BWC Board of Directors

INVESTMENT COMMITTEE

Thursday, July 30, 2009 10:00 a.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 10:10 am.

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

APPROVE MINUTES OF THE JUNE 18, 2009 MEETING
Upon motion of Mr. Caldwell, seconded by Mr. Price, the minutes of the June 18, 2009 meeting were approved as written. Roll call was taken and the motion passed 6-0.

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

Prior to beginning the discussion items, Mr. Smith addressed the changes to the Investment Committee's calendar and its planned activities for the following six months. Mr. Smith's comments are incorporated into the minutes by reference. He noted that the Committee had intended to learn about and discuss High Yield Bonds as part of the Mix 6 Asset Allocation Strategy proposed by Mercer Consulting (Mercer) and authorized by the Board in April, 2009. It was noted that the presentation on this issue had been postponed until the first part of the calendar year 2010. This change was made due to the number of months the Committee has spent moving with thought and deliberation through the decisions needed with respect to the desired asset allocation, the Investment Policy Statement (IPS) changes and the plan to implement the transitions. It was emphasized that the Investment Division is working diligently to implement the current transition; a complicated transition that will require extensive research, time and resources. Additionally, the transition requires a massive Request for Proposals(RFP) to obtain investment managers who will likely be selected before the end of the year. Mr. Smith emphasized that this change was unlikely to have much effect on the final outcome, as the model is projected over a 5-10 year period. Guy Cooper, Principal of Mercer agreed that this change is unlikely to have any lasting impact on investment returns due to the Bureau's long term investment plan. Mr. Smith noted that the change will give Mercer time to fully concentrate on the current and future asset allocation changes. Lastly, Mr. Smith emphasized that although the Committee has shown the capability of moving quickly and competently through a variety of issues simultaneously, the modifications in the Committee calendar prudently reflect the Committee's commitment to the Bureau's investment priorities.

ACTION ITEMS:

ASSET ALLOCATION IMPLEMENTATION
Bruce Dunn, BWC Chief Investment Officer, referred the Committee to his July 15, 2009 Asset Allocation Change Implementation Recommendation Memo and Mr. Cooper's July 21, 2009 State Insurance Fund-Third Priority Transition Memo, detailing support for the Third Priority Transition implementation strategy. Both memos are incorporated into the minutes by reference. Mr. Dunn also referred to the June 18, 2009 Update to the State Insurance Fund Asset Allocation Change Implementation presentation, noting that it details the entire transition plan. The report is incorporated into the minutes by reference. Mr. Dunn mentioned the First Priority Transition is progressing, noting that U.S. Long Government bonds were currently being sold to fund bond investments consistent to the Barclay's Aggregate Fixed Income Index by the chosen BWC transition manager. In the same way, the Second Priority Transition is being addressed with the Transition Manager Evaluation Committee reviewing and evaluating Transition Managers. Mr. Dunn referred the Committee to the Third Priority Transition, indicating that it was less complicated than the

first two priority transitions. The Third Priority Transition will transition funds from the S&P 500 Equity Index to the Russell 3000 Equity Index in order to add exposure to mid and small cap stocks. It is widely accepted that the S&P 500 Index consists of 500 large cap stocks. Those stocks make up approximately 85% of the Russell 3000 Index. The remaining 15% largely consists of mid cap stocks, as a portion of the Russell 1000 Index and the entire Russell 2000 Index of small cap stocks. One proposal being considered recommends that the S&P 500 stocks continue to be held by Northern Trust until the end of the transition period. The remaining 15% would be purchased through futures in order to gain exposure to the mid and small cap stocks during the transition period. Futures contracts of the Russell 2000 Index would be purchased to gain exposure to small cap funds while futures contracts of the S&P 400 Index would be purchased to gain exposure to mid cap stocks during the transition period. Mr. Dunn noted that this plan would have a slight tracking error and would increase exposure to the small and mid cap stocks during the transition period. He indicated that this strategy has some merit, but that the ultimate transition plan might deviate from it, based on the pre-trade proposals submitted by the transition managers. Ultimately, the Evaluation Committee will make the final decision. Mr. Dunn noted that the Investment Committee had approved the use of futures contracts in the prior meeting. He recommended approval of the implementation of the Priority Three Transition, assuring the Committee that two proposals for transition implementation would be reviewed and evaluated in the next 3-4 weeks to determine which proposal would be used to execute the asset allocation change. The transition is expected to begin in September. Mr. Smith clarified that the Investment Policy Statement (IPS) would not need to be amended. Mr. Dunn reiterated that the IPS had been amended previously to include the use of derivatives, although he explained that the proposal might not include their use. Mr. Cooper assured the Committee that Mercer also supported the approval of the Priority Three transition, indicating that the presentation included a good summary of the strategy. Updates and summaries will be provided to the Committee upon completion of each separate transition activity engagement.

A motion was made by Mr. Smith and seconded by Mr. Caldwell that the Investment Committee of the Workers' Compensation Board of Directors recommend to the Board that it authorize the BWC Investment Division Staff to implement the Third Priority Transition mandate of the 21st Century Transition Strategy option for the State Insurance Fund, commencing in September 2009, as that mandate is outlined in the memorandum of the Chief Investment Officer dated July 15, 2009, and supported by the memorandum of Mercer Investment Consulting, Inc., dated July 21, 2009. Roll call was taken and the motion passed 6-0.

DISCUSSION ITEMS:

MONTHLY AND FISCAL YEAR TO DATE PORTFOLIO VALUE COMPARISONS

Mr. Dunn referred the Committee to the BWC Invested Assets as of July 29, 2009 chart and the Invested Assets Market Value Comparison, dated July 17, 2009. Both reports are incorporated by reference into the minutes. He pointed out that the amount of cash value has been declining over the last several months, declining by over $100 million from May to June, but assuring the Committee that this was expected due to the seasonal nature of collecting premiums. Net investment income in July 2009 showed a net positive return of 1.8% on invested assets. Mr. Dunn noted that both the bond and equity markets posted positive returns. Bonds outperformed stocks with a positive return of 2.3% as compared to a positive 0.2% return for equities. Long duration fixed income had a positive return of 3.0% for June 2009. The Committee was reminded that a rebalancing action is currently in place to shift money from the Bureau's bond portfolio into its stock portfolio. The asset allocation transition is intended to increase the stock portfolio from 20% to 30% for the State Insurance Fund portfolio. For June 2009, the equity portfolio had a $109 million net realized loss. Mr. Dunn pointed out that this loss was due primarily to the shifting of the Coal Workers' Pneumoconiosis Fund (CWPF) and the Disabled Workers' Relief Fund (DWRF) equity portfolios from separate accounts to commingled accounts through Northern Trust. The separate accounts were closed as of June 29, 2009 at their current value, resulting in the bulk of the realized loss. The 2009 fiscal year had a negative net investment income of $192 million which included $925 million in net unrealized losses. For fiscal year 2009, the BWC investment portfolio had a negative return of 1.1%. Mr. Dunn directed the Committee to the difference in 2009 fiscal year returns for the bond and equity portfolios. The bond portfolio had a positive return of 4.1% while the equity market had a negative return of 26%. Mr. Dunn noted to the Committee that the S&P 500 index had a negative return of 26.2% for the same 12 month period, indicating that the timing of portfolio rebalancing during the fiscal year had a modestly positive impact on performance. Additionally, the Bureau has exercised large redemptions from the bond portfolios. Approximately $1.2 billion had been redeemed from the bond portfolios in order to execute rebalancing activities and fund seasonal operational cash needs. The BWC total investment portfolio experienced a negative return of only 1.1% for fiscal year 2009. Mr. Smith asked if this reflected a money-weighted or a time-weighted rate of return. Mr. Dunn responded that the return combines both methods but is primarily a time weighted return. Mr. Haffey asked about the difference in the amount of risk due to the rebalancing. Mr. Dunn and Ms. Damsel, the Bureau Director of Investments, indicated that the portfolio rebalancing at each month-end was being funded from cash interest income earned from bonds at the end of each month and reinvested into stocks only for the State Insurance Fund account in order to assist in the move from 20% to a 30% equities asset allocation objective. Mr. Dunn noted that the Investment Division was also reducing the bond duration in order to decrease price volatility. Mr. Smith pointed out that a higher percentage in stocks would increase risk. Ms. Falls asked Mr. Dunn to compare the risks and benefits of the former asset allocation with the new allocation for the State Insurance Fund. She specifically asked if the risk was being increased in order to decrease standard deviation of expected portfolio return. Mr. Dunn agreed that it was, but assured the Committee that the asset allocation change was only slightly increasing risk while increasing returns and significantly reducing standard deviation compared to the former portfolio strategy. Mr. Smith emphasized that during the 2009 fiscal year, the S&P 500 has lost 26% while the Bureau has only lost 1.1% during that same period. He noted that the Bureau's 1.1% loss needed to be reviewed and assessed within the context of the unusual and volatile market circumstances existing at the time.

Mr. Dunn pointed out that stocks had outperformed bonds in July 2009 to date. He remarked that equities had a positive return of 6.1% for July 2009 as of July 29, 2009 and bonds had a positive return of 0.1% for the same period. The July 2009 to date market value increase of bonds plus equities was a positive 1.4%. Mr. Dunn referred the Committee to the Bureau's net assets chart for the beginning, middle and end of the 2009 fiscal year. The June 30, 2009 adjustments to income have increased net assets to over $2.5 billion. He emphasized that rebalancing activities have assisted in increasing equities to 21.6% of the portfolio. The portfolio return for the calendar year 2008 was negative 2.3%. Mr. Dunn noted a significant difference in U.S. Long Credit and U.S. Long Government bonds performance. Year-to-date, the Long Credit bonds have returned a positive 8.1% while Long Government bonds have returned a negative 12.9%. Since March 2009, Long Credit bonds have returned a positive 16% and Long Government bonds had a negative 8% return. At the end of March 2009, the yield spread between these two sectors was over 4.0%. It has now narrowed to only 2.17%. Mr. Dunn noted that liquidity has improved over the last few months. He indicated that banks have issued a significant amount of bonds recently. Mr. Dunn emphasized that the U.S. banks are in a much better capital position than they were earlier this year. Mr. Smith added that the market issues started in the credit market and moved to equities, but the decline in the Treasury price has increased the performance differential between equities and Treasuries. Mr. Dunn agreed, stating that he felt good about the strategy of tilting toward equity.

TRANSITION IMPLEMENTATION UPDATE- STATE INSURANCE FUND

Mr. Dunn referred the Committee to the July 20, 2009 Transition Implementation Strategy Update for the Second Priority Transition. The report is incorporated into the minutes by reference. Mr. Dunn indicated that the Investment Committee and Board of Directors approved the Second Priority Transition Strategy to gain exposure to international equities by purchasing assets that are correlated with the MSCI All Country World Index excluding U.S. in their respective June 2009 meetings. He noted that it is a large benchmark with over 2,000 securities. The Investment Division received two formal proposals from two different Transition Managers. The two proposals differed widely. Only one proposal used derivatives. The other proposal was recommended by Barclays Global Investors (BGI) whereby the Bureau would use the BGI's commingled passively managed indexed funds to correlate with the benchmark, significantly reducing the tracking error. Mr. Dunn added that even a small difference of a few basis points in the tracking error could have a significant impact due to the size of the portfolio. A closer review of this proposal, as well as the one that proposed using derivatives, determined that both plans included securities lending, which is currently suspended by the IPS. BGI then proposed a new implementation strategy that removed securities lending without adding the use of derivatives. The new plan included a slightly higher tracking error, but removed the prohibited securities lending. The plan employs passively managed commingled funds of which 80% of invested assets will be comprised of developed countries and Canada with the remainder being invested in the emerging markets that include, among other countries, Brazil, Taiwan, South Korea, China, India, Israel and South Africa. By charter, the commingled Canada passive index fund is permitted to engage in securities lending, but the fund does not do it in practice. Mr. Dunn emphasized that this strategy allows for the most efficient way to get exposure to the emerging markets using passively managed funds with the lowest cost and lowest tracking error. Additionally, he added that the plan is attractive in that it does not rely on the use of derivatives and avoids securities lending. Mr. Dunn expressed the difficulty in finding funds that do not perform securities lending. He noted that most investors use securities lending to offset the high transaction costs of emerging country equity markets in order to meet the benchmark. After investigating, the Investment Division learned that neither Transition Manager had a single commingled passively managed fund of significant size that did not engage in securities lending. Mr. Dunn pointed out that Barclays does have 14 separate country passively managed commingled emerging market funds that are non-lending. Mr. Dunn directed the Committee's attention to Item D on Page 3, pointing out that the BGI managed commingled non-lending Emerging Markets Strategic Index fund is not passively managed. The fund overweights certain individual emerging market countries such as China and underweights others such as Taiwan. He assured the Committee that the fund is non-lending, but added that the fund does not include sufficient exposure to China, India, Israel and South Africa, necessitating the purchase of American Depository Receipts (ADRs) to get the necessary targeted exposure to those remaining countries consistent with the benchmark index. Mr. Smith inquired if the ADRs would give the Bureau access to all four remaining countries. Mr. Dunn replied in the affirmative. Mr. Dunn added that the Barclays transition team would be serving as the interim index manager for the Bureau's international equities. Mr. Smith complimented the Investment Division on finding a creative solution to accomplish the objective. Mr. Cooper agreed, noting that the matter was complicated and complimenting Mr. Dunn on finding a solution that followed the IPS. Mr. Smith then asked about the active component of the management strategy. Mr. Dunn and Mr. Cooper assured the Committee that although there is some active management, the transition strategy proposed falls within the definition of passive management. Mr. Smith asked if the Evaluation Committee had chosen to use the outlined strategy. Mr. Dunn responded in the positive, noting that the Evaluation Committee had been under the impression that derivatives would be necessary; however this strategy did not include their use. Mr. Smith expressed his support for both the addition of derivatives to the IPS (previously approved) as well as the agreed upon Second Priority Transition strategy. Ms. Falls added that Board approval would have been needed to add securities lending if that plan had been recommended. She congratulated the Evaluation Committee on finding a workable resolution.

CIO REPORT

Mr. Dunn referred the Committee to the June 2009 CIO Report. The report is incorporated into the minutes by reference. Mr. Dunn referred the Committee to the Fifth Strategic Goal, noting that there is anticipation that a cash distribution in excess of $100,000 will be received by the Bureau shortly. Although the litigation on the coin fund is still progressing, it is believed that there are sufficient funds in the capital coin fund bank account to cover the remaining fees and expenses. DSI has been acting as an advisor. As was reiterated in a report provided to the Administrator by the Investment Division prior to the Committee meeting, the Bureau hopes to resolve its remaining legal disputes soon. The "net/net" recovery should be about $54.5 million compared to $50 million invested.

Mr. Dunn directed the Committee's attention to the amendment to the June 12, 2009 Management Fee Schedule Comparisons for the Long Duration Fixed Income Portfolios of the State Insurance Fund. The amended chart is incorporated into the minutes by reference. State Street Global Advisors (State Street) is an existing investment manager for the movement of the long duration bond portfolio from the Long Duration Government/Credit index into the Long Government Index and the Long Credit Index for the State Insurance Fund (SIF). It was noted that State Street's management fee for all assets in excess of $2 billion for the Long Credit portfolio is actually 2.5 basis points, rather than the typographical error of1.0 basis points represented in this June 12, 2009 report of Mr. Dunn. Mr. Dunn indicated all other numbers in his report, including pro-forma estimates of new management fees, were accurate and that this typographical error did not impact any conclusions and recommendations provided in his report.

Mr. Dunn discussed the conversion of the CWPF and DWRF equity portfolios from separate to commingled accounts. The transfer was concluded on June 29, 2009 with a total market value of $46 million for the CWPF assets and $220 million for the DWRF assets. The net realized loss consisted of $18 million for the CWPF conversion and $79 million for the DWRF conversion. Mr. Dunn pointed out that the funds had returned a cumulative loss of 36% since September 2007 inception which was approximately 0.75% better than the S&P 500 benchmark for the same holding period. The rebalancing actions reduced the loss as compared to the index. The annualized rate of return for the two funds was 0.50% better than the benchmark.

Mr. Dunn then discussed the Master RFP for Passive Index Management Services. The RFP was issued on July 2, 2009. The RFP responses are due by August 4, 2009. Mr. Dunn indicated that there are eight different mandates included in the request. Six of the mandates refer to the SIF while the remaining two are holdover mandates for the CWPF and DWRF accounts. The two holdover mandates deal with the Long Duration Fixed Income and the S&P 500 Equity transitions. Mercer will be assisting in the evaluation process of the RFP. The goal of the Evaluation Committee is to present the finalists for recommendation to the Investment Committee and the Board of Directors between September and December 2009.

The Committee moved to a discussion regarding the quarterly Investment Manager meeting summary. Mr. Dunn noted that the Investment staff met with representatives of the Bureau's passive management firms in May 2009 as per its normal quarterly due diligence meeting process. It was emphasized that State Street recently passed the Federal Reserve stress test. Additionally, State Street just completed a secondary stock issue to raise $2.3 billion and a $500 million debt offering to repay the government TARP funds. As a result, State Street's stock has gone up, the TARP funds were repaid and State Street continues to gain market share. State Street has gained $37 billion in net new business in the first quarter of 2009 due to a move by investors toward passive investing. Ms. Falls noted that she appreciated the depth of the report. She emphasized the change in State Street's business model from active to more passive, indicating that this change bears close monitoring. Mr. Smith inquired if the increase in market share seemed to be temporary due to clients leaving their funds with State Street during the transition period. Mr. Cooper responded that the increased business was likely permanent. Mr. Smith asked that the situation be followed in order to determine if the increase was temporary.

Mr. Dunn then referred the Committee to the report on Barclay's Global Investors (BGI). Mr. Dunn noted that BGI is being acquired by BlackRock for $13.5 billion. He assured the Committee that BlackRock is a very astute firm that mostly actively manages accounts while BGI practices passive management. He noted that there will likely be some changes at the management level, but the core personnel are expected to be retained after the acquisition is completed. A recent stress test on Barclay's Bank in the United Kingdom found that an influx of government funds would not be needed. Mr. Dunn indicated that BlackRock is on the leading edge when it comes to investment management, but the Investment Division will continue to watch it closely. Mr. Dunn assured the Committee that Barclays' management is highly regarded and the staff would monitor it closely to ensure that there were no material changes. Mr. Cooper added that Merrill Lynch purchased 49% of BlackRock prior to being purchased by Bank of America. He pointed out that the situation bears watching. Mr. Smith asked if the other 51% was controlled by BlackRock. Mr. Dunn replied that PNC Bank, insiders and public shareholders own the remainder of shares. Ms. Falls added that Bank of America has a history of mismanagement whereby this situation needs to be closely watched. Mr. Cooper added that the executives received a significant amount of money when BlackRock was sold to Merrill Lynch and opined that they might have less incentive to stay.

Mr. Dunn directed the Committee's attention to the update on Northern Trust. Northern Trust recently raised $1.25 billion in equity and $500 million in senior debt issuance in order to begin to repay its TARP loan. He reiterated that Northern Trust had not needed the TARP funds, as it is one of the best capitalized banks in the nation; however the low cost of capital terms enticed the bank to accept the funds. Northern Trust has strong incentive to repay the loan to remove government involvement. Mr. Dunn emphasized that the firm is extremely well managed and well organized. He added that the firm has recently closed their New York investment management office and has moved the majority of the managers and traders to Chicago.

COMMITTEE CALENDAR

Mr. Smith made brief discussion of an overview of the agenda schedule for the August 2009 meeting, noting the fiscal year 2010 Investment Division goals and the investment consultant performance report are to be discussed.

ADJOURN:
Motion was made by Mr. Harris, seconded by Ms. Fall, to adjourn the meeting at 11:28 am. Roll call was taken and the motion passed 6-0.

Prepared by: Linda Byron, Staff Attorney, Legal Division, August 4, 2009