

# Investment Structure

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# 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