



Investment Performance FY 2022  
and  
Budget Request FY 2024

Presented to

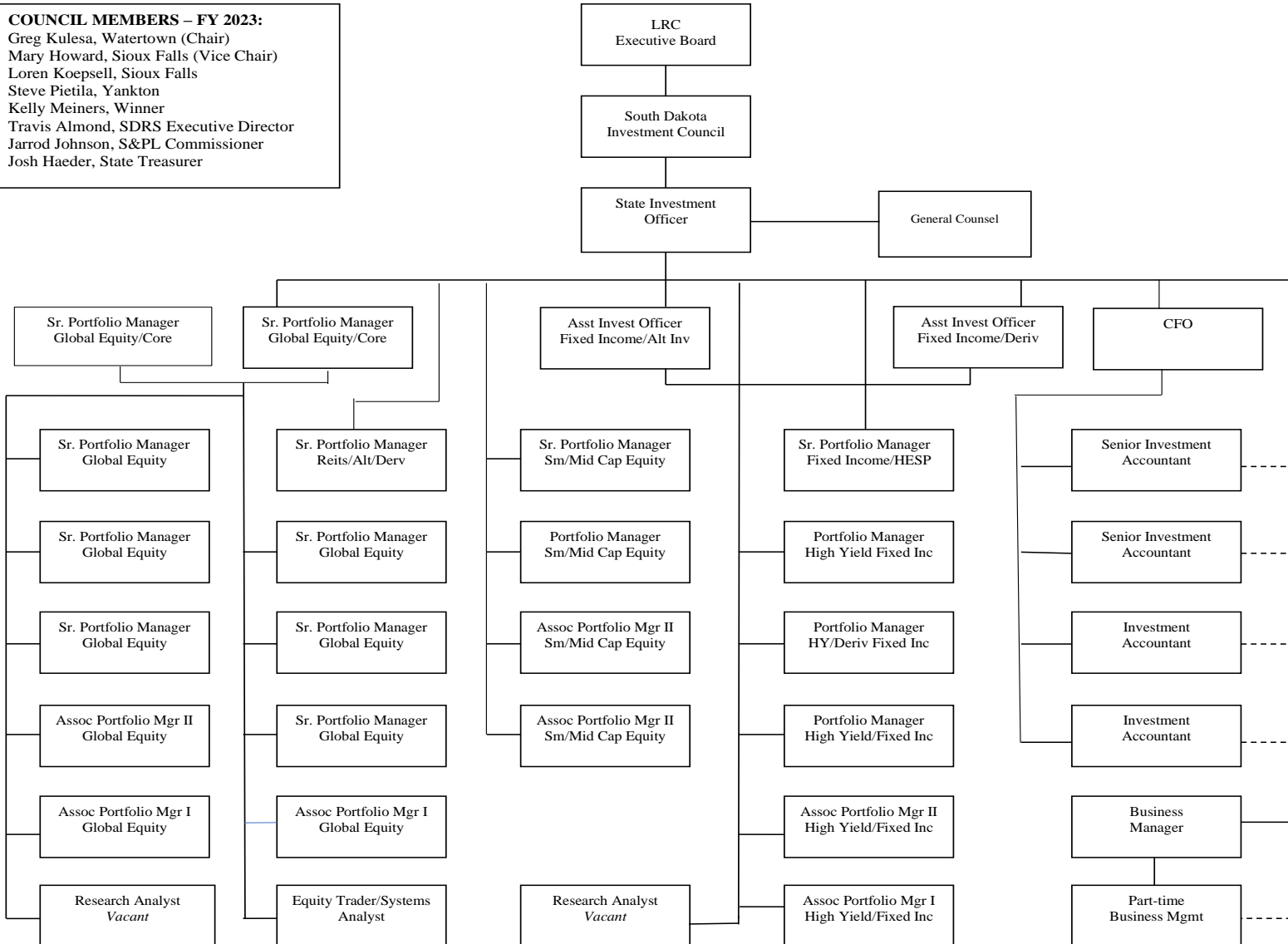
LRC Executive Board

August 23, 2022

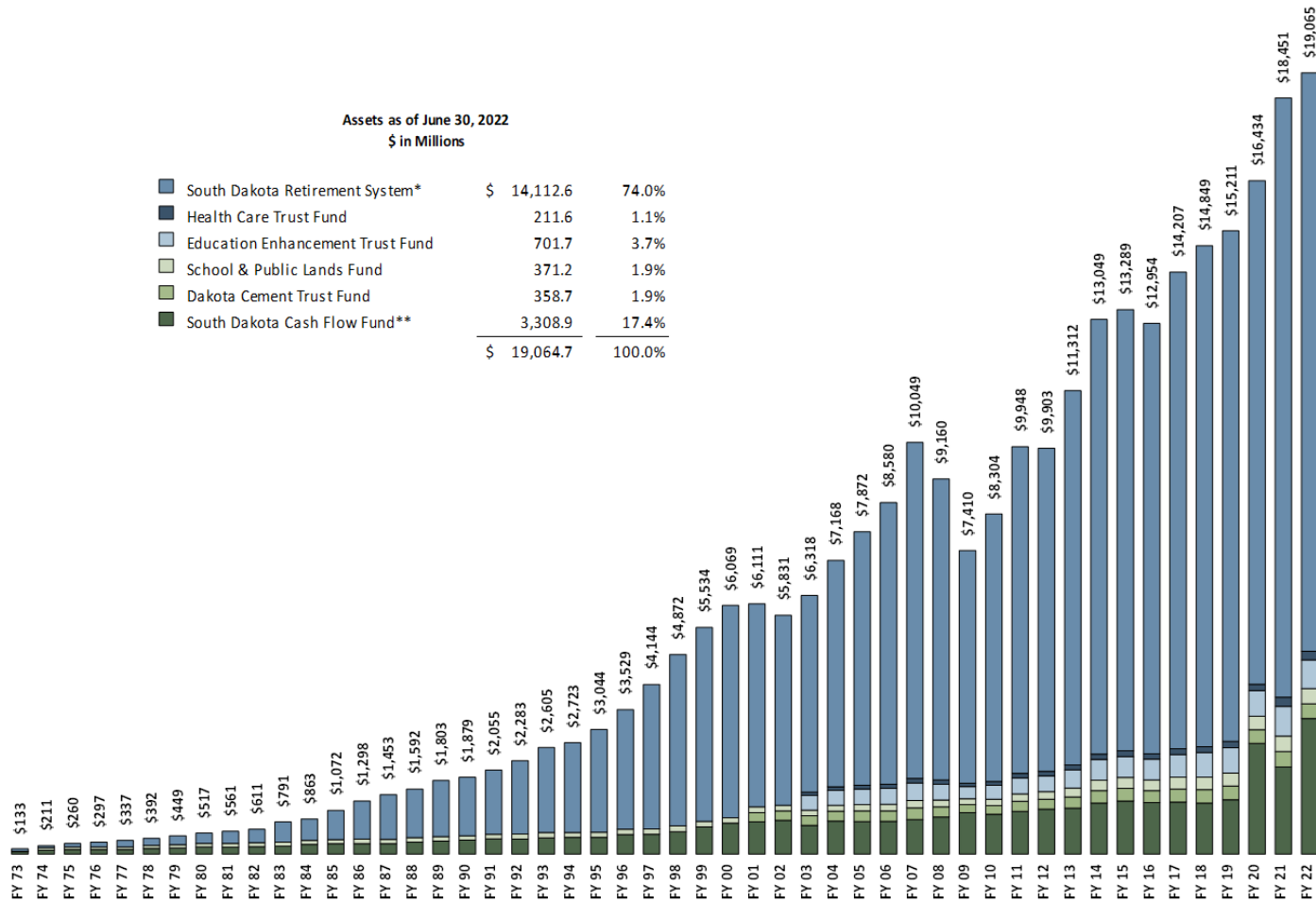
# Organization Chart

**COUNCIL MEMBERS – FY 2023:**

Greg Kulesa, Watertown (Chair)  
 Mary Howard, Sioux Falls (Vice Chair)  
 Loren Koepsell, Sioux Falls  
 Steve Pietila, Yankton  
 Kelly Meiners, Winner  
 Travis Almond, SDRS Executive Director  
 Jarrod Johnson, S&PL Commissioner  
 Josh Haeder, State Treasurer



# Assets



\*The South Dakota Cement Plant Retirement Fund (CPRF) was consolidated into the South Dakota Retirement System (SDRS) on April 1, 2014, per SDCL 3-12C-1642.

For purposes of this exhibit, CPRF Assets for Fiscal Years 1973 - 2013 are included with SDRS.

\*\*South Dakota Cash Flow Fund assets include Coronavirus Relief Fund for Fiscal Years 2020, 2021 and 2022.

# Investment Performance

## Returns vs. Benchmarks (unaudited)

	<u>FY 2022</u>	<u>5 years Annualized FY 18 - 22</u>	<u>10 years Annualized FY 13 - 22</u>	<u>20 years Annualized FY 03 - 22</u>
• SDRS Total Fund *	-0.69%	6.86%	8.95%	8.35%
• Capital Market Benchmark	-13.02%	5.74%	7.39%	6.98%
Added Value	12.33%	1.12%	1.56%	1.37%
• State Universe (est)	-2.97%	7.55%	8.43%	7.51%
Added Value **	2.28%	-0.69%	0.52%	0.84%
• Beginning FY 2022 SDRS Assets		\$14.619 billion		
• Ending FY 2022 SDRS Assets		\$14.113 billion		

Note: \*Time-weighted rates of return are net of fees FY 14-21 and gross of fees FY 02-13

\*\* Added Value using time weighted rate of return net of fees for all periods

# Investment Performance

## Returns vs. Benchmarks (unaudited)

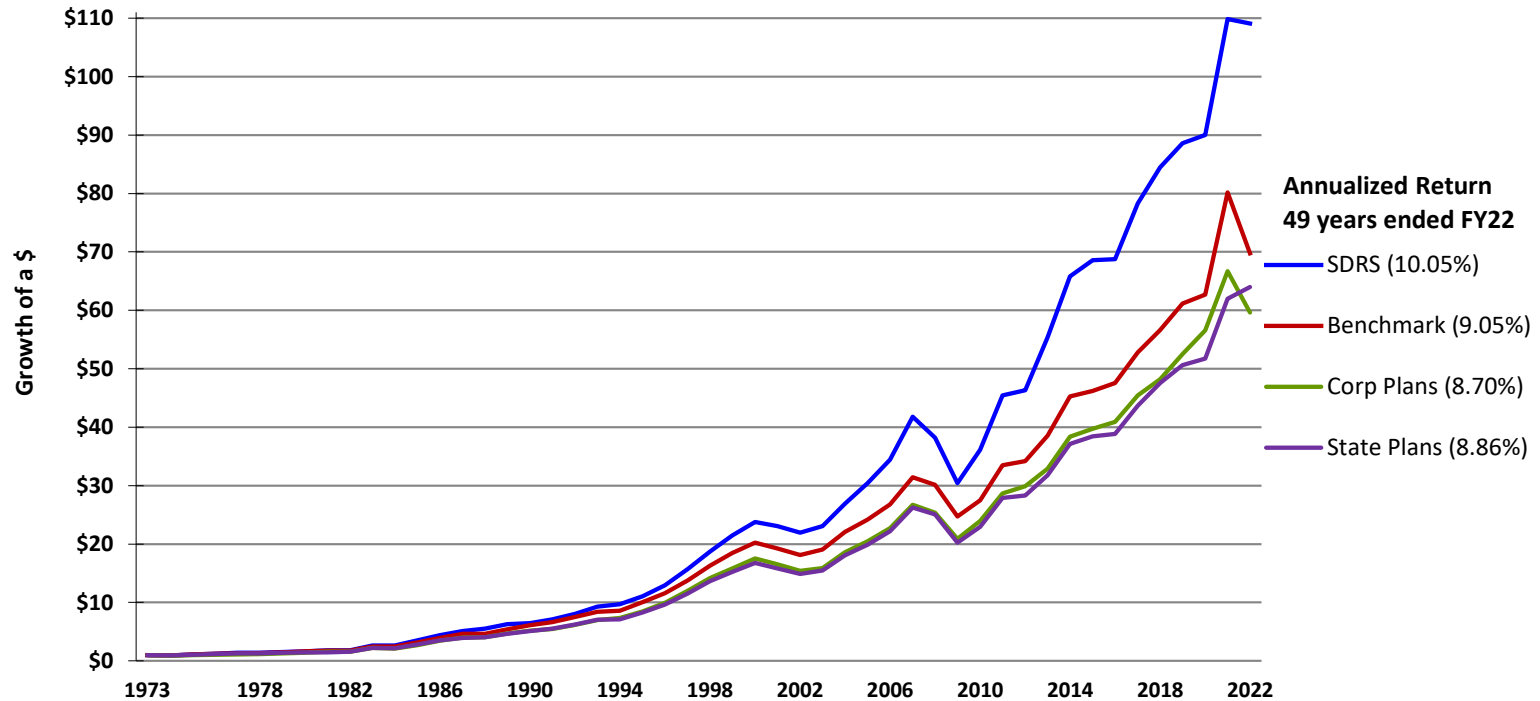
- Total SDRS dollars earned Fiscal Year 2022 \$ -39.6 million
- Total SDRS dollars earned last 5 years \$ 4.514 billion
- Total SDRS dollars earned last 10 years \$ 9.724 billion
- Total SDRS dollars earned last 20 years \$14.379 billion

- **Extra earnings** resulting from performance:  
(including compounding)

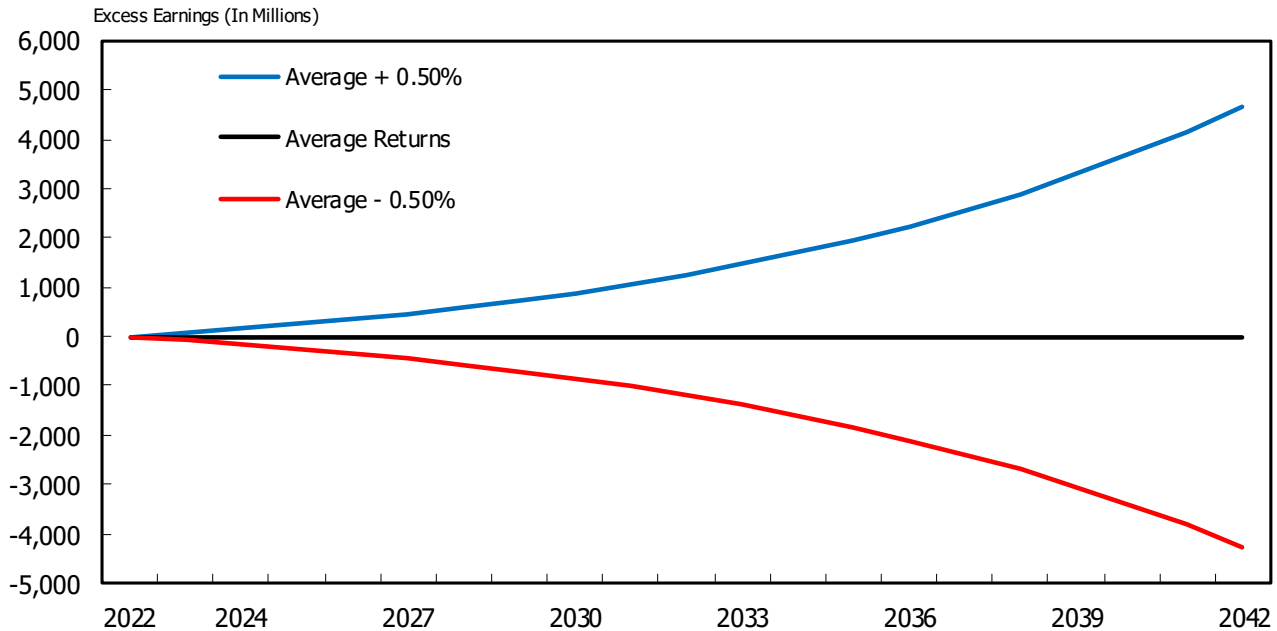
	<u>1 year</u>	<u>5 years</u>	<u>10 years</u>	<u>20 years</u>
○ vs Capital Markets Benchmark	\$1.802 billion	\$572 million	\$2.160 billion	\$4.357 billion
○ vs State Funds	\$333 million	\$-810 million	\$796 million	\$2.958 billion

# Superior returns add up over time

Cumulative returns for SDRS, Benchmark, Corporate Plans, and other States



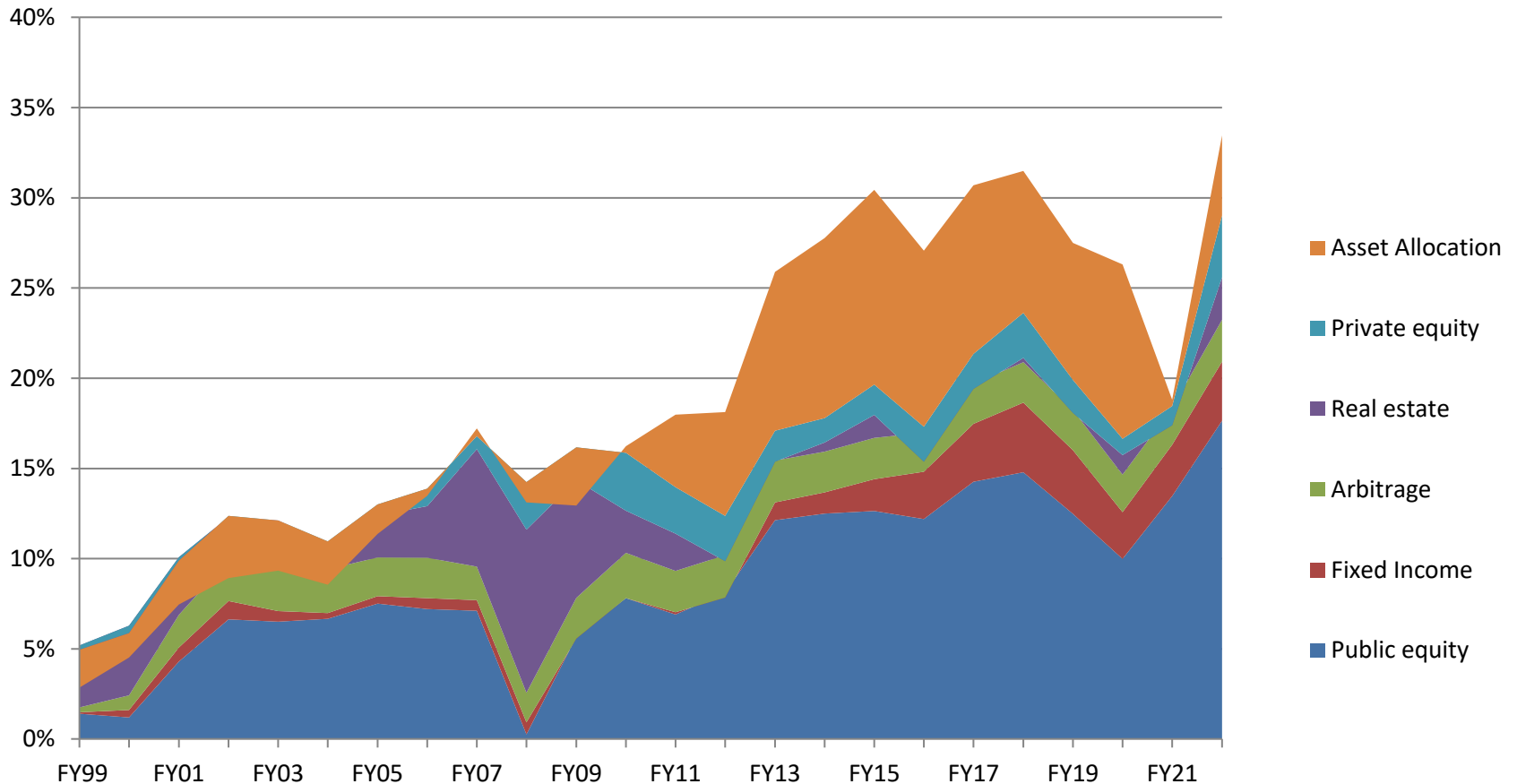
# Potential Excess Earnings



- SDRS 49-year outperformance = 1.0% annualized vs. benchmark
- Outperformance of .5% next 20 years = extra \$4.7 billion
- Underperformance of .5% = cost to retirement system of \$4.3 billion.

# Many pistons contribute

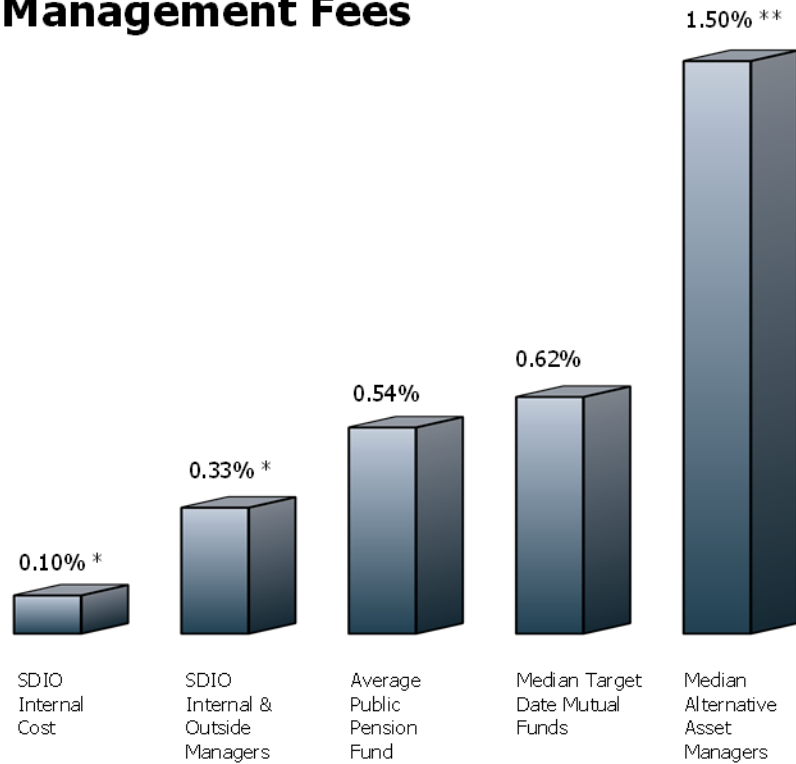
Cumulative added value by source FY99 to FY22





# Cost Efficiency

## Management Fees



Difference between SDIC cost of .33% and average public pension fund cost of .54% is \$40.0 million per year

\* SDIC projected expenses for FY 2024 using adjusted assets and expected average performance incentives

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

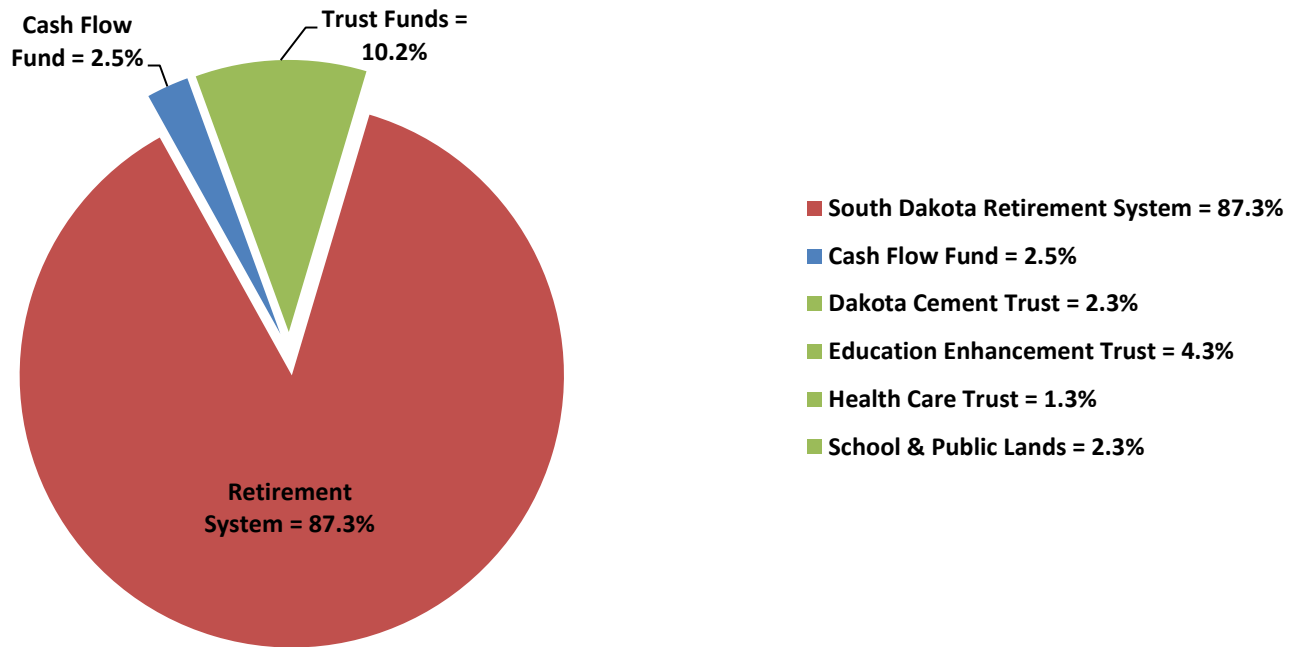
# Compensation Overview

- Long term results have significantly exceeded benchmarks
- Cost efficient due to internal management capabilities
  - Securing team to preserve internal capabilities best chance to remain cost efficient
  - Internal cost .1% with expected average incentives
- Continued success dependent on high caliber team
  - Internally manage most assets using internally generated research
- Future team depends on retention of talent pipeline and trainers
  - Develop internally as cannot compete for top tier experienced talent
- Compensation plan aligned with goal of adding value over long term
  - Motivate superior long-term performance and retain successful staff

# Compensation Overview, cont'd

- Compensation target
  - Council target is 70% of cost-of-living adjusted median industry pay to balance getting a good deal for South Dakota without losing the good deal if we cannot keep our people
  - Incorporates performance incentives
  - Compensation study updated approximately every three years
  
- Compensation study 2013
  - Study showed compensation had fallen to 55%
  - Expanded incentive compensation plan as opposed to adjusting base compensation
  - Incentives expanded to include longer term and stretch incentives and expected to average 80% (0% to 200%) -- This reached 95% of 70% target
  - Incentives aligned with the goal of adding value and only paid if add value
  
- Compensation study 2016 and 2019
  - Indicated moderate slippage, but not sufficient to request adjustment
  
- Compensation study 2022
  - Indicated further slippage to 10% threshold just sufficient to request adjustment
  - Council recommends increase in incentive maximum to 225% focusing on 10 yr. performance including stretch component. This reduces to half of shortfall.

# Budget Funding Sources



Budget funded by assets under management  
0% General Fund appropriation

Note: S&PL share of SDIC expenses paid from earnings of Cash Flow Fund

# Long-Term Plan Executive Summary

## Projected LTP Budget

<b>INVESTMENT COUNCIL BUDGET</b>	<b><u>FY 2024</u></b>	<b><u>FY 2029</u></b>	<b><u>FY 2034</u></b>
<b>Personal Services</b>			
Number of Employees	35.00	35.00	37.00
Base Compensation - Total Staff	7,121,678	8,861,800	11,603,634
Student Interns	91,664	102,451	114,507
Investment Council	7,377	8,245	9,216
Flexibility funds-Retirements & Resignations	194,739	217,655	243,268
Investment Incentive Maximum	14,612,823	17,436,308	22,895,353
Benefits	3,175,570	3,549,619	4,730,822
<b>Total Personal Services</b>	<b>25,203,852</b>	<b>30,176,079</b>	<b>39,596,800</b>
<b>Operating Expenses</b>			
Contractual Services	2,635,436	2,881,931	3,134,024
Travel	86,431	96,602	107,970
Office Supplies & Postage	7,000	7,824	8,744
Capital Assets	40,520	54,952	62,132
<b>Total Operating Expenses</b>	<b>2,769,387</b>	<b>3,041,308</b>	<b>3,312,871</b>
<b>Total Investment Council Budget <sup>(1)</sup></b>	<b>27,973,239</b>	<b>33,217,388</b>	<b>42,909,671</b>
<b>ASSET SUMMARY <sup>(2)</sup></b>			
Internal Assets	15,296,416,830	18,808,528,243	23,141,007,379
External Assets	4,830,447,420	5,939,535,235	7,307,686,541
<b>Total Assets</b>	<b>20,126,864,250</b>	<b>24,748,063,478</b>	<b>30,448,693,919</b>
<b>EXPENSE SUMMARY</b>			
Internal Expenses	27,973,239	33,217,388	42,909,671
External Manager Fees	53,134,922	65,334,888	80,384,552
<b>Total Expenses</b>	<b>81,108,161</b>	<b>98,552,275</b>	<b>123,294,223</b>
<b>UNIT COST SUMMARY <sup>(3)</sup></b>			
Internal Expenses as % of Total Assets	0.099%	0.096%	0.100%
<b>Total Expenses as % of Total Assets</b>	<b>0.334%</b>	<b>0.331%</b>	<b>0.335%</b>

<sup>(1)</sup> FY 2024 amounts differ from the actual final budget request. To reflect all costs, the LTP includes an assumed salary policy of 2.25% and an additional 1.75% increase for investment positions. The salary policy is not included in the budget request as any salary policy is added afterward.

<sup>(2)</sup> Projections based on long-term assumed returns applied to 6/30/22 assets. Updated each June 30.

<sup>(3)</sup> Unit Cost Summary uses assumed average investment performance incentives

# FY 2022 Budget and Actual

	Expended FY 2022	Received FY 2022	Unexpended FY 2022
<b>PERSONAL SERVICES</b>			
TOTAL FTEs	33.50	35.00	
<b>BASE COMPENSATION</b>			
Base Compensation - Investment Staff	5,424,077	5,924,242	500,165 *
Base Comp - Admin, Acct, Legal, Longevity	486,468	691,805	205,337
TOTAL STAFF - FULL TIME	5,910,545	6,616,047	705,502
Part-Time - Legal & Interns	66,142	83,422	17,280
Investment Council	2,025	6,790	4,765
Retirement & resignation flexibility funds	216,420	167,795	(48,625)
Benefits	1,018,045	1,286,459	268,414
<b>Total Base Compensation</b>	<b>7,213,177</b>	<b>8,160,513</b>	<b>947,335</b>
<b>Investment Performance Incentives</b>			
Maximum Potential Investment Perf Incentive	1,821,039	11,191,009	9,369,970
Benefits	199,518	1,344,359	1,144,841
<b>Total Investment Performance Incentives</b>	<b>2,020,557</b>	<b>12,535,368</b>	<b>10,514,811</b>
<b>Total Personal Services</b>	<b>9,233,735</b>	<b>20,695,881</b>	<b>11,462,146</b>
<b>OPERATING EXPENSES</b>			
Contractual Total (see appendix for further details)	1,846,851	2,372,642	525,791
Travel	6,833	86,431	79,598
Office Supplies	5,470	7,000	1,530
Capital Assets	16,810	40,520	23,710
<b>Total Operating Expenses</b>	<b>1,875,966</b>	<b>2,506,593</b>	<b>630,627</b>
<b>TOTAL BUDGET</b>	<b>11,109,700</b>	<b>23,202,474</b>	<b>12,092,774</b>

\*Includes \$59,881 Vertus reimbursement & unused compensation

Note: Budget is funded as needed and ended year with a cash balance of \$2,855,261.26 which is credited against FY 2023 authorized budget

# FY 2024 Budget Request Summary

	<u>Received FY 2023</u>	<u>Request FY 2024</u>	<u>% change</u>
<b>PERSONAL SERVICES</b>			
TOTAL FTEs	35.00	35.00	
<b>BASE COMPENSATION</b>			
Base Compensation - Investment Staff	6,494,589	6,263,428	-3.56%
Base Comp - Admin, Acct, Legal, Longevity	739,095	687,960	-6.92%
TOTAL STAFF - FULL TIME	7,233,684	6,951,388	-3.90%
Part-Time - Legal & Interns	89,429	90,053	0.70%
Investment Council	7,197	7,359	2.25%
Retirement & resignation flexibility funds	189,989	189,989	0.00%
Benefits	1,367,668	1,327,229	-2.96%
<b>Total Base Compensation</b>	<b>8,887,966</b>	<b>8,566,018</b>	<b>-3.62%</b>
<b>Investment Performance Incentives</b>			
Maximum Potential Investment Perf Incentive	11,848,483	14,612,825	23.33%
Benefits	1,435,090	1,816,570	26.58%
<b>Total Investment Performance Incentives</b>	<b>13,283,573</b>	<b>16,429,394</b>	<b>23.68%</b>
<b>Total Personal Services</b>	<b>22,171,539</b>	<b>24,995,412</b>	<b>12.74%</b>
<b>OPERATING EXPENSES</b>			
Contractual Total (see next page for further details)	2,454,980	2,635,435	7.35%
Travel	86,431	86,431	0.00%
Office Supplies	7,000	7,000	0.00%
Capital Assets	40,520	40,520	0.00%
<b>Total Operating Expenses</b>	<b>2,588,931</b>	<b>2,769,386</b>	<b>6.97%</b>
<b>TOTAL BUDGET</b>	<b>24,760,469</b>	<b>27,764,798</b>	<b>12.13%</b>
<b>UNIT COST SUMMARY *</b>			
Internal Expenses as % of Total Adjusted Assets	0.096%	0.099%	
Total Expenses as % of Total Adjusted Assets	0.331%	0.344%	

\* For FY 23 & 24--unit cost based on total assets adjusted to long-term value, expenses using assumed average investment performance incentives, long-term average of retirement & resignation flexibility funds, and an assumed 2.5% salary policy.

# FY 2024 Budget Request

## Contractual services detail

	<b>Received</b> <b><u>FY 2023</u></b>	<b>Request</b> <b><u>FY 2024</u></b>	<b><u>% chng</u></b>
<b>CONTRACTUAL SERVICES</b>			
<b>Investment Services</b>			
Consulting Services	180,000	180,000	0.00%
Investment Accounting, Performance Benchmarking	175,451	251,377	43.27%
Investment Databases, Newsfeeds & Quote Fees	762,722	802,063	5.16%
Investment Research Services	419,200	450,910	7.56%
Flexibility - From Brokerage to Independent Research	225,000	225,000	0.00%
<b>Total Investment Services</b>	<b>1,762,373</b>	<b>1,909,350</b>	<b>8.34%</b>
<b>Administrative Expenses</b>			
Office Rent	153,000	160,000	4.58%
Bond/Liability Insurance	8,385	8,385	0.00%
Telephone	18,000	18,000	0.00%
Office Equip Rental/Maintenance/Misc	10,031	10,031	0.00%
Bureau of Info & Telecommunications (BIT)	97,218	97,218	0.00%
State Central Services	14,038	14,038	0.00%
Legislative Audit	60,510	65,351	8.00%
Janitorial	0	11,400	0.00%
Custodial Fees - Global	293,425	305,162	4.00%
Seminars/Educational Programs	35,000	35,000	0.00%
Business Publications	3,000	1,500	-50.00%
<b>Total Administrative Expenses</b>	<b>692,607</b>	<b>726,085</b>	<b>4.83%</b>
<b>TOTAL CONTRACTUAL SERVICES</b>	<b>2,454,980</b>	<b>2,635,435</b>	<b>7.35%</b>



# Trust Funds (unaudited)

## Health Care Trust (established April 2001)

Principal as of 6/30/22	\$ 135,631,024
Principal as of 6/30/22 adjusted for inflation	\$ 195,376,942
Fair Value (FV) as of 6/30/22	\$ 211,605,434
Difference - FV less principal	\$ 75,974,410
Difference - FV less infl. adj. prin.	\$ 16,228,492
Fiscal year to date return	-2.52%
Longterm expected mean return	5.63%
Payout of 4% plus expected inflation of 2.25%	6.25%
Expected return cushion/shortfall	-0.62%

Distribution for FY 23 (July 1, 2022)	6,612,325
Distribution for FY 21 (July 2, 2021)	5,839,236

## Education Enhancement Trust (established April 2001)

Principal as of 6/30/22	\$ 431,659,484
Principal as of 6/30/22 adjusted for inflation	\$ 658,058,817
Fair Value (FV) as of 6/30/22	\$ 701,701,457
Difference - FV less principal	\$ 270,041,973
Difference - FV less infl. adj. prin.	\$ 43,642,640
Fiscal year to date return	-1.54%
Longterm expected return (lower due to tax-exempts)	5.62%
Payout of 4% plus expected inflation of 2.25%	6.25%
Expected return cushion/shortfall	-0.63%

Distribution for FY 23 (July 1, 2022)	25,277,997
Distribution for FY 22 (July 1, 2021)	23,673,657

<u>Asset Allocation</u>	FY 22	
	<u>Current</u>	<u>Benchmark</u>
Global & Private Equity	30%	51%
Real Estate	10%	10%
Fixed Income-IG	14%	30%
Fixed Income-HY	4%	7%
HY RE Debt	1%	0%
Money Market	<u>41%</u>	<u>2%</u>
Total	100%	100%

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.

<u>Asset Allocation</u>	FY 22	
	<u>Current</u>	<u>Benchmark</u>
Global & Private Equity	31%	51%
Real Estate	10%	10%
Fixed Income-IG	8%	24%
Fixed Income-tax ex	6%	6%
Fixed Income-HY	3%	7%
HY RE Debt	1%	0%
Money Market	<u>42%</u>	<u>2%</u>
Total	100%	100%

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.

# Trust Funds (unaudited)

## Dakota Cement Trust (established April 2001)

		<u>Asset Allocation</u>	<u>Current</u>	<u>FY 22 Benchmark</u>
Principal as of 6/30/22	\$ 238,000,000	Global & Private Equity	29%	51%
Principal as of 6/30/22 adjusted for inflation	\$ 397,556,923	Real Estate	11%	10%
Fair Value (FV) as of 6/30/22	\$ 358,650,927	Fixed Income-IG	15%	30%
Difference - FV less principal	\$ 120,650,927	Fixed Income-HY	4%	7%
Difference - FV less infl. adj. principal	\$ (38,905,996)	HY RE Debt	1%	0%
Fiscal year to date return	-1.67%	Money Market	<u>41%</u>	<u>2%</u>
Longterm expected mean return	5.63%	Total	100%	100%
Payout of 4% plus expected inflation of 2.25%	6.25%			
Expected return cushion/shortfall	-0.62%			
Distribution for FY 22 (May 2022 to GF)	13,982,377			
Distribution for FY 21 (May 2021 to GF)	13,404,156			

Constitution allows 4% of the lesser of 1) the 16 quarter average balance or 2) the current December 31 fair value, be distributed by June of the following year.

## School & Public Lands

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

		<u>Asset Allocation</u>	<u>Current</u>	<u>FY 22 Benchmark</u>
Fair Value as of 6/30/22	\$ 371,237,952	Global & Private Equity	31%	51%
Fiscal year to date return	-1.77%	Real Estate	10%	10%
Longterm expected mean return	5.63%	Fixed Income-IG	14%	30%
Distribution for FY 21 K-12 (2/8/22)	9,839,699	Fixed Income-HY	1%	7%
Distribution for FY 21 Board of Regents (6/13/22)	<u>2,870,629</u>	HY RE Debt	3%	0%
TOTAL for FY 22	12,710,328	Money Market	<u>41%</u>	<u>2%</u>
		Total	100%	100%

# Investment Performance Incentive – FY 2022 State Investment Officer

Return-linked compensation maximum is 200% on base compensation of \$516,258.  
Performance Period is the one year, four year and ten year annualized fiscal years payable in FY 2023

## I. 60% OF PLAN BASED ON TOTAL FUND RESULTS

### A) 30% BASED ON INVESTMENT COUNCIL'S CAPITAL MARKET BENCHMARK (CMB)

<u>Period</u>	<u>Basis Points Outperformance</u>	<u>% Payout</u>	<u>\$ Payout</u>
1 year	+1232.81	100%	\$ 51,625.75
4 year	+ 125.59	100%	\$103,251.65
10 year	+ 155.34	100%	\$ 51,625.75
4 yr stretch	+ 125.59	80%	\$ 61,950.96
10 yr stretch	+ 155.34	100%	\$ 25,812.95

### B) 30% BASED ON MELLON TOTAL BILLION DOLLAR FUNDS - CORPORATE UNIVERSE (using yearly medians prior to FY 14 and CMB from FY 14 on)

<u>Period</u>	<u>Basis Points Outperformance</u>	<u>% Payout</u>	<u>\$ Payout</u>
1 year	+1232.81	100%	\$ 51,625.75
4 year	+ 125.59	100%	\$103,251.65
10 year	+ 181.83	100%	\$ 51,625.75
4 yr stretch	+ 125.59	80%	\$ 61,950.96
10 yr stretch	+ 181.83	100%	\$ 25,812.95

## II. 40% OF PLAN BASED ON AGGREGATE PORTFOLIO MANAGERS' RESULTS

Performance measurement based on the aggregate return-linked compensation of the assistant investment officers and investment staff divided by the aggregate potential return-linked compensation for the performance period, based on one year, 4 years, 10 years, 4 years stretch and 10 years stretch.

<u>Maximum Potential Compensation</u>	<u>Earned Return-linked Compensation</u>	<u>% Payout</u>	<u>\$ Payout</u>
\$8,901,134.31	\$ 5,944,436.32	66.7829%	\$275,817.68
<b>TOTAL EARNED RETURN-LINKED COMPENSATION</b>			<b>\$864,351.80</b>
<b>Percentage of Salary</b>			<b>167.426%*</b>

\*before reduction for support staff incentive

# Appendix

- Investment performance incentives
- Target discount rationale
- FY22 Budget and Actual - Contractual Services details

# Investment performance incentives

Align compensation with goal of adding value

- Encourage superior performance
  - Counters underperformance career risk that can discourage efforts to add value
  - Multiyear timeframes encourage investing for the long term
- Encourage retention of successful staff
  - Team is most attractive to other organizations when winning
  - Shifts compensation higher when people more sought and down when losing
- Incentives paid only for added value
- Important to encourage adding value in good and bad markets
  - Added value in down markets more important than in up markets
  - Encourages adding value by reducing risk when markets expensive

# Target discount rationale

- Need top caliber people long term
  - Unsuccessful people or job hoppers always available but no bargain, even if free
  - Compensation is too low to recruit veteran high-performers from elsewhere
  - Must develop team internally by training cream of crop local University graduates
  - Takes 15 to 20 years to fully develop seasoned talent
  - If lose talent pipeline or trainers, will jeopardized handoff to next generation
- Our past history and observation of others suggest 70% target
  - Only way to know for sure how large discounts can work is to risk damaging team
  - 50% discount levels in past led to difficulties
  - 30% discount believed significant relative to other high-end professionals
  - Industry subject to intense performance measurement with significant consequences for winning and losing which intensifies desire for financial security
  - Discounts for top SDIC performers may be much larger as industry pay for top quartile performers can be double the median

# FY22 Budget and Actual

## Contractual services detail

	<b>Expended</b> <b><u>FY 2022</u></b>	<b>Received</b> <b><u>FY 2022</u></b>	<b>Unexpended</b> <b><u>FY 2022</u></b>
<b>CONTRACTUAL SERVICES</b>			
<b>Investment Services</b>			
Consulting Services	5,948	180,000	174,053
Investment Accounting, Performance Benchmarking	190,577	160,924	(29,653)
Investment Databases, Newsfeeds & Quote Fees	630,068	734,267	104,199
Investment Research Services	376,620	378,655	2,035
Flexibility - From Brokerage to Independent Research	0	250,000	250,000
<b>Total Investment Services</b>	<b>1,203,213</b>	<b>1,703,846</b>	<b>500,633</b>
<b>Administrative Expenses</b>			
Office Rent	139,019	139,019	0
Bond/Liability Insurance	7,865	8,385	520
Telephone	16,986	18,000	1,014
Office Equip Rental/Maintenance/Misc	5,165	10,020	4,855
Bureau of Info & Telecommunications (BIT)	86,445	93,635	7,190
State Central Services	11,779	13,555	1,776
Legislative Audit	63,089	60,510	(2,579)
Janitorial	0	-	0
Custodial Fees - Global	288,344	287,672	(672)
Seminars/Educational Programs	24,109	35,000	10,891
Business Publications	838	3,000	2,162
<b>Total Administrative Expenses</b>	<b>643,639</b>	<b>668,796</b>	<b>25,157</b>
<b>TOTAL CONTRACTUAL SERVICES</b>	<b>1,846,851</b>	<b>2,372,642</b>	<b>525,791</b>