BOARD MEETING

SOUTH DAKOTA RETIREMENT SYSTEM

April 6, 2016

The Board of Trustees of the South Dakota Retirement System held its regular Board meeting on April 6, 2016. The meeting began at 9:00 a.m. in the Downstairs Conference Room at the View 34 Restaurant in Pierre.

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BOARD MEMBERS IN ATTENDANCE:

Elmer Brinkman, Chair
Karl Alberts
Steven Caron
Jason Dilges
Jilena Faith
Laurie Gill
Laurie Gustafson
James Hansen
James Johns
Louise Loban
Bonnie Mehlbrech
Matt Michels
KJ Peterson
Eric Stroeder
Matt Clark – Ex Officio

Board members Dave Merrill and Steve Zinter were absent.

OTHERS IN ATTENDANCE:

Deene Dayton
Stephanie Gruba, LRC
Bob Mercer, Newspaper
Paul Schrader
Sandra Waltman, SDEA
Rob Wylie

Travis Almond
Doug Fiddler
Susan Jahraus
Michelle Mikkelsen
Jess Reitzel
Jane Roberts
Dawn Smith
Jacque Storm

AGENDA ITEM 1
APPROVAL OF MEETING MINUTES

Board Action
IT WAS MOVED BY MS. LOBAN, SECONDED BY MS. PETERSON, TO APPROVE THE MINUTES OF THE NOVEMBER 18, 2015, AND DECEMBER 3, 2015, BOARD MEETINGS. THE MOTION PASSED UNANIMOUSLY ON A VOICE VOTE.

AGENDA ITEM 2
BOARD MEMBER ANNOUNCEMENTS AND ELECTION UPDATE

Summary of Discussion
Ms. Bonnie Mehlbrech informed the Board of her decision to resign from the Board effective July 1, 2016. She stated that she will be moving to Alaska to teach in a remote village. The Board wished her well in her new adventure.

Ms. Dawn Smith, SDRS Executive Assistant, informed the Board of the process to fill a vacancy. She stated that a letter would be sent to all the schools informing them of the vacancy for a teacher member and requesting any interested candidate to submit a resume. It is the Board's responsibility to appoint a replacement at the June meeting.

Board Action
No action was required.

AGENDA ITEM 3
EXECUTIVE DIRECTOR/ADMINISTRATOR'S EVALUATION

Summary of Discussion
Mr. Elmer Brinkman, SDRS Board Chair, informed the Board that he had received and tallied the results of the Executive Director/Administrator's evaluation.

The Board requested that staff look into using electronic medium for future evaluations.

Board Action
IT WAS MOVED BY MS. PETERSON, SECONDED BY MR. ALBERTS, TO GO INTO EXECUTIVE SESSION PURSUANT TO SDCL 1-25-2 FOR PERSONNEL MATTERS. THE MOTION PASSED UNANIMOUSLY ON A VOICE VOTE.

IT WAS MOVED BY LT. GOV. MICHELS, SECONDED BY MR. STROEDER, TO AUTHORIZE THE SAME ACROSS-THE-BOARD SALARY ADJUSTMENT INCLUDING ANY MOVEMENT TO MARKET VALUE FOR THE EXECUTIVE DIRECTOR/ADMINISTRATOR AS THE GOVERNOR APPPROVED FOR ALL OTHER STATE GOVERNMENT EMPLOYEES. THE MOTION PASSED UNANIMOUSLY ON A VOICE VOTE.

AGENDA ITEM 4
2016 LEGISLATIVE REPORT

Summary of Discussion
Mr. Rob Wylie, SDRS Executive Director/Administrator, discussed the 2016 Legislative Session. He explained that all of the SDRS bills passed through both bodies of the Legislature and were signed by the Governor.

Ms. Jacque Storm, SDRS General Counsel, stated that there were several other bills SDRS was watching during the Legislative Session. These included bills in three topic areas – public meetings, conflicts of interest, and performance management - that might impact SDRS in some way.

Mr. Wylie reviewed the changes to the SDRS Legislative Policies and Procedures. He noted that there were only a few changes including adding a paragraph that asked the Retirement Laws Committee to send any legislation that does not come from the Board back to the Board before taking any action on it, and changing the testimony to include that if testimony by staff is not appropriate, the Chair shall determine who will testify on behalf of the Board.

Board Action
IT WAS MOVED BY MS. LOBAN, SECONDED BY MS. MEHLBRECH, TO APPROVE THE REVISED LEGISLATIVE POLICIES AND PROCEDURES AS PRESENTED BY STAFF. THE MOTION PASSED UNANIMOUSLY ON A VOICE VOTE.

AGENDA ITEM 5
FINANCIAL INFORMATION UPDATE

Summary of Discussion

Ms. Jane Beer, SDRS Chief Financial Officer, stated that the budget went very well this year. She noted that SDRS asked for an increase of $45,000 in the budget and that increase was approved. She added that she is currently working with Bureau of Finance and Management on obtaining expenditure authority from the developmental pool for a contract to finish the new computer system.

Ms. Beer stated that SDRS implemented GASB 67 Financial Reporting for pension plans in fiscal year 2014 and GASB 68 accounting and financial reporting for pension plans in fiscal year 2015.

She noted that SDRS had more than 250 staff hours in preparing data, templates, and training for employers. For the State CAFR, the Bureau of Finance and Management estimated they had between 250-300 staff hours just in the implementation and estimated another 100-150 staff hours going forward. In looking at what it might take for a smaller employer, noted Ms. Beer, the Department of Legislative Audit estimated that it would take 15-20 staff hours for the Mobridge Schools, for example.

Other GASB issues, advised Ms. Beer, included the covered payroll vs covered employee payroll, employer paid contributions being treated consistently between Statement 67 and 68, and the actuarial assumptions disclosed under Statements 67, 68, and 73.

Board Action

No action was required.

AGENDA ITEM 6
INVESTMENT PERFORMANCE UPDATE

Summary of Discussion

Mr. Matt Clark, State Investment Officer, stated that through March 31, the estimated return for SDRS was minus 2.9 percent.

Board Action

No action was necessary.

AGENDA ITEM 7
REVIEW OF PROJECTED FUNDED STATUS

Summary of Discussion

Mr. Doug Fiddler, SDRS Senior Actuary, noted that the presentation had a new look to it. He noted that in addition to the range around the estimated investment return, there were other important investment return assumptions based on the milestones for the funding measures.

Mr. Fiddler stated that as of June 30, 2015, the SDRS fair value funded ratio was 104 percent and the actuarial value funded ratio was 100 percent.

If the investment return for the fiscal year ending June 30, 2016, is negative 2.5 percent, advised Mr. Fiddler, the market value funded ratio would decrease to 95 percent, the actuarial value funded ratio would remain at 100 percent, the deficit would increase to $576 million, and the risk management contribution would remain at $32 million.

It is likely, advised Mr. Fiddler, that SDRS will report a fair value funded ratio (FVFR) of less than 100 percent, an actuarial value funded ratio (AVFR) of 100 percent and a deficit rather than at cushion at June 30, 2016. The 100 percent FVFR goal will not be met unless the investment returns are 2.9 percent or greater. The 100 percent AVFR goal will continue to be met if FY 2016 investment results are greater than negative 14 percent. If these returns are not met, a number of the Board's funding goals will not be met. With additional losses, SDCL 3-12-122 condition (3) may be reached requiring additional reporting on possible corrective actions.

Moving to the GASB results, Mr. Fiddler stated that with a negative 2.5 percent return the net pension liability at June 30, 2016, would be $576 million. This would leave a net balance sheet asset of $310 million and a plan expense of $170 million.

Mr. Fiddler stated that the first two years under GASB Statement numbers 67 and 68, the SDRS funded ratios had resulted in balance sheet assets and revenues. SDRS will have a net pension liability as of June 30, 2016, instead of a net pension asset. However, GASB requires a five-year recognition of investment gains and losses, therefore the net impact to the employers' balance sheets will remain an asset as of June 30, 2016, and pension plan expense, not revenue, will be recognized on the employers' income statements.

With a negative 2.5 percent return, stated Mr. Fiddler, the minimum annual investment return required over the next 5, 10, and 20 years would be 8.5 percent, 7.9 percent, and 7.6 percent, respectively. He noted that the required net investment returns consider the risk management contribution made until the cushion is exhausted at the end of each period. At that point, investment returns (less the effect of the risk management contribution) must equal or exceed the assumed investment return to avoid creating a deficit. Future risk management contributions will reduce the net investment income required.

Mr. Fiddler stated the minimum annual net investment return required to avoid corrective actions over the next 5, 10, and 20 years with a negative 2.5 percent return would be 3.9 percent, 5.7 percent, and 6.7 percent respectively. Lower returns will result in crossing the SDCL 3-12-122 thresholds for corrective action.

AGENDA ITEM 8
CURRENT FUNDED STATUS IMPLICATIONS AND FUTURE ISSUES

Summary of Discussion

Mr. Paul Schrader, SDRS Consultant, gave the Board a brief synopsis of what has happened since 2009. He stated that in 2010 the Board did corrective actions based on the 2009 funding results. SDRS has had very favorable investment results of over 11 percent per year since then, but they were less than the assumption for the last two years. The corrective actions and favorable returns have together eliminated the deficit and returned the fair value funded ratio to over 100 percent, paid off unfunded liabilities, and allowed strengthening of actuarial assumptions. There has also been very low inflation, about 1.6 percent per year.

The adoption of Senate Bill 13, the new benefit design for new members, advised Mr. Schrader, will be very important long-term to the management of SDRS; however, it will be a slow process as it only impacts new people after 2017. Therefore, it will not help the funded status of the system in the short-term.

Without a market recovery prior to June 30, advised Mr. Schrader, the Board funding objective of 100 percent fair value funded ratio will not be met, there will be no cushion, the actuarial value funded ratio will be met resulting in no unfunded liabilities and statutory contributions exceeding the actuarial requirements will be met. The fair value of assets/actuarial value of assets ratio may be near 90 percent, which is SDCL 3-12-122 condition (3).

Senate Bill 13's benefit structure for generational members adds flexible benefits that will eventually help stabilize the funded status by automatically adjusting a portion of benefits and liabilities based on investment performance. It does not address the benefits and liabilities of foundation members, which are 100 percent of existing liabilities and will be the vast majority of liabilities for a significant period.

Mr. Schrader noted that there are three conditions to SDCL 3-12-122. They are condition (1) contributions do not meet the actuarial requirement; condition (2) funded ratio is less than 80 percent; and condition (3) fair value of assets is less than 90 percent of the actuarial value of assets. If any of the three conditions exist for one year, reporting, analysis, and recommendation for circumstances and timing of changes are required. If any of the three conditions exist for three consecutive years, recommendations for benefit changes, contribution changes or other corrective actions are required.

Since 1986, SDCL 3-12-122 conditions existed only at June 30, 2009, when all three existed, advised Mr. Schrader. In 2009 the Board recommended immediate corrective actions which resolved only conditions (1) and (2). This left a significant deficit requiring continued market recovery to eliminate condition (3). The Board discussed treating condition (3) only as a "yellow light" and not recommending corrective actions to resolve condition (3) unless it existed for three years. The combination of corrective actions and the market recovery resulted in a fair value funded over 100 percent by June 30, 2011.

Mr. Schrader stated that considering the projected SDRS results and the current volatile financial markets, formalizing a SDCL 3-12-122 action plan addressing the following issues would be prudent and advisable:

- If condition (3) exists alone, does the Board recommend corrective actions immediately or only after three years?
- If conditions (1) and (2) exist, does the Board again recommend corrective actions immediately?
- If conditions (1) and (2) exist, does the Board again recommend corrective actions large enough to resolve conditions (1) and (2) but not condition (3)?
- Should specific benefit provisions be addressed before others?
- What conclusions can the Board draw from the favorable opinion on the lawsuit?

Mr. Schrader stated that the last comprehensive review of actuarial assumptions was completed prior to the June 30, 2012, valuation with the mortality assumption updated effective June 30, 2014. The select investment return assumption expires June 30, 2017. The most common period between experience studies is five years, which typically provides sufficient data to determine trends. Doing the next experience study after the June 30, 2016, actuarial valuation may be advisable as the assumption changes impact both long-term cost projections and short-term comparisons to funding objectives and SDCL 3-12-122 conditions.

The current SDRS investment return assumption of 7.25/7.5 percent is more optimistic than the outlook by most investment professionals, including the South

Dakota Investment Council. The SDRS inflation assumption of 3.25 percent is also significantly higher than recent experience and most outlooks.

Mr. Fiddler stated that other issues facing SDRS is the impact of the teacher salary increases. The 2016 legislation increased the state sales tax with a large portion of the proceeds (estimated $67 million) designated for teacher salary and benefit increases. The increased benefit costs will reduce the actual salary increase to $57 million, compared to a projected FY 2017 SDRS covered payroll of $1.85 billion, a 3.1 percent increase. SDRS experiences liability losses if salaries increase more than assumed. The $57 million salary increase for teachers is expected to eventually increase SDRS liabilities by about $133 million. However, several factors could delay or offset the potential losses.

Another issue facing SDRS, advised Mr. Fiddler, is the Public Employee Pension Transparency Act (PEPTA). This was re-introduced in the House this year. It would require additional disclosure and determination of funding status using three segment rates based on the US Treasury Obligation Yield Curve. Liabilities would be "current liabilities" based on accrued benefits rather than "entry age accrued liabilities". The detailed requirements would be in IRS regulations. Under the proposed PEPTA, the SDRS funded ratio would go from its current 104 percent down to 81 percent. This would portray SDRS as underfunded, create doubt as to proper calculation basis, and add even more confusion.

Board Action

IT WAS MOVED BY LT. GOV. MICHELS, SECONDED BY DR. HANSEN, FOR STAFF TO START AN EXPERIENCE STUDY AFTER COMPLETION OF THE FY16 ACTUARIAL VALUATION. THE MOTION PASSED UNANIMOUSLY ON A VOICE VOTE.

AGENDA ITEM 9
REVIEW OF THE SDRS MISSION STATEMENT AND SDRS FUNDING POLICY

Summary of Discussion

Mr. Wylie stated that staff thought this was the right opportunity for SDRS to rework its mission statement and have just the straightforward mission statement with an emphasis on sustainability and moving the remainder of the old mission statement to a section called core values. The new document is really just restructuring what SDRS has had but also adding some emphasis on sustainability and recognition of a fixed resource that SDRS has worked with for the past 40 years.

Moving to the Funding Policy, Mr. Wylie stated that throughout the document, market value was changed to fair value, the order of actuarial value of assets and cushion was switched, the reserve was moved to the third column, and a statement about the annual funded status report to the Governor and Retirement Laws Committee was added.

Mr. Wylie noted that ultimately, as staff begins working on the generational benefit design, the funding policy may need to be amended again.

Board Action

IT WAS MOVED BY LT. GOV. MICHELS, SECONDED BY MS. PETERSON, TO ADOPT THE PROPOSED AMENDMENTS TO THE SDRS MISSION STATEMENT AS PRESENTED BY SDRS STAFF, WITH THE REMOVAL OF THE WORDS "SOUND AND" FROM THE PROPOSED SDRS MISSION STATEMENT, AND THE WORD "ADEQUATE" FROM THE PROPOSED CORE VALUES. THE MOTION PASSED UNANIMOUSLY ON A VOICE VOTE.

IT WAS MOVED BY MR. STROEDER, SECONDED BY MS. GUSTAFSON, TO ADOPT THE PROPOSED AMENDMENTS TO THE FUNDING POLICY AS PRESENTED BY SDRS STAFF. THE MOTION PASSED UNANIMOUSLY ON A VOICE VOTE.

AGENDA ITEM 10
CEM REPORT

Summary of Discussion

Mr. Wylie explained that since the first CEM Benchmarking report was completed for SDRS in 2005, there have been many improvements made in the customer service areas of SDRS.

Mr. Wylie stated that SDRS was by far one of the smallest state plans that CEM had in their study and was the smallest system in the peer group used for comparison of SDRS.

He noted that SDRS' total pension administration cost per active member and annuitant was $67. This was higher than in the past years because of the major project of the data transformation system upgrade.

Some of the reasons why SDRS' total cost was below the peer average included the lower transactions per members, higher transactions per FTE, lower costs per FTE for salaries and benefits, lower third-party and other costs in front–office activities, and paying less for back-office activities.

The total service score for SDRS, advised Mr. Wylie, was 85 out of 100. This was above the peer median of 81. CEM defines service from the member's perspective as faster turnaround times, more availability, more choice, and higher quality.

The key takeaways from this year's CEM report, stated Mr. Wylie, were:

- SDRS' cost of $67 per member and annuitant was among the lowest of the peer group and one of the lowest in CEM's universe.
- SDRS' service score was 85 – above the peer median score of 81.
- SDRS' has maintained or increased its service levels in all activities.

Board Action
No action was necessary.

AGENDA ITEM 11
DATA PROCESSING PROJECT UPDATE

Summary of Discussion
Ms. Susan Jahraus, SDRS Operations and Compliance Director, reviewed the legacy code transformation data processing system upgrade timetable. She noted that the process began in October of 2012 with the Board authorizing the request for proposals. In January 2014 the Board authorized finalizing the negotiations with Metex and the statement of work was signed in April 2014. In February 2015 SDRS submitted a change request for a portion of the legislation that went into effect July 1, 2015. User testing began in May and SDRS submitted a second change request for the "group by" issues in November 2015. In March 2016, user testing was completed, SDRS confirmed acceptance, the source code was released to SDRS, the final invoices were paid and the project was closed.

Ms. Jahraus noted that $79,500 in additional costs were incurred as the result of the two change requests. This brought the total cost for the project to $1,579,000.

The next step, advised Ms. Jahraus, is for staff to use side by side processing to continue testing, monitoring and resolving all new and previously unidentified problems/defects that staff become aware of. Staff will also prioritize and complete programming for the backlog of work orders since the code freeze in April 2014.

Once that is done, noted Ms. Jahraus, the programmers will complete the programming in the new system for changes made during code freeze, including legislation effective July 1, 2015. They will also complete the programming for the 2016 legislation (supplemental pension benefit) and for the generational design legislation that is effective July 1, 2017. And lastly, they will prioritize and complete programming for any new work orders.

This will be a continued team effort with SDRS staff, one BIT overall project manager, one BIT software engineer manager, three BIT programmers located at SDRS and two additional programmers from Smart Software Solutions also located at SDRS. It is estimated that 8,000 hours of additional programming will be needed. This adds an additional $700,000 of non-budgeted costs with an estimated new completion date of April 2017.

Board Action
No action was necessary.

AGENDA ITEM 12
EFFECTIVE RATE OF INTEREST FOR FY2017

Summary of Discussion
Ms. Jane Beer noted that SDCL 3-12-47(27) states that SDRS's annual effective rate of interest shall be no greater than 90 percent of the average 91-day United States Treasury bill rate for the immediately-preceding calendar year.

Advising that the United States 91-day Treasury bill rate was 0.05 percent for 2015, Ms. Beer stated that 90 percent of the rate is 0.045 percent. She noted that this interest rate would be credited on July 1, 2017, for the period of July 1, 2016, through June 30, 2017.

Board Action
IT WAS MOVED BY DR. HANSEN, SECONDED BY MS. GILL, TO SET THE EFFECTIVE RATE OF INTEREST FOR FY 2017 AT 0.045 PERCENT. THE MOTION PASSED UNANIMOUSLY ON A VOICE VOTE.

AGENDA ITEM 13
SET FY2017 SUPPLEMENTAL PENSION BENEFIT INTEREST RATE ASSUMPTION

Summary of Presentation
Mr. Wylie stated that the Board needed to establish the periodic Supplemental Pension Benefit interest rate assumption. He added that the interest rate assumption could not be greater than the actuarial assumed rate of return for SDRS, nor could it be less than the SDRS effective rate of interest.

He advised that the interest rate assumption is established based on the recommendations of both the System's outside actuary and the State Investment Officer with the input of the Executive Director/Administrator. The outside actuary recommended between 2.8 and 3.8 percent and the state investment officer recommended between 3.5 and 4 percent.

Based on all of the information, and the process established by the Board, Mr. Wylie stated it was his recommendation that the Board set the Supplemental Pension Benefit interest rate assumption at 3.5 percent, effective July 1, 2016.

Board Action

IT WAS MOVED BY DR. HANSEN, SECONDED BY MS. GUSTAFSON, TO SET THE INTEREST RATE FOR THE SUPPLEMENTAL PENSION BENEFIT AT 3.5 PERCENT, EFFECTIVE JULY 1, 2016. THE MOTION PASSED UNANIMOUSLY ON A VOICE VOTE.

AGENDA ITEM 14
CONFERENCE ATTENDANCE REQUEST

Summary of Presentation

Ms. Louise Loban requested permission to attend the IFEBP Conference in Orlando, FL, November 13-16, 2016

Board Action

IT WAS MOVED BY MS. PETERSON, SECONDED BY MS. MEHLBRECH TO APPROVE MS. LOBAN'S CONFERENCE ATTENDANCE REQUEST. THE MOTION PASSED UNANIMOUSLY ON A VOICE VOTE.

AGENDA ITEM 15
OLD/NEW BUSINESS

Summary of Discussion

SDRS Year-End Survey Results

Mr. Wylie went over the year-end survey results.

Surviving Spouse Benefit

Ms. Storm stated that a legislator had visited with her about possibly bringing legislation forward to change the surviving spouse benefit and making it available to a spouse who married the member after the member's retirement if that member was married to a different spouse prior to retirement.

Upcoming Meetings
The Board discussed the upcoming meeting schedule.

<u>Board Action</u>
No action was necessary.

ADJOURNMENT

IT WAS MOVED BY MS. LOBAN, SECONDED BY MR. ALBERTS, 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/Administrator