

LRC Executive Board

Investment Council Update

June 13, 2016

- Assets managed
 - SDRS – FY 2016 return through 5/31/16 estimate 0%
 - Trust Funds – FY 2016 returns through 5/31/16 estimates between 0% and -0.3%

- 529 Scholarship Update – Transfers to Dakota Corps Scholarship Program
 - Last year (July 2015) transfer \$ 1,616,835
 - Cumulative transfers since Sept 2007 \$10,089,324
 - Estimated transfer for July 2016 \$ 1,500,000

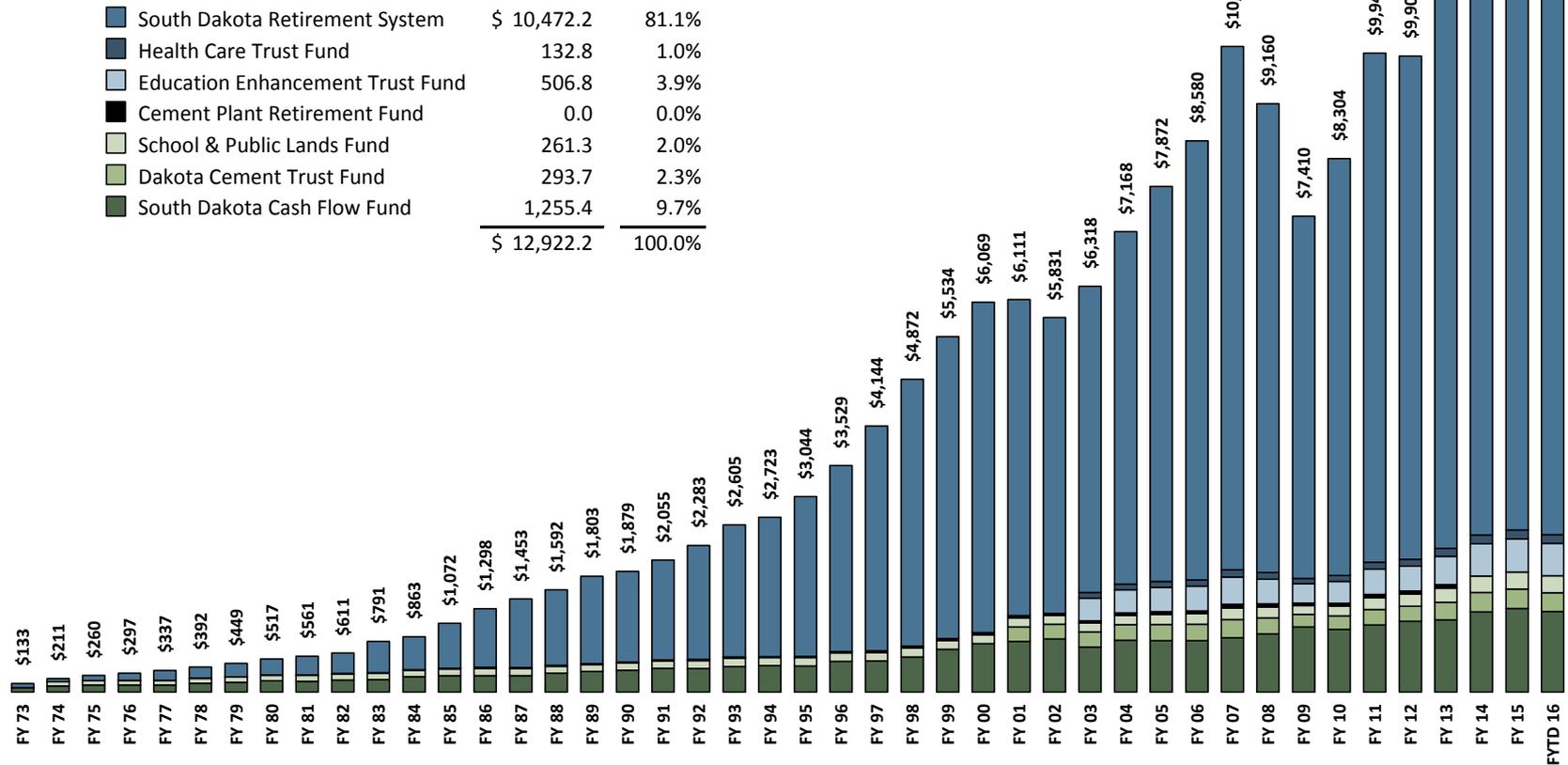
- Council Role & Selection

- Investment Officer FY 2017 Compensation

- Compensation Methodology

Assets

Fiscal Years 1973 to 2015 and
Fiscal Year 2016 through May 31, 2016 (est)
\$ in Millions



Trust Funds

As of 5/31/16 – Estimates (unaudited)

Health Care Trust (established April 2001)

Principal as of 5/31/2016 (EST)	\$ 85,631,024
Principal as of 5/31/2016 (EST) adjusted for inflation	\$ 112,931,046
Fair Value (FV) as of 5/31/2016 (EST)	\$ 132,786,962
Difference - FV less principal	\$ 47,155,938
Difference - FV less infl. adj. prin.	\$ 19,855,916
Fiscal year to date return	-0.05%
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 17 (July 1, 2016)	4,970,123
Distribution for FY 16 (July 1, 2015)	4,674,130

	FY 16	
<u>Asset Allocation</u>	<u>Current</u>	<u>Benchmark</u>
Global Equity	39%	51%
Private Equity	3%	0%
Real Estate	9%	10%
Fixed Income-IG	21%	30%
Fixed Income-HY	10%	7%
Fixed Income-Tips	3%	0%
Money Market	<u>15%</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.

Education Enhancement Trust (established April 2001)

Principal as of 5/31/2016 (EST)	\$ 358,320,995
Principal as of 5/31/2016 (EST) adjusted for inflation	\$ 464,265,710
Fair Value (FV) as of 5/31/2016 (EST)	\$ 506,815,144
Difference - FV less principal	\$ 148,494,149
Difference - FV less infl. adj. prin.	\$ 42,549,434
Fiscal year to date return	-0.31%
Longterm expected return (lower due to tax-exempts)	5.95%
Payout of 4% plus expected inflation of 3%	7.00%
Expected return cushion/shortfall	-1.05%

Distribution for FY 17 (July 1, 2016)	18,242,854
Distribution for FY 16 (July 1, 2015)	17,036,734

	FY 16	
<u>Asset Allocation</u>	<u>Current</u>	<u>Benchmark</u>
Global Equity	39%	51%
Private Equity	3%	0%
Real Estate	8%	10%
Fixed Income-IG	10%	20%
Fixed Income-tax e:	10%	10%
Fixed Income-HY	10%	7%
Fixed Income-Tips	3%	0%
Money Market	<u>17%</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.

Trust Funds

As of 5/31/16 – Estimates (unaudited)

Dakota Cement Trust (established April 2001)

		<u>Asset Allocation</u>	<u>Current</u>	<u>Benchmark</u>
Principal as of 5/31/2016 (EST)	\$ 238,000,000	Global Equity	40%	51%
Principal as of 5/31/2016 (EST) adjusted for inflation	\$ 304,335,086	Private Equity	3%	0%
Fair Value (FV) as of 5/31/2016 (EST)	\$ 293,697,544	Real Estate	9%	10%
		Fixed Income-IG	21%	30%
Difference - FV less principal	\$ 55,697,544	Fixed Income-HY	11%	7%
Difference - FV less infl. adj. principal	\$ (10,637,542)	Fixed Income-Tips	3%	0%
		Money Market	<u>12%</u>	<u>2%</u>
Fiscal year to date return	-0.09%	Total	100%	100%
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 (May 2016 to GF)	11,436,003			
Distribution for FY 15 (June 12, 2015 to GF)	10,803,626			

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)

		<u>Asset Allocation</u>	<u>Current</u>	<u>Benchmark</u>
Fair Value as of 5/31/2016 (EST)	\$ 261,252,503	Global Equity	39%	51%
		Private Equity	3%	0%
Fiscal year to date return	-0.27%	Real Estate	8%	10%
Longterm expected mean return	6.03%	Fixed Income-IG	20%	30%
		Fixed Income-non-r	1%	
Distribution for FY 16 K-12 (2/4/16)	10,227,405	Fixed Income-HY	10%	7%
Distribution for FY 15 Board of Regents (6/9/16)	<u>2,264,613</u>	Fixed Income-Tips	3%	0%
TOTAL	12,492,018	Money Market	<u>16%</u>	<u>2%</u>
		Total	100%	100%

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 2017 Compensation

Investment Council Motion 5/12/16

Recommendation to LRC Executive Board for Investment Officer FY2017 Compensation:

DAVID HILLARD MOVED, SECONDED BY LAURA McNALLY, THAT THE INVESTMENT COUNCIL RECOMMEND TO THE LRC EXECUTIVE BOARD THAT TOTAL COMPENSATION FOR THE STATE INVESTMENT OFFICER PAYABLE IN FISCAL YEAR 2017 BE COMPRISED OF A 4.5% INCREASE IN BASE SALARY AND CONTINUATION OF THE INVESTMENT INCENTIVE PERFORMANCE INCENTIVE PLAN, WITH ANY EARNED INCENTIVES TO BE PAID FOLLOWING COMPLETION OF THE AUDIT. MOTION PASSED UNANIMOUSLY ON A ROLL CALL VOTE.

Compensation Overview

- Long term results have significantly exceeded benchmarks
 - Added over 30% beyond benchmark to SDRS assets in the past 17 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, most recently 2016
 - 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
 - Had difficulties in the past when discount got too close to 50%
 - 30% discount believed large 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
 - Industry pay for top quartile performers can be double the median. SDIC performance is better than top quartile, discount versus top quartile is large