

Executive Board Meeting Investment Council Comments

November 16, 2009

- Fiscal year-to-date estimated returns (since June 30)
 - SDRS +16.6% (as of November 13)
 - Trusts range from +13.7% to +14.5% (as of November 13)
 - Details and payout implications on summary sheet
- Budget
 - Planning to adjust budget provided to BFM and Appropriations to remove salary policy portion of any compensation increases
 - I.O. and senior staff - would get zero increase
 - Younger to Intermediate investment staff – salary policy portion also would be zero. Would receive only promotion related increases which is largest component for most
- Desire for update to open meeting law to make compatible with new open records law with respect to proprietary confidential information
 - Allow proprietary confidential information protected by new open records law to be discussed in executive session

TRANSMITTAL LETTER

TO THE GOVERNOR, LEGISLATURE AND PEOPLE OF SOUTH DAKOTA:

This is the performance review of the South Dakota Investment Council for the fiscal year ended June 30, 2009.

FINANCIAL CRISIS

Last year's annual report transmittal letter discussed origins of the financial crisis. To review, it was suggested strong markets and low interest rates during the 2003 to 2007 period encouraged investors toward riskier assets and increasing leverage. This became most excessive for residential real estate markets and complex investment structures. Perception of prosperity led to a surge in imports and consumption, spurring abnormal growth in emerging markets. This drove up energy and commodity prices. Fear of increasing inflation led monetary authorities across the globe to raise interest rates. Indebtedness had become so excessive that even moderately higher rates triggered a deleveraging downward spiral. Those who could not handle their debts were forced to sell assets. This drove asset prices down further, which exacerbated the distress for others. The severity of the crisis was linked to indebtedness being the most pervasive since the previous peak in 1929.

Last year's letter also discussed massive injections of liquidity provided by governments across the globe. It was suggested deleveraging would eventually exhaust itself, aided by low interest rates, stimulus, and the allure of bargain prices, and that financial markets tend to recover prior to the economy. It was noted there are many challenges and headwinds to future growth, but there have always been challenges to face. Economic policy mistakes may be made in our country and around the world, but mistakes were also made in the past. In spite of past challenges and mistakes, the economy and markets grew over time due to a strong work ethic, entrepreneurial spirit, and rapid pace of innovation. The Investment Council expressed belief that long-term optimism was warranted relative to prevailing pessimism.

As of the writing of this transmittal letter (late October 2009), recovery of financial markets appears to be underway. The collapse seems to have been arrested by the monetary and fiscal stimulus. However, the economy remains weak. Some degree of self-sustaining economic recovery may need to begin in the next year for the market recovery to continue. The Investment Council remains guardedly optimistic toward long-term positive growth in the economy and markets though mindful of the constraining consequences of the large buildup of federal government debt.

FISCAL YEAR 2009 PERFORMANCE

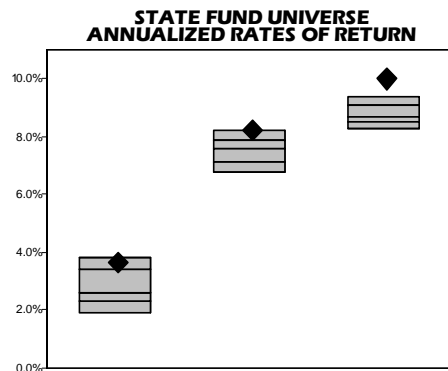
The Investment Council focuses attention on long-term performance rather than one-year results. However, fiscal year 2009 returns were significantly negative and merit discussion. The return for the South Dakota Retirement System (SDRS) was -20.36%, and the trust funds ranged from -14.64% to -17.53%. The most significant loss relative to benchmarks was in the real estate area with write-downs of roughly 50%. On the positive side, most internally managed portfolios, including global equity and fixed income, outperformed benchmark indexes. Prospects for recovery of real estate write-downs likely depend on recovery of the economy and financing markets in the next three to five years as maturing financing for properties must be rolled over.

In the fall of 2008, allocations to equity (stocks) and equity-like assets were increased as discounts to long-term value exceeded thresholds that trigger the Investment Council to try to take advantage of bargains. Markets subsequently declined to the largest discount in the history of the Council. Additional purchases were made as the market bottomed in early March 2009 in order to maintain the target allocation. The subsequent partial market recovery through the end of the fiscal year offset the negative impact of the allocation increases done earlier in the fiscal year. Any ultimate benefit of these efforts to take advantage of bargains will depend on whether markets continue to recover in fiscal year 2010 and beyond.

The crisis highlighted the importance of maintaining discipline. The Investment Council continued its patient pursuit of adding value by focusing on the long term. Another lesson of the crisis is that research efforts must focus on understanding excesses in the markets and economy and the linkages to those who bear the risk.

LONG-TERM PERFORMANCE

The Investment Council has been responsible for managing the assets of the SDRS for the past 36 years. As the following exhibit illustrates, investment returns have meaningfully exceeded the returns of the state fund universe and the Investment Council's capital markets benchmark (CMB).



ANNUALIZED RETURNS

	10 Years	20 Years	36 Years
	<u>2000-2009</u>	<u>1990-2009</u>	<u>1974-2009</u>
10th %tile	3.8	8.2	9.4
25th %tile	3.4	7.9	9.1
Median	2.6	7.6	8.7
75th %tile	2.3	7.1	8.5
90th %tile	1.9	6.8	8.3
◆ SDRS Fund	3.6	8.2	10.0
SDRS CMB	2.9	7.9	9.3
SDRS %tile Rank	15	10	1

There have been a number of under-performing periods throughout the Investment Council's history, including FY 2008 and FY 2009. The SDRS total fund annual return has lagged the CMB 11 of the 36 years, the private sector universe median 14 of the 36 years, and the state fund universe median 6 of the 36 years. Investment returns for the SDRS total fund and CMB can be found on page 11 for various rolling periods of time.

RETURN EXPECTATIONS

Since the mid 1990s, the Investment Council has cautioned against expecting continuation of the double-digit returns earned, on average, from the beginning of the bull market in the early 1980s. Market return expectations should not be based on extrapolation of past returns, which tend to be inversely related to future results, but rather on forward-looking long-term economic projections. As shown in the following exhibit, bond yields were 13.7% in 1982, and the expected return for stocks based on projected dividends and cash flows was 14.9%. The subsequent 13-year returns of 12.2% for bonds and 17.1% for stocks were close to expectations. By June 30, 1995, bond yields had declined to 6.3%, and the expected return for stocks was down to 9.3%. The subsequent 13-year returns were 6.2% for bonds and 8.7% for stocks.

AN UPDATE ON REALISTIC EXPECTATIONS					
	Expected Returns as of 6/30/82	Actual Returns 7/1/82- 6/30/95	Expected Returns as of 6/30/95	Actual Returns 7/1/95- 6/30/08	Expected Returns as of 6/30/09
Bonds*	13.7%	12.2%	6.3%	6.2%	3.5%
S&P 500	14.9%	17.1%	9.3%	8.7%	9.4%
S&P 500 Yield	6.1%		2.4%		2.6%

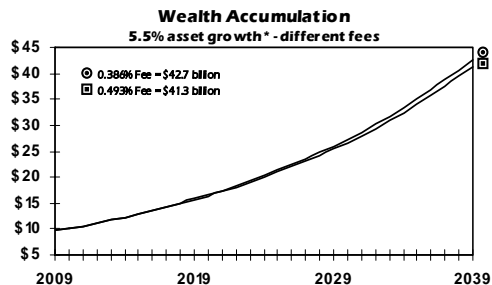
* Expected returns are for the 10-year Treasury note. Actual returns are for the Citigroup Broad Investment-Grade (BIG) Index.

As of June 30, 2008, before the worst of the crisis began, expected returns were even lower. Bond yields were 4.0% and the long-term expected return for stocks was 8.8%. The expected long-term return for the overall SDRS portfolio, which is diversified across a number of asset categories, was 7.7%.

As of June 30, 2009, bond yields were 3.5%, the expected return for stocks was 9.4%, and the expected return for the overall SDRS portfolio was 8.2%. It is important to note that this was the mid-point of a range of possible return outcomes. For a ten-year horizon, the standard deviation, which statistically encompasses the central two-thirds of potential outcomes, was plus or minus 4.8% around the expected return of 8.2% for a range of 3.4% to 13.0% per annum. For a twenty-year horizon, it was plus or minus 3.4% for a range of 4.8% to 11.6%. These expected returns exclude any value added or detracted relative to index returns resulting from managing the portfolio.

IMPORTANCE OF LOW COSTS

The following exhibit illustrates the importance of keeping investment management costs low.



Even without considering the potential for continuing superior long-term Council performance, future wealth grows an extra \$1.4 billion by keeping costs low!

* expected returns less net withdrawals and distributions

The Investment Council's internal management cost is \$1.11 per \$1,000 of assets. Including external management fees, the Council's cost is \$3.86 per \$1,000, which compares with the median industry cost of \$4.93 per \$1,000. This cost savings of \$1.07 per \$1,000 exceeds \$9.8 million per year. Compounding these savings over many years can result in hundreds of millions of dollars.

LONG-TERM APPROACH

The Investment Council has historically attempted to add value by investing in assets believed to be undervalued from a long-term perspective based principally on the present value of future cash flows. Risk is managed through diversification and reducing amounts invested in assets considered overvalued. The Council believes patience and discipline are important in implementing a long-term oriented investment approach, particularly during periods of underperformance. The Council has and will continue to adhere to its long-term strategies.

A TEAM EFFORT

The Investment Council recognizes the importance of the consistent long-term support of the Legislature, primarily through the Executive Board and Appropriations Committee, and the Executive Branch. This support has made possible the Council's Long-Term Plan. This bottom line focused business plan, in place for more than two decades, has allowed development of a stable, experienced, home-grown, investment team essential to the Council's success. A key aspect of this support is an understanding of the long-term nature of the Council's investment strategies.

The Council values the excellent working relationships with the state entities related to the various funds, 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 would also like to acknowledge the important contributions of the Legislative Research Council, the Attorney General's Office, the Department of Legislative Audit, and the Bureau of Information and Telecommunications.

The Council and investment team greatly appreciate all the help and support from each of these groups, especially in this most difficult period. The past two years have been the most challenging to investment management since the 1930s. We believe the strength of the Council is a function of a supportive environment, a talented and passionate investment team, and a disciplined focus on long-term investment value. The Council believes these strengths will serve us well in the decades to come.

As the Investment Council embarks on its thirty-eighth year, we encourage your continued suggestions, guidance and comments.

RESPECTFULLY SUBMITTED,

Curt Johnson

Curt Johnson, Chair
South Dakota Investment Council

Matthew L. Clark

Matthew L. Clark, CFA
State Investment Officer

State of South Dakota

EIGHTY-FIFTH SESSION LEGISLATIVE ASSEMBLY, 2010

158R0183

SENATE BILL NO. _____

Introduced by: _____

1 FOR AN ACT ENTITLED, An Act to authorize the State Investment Council to discuss in
2 executive session certain information exempt from public disclosure.

3 BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF SOUTH DAKOTA:

4 Section 1. That chapter 1-25 be amended by adding thereto a NEW SECTION to read as
5 follows:

6 The State Investment Council may, in executive session, discuss and consider any document
7 or information exempt from public disclosure requirements under the provisions of subdivision
8 1-27-1.6(5).



SUMMARY OF TRUST FUND VALUE AND ASSET ALLOCATION

	11/13/2009 ESTIMATE	10/31/2009 ESTIMATE		Current	Benchmark
Health Care Trust					
Principal as of 10/31/09	\$ 85,631,024	\$ 85,631,024	<u>Asset Allocation</u>		
Principal as of 10/31/09 adjusted for inflation	\$ 102,011,400	\$ 102,011,400	Global Equity	53%	48%
Fair Value as of 10/31/09	\$ 94,037,542	\$ 91,677,035	Private Equity	2%	2%
			Real Estate	5%	5%
Difference - FV less principal	\$ 8,406,518	\$ 6,046,011	Fixed Income-IG	30%	33%
Difference - FV less infl. adj. principal	\$ (7,973,858)	\$ (10,334,365)	Fixed Income-HY	3%	5%
			Fixed Income-Tips	5%	5%
Fiscal year to date return	14.39%	11.52%	Money Market	<u>1%</u>	<u>2%</u>
Longterm expected mean return	7.55%	7.55%	Total	100%	100%
Payout of 4% plus expected inflation of 3%	7.00%	7.00%			
Expected return cushion/shortfall	0.55%	0.55%			
Distribution for FY 10 (July 1, 2009)	0.00	0.00			

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
3,885,709.00 ESTIMATE FY 11

	11/13/2009 ESTIMATE	10/31/2009 ESTIMATE		Current	Benchmark
Education Enhancement Trust					
Principal as of 10/31/09	\$ 329,329,930	\$ 329,329,930	<u>Asset Allocation</u>		
Principal as of 10/31/09 adjusted for inflation	\$ 392,909,459	\$ 392,909,459	Global Equity	52%	48%
Fair Value as of 10/31/09	\$ 343,170,118	\$ 334,828,411	Private Equity	2%	2%
			Real Estate	5%	5%
Difference - FV less principal	\$ 13,840,188	\$ 5,498,481	Fixed Income-IG	0%	0%
Difference - FV less infl. adj. principal	\$ (49,739,341)	\$ (58,081,048)	Fixed Income-tax ex	36%	37%
			Fixed Income-HY	3%	5%
Fiscal year to date return	13.69%	10.93%	Fixed Income-Tips	0%	1%
Longterm expected return (lower due to tax exempts)	7.10%	7.10%	Money Market	<u>1%</u>	<u>2%</u>
Payout of 4% plus expected inflation of 3%	7.00%	7.00%	Total	100%	100%
Expected return cushion/shortfall	0.10%	0.10%			
Distribution for FY 10 (July 1, 2009)	0.00	0.00			

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
13,840,187.53 ESTIMATE FY 11

	11/13/2009 ESTIMATE	10/31/2009 ESTIMATE		Current	Benchmark
Dakota Cement Trust					
Principal as of 10/31/09	\$ 238,000,000	\$ 238,000,000	<u>Asset Allocation</u>		
Principal as of 10/31/09 adjusted for inflation	\$ 290,487,885	\$ 290,487,885	Global Equity	54%	48%
Fair Value as of 10/31/09	\$ 222,879,424	\$ 217,301,471	Private Equity	2%	2%
			Real Estate	6%	5%
Difference - FV less principal	\$ (15,120,576)	\$ (20,698,529)	Fixed Income-IG	28%	33%
Difference - FV less infl. adj. principal	\$ (67,608,461)	\$ (73,186,414)	Fixed Income-HY	2%	5%
			Fixed Income-Tips	6%	5%
Fiscal year to date return	14.48%	11.95%	Money Market	<u>2%</u>	<u>2%</u>
Longterm expected mean return	7.55%	7.55%	Total	100%	100%
Payout of 5% plus expected inflation of 3%	8.00%	8.00%			
Expected return cushion/shortfall	-0.45%	-0.45%			
Distribution for FY 10 (June 2010 to Gen. Fund)	12,000,000.00	12,000,000.00			
Distribution for FY 10 for education	-	-			

Pays out 5% of average balance with \$12 million always paid. Education money distributed as long as principal not violated as of June 30 each year

	11/13/2009 ESTIMATE	10/31/2009 ESTIMATE		Current	Benchmark
School & Public Lands					
Inflation protection mandated by Constitutional Amendment - (payout is reduced by inflation to extent inflation not offset by realized gains)					
Fair Value as of 10/31/09	\$ 160,061,520	\$ 156,007,723	<u>Asset Allocation</u>		
			Global Equity	54%	48%
Fiscal year to date return	14.46%	11.56%	Private Equity	2%	2%
Longterm expected mean return	7.55%	7.55%	Real Estate	5%	5%
			Fixed Income-IG	26%	33%
Distribution for FY 10 (pay in Feb 2010 to K-12)	8,673,527	8,673,527	Fixed Income-non-mk	2%	
Distribution for FY 09 to Board of Regents (June)	1,974,654	1,974,654	Fixed Income-HY	3%	5%
			Fixed Income-Tips	6%	5%
			Money Market	<u>2%</u>	<u>2%</u>
			Total	100%	100%

Pays out all received income after inflation adjustment