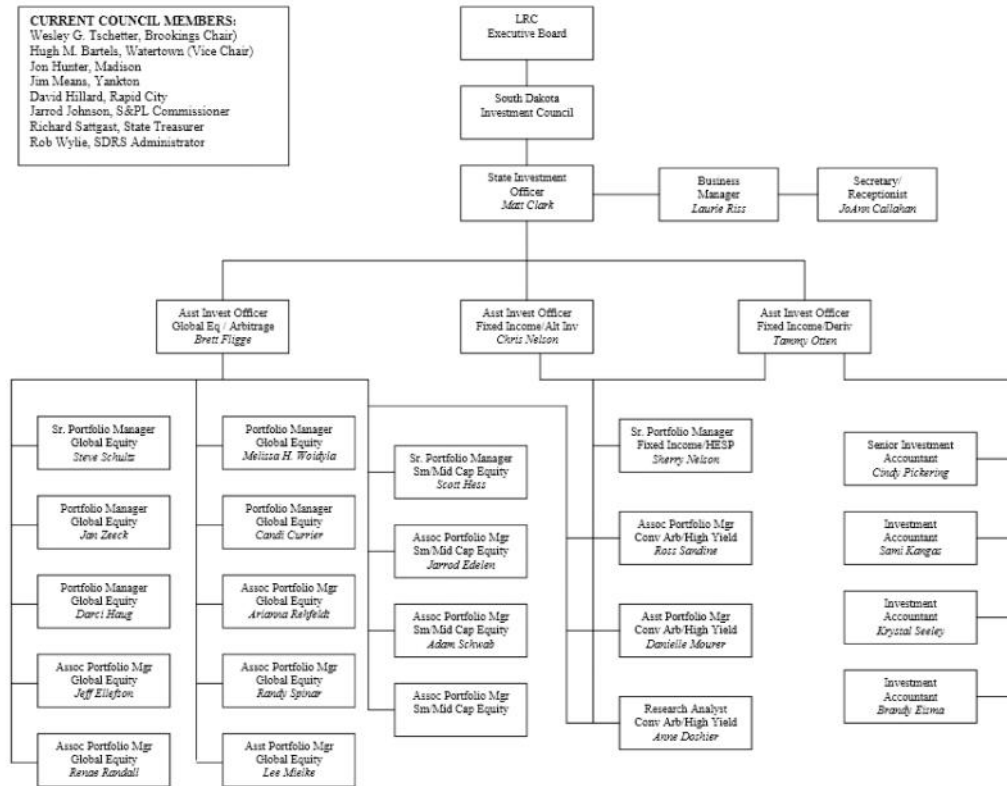


## **SD Investment Council FY 2014 Budget Presented to Joint Appropriations Committee February 6, 2013**

- Organization Chart
- Assets
- Cost Efficiency
- Budget Process & Long Term Plan
- Compensation Methodology
- FY 2012 Budget Review
- FY 2014 Budget Request
- Investment Performance
- Trust Fund Summary
- Appendix

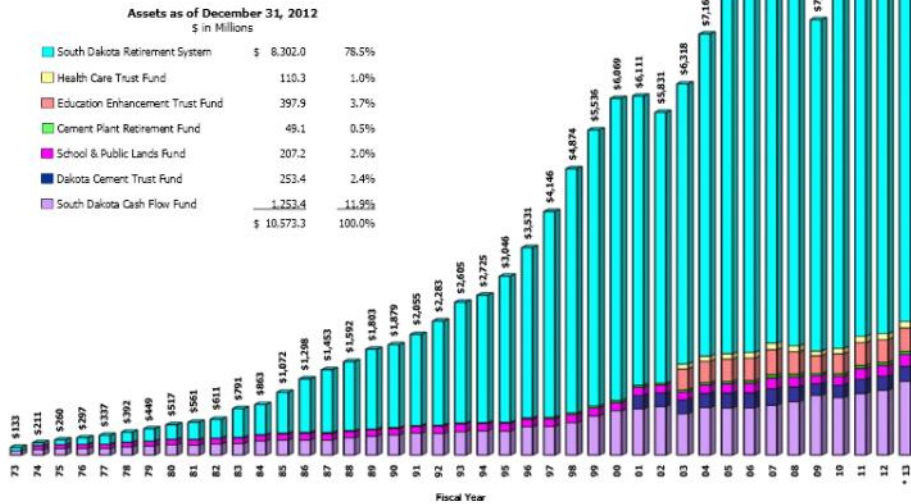
# Organization Chart

**CURRENT COUNCIL MEMBERS:**  
 Wesley G. Tschetter, Brookings Chair  
 Hugh M. Bartels, Watertown (Vice Chair)  
 Jon Hunter, Madison  
 Jim Means, Yankton  
 David Hillard, Rapid City  
 Jarrod Johnson, S&PL Commissioner  
 Richard Sattgast, State Treasurer  
 Rob Wylie, SDRS Administrator



# Assets

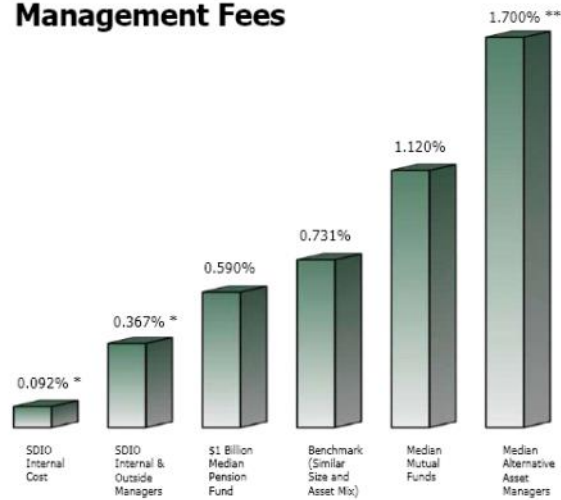
## South Dakota Investment Council Assets Managed Fiscal Years 1973 to 2012 and Fiscal Year 2013 through 12/31/12



\* Fiscal Year to Date as of 12/31/2012

# Cost Efficiency

## Management Fees



Difference between SDIC cost of .367% and benchmark cost of .731% is \$36 million per year

\* Using fully budgeted maximum investment performance incentives

\*\* Plus 20% profit participation after preferred return

# Budget Process & Long-Term Plan

- **Budget**

- Budget approved by LRC Executive Board before presenting to Bureau of Finance and Management and Appropriations Committee (SDCL 4-5-22)
- Budget deducted from assets under management, no general fund appropriations (SDCL 4-5-30)

- **Long-Term Plan**

- Developed Plan in 1987 – has helped guide operations for 26 years
- Recommended by Appropriations Committee and Executive Board
- Key to development and retention of high-quality internal investment team

# Long Term Plan Executive Summary

## Projected LTP Budget

	<u>FY 2014</u>	<u>FY 2019</u>	<u>FY 2024</u>
<b>INVESTMENT OFFICE BUDGET</b>			
<b>Personal Services</b>			
Number of Employees	[30]	[32]	[34]
Compensation w/0% Investment Performance Incentive	4,397,122	6,698,959	8,872,003
Total Maximum Potential Investment Perf Incentive	3,573,300	5,685,354	7,595,998
Intern, Council, Longevity	37,228	45,630	57,645
Benefits	1,308,450	2,031,053	2,700,290
Total Personal Services	9,316,100	14,460,995	19,225,936
<b>Operating Expenses</b>			
Contractual Services	1,500,980	1,907,927	2,361,874
Travel	78,000	103,854	137,925
Office Supplies & Postage	12,733	17,170	23,062
Capital Assets	29,894	56,049	69,644
Total Operating Expenses	1,621,607	2,085,000	2,592,506
<b>Total Investment Council Budget</b>	<b>10,937,707</b>	<b>16,545,994</b>	<b>21,818,442</b>
<b>ASSET SUMMARY *</b>			
Internal Assets	8,228,819,037	10,697,981,728	14,018,943,392
External Assets	2,742,939,679	3,565,993,909	4,672,981,131
Total Assets	10,971,758,716	14,263,975,637	18,691,924,523
<b>EXPENSE SUMMARY</b>			
Internal Expenses	10,937,707	16,545,994	21,818,442
External Manager Fees	30,172,336	39,225,933	51,402,792
Total Expenses	41,110,044	55,771,927	73,221,234
<b>UNIT COST SUMMARY</b>			
Internal Expenses as % of Total Assets	0.100%	0.116%	0.117%
Internal Exp as % of Total Assets (1/2 assumed incentives)	0.083%	0.096%	0.096%
Total Expenses as % of Total Assets	0.375%	0.391%	0.392%

\* Projections based on long-term assumed returns applied to 6/30/12 assets. Updated each June 30.

# Compensation Methodology

## Plan Details

- Deloitte compensation study presented to Council in April 2006, updated in April 2010, developed investment industry compensation benchmarks for SDIC investment positions. Study in process of being updated Spring 2013. Council will assess implications for FY 2015 budget
  - Benchmark is the median total cash compensation for best position match
  - Benchmark is adjusted for cost-of-living differences
- SDIC target is 70% of benchmark to balance desire to get a good deal for South Dakota (quality results at low cost) with the risk of losing the good deal if we cannot keep our people
  - 30% discount from benchmark is after adjustment for cost-of-living differences
  - Total compensation consists of two-thirds in the form of base pay and one-third in investment incentive
  - Investment performance incentive expected to average 50% assuming SDIC historic level of superior investment performance continues to be achieved
  - Discount drifted to about 40% for FY2011. Discount for FY 2012 has increased to 45%
  - Any changes toward target compensation may involve increasing performance incentive compensation to encourage outstanding investment performance
- SDIC target is less than one-third the industry top quartile pay level
  - Benchmark based on median, but pay for top quartile performers can be at least double the median
  - SDIC historic results are not only top quartile, but are in top 10% versus private sector
  - If SDIC historic success is not maintained, then incentives will be negatively impacted and the discount will also be larger versus median pay levels

# FY12 Budget and Actual

## Unexpended credited against FY13

	Received FY 2012	Actual Exp FY 2012	Unexpended
<b>PERSONAL SERVICES</b>			
Compensation with 0% Invest Performance Incentive	3,343,185	3,271,382.44	71,802.56 *
Total Maximum Potential Incentive	2,553,557	1,595,763.23	957,793.77
Compensation w/100% max potential Invest Perf Incent	5,896,742	4,867,145.67	1,029,596.33
One-Time Payment (granted to all state employees)	0.00	156,830.91	(156,830.91)
Intern	3,977	0.00	3,977.00
Council Compensation	7,088	2,850.00	4,238.00
Longevity	6,825	6,985.00	(160.00)
Personal Benefits	975,770	845,154.21	93,233.47
<b>Total Personal Services</b>	<b>6,890,403</b>	<b>5,878,965.79</b>	<b>1,011,437.21</b>
<b>OPERATING EXPENSES</b>			
Contractual Services (see appendix for line item details)	1,702,210	1,207,608.19	494,601.81
Travel	65,700	60,739.25	4,960.75
Office Supplies & Postage	12,733	9,150.41	3,582.59
Capital Assets	28,242	13,010.91	15,231.09
<b>Total Operating Expenses</b>	<b>1,808,885</b>	<b>1,290,508.76</b>	<b>518,376.24</b>
<b>TOTAL BUDGET</b>	<b>8,699,288</b>	<b>7,169,474.55</b>	<b>1,529,813.45</b>

\* Includes \$49,492.77 Allianz reimbursement & compensation changes in investment accountants due to turnover



# FY 2014 Budget Request

## Major Items

- Two new entry level Investment Professionals
- Rent increase for larger conference room and additional cubicle spaces
- Capital Assets – primary purchases include Mitel VOIP phone system, two computers and furniture for new space
- Incentive Program fully funded to 100%
- Legislative Audit fees increase to allow interim auditing
- Travel to increase interaction with managers, companies, and leading peers

# FY14 Budget Request Summary

	Received FY 2013	Request FY 2014	% Change
<b>INVESTMENT OF STATE FUNDS 3210</b>			
<b>Personal Services</b>			
Base Compensation	3,608,630	3,804,571	5.43%
Two new FTE investment positions	0	106,000	new
Retirement & resignation flexibility funds	0	124,473	new
Total Intern, Council, Longevity	15,336	34,790	126.85%
Benefits	674,779	748,618	10.94%
<b>Total Personal Services</b>	<b>4,298,745</b>	<b>4,818,452</b>	<b>12.09%</b>
<b>Operating Expenses</b>			
Contractual Total (see attached for line item details)	1,473,677	1,434,119	-2.68%
Travel	65,700	85,000	29.38%
Office Supplies & Postage	12,733	12,733	0.00%
Capital Assets	28,242	48,500	71.73%
<b>Total Operating Expenses</b>	<b>1,580,352</b>	<b>1,580,352</b>	<b>0.00%</b>
<b>BUDGET REQUEST 3210</b>	<b>5,879,097</b>	<b>6,398,804</b>	<b>8.84%</b>
<b>PERFORMANCE BASED COMPENSATION 3211</b>			
Maximum potential Investment Performance Incentive	2,555,074	3,261,124	27.63%
Benefits	351,147	448,582	27.75%
<b>BUDGET REQUEST 3211</b>	<b>2,906,221</b>	<b>3,709,706</b>	<b>27.65%</b>
<b>TOTAL BUDGET REQUEST</b>	<b>8,785,318</b>	<b>10,108,510</b>	<b>15.08%</b>
<b>UNIT COST SUMMARY</b>			
Internal Expenses as % of Total Assets	0.084%	0.092%	
Internal Expenses as % of Total Assets (with 50% avg Inv Perf Incent)	0.072%	0.077%	
Total Expenses as % of Total Assets	0.359%	0.367%	

# FY14 Budget Request

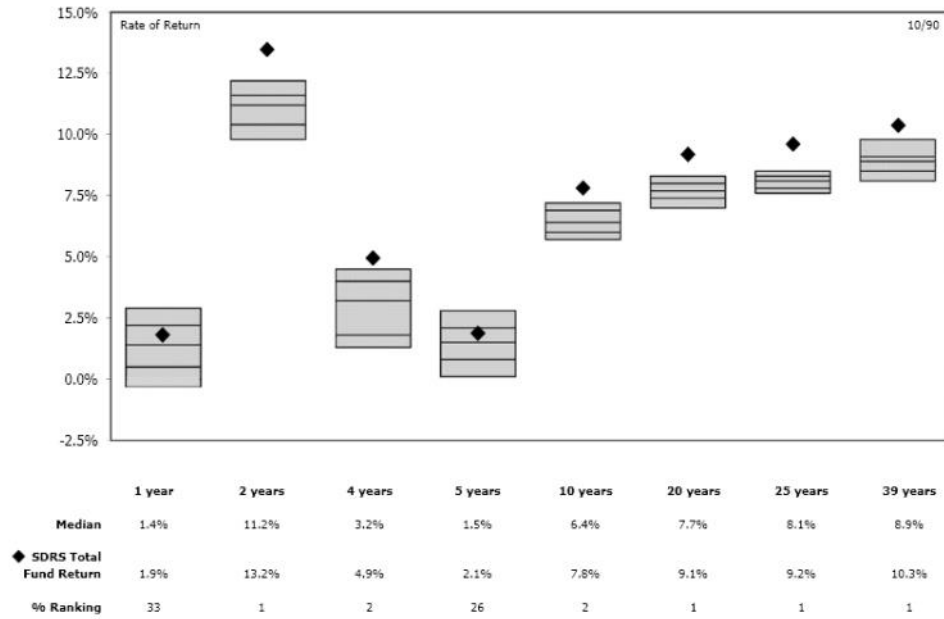
## Contractual services detail

	<u>Received FY 2013</u>	<u>Request FY 2014</u>	<u>% Change</u>
<b>Contractual - Investment Services</b>			
Consulting Services	30,000	30,000	0.00%
Investment Accounting, Performance Benchmarking	94,000	94,000	0.00%
Investment Databases, Newsfeeds & Quote Fees	434,872	415,213	-4.52%
Investment Research Services	247,528	247,572	0.02%
Flexibility - From Brokerage to Independent Research	150,000	83,139	-44.57%
<b>Total Contractual - Investment</b>	<u>956,400</u>	<u>869,924</u>	<u>-9.04%</u>
<b>Contractual - Administrative</b>			
Office Rent	101,542	129,125	27.16%
Bond/Liability Insurance	7,020	7,410	5.56%
Telephone	10,000	10,000	0.00%
Office Equip Rental/Maintenance	6,000	6,000	0.00%
Bureau of Info & Telecommunications (BIT)	42,639	42,639	0.00%
State Central Services	8,741	8,351	-4.46%
Legislative Audit	37,135	55,700	49.99%
Attorney General's Office - Legal Services	16,000	17,970	12.31%
Custodial Fees - Global	250,500	250,500	0.00%
Seminars/Educational Programs	33,500	33,500	0.00%
Business Publications	4,200	3,000	-28.57%
<b>Total Contractual - Administrative</b>	<u>517,277</u>	<u>564,195</u>	<u>9.07%</u>
<b>CONTRACTUAL TOTAL</b>	<u>1,473,677</u>	<u>1,434,119</u>	<u>-2.68%</u>

# State Funds Universe

## Annualized Returns

### Annualized Total Fund STATE FUND UNIVERSE Ending June 30, 2012



# Investment Performance

## Returns vs. Benchmarks

	<u>FY 2012</u>	<u>4 Years Annualized FY 09 – 12</u>	<u>10 Years Annualized FY 03 – 12</u>
▪ SDRS Total Fund	1.91%	4.94%	7.75%
▪ Mellon Analytics Billion \$ Corp Plan Added Value	4.35% <b>-2.44%</b>	4.36% <b>.58%</b>	7.08% <b>.67%</b>
▪ Capital Market Benchmark Added Value	2.02% <b>-0.10%</b>	3.21% <b>1.73%</b>	6.57% <b>1.18%</b>
▪ State Fund Universe Added Value	1.40% <b>0.51%</b>	3.20% <b>1.74%</b>	6.40% <b>1.35%</b>
▪ SDRS Beginning FY12 Assets		\$7.926 billion	
▪ SDRS Ending 6/30/12 Assets		\$7.835 billion	

# Investment Performance

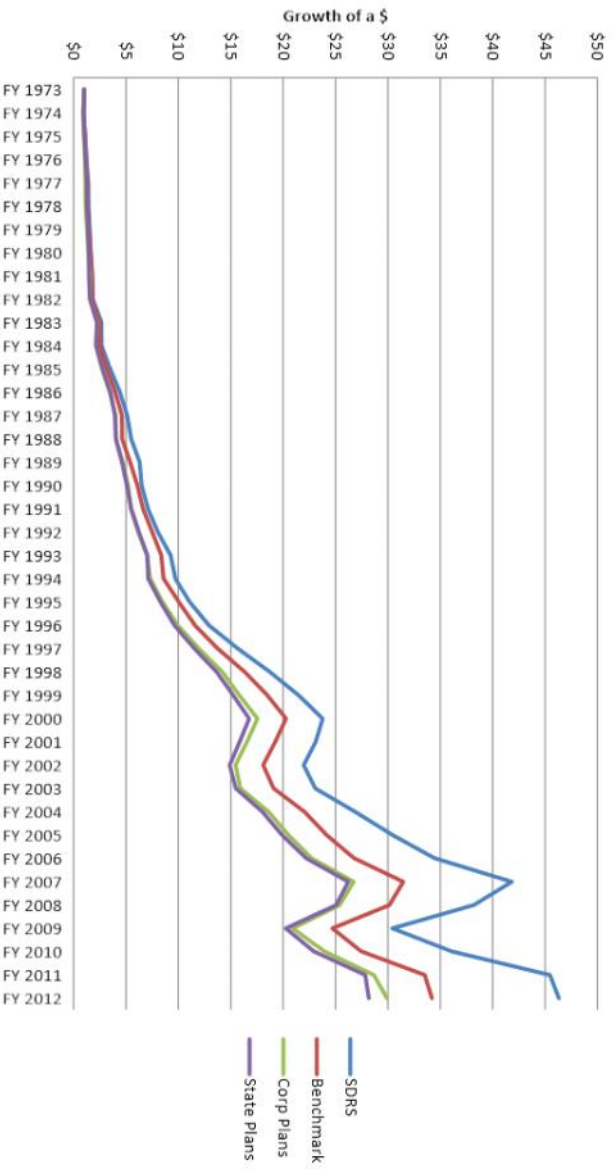
## Earnings vs. Benchmarks

- Total SDRS dollars earned Fiscal Year 2012: \$142.6 million
- Total SDRS dollars earned last 4 years: \$1.226 billion
- Total SDRS dollars earned last 10 years: \$4.656 billion
- **Extra earnings** resulting from last 1, 4 and 10 years of performance:

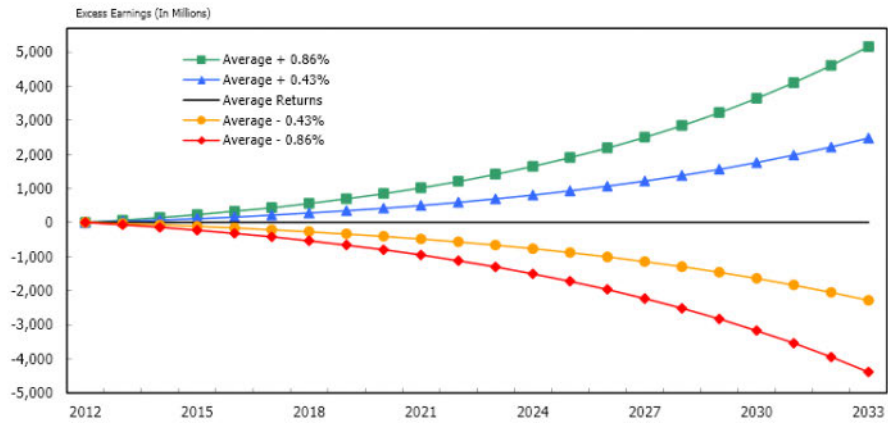
	<u>1 year</u>	<u>4 years</u>	<u>10 years</u>
○ vs. Mellon Analytics Corporate:	<b>\$(193 million)</b>	<b>\$247 million</b>	<b>\$592 million</b>
○ vs. Capital Market Benchmark:	<b>\$ (9 million)</b>	<b>\$493 million</b>	<b>\$773 million</b>
○ vs. State Funds:	<b>\$ 40 million</b>	<b>\$535 million</b>	<b>\$738 million</b>

# Superior Returns add up over time

Cumulative Investment Return  
SDRS, Benchmark, Corp Plans, State Plans



# Potential Excess Earnings

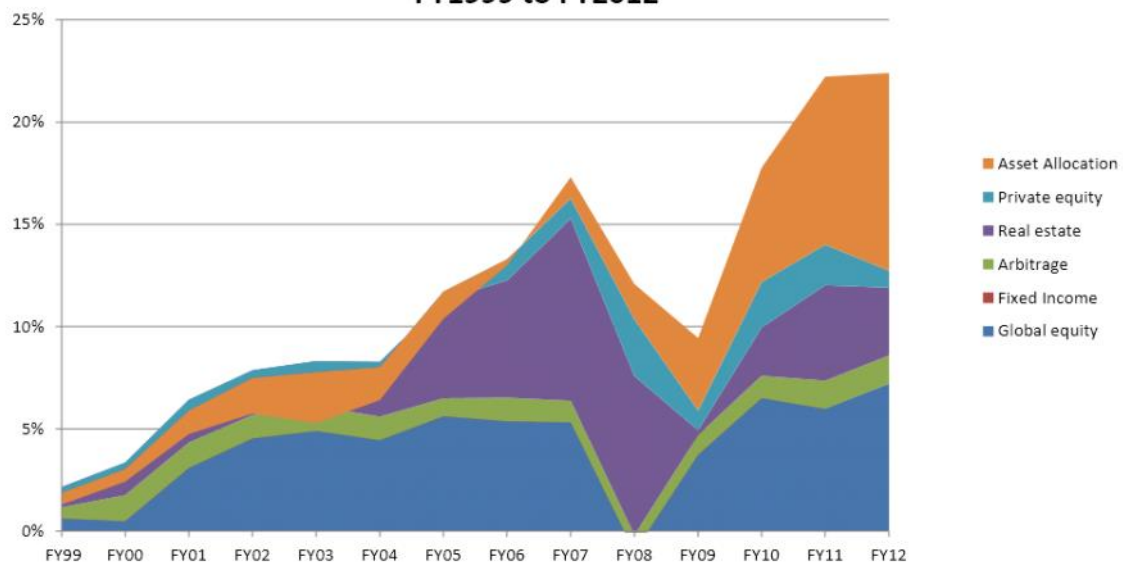


- SDIC 39-year outperformance = .86% annualized vs. benchmark
- If .86% outperformance continues next 20 years = extra \$5.2 billion
- Outperformance of even half that amount = extra \$2.5 billion
- Underperformance of .86% = cost to retirement system of \$4.4 billion.



# Many Pistons Contribute

Cumulative added value by source  
FY1999 to FY2012



# Every asset category has good and bad years

Annual added or detracted value by source

Asset	FY99	FY00	FY01	FY02	FY03	FY04	FY05	FY06	FY07	FY08	FY09	FY10	FY11	FY12
Global Equity	0.8%	-0.1%	2.9%	1.9%	0.0%	-0.4%	0.8%	-0.3%	-0.1%	-6.2%	5.6%	2.1%	-0.8%	1.1%
Fixed Income	-0.1%	-0.1%	-0.3%	-0.6%	0.3%	0.0%	0.3%	0.1%	0.0%	0.2%	-0.9%	0.6%	.4%	-0.3%
Arbitrage	0.5%	0.7%	0.0%	-0.1%	0.1%	-0.1%	-0.3%	0.3%	-0.1%	-0.2%	0.2%	0.1%	.3%	0%
Real Estate	1.0%	0.6%	0.5%	0.1%	0.0%	0.5%	2.1%	0.9%	3.0%	-1.0%	-7.0%	2.1%	2.3%	-1.3%
Private Equity	-0.3%	0.0%	-0.2%	0.2%	-0.2%	0.3%	0.7%	0.6%	-0.1%	1.8%	-1.8%	1.2%	-0.2%	-1.1%
Asset Allocation	-0.6%	0.0%	-0.6%	-0.6%	-0.7%	0.8%	0.1%	0.8%	1.0%	1.0%	1.5%	1.4%	1.9%	1.5%
Total	1.3%	1.1%	2.3%	1.0%	-0.4%	1.1%	3.7%	2.4%	3.8%	-4.5%	-2.4%	7.6%	3.8%	-0.1%

# Health Care Trust

## As of 12/31/12 (unaudited)

### Health Care Trust (established April 2001)

Principal as of 12/31/12	\$ 85,631,024	<u>Asset Allocation</u>	<u>Current</u>	FY 13 <u>Benchmark</u>
Principal as of 12/31/12 adjusted for inflation	\$ 109,191,260	Global Equity	52%	52%
Fair Value (FV) as of 12/31/12	\$ 110,293,014	Private Equity	3%	2%
Difference - FV less principal	\$ 24,661,990	Real Estate	12%	6%
Difference - FV less infl. adj. prin.	\$ 1,101,754	Fixed Income-IG	23%	28%
Fiscal year to date return	7.27%	Fixed Income-HY	4%	5%
Longterm expected mean return	6.43%	Fixed Income-Tips	5%	5%
Payout of 4% plus expected inflation of 3%	7.00%	Money Market	1%	2%
Expected return cushion/shortfall	-0.57%	Total	100%	100%
Distribution for FY 14 (July 1, 2013)	<b>3,959,754</b>			
Distribution for FY 13 (July 2, 2012)	3,825,385			

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

As of 12/31/12 (unaudited)

## Education Enhancement Trust (established April 2001)

Principal as of 12/31/12	\$ 329,329,930	<u>Asset Allocation</u>	<u>Current</u>	<u>FY 13 Benchmark</u>
Principal as of 12/31/12 adjusted for inflation	\$ 420,563,572	Global Equity	50%	52%
Fair Value (FV) as of 12/31/12	\$ 397,930,633	Private Equity	3%	2%
		Real Estate	12%	6%
Difference - FV less principal	\$ 68,600,703	Fixed Income-IG	0%	0%
Difference - FV less infl. adj. prin.	\$ (22,632,939)	Fixed Income-tax ex	29%	30%
		Fixed Income-HY	4%	5%
Fiscal year to date return	6.94%	Fixed Income-Tips	0%	3%
Longterm expected return (lower due to tax exempts)	5.97%	Money Market	<u>1%</u>	<u>2%</u>
Payout of 4% plus expected inflation of 3%	7.00%	Total	100%	100%
Expected return cushion/shortfall	-1.03%			
Distribution for FY 14 (July 1, 2013)	<b>14,413,354</b>	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		
Distribution for FY 13 (July 2, 2012)	14,052,700			

# Dakota Cement Trust

## As of 12/31/12 (unaudited)

### Dakota Cement Trust (established April 2001)

Principal as of 12/31/12	\$ 238,000,000	<u>Asset Allocation</u>	<u>Current</u>	<u>FY 13 Benchmark</u>
Principal as of 12/31/12 adjusted for inflation	\$ 310,933,269	Global Equity	50%	52%
Fair Value (FV) as of 12/31/12	\$ 253,441,000	Private Equity	3%	2%
		Real Estate	13%	6%
Difference - FV less principal	\$ 15,441,000	Fixed Income-IG	23%	28%
Difference - FV less infl. adj. principal	\$ (57,492,269)	Fixed Income-HY	4%	5%
		Fixed Income-Tips	5%	5%
Fiscal year to date return	7.22%	Money Market	<u>2%</u>	<u>2%</u>
Longterm expected mean return	6.43%	Total	100%	100%
Payout of 5% plus expected inflation of 3%	8.00%			
Expected return cushion/shortfall	-1.57%			
Distribution for FY 13 (June 2013 to Gen. Fund)	<b>9,351,177</b>			
Distribution for FY 12 (June 15, 2012 to Gen. Fund)	12,000,000			

Constitution allows 4% of the lesser of 1) the 16 quarter average balance or 2) the current December 31 market value be distributed by June of the following year.  
(Change Nov. 2012)

# School & Public Lands Fund

As of 12/31/12 (unaudited)

## School & Public Lands

Inflation protection mandated by Constitutional Amendment - (payout is reduced by inflation to extent inflation not offset by realized gains)

		FY 13	
		<u>Asset Allocation</u>	<u>Current</u> <u>Benchmark</u>
Fair Value as of 12/31/12	\$ 207,226,129	Global Equity	52%    52%
Fiscal year to date return	7.24%	Private Equity	3%    2%
Longterm expected mean return	6.43%	Real Estate	11%    6%
		Fixed Income-IG	22%    28%
		Fixed Income-non-mk	1%
Distribution for FY 13 (Feb 4, 2013 to K-12)	<b>7,422,432</b>	Fixed Income-HY	4%    5%
Distribution for FY 12 to Board of Regents	<b>1,956,537</b>	Fixed Income-Tips	4%    5%
	<b>TOTAL</b>	Money Market	<u>3%</u> <u>2%</u>
		Total	100%    100%

# Appendix

- JCA Supplemental Questions
- Compensation Methodology
- FY12 Budget and Actual - Contractual Services details

# JCA Supplemental Questions

1. What current activities are you going to stop doing? **None**
2. What activities are you going to change? **None**
3. What new activities are you going to initiate? **None**
4. What initiatives for improving efficiency of operations are planned in FY 14? **Hoping to improve efficiencies of “out-of-office” research and internal research discussions with use of remote access devices and Wi-Fi. Electronic and shareable research will enhance team interaction.**
5. What are the standards of performance or metrics by which you judge the success and efficiencies of your agency’s outcomes? **The exhibits in the SDIC presentation illustrate standards of performance by which we judge success and efficiencies. Success specifically addressed on pages 11 through 17 and efficiencies on page 3.**
6. What funds from FY 13 are planned to be applied to FY 14 activities? Are these amounts in addition to amounts contained in the Governor’s FY 14 budget? **None. SDCL 4-5-30 established process for funding budget. Any cash balance remaining in a fiscal year offsets the following year budget authorization. No funds are carried over in addition to budget authorization.**
7. What are your plans regarding amending the FY 13 General Bill? **None**



# Compensation Methodology

## Aligned with Goal of Adding Value

- Primary goal of compensation plan is to motivate superior investment performance and retain value added investment staff for the long term
- Strong aversion by most investment managers to underperforming their benchmarks
  - Punishment for underperformance (termination risk) discourages attempts to add value
  - Linking compensation to performance encourages efforts to add value to counter risk of punishment
- Longer-term focused incentives can help encourage investing for the long term
  - Investors focus more on longer-term opportunities if results stay in their incentive several years
  - Long-term incentives guard against short-term risk-taking problems which have sunk many firms
- Believe our investment team is most attractive to competitors when outperforming
  - Total compensation should be higher when people are more sought after and less when they are not
  - Our plan has up to half of potential compensation dependent on adding value
- Important that incentives encourage adding value in difficult markets, not just up markets
  - Investment team varies exposures within allowed ranges in relation to perceived opportunity. Even if at minimum exposure, we will lose some money in difficult markets
  - Added value in down markets may be even more important than in up markets
  - Skewing incentives to reward added value only when markets go up would discourage attempting to add value by reducing risk when markets are thought to be expensive

# Compensation Methodology

## Target Discount Rationale

- Need top caliber people who stay long term – anything less is no bargain, even if free
  - We don't want to fill positions with people seeking a short stint to gain experience at our expense or by lesser performers. We would pay a far higher price through lower returns
  - Investment industry is subject to intensive performance measurement. All organizations want to win. Those who deliver the win are in demand and those who cannot are flushed out. SDIC people know their career here depends on adding value long term. This career risk motivates desires to secure financial security
  - No one can be certain what size discount goes too far, but we can learn from our own past and from the experiences of others. This was taken into account in developing the 30% discount target
  - A 30% discount is large relative to other organizations employing successful high-end professionals
  - It takes roughly 20 years to train a senior investment professional. SDIC compensation is far too low to attract veteran high-performing investors. If we lose our pipeline of talent, we may never recover, as current senior people will not have sufficient time remaining to bring a new group to maturity
  
- Sustained success comes from a durable foundation
  - Luck can lead to success for a time but tends to eventually average out. Our challenge is to deserve success by doing things right and not rely on luck
  - Believe we can keep people we train at reasonable discounts. Also believe compensation viewed as too low leads to accumulating under-performers or the inexperienced, and this leads to losing, not winning

# FY12 Budget and Actual

## Contractual services detail

	Received FY 2012	Actual Exp FY 2012	Unexpended
<b>CONTRACTUAL SERVICES</b>			
<b>Investment Services</b>			
Consulting Services	30,000	0	30,000.00
Investment Accounting, Performance Benchmarking	92,000	126,498.73	(34,498.73)
Investment Databases, Newsfeeds & Quote Fees	442,459	392,266.47	50,192.53
Investment Research Services	283,815	200,592.51	83,222.49
Flexibility - From Brokerage to Independent Research	74,762	0.00	74,762.00
<b>Total Investment Services</b>	<b>923,036</b>	<b>719,357.71</b>	<b>203,678.29</b>
<b>Administrative Expenses</b>			
Office Rent	101,542	101,541.84	0.16
Bond/Liability Insurance	7,020	7,120.24	(100.24)
Telephone	10,000	4,421.45	5,578.55
Office Equip Rental/Maintenance	6,000	4,394.85	1,605.15
Bureau of Info & Telecommunications (BIT)	36,036	36,831.46	(795.46)
State Central Services	8,741	8,111.94	629.06
Legislative Audit	37,135	37,232.00	(97.00)
Attorney General's Office - Legal Services	0	16,928.00	(16,928.00)
Custodial Fees - Global	538,750	250,499.87	288,250.13
Seminars/Educational Programs	29,750	19,023.56	10,726.44
Business Publications	4,200	2,145.27	2,054.73
<b>Total Administrative Expenses</b>	<b>779,174</b>	<b>488,250.48</b>	<b>290,923.52</b>
<b>TOTAL CONTRACTUAL SERVICES</b>	<b>1,702,210</b>	<b>1,207,608.19</b>	<b>494,601.81</b>