

BWC Board of Directors
Investment Committee
Thursday, July 24, 2008, 12:00 PM
William Green Building
Neil Schultz Conference Center
30 W Spring St., 2ND Floor (Mezzanine)
Columbus, OH 43215

Members Present: Robert Smith, Chair
Alison Falls, Vice Chair
David Caldwell
James Harris
Larry Price
William Lhota, ex officio member

Other Members Present:
James Hummel
James Matesich
Philip Fulton
Kenneth Haffey

Others Present: John Williams, Assistant Attorney General

CALL TO ORDER

Mr. Smith called the meeting to order at 12:00 pm and the roll call was taken. All members were present.

MINUTES OF JUNE 26, 2008

Motion was made by Ms. Falls, and seconded by Mr. Price, to approve the June 26, 2008 minutes.

NEW BUSINESS / ACTION ITEMS

Alternative Investment Options Update for Public Work Relief Employees' Compensation Fund and Marine Industry Fund – Commingled Index Manager RFQ Alternative Next Steps

Mercer conducted research regarding alternative investment options at the request of the Board. Guy Cooper of Mercer Consulting provided an update, including a two page letter dated July 15, 2008, incorporated into the minutes, on this matter. There are two ancillary funds at issue: the first fund has approximately twenty-two and one-half million dollars, and the other fund has sixteen million seven hundred thousand dollars. These funds are the Public Work Relief Employees' Compensation Fund and the Marine Industry Fund, respectively. Mercer Consulting evaluated four firms as possible candidates for management of these funds. Two of the firms are essentially the same entity, therefore there were three different entities evaluated. Miln Asset Management is a viable candidate. Their fees are reasonable, and their tracking error is ten to

fifteen basis points. Bruce Dunn, Chief Investment Officer, indicated that he is sensitive to tracking error, but there are trade offs. Mr. Dunn continued to emphasize State Street, and the fact that they have never used derivatives. For small funds, like the two ancillary funds in question, separate account management is not a reasonable alternative in the opinion of Mr. Dunn. Mr. Dunn recommends continued discussion with State Street and possible amendment to the Investment Policy permitting derivatives. Guy Cooper suggested possible options, including an RFQ for a separate account manager, the modification of the Investment Policy Statement to permit the use of derivatives, and to not do anything until the comprehensive five step review of the investment policy has been completed. It is important to evaluate the Board's risk tolerance. The third option has the highest cost, but is the most conservative. Mr. Fulton expressed concern over the difficulty in finding an entity that does not use derivatives, and suggested the possibility of using State Street, unless and until the Board finds a firm that does not use derivatives at all. Mr. Cooper said it was not a good idea to enter into an agreement that contradicts policy. Mr. Caldwell inquired as to the probability of State Street using derivatives, and the amount of risk to which BWC would be subjected through the use of derivatives. Mr Cooper indicated that the educational session on derivatives at the August meeting will address the risks and possible losses from derivatives.

Mr. Smith raised the issue of amending the policy and taking a look at best practices. Mr. Cooper indicated that the use of derivatives is well accepted within the financial markets. Ms. Falls noted that although derivative use might be a common financial practice, she still expressed concern given the current economic environment. Mr. Matesich inquired as to whether or not derivatives were rated. Mr. Cooper stated no. Mr. Smith inquired as to what derivatives State Street uses, and what will the risk be? Mr. Dunn doesn't believe that State Street will be specific about any particular ones to be used. There is potential for all forms of derivatives to be used, including options, swaps, and futures as stated in the Fund Declaration of State Street for its commingled fund product offered. Ms. Falls emphasized the importance of Board education on this issue. Mr. Price asked how easily the agency could get out of investments with State Street if there is a negative impact. Ms. Falls further inquired how many of the Bureau's peers in Ohio have investment policies that permit investments with derivatives. Mr. Cooper indicated that on the national level, many of the Bureau's peers do use derivatives, and it is believed that the various Ohio retirement funds do so as well. Mr. Lhota inquired whether the pending legislation that outlines the Bureau's permissible investment options addresses derivative use. Administrator Ryan responded that it is her understanding that derivatives are not specifically excluded in the pending legislation at this time.

Chairman Smith state it is important for the committee and the public to understand the best practices and risk involved with derivatives.

For next month's Investment Committee meeting, Mercer Consulting was asked to provide an educational session on types of derivatives to be used, as well as the positives and negatives concerning the use of derivatives. In addition, proposed language to change the IPS to permit the use of derivatives should be prepared for the Committee's consideration and deliberation. Finally, at the request of Mr. Harris, Mercer Consulting will provide confirmation as to whether the other Ohio retirement funds use derivatives. As a result of this rigorous discussion there will be future consideration of the management of the Public Work Relief Employees' Compensation Fund and the Marine Industry Fund.

DISCUSSION ITEMS

Monthly and Fiscal Year to Date Portfolio Value Comparisons

Discussion was made by Mr. Dunn concerning portfolio values. A handout was included in the presentation, and is incorporated into the minutes. Discussion was made of reports for June of 2008, May of 2008, and June of 2007. Mr. Dunn reported that the preliminary unaudited total rate of return of Bureau invested assets for fiscal year 2008 was approximately 4.3%.

CIO Report – June 2008

Mr. Dunn provided the Board with highlights from his report, which is incorporated into the minutes. Mr. Dunn reported that the Investment Department is recruiting a senior investment manager. Mr. Dunn's license as Bureau chief investment officer has been renewed.

Ms. Ryan discussed recovery from the coin funds. The net recovery to date has exceeded the original amount invested totaling \$50 million. There is an estimated \$53.5 million to \$55 million total net recovery. This is positive news, but does not include lost opportunity costs of \$13.5 to \$16 million.

Mr. Dunn's report next month shall include deliverables with regard to investment asset class performance and values and a summary of investment policy statement changes for fiscal year 2008.

Mercer Investment Topics for Education

Mercer Consulting presented on asset and liability matching, along with a discussion of equity investments. The presentation concentrated on asset and liability modeling, management and matching. A power point presentation, along with a handout, was included and is incorporated into the minutes by reference. It is important to manage assets to meet the stream of liabilities. The fundamental theorem of asset and liability management was discussed in detail. The discussion included such issues as matching the market value of the asset to the market value of the liability and matching the duration of the asset to the duration of the liability.

There was an educational session of equities by Mercer. The discussion included the characteristics of equities. Cyclical and non-cyclical stocks were discussed. Capitalization and performance ranges were discussed. In addition, discussion was made of various equity indices. There was further discussion on active and passive management, top down vs. bottom up investing, as well as a discussion of various portfolio management construction methods. Mr. Lhota asked what diluted shares are. Mercer Consulting indicated that they are total shares already issued and outstanding as well as shares eligible for conversion to shares outstanding. Discussion was made of non-U.S. equities. The global share of non-U.S. equity markets is increasing. There are various types of foreign markets. The risk and return profile is different for foreign equity as opposed to domestic equity.

ADJOURNMENT

Upon motion by Mr. Caldwell, seconded by Mr. Harris, the meeting was adjourned at 2:00 pm. Roll call was taken, and the motion passed 5-0.

Prepared by Tom Woodruff, BWC staff counsel.