BWC Board of Directors

INVESTMENT COMMITTEE

Thursday, March 25, 2010 9:30 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 Kenneth Haffey Larry Price William Lhota, ex officio
Other Members Present:	Charles Bryan, Jim Harris, 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 9:55 a.m.

ROLL CALL
Roll call was taken. All members but Mr. Lhota were present at the roll call.

APPROVE MINUTES OF THE FEBRUARY 25, 2010 MEETING
Upon motion of Mr. Haffey, seconded by Mr. Caldwell, the minutes of the February 25, 2010 meeting were approved as written. Roll call was taken and the motion passed 5-0.

AGENDA
Upon motion of Mr. Caldwell, seconded by Mr. Haffey, the agenda was approved as written. Roll call was taken and the motion passed 5-0.

NEW BUSINESS/ACTION ITEMS:

MERCER INVESTMENT CONSULTING, INC. CONTRACT SECOND ANNUAL RENEWAL OPTION
Mr. Dunn noted that Mercer Investment Consulting, Inc. (Mercer Consulting or Mercer) initially entered into a consulting contract with the Bureau in February 2008, after the Investment Committee and Board had voted to approve the firm in January 2008. The Committee and the Board approved a one-year renewal as of July 1, 2009. Mr. Dunn

referred to the Mercer Investment Consulting, Inc. Investment Consulting Contract Renewal memorandum, dated March 11, 2010. The memorandum is incorporated into the minutes by reference. Mr. Dunn indicated the memorandum summarizes the existing terms of the consulting contract with Mercer whereby such contract will end on June 30, 2010 unless renewed for a final one-year period ending June 30, 2011. Mr. Dunn added that a new RFP for investment consulting services would be issued promptly if the Board decided not to renew for an additional year; in any event an RFP for investment consulting services will be issued around the end of this calendar year. Mr. Smith asked if there were any cited reasons to disapprove the renewal. Mr. Dunn responded in the negative, indicating that he was a strong advocate for the firm. He added that the firm has a good team servicing the Bureau; he was impressed with their research and the quality of their presentations and he appreciated the firm's responsiveness to inquiries. Mr. Price applauded Mercer's responsiveness, availability and informative presentations.
Mr. Smith asked if there were any change in fees. Mr. Dunn replied in the negative. He added that fees were $40,833 per month or $490,000 annually. The fee includes eighteen traditional manager searches over the entire contract term. Traditional manager searches include searches on active or passive managers for stock or bond assets. Eleven investment manager searches have been performed by Mercer so far and a Mercer representative has accompanied the Investment Division Staff on several on-site visits. Mr. Smith pointed out that the Bureau had changed investment consultants in 2008 resulting from the RFP process when the agency changed the scope of services which resulted in a reduction of annual fees. Mr. Haffey asked if any extra fees had been paid for optional additional services. Mr. Dunn responded in the negative but added, as an example, that an additional $40,000 could be paid in the future if Mercer was involved in an alternative manager search. He also noted that Mercer had contracted to perform one asset/liability study, but in addition to studying the State Insurance Fund investments, Mercer Consulting had also reviewed the Coal Workers', Marine Industry and Public Work-Relief Employees' funds without receiving additional compensation. In response to a question from Ms. Falls, Mr. Dunn stated it is his interpretation of the contract that there would not be additional costs if BWC requests a search for Minority or Women Business Enterprises (MWBE's) investment managers unless the maximum eighteen traditional manager searches have been reached.

Ms. Falls made a Motion for the Investment Committee to recommend renewal of the Investment Consulting Contract with Mercer, seconded by Mr. Price as follows: I move that the Investment Committee of the Workers' Compensation Board of Directors recommend to the Board that it renew the current contract with Mercer Investment Consulting, Inc. for a one-year period effective July 1, 2010 through June 30, 2011. Roll call was taken and the motion passed 5-0.

MERCER ASSET-LIABILITY MODELING REPORT
Mr. Smith referenced the Strategic Asset Allocation Analysis Marine Industry Fund and Public Work Relief Employees' Fund presentation, dated March 2010. The presentation is incorporated into the minutes by reference. He noted that during the February meeting, Mercer made a preliminary recommendation to maintain the current allocation for both funds, and that recommendation did not change for this month. Based on the discussion this month, if the Committee was comfortable, he would ask for a waiving of the second reading.

Mr. Cooper, Principal with Mercer Consulting, stated both funds have more assets than is necessary to fund anticipated future liabilities. The Marine Industry Fund (MIF) currently has ten times the funded assets needed for funded liabilities and the Public Work-Relief Employees' Fund has six to seven times the funded assets needed. The goal for both funds is to retain the funded assets by being more conservative. The intermediate bond fund strategy provides a consistent return. Various economic scenario environments were reviewed in order to determine projected returns. The base case is the most likely scenario. The MIF had $17.4 million in funded assets with $1.7 million in funded liabilities. Mr. Lhota returned to the meeting during this discussion at 10:16 a.m. Mix A shows the current investment strategy with 100% invested in Intermediate bonds. Mix B shows the investment strategy with 100% of the fund invested in the U.S. Aggregate Index. Mix C has 50% invested in the Aggregate Index and 50% invested in TIPS. With the current allocation, the long term expected return is 4.7%. Mix B has an expected return of 4.9% and Mix C at 4.8%. Mix B has a higher standard deviation of return at 5.5%. The other mixes result in a 4.5% standard deviation of return. Mr. Price asked how the MIF is funded. John Pedrick, the Bureau's Chief Actuarial Officer, answered that this is done using rates and classifications. Mr. Cooper added that the benefits of adding equities are outweighed by the risk.

At the end of the next ten years, under the current strategy, the funded ratio is projected to be twenty-two times the funded liabilities. Under the best and worst cases, the funded ratio is projected to be twenty-seven times to eighteen times the funded liabilities. Mr. Cooper indicated that the alternative mixes would likely result in marginal changes, but would increase transaction costs and require additional time and effort from the Investment staff. A new RFP would need to be issued. The current mix would provide favorable funding. The projected surplus in 2019 for the alternative mixes was mentioned. Mr. Cooper emphasized that Mercer supports continued investment in the current asset allocation (Mix A). A shorter duration fixed income portfolio is desirable over a longer duration portfolio. Mr. Matesich asked if the durations would start shorter and increase in duration or if a shorter duration would be chosen and then the bonds would be changed. Mr. Cooper responded that shorter durations would be chosen without changing the existing portfolio.

The Public Work-Relief Employees' Fund (PWRF) was discussed. As of June 30, 2009, the PWRF had $23.4 million in funded assets with $4.0 million in funded liabilities. The fund is currently invested in intermediate bonds with duration of approximately four years. Mix A (the current allocation), has a 4.7% long term expected annual return. As of June 30, 2009, the fund had a 585% funded ratio or almost six times the amount of the funded liabilities. In the alternative mixes, Mix B would allocate 100% of the fund in Aggregate Fixed Income and Mix C would invest 50% in TIPS and 50% in Aggregate Fixed Income. Mercer Consulting recommends keeping the current allocation. Mr. Harris asked if the PWRF was used often. The Bureau Administrator, Marsha Ryan, stated that the fund was most active in the 1980s and its use has diminished over the years. Ms. Falls noted that the Bureau needs to continue to study whether the funds can be combined at a later date and whether premium decreases would be recommended. Mr. Price asked if the Administration was considering lowering premiums for the PWRF since the fund has over $23.0 million in funded assets. Mr. Pedrick indicated that the rates on public employer taxing districts had changed as of January 1st.

Mr. Dunn noted the Chief Investment Officer Recommendations Asset Allocation Strategy Public Work-Relief Employees' Fund and Marine Industry Fund memorandum, dated March 16, 2010. The memorandum is incorporated into the minutes by reference. The memorandum indicates the Chief Investment Officer's support for the current asset allocation on both funds. Mr. Dunn added that both funds need steady, safe and sure investment income to grow. The benchmark index currently used for both of these funds is invested in U.S. Treasuries, U.S. Agencies and intermediate credit bonds. The bonds have a high average quality rating of between AA1 and AA2. The investment management fee of State Street Global Advisors is estimated at approximately $16,000 per year for both funds combined based on current market value. The current management contract with State Street is through June 2011 with an optional extension through June 2013 at the same annual fee. Mr. Smith asked if the Investment Policy Statement (IPS) needed revision. Mr. Dunn replied that the current IPS supports the current asset allocations, but the liabilities are represented as intermediate in duration of three to four years rather than their actual long duration of ten years based on the representation of the Mercer Strategic Asset Allocation Analysis report presented today.

Mr. Price made a motion, seconded by Ms. Falls, to waive the second reading of the Mercer Asset-Allocation Modeling Report on the Public Work-Relief Employees' Fund and Marine Industry Fund. Roll call was taken and the motion passed 5-0. Mr. Haffey was not present at the roll call vote, but upon a motion by Director Price, seconded by Mr. Caldwell, the vote was left open until either Mr. Haffey arrived or until the conclusion of the March 25, 2010 Investment Committee meeting. Roll call was taken and the motion passed 5-0 to record Mr. Haffey's vote. When Mr. Haffey returned, he was read the motion and he approved it, as well. The motion ultimately passed 6-0.

A Motion of the Investment Committee to maintain the current asset mix for the Public Work-Relief Employees' Fund and to make relevant revisions to the BWC Investment Policy Statement was made by Ms. Falls and seconded by Mr. Caldwell as follows: I move that the Investment Committee of the Workers' Compensation Board of Directors recommend to the Board that it maintain current asset allocation Mix "A" for the Public Work-Relief Employees' Fund, including its 1% cash allocation, as discussed in the Mercer Strategic Asset Allocation Analysis presentation dated March 2010, and the memorandum of the Chief Investment Officer, dated March 16, 2010, and also that the Investment Committee recommend to the Board that it adopt relevant revisions to Section VI.D of BWC's Statement of Investment Policy and Guidelines as they are set forth in the red-lined versions attached to the Chief Investment Officer's memorandum. Roll call was taken and the motion passed 5-0. Mr. Haffey was read the motion upon his arrival and he approved the motion, as well. The motion ultimately passed 6-0.

A Motion of the Investment Committee to maintain the current asset mix for the Marine Industry Fund and to make relevant revisions to the BWC Investment Policy Statement was made by Ms. Falls and seconded by Mr. Caldwell as follows: I move that the Investment Committee of the Workers' Compensation Board of Directors recommend to the Board that it maintain current asset allocation Mix "A" for the Marine Industry Fund, including its 1% cash allocation, as discussed in the Mercer Strategic Asset Allocation Analysis presentation dated March 2010, and the memorandum of the Chief Investment Officer dated March 16, 2010, and also that the Investment Committee recommend to the Board that it adopt relevant revisions to Section VI.E of BWC's Statement of Investment

Policy and Guidelines as they are set forth in the red-lined versions attached to the Chief Investment Officer's memorandum. Mr. Haffey arrived during this action item. Roll call was taken and the motion passed 6-0.

DISCUSSION ITEMS:

MONTHLY AND FISCAL YEAR TO DATE PORTFOLIO VALUE COMPARISIONS
Mr. Dunn referred to the Invested Assets Value Market Value Comparison Total Funds statement. The statement is incorporated into the minutes by reference. Net investment income was $119 million for the month of February 2010 representing a net portfolio return of 0.7%. The bond portfolio had a flat return of 0.0% and the equity return had a positive return of 2.3% for the month. The eight-month fiscal year 2010 to date period ending February 2010 comparison results were discussed. Net investment income was positive 9.8% in fiscal year 2010. The bond market had a positive fiscal year 2010 net return of 7.1%. The equity market had a positive net return in fiscal year 2010 of 19.4%.

MONTH-END PORTFOLIO ASSET ALLOCATION VALUES
Mr. Dunn referred to Investment Asset Allocation-Combining Schedules as of February 28, 2010 and January 31, 2010. The schedules are incorporated into the minutes by reference. Net cash in the State Insurance Fund (SIF) had an allocation of 2.9% as of the end of February 2010. This amount had increased from 1.5% as of January 31, 2010. Bonds in the State Insurance Fund had an asset allocation of 67.2% as of February 28, 2010. That allocation had decreased from 68.6% at the end of January 2010. The MIF asset allocation of cash as of February 28, 2010 had increased to 2.6% in comparison to the target of 1.0%. Mr. Dunn pointed out that February is a large premium receipt month for the State Insurance Fund. Net cash increased from over $257 million at the end of January 2010 to more than $508 million at the end of February 2010.

Mr. Dunn noted the BWC Invested Assets as of March 24, 2010 chart. The chart is incorporated into the minutes by reference. As of March 24, 2010, equities had returned a positive 6.1% for the month. Bonds had decreased by 0.6% in return during the month to date 2010. Bonds and equities combined had a positive return of 1.4%, or positive $264 million, month to date 2010. Fiscal year to date through February 2010 had a positive return of 9.8%. The Bureau had over $19.0 billion in invested assets as of March 24, 2010. Mr. Haffey asked Mr. Dunn when the Bureau's assets had last been up to that amount. Mr. Dunn replied that it would have been at least several years prior. Ms. Falls noted that bonds were lower than the 70% target amount and could move lower if bonds continued to be sold by investors in the bond market. She asked if this would trigger the rebalancing policy. Mr. Dunn replied that the policy would not likely be triggered at that time. Mr. Dunn added that the equity allocations in the DWRF and Black Lung Fund were being watched as they are near the upper end of their target range of 23%. Mr. Price asked if the $19.0 billion in Bureau assets was projected to continue to grow. Mr. Dunn responded that for Bureau investment income projection purposes, bond return assumptions reflect projected interest income payments to be earned but do not project any realized or unrealized gains or losses. With respect to equity investment income projections, expected dividend income earned is projected along with an estimated amount of unrealized gains that is considered conservative and less than annual return assumptions provided by Mercer in their publications.

CIO REPORT

Mr. Dunn mentioned the CIO Report for February 2010 dated March 15, 2010. The report is incorporated into the minutes by reference. The report contains a transition activity update. With regard to the SIF Priority #2 transition into International Equities, the assets were moved from the Transition Manager to the Target Manager over the last week in February 2010. A new commingled fund was created with approximately $1.6 billion in the account. In the TIPS portfolio of the SIF, approximately 12% of the fund assets were moved to BlackRock as the Target Manager. The remaining 5% of total SIF assets represented by TIPS will continue to be managed by State Street Global Advisors (State Street). The transfer was an in-kind transfer at no cost. The TIPS portfolio will be fully replicated. BlackRock is now the majority manager of TIPS. A portion of the State Insurance Fund Long Credit fixed income portfolio previously managed by State Street was transferred in kind to BlackRock as the Target Manager. BlackRock received $486.0 million of securities and now manages a targeted 8% of total SIF assets as represented by this SIF Long Credit Portfolio. State Street will manage the remaining 20% of the remaining targeted SIF assets as represented by the Long Credit portfolio. Future SIF transitions include a plan to transition U.S. Equities to Northern Trust and Mellon. Included in future transitions for the Disabled Workers' and Coal Workers' funds is a shift in assets from the S&P 500 indexed commingled fund, currently managed by Northern Trust, to the Russell 3000 Index commingled fund to be managed by State Street.

As part of the update, Mr. Dunn mentioned that the Bureau Investment Staff attended quarterly meetings with BlackRock, Northern Trust and State Street in early February, with a summary of each of these meetings provided in his CIO Report. Mr. Dunn indicated that Ray Mazzotta, the Bureau's Chief Operating Officer, also attended all three meetings and that Administrator Ryan attended two of the three meetings. The purpose of the face-to-face meetings was to discuss the firm, the markets and the Bureau's investment management mandates with the firm managers.

Ms. Falls asked about the status of the goal of reviewing daily cash management in the fiscal year 2010 goals. She noted that the Investment Division Staff and the Investment Committee were committed to many other time-consuming fiscal year 2010 goals. Mr. Dunn replied that this goal would likely be extended to the 2011 fiscal year. He added that currently the investment staff is exploring software to help manage cash internally, but added that a new junior level manager would have to be hired to assist in daily cash management. He also added that this goal has a lower priority than all upcoming transition activities.

COMPARISON OF ACTIVE AND PASSIVE INVESTMENT MANAGEMENT

Mr. Smith indicated that passive investing has lower fees and very little tracking error in comparison to active investing. Mr. Kweku Obed, a Senior Associate with Mercer Consulting, referred to the Active vs. Passive Management presentation, dated March 25, 2010. The presentation is incorporated into the minutes by reference. Mr. Obed explained that a passive manager will track the benchmark index while an active manager will try to outperform the index. Specific risk is idiosyncratic with certain asset classes such as credit bonds, real estate or small cap stocks. When determining which investment strategy is preferable, other considerations must include fees, management

selection and the ability to save costs by managing assets internally. The market efficiency of each asset class must be considered, as well. Active management gives the Bureau more opportunity to review emerging manager firms and Minority or Women-Owned Business Enterprises (MWBEs). A manager's skill can be calculated on a net of fee basis. Mercer Consulting does recommend that the Bureau consider adding active management to its investment strategy. Enhanced indexing is active management to a small controlled level. Mr. Obed indicated that active management is recommended for U.S. Small and Mid Cap Equities since they are very inefficient. Active management is also recommended for International Equities and Long Credit Fixed Income. TIPS and Long Government Fixed Income are very efficient, so passive management is recommended. A significant amount of credit analysis is needed for High Yield Bonds, so active management is recommended. Mr. Obed pointed out that alternative investments are difficult to benchmark. Mr. Smith indicated that Emerging firms and MWBEs must be reviewed based on the asset class. For passive management, the average tracking error is less than 10 basis points. Risk must be considered when calculating the information ratio. Mr. Smith added that the Bureau and the Investment Committee are used to minuscule tracking errors, but active management will increase them. Mr. Lhota indicated that for investment returns, being in the lowest percentile is preferable, while being in the higher percentile is preferable when reviewing tracking error. Mr. Smith added that hiring active managers removes the near certainty of market performance. Mr. Obed stated that risk can be managed by active management through security selection.

Mr. Obed indicated that it is difficult to outperform the large cap equity indexes since a significant amount of information is available and is updated almost instantly. The average fee for actively managing a $100 million U.S. Large Cap Equity portfolio is 0.49% while the average gross excess return from 1986-2009 above the index is 0.46%. Mr. Price asked if this created an incentive to outperform the index. Mr. Obed responded that the incentive remains only when the result is reviewed net of fees. Since the management fee is greater than the gross excess return, passive management is recommended for the U.S. Large Cap Equity asset class. Mr. Haffey mentioned studies that indicate that passive management outperforms active management and pointed out that the presentation reflects this. Mr. Obed cautioned that other factors must also be reviewed. Ms. Falls indicated that the length of the comparisons were helpful. Mr. Smith noted that there is not much discretion for management fees due to the existence of Most Favored Nation status clauses in many investment management contracts but that the goal of an active manager is to outperform the benchmark nonetheless.

Mr. Obed indicated that there is an information advantage to active management of Small or Mid Cap Equity funds. The median fee on a $100 million actively managed small cap core equity portfolio is 0.75% and 0.63% for a Mid Cap core equity portfolio. The fee increases to 0.77% on a separately active managed Small-Mid Cap equity strategy. From 1985-2009, the gross excess return over the index was 1.50% on the Small-Mid Cap equity strategy, so active management is recommended. Ms. Falls commended the length of the study and noted that the Board must look at the long view. Mr. Smith agreed, indicating that they must look at the long view so that they do not get rid of a manager too soon or keep one for too long. Mr. Pitts asked about timing the entry into active management. Mr. Obed replied that timing the market is not recommended, but there is a need to be diligent. He noted that the implementation should be phased in and the

allocation should be reviewed. Mr. Haffey added that the Board needs to emphasize diligence in their selection of managers rather than trying to time the market. Mr. Obed indicated that some tolerance for underperformance should be allowed since outperformance can be based on higher risk than is allowed by the IPS. Mr. Price stated that we are able to look back, but cannot necessarily predict the future, so the key is long-term stability. Mr. Bryan noted that prior outperformance does not predict future outperformance. Mr. Smith added that both the history of outperformance and the due diligence of picking high quality rated managers must be considered.

Mr. Obed referred to International Equity. The Bureau is currently invested in the EAFE index as a large segment of its ACWI ex-US benchmark index. He indicated that there is a greater opportunity for outperformance with this asset class since the manager would be investing in many different foreign markets. The average gross excess return from 1986-2009 was 1.11% while the median fee is 0.63%, making active management preferable.

In reviewing core fixed income, Mr. Obed noted that the asset class for the Bureau was more conservative until 2008. He added that the Bureau can benefit from active management in this area by using a firm's research. Ms. Falls asked how active management in the different asset classes would be prioritized. Mr. Obed replied that the percentage of excess returns would be compared to the fees. Mr. Lhota pointed out that the difference between returns and fees must be considered as well as reputational risk. Mr. Cooper added that the time for administration of the new funds must be taken into consideration. Mr. Caldwell asked if any conclusions could be made based on comparing the excess returns with the fees. Mr. Obed replied that the length of the comparisons should allow for some reliance. Mr. Haffey asked how much weight should be placed on the last two years versus the last twenty years. Mr. Cooper replied that all of the markets are becoming more efficient. Mr. Smith cautioned that only some of the rules have changed, so the long term history cannot be discounted. Mr. Price thanked Mr. Smith, Mr. Dunn, and Ms. Damsel, the Bureau Director of Investments, as well as Mercer Consulting for their work.

COMMITTEE CALENDAR

Mr. Smith referred to the Draft Calendar for Active/Passive Management Topics, dated March 23, 2010 and revised March 24, 2010. The calendar is incorporated into the minutes by reference. Mr. Dunn noted that Mercer would be working with the Bureau, using its shared manager database in order to assist in the selection of top tier managers who is sustainable over time. He added that the costs will be analyzed and Mercer can perform the manager screening. In June, a discussion on MWBEs will be introduced. Mr. Dunn ended by noting that there is currently no set time period for any decisions or votes involving active management.

ADJOURN

A motion was made by Mr. Haffey, seconded by Ms. Falls to adjourn the meeting at 12:07 p.m. Roll call was taken and the motion passed 6-0.

Prepared by: Linda Byron, Staff Attorney, Legal Division, April 1, 2010