BWC Board of Directors

INVESTMENT COMMITTEE

Thursday, May 28, 2009 12:00 p.m.
William Green Building
30 West Spring Street, 2nd Floor (Mezzanine)
Columbus, Ohio 43215

Members Present:	Robert Smith, Chair Alison Falls, Vice 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:	None
Counsel Present:	John Williams, Assistant Attorney General

CALL TO ORDER
Mr. Smith called the meeting to order at 12:02 pm.

ROLL CALL
Roll call was taken. All committee members were present at the roll call.

APPROVE MINUTES OF THE APRIL 29, 2009 MEETING
Ms. Falls asked that the minutes reflect an addendum to the April 29, 2009 minutes with the addition of the Overview of Process- Setting Investment Strategy chart referred to in the April 29, 2009 minutes. Upon motion of Mr. Caldwell, seconded by Ms. Falls, the minutes of the April 29, 2009 meeting with the addendum were approved. Roll call was taken and the motion passed 6-0.

AGENDA
Upon motion of Mr. Price, seconded by Ms. Falls, the agenda was approved as written. Roll call was taken and the motion passed 6-0.
ACTION ITEMS:

TRANSITION MANAGEMENT RFP SUMMARY

Bruce Dunn, Chief Investment Officer (CIO), referred the Committee to the Investment Division Transition Management Report and the Transition Manager RFP (Request for Proposals) timeline. The reports are incorporated by reference into the minutes. He noted that the process had begun in February 2009 with advertisement of the RFP. After an intense review of the candidates, the RFP Evaluation Committee recommends three firms: Barclays Global Investors, Russell Investments and State Street Global Markets. The evaluation process was performed by Bruce Dunn, Lee Damsel, BWC Director of Investments, Douglas Walouke, BWC Senior Investment Manager and Guy Cooper, Principal of Mercer Consulting. The process included questioning, evaluating and independently scoring each of ten possible candidate firms. After a rigorous review, the Evaluation Committee performed four on-site due diligence visits and determined that Credit Suisse would not be among the finalists recommended to the Board. Mr. Smith asked if Credit Suisse had been eliminated prior to the interview process. Ms. Damsel answered that all four firms had been considered at that point. Mr. Dunn noted that Barclays Global Investors and State Street Global Markets were currently acting as Transition Managers for the Bureau. He also expressed the intent to have the new Transition Managers under contract within thirty days. A motion was made by Mr. Smith and seconded by Ms. Falls as follows: that the Investment Committee of the Workers' Compensation Board of Directors recommend to the Board that it approve Barclays Global Investors, Russell Investments and State Street Global Markets as the Bureau's pool of Transition Managers from which the Bureau may secure transition management services in satisfaction of the Bureau's Statement of Investment Policy and Guidelines, for the reasons set forth in the transition management RFP report prepared by the BWC Investment Division dated May 28, 2009, and upon such terms as are outlined in their responses to the Request for Proposals issued February 19, 2009, and such other terms as are favorable to the Bureau. Roll call was taken and the motion passed 6-0.

Ms. Falls inquired as to whether the fiduciary responsibilities of the Transition Managers mirrored those of the Permanent Managers. Mr. Dunn responded that their responsibilities were the same. He added that Transition Managers must also abide by the Investment Policy Statement (IPS) and that frequent reporting is required. Mr. Cooper noted one difference in that Transition Managers are engaged for a limited period of time, on a project basis, whereas Permanent Managers are intended to work forever. Mr. Smith clarified the difference between permanent and forever. Ms. Fall asked if performance benchmarks were tracked for the Transition Managers. The CIO stated that they closely track the performance to ensure that they are highly correlated with the mandate. Ms. Falls asked how closely they track the target manager to the performance benchmark. Ms. Damsel responded that they use the T standard and monitor it every day. Jordan Nault, Senior Associate with Mercer Consulting added that there is a separate transition account that is reviewed when determining performance. Guy Cooper noted that they also compare the transition costs with the estimate. Mr. Bryan asked the repercussions if a significant deviation is found while tracking costs. Mr. Dunn responded that the Investment Division would be aware of the deviation and would monitor it closely.

PASSIVE INDEX INVESTMENT MANAGER MASTER RFP

Mr. Smith inquired about the extent of the new RFP and the types of the questions asked. Mr. Dunn noted that the current IPS modified five asset class mandates for the State Insurance Fund (SIF). He emphasized that the intent was to review ancillary fund mandates later in the year. He also pointed out that if the changes to the ancillary fund mandates were endorsed, this could be incorporated into the new RFP. Ms. Damsel stressed that the overall timeline for approval of managers had been extended because there was too much information to enable all managers to be evaluated and approved in one meeting. Mr. Smith noted that the current RFP dealt only with Transition Managers and noted that Permanent Managers were not included. Ms. Damsel assured the Committee that the new RFP could be altered, if needed. Mr. Dunn mentioned that the new IPS assisted the Investment Division in developing the new RFP. He pointed out that the blackout notification would be issued if the motion passed in the current meeting and that the Investment Division was on schedule for the issuance of the new RFP in July. The CIO explained that the questions for the firms are being crafted to allow for maximum flexibility for potential future IPS changes. He noted that the questions dealt with both separate and commingled accounts, as it might be more efficient later to move the funds from separate to commingled accounts with a view toward lowering fees. Additionally the management fee questions will reflect options both with and without securities lending. Mr. Smith emphasized that the timeline included several items for May and noted that it was important to begin each item immediately. A motion was made by Mr. Smith and seconded by Ms. Falls as follows: that the Investment Committee of the Workers' Compensation Board of Directors recommend to the Board that it authorize the Administrator to issue a Request for Proposals ("RFP") for investment managers for the passive indexed investment asset classes within the State Insurance Fund, the Disabled Workers' Relief Fund, and the Coal Workers' Pneumoconiosis Fund, and to follow the anticipated timeline for issuance of the RFP, evaluation of responses, and approval of the managers that is set forth in the presentation prepared by the BWC Investment Division dated May 28, 2009. Roll call was taken and the motion passed 6-0.

PROPOSED INVESTMENT POLICY STATEMENT REGARDING LONG DURATION FIXED INCOME BENCHMARK INDEX

Mr. Smith directed the Committee's attention to long duration government bonds and the prior concerns voiced by the CIO regarding long duration treasuries and their volatility. Mr. Smith expressed his concerns about the unpredictable and significant rate changes in the long duration treasuries that had occurred recently and noted that this created concern about the SIF and the volatility and heightened risk in its bond portfolio. Mr. Dunn noted the updated Asset and

Liability Projection Model Summary for the State Insurance Fund, dated May 28, 2009 from Mercer where the long duration fixed income (LDFI) is weighted more towards credit rather than government bonds as well as the May 21, 2009 CIO memo for the Proposed Investment Policy Statement Revision of the LDFI benchmark index for the State Insurance Fund. The reports are incorporated by reference into the minutes. Mr. Cooper referred to the asset mix detail on the first page of the Mercer presentation. He noted that the asset mix designated as “Current” was the mix used prior to the proposed amended IPS. The first Mix 6 allocation that is listed is the allocation that was approved based on the revised IPS. That Mix 6 allocates 30% to public equity and 70% to fixed income. Mr. Cooper noted that this mix allowed for better net asset results and funding ratio than the prior allocation. Mercer ultimately recommends a movement toward Mix 6. Mix 6 moves from 16% of the portfolio each in long duration government and long duration credit fixed income to 8% long duration government and 24% long duration credit fixed income. The long term expected annual return increases from 6.7% to 6.87%. Mr. Cooper noted that the funding ratio and the downside risk percentages increase with Mix 6’ in looking at the five year and ten year projections. Mr. Dunn cautioned that if the proposed changes were not approved, both government and credit bonds would need to be sold equally, but only government bonds would need to be sold if the proposed mix was approved in the execution of new asset allocation targeted priorities. The CIO emphasized the four primary benefits of the proposed changes as set forth in his memo from May 21, 2009. The benefits to the SIF portfolio include significant increased interest income, higher overall bond portfolio yield, a more diversified bond portfolio and more efficient and less costly portfolio transition implementation. Ms. Falls pointed out that weighing the pros and cons is valuable. She stated that she agreed with the pros, but wanted to know the cons of the proposed changes. Mr. Dunn answered that the change makes the funds slightly less liquid. He assured the Committee that the assets could be sold, however there would be a difference in the bid/ask trading price spread between credit bonds and government bonds with this spread being much narrower for government bonds. He also noted that if there is a major relapse in the economy, the difference in liquidity would be aggravated. Mr. Smith asked the effect if Treasury bond prices increased. Mr. Dunn responded that this proposal was based on a long term investment approach. He assured the Committee that even if the economy strengthens, the long term approach supported this move. He also noted that the fund would continue to hold a high quality credit portfolio and 30% of the total assets would still remain in Treasuries. Prior to the amendment to the IPS, that percentage had been 50%. He also emphasized that the average insurance company holds approximately 5% of their assets in Treasuries. Mr. Smith noted that an increase in yield equates to an increase in interest income. Mr. Dunn added that if the proposal is not accepted, the portfolio yield would decrease. Based on the 4/30/09 yields, a split in which 28% is weighted to the Long Credit index and 9% to the Long Government index would provide a weighted average yield of 6.70% compared to 5.82% for the 37% of the portfolio allocated to long duration bonds. If there was no modification in the current LDFI benchmark index for the 52% of the SIF portfolio allocated to long duration and intermediate bonds (exclusive of TIPS), that portion of the SIF portfolio would have a yield of 5.31%. However, the splitting of the LDFI benchmark to favor the Long Credit Index would increase that portion of the SIF's bond portfolio to a blended weighted yield of 5.94%. Mr. Dunn emphasized that 2008 had a very unusual economic climate due to investor fear, but noted that between 2003 and 2007, the average yield spread differential between the Long Government Index and the Long Credit index was 1.24%. That average yield spread averaged 2.79% in 2008 and was a wide 3.48% as of 4/30/09. Mr. Dunn emphasized that the Bureau needs to diversify and take some risks in its bond portfolio, but assured the Committee that the bonds held would still remain an average quality of AA after this proposed shift favoring long duration Credit bonds. Additionally, if projected out 10-20 years, the differential in investment income becomes very significant. Mr. Cooper cautioned that there is the potential that some municipalities might not make their interest payments. Additionally, he noted that not all of the investments are in government bonds, as 30% of the amount retained is invested in financial institutions. Despite these potential issues, he wholeheartedly supports the proposed changes. Mr. Smith emphasized that the Committee has spent a considerable amount of time discussing the SIF portfolio and evaluating the proposed changes. He noted that he believes that the advantages of this proposal greatly outweigh the potential negatives, even though the prior IPS asset mix in 2008 had provided comparatively excellent performance. A motion was made by Mr. Smith and seconded by Ms. Falls as follows: that the Investment Committee of the Workers' Compensation Board of Directors recommend to the Board that it amend section VI (A) of BWC's Statement of Investment Policy and Guidelines ("IPS") to modify the indexed Long Duration Fixed Income performance benchmark applicable to the State Insurance Fund, as reflected in the red-lined version of the IPS and so incorporated by reference into the minutes of the Committee Meeting, for the reasons set forth in the memorandum of BWC's CIO dated May 21, 2009 and as supported by the memorandum of Mercer Investment Consulting, Inc. dated May 27, 2009. Roll call was taken and the motion passed 6-0. Ms. Falls asked that the minutes reflect that the red-lined version changes were to be relied upon.

NEW ASSET ALLOCATION IMPLEMENTATION STRATEGY

Mr. Dunn referred the Committee to the proposed process for reallocating the funds to increase the investment in the equity market for the State Insurance Fund from 20% to 30% as approved by the Board. Mr. Dunn proposed that the LDFI and TIPS bonds would be used to facilitate the transition whereby investment income from those assets would be captured and redeemed at the end of each month and reinvested into the equity market. For the current month, $ 60 million in cash is to be redeployed into the S & P 500. Ms. Falls asked for Mercer's opinion on this strategy. Guy Cooper, Principal of Mercer Consulting, responded that overall the amount of money is small, but he had no objections. Mr. Smith clarified that the money is to be moved as it is received. For purposes of due process, Ms. Falls asked for a written recommendation from the CIO and Mercer Consulting in order to track the recommendation and receive input from Mercer. Mr. Dunn responded that this was reflected in this implementation strategy proposal document so the supporting documentation included a proposal, but no memorandum of recommendation in support had been written. Mr. Smith commented that protocol must be supported by whichever method was chosen to present the proposal. Mr. Price agreed with Ms. Falls that a memo in support was necessary to provide an explanation for the recommendation. It was decided that a memorandum in support would be written by the CIO to present to the Board for the meeting scheduled for the following day. A motion was made by Mr. Smith and seconded by Mr. Caldwell as follows: that the Investment Committee of the Workers' Compensation Board of Directors recommend to the Board that it adopt an asset allocation implementation strategy for the State Insurance Fund that would permit redemption of all cash interest income earned from the BWC's fixed income managers at the end of each month, beginning May 29, 2009, and reinvestment of such cash interest income into equities, until such time that the equity transitions are sufficiently funded to the target asset allocations. Roll call was taken and the motion passed 6-0.

Guy Cooper referred the Committee to the State Insurance Fund Asset Allocation Change Implementation proposal, dated May 28, 2009. The report is incorporated into the minutes by reference. He noted that there are five current mandates. He explained the differences among the three possible scenarios for completing the five transitions. For these mandates, the Traditional Transition, the 1990's Transition or the 21^{st} Century Transition approaches could be implemented. These strategies include performing a Traditional Transition whereby the Transition Manager would be engaged only after a new manager was approved to work with the new target manager and legacy manager to perform the transition. In using this strategy, a number of months would pass before the transition could be performed. Another possible scenario included the use of the 1990's Transition. The 1990's Transition approach is similar to the Traditional Transition approach except that futures contracts can be utilized by the transition manager in the implementation of the transition strategy after the target manager is selected. The third option is the 21^{st} Century Transition whereby the Transition Manager may be selected months before a target manager is even identified and approved. Under the 21^{st} Century Transition approach, the transition manager can purchase a combination of physical securities and derivative contracts to achieve a portfolio of assets that correlates to the target asset class mandate. These target portfolio assets are managed by the transition manager until the target manager is chosen and ultimately funded. Mr. Cooper cautioned that before the transitions can be made, the type of derivative contracts to be used must be reviewed and it must be determined if the IPS supports that use. Mr. Smith asked why the 21^{st} Century Transition strategy would be used as opposed to the other strategies. Mr. Cooper explained that most investors would want to have their transitions performed immediately and most transitions occur on a much larger scale. Mr. Smith asked for an assurance that leverage would not be used to enhance returns. Mr. Cooper replied that margin would be used; however it would not be used to enhance returns. Mr. Smith also asked for an assurance that the Committee would only be approving transitions that were allowed by the IPS. Mr. Cooper gave that assurance. Mr. Cooper noted that the transitions could be performed over a several month period without the use of derivatives, but this strategy was less efficient. Mr. Smith surmised that costs would be saved if derivatives were used and Mr. Cooper agreed. Mr. Lhota asked for the acceptable amount of risk with the use of futures. Mr. Cooper answered that there would not be any increased risk as the managers had the ability to buy futures that followed the fund index that would ultimately be purchased or the manager would be able to invest in the fund index directly. Ms. Falls asked if Exchange Trade Funds would be used. Mr. Cooper responded in the negative for the represented Priority One transition of this referenced report dated May 28, 2009. Mr. Smith asked about the expected amount of market risk. Mr. Dunn described the amount of risk as slight. Mr. Harris asked for additional clarification on the amount of risk. Mr. Dunn added that the risk would be slightly greater than what would be quantified as a small amount of risk.

Mr. Dunn referred the Committee to the five transition implementation priorities emphasizing that the Legacy Portfolio sources would be reallocated to the Target Portfolio mandates. He also noted that the mandates included a reduction in the LDFI portfolio and a move from the S&P 500 to the Russell 3000 index. He noted that only long duration government bonds would be sold to support the Priority One transition. Mr. Dunn also assured the Committee that Priority One could be completed within a few days and without the use of futures by the selected transition manager. He explained however, that Priority Two would involve the use of futures. Priorities Three, Four and Five would involve securities in which over 70% of the securities that are currently owned can be used by the target managers in receiving an in-kind transfer of such securities. Mr. Dunn opined that the entire S&P 500 portfolio could be held until the new Russell 3000 target portfolio manager receives BWC assets from the transition manager. He also emphasized that the current primary focus was on implementing Priority One, but mentioned that the 21st Century Transition could be used for the International Equity Transition. Mr. Smith clarified that this referred to the moving of the current allocation of 20% in equity to the new strategy of having 30% in equity with 10% in international securities. Mr. Smith inquired if the recommendation was to dollar/cost average 2% per month over the next five months. Mr. Dunn indicated that he would likely be recommending a 2.5% per month staging increase. Mr. Dunn replied that he did not want any transition manager to buy physical foreign equity securities as they are too labor intensive to own directly from an operations viewpoint, in his opinion. A motion was made by Mr. Smith and seconded by Mr. Harris as follows: that the Investment Committee of the Workers' Compensation Board of Directors recommend to the Board that it adopt and implement the described Priority One Transition for the State Insurance Fund and that it direct the Administrator to proceed to hire a Transition Manager to implement the Priority One Transition under the 21st Century Transition Strategy Option, beginning in July 2009, as outlined in the materials prepared by the BWC Investment Division dated May 28, 2009. Mr. Cooper clarified that Priority One included moving from Long Bonds into the new Aggregate Fixed Income benchmark index. Ms. Falls asked for additional clarification that although the transition was being termed the use of the 21st Century Transition, futures would not be used. Mr. Dunn responded that although a Transition Manager can be used and the first step of the transition can be finished within 2-3 days with the purchase of all Government Bonds and Mortgage-Backed Securities, there would still be a large exposure to Long Credit as it will take approximately 3-6 weeks to purchase the remaining 20% and there would be no way to use futures as a hedge if the spread would tighten. Ms. Falls expressed concern that the motion referred to the use of the 21st Century Transition Strategy although futures would not be used for the current transition. Mr. Dunn responded that the Asset Allocation Change Implementation document sets forth the steps to be undertaken using the 21st Century Transition Strategy. Mr. Cooper noted that the presentation did not note the use of derivatives, as they would not be necessary for the current transition. Mr. Lhota suggested adding the words "what is termed" in conjunction with the 21st Century Transition Strategy Option in the motion to further explain the use of that strategy. Ms. Falls expressed concern that the use of the 21st Century Strategy wording automatically implied the use of derivatives. Ms. Falls complimented the staff on their superb work in explaining the options and focusing on the priorities and the final overall outcome. She noted that the documentation attached did not include a written recommendation by the CIO that supported the Priority One Transition. Mr. Smith asked that the minutes reflect that the CIO, Bruce Dunn, supported the Priority One recommendation. Ms. Falls reiterated that she felt uncomfortable agreeing to $ 2.25 billion of exposure effective July 1, 2009 by the Transition Manager without a written recommendation by the CIO that supported that transition. Mr. Harris suggested that a written recommendation be provided to the Committee prior to the Board meeting where a vote would be taken on the issue. Mr. Smith asked if a new protocol should be agreed upon where all committees receive a written memorandum to support each motion. Ms. Falls responded that she felt that all motions should be supported by a written recommendation by management. Mr. Price concurred with Ms. Falls in asking that a written recommendation be provided for this transition, adding that he would prefer a written recommendation from both the CIO and Mercer Consulting in order to have the opportunity to review and study the presentation, as well as process the information provided. Additionally, he added that the written recommendation would provide support should the Committee's approval later be questioned. Mr. Caldwell noted that the supporting documentation included in the report designated the steps for the transition which he felt was sufficient. Mr. Harris concurred with Ms. Falls and Mr. Price. It was agreed that both Mercer and the CIO would provide a memorandum in support of the motion prior to the Board vote. Ms. Falls proposed that the motion be amended to emphasize that derivatives would not be used in the Priority One Transition. The Committee decided against adding the proposed language. A motion was made by Mr. Smith and seconded by Mr. Harris as follows: that the Investment Committee of the Workers' Compensation Board of Directors recommend to the Board that it adopt and implement the described Priority One Transition for the State Insurance Fund and that it direct the Administrator to proceed to hire a Transition Manager to implement the Priority One Transition under what is termed the 21st Century Transition Strategy Option, beginning in July 2009, as outlined in the materials prepared by the BWC Investment Division dated May 28, 2009 and contingent on a memo being presented to the Board by the Chief Investment Officer and Mercer Investment Consulting. Roll call was taken and the motion passed 6-0.

MONTHLY AND FISCAL YEAR TO DATE PORTFOLIO VALUE COMPARISONS

Bruce Dunn, CIO referred the Committee to the Invested Assets Market Value Comparison. The report is incorporated by reference into the minutes. Mr. Dunn noted the change in performance returns of assets for each asset sector between March 2009 and April 2009. Comparisons were also made between the June 2008 and April 2009 fiscal year-to-date returns.
Net investment income in April 2009 showed a net positive return of .5%. The CIO mentioned that long bonds had increased in yield. The bond market value decreased in April to show a negative return of 1.4%; however this was greatly outweighed by a positive 9.4% gain in stocks. Mr. Dunn pointed out that the March 2009 return showed a positive gain of 8.7% for stocks. The JP Morgan Prime money market fund demonstrated a 30-day yield average of 0.41%. Mr. Dunn noted that there was an inconsequential change in net assets. Net cash balances decreased $ 244.5 million in April 2009 due largely to decreased operating cash balances of which $ 80 million was used for rebalancing purchases. For the fiscal year to date comparisons, it was noted that equity market has lost 30.3% in the fiscal year to date while the bond market showed a positive return of 0.3%.

PORTFOLIO PERFORMANCE
Jordan Nault, Senior Associate with Mercer directed the Committee's attention to the Performance Summary Report for the First Quarter 2009. The report is incorporated into the minutes by reference. She noted the change in real Gross Domestic Product (GDP) by quarter and the percentage changes in contributions to the GDP which consisted of changes in government spending, investment income, net exports, personal consumption and the GDP. The civilian unemployment rate was discussed with Ms. Nault estimating the Ohio unemployment rate at 10.2%, which is higher than the national average. The personal savings rate increased while the consumer confidence level fell. For the growth and value posted losses, Ms. Nault pointed out that the S&P 500 fund had decreased by 11%. The Russell 3000 decreased by 10.8%. High volatility continued in the market due to investor uncertainty. First quarter returns for the

Barclays Capital Long Government and Credit fund were negative 6.2% while the Barclays Capital High Yield fund increased by 6.0%. The asset allocation for each fund was mentioned. In the asset allocation versus the long term investment policy, it was noted that the funds are over weighted in TIPS and cash while being underweighted in long duration fixed income and large cap equity assets. The SIF lost 6.8% in the last year while gaining 1.3% in the last three years. The SIF trailed the policy benchmark. The SSGA LDFI tracked the benchmark. The SIF TIPS fund had a positive return of 4.3%, however the benchmark was 5.5%. It was noted that the custodial and management fees could account for the difference.

CIO REPORT

Mr. Dunn referred the Committee to the CIO Report for April 2009. The report is incorporated by reference into the minutes. It was noted five strategic goals have been created for the Investment Division. The first goal is to determine the process for implementation of the SIF portfolio transition. It was mentioned that a timeline has been drafted in order to streamline the process for the evaluation and approval of the new investment managers. Additionally, a new timeline is in place to prioritize the five new mandates for reallocation of funds within the SIF portfolio.

COMMITTEE CALENDAR

Mr. Smith made brief discussion of an overview of the Investment Committee twelve-month calendar presented for the June 2009 meeting. Mr. Dunn mentioned that the calendar reflects that Mercer is scheduled to begin a high yield education presentation at the July, 2009 meeting and an asset-liability modeling report for the Disabled Workers and Coal Workers funds at the September, 2009 meeting. Mr. Smith complimented the Investment Division and Mercer Consulting for their extensive work in preparing this presentation.

ADJOURN:

Motion was made by Mr. Smith, seconded by Ms. Fall, to adjourn the meeting at 2:00 pm. Roll call was taken and the motion passed 6-0.

Prepared by: Linda Byron, Staff Attorney, Legal Division, May 5, 2009