



Investment Structure

Presentation to the Governor's Task Force
on PERA Solvency

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South Dakota Retirement System

The South Dakota Perspective

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SDRS Structure

SDRS is a hybrid, defined benefit plan covering essentially all South Dakota public employees

- SDRS operates within the resources provided by **fixed, statutory member and employer contributions**
- Recent plan changes have added significant **variable features** that adjust benefits to changing market conditions and plan experience
- South Dakota statutes provide **funding thresholds** that if crossed require the SDRS Board of Trustees to recommend corrective actions (benefit reductions)

As a result, SDRS has a fixed budget for retirement benefits, automatically adjusting benefit features, and specific funding measures that dictate when corrective action must be taken

SDRS was 100% funded in 2017 and in 27 of last 32 years



Our Perspective on Benefits

- A **defined benefit** plan is preferred because it is the most efficient and advantageous design for SDRS members, employers, and taxpayers
- **Hybrid features** that combine the advantages of both defined benefit and defined contribution plans are essential for an equitable distribution of benefits to both career and non-career members
- **Variable benefits** based on affordability measures are essential for sustainability and the COLA is the most logical benefit feature to vary
- Benefits should meet **specific income replacement objectives**; excessive benefits must be avoided
- Provisions and practices that result in higher than intended and/or **artificially inflated benefits** must be avoided and corrected to protect scarce resources and to reinforce adherence to our goals



Our Perspective on Plan Management and Funding Policy

- The **SDRS Board of Trustees** must have the expertise, knowledge, and resources and act as fiduciaries, recommend benefit and funding policies, and actively lead SDRS
- **Fixed contributions** are a prudent financial decision, and **SDRS benefits must be managed** accordingly since:
 - Variable contributions may require significant and unpredictable higher costs
 - Contribution increases alone may not be adequate to solve funding issues
- The SDRS funding policy must specify **minimum funding standards** to dictate when changes are required or should be considered
- Contribution rates with a **50% chance of funding** actuarial liabilities are not acceptable unless accompanied with flexible benefits
- Additional **risk measures** must be developed and communicated to provide transparent disclosure of the likelihood of meeting the funding policies and benefit goals of SDRS



Recent Plan Changes

Recent initiatives have added automatic benefit features that adjust with changing economic environments

- Legislation in 2016 redesigned the benefit structure for new hires after June 30, 2017 (Generational Design):
 - Increased normal retirement ages by two years and increased benefit multiplier
 - Eliminated subsidies (early retirement incentives, subsidized spousal benefits, compensation loopholes)
 - Added a new variable benefit within the defined benefit plan
- Legislation in 2017 changed the COLA to vary with CPI and affordability to maintain 100% funding in all but the most extreme conditions
 - COLA equals CPI-W with minimum rate of .5% and maximum rate of 3.5%
 - COLA maximum may be restricted based on resources available

Investment Structure Overview

Goal

- Add value over the long term

Governance

- Role of staff, Council, Legislature and Governor
- Business-like environment

Process

- Focus on long-term value
- Internal management of most assets
- Risk measurement for severe environments

People

- Recruited as interns from area universities and trained internally
- Research coverage redundancy to promote internal discussion and continuity
- Compensation linked to added value

Goal

Goal is to add value over long term versus index returns

- Difficult for most to outperform market index benchmarks
- Accomplishment provides most resources to meet needs
- Everyone must agree on goal to have chance to succeed

Daily efforts focus on drivers of success over the long term

- Common sense long-term contrarian culture
- Willingness to endure short-term underperformance
- Valuation competencies

Governance

Investment Council and Retirement System have separate boards

- Council members appointed based on investment and business experience
- Retirement System Executive Director is member of Investment Council and State Investment Officer is member of Retirement System Board to aid coordination

Legislature and Governor

- Legislature appoints majority of Council members and approves budget
- Governor recommends budget and appoints two Retirement System trustees

Council

- Select State Investment Officer and maintain non-political environment
- Establish investment policy, benchmarks, and ranges, and monitor compliance
- Approve annual budget, compensation methodology, and long-term plan

Staff

- Recommend policies
- Implement investment programs within approved policies

Business-like environment

Majority of Council appointed by Exec. Board of Legislature

- Traditionally respected business leaders from across South Dakota

Focus on maximum risk-adjusted return

- Prohibition against social investing considerations (exception for sanctioned countries)

Long-term business plan

- Established under direction of Legislature in 1988 to create stable environment for internal management and alleviate turnover problems

Investment Council funded from assets under management

- Funding shifted from general fund to managed assets in 1988
- Emphasis on unit cost

Process

Focus on long-term value

- Only reliable way to add value long term is to buy when cheap, sell when expensive
- Many investors would rather focus on short-term market movements
- Need long-term value measures, patience, confidence, continuous preparation

Internal management

- Cost of internal management is lower than external active management cost
- Returns benefit from influence over internal staff to focus on long term
- Increased conviction comes from doing your own work
- Internal management is a lot more work than hiring outside managers

Risk management

- Risk measurement focused on equity-like and bond-like risk
- Conventional statistical risk measures are adjusted to reflect higher real-world frequency and magnitude of adverse outlier events
- Risk managed by broad diversification and avoiding expensive assets
- Strong financial condition important to help weather difficult periods

People

Recruitment

- Intern program for top students from area universities
- Gauge aptitude for contrarian philosophy and cash flow modeling

Training

- Understand long-term contrarian philosophy
- Develop cash flow modeling capability

Research coverage redundancy

- Double coverage promotes internal discussion and continuity
- Analysts manage individual portfolios to heighten focus and accountability

Compensation

- Based on private sector comparable positions with targeted discount
- Linked to added value through incentive compensation component

Compensation linked to added value

Encourage retention of successful staff

- Team is most attractive to other organizations when winning
- Shifts compensation higher when people more sought after and down when losing

Incentives encourage performance

- Multiyear timeframes encourage investing for the long term
- Counters underperformance risk that can discourage efforts to add value

Incentives paid only for added value

Important to encourage added value in all markets

- Encourages adding value by reducing risk when markets expensive
- Added value in down markets more important than in up markets