BWC Board of Directors
Investment Committee
Thursday, May 29, 2008, 12:15 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:

Charles Bryan
Philip Fulton
James Hummel
James Matesich

Others Present: John Williams, Assistant Attorney General

Call to order

Mr. Smith called the meeting to order at 12:15 pm and the roll call was taken. All members were present.

Minutes of April 24, 2008

Motion was made by Mr. Price, and seconded by Mr. Caldwell, to approve the April 24, 2008 minutes. The motion passed unanimously.

New business /Action items

Charter Subcommittee Language

Alison Falls discussed charter subcommittee language. There is draft language in a handout, which is incorporated by reference into the minutes. The language is to be inserted under the duties and responsibilities section of the charter. Motion was made by Ms. Falls, seconded by Mr. Harris, as follows: that the Investment Committee of the Bureau Board of Directors, recommend that the Board of Directors approve an amendment to their Committee Charter. This amendment outlines the process for the Committee to create a subcommittee. Roll call was taken and the motion passed unanimously.

Revised Commingled Index Managers RFP Proposal

Bruce Dunn, Chief Investment Officer, first discussed new developments regarding the use of derivatives by Barclays Global Investments, approved in April, 2008 as the fixed income manager from the RFQ issued for the Public Work-Relief Employers' Fund and the Marine Industry Fund.

A presentation was made, by Mr. Dunn and Lee Damsel, Director of Investments, on the use of derivatives by Barclays in the management of the cash collateral pool applicable for the securities lending activity. This use of derivatives by Barclays was not known by either the investment staff or the investment consultant of the Bureau at the time Barclays was presented for approval. Mr. Dunn indicated that derivatives used in the Barclays managed securities lending dedicated cash collateral pool included certain swaps, including synthetic swaps. Mr. Dunn indicated that the Bureau has a no derivative policy except for, as provided on page thirteen of the Investment Policy Statement, defined permissible derivatives. All other derivatives must be approved by the Board.

Mr. Smith inquired as to whose asset is the collateral of the securities lending cash collateral pool. Mr. Dunn indicated that it is legally a Bureau asset. Ms. Damsel noted that securities are loaned, and then a cash collateral pool is used as collateral to cover for the security on loan. Ms. Damsel noted that Barclays targeted designated "money market fund" supports the 102% market value cash collateral position for any loaned security. Mr. Smith raised the issue whether the Bureau is in violation of policy if it enters into an agreement with Barclays. Ms. Damsel raised the issue as to whether the Bureau wants derivatives to be utilized by the Bureau's security lender. Ms. Falls emphasized the importance of not lending securities without collateral. There must be a claim on collateral in the event of default. Ms. Falls inquired as to whether this is in alignment with the investment policy. Ms. Falls noted that credit default swaps are harder to value today. Over time, she indicated a comfort level may be developed with derivative synthetic securities by the Investment Committee and Board. Mr. Bryan inquired with regard to the issue of inability to collect on collateral. There is an issue of potential negative public perception with regard to investing in derivatives. Mr. Dunn indicated that Barclays had specifically stated there were no derivatives in the bond management of the assets of the two ancillary trust funds pertinent to the RFQ. As it turns, out, however, Barclays would be using derivatives at the securities lending collateral protection level. Guy Cooper, of Mercer Consulting, discussed bond portfolio management. Mr. Cooper indicated that the Bureau probably shouldn't invest in this particular fund offered by Barclays given this new information. Mr. Smith noted this was not the correct time for the Bureau to invest in securities lending with derivatives exposure due, in part, to the current credit cycle. Mr. Dunn noted that the Bureau needs to go with a commingled structure with its smaller ancillary trust funds due to investment management efficiencies and management fee considerations, but can remain with a separate account management structure for its largest trust funds. Securities lending without derivatives is not offered for a commingled managed structure offered presently by Barclays. Mr. Dunn stated that it is his recommendation to defer entering into a contractual management agreement with Barclays at the present time, and discuss the issue further with Barclays and the other RFQ submitter, State Street. Mr. Dunn is not ready to make any further recommendation at this point in time.

Ms. Falls noted that the RFQ fund manager selection process was outstanding, and characterized by meticulous detail and exercise of due diligence. She is very pleased with the staff of the Bureau's handling of this process with the discovery of new information on the approved investment manager and also encouraged by the Board's lengthy and involved discussion of the issue. Ms. Falls noted that commingled management reduces costs. Securities lending may be evaluated with regard to the possibility of increasing returns. With respect to a RFQ, the Board needs additional information, gathered by Bureau Staff and Mercer Consulting, with recommendations and alternatives, prior to the Board rendering a decision.

A contract with Barclays has not been executed. Mr. Dunn noted that obtaining a more thorough understanding of the process and controls of Barclays with respect to the management of the securities lending cash collateral pool are important. This issue needs to be discussed with Barclays further.
Matesich inquired as to what counterparty risk was. Mr. Dunn indicated that a securities lender has an approved list of borrowing entities the lender is comfortable with, with respect to the borrowing party returning the security back when the loan expires. The risk associated with the party returning the security is counterparty risk. Ms. Damsel noted counterparty risk is greater than cash pool risk. Mr. Price inquired as to whether using Barclays will violate the investment policy. Mr. Dunn indicated that the Bureau investment policy would need revision and clarity with regards to derivative use for securities lending cash collateral pool management in order to use Barclays as commingled passive manager for the two ancillary funds in question. Mr. Harris is concerned about investment decisions violating express provisions of policy. Mr. Lhota expressed concern over changing policy. Work will continue on evaluating these investment issues for the next meeting.

Mr. Cooper of Mercer Consulting presented to the Investment Committee and Board a handout on BWC portfolio market value sensitivity to selected interest rate movements. This handout is incorporated into the minutes by reference. The discussion focused on investment sensitivity to interest rate changes, and the impact of shortening the duration of the fixed income portfolio of the Bureau. Comparison was made of three examples of different duration fixed income portfolios and the impact of interest rate change. Yield and duration were discussed. A shorter duration portfolio market value decline is not as significant as a long duration portfolio market value decline if interest rate levels increase. A shorter duration portfolio will earn less than the long duration portfolio if interest rates decline. With our current bond portfolio, market value would decrease by $1.39 billion with a one percent increase in the interest rate. Ms. Falls noted that it is important to have stability in premiums. Therefore, the Board must understand the potential counter-productive consequences if investment returns are highly volatile over a lengthy period of time. Mr. Cooper discussed the implications of changing from long duration fixed income to intermediate duration fixed income.

Mr. Haffey joined the meeting at 1:25 pm.

Mr. Dunn emphasized the need to consider the volatility of various fixed income strategies. Mr. Dunn further discussed the advantages of delaying the issuance of a commingled passive manager RFP involving the long duration fixed income mandate. He indicated there could be significant transaction and transition costs involved in removing significant long duration fixed income assets from a commingled passive investment manager. Ms. Damsel emphasized the need to be mindful prior to transitioning significant Bureau assets of the portfolio for the third time in four years. Mr. Lhota asked about the typical cost of transitions. Ms. Damsel responded that the 2006 transition was between ten million and fifteen million dollars in transition fees and transaction costs.

Motion was made by Ms. Falls, and seconded by Mr. Harris, as follows: that the Investment Committee of the Workers' Compensation Board of Directors recommend to the Board that the request for proposal (RFP) for commingled passive indexed investment managers, previously approved by the Investment Committee and the Board of Directors in December 2007, be amended to exclude the long duration fixed income asset class mandate at this time, for the reasons set forth in the memorandum of the Bureau's Chief Investment Officer dated May 16, 2008. The amended RFP process would therefore be for the U.S. TIPS, and Large Cap U.S. Equity asset class mandates for the State Insurance Fund, the Disabled Workers Fund and the Coal Workers Fund. Roll call was taken and the motion passed unanimously.

Discussion items

Monthly and Fiscal Year to Date Portfolio Value Comparisons
Mr. Dunn provided value comparisons. A handout is incorporated by reference into the minutes. Discussion was made of bonds, equity, and net cash investments. The performance of stocks has improved. Comparison was made of April 2008 and March 2008, as well as April 2008 and June of 2007.

CIO Report – April 2008
A written report, dated May 27, 2008, was included in Mr. Dunn's presentation and is incorporated into the minutes. Two new members of the investment team were introduced. Michael Berger is the new Assistant Manager and Fraser Nega is the new Administrative Assistant. Private equity matters were discussed. There were no additional sales of private equity partnerships in April of 2008. Sixty-five partnerships have been sold. Mr. Dunn indicated there was one additional private equity partnership sold in May of 2008. Discussion was made of Axxon Capital, a private equity limited partnership that just emerged from Small Business Administration imposed receivership status in May 2008 and converted to a limited liability corporation (LLC).This LLC investment is now being liquidated and no new investments will be made. Mr. Haffey inquired as to current LLC assets, and what they constituted. Mr. Dunn stated assets consisted mostly of cash. Mr. Dunn indicated that the BWC portfolio is in compliance with the Investment Policy Statement at the end of April, 2008.

Calendar
There will be a further discussion of securities lending and derivatives in June of 2008. The first quarter Mercer performance report and presentation has been deferred until June of 2008. Directors were advised to bring their Mercer educational topic books with them for next month's meeting. Ms. Falls emphasized the importance of a timeline for deliverables of Mercer working in coordination with Deloitte-Touche. The five point Mercer process must be allowed to proceed by August 2008. If it does not, it must be determined what elements are missing, preventing it from moving forward.

Adjournment

Upon motion by Mr. Price, seconded by Ms. Falls, the meeting was adjourned at 1:50 pm.

Prepared by Tom Woodruff, BWC Staff Counsel