TRANSMITTAL LETTER

TO THE GOVERNOR, LEGISLATURE, AND PEOPLE OF SOUTH DAKOTA:

The South Dakota Investment Council annual report provides information about the investment of South Dakota Retirement System assets, state trust funds, and other financial assets of the State of South Dakota. This letter summarizes fiscal year 2021 performance and discusses the Council's long-term approach; future return expectations; importance of low costs; and productive working relationships with the Legislature, the Executive Branch, and others.

FISCAL YEAR 2021 PERFORMANCE

The fiscal year 2021 time-weighted investment return for the South Dakota Retirement System (SDRS) was 22.0% net of investment management cost. This was less than the Council's market index-based Capital Markets Benchmark (CMB) return of 28.0%. Having approximately 20% lower allocation to equities was the largest detractor, magnified by the large increase in the stock market. The real estate category also underperformed the real estate benchmark. The public equities and high yield debt portfolios significantly outperformed their benchmarks.

The net returns for the trust funds, which include School and Public Lands, Dakota Cement Trust, Health Care Trust, and Education Enhancement Trust, were 17.3% to 17.8%. The South Dakota Cash Flow Fund yield was 1.3%.

INVESTING FOR THE LONG TERM

The Council's goal is to add value over the long term compared to market indexes. Accomplishment of this goal for SDRS provides additional resources to fund retirement benefits for about 95,000 members. Added value for the trust funds and cash flow fund provides additional revenues to the state.

Results vary significantly from year to year with many interim periods of underperformance in the Council's history. Whether an individual year is good, bad, or average, it is important to be mindful that the Council invests for the long term and that actions taken in one year may impact performance several years down the road. Success has resulted primarily from adhering to strategies during the underperforming periods.

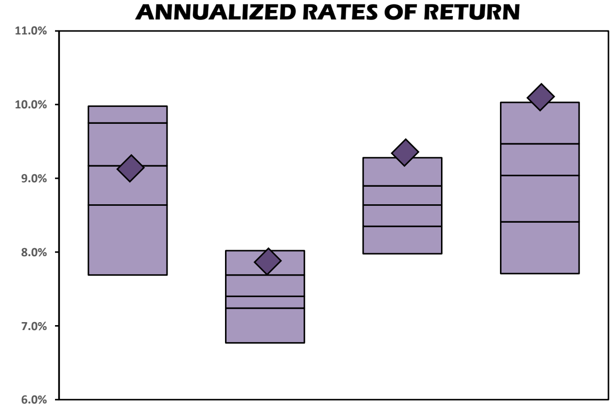
The Council invests in assets believed to be undervalued from a long-term perspective. The valuation process is based on the view that the worth of an asset is the present value of future cash flows. Internal research efforts focus on estimating future cash flows and assessing risk which impacts the rate used to discount cash flows to present value.

Disciplined adherence to the long-term value approach is essential. This is most difficult following underperforming periods. Performing the research function internally and using a sensible valuation process can strengthen conviction. Experience in prior difficult periods adds confidence. Contingency planning also improves the likelihood of adhering to the plan.

Risk is managed by diversifying across multiple asset categories and reducing exposure to expensive assets. Conventional statistical risk measures, such as standard deviation and correlation, help measure volatility and diversification. Conventional measures are good for understanding risk in normal times but tend to understate real-world frequency and magnitude of severe market declines. Since before the 2008-2009 financial crisis, the Council has adjusted risk measures to better reflect risk during periods of market stress. Standard deviations are increased to reflect higher frequency of severe declines, and correlations are adjusted to reflect that most asset categories are less diversifying during severe declines.

The Council has managed SDRS assets for the past 48 years. The return over the full period has exceeded other state retirement systems across the nation as shown on the following exhibit.

STATE FUND UNIVERSE
ANNUALIZED RATES OF RETURN



NET ANNUALIZED RETURNS

	10 Years 2012-2021	20 Years 2002-2021	30 years 1992-2021	48 Years 1974-2021
10th %tile	10.0	8.0	9.3	10.0
25th %tile	9.8	7.7	8.9	9.5
Median	9.2	7.4	8.6	9.0
75th %tile	8.6	7.2	8.4	8.4
90th %tile	7.7	6.8	8.0	7.7
◆ SDRS Fund	9.1	7.9	9.3	10.1
SDRS %tile Rank	50	16	4	1-4*

*Ranked 1st from fiscal years 1974-1991 and 4th from fiscal years 1992-2021.

SDRS total fund and capital markets benchmark returns can be found on page 8 of the annual report for every fiscal year since inception and various rolling time periods. Trust fund returns can be found in their respective sections.

RETURN EXPECTATIONS

The Council believes market return expectations should be based on forward-looking, long-term cash flows rather than extrapolation of past returns, which tend to relate inversely to future results. The Council began developing long-term expected returns in the early 1980s. The following exhibit shows expected returns resulting from the Council's process for bonds and stocks as of 6/30/82, 6/30/92, 6/30/02, and 6/30/21.

UPDATE ON RETURN EXPECTATIONS

	Bonds*	S&P 500	S&P 500 Yield
Expected Long-Term Returns as of 6/30/82	14.4%	15.6%	6.2%
Actual 10-year Returns - 7/1/82 to 6/30/92	13.7%	18.3%	
Actual 20-year Returns - 7/1/82 to 6/30/02	10.5%	14.9%	
Expected Long-Term Returns as of 6/30/92	7.1%	9.5%	3.0%
Actual 10-year Returns - 7/1/92 to 6/30/02	7.4%	11.5%	
Actual 20-year Returns - 7/1/92 to 6/30/12	6.6%	8.4%	
Expected Long-Term Returns as of 6/30/02	4.8%	7.9%	1.6%
Actual 10-year Returns - 7/1/02 to 6/30/12	5.8%	5.3%	
Actual 19-year Returns - 7/1/02 to 6/30/21	4.4%	10.2%	
Expected Long-Term Returns as of 6/30/21	1.5%	6.7%	1.4%

*Expected returns are the 10-year Treasury yield. Actual returns are the FTSE US Broad Investment-Grade (USBIG) Bond Index.

In 1982, bond yields were 14.4%, and the Council's long-term expected return for stocks, based on projected dividends and growth, was 15.6%. Expected returns were high because markets were very cheap, having performed poorly for many years. Subsequent actual 10-year and 20-year returns were 13.7% and 10.5% for bonds and 18.3% and 14.9% for stocks. By June 30, 1992, bond yields were 7.1%, and the expected stock return was 9.5%. Subsequent actual 10-year and 20-year returns were 7.4% and 6.6% for bonds and 11.5% and 8.4% for stocks. As of June 30, 2002, expected returns were 4.8% for bonds and 7.9% for stocks. Subsequent actual 10-year and 19-year returns were 5.8% and 4.4% for bonds and 5.3% and 10.2% for stocks.

As of June 30, 2021, expected returns were 1.5% for bonds and 6.7% for stocks. Low interest rates foreshadow very low future bond returns. The expected return for stocks is also lower than earned on average historically. The expected long-term return for the overall SDRS fund, which is diversified across several asset categories, was 5.9%. This excludes consideration of potential value added or detracted relative to index returns. The expected return also excludes the impact of timing of withdrawals to pay benefits. As SDRS matures, benefit payments are increasingly funded from investment earnings. These withdrawals are larger as a percentage of the fund when markets are depressed which can reduce long-term asset growth.

The expected return is the mid-point of a range of possible outcomes. The one standard deviation range, which statistically encompasses the central two-thirds of potential outcomes, is 1.0% to 10.7% per annum for a 10-year horizon and 2.4% to 9.3% for a 20-year horizon.

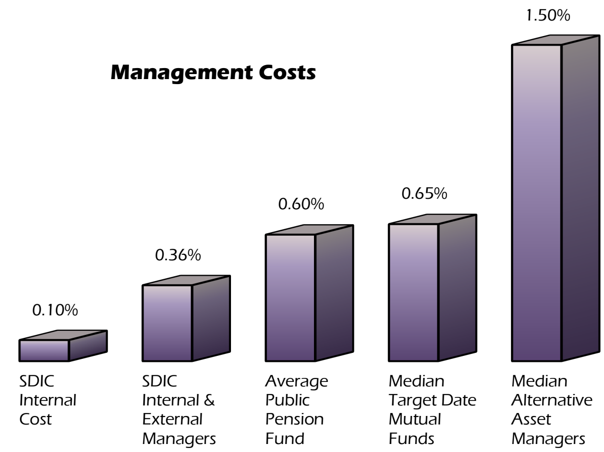
History has shown that following large market increases, opportunities may be sparse for a time. Chasing lesser opportunities has tended to backfire when assets became much cheaper later. The lesson learned is to wait for worthwhile opportunities, and when absent, be satisfied with modest results until better opportunities come along.

IMPORTANCE OF LOW COSTS

The Investment Council manages the majority of assets internally to save money and to try to earn higher returns. Managing assets internally is cheaper than using external managers, especially for more expensive categories such as global equity, high yield, and arbitrage. Index funds are another low-cost alternative but would preclude any opportunity to add value above index returns. The Council believes historic success of internal management efforts relate to greater focus on long-term value and increased conviction from performing research in-house.

The Council began investing in real estate and private equity partnerships in the mid-1990s. Management costs are generally 1% to 2% of partnership assets per year. Partnership managers are also typically allocated 20% of profits. These investments can be more expensive than traditional external managers and much more expensive than the Council's internal cost. Unlike traditional managers that buy and sell securities, partnership managers have hands-on involvement with underlying investments which complicates cost comparisons. Real estate partnership managers buy and manage underlying properties. Private equity partnership managers buy and operate whole companies. The Council evaluates partnership returns compared to traditional real estate and stock market indexes. Partnership returns are net of all fees and profit allocations.

The following exhibit shows Council management costs compared to other funds.



Internal management cost is projected to average 0.10% of assets. Including external management, total cost is expected to average 0.36%. The total cost fluctuates from year to year primarily due to variation in amounts invested in partnerships, and in some cases, the return of partnership fees if the investment is profitable. This compares to the average public pension fund cost of 0.60% and median target date mutual fund cost of 0.65%. The difference of 0.24% versus the average public pension fund results in approximately $44 million of savings per year. Compounding these savings over many years can result in hundreds of millions of dollars.

A TEAM EFFORT

The Investment Council's historic success has been a team effort. Consistent support by the Legislature, the Executive Branch, and others over multiple decades has allowed the Council to pursue a long-term investment approach and implement a long-term business plan to develop an internal investment team. The Council recognizes the unique challenges and patience required to support an internal investment organization and long-term investment approach. The Council is very appreciative of the significant efforts of Legislators, the Governor and her team, and their predecessors, to provide the Council with the opportunity to succeed.

The Council benefits from cooperative relationships with other state entities related to the funds managed, including the South Dakota Retirement System, the State Treasurer's Office, the School and Public Lands' Office, and the Bureau of Finance and Management. The Council also benefits from important contributions by the Legislative Research Council, the Attorney General's Office, the Department of Legislative Audit, the Bureau of Information and Telecommunications, and other agencies.

The Council believes its strengths of a disciplined focus on long-term investment value, an exceptionally supportive environment, and a stable internal investment team will serve us well in the decades to come.

Respectfully submitted by:

Jeffrey L. Nelson, Chair
South Dakota Investment Council

Matthew L. Clark, CFA
State Investment Officer