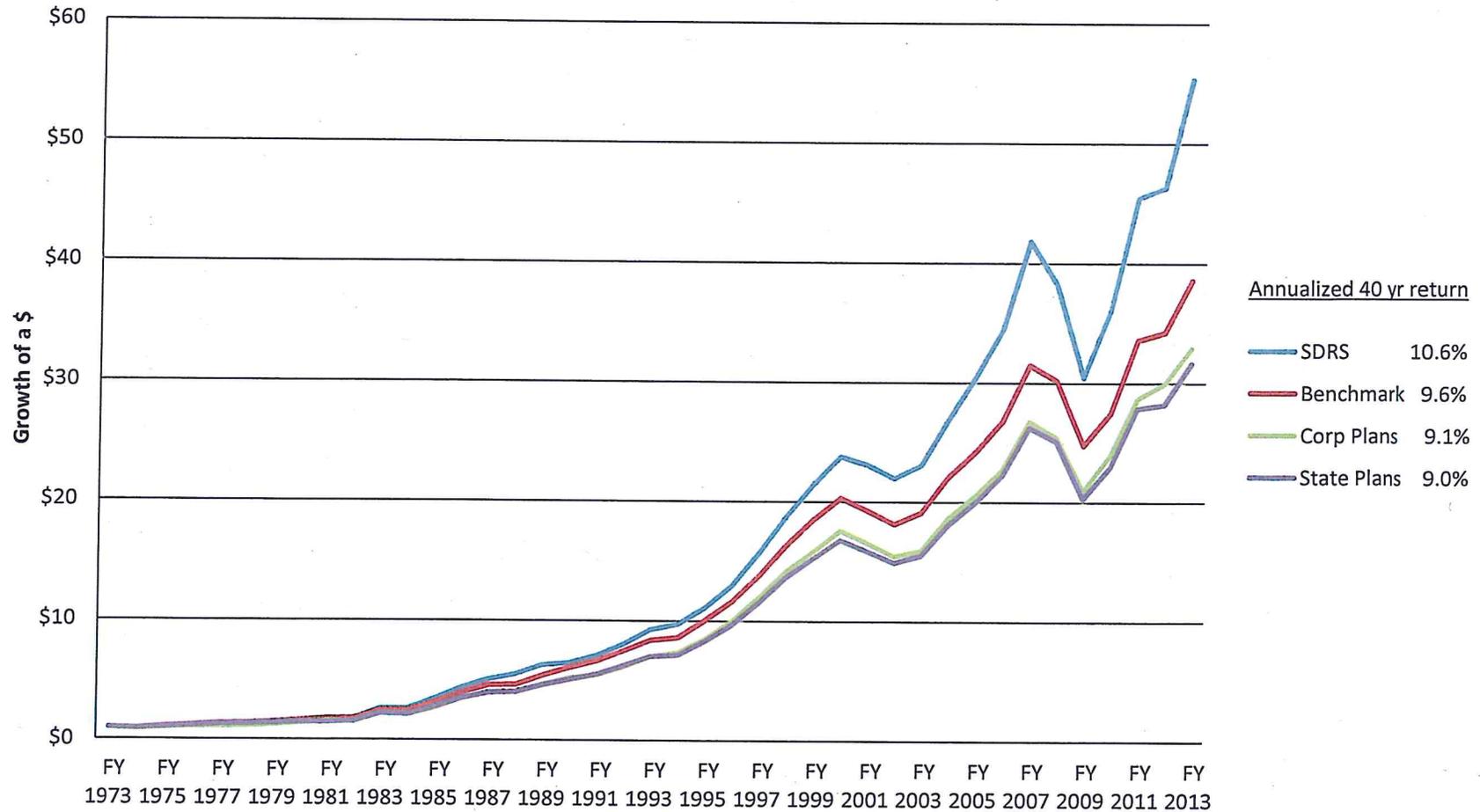


	Value	%Tile								
5th Percentile	15.08		14.54		9.49		7.62		9.70	
25th Percentile	12.87		13.31		8.45		6.74		8.90	
Median Percentile	9.98		12.13		7.71		6.14		8.48	
75th Percentile	7.35		11.22		7.14		5.53		7.79	
95th Percentile	2.46		9.84		6.27		4.60		7.21	
# of Portfolios	108		105		89		76		68	
● SDRS Total Fund	19.53	1	16.15	1	9.16	9	7.50	7	9.35	12
■ SDRS Benchmark	12.73	28	11.76	62	7.29	68	5.90	64	7.93	71

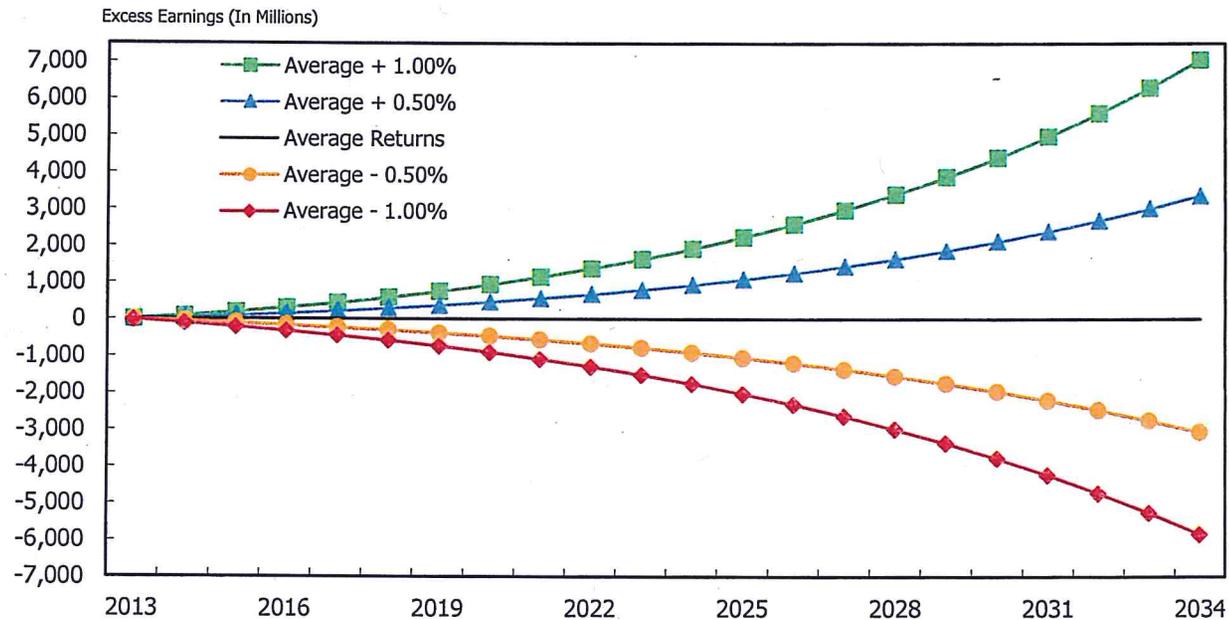
Universe Source: The Bank of New York Mellon Corporation; Universe Status: Final

Superior returns add up over time

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



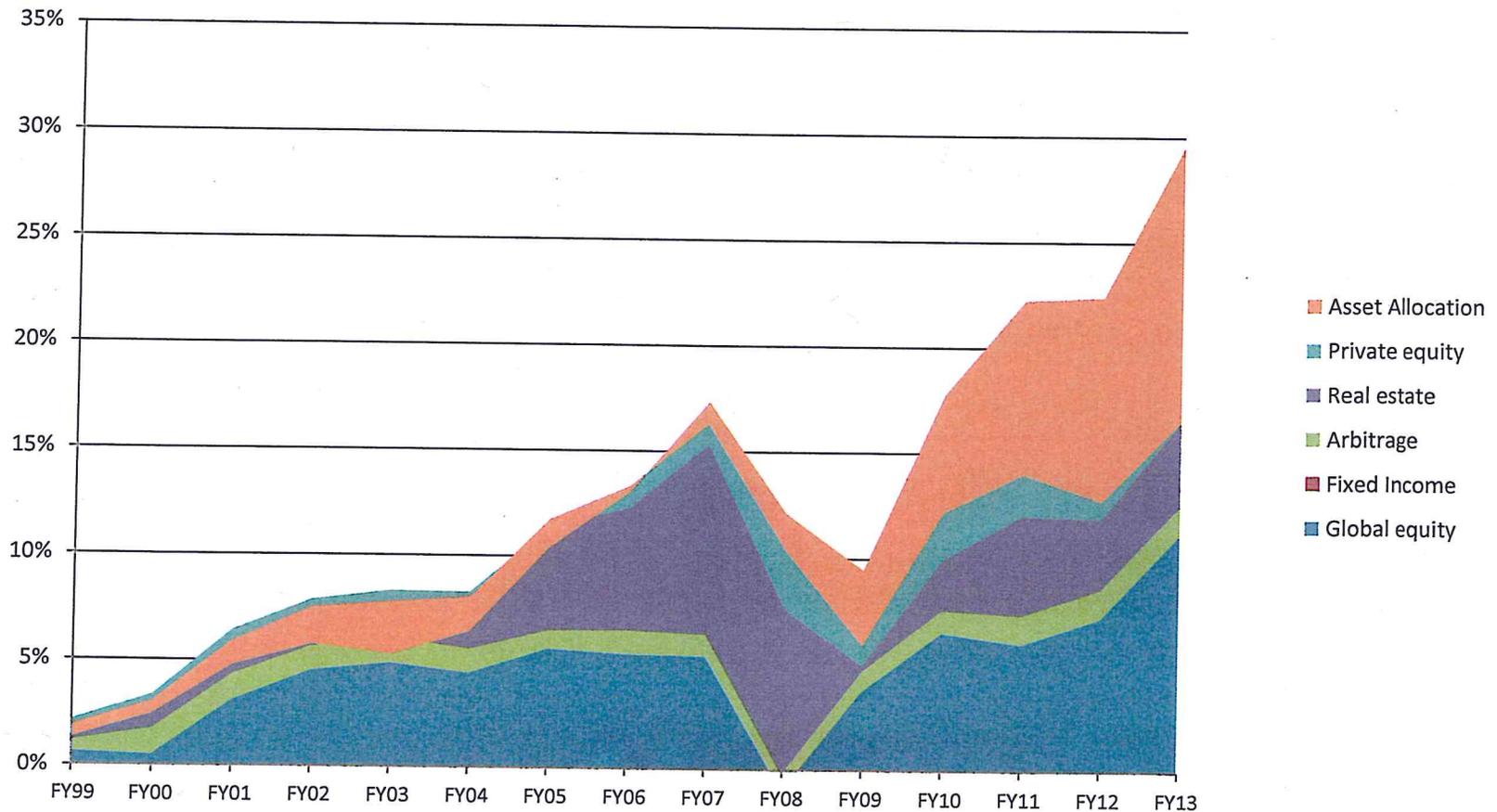
Potential Excess Earnings



- SDIC 40-year outperformance = 1% annualized vs. benchmark
- If 1% outperformance continues next 20 years = extra \$7 billion
- Outperformance of even half that amount = extra \$3.4 billion
- Underperformance of 1% = cost to retirement system of \$5.8 billion.

Many pistons contribute

Cumulative added value by source FY99 to FY13



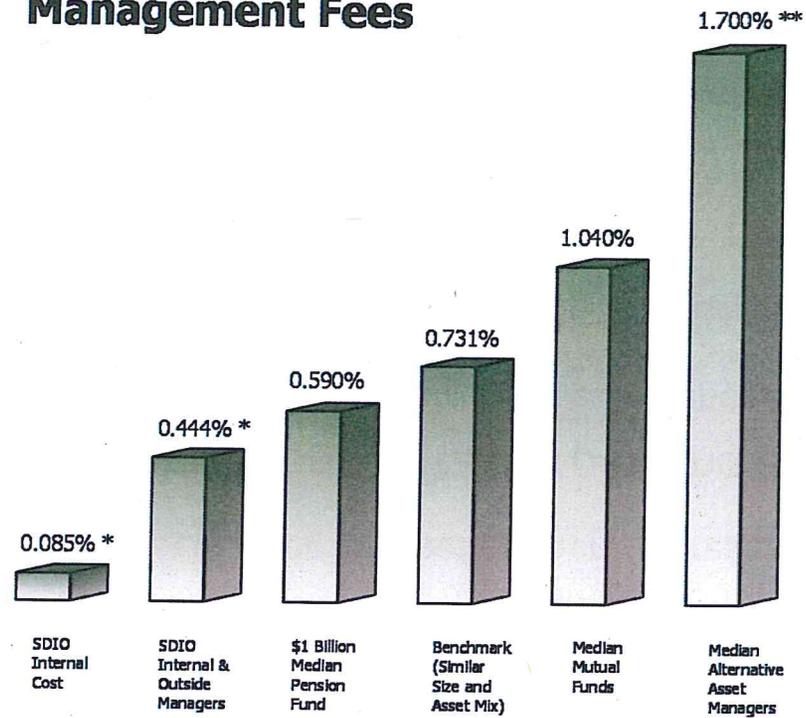
Every asset category has good and bad years

Annual added or detracted value by source

Asset Class	FY99	FY00	FY01	FY02	FY03	FY04	FY05	FY06	FY07	FY08	FY09	FY10	FY11	FY12	FY13
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%
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%
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%
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%
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%
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%
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%

Cost Efficiency

Management Fees



Difference between SDIC cost of .444% and benchmark cost of .731% is \$29 million per year

* SDIC projected expenses for FY 2015 using expected average performance incentives

** Plus 20% profit participation after preferred return

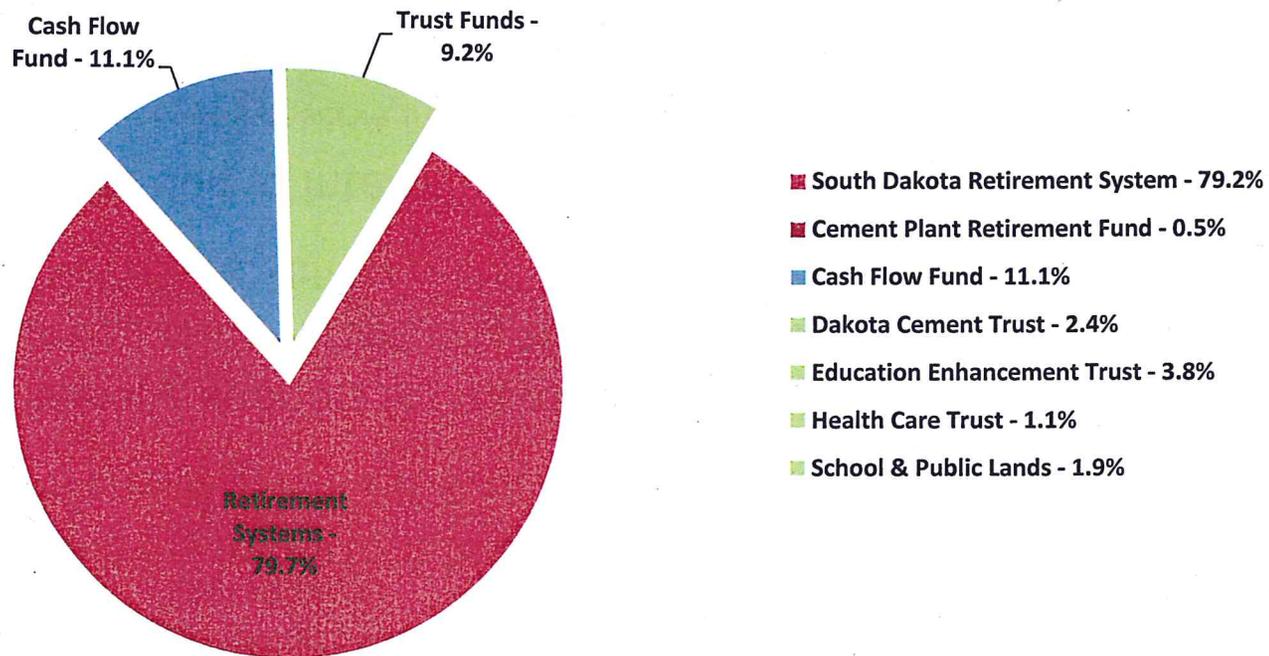
Compensation Overview

- Long term results have significantly exceeded benchmarks
 - Added over 25% beyond benchmark to SDRS assets in the past 15 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 100%) which are expected to average 50% with continuation of SDIC historic level of superior performance
 - Pay was increased to 70% target after 2006 study

Compensation Overview, continued

- 2013 study indicated compensation is below 70% target
 - SDIC pay at 55% rather than 70% of cost of living adjusted industry median
- Council believes important to get back to target compensation
 - Want to provide best chance for future success
- Council seeking support for increase in incentive plan to get to target
 - To expected average of 80% (0 to 200%) adding longer term and stretch incentives
 - 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

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 2015</u>	<u>FY 2020</u>	<u>FY 2025</u>
INVESTMENT OFFICE BUDGET			
Personal Services			
Number of Employees	30	34	34
Base Compensation - Total Staff	4,396,985	6,757,537	8,567,646
Intern, Council members, Longevity	37,055	48,297	61,432
Flexibility funds-Retirements & Resignations	140,431	162,798	188,728
Investment Incentive Maximum	7,323,947	11,711,908	15,073,511
Benefits	1,849,403	2,851,759	3,614,136
Total Personal Services	13,747,820	21,532,300	27,505,452
Operating Expenses			
Contractual Services	1,552,487	1,835,194	2,098,241
Travel	85,000	109,247	126,647
Office Supplies & Postage	12,733	16,729	19,394
Capital Assets	43,000	50,710	58,787
Total Operating Expenses	1,693,220	2,011,880	2,303,069
Total Investment Council Budget	15,441,039	23,544,180	29,808,521
ASSET SUMMARY *			
Internal Assets	8,760,839,790	11,152,302,626	14,141,804,689
External Assets	3,578,371,182	4,337,006,577	5,499,590,712
Total Assets	12,339,210,972	15,489,309,203	19,641,395,401
EXPENSE SUMMARY			
Internal Expenses	15,441,039	23,544,180	29,808,521
External Manager Fees	39,362,083	47,707,072	60,495,498
Total Expenses	54,803,122	71,251,252	90,304,019
UNIT COST SUMMARY			
Internal Expenses as % of Total Assets	0.125%	0.152%	0.152%
Internal Exp as % of Total Assets (with assumed avg Inv Perf Incnt)	0.085%	0.100%	0.099%
Total Expenses as % of Total Assets	0.444%	0.460%	0.460%

*Projections based on long-term assumed returns applied to 6/30/13 assets. Updated each June 30.

FY13 Budget and Actual

Unexpended credited against FY14

	<u>Actual Exp FY 2013</u>	<u>Budget Rec'd FY 2013</u>	<u>Unexpended</u>
PERSONAL SERVICES			
Base Compensation			
Base Compensation - Investment Staff	3,106,074	3,259,847	153,773 *
Base Compensation - Accounting & Administrative	347,507	347,507	(0)
TOTAL STAFF	3,453,581	3,607,353	153,772
Total Intern, Council, Longevity	15,650	17,890	2,240
Benefits	790,796	817,281	26,485
Total Base Compensation	4,260,027	4,442,524	182,497
Investment Performance Incentives			
Maximum Potential Investment Perf Incentive	1,985,287	2,553,797	568,510
Benefits	177,548	208,645	31,097
Total Investment Performance Incentives	2,162,835	2,762,442	599,607
Total Personal Services	6,422,862	7,204,966	782,105
OPERATING EXPENSES			
Contractual Total (see appendix for line item details)	1,221,329	1,473,677	252,348
Travel	57,085	65,700	8,615
Office Supplies & Postage	12,131	12,733	602
Capital Assets	27,970	28,242	272
Total Operating Expenses	1,318,515	1,580,352	261,837
TOTAL BUDGET	7,741,377	8,785,318 **	1,043,941

* Includes \$50,446 Allianz reimbursement & unused compensation due to turnover

**Does not include \$45,888 Appropriation transfer for health ins & BIT - did not affect cash

FY15 Budget Request Summary

	<u>Received FY 2014</u>	<u>Request FY 2015</u>	<u>% Change</u>
PERSONAL SERVICES			
Base Compensation			
Base Compensation - Investment Staff	3,661,973	4,017,261	9.70%
Base Compensation - Accounting & Administrative	353,941	379,724	7.28%
TOTAL STAFF	4,015,914	4,396,985	9.49%
Retirement & resignation flexibility funds	140,431	140,431	0.00%
Total Intern, Council, Longevity	35,582	37,055	4.14%
Benefits	792,397	838,698	5.84%
Total Base Compensation	4,984,324	5,413,169	8.60%
Investment Performance Incentives			
Maximum Potential Investment Perf Incentive	3,261,124	7,323,946	124.58%
Benefits	448,582	1,010,705	125.31%
Total Investment Performance Incentives	3,709,706	8,334,651	124.67%
Total Personal Services	8,694,030	13,747,819	58.13%
OPERATING EXPENSES			
Contractual Total (see next page for further details)	1,434,815	1,552,487	8.20%
Travel	85,000	85,000	0.00%
Office Supplies & Postage	12,733	12,733	0.00%
Capital Assets	48,500	43,000	-11.34%
Total Operating Expenses	1,581,048	1,693,220	7.09%
TOTAL BUDGET	10,275,078	15,441,039	50.28%
UNIT COST SUMMARY			
Internal Expenses as % of Total Assets	0.094%	0.125%	
Internal Expenses as % of Total Assets (with avg Inv Perf Incent)	0.077%	0.085%	
Total Expenses as % of Total Assets	0.369%	0.444%	

FY15 Budget Request

Contractual services detail

	Received <u>FY 2014</u>	Request <u>FY 2015</u>	<u>% Change</u>
CONTRACTUAL SERVICES			
Investment Services			
Consulting Services	30,000	30,000	0.00%
Investment Accounting, Performance Benchmarking	94,000	191,000	103.19%
Investment Databases, Newsfeeds & Quote Fees	415,213	435,189	4.81%
Investment Research Services	247,572	254,232	2.69%
Flexibility - From Brokerage to Independent Research	83,139	83,139	0.00%
Total Investment Services	869,924	993,560	14.21%
Administrative Expenses			
Office Rent	129,125	115,148	-10.82%
Bond/Liability Insurance	7,410	7,410	0.00%
Telephone	10,000	10,000	0.00%
Office Equip Rental/Maintenance	6,000	6,000	0.00%
Bureau of Info & Telecommunications (BIT)	43,335	43,335	0.00%
State Central Services	8,351	9,000	7.77%
Legislative Audit	55,700	50,000	-10.23%
Attorney General's Office - Legal Services	17,970	18,509	3.00%
Custodial Fees - Global	250,500	263,025	5.00%
Seminars/Educational Programs	33,500	33,500	0.00%
Business Publications	3,000	3,000	0.00%
Total Administrative Expenses	564,891	558,927	-1.06%
TOTAL CONTRACTUAL SERVICES	1,434,815	1,552,487	8.20%

Trust Funds (unaudited)

Health Care Trust (established April 2001)

Principal as of 6/30/13	\$ 85,631,024
Principal as of 6/30/13 adjusted for inflation	\$ 110,120,179
Fair Value (FV) as of 6/30/13	\$ 121,106,711
Difference - FV less principal	\$ 35,475,687
Difference - FV less infl. adj. prin.	\$ 10,986,532
Fiscal year to date return	17.86%
Longterm expected mean return	6.27%
Payout of 4% plus expected inflation of 3%	7.00%
Expected return cushion/shortfall	-0.73%

Distribution for FY 14 (July 1, 2013)	3,959,754
Distribution for FY 13 (July 2, 2012)	3,825,385

<u>Asset Allocation</u>	FY 13	
	<u>Current</u>	<u>Benchmark</u>
Global Equity	47%	52%
Private Equity	3%	2%
Real Estate	11%	6%
Fixed Income-IG	21%	28%
Fixed Income-HY	5%	5%
Fixed Income-Tips	4%	5%
Money Market	9%	2%
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

Education Enhancement Trust (established April 2001)

Principal as of 6/30/13	\$ 334,012,613
Principal as of 6/30/13 adjusted for inflation	\$ 428,842,498
Fair Value (FV) as of 6/30/13	\$ 441,011,625
Difference - FV less principal	\$ 106,999,012
Difference - FV less infl. adj. prin.	\$ 12,169,127
Fiscal year to date return	17.32%
Longterm expected return (lower due to tax exempts)	6.20%
Payout of 4% plus expected inflation of 3%	7.00%
Expected return cushion/shortfall	-0.80%

Distribution for FY 14 (July 1, 2013)	14,413,354
Distribution for FY 13 (July 2, 2012)	14,052,700

<u>Asset Allocation</u>	FY 13	
	<u>Current</u>	<u>Benchmark</u>
Global Equity	47%	52%
Private Equity	3%	2%
Real Estate	12%	6%
Fixed Income-IG	11%	0%
Fixed Income-tax ex	11%	30%
Fixed Income-HY	5%	5%
Fixed Income-Tips	4%	3%
Money Market	7%	2%
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

Trust Funds (unaudited)

Dakota Cement Trust (established April 2001)

Principal as of 6/30/13	\$ 238,000,000	<u>Asset Allocation</u>	<u>Current</u>	<u>FY 13 Benchmark</u>
Principal as of 6/30/13 adjusted for inflation	\$ 313,578,462	Global Equity	47%	52%
Fair Value (FV) as of 6/30/13	\$ 268,843,121	Private Equity	4%	2%
		Real Estate	13%	6%
Difference - FV less principal	\$ 30,843,121	Fixed Income-IG	21%	28%
Difference - FV less infl. adj. principal	\$ (44,735,340)	Fixed Income-HY	6%	5%
		Fixed Income-Tips	4%	5%
Fiscal year to date return	17.76%	Money Market	<u>6%</u>	<u>2%</u>
Longterm expected mean return	6.27%	Total	100%	100%
Payout of 4% plus expected inflation of 3%	7.00%			
Expected return cushion/shortfall	-0.73%			
Distribution for FY 13 (June 2013 to Gen. Fund)	9,356,955			
Distribution for FY 12 (June 15, 2012 to Gen. Fund)	12,000,000			

Constitution allows 4% of the lesser of 1) the 16 quarter average balance or 2) the current December 31 market value be distributed by June of the following year.

(Change Nov. 2012)

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 6/30/13	\$ 222,342,174	<u>Asset Allocation</u>	<u>Current</u>	<u>FY 13 Benchmark</u>
		Global Equity	50%	52%
Fiscal year to date return	17.58%	Private Equity	3%	2%
Longterm expected mean return	6.27%	Real Estate	11%	6%
		Fixed Income-IG	21%	28%
Distribution for FY 13 (Feb 4, 2013 to K-12)	7,422,432	Fixed Income-non-mk	1%	
Distribution for FY 13 to Board of Regents	1,980,791	Fixed Income-HY	5%	5%
		Fixed Income-Tips	4%	5%
TOTAL	9,403,223	Money Market	<u>6%</u>	<u>2%</u>
		Total	100%	100%

Investment Performance Incentive Plan

Recommended change

Investment Council Motion 6/18/13

SDIC Recommendation to LRC Executive Board for benchmark change to Investment Officer's incentive plan for FY 2014 performance, payable in FY 2015.

HUGH BARTELS MOVED, SECONDED BY JIM MEANS, TO RECOMMEND TO THE LRC EXECUTIVE BOARD AT THEIR AUGUST 19, 2013 MEETING THAT BEGINNING WITH THE FY 2014 PERFORMANCE RESULTS PAYABLE IN FY 2015, THE INVESTMENT OFFICER'S INCENTIVE PROGRAM BE CHANGED SO THAT TOTAL FUND PERFORMANCE (60% OF INCENTIVE) IS COMPARED SOLELY TO THE CAPITAL MARKETS BENCHMARK AND THAT INVESTMENT RETURN COMPARISONS USE TOTAL NET TIME-WEIGHTED RATES OF RETURN. MOTION PASSED UNANIMOUSLY.

Appendix

- Investment performance incentives
- Target discount rationale
- FY13 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
 - 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

FY13 Budget and Actual

Contractual services detail

	<u>Actual FY 2013</u>	<u>Received FY 2013</u>	<u>Unexpended</u>
CONTRACTUAL SERVICES			
Investment Services			
Consulting Services	17,552	30,000	12,448
Investment Accounting, Performance Benchmarking	90,800	94,000	3,200
Investment Databases, Newsfeeds & Quote Fees	393,070	434,872	41,802
Investment Research Services	221,776	247,528	25,752
Flexibility - From Brokerage to Independent Research	0	150,000	150,000
Total Investment Services	<u>723,198</u>	<u>956,400</u>	<u>233,202</u>
Administrative Expenses			
Office Rent	103,810	101,542	(2,268)
Bond/Liability Insurance	3,384	7,020	3,636
Telephone	5,191	10,000	4,809
Office Equip Rental/Maintenance	6,503	6,000	(503)
Bureau of Info & Telecommunications (BIT)	38,091	42,639	4,548
State Central Services	8,838	8,741	(97)
Legislative Audit	42,899	37,135	(5,764)
Attorney General's Office - Legal Services	17,445	16,000	(1,445)
Custodial Fees - Global	250,500	250,500	0
Seminars/Educational Programs	19,114	33,500	14,386
Business Publications	2,357	4,200	1,843
Total Administrative Expenses	<u>498,131</u>	<u>517,277</u>	<u>19,146</u>
TOTAL CONTRACTUAL SERVICES	<u>1,221,329</u>	<u>1,473,677</u>	<u>252,348</u>