BWC Board of Directors

INVESTMENT COMMITTEE

Thursday, June 18, 2009 12:00 p.m.
William Green Building
30 West Spring Street, 2nd Floor (Mezzanine)
Columbus, Ohio 43215

Members Present:	Robert Smith, Chair David Caldwell James Harris Larry Price William Lhota, ex officio
Other Members Present:	Charles Bryan Kenneth Haffey James Hummel Jim Matesich Thomas Pitts
Members Absent:	Alison Falls, Vice Chair
Counsel Present:	John Williams, Assistant Attorney General

CALL TO ORDER
Mr. Smith called the meeting to order at 12:20 pm.

ROLL CALL
Roll call was taken. Ms. Falls and Mr. Lhota were not present for the roll call. Mr. Smith explained that Ms. Falls would be unable to attend due to family issues.

APPROVE MINUTES OF THE MAY 28, 2009 MEETING
Upon motion of Mr. Price, seconded by Mr. Caldwell, the minutes of the May 28, 2009 meeting were approved as written. Roll call was taken and the motion passed 4-0.

AGENDA
Upon motion of Mr. Price, seconded by Mr. Harris, the agenda was approved as written. Roll call was taken and the motion passed 4-0.

DISCUSSION ITEMS:

DERIVATIVES

Mr. Smith directed the Investment Committee to the June 12, 2009 recommendation by Bruce Dunn, the Chief Investment Officer (CIO), detailing the reasons for support of the use of derivatives including lower costs and more efficient implementation of the new asset allocation mandates. The report is incorporated into the minutes by reference. A presentation was made by Michael Thomas, Chief Investment Officer for Russell Investments to provide an explanation of derivatives and to reiterate his support for their use. The written presentation is incorporated into the minutes by reference. Mr. Lhota arrived at 12:30 PM during this discussion item.

Mr. Dunn emphasized Mr. Thomas' extensive experience in the investment arena and noted his position at Russell Investments, a firm that is currently working as a Transition Manager for the Bureau. Mr. Thomas noted that use of derivatives is not appropriate for some transactions; however at times, they can be used to gain exposure to an asset class in a less time consuming and less expensive manner than buying the physical securities. Additionally, he emphasized that there are many different types of derivatives with widely varying degrees of risk ranging from Exchange Traded Funds and collateralized debt obligations to esoteric instruments. He also noted the difference between Exchanged Traded Futures, which are derivative contracts and ETFs which are Exchange Traded Funds. Mr. Bryan asked for additional clarification on ETFs. Mr. Thomas explained that brokers must buy securities first and then combine the securities into ETFs. Mr. Pitts inquired about the difference between ETFs and index funds. Mr. Thomas answered that the index funds can be traded only one time per day at the close of the market. He indicated that an ETF can be traded at any time, creating more flexibility and investment opportunities. Mr. Thomas emphasized that the best opportunity for the Bureau to use ETFs would be in creating exposure in the emerging markets portion of the benchmark index pursuant to the international equities mandate. Mr. Smith explained that emerging markets are a portion of the non-U.S. equities mandate. Mr. Thomas directed the Investment Committee's attention to page 6 of his written presentation, noting that the EEM fund has an average daily volume of $2.3 billion and a management fee of 6 basis points per month. Mr. Smith asked for the amount of fees on an average index fund. Mr. Thomas answered that it would be approximately 15 basis points for an individual, but would be higher when working with emerging markets. Mr. Thomas reiterated that by using derivatives, the Bureau could better control the timeline associated with the asset shift. Mr. Smith indicated that the transition would take 6-7 months if the transition were done without the approval of the current proposal. Mr. Bryan asked for an explanation as to why derivatives contracts would be necessary. Mr. Thomas responded that the trading costs can be lower, as indicated by the cost chart. He also pointed out that the cost difference is higher when trading in small cap funds. Guy Cooper, Principal of Mercer Consulting clarified that the cost of buying futures was being expressed in basis points. Mr. Thomas noted that generally the cost of using derivatives when trading is lower. Additionally, using derivatives can create unique opportunities due to synthetic mispricings where the futures contract is priced lower than the market value due to lower demand.

Mr. Caldwell asked if losses were possible. The answer was in the affirmative, but the same losses are possible with physical possession of the stocks. Mr. Lhota asked about the chart on page 8 and the risks of buying the synthetic versus buying the physicals. Mr. Thomas noted that the costs would be higher if the Bureau decided to "go short" and lower if the Bureau decided to "go long." Mr. Bryan asked for clarification on those terms. Mr. Smith explained that to "go short" is to sell while to "go long" is to hold in anticipation of long term gains. Mr. Thomas pointed out the list of Russell overlay clients, emphasizing that it is not uncommon to use derivatives, but assuring the Investment Committee that he is only referring to the less risky type of derivatives.

Mr. Thomas then discussed investment manager return. He noted that the investment manager return includes both the alpha and the equity market return, composed of both the market risk premium and the risk free rate. Mr. Bryan noted that although the manager's return chart is shown with a positive return, the return can also be negative with a negative risk premium and a negative alpha. Mr. Pitts asked if the amount provided by the derivatives was the amount of physicals less the risk free rate. Mr. Thomas answered in the positive. Mr. Thomas pointed out that when obtaining the return for synthetic passive US equity exposure, the risk free rate is shown. Mr. Cooper pointed out that the synthetic exposure chart implied that there would not be any fees although fees would, in fact, be charged. Mr. Thomas assured the Investment Committee that initial margin, also called collateral, and maintenance margin would be used to protect both parties in the transaction. He also indicated that the total amount of cash would earn interest income, but a broker would hold the margin in collateral in order to cover any shortages that might occur and to reconcile the contract, should it end. Additionally, he indicated that the account is reconciled at the end of each day allowing for an accurate valuation of the account. Mr. Bryan asked for the difference between hedging and speculating. Mr. Thomas noted that all of their clients' hedge, buying funds with the anticipation of market gain, but none speculate using leverage, as it is too risky. Mr. Harris asked when the reconciling is done. Mr. Thomas answered that each morning the broker will reconcile the account and cover the previous day's gain or loss. Mr. Thomas then explained forwards. He pointed out that forwards work best in situations where US dollars are used to buy international funds that are held in a foreign currency.

Mr. Thomas then discussed the differences between forwards and futures, noting that a clearinghouse serves as the counterparty when exchange traded futures are purchased. He emphasized to the Committee that the clearinghouse has never defaulted and that the clearing broker is responsible for reconciling the margin account at the end of each day. Mr. Bryan asked about the repercussions if the clearing broker makes a mistake. Mr. Thomas assured the Investment Committee that the clearing broker has some discretion when those types of situations arise to remedy the mistake. Mr. Thomas then explained forwards, emphasizing that the investor can protect their interests through a collateralization agreement when a clearinghouse is not involved. He noted that the parties can agree to the collateralization terms and an initial collateral amount. They are also able to create a threshold amount for reconciling. Mr. Bryan asked about the amount of risk. Mr. Thomas replied that the risk is no greater than if the securities were purchased instead, unless the investor is leveraged. Russell Investments does not allow their investors to be leveraged due to the risk. The firm reconciles each account every day to ensure that the investors are not leveraged. Mr. Lhota pointed out that these scenarios assume that the counterparty is reputable. Mr. Thomas noted that the clearinghouse is relied upon when futures are purchased. Mr. Caldwell asked about the risk of the clearinghouse acting inappropriately. Mr. Thomas agreed that there was a risk however the clearinghouse has access to the collateral maintained with the clearing broker if needed. Mr. Smith countered with an example of a firm that was closed by the CFTC after the principals had accessed the money in the account. BWC's transition managers would not have access to funds maintained as collateral with the clearing broker. Mr. Thomas replied that the money is still held by the custodian and assured the Investment Committee that the principals are only able to access the account if the agreement allows it. Mr. Dunn noted that recently when several investment firms were closed due to mismanagement, no defaults occurred with investors who held futures. He noted that the defaults only occurred with forwards that were not collateralized. Mr. Caldwell indicated that the defaults occurred because the investments were not backed by the CFTC. Mr. Pitts inquired if this transaction was limited to keeping just cash rather than cash plus collateral. Mr. Thomas indicated that brokers do have the ability to buy more than the investor has in cash, but those situations create leverage. He noted that the broker must trade in order to remove the leverage and reconcile the account by the end of that day. Mr. Pitts asked if the reconciling occurred due to market forces. Mr. Thomas replied that his company reconciles the accounts at the end of each day and requires that any leverage be removed. Mr. Matesich asked about the procedure if the margin drops below the required amount. It was explained that a margin call would be made to require that the money be moved. Mr. Matesich asked about the advantage of buying futures over physicals when the risks and the returns are identical. Mr. Smith answered that the timing could be better controlled for transition purposes. Mr. Dunn indicated that the costs are generally lower.

Mr. Thomas noted the possible problems as listed in his presentation. He noted that Bruce Dunn, the CIO had extensively and thoroughly reviewed their systems, procedures and safeguards. Mr. Thomas assured the Committee that their system is linked to one in London that continues running if the local server fails. Mr. Bryan asked about the repercussions if there are problems with the staff member who is overseeing the account. Mr. Thomas responded that the staff members do not have the authority to trade accounts. Additionally, the staff and the custodian review the accounts each day to find any inconsistencies so any inappropriate behavior could not be hidden. He also assured the Committee that his firm performs daily compliance checks. Lastly, he indicated that there is no ability to profit from acting improperly and therefore, no motivation. Mr. Haffey noted that he supported the daily rebalancing and realized that Russell Investments (Russell) seemed like a good organization, but past experience has shown that the Committee needs to make a thorough investigation and needs to move cautiously. Mr. Thomas agreed that as fiduciaries, the Committee needs to be comfortable with its decision. Lee Damsel, Director of Investments for the Bureau, assured the Committee that any use of derivatives added to the Investment Policy Statement (IPS) would be monitored on a daily basis by the investment staff as a continuation of existing portfolio oversight procedures and that the internal audit division receives a daily portfolio compliance report generated by the investment accounting system. She also noted that an additional safeguard would allow only the transition manager to access the transition account. Additionally, the custodian would protect the account by restricting its access. Mr. Lhota asked if any of Russell’s compensation is tied to performance. Mr. Thomas indicated that compensation is paid based on how the manager tracks the client’s goals and matches the passive benchmark and not on out-performance of the benchmark. Mr. Bryan noted that the presentation included a good description of the firm’s safeguards. He then inquired if Russell would be responsible for errors. Mr. Thomas assured the Committee that Russell would be responsible for curing any error. He indicated that if the error favored the investor, the investor would be able to keep the difference and if the error impacted the investor negatively, the firm would pay the difference and cure the error. Mr. Bryan then asked if Russell would be responsible for system failures or programming errors. Mr. Thomas responded positively. Mr. Harris asked if the firm has retained traders who have made previous errors. Mr. Thomas noted that the firm has retained traders who have made innocent mistakes, but will terminate any corrupt employees. Ms. Damsel indicated that Russell was different from other transition managers, as the firm had responded to the transition manager RFP and been approved as one of the three finalists. She also noted for the record that Russell had chosen to become a fiduciary and has been approved after a thorough investigation to remain as one of the three finalists.

Mr. Thomas pointed out the chart that recommends the use of derivatives for the Priority 2 and 3 transitions, while suggesting the use of physicals for the Priority 1, 4 and 5 transitions. He emphasized that the Priority 2 and 3 transitions would be finished quicker and done more cheaply by using derivatives rather than trading actual stocks. Mr. Cooper asked how Russell is compensated. Mr. Thomas responded that the firm is typically paid an investment manager fee and basis points based on the notional exposure, but noted that an amount had not been agreed upon because the final decision on the transition manager approvals was still pending. Mr. Thomas emphasized that the possibility of slippage is most acute during asset allocation shifts where a manager must be cognizant of the timing and trading costs while avoiding missed opportunities. Mr. Pitts asked if futures were to be used to buy the ACWI index in Priority 2. Mr. Thomas responded that currency forwards could also be used. Mr. Smith pointed out that Mercer had also included the possibility of using currency forwards for Priority 2.

NEW ASSET ALLOCATION IMPLEMENTATION STRATEGY

Mr. Dunn referred the Committee to the Asset Allocation Change Implementation Recommendation dated June 12, 2009 and Mercer's State Insurance Fund Second Priority Transition document dated June 16, 2009, indicating that both documents supported the change. These documents are incorporated into the minutes by reference. Mr. Dunn noted that the Priority 1 mandate had already been approved. He indicated that the current focus was on Priority 2, emphasizing that it was important to follow the benchmark for international equity and capture exposure during the transition period. Mr. Dunn pointed out that the Priority 2 transition timeline shows 10 different futures contracts for purchase. He emphasized that it is not necessary to give up liquidity in this transition, but it would be a consideration if giving up liquidity would be more advantageous. Mr. Dunn indicated that this approach allowed for flexibility in transitioning in stages over a four month period. JP Morgan will be acting as the custodian, but it is necessary to find a clearing broker to oversee the margin account. He also explained that a notional is equal to the underlying amount of exposure to that index. He assured the Committee that the clearing broker will only hold the initial margin, which is likely to be around

10%. The maintenance margin will be 15%. A separate account will hold the remainder in cash, so if the market moves, there will be liquidity available to cover the change, while 25% will be held as margin. He emphasized that this is a more efficient way to implement this transition than using the physicals. Specifically, using physicals as a direct owner would be very labor intensive and would take much longer. Mr. Dunn recommended that the Investment Committee approve moving forward with Priority 2 transition unleveraged. He noted that the transition will be safeguarded by the clearinghouse and that the futures investments will be in funds from recognized, developed nations. Additionally, Russell has provided a list of 20-25 counterparties, the counterparties can be diversified and the term of the forward account can be limited to one month. Mr. Smith noted that this action was consistent with the recommendation memo of the CIO. Mr. Cooper indicated that he agrees with the recommendation. Mr. Pitts asked who manages the cash account. Mr. Dunn answered that JP Morgan will manage the account, but the money will remain on the books. Mr. Pitts inquired as to how long the derivatives would be held after being purchased. Mr. Dunn responded that they would be held for the length of the transition and each contract was anticipated to be three months in term for futures and thirty days for forwards. Mr. Pitts then inquired as to what will remain in the account at the end of the transition. Mr. Dunn responded that the account will hold the gain or loss that correlated with and followed the benchmark of the funds during the transition. Mr. Smith pointed out that a permanent manager will have been hired by then to move the money. Mr. Caldwell asked how much of the money would be at risk if there were a downturn in the economy. Mr. Dunn replied that the entire amount of money would be at risk. Ms. Damsel added that the risk would be the same as if the physicals had been held, but the transition would take much longer if purchasing physicals, so the use of futures was best. Mr. Dunn noted that a higher amount could be held in the maintenance account to minimize wire transfers.

The risks were then discussed. Mr. Hummel stated that he understood the risk of waiting, but wanted to know if there were other risks. Mr. Dunn answered that there are operational risks and that the fiduciary must be overseen. He assured the Committee that Russell had been chosen as a transition manager candidate pool member for the Bureau after an extensive investigation and consideration. He also indicated that the Investment Division was willing to take the risk since the execution costs were lower than purchasing the physicals. Ms. Damsel cautioned that there was a greater risk in missing the market while waiting to change the asset allocation and waiting longer for the fund to recover. She added that there are counterparty risks, operational risks and the probability of missed opportunities, but these are outweighed by the lower costs, the quicker transition and the ability to identify managers sooner. Mr. Haffey asked the cost of the transition. Mr. Dunn answered that at this point, the Investment Division has not received any pre-trade analyses from its transition managers on the Priority 2 transition. Mr. Haffey inquired as to the insurance costs. They are not known at this time.

A motion was made by Mr. Smith and seconded by Mr. Harris as follows: that the Investment Committee of the Worker's Compensation Board of Directors recommend to the Board that it authorize the BWC Investment Division staff to implement the Second Priority Transition Mandate of the 21st Century Transition strategy option for the State Insurance Fund, commencing in August 2009, as that mandate is outlined in the memorandum of the Chief Investment Officer dated June 12, 2009, and supported by the memorandum of Mercer Investment Consulting, Inc., dated June 16, 2009. Roll call was taken and motion passed 5-0.

PROPOSED INVESTMENT POLICY STATEMENT REVISION

Mr. Dunn referred the Committee to the changes in the red-lined version of the IPS, noting that it slightly expands the definition of derivatives. Mr. Smith made a motion that was seconded by Mr. Harris as follows: that the Investment Committee of the Workers' Compensation Board of Directors recommend to the Board that it amend current section IV.C.vii (2) of the Statement of Investment Policy and Guidelines ("IPS") to permit Investment Transition Managers to utilize both forward currency contracts and Exchange Traded Funds, and further, that it also amend current section IV.C.ix (a) of the IPS to permit the selling of futures contracts for risk control purposes, for the reasons set forth in the memorandum of the Chief Investment Officer dated June 12, 2009, and in the memorandum of Mercer Investment Consulting, Inc., dated June 11, 2009. The exact changes recommended are shown in the red-lined version of the IPS language and will be incorporated into the minutes of this meeting of the Committee. Mr. Dunn noted that the sections to be changed were IV.C.vi (2) and IV.C.viii (a). Mr. Smith made a motion to amend the sections to IV.C.vi (2) and IV.C.viii (a). The motion was seconded by Mr. Price. Roll call was taken and the motion passed 5-0. Mr. Smith made a motion to approve the motion as amended and was seconded by Mr. Price. The amended motion would read as follows: that the Investment Committee of the Workers' Compensation Board of Directors recommend to the Board that it amend current section IV.C.vi (2) of the statement of Investment Policy and Guidelines ("IPS") to permit Investment Transition Managers to utilize both forward currency contracts and Exchange Traded Funds, and further, that it also amend current section IV.C.viii (a) of the IPS to permit the selling of futures contracts for risk control purposes, for the reasons set forth in the memorandum of the Chief Investment Officer dated June 12, 2009, and in the memorandum of Mercer Investment Consulting, Inc., dated June 11, 2009. The exact changes recommended are shown in the red-lined version of the IPS language and will be incorporated into the minutes of this meeting of the Committee. Roll call was taken. The motion passed 5-0.

MANAGEMENT FEE REVISIONS

Mr. Dunn referred the Committee to the June 12, 2009 memorandum entitled Management Fee Proposed Revisions Recommendation. The memorandum is incorporated in the minutes by reference. He noted that a manager was needed to move the Long Duration Fixed Income index into the Barclays Capital U.S. Long Government Index and the Barclays Capital U.S. Long Credit Index for the State Insurance Fund. The Investment Division approached State Street Global Advisors and Barclays Global Investors to determine the management fee amount for continued management of the funds. Mr. Dunn noted the current and proposed fee schedules for each investment company. He assured the Committee that the changes have a negligible impact on fees and emphasized that the modest fee increase is far outweighed by the additional investment income to be earned by the emphasis on long duration credit bonds. Mr. Smith noted that Mercer had no comment on the issue. Mr. Smith made a motion that was seconded by Mr. Price as follows: that the Investment Committee of the Workers' Compensation Board of Directors recommend to the Board that it approve the new management fee schedules for each of the two split Long Duration Fixed Income indexed portfolios for the State Insurance Fund proposed by State Street Global Advisors and Barclays Global Investors, for the reasons set forth in the memorandum of the Chief Investment Officer dated June 12, 2009. Roll call was taken. The motion passed 4-0.

Mr. Price indicated his hesitation in approving derivatives. He noted that the presentation made him feel more comfortable in knowing that the purchase would be moving with the market rather than behind it. Mr. Harris agreed, indicating that all of the members were concerned about the use of derivatives. He complimented the presentation as being very informative and noted that he was less concerned and more informed.

MONTHLY AND FISCAL YEAR TO DATE PORTFOLIO VALUE COMPARISON

Mr. Dunn referred the Committee to the Invested Assets Market Value Comparison dated June 15, 2009 and the June 17, 2009 Estimated BWC Assets chart. Both documents are incorporated into the minutes by reference. Mr. Dunn indicated that there was a late improvement in the portfolio market value in the closing days of May. The net investment income in May 2009 was $355 million and the investment portfolio returned a positive 2.2%. Net assets were approaching $1.9 billion as of May 31, 2009. Stocks had a positive monthly return of 5.6%. Stocks constitute 20% of the current asset allocation. Bonds increased late in the month and had a final positive return in May of 1.4%. The JP Morgan Government money market fund had a low seven-day yield average of 0.32% at the end of May. In the fiscal year to date comparisons, it was noted that the investment portfolio returned a negative 2.9%. Bonds had a positive return of 1.7% over this same period. It was emphasized that stocks had been down 40%, but had recovered to a fiscal year to date return of negative 26%. It was noted that the portfolio had a modest positive monthly performance through June 17, 2009 and net assets have improved, approaching $ 1.9 billion.

CIO REPORT

Mr. Dunn referred the Committee to the May 2009 CIO report. The report is incorporated into the minutes by reference. He indicated that a timeline has been created for issuance of the master RFP for passive indexed investment managers in July 2009. Ms. Damsel pointed out that this was a large RFP where the goal is to issue it during the first week of July. Ms. Damsel added that after the RFP is issued, the blackout period will begin. Ms. Damsel thanked Mercer Consultant Jordan Nault who helped to refine several questions and Guy Cooper who will assist in grading the responses. She indicated for the record that August 4, 2009 will be the deadline for proposals after which Bruce Dunn, Lee Damsel, Guy Cooper and BWC Senior Investment Manager Doug Walouke will begin grading the responses.

COMMITTEE CALENDAR

Mr. Smith briefly discussed the Committee calendar, noting that next month's meeting will consist of one of two presentations by Mercer on High Yield Bonds as well as a discussion on the Investment Division's goals for the 2010 fiscal year.

ADJOURN

A motion was made by Mr. Lhota and seconded by Mr. Price to adjourn the meeting at 2:10. Roll call was taken. The motion passed 4-0, with Mr. Caldwell absent at the time of the vote.

Prepared by: Linda Byron, Staff Attorney, Legal Division, June 26, 2009