ANNUAL REPORT OF THE FUNDED STATUS OF THE SOUTH DAKOTA RETIREMENT SYSTEM TO THE GOVERNOR AND LEGISLATURE OF THE STATE OF SOUTH DAKOTA

JANUARY 2016

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South Dakota Retirement System

January 13, 2016

To the Governor and the Legislature of the State of South Dakota

We are pleased to present the Annual Report of the Funded Status of the South Dakota Retirement System (SDRS) for the fiscal year ended June 30, 2015. The information in this report focuses on the funded status and financial condition of SDRS – the consolidated retirement system in South Dakota for most public employees.

For the third consecutive year, SDRS is fully funded on both a Fair (Market) Value basis and an Actuarial Value basis at 104.1 percent and 100.0 percent, respectively. In addition, June 30, 2015 marks the 17th time in the last 20 years that SDRS has been fully funded on a Fair Value basis. The funded status as of June 30, 2015 also results in a Net Pension Asset under Governmental Accounting Standards for our participating employers, rather than a balance sheet liability. These exceptional achievements were realized as a result of the conservative oversight of the Board of Trustees, the outstanding long-term success of the South Dakota Investment Council, and the ongoing support of the Executive and Legislative branches of state government and the SDRS membership. SDRS continues to be one of the most financially sound public employee retirement systems in the nation and is well positioned to confront the challenges of the future.

For fiscal year 2015, the SDRS Trust Fund, under the management of the South Dakota Investment Council, produced a net investment return of 4.2 percent. This exceeded the Council’s investment benchmark, but did not meet the SDRS long-term investment return assumption. Even with this lower than expected return, SDRS remains fully funded with no Unfunded Liability.

When 2015 results are released for all statewide plans, SDRS will remain among the best funded public plans nationally with Funded Ratios approximately 30 percent greater than the average of all statewide plans. This is more impressive considering that the SDRS investment return and mortality assumptions are among the most conservative used by statewide plans.

The enclosed information highlights the SDRS Mission Statement and the Board’s funding objectives. It also provides an in-depth summary of the current SDRS funded status and comparisons with the objectives, investment and actuarial experience for the year, comparative data, and initiatives of SDRS. Included is a summary of the significant legislation the Board of Trustees is proposing for the 2016 legislative session.

Looking to the future, the SDRS Board of Trustees will continue to analyze risks and anticipated future experience, study long-term sustainability, and evaluate our long-term benefit goals. SDRS remains fully committed to the SDRS hybrid defined benefit plan model that is fiscally responsible and efficient and provides adequate retirement income to our members. In addition, SDRS strives to provide outstanding member service at the lowest possible cost.

We welcome your comments and questions.

Sincerely,

Robert A. Wylie
Executive Director/Administrator

Elmer P. Brinkman
Chair of the Board of Trustees

SDRS MISSION STATEMENT

To plan, implement, and administer income replacement programs, and to encourage additional savings for retirement, all of which offer SDRS members and their families the resources and the opportunity to achieve financial security at retirement, death or disability by providing an outstanding, appropriate and equitable level of benefits.

The Board of Trustees believes this mission is achievable with the resources available in a progressive working environment, by sound and efficient management, through superior investment performance and by exercising the fiduciary responsibility associated with the proper stewardship of member assets.

LONG-TERM INCOME REPLACEMENT GOALS

SDRS INCOME REPLACEMENT GOAL:
Lifetime income replacement from SDRS resources of at least 55 percent of final average compensation for career employees in each membership class.

RECOMMENDED MEMBER TOTAL INCOME REPLACEMENT GOAL:
Lifetime income replacement of at least 85 percent of final average compensation, including income from SDRS, Social Security, and personal retirement savings of at least one time annual compensation at retirement.

FUNDING POLICY OBJECTIVES

The SDRS Board's Funding Policy (Appendix C) includes the following Funding Objectives:

- Funded Ratios[1] of 100% or greater for the Fair (Market) Value Funded Ratio and 100% for the Actuarial Value Funded Ratio.
- Ratio of Fair Value of Assets to Actuarial Value that exceeds 100%, resulting in a Cushion[2].
- Maintaining a fully funded system with no Unfunded Liabilities.
- Statutorily fixed contributions that meet or exceed the actuarially determined contribution of Normal Cost (the cost of benefits earned each year), expenses, and payment of Unfunded Liabilities over a period not to exceed 20 years when Unfunded Liabilities exist.

[1] The Funded Ratios compare the system assets at Fair Value and Actuarial Value (the expected value) to the liabilities of the System for all benefits earned to date. A value of 100% or greater means all liabilities have been funded to date and no Unfunded Liabilities exist.

[2] The Cushion represents past favorable experience and is not considered in determining the funding requirements of SDRS. It is available to offset future unfavorable experience.

CURRENT SDRS FUNDED STATUS

MEETING THE BOARD'S FUNDING OBJECTIVES

The 2015 actuarial valuation of SDRS confirms that each of the Board's funding objectives has been met as follows:

- Fair Value Funded Ratio = 104.1%
- Actuarial Value Funded Ratio = 100.0%
- Cushion of $424M, (Fair Value of Assets exceeds Actuarial Value by 4.1%)
- Fully funded System with no Unfunded Liabilities
- Statutory contributions that exceed the actuarially determined contributions by 1.75% of pay, resulting in a Risk Management Contribution

FISCAL YEAR 2015 SDRS EXPERIENCE

The SDRS money-weighted investment return based on the Fair Value of Assets was 4.2% after investment expense. This return was less than the assumed annual rate of return of 7.25%, resulting in an actuarial investment loss of $271M.

Actual Investment Return	$ 436M
Less Expected Return	(706M)
Actuarial Investment Gain/(Loss)	$ (271M)

In addition, the SDRS liabilities were 0.5% higher ($54M) than expected as of June 30, 2015.

No changes were made in SDRS benefits or actuarial assumptions during the year.

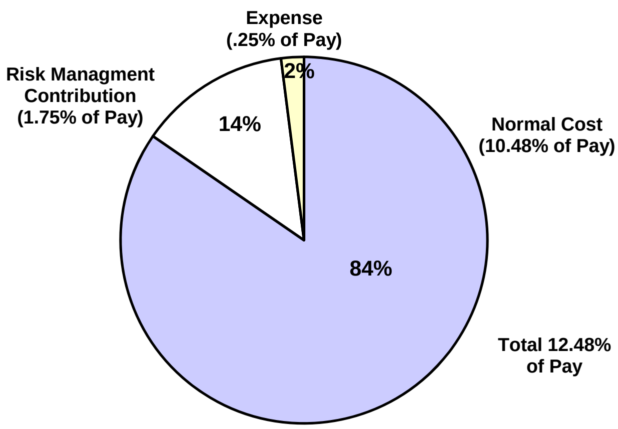
The 2015 experience combined to reduce the SDRS Fair Value Funded Ratio from 107.3% at the beginning of the year to 104.1% at the end of the year.

DISTRIBUTION OF FUNDING REQUIREMENTS

SDRS paid off its Unfunded Liabilities in 2013 from its Cushion. As a result, SDRS has had no Unfunded Liability since June 30, 2013. Current statutorily required Employer and Member Contributions exceed the actuarially determined contribution (the Normal Cost and expenses of the system) and are then able to fund a Risk Management Contribution that will build the Cushion to protect the System against future unfavorable experience.

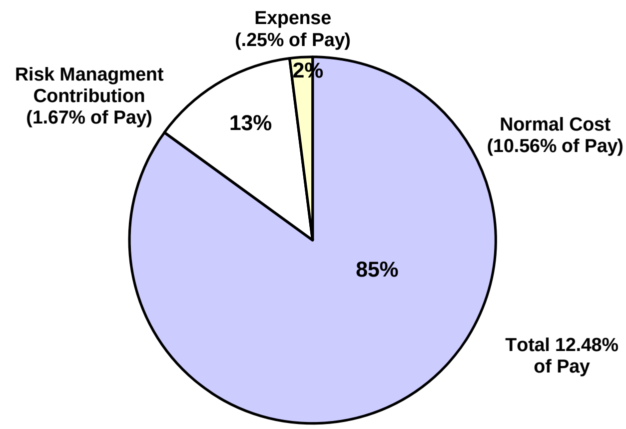
For fiscal year 2015, fixed statutory contributions were sufficient to pay the Normal Cost and expenses and provide a Risk Management Contribution of 1.67% of pay to increase the Cushion. For fiscal year 2016, the Risk Management Contribution will be 1.75% of pay.

June 30, 2015



Funding Policy Contribution Rate: 10.73% of Pay
Total Anticipated Contribution Rate: 12.48% of Pay

June 30, 2014



Funding Policy Contribution Rate: 10.81% of Pay
Total Anticipated Contribution Rate: 12.48% of Pay

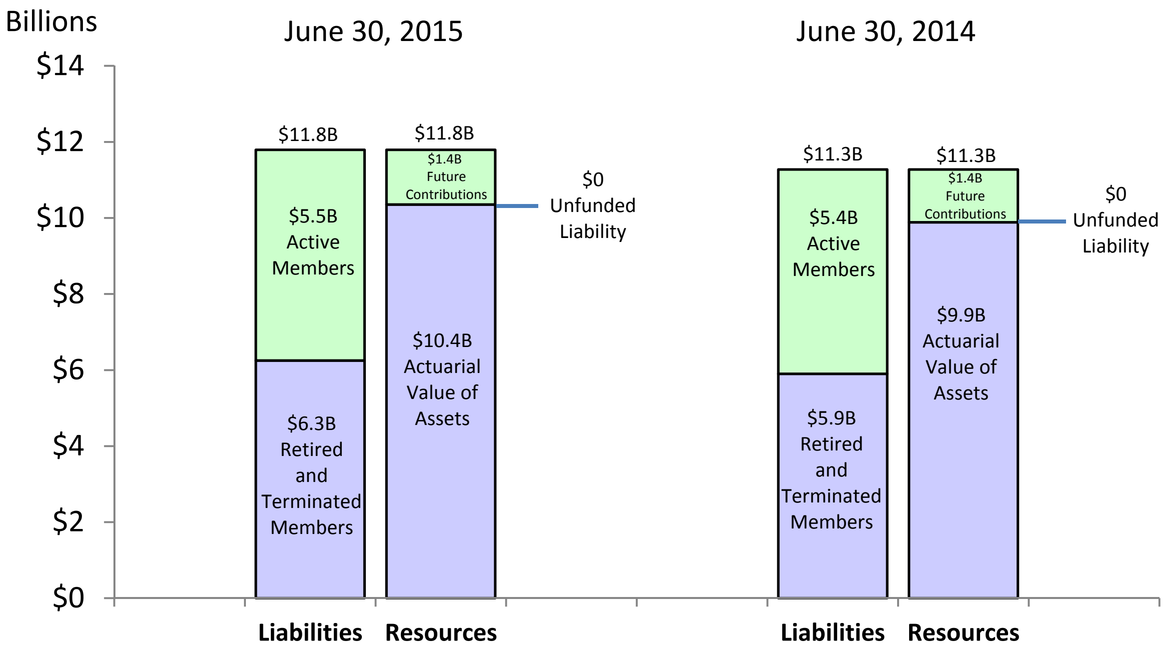
SDRS LIABILITIES AND RESOURCES

In order for a retirement system to be sustainable, its resources must equal or exceed the value of benefits payable to its members. SDRS liabilities and resources as of 2014 and 2015 are shown on page 5.

At June 30, 2015, current SDRS members are projected to receive future benefits from SDRS that have a present value of $11.8B. Of that amount, 53% is attributed to current retirees and terminated members and 47% is attributed to current active members. SDRS resources include existing assets of $10.4B at Actuarial Value to offset those future costs and $1.4B that will be paid to the System from statutory contributions for future Normal Costs for current members.

In addition to those resources, SDRS will also have the Cushion ($424M currently) and future Risk Management Contributions ($29M for FY 2015) available to meet its obligations.

The Cushion has been impacted over the last several years by the volatile investment climate and the changes in actuarial assumptions. It has varied from a high of $2.1B in 2007 to a negative $1.1B in 2009 after the Great Recession. The recent changes in actuarial assumptions alone have reduced the Cushion by nearly $1B.



FUNDED RATIO COMPARISONS

The long-term experience of SDRS has been very favorable, resulting in a funded status that exceeds virtually all other statewide public retirement systems.

	June 30, 2015		June 30, 2014	
	SDRS	Average[(1)]	SDRS	Average[(1)]
Funded Ratio (Actuarial Value of Assets)	100%	74%	100%	78%
Funded Ratio (Fair Value of Assets)	104%	74%	107%	80%

[(1)] 2014 averages from 2015 Wilshire Associates State Retirement Plan Funding Report for statewide public systems. 2015 averages estimated based on 2014 data from the 2015 Wilshire report.

SDRS currently has no Unfunded Liability. To put this into perspective, if SDRS was 74% funded like the national average, the System would have an Unfunded Liability of $2.7 billion.

HISTORY OF SDRS FUNDED RATIOS

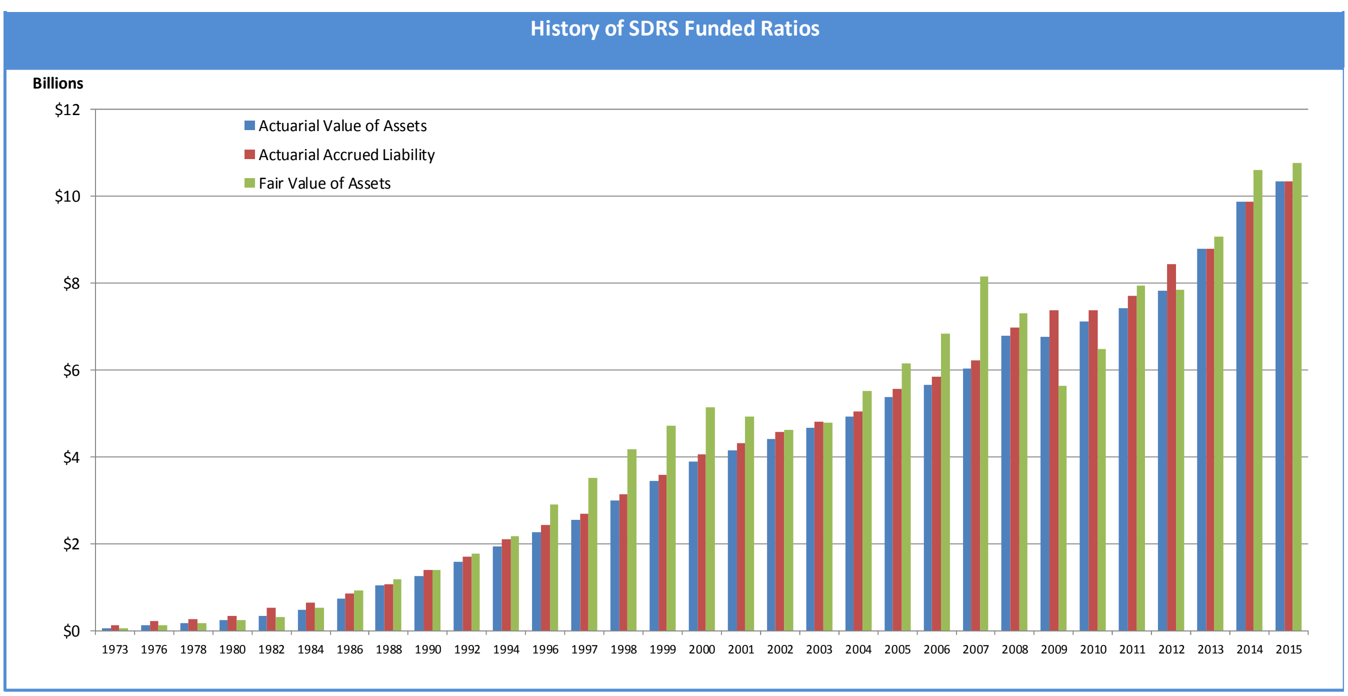
The SDRS Funded Ratios since consolidation in 1974 are shown below.

The SDRS Fair Value Funded Ratio:

- Was 40% in 1973.
- Has been over 75% each year since 1984.
- Has been over 100% in 17 of the last 20 actuarial valuations.
- Decreased to 76% as a result of the significant asset losses suffered in 2008 and 2009 due to the Great Recession
- Asset gains since 2009 and corrective actions in 2010 increased the Funded Ratio to 107% as of June 30, 2014 despite significant increases in liabilities as a result of strengthened actuarial assumptions.
- Decreased from 107% due to lower than assumed investment performance in fiscal year 2015, but because of the Cushion built in prior years, remains fully funded at 104%.

The SDRS Actuarial Value Funded Ratio:

- Was 40% in 1973.
- Has been over 90% each year since 1988.
- Dropped to 92% in 2009 as a result of the significant asset losses suffered in 2008 and 2009 due to the Great Recession
- Asset gains since 2009 and corrective actions in 2010 restored the Funded Ratio to over 95% in 2010 and 2011.
- Decreased to 93% due to the demographic and economic assumption changes in 2012.
- Increased to 100% in 2013 after Unfunded Liabilities paid off and has remained at 100% since.



	1973	1976	1978	1980	1982	1984	1986	1988	1990	1992	1994	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Fair Value Funded Ratio (%)	40%	57%	68%	76%	63%	81%	106%	111%	101%	104%	103%	120%	130%	133%	132%	126%	114%	101%	99%	109%	111%	117%	131%	105%	76%	88%	103%	93%	103%	107%	104%
Actuarial Value Funded Ratio (%)	40%	57%	68%	76%	67%	75%	85%	97%	91%	94%	92%	94%	95%	96%	97%	95%	96%	97%	97%	98%	97%	97%	97%	97%	92%	96%	96%	93%	100%	100%	100%

GOVERNMENTAL ACCOUNTING STANDARDS

The Governmental Accounting Standards Board (GASB) has issued new accounting standards applicable to pension systems. The new standards require accounting calculations (distinct from the funding calculations) which are included in SDRS' financial reports and also proportionately allocated to participating employers for inclusion on their balance sheets. These calculations include the following:

- Net Pension Liability/(Asset) – Total Pension Liability (similar to Actuarial Accrued Liability) less the Plan Fiduciary Net Position (equal to the Fair Value of Assets)
- Deferred Inflows/Outflows of Resources – Unexpected changes in Total Pension Liability or Plan Fiduciary Net Position that impacted the Net Pension Liability but are yet to be recognized

The Net Pension Liability/(Asset) is a measurement of the current funded status based on the Fair Value of Assets. The standards require recognition of changes from expected experience over a specified period, as follows:

- Five years for investment returns different than expected
- A period based on plan demographics (approximately four and a half years for SDRS) for liability gains or losses and assumption changes.

The Deferred Inflows/Outflows of Resources are the unrecognized portion of the unexpected changes. The total impact on the balance sheets of employers will be the sum of the Net Pension Liability/(Asset) and the Deferred Inflows/Outflows of Resources.

SDRS is one of a very few public pension systems with a Net Pension Asset at both June 30, 2014 and June 30, 2015. The SDRS Net Pension Asset at June 30, 2015, is $424M. Together with the Deferred Inflows/Outflows of Resources, the net impact of SDRS is an asset of $481M as of June 30, 2015, to be proportionately allocated to participating employers' balance sheets.

Because it is based on the Fair Value of Assets, the Net Pension Liability/(Asset) is expected to vary significantly from one year to the next. The recognition of unexpected changes over approximately five years will mitigate some of the volatility but may also add confusion. For example, a plan could have a Net Pension Liability, but when the Deferred Inflows/Outflows of Resources are considered, the net result may be a balance sheet asset, and vice versa.

The income statements of participating employers will also include an allocation of the Pension Plan Expense/(Revenue) that recognizes the net changes in the balance sheet items from one year to the next.

CURRENT FUNDED STATUS SUMMARY

The prudent management of SDRS combined with the outstanding investment performance of recent years has allowed SDRS to emerge from the Great Recession in a very strong position. Although the fiscal year 2015 investment return was less than the long-term investment return assumption, the June 30, 2015 Funded Ratios remain at 100% or greater (Actuarial Value Funded Ratio is 100% and the Fair Value Funded Ratio is 104%).

Because SDRS has no Unfunded Liability, statutorily fixed Member and Employer Contributions continue to be sufficient to fund the actuarial requirements of the System and provide a Risk Management Contribution that will build the Cushion to protect the System against future unfavorable experience. In addition, SDRS participating employers will show a Net Pension Asset on their balance sheet rather than any balance sheet liability pertaining to SDRS.

These results are particularly remarkable considering the Board of Trustees has adopted more conservative actuarial assumption changes in recent years that have increased the SDRS expected liability by nearly $1 billion. SDRS' actuarial assumptions are among the most conservative in use by statewide plans.

With a Fair Value Funded Ratio of 104% and a Fair Value of Assets of $10.8 billion, SDRS remains in actuarial balance and is a financially solid retirement system. However, if capital markets continue their recent decline, the funded status of pension systems, including SDRS, will be reduced and the SDRS Fair Value Funded Ratio may be less than 100% as early as the end of the 2016 fiscal year.

SDRS INITIATIVES

During fiscal year 2015, the Board of Trustees continued its comprehensive review of SDRS including:

- Consideration of long-term benefit goals and fiscally sustainable benefit designs
- Evaluation and comparison of economic and demographic actuarial assumptions
- Long-term modeling of asset and liability experience under anticipated and unanticipated conditions
- Analysis and assessment of risks facing SDRS and its stakeholders

The reviews of recent investment performance, actuarial assumptions, and anticipated asset and liability experience resulted in significant changes to the actuarial assumptions in 2012 and again in 2014. The review of benefit designs led to legislation enacted in 2014 and effective July 1, 2015, regarding disability benefits and certain survivor benefits.

The consideration of long-term benefit goals, fiscally sustainable benefit designs, and the analysis of risks facing SDRS and its stakeholders has resulted in proposed legislation creating a new benefit structure for members who enter SDRS after June 30, 2017. The benefits for existing members will not change.

The Board of Trustees has recommended changes that will recognize increasing life expectancies, eliminate the most significant subsidies available to only a portion of SDRS members, and enhance the sustainability of SDRS by adding a Variable Retirement Account that will be credited with actual SDIC returns.

The specific changes in the proposed legislation include:

- Recognizing lengthening life expectancy by increasing Normal Retirement Ages by two years to age 67 (Class A and Judicial) and age 57 (Public Safety)
- Eliminating the subsidies provided by the Rule of 85 (Class A), Rule of 80 (Judicial) and Rule of 75 (Public Safety) Special Early Retirement benefits
- Eliminating the subsidy provided for early retirement by increasing the reduction from 3% to an actuarially neutral 5% per year prior to Normal Retirement Age
- Eliminating the post-retirement survivor subsidy to married members by providing post-retirement spousal benefits only if elected and paid for by the member through reduced benefits
- Increasing the Class A base benefit formula to 1.8% of Final Average Compensation for each year of service
- Eliminating the Class A Alternate Formula
- Adding a Variable Retirement Account that will be credited each year with 1.5% of pay, giving members a share of SDIC success and enhancing sustainability by providing a portion of benefits and liabilities that increase and decrease with investment results

Initiating a revised benefit structure for new members while SDRS is well funded allows the cost of the benefits for new members to be the same as for current benefits, enhancing intergenerational equity and avoiding new members subsidizing existing members.

This is the first wholesale redesign of SDRS retirement benefits since consolidation in 1974. During this process, the SDRS Board of Trustees focused on both increasing the sustainability of SDRS and achieving a greater equity in benefits provided by restructuring benefits to better fit the anticipated future retirement needs of the next generation of SDRS members and their employers.

SDRS 2016 LEGISLATION

The SDRS Board of Trustees will submit the following bills for consideration during the 2016 legislative session:

- SB 13: An Act to establish a new retirement benefit structure for certain public employees who are members of the South Dakota Retirement System.
- SB 14: An Act to revise certain administrative provisions and repeal certain obsolete provisions relating to the South Dakota Retirement System.
- SB 15: An Act to revise certain provisions concerning the membership of the South Dakota Investment Council.

Appendix A: Key SDRS Metrics

Membership		
Valuation Date	**June 30, 2015**	**June 30, 2014**
Active Members	39,383	38,951
Benefit Recipients	25,656	24,741
Vested Terminated Members	8,993	8,702
Non-Vested Terminated Members	7,601	7,111
Total System Members	81,633	79,505

Cash Flow		
Year Ended	**June 30, 2015**	**June 30, 2014**
Contributions	$ 220M	$ 211M
Benefit Payments and Expenses	$ (486M)	$ (454M)
Net Investment Income	$ 436M	$ 1,695M

Funded Status		
Valuation Date	**June 30, 2015**	**June 30, 2014**
Fair Value of Assets	$ 10.8B	$ 10.6B
Actuarial Value of Assets	$ 10.4B	$ 9.9B
Actuarial Accrued Liability	$ 10.4B	$ 9.9B
Actuarial Value Funded Ratio	100.0%	100.0%
Fair Value Funded Ratio	104.1%	107.3%
Cushion	$ 424M	$ 720M

Statutory and Actuarially Determined Contribution Rates		
Valuation Date	**June 30, 2015**	**June 30, 2014**
Fixed, Statutory Member and Employer Contribution Rate	12.482%	12.482%
Normal Cost Contribution Rate	10.485%	10.561%
Expense Allowance	0.250%	0.250%
Amortization of Frozen Unfunded Actuarial Accrued Liability	0.000%	0.000%
Actuarially Determined Contribution Rate	10.735%	10.811%
Risk Management Contribution Rate	1.747%	1.671%

Appendix B: SDRS Benefits

The following exhibit presents a schedule of the annualized benefits payable as of July 1, 2015, by SDRS on a county-by-county basis.

County	Annual Benefits	County	Annual Benefits	County	Annual Benefits
Aurora	$ 1,625,410	Fall River	$ 3,505,044	McPherson	$ 783,420
Beadle	$ 8,199,006	Faulk	$ 1,360,731	Meade	$ 9,949,309
Bennett	$ 629,883	Grant	$ 3,057,762	Mellette	$ 531,211
Bon Homme	$ 4,233,612	Gregory	$ 2,324,057	Miner	$ 1,258,515
Brookings	$ 30,798,144	Haakon	$ 656,922	Minnehaha	$ 69,166,469
Brown	$ 20,860,095	Hamlin	$ 2,229,040	Moody	$ 2,607,177
Brule	$ 2,277,797	Hand	$ 1,471,760	Oglala Lakota	$ 274,556
Buffalo	$ 30,562	Hanson	$ 760,682	Pennington	$ 59,245,349
Butte	$ 4,008,356	Harding	$ 317,205	Perkins	$ 1,168,231
Campbell	$ 803,758	Hughes	$ 30,247,413	Potter	$ 1,537,713
Charles Mix	$ 3,884,133	Hutchinson	$ 3,727,790	Roberts	$ 3,635,854
Clark	$ 1,546,236	Hyde	$ 676,139	Sanborn	$ 921,076
Clay	$ 13,732,038	Jackson	$ 902,095	Spink	$ 5,553,119
Codington	$ 15,147,726	Jerauld	$ 775,071	Stanley	$ 4,078,059
Corson	$ 667,269	Jones	$ 643,960	Sully	$ 712,954
Custer	$ 5,407,999	Kingsbury	$ 2,404,793	Todd	$ 1,104,317
Davison	$ 10,421,634	Lake	$ 7,612,742	Tripp	$ 2,706,939
Day	$ 3,057,705	Lawrence	$ 16,349,070	Turner	$ 3,114,763
Deuel	$ 1,385,370	Lincoln	$ 5,623,859	Union	$ 5,207,466
Dewey	$ 1,098,374	Lyman	$ 1,429,055	Walworth	$ 3,549,733
Douglas	$ 1,290,683	Marshall	$ 2,525,233	Yankton	$ 13,983,165
Edmunds	$ 1,780,774	McCook	$ 2,080,050	Ziebach	$ 366,267

Total SDRS Benefits Paid in South Dakota	**$ 415,022,699**
Total SDRS Benefits Paid Outside of South Dakota	**$ 55,444,913**
Total SDRS Benefits	**$ 470,467,612**
Total Cement Plant Benefits Paid in South Dakota	**$3,896,901**
Total Cement Plant Benefits Paid Outside South Dakota	**$325,816**
Total Cement Plant Benefits Paid	**$4,222,717**
Total SDRS and Cement Plant Benefits Paid	**$ 474,690,329**

Appendix C: SDRS Funding Policy

Elements			
Funding Objectives (Discussed at the Quadrennial Funding Study presentations in 1999 and 2002, and formally adopted April 2006 and revised September 2013)	**Establishment of Cushion and Reserve** (The Reserve for Funding of Long-Term Benefit Goals, adopted in 1995 and later revised in 1998, 2001 and 2013)	**Policy Regarding Consideration of Benefit Improvements** (Adopted in 2004 and revised in 2013)	**Statutory Conditions That Would Require Corrective Action** (SDCL 3-12-122, refined during 2004 Legislative Session)
• Funded Ratios (Assets ÷ Actuarial Accrued Liabilities) o Based on Fair Value of Assets – 100% or greater o Based on Actuarial Value of Assets – 100% • Ratio of Fair Value of Assets to Actuarial Value of Assets o Exceeds 100%, which results in a Cushion • Maintain a fully funded system o No Unfunded Liabilities under Entry Age Normal Cost method o If future Unfunded Liabilities created because of unfavorable experience, fully fund over a period not to exceed 20 years • Statutorily fixed contributions meet or exceed the actuarially required contribution each year o Normal Cost plus expenses when System is fully funded o Includes payment of Unfunded Liabilities over a period not to exceed 20 years if System not fully funded	• Cushion o Excess of Fair Value of Assets over Actuarial Value o Captures all net favorable experience • Actuarial Value of Assets o asset value if all assumptions met o minimizes volatility in actuarial measures o limited to 80-120% of market value of assets o set to market value if no Cushion for five consecutive years • Reserve o Delays recognition of asset gains (and liability experience gains/losses) over five years, but recognizes asset losses immediately • Both Cushion and Reserve provide resources to: o Protect SDRS during times of unfavorable experience, and o Pre-fund benefit improvements	• After consideration of the expense of the benefit improvement the Fair Value Funded Ratio must be at least 120% • In addition, the following guidelines must be satisfied: o Reserve is sufficient to fully fund the present value of the benefit improvement o After consideration of the recommended benefit improvement all funding objectives must still be met • Proposed benefit improvement must be consistent with both the Board's long-term benefit goals and public policy with regard to retirement practices	• Funded status report to Governor and Retirement Laws Committee (RLC) if any of the following exists: o Contributions not sufficient to fund current benefit structure o Funded Ratio (based on Fair or Actuarial Value) less than 80% o Fair Value of Assets less than 90% of the Actuarial Value of Assets The report shall include an analysis of the conditions required for an improvement of the funded status of the system and recommendations for the circumstances and timing for any future benefit changes, contribution changes, or changes in actuarial assumptions • If any of the above conditions exist for three consecutive actuarial valuations, the following recommendations shall be made by the Board to the Governor and RLC, effective as soon as possible to improve the SDRS funded status o Benefit reductions o Contribution changes o Combination of the two

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