

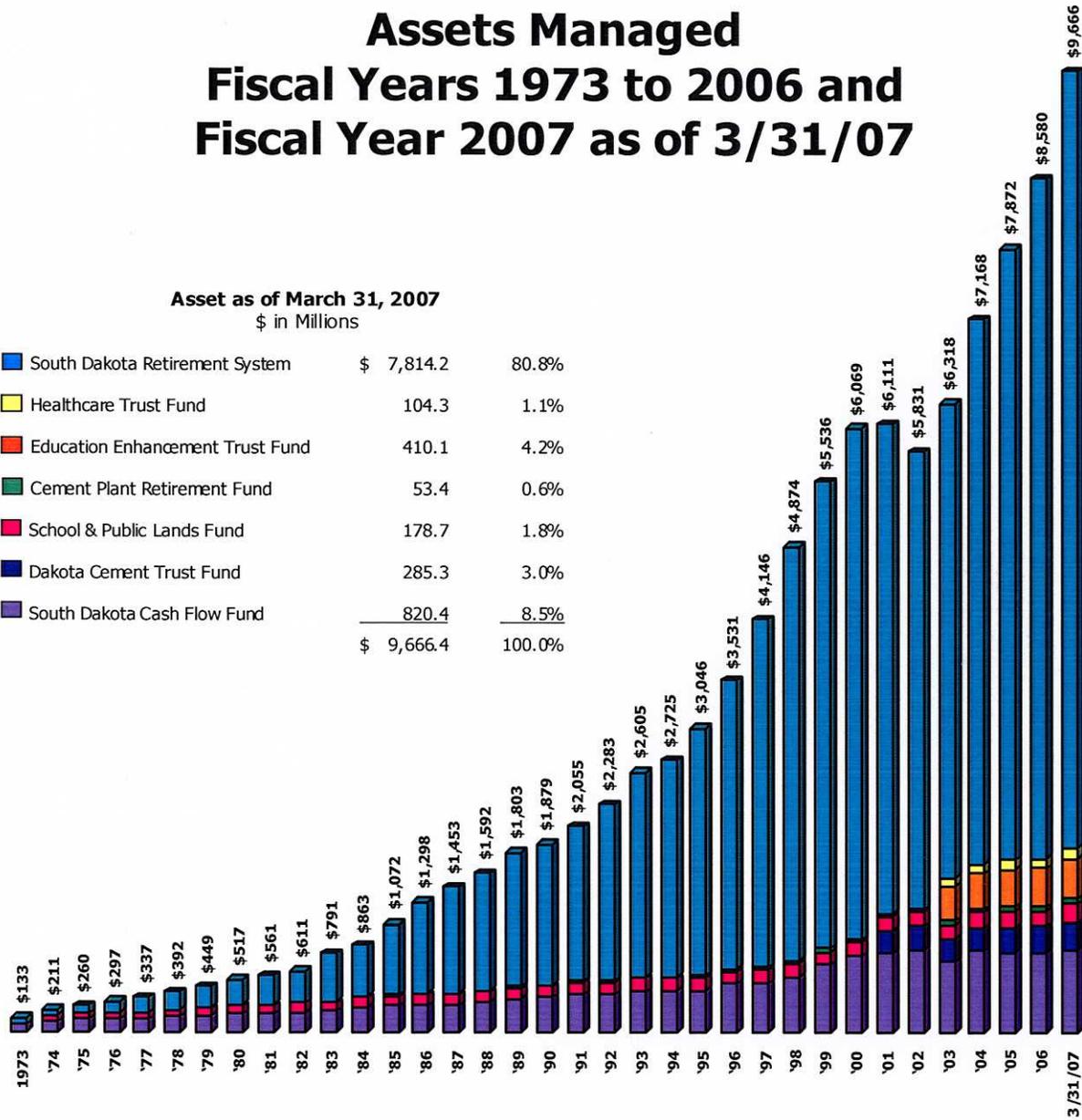
Investment Council  
Appropriations Committee Visit

July 2007

# South Dakota Investment Council Assets Managed Fiscal Years 1973 to 2006 and Fiscal Year 2007 as of 3/31/07

**Asset as of March 31, 2007**  
\$ in Millions

■	South Dakota Retirement System	\$ 7,814.2	80.8%
■	Healthcare Trust Fund	104.3	1.1%
■	Education Enhancement Trust Fund	410.1	4.2%
■	Cement Plant Retirement Fund	53.4	0.6%
■	School & Public Lands Fund	178.7	1.8%
■	Dakota Cement Trust Fund	285.3	3.0%
■	South Dakota Cash Flow Fund	820.4	8.5%
		\$ 9,666.4	100.0%



**CURRENT COUNCIL MEMBERS:**

Angeline Lavin, Vermillion (Chair)  
 Curt Johnson, Watertown, (V-Chair)  
 Paul Livermore, Sioux Falls  
 Haven Stuck, Rapid City  
 Joseph A. Anglin, Spearfish  
 Jarrod Johnson, S&PL Commissioner  
 Vern Larson, State Treasurer  
 Rob Wylie, SDRS Administrator

Executive Board  
of the  
LRC

South Dakota  
Investment  
Council

State Investment  
Officer  
*Matt Clark*

Business  
Manager  
*Laurie Riss*

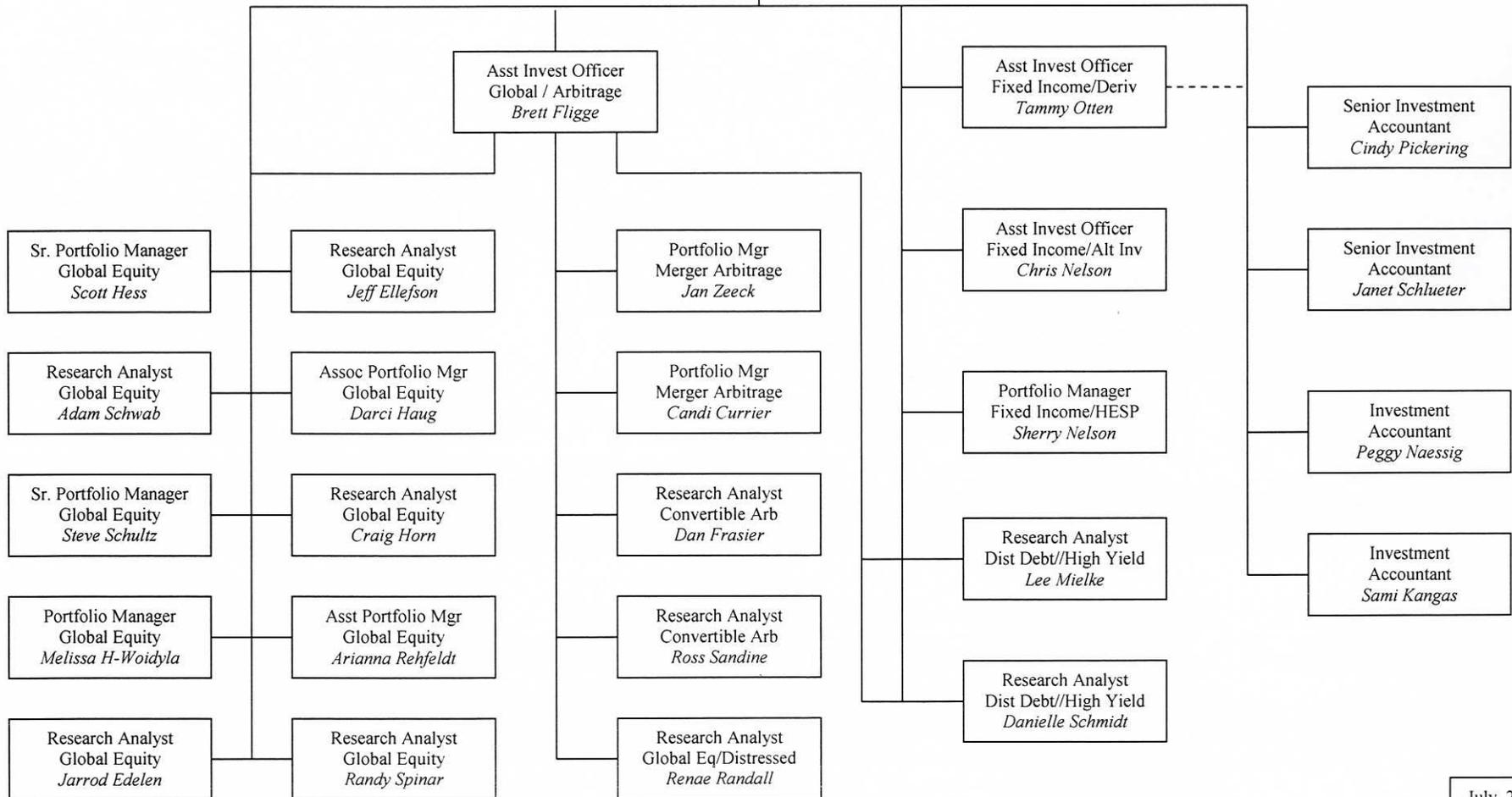
Secretary/  
Receptionist  
*JoAnn Eidenshink*

**Global Equity**

**Arb/Distressed**

**Fixed Income**

**Investment  
Accounting**



# Goal

## Add Value Over Long Term

- Thirty plus years of success & trying to get better
  - Added value vs. benchmark +.8% (32years) and +1.4% (10yr)
  - Added value vs. peer comparison +1.5% (32yr) and +1.6% (10yr)
  
- Efforts focused on deserving to be among the best
  - Environment
  - People
  - Process
  - Improvement

# Environment

## ➤ Business like

- Five of the eight Council members appointed by bi-partisan Executive Board of Legislature
- Selected on the basis on business and finance experience
- Other 3 - State Treasurer, S&PL Commissioner, SDRS designee

## ➤ Non political

- Council has historically emphasized the importance of keeping politics out of investment process

## ➤ Long term business plan

- Focus on primarily internal management to keep cost low
- Ten year budget – staffing, compensation, general budget items
  - » Compensation benchmarked to private sector comparisons
  - » First to adopt incentive plan – still highest payout (up to 100% of base)

# People

- Hire the best raw talent available
  - Ethical, smart, hard working, team oriented, passion for investments, desire for long term opportunity
- Train them to apply “our” investment process
  - Usually starts with summer internship “boot camp”
- Motivate them to work hard (hustle attitude)
  - Sense of urgency, expectation of winning, contagiousness
- Instill teamwork philosophy
  - Well functioning teams superior to individuals
- Get them to want to stay long term
  - Fair treatment, quality teammates, support when underperforming

# Process

- Valuation frameworks focus on long term value
  - Based on present value of future cash flows
  - Inputs must reflect underlying economics
  
- Disciplined implementation and patience

# Improvement

- Learn from mistakes
  - Admit to mistakes
  - Depersonalize to prevent defensiveness
  - Discuss what can be learned
  
- Involve teammates
  - Goal is more important than individual ego
  - Allows best thoughts to get incorporated in process

# Asset Categories

## ➤ Internal

- Global Equity – (since 2004, domestic 1974, international 1992)
- Fixed Income (since 1973)
- High Yield Corporate Debt (since 1977)
- Merger Arbitrage (since 1990)
- Convertible Arbitrage (since 1993)
- Asset Allocation (since 1986)
- Distressed Corporate Debt (starting in 2007)

## ➤ External

- Private Equity (since 1995)
- Real Estate (since 1994)
- Distressed mortgage debt (starting in 2007)
- Educational relationships – Global Equity, Distressed debt

# Equity Valuation Process Overview

- Fundamental background research
  - company and industry competition dynamics
- Estimate normal earnings
  - line by line income statement normalization
  - adjust to reflect economic reality - options, pensions, R&D, goodwill
- Estimate normal growth
  - assess amount of reinvestment, return on reinvestments, acquisitions, repurchases, leverage, industry potential
- Calculate normalized dividend stream
  - based on normalized earnings, pay-out ratio, and growth rate
- Calculate discounted value of normalized dividend stream
  - discount rate is risk adjusted using assigned risk rating
- Probability weight scenarios such as being acquired
- Compare price to discounted value to get **Price/Value**

# Concerns

- Liability side of pension funds
  - New promises only when can afford under conservative scenarios
  - Do not extrapolate past returns – must focus on underlying drivers
  
- Asset Allocation
  - Many chase past performance – by then too late – be contrarians
    - » Deviate from normal only if prices have deviated from fair value
  - Be skeptical regarding historical correlations and volatilities
    - » Future risks may not be represented in the historical sample period
    - » Limited true historic sample size – subdividing periods  $\neq$  bigger sample
    - » Risk measures should focus on severe adverse outcomes – not normal times
    - » Extra risk taken in reliance on false diversification increases systemic risk
  
- Alpha Strategies (i.e. efforts to add value with lots of leverage and at high fees)
  - Alpha universe returns suffer survivor bias – believe return history distorted
  - Too much money inflow – end up with leveraged exposure to traditional indices