JOINT MEETING

SOUTH DAKOTA RETIREMENT SYSTEM and SOUTH DAKOTA INVESTMENT COUNCIL

June 14, 2017

The Board of Trustees of the South Dakota Retirement System held a joint meeting with the South Dakota Investment Council on June 14, 2017. The meeting was held at the South Dakota Investment Council conference Room, 4009 W. 49th Street, Sioux Falls, South Dakota.

BOARD MEMBERS IN ATTENDANCE:

James Johns, Vice Chair
Karl Alberts
Penny Brunken
Jilena Faith
Laurie Gill
Kathy Greeneway
Laurie Gustafson
James Hansen
Myron Johnson
Louise Loban
Matt Michels
KJ Peterson
Eric Stroeder
Matt Clark, Ex Officio

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Board members Steve Caron and Justice Steven Zinter were absent.

SOUTH DAKOTA INVESTMENT COUNCIL MEMBERS IN ATTENDANCE:

David Hillard, Chair
Lorin Brass
Ryan Brunner
Steve Kirby
Laura McNally
Jeff Nelson
Rich Sattgast

OTHERS IN ATTENDANCE:

Liza Clark, BFM
Deene Dayton
Brett Fligge, SDIC
June Larson, Nationwide Retirement Solutions
Chris Nelson, SDIC
Kevin Nom, DOT Intern
Eric Ollila, SDSEO
Tammy Otten, SDIC
Paul Schrader
Christa Siter, SDIC
Lowell Slyter
Jim Terwilliger, BFM
Mark Quasney, BFM
Rob Wylie
Jane Beer
Doug Fiddler
Michelle Mikkelsen
Ryan Mikkelsen
Dawn Smith
Jacque Storm

For continuity, these minutes are not necessarily in chronological order.

AGENDA ITEM 1
BOARD MEMBER CONFLICTS DISCLOSURE

Summary of Presentation
No board member had any conflict to disclose.

Board Action
No action was necessary.

AGENDA ITEM 2
APPROVAL OF NOVEMBER 3, 2016, AND APRIL 5, 2017, MEETING MINUTES

Board Action
IT WAS MOVED BY MS. PETERSON, SECONDED BY DR. HANSEN, TO APPROVE THE MINUTES OF THE NOVEMBER 3, 2016 AND APRIL 5, 2017, BOARD OF TRUSTEES MEETING AS CORRECTED. THE MOTION PASSED UNANIMOUSLY ON A VOICE VOTE.

AGENDA ITEM 3
OLD/NEW BUSINESS

Summary of Presentation
Mr. Rob Wylie, SDRS Executive Director, discussed the upcoming SDRS Board meeting dates.

Board Action
No action was necessary.

AGENDA ITEM 4
ELECTION RESULTS

Summary of Presentation
Ms. Dawn Smith, SDRS Executive Assistant, stated that there were five positions up for election this year. James Appl (Teachers), Laurie Gustafson (State Employees), Dr. James Hansen (Retirees), and KJ Peterson (County Employees) won their respective elections and will begin their new four-year term July 1, 2017. She noted that there were no candidates for the Elected Municipal Official representative and stated that the Board would have to appoint a replacement.

Board Action
IT WAS MOVED BY MS. BRUNKEN, SECONDED BY MS. GREENEWAY, TO ACCEPT THE ELECTION REPORT AND DECLARE JAMES APPL (TEACHERS), LAURIE GUSTAFSON (STATE EMPLOYEES), DR. JAMES HANSEN (RETIREES), AND KJ PETERSON (COUNTY EMPLOYEES) AS THE WINNERS OF THE 2017 SDRS BOARD OF TRUSTEES ELECTION. THE MOTION PASSED UNANIMOUSLY ON A VOICE VOTE.

AGENDA ITEM 5
APPOINTMENT OF ELECTED MUNICIPAL OFFICIAL REPRESENTATIVE

Summary of Presentation
Ms. Smith noted that because Ms. Laurie Gill, the elected municipal official representative, did not seek another term as mayor she would no longer be eligible for her position effective June 30, 2017. The Board therefore, needs to appoint a replacement elected municipal official representative for the term July 1, 2017, through June 30, 2021.

Board Action
ROY LINDSAY RECEIVED THE MOST VOTES, WHICH WERE CAST BY SECRET BALLOT. IT WAS MOVED BY DR. HANSEN, SECONDED BY MS. GILL TO APPOINT ROY LINDSAY AS THE ELECTED MUNICIPAL OFFICIAL REPRESENTATIVE TO REPLACE LAURIE GILL. THE MOTION PASSED UNANIMOUSLY ON A VOICE VOTE.

AGENDA ITEM 6
RECOGNITION OF RETIRING BOARD MEMBER

Board Action
IT WAS MOVED BY MS. LOBAN, SECONDED BY MR. ALBERTS FOR A VOTE OF APPRECIATION TO STEVE CARON FOR HIS SERVICE ON THE BOARD OF TRUSTEES BY ADOPTING THE FOLLOWING RESOLUTION:

> WHEREAS, Steve Caron has served the Board of Trustees of the South Dakota Retirement System for eight years;
>
> WHEREAS, Steve Caron has worked and been very concerned for a financially sound and progressive retirement system;
>
> NOW THEREFORE, BE IT RESOLVED, that the Board of Trustees of the South Dakota Retirement System wishes to thank Steve Caron for his positive efforts toward meeting the objectives of the plan and to wish him success in all future endeavors.

THE MOTION PASSED UNANIMOUSLY ON A VOICE VOTE.

AGENDA ITEM 7
FINALIZE THE FY2018 IMPROVEMENT FACTOR

Summary of Presentation
Mr. Wylie stated that SDCL 3-12-89.5 regarding the improvement factor states that the annual increase shall be established by the Board for each fiscal year, based on the Consumer Price Index and the System's fair value funded ratio.

After review of the improvement factor calculation process, 2.1 percent is the recommended FY2018 improvement factor (COLA).

Board Action:
IT WAS MOVED BY MR. JOHNSON, SECONDED BY MS. GILL, TO ESTABLISH THE IMPROVEMENT FACTOR FOR FISCAL YEAR 2018 AT 2.1 PERCENT. THE MOTION PASSED UNANIMOUSLY ON A VOICE VOTE.

AGENDA ITEM 8
FY 2019 BUDGET REQUEST

Summary of Presentation
Ms. Jane Beer, SDRS Chief Financial Officer, stated that the financial impact related to the staff's recommended expenditure authority changes for the FY 2019 budget is $82,000.

Ms. Beer noted that the recommended line-item expenditure authority changes included:

- $5,000 to cover the fees associated with ACH expenditures through the banking system;
- $25,000 to cover expenses related to central services;
- $50,000 for the increase in administrative hearings to cover legal fees associated with the HHS/OMB appeal; and
- $2,000 for the rent of meeting spaces for the planners when they travel the state.

Mr. Michels stated that in his opinion, SDRS should ask for $100,000 increase in administrative hearings to cover the HHS/OMB appeal.

Board Action:
IT WAS MOVED BY MS. PETERSON, SECONDED BY MS. LOBAN, TO APPROVE THE BUDGET REQUEST AS DISCUSSED WITH THE ADDITIONAL $50,000 FOR ADMINISTRATIVE HEARINGS. THE MOTION PASSED UNANIMOUSLY ON A VOICE VOTE.

AGENDA ITEM 9
SUPPLEMENTAL RETIREMENT PLAN
THIRD PARTY ADMINISTRATOR CONTRACT

Summary of Presentation
Mr. Wylie stated that the Supplemental Retirement Plan third party administrator contract was up for renewal. He requested authority to extend the contract for six months to allow CEM to do a benchmarking study and noted that in December he would have a recommendation for the renewal based on the results of the study.

Board Action
IT WAS MOVED BY MR. ALBERTS, SECONDED BY DR. HANSEN, TO EXTEND THE THIRD PARTY ADMINISTRATOR CONTRACT FOR SIX MONTHS. THE MOTION PASSED UNANIMOUSLY ON A VOICE VOTE.

AGENDA ITEM 10
REVIEW OF SDRS LONG-TERM BENEFIT GOALS

Summary of Presentation
Mr. Paul Schrader, Retirement Consultant, stated that due to the extensive benefit changes that have taken place over the past couple of years, the SDRS long-term benefit goals document had been updated to include the differentiation between the Foundation provisions and the Generational provisions compared to the SDRS long-term benefit goals.

Board Action
IT WAS MOVED BY MS. LOBAN, SECONDED BY MS. GREENEWAY, TO CONCUR WITH THE CHANGES TO THE LONG-TERM BENEFIT GOALS AS PRESENTED. THE MOTION PASSED UNANIMOUSLY ON A VOICE VOTE.

AGENDA ITEM 11
UPDATE TO THE SOUTH DAKOTA PERSPECTIVE

Summary of Presentation
Mr. Wylie discussed the benefit policy positions for SDRS. He stated that a defined benefit plan is preferred because it is the most efficient and advantageous design for members, employers, and taxpayers. The hybrid features that combine the advantages of both a defined benefit and a defined contribution plan are essential for an equitable distribution of benefits to both career and non-career members.

Moving to governance and plan management positions, Mr. Wylie stated that the SDRS Board of Trustees must act as fiduciaries of the plan and actively lead SDRS. He noted that fixed contributions are a prudent financial decision and SDRS benefits must be managed accordingly. The realistic planning horizon for mature systems like SDRS is 10-20 years due to the duration of liabilities.

Moving to the funding policy positions, Mr. Wylie stated that the SDRS funding policy must specify the minimum funding standards that dictate when changes are required or should be considered. He added that future mortality improvement must be considered in the actuarial assumptions and that recommendations for corrective actions are required under SDCL 3-12-122 unless both the fixed, statutory contributions are sufficient to meet the actuarial requirement and the fair value funded ratio is 100 percent or more.

In conclusion, Mr. Wylie noted that a well-funded defined benefit plan with fixed, shared member and employer contributions and hybrid, variable benefit features is the most efficient and advantageous design for members, employers, and taxpayers.

Board Action
No action was required.

AGENDA ITEM 12
LOOKING BACK AND PLANNING FORWARD

Summary of Presentation
Mr. Schrader stated that SDRS is unique with fixed, statutory contributions, adjustable benefits to meet resources and economic realities, and recent initiatives and future planning that the Board has undertaken in managing SDRS to be sustainable and successful.

Referring to studies done by Wilshire and Milliman, Mr. Doug Fiddler, SDRS Senior Internal Actuary, stated that the SDRS fair value funded ratio compared to our peers has consistently been more than 20 percent higher since 2012. In 2016, SDRS' fair value funded ratio was 97 percent, compared to the statewide plan average of 70 percent. He noted that SDRS had added approximately one billion dollars in liability due to assumption changes during that time period as well.

Mr. Schrader reviewed the recent initiatives that SDRS has undertaken. These initiatives include the SDRS funding policy and the commitment to fully fund the system with no unfunded liabilities, the expanded variable benefits in a new design for future members hired after July 1, 2017, and the restructured COLA that considers inflation and SDRS resources. There were also changes to the actuarial assumptions including the adoption of the generational mortality table, a completed five-year experience analysis, changes to the economic assumptions to align with SDIC expectations, and modifications to the demographic assumptions to match experience.

Other initiatives, stated Mr. Schrader, include changes to GASB requirements, addressing subsidies and inequities within SDRS, documenting South Dakota and SDRS perspectives on system management, and the installation of a new administrative system.

Mr. Schrader reviewed the alternative approach in the industry called the financial economics theory which uses risk-free rates as opposed to the estimated returns for plan assets and what that theory would mean to SDRS. He noted that if SDRS used the financial economics theory, SDRS would:

- have a funded ratio of 64 percent instead of 97 percent;
- have to increase contributions to over 50 percent of pay or reduce benefits by 65 percent; and
- have assets of less than $2 billion rather than over $11 billion.

Mr. Schrader noted that SDRS started with $49 million in 1974. Since that time, $4.5 billion in contributions were added, $6.6 billion in benefits/expenses were paid, and $12.5 billion in investment income was received to get SDRS to $10.5 billion in assets as of June 30, 2016.

Mr. Schrader pointed out that SDRS has a lot of synergy with SDIC. For example, SDRS utilizes a strategic long-term approach to managing SDRS with fixed resources, stakeholder buy-in, benefit and administrative efficiencies, a contrarian approach, and a 6.5 percent investment return assumption that aligns with the SDIC outlook.

Reviewing the future planning issues, Mr. Schrader stated that SDRS will need to update policies and goals, refine risk measures, establish a plan for future benefit changes, and monitor, communicate, and recommend all changes to stakeholders.

Board Action

No action was required.

AGENDA ITEM 13
UPDATE OF FY2017 INVESTMENT PERFORMANCE

Summary of Presentation
Mr. Matt Clark, South Dakota State Investment Officer, informed the Board that as of May 31, the SDRS trust fund had a fiscal year-to-date return rate of approximately 13 percent.

Board Action
No action was required.

AGENDA ITEM 14
REVIEW OF SDRS PROJECTED FUNDED STATUS

Summary of Presentation:
Mr. Fiddler presented estimated funding status results for June 30, 2017. He stated that if the investment return for SDRS for the fiscal year ending June 30, 2017, remained at approximately 12 percent, the fair value funded ratio would be approximately 100 percent.

Mr. Fiddler stated that average inflation from 2010-2016 was 1.3 percent. During that same time period, the SDRS COLA has averaged 2.7 percent. Mr. Fiddler advised that over that time period SDRS retirees' benefits increased 10 percent more than if they just kept pace with inflation.

Mr. Fiddler discussed the impact of the fiscal year 2017 investment return on the 2018 maximum COLA, the projected future COLA ranges, and the likelihood of additional required corrective actions assuming a 12 percent net investment return for fiscal year 2017. He stated that the preliminary estimated 2018 restricted COLA maximum would be 1.8 percent based on a 12 percent fiscal year 2017 net investment return.

Board Action
No action was necessary.

AGENDA ITEM 15
ASSET ALLOCATION

Summary of Presentation
Mr. Clark discussed the asset allocation process, importance, and application to SDRS. He discussed the recommended benchmark allocation and ranges, expected return and standard deviations, asset category valuation, and the movement of category allocations within ranges based on valuation.

Mr. Clark discussed the recommended benchmark level of equity-like and bond-like risk to balance long-term potential returns with drawdown risk in difficult markets. He indicated this was for the benchmark which should represent what could be adhered to through thick and thin. He showed charts of historic returns noting the dominance of equity returns over the very long term and also highlighted the diversification benefit of mixing in some bonds during market downturns. He discussed the recommended range for equity-like risk and bond-like risk. He said the goal is to enter market downturns with below benchmark risk and increase toward maximum during the downturn to benefit from an eventual rebound. He added that after getting to minimums and maximums, markets will typically move further, which can be very painful. It is essential to be patient for at least another three to five years.

Mr. Clark discussed equity-like and bond-like risk mapping for all asset categories. He discussed the specific asset categories to be included in the benchmark which are significant and passively implementable. He discussed other niche or skill-based categories which are not in the benchmark but that have a permitted range. He presented the SDRS capital market benchmark allocations and minimum/maximum ranges for each asset category. The capital markets benchmark allocations for fiscal years 2009 through 2017 were shown. The staff's recommended benchmark for FY 2018 was also shown.

Mr. Clark showed the SDRS historical levels of equity-like allocation back to 1987. He reviewed the asset allocation risk/return analysis. The first portion focused on long-term mean expected returns with conventional expected standard deviation and asset correlations as provided by JP Morgan Asset Management. The incremental return and standard deviation impact of each asset class was shown. The second portion was the same except internal asset category expected returns and internal adjusted risk measures were used.

Mr. Clark discussed additional risk measures and risk control. He reiterated that the focus is on equity-like risk and bond-like risk which includes embedded equity and bond risk of all categories. He said statistical measures of risk such as standard deviation and correlation are also calculated but are adjusted to reflect higher real world frequency and magnitude of adverse outlier events. Behavior of some assets in a crisis can vary depending on whether the crisis is rooted in inflation or deflation concerns. Mr. Clark discussed how risk is managed by broad diversification and by reducing amounts invested in expensive assets. He said adequate liquidity is maintained to avoid liquidations of depressed assets and to allow rebalancing. He stated that participation in the economic system is necessary to get the highest long-term rewards but short-term ebbs and flows must be endured. He added that strength and determination is important to be able to handle tough markets, which is helped by strong funding built up in good markets.

Mr. Clark then discussed asset category valuation. The modeling process for equities (S&P500) is similar to how individual companies are valued using estimated future cash flows based on normal earnings and growth rates and a risk impacted discount rate. He discussed adjustments to fair value based on monetary conditions and corporate earnings strength. He discussed the equity and bonds, real estate, and high yield valuation processes.

Mr. Clark showed the current and historical valuations of each asset class and historical efficacy of the valuation process and discussed the plan for adjusting allocations within permitted ranges based on valuation.

There was discussion about the use of valuation of the S&P500 to adjust equity-like risk. It was noted that valuations of non U.S. markets or small caps can be different than for the S&P500. Mr. Clark indicated large cap U.S stocks represented the majority of the internal equity universes and further non U.S. securities are half-weighted to create a home country bias. He added that historical data for the S&P500 is more robust, enhancing confidence in the process. He said smaller and non U.S. stocks are valued one stock at a time through the internal equity portfolio management process, and those areas can be over-weighted in the equity portfolios when attractively valued. He said research projects were underway to value non U.S. and smaller company at the index level which could help broaden valuation inputs used to set the equity-like risk.

Board Action
No action was necessary.

ADJOURNMENT

Board Action
IT WAS MOVED BY MS. PETERSON, SECONDED BY MR. JOHNSON, THAT THERE BEING NO FURTHER BUSINESS, THE MEETING BE DECLARED ADJOURNED. THE MOTION PASSED UNANIMOUSLY ON A VOICE VOTE.

Respectfully Submitted,

Robert A. Wylie
Executive Director