BWC Board of Directors

INVESTMENT COMMITTEE

Thursday, April 29, 2010 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
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
F. Ronald O'Keefe, Fiduciary Counsel, Hahn Loeser & Parks LLP

CALL TO ORDER
Mr. Smith called the meeting to order at 10:10 a.m.

ROLL CALL
Roll call was taken. All members but Mr. Lhota were present at the roll call. Mr. Lhota joined the meeting at approximately 10:59 a.m.

APPROVE MINUTES OF THE MARCH 25, 2010 MEETING
The minutes of the March 25, 2010 Investment Committee meeting were amended as follows: under the Committee Calendar discussion item, the sentence regarding the shared manager database should read: Mr. Bruce Dunn, the Bureau's Chief Investment Officer, 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 are sustainable over time. Upon motion of Ms. Falls, seconded by Mr. Haffey, the minutes of the March 25, 2010 meeting were approved as amended. Roll call was taken and the motion passed 5-0.

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

DISCUSSION ITEMS:

SUMMARY OF MERCER ASSET LIABILITY ANALYSIS AND STRATEGIC ASSET ALLOCATION TARGETS

The Bureau's Mercer Investment Consulting, Inc., team comprised of Mr. Guy Cooper, Partner and Ms. Jordan Nault, Principal, made a presentation to the Committee regarding asset liability studies of the Disabled Workers' Relief Fund (DWRF) and the Marine Industry Fund (MIF).

Ms. Jordan referred to the April 2010 "Ohio Bureau of Workers' Compensation Summary of Asset Liability Analysis and Strategic Asset Allocation Targets" presentation prepared by Mercer and provided to the Board in advance of the meeting. The presentation is incorporated into the minutes by reference.

Ms. Jordan noted these two specialty funds are separate from the State Insurance Fund (SIF). The funded assets and liabilities for the State Insurance Fund (SIF) were discussed. The funded assets were $17.0 billion and the funded liabilities were $14.8 billion with approximately 70% of assets allocated to fixed income investments and 30% allocated to equity investments. The target allocation for the SIF includes 37% to Long Duration Fixed Income, 15% to Aggregate Fixed Income, 17% to TIPS, 1% to cash and 30% to equity. Mr. Cooper noted the funding ratio for the SIF was 120% in the asset and liability analysis summary.

The Disabled Workers' Relief Fund (DWRF) target allocation includes 34% to Aggregate Fixed Income, 35% to TIPS, 1% to cash and 30% to equity. Of the 30% to equity, 10% is to be invested in international. The Coal Workers' Pneumoconiosis Fund (BLF) target allocation allots 80% to fixed income and 20% to equity while the Public Work-Relief Employees' Fund (PWRF) and Marine Industry Fund (MIF) target allocations invest almost 100% in intermediate fixed income. The Self Insured Employers' Guarantee Fund (SIEGF) is scheduled to be reviewed in August 2010. The SIEGF currently allocates 100% to cash and cash equivalents.

Mr. Haffey noted the improvement in the BWC's investment positions from where they were previously. Ms. Falls added that investing was a dynamic area and that markets can quickly change. She noted that, overall, the specialty funds were predominantly invested in intermediate fixed income obligations and added that the funds should be reviewed in a year to see if that strategy was still endorsed. She indicated that the DWRF should be reviewed in a year as the Actuarial

Committee updates their projections since 20% currently and soon to be 30% of its portfolio is invested in equities. She indicated that equities can be volatile.

Mr. Smith noted that the Audit Committee planned to discuss a request to access the BLF that might be contrary to the fund's stated purpose. Ms. Falls added the request to disburse funds from BLF had not been anticipated when the investment of that fund was being allocated. Ms. Nault assured the Investment Committee that the latest $2.28 million disbursement was appropriate in part because the asset funding ratio was so high. She also stated it was her understanding this would be a one-time request. Ms. Falls noted for the record that this is anticipated to be a one-time request which, under the circumstances, helps make it feasible.

MONTHLY AND FISCAL YEAR TO DATE PORTFOLIO VALUE COMPARISONS

Mr. Dunn referred to the Invested Assets Market Value Comparison-Total Funds report dated April 16, 2010 previously provided to the Board. The report is incorporated into the minutes by reference. The investment portfolio in March 2010 had a positive return of 1.7%, representing an increase of $326 million in net investment income. Equity investments had a monthly net return of positive 6.4% in March 2010. Bond investments had a net return of negative 0.2% in the same month, including $34.4 million in net realized gains resulting from a shift of long credit bonds from State Street to BlackRock to fulfill the decision of the Board to allocate 8% of total assets represented by long credit bonds to BlackRock. In the June 2009 to March 2010 fiscal year to date results, the investment portfolio had a positive return of 11.6%, with bond investments gaining 6.9% and equity investments 27.1% in fiscal year 2010 to date. The market value of the Bureau's investments was more than $19.0 billion at the end of such period.

MONTH-END PORTFOLIO ASSET ALLOCATION VALUES

Mr. Dunn noted the Investment Asset Allocation Combining Schedules as of March 31, 2010 and February 28, 2010. The schedules are incorporated into the minutes by reference. The bond allocation in the SIF had decreased from 67.2% as of the end of February 2010 to 66.3% at the end of March 2010, a decrease of 0.9%. The allocation of stocks in the SIF increased 1.4%, from 29.9% to 31.3% in the same period. Cash in the SIF declined from 2.9% to 2.4% by the end of March 2010, a decline totaling almost $100 million dollars due to claim payments that exceeded premium collections. In March 2010, the long government bond benchmark index in the SIF returned negative 1.86% while the long credit bond benchmark index returned a positive 0.20%. In the current fiscal year through the end of March, the long credit benchmark index had a positive return of 11.2% and the long government index had a positive return of only 1.7%. Mr. Dunn indicated that the shift from long government fixed income to long credit fixed income occurring in July and August of 2009 had a beneficial effect on the portfolio. The yield spread between these two fixed income sectors has compressed during the course of this fiscal year. At the beginning of the fiscal year, the yield spread was 2.5%. It has now decreased to 1.6%. Mr. Dunn indicated that such long credit bond spreads may continue to tighten in comparison to long government bonds. He noted that the current European sovereign risk concerns are incidental to the bond portfolio, as the Bureau only has exposure to Italy in the bond portfolio, and that investment is minimal. He added that credit to bond issuers generally appears to be more available and the credit markets are increasingly liquid. Ms. Falls noted for the record that the Bureau's bond portfolio has no exposure to Greece, Portugal or Spain. Mr. Matesich asked if the Bureau had some exposure to those countries in its equity portfolio. Mr. Dunn answered in the affirmative. Mr. Smith pointed out that the market has recently seen some reduction in value in the S&P 500 index due to the concerns of foreign debt.

QUARTER-END PORTFOLIO TARGET ASSOCIATION RESULTS AND VARIANCES

Mr. Dunn referred to the chart displaying Investment Asset Allocation by Fund-Target Variance as of March 31, 2010. The chart is incorporated into the minutes by reference. This is a new chart that shows each fund and asset class, denoting the position of each asset in relation to the target ownership range for that asset class. The chart shows the outperformance of long credit fixed income to long government fixed income in the SIF. There is a positive 0.8% ownership variance for long credit bonds above the target allocation percentage and a negative 1.9% ownership variance in the SIF with long government bonds being below the target allocation percentage. Mr. Dunn indicated that all of the SIF asset classes are comfortably within target range. The DWRF and BLF portfolios do not have variances shown as their portfolios are in transition. Ms. Falls complimented the chart, indicating that it presented visually understandable information. She also asked if an updated chart would be presented at the June Investment Committee meeting. Mr. Dunn replied that the chart would be presented after the end of each quarter. He added that Mellon provides daily reports to show the status of the Bureau's portfolio and that he intends to comment at the June meeting and subsequent meetings held on the month nearing quarter-end on any asset classes that are close to or in fact falling outside the target ownership ranges at the time of such meeting. These comments would alert the Investment Committee about potential portfolio rebalancing actions.

Mr. Dunn referred to the BWC Invested Assets as of April 28, 2010 report that was distributed and made available at the meeting. The report is incorporated into the minutes by reference. Mr. Dunn pointed out that stocks and bonds have performed well over the month of April 2010. In April 2010 through April 28, bonds plus equities had returned a combined positive 1.5% return, an increase in portfolio value of $281 million.

CIO REPORT- MARCH 2010

Mr. Dunn referred to the CIO Report for March 2010 previously provided to the Board. The report is incorporated into the minutes by reference. Mr. Dunn noted that the management contract for Northern Trust and Mellon will be completed within the next couple of weeks. The goal is to make the transition of the Russell 3000 indexed portfolio to these two target managers by the end of May 2010 in order to be so invested prior to the June 2010 reconstitution of the index. The Bureau would prefer a target manager to review the funds, rather than a transition manager. Mr. Dunn indicated the transition manager for the DWRF and BLF portfolios was selected the day before the current Investment Committee meeting and was awaiting a new contract. The Investment Division has a goal to complete the transitions for these two funds during this quarter. Once these transitions begin, it is anticipated that the new target asset allocation and fixed income portfolio target duration for both portfolios will be reached by the end of the first day of trading by the transition manager under the transition strategy approved by the Investment Division.

COMPARISON OF ACTIVE AND PASSIVE INVESTMENT MANAGEMENT- SECOND REVIEW

Mr. Kweku Obed, Senior Associate, Investment Consulting, Inc., referred to the document entitled "Ohio Bureau of Workers' Compensation Active vs. Passive Management," dated March 25, 2010. The presentation is incorporated into the minutes by reference. The purpose of the presentation was to explore the appropriate use of active vs. passive management for various asset classifications. He explained that it is generally difficult for a manager to outperform efficient markets since information is disseminated so quickly. Large Cap funds are considered to be very efficient. In contrast, the real estate market is much less efficient, so an active manager would be recommended for this space. Core fixed income funds add the opportunity for alpha. Mr. Smith asked if Mercer would recommend regulations on the amount of risk and type of risk with a core fixed income manager. Mr. Obed responded that the Bureau could limit the types of investments, the amount of risk and the type of risk. The average gross excess return is 0.54% in actively managed core fixed income as represented in the Mercer presentation. TIPS are securities whose interest rate is tied to the Consumer Price Index. The purpose of TIPS is to hedge inflation. TIPS will lose principal with deflation. TIPS are considered to be very efficient and transparent. The average gross excess return on TIPS is 0.08% shown in the Mercer presentation, which is less than the 0.14% median fee. For these reasons, passive investing is recommended for TIPS.

High yield fixed income instruments are bonds that are rated below investment grade (such as below BBB and below Baa). Mr. Obed cautioned that there is a lot of credit risk with this type of investment, so a significant amount of specialist research is needed. This can also include private equity type analysis. Mr. Smith pointed out that the Bureau does not have high yield bonds in the portfolio currently. He questioned what the anticipated percentage of the portfolio this would be and how popular this investment was. Mr. Cooper replied that the percentage would not exceed the percentage of equities. He noted that a small percentage of pension funds invest in high yield bonds, whereas most insurance companies invest in high yield bonds. The Mercer document shows that with high yield bonds, the gross excess return is 1.0% for active management, which exceeds the median management fee of 0.43%.

Mr. Obed pointed out that the majority of the Bureau's fixed income portfolio is invested in long duration bonds. Mr. Smith clarified that that the timing of the cash flows should also be considered when discussing long duration. Mr. Obed noted that an active manager can add value by looking at spreads and performing research. He added that if the question was whether to actively manage long duration government or long duration credit bonds, he would recommend active management of long credit. He pointed out that the markets for long government bonds are more efficient (since information on government issued securities can be easily accessed) than markets for long credit bonds. Mr. Smith clarified that the average excess gross return is being used to determine where active management adds value and the recommendations for active management are being made based on that data. Mr. Obed agreed. Mr. Cooper noted that this was just one factor to consider. For long duration credit bonds, the average gross excess return is 0.45% which exceeds the average 0.22% fees. Mr. Dunn pointed out that the chart includes both long government and long credit bonds. Mr. Smith questioned whether the excess returns were enough to justify active management if the long government bonds were removed from the chart. Mr. Obed replied that the data presented was for government and credit bonds; however, if one were to split the two, the expectation would be that long credit bonds would outperform long government bonds over the time periods being analyzed.

Mr. Obed referred to active management with regard to alternative investments. Alternative investments include hedge funds, private equity and private real estate. These investments are generally esoteric, riskier and are less liquid in nature. There is also much less public information available on these types of strategies, so active management is recommended. Mr. Smith asked if public securities alternatives were included. Mr. Obed responded in the affirmative. (Note: Mr. Haffey left the meeting during this discussion item at 10:57 a.m.) Mr. Smith pointed out that with passive management of this asset class, the managers are tied to the benchmark of a return that is not based on identical investments, but with active management, the manager can choose a less restrictive benchmark. Mr. Obed agreed, but added that the Bureau can choose the appropriate benchmark to be used for actively managed alternative investments. (Mr. Lhota joined the meeting at 10:59 a.m.) Mr. Obed referred to the materials and noted that the "Bailey Criteria" is used to determine if a benchmark is appropriate. The benchmark must be specified in advance before the portfolio is funded. The investments must also be unambiguous, investable, measureable and appropriate where the amount of risk has been considered. Accurate information must be available in order for a benchmark to be measureable. Mr. Smith noted that active management of alternative investments includes very high fees. Mr. Obed agreed that the fees can be high. Mr. Obed mentioned Minority and Women Owned Business Enterprises (MWBE). He noted that emerging managers have strong representation in domestic equity, non-U.S. equity, U.S. fixed income, non-U.S. fixed income, private equity and private real estate.

Mr. Obed referred to other factors to consider with active management. He mentioned the S&P's SPIVA scorecard, a study that is performed each year to compare the performance of the different S&P indices against actively managed strategies. He noted that the study did not reflect well on active management, as it showed that active management had underperformed passive indexing. Mr. Smith noted that unlike other regular investors, the Bureau would be choosing from a list of managers who were recommended after extensive research, rather than randomly choosing managers. Mr. Obed noted that the Bureau needs to look at its time horizon, the amount of risk and the type of portfolio before deciding if active management is preferable. He added that alpha opportunities exist with manager selection. Value is added by research, as well. With inefficient asset classes, there are opportunities to outperform with active management. Mr. Obed pointed out that the Bureau is a large organization with a significant portfolio which allows for negotiation of fees. Mr. Obed emphasized that the excess gross returns in Mercer's presentation were based on an analysis of returns and fees from active vs. passive management from 1986-2009. The S&P 500 study on passive management only reviewed two rolling five-year periods. Additionally, Mercer has a Manager Research division that deals solely with evaluation of investment managers.

Mr. Obed noted in determining alpha opportunities through manager selection, a review of the manager's ability to generate new and profitable investment ideas should be considered. Portfolio construction is also a factor to consider. Another consideration to review is how much of the value-added is given back through the costs of implementation. Any firm-wide issues such as risks or red flags should be considered. A Mercer rating of A or A- for a manager is the best. This rating shows that the manager can out-perform passive investments of the same asset class over the long term. A B+ rated manager would still be recommended. Mr. Smith noted that the hiring process for managers can be very selective and rigid. He emphasized that objectivity would be necessary since the size of the portfolio or the size of the mandate has traditionally excluded emerging or MWBE managers. Mr. Obed also indicated that alpha opportunities are available on fee savings. On a $25 million actively managed investment, the average management fee for an upper quartile management firm would be 75 basis points (bps). The average fee would be 51 bps on a $250 million investment. Mr. Obed added that some larger institutional investors have internal staff members who also manage funds. He added that the Bureau might save money by hiring an internal active manager rather than paying the external management fees. Mr. Smith noted that the Bureau would likely have a long, steep, expensive learning curve before hiring, and investing with, an internal manager.

In general, the current state of the economy has created opportunities to invest in high quality companies. Mr. Obed noted that an active manager has the ability to position the portfolio to pay off with stronger returns. Mr. Obed discussed an example given in the Mercer presentation of how an active equity manager was strategic in overweighting and underweighting important industry sectors.

With active management, there is an option of enhanced indexing. Enhanced indexing combines passive and active management. It allows a manager to replicate the index in most areas while permitting deviations to the index to capture extra returns. (Mr. Haffey re-joined the meeting during this discussion item at 11:29 a.m.)

Mr. Obed summarized the advantages and disadvantages of active management. Advantages include: expert analysis, higher returns and access to defensive measures to control risk. Higher fees and operating expenses are disadvantages to active management. Active management allows for the possibility of mistakes being made. These could lead to significant losses. Active management could create style issues where a manager's style clashes with the market. Mr. Smith pointed out that the best performance can follow underperformance. Mr. Price asked if mistakes could be limited. Mr. Obed replied that they can be somewhat limited by prohibiting derivatives and other risky investments, but he indicated that mistakes can be made when a manager is over-weighted in an area. Mr. Price noted that active management allows for the possibility of greater returns, but also the risk of greater losses.

The advantages and disadvantages of passive management were discussed. The advantages include: lower fees, guaranteed market performance and lack of a tracking error due to full or optimized replication. One disadvantage of passive indexing is the lack of control over the fund. An investor is limited by the actions of the fund managers or the firm. Additionally, performance is limited to market returns. With passive management, the duration of bonds cannot be adjusted based on rates.

The advantages and disadvantages of enhanced indexing were also discussed. Enhanced indexing allows for careful managing of position sizes and better control over market timing. The manager has the ability to hedge and can utilize leverage. Enhanced indexing is riskier than passive management. It also has relatively higher costs and a higher risk of losing capital due to ineffective fund management. With enhanced indexing, the selection of a manager is very important.

To determine which method to use, fees are important. The investor's goals and objectives need to be reviewed. Manager selection is important, as well as the amount of value added by an active manager. The Bureau's portfolio needs to be analyzed to determine which strategy is appropriate for each asset class. Mr. Caldwell observed there are no simple answers, based on the information gathered, as to whether the Bureau should switch to active management and, if so, for which asset classes. Mr. Smith noted that active management seems preferable for some asset classes, but ultimately, the expertise of the consultant is needed to determine which classes. Mr. Obed added that the Bureau needs to look at its objectives, the overall portfolio and the list of potential managers before a determination is made.

MERCER RECOMMENDED INVESTMENT MANAGERS VALUE ADDED RESEARCH DATABASE RESULTS

Mr. Obed referred to the document entitled "Value Added through Mercer Manager Research Recommendations" presentation, dated December 31, 2009, previously provided to the Board. The presentation is incorporated into the minutes by reference. Mercer's recommended manager candidates will generally be rated an A or A- with a view toward where value would be added with each asset class. The methodology for manager selection does not include transition fees. Ms. Falls noted that the average fees for each class needed to be considered. She also pointed out that the average turnover of managers is 16% per annum based on Mercer's presentation. Mr. Cooper responded that the presentation includes the portfolio transaction costs or trading costs of each manager, but excludes any transition costs involved in switching managers. Mr. Dunn added that a pre-trade analysis is requested of transition managers in order to find out the transition implementation costs. It was anticipated that the range of implementation costs would typically be between 10-25 bps. Mr. Harris pointed out that there is a disclaimer that performance is not guaranteed. Mr. Obed replied that the Mercer study shows where value has been added, but this does not guarantee that the portfolio will replicate past results. It also does not take into account the risk profile and the return streams. With U.S. Long Duration Fixed Income, the value added since inception is 1.4% and the information ratio since inception is 1.0 of A/A- managers. Mr. Obed indicated that the information ratio is the alpha divided by the tracking error of the portfolio (an adjusted return based on the risk taken). Mr. Smith pointed out that the higher information ratio is preferable since the return was high, but the tracking error risk was low. Ms. Falls pointed out the low information ratios. Mr. Obed responded that A/A- managers are not a homogeneous group. A manager may be A/A- if it opportunistically invests or if it is a conservative investor. Therefore the aggregation of performance and information ratios can skew results downwards if there are more conservative managers contained in a peer group.

Mr. Smith asked whether the Mercer "Sample of Highly Rated Managers of Active Strategies" presentation, previously provided to the Board, could be postponed due to time constraints. Mr. Cooper replied that the presentation would be moved to the May 2010 meeting. Mr. Smith complimented Mr. Obed on the presentations, noting that they did a good job in showing all of the factors and variables.

CALENDAR

Mr. Dunn referred to the 12-month Investment Committee Calendar. The calendar is incorporated into the minutes by reference. He noted that the May 27, 2010 Investment Committee meeting calendar reflects a discussion on cost analysis of active and passive management of the SIF asset classes. He added that there had been some mention of adding staff to handle the active management internally. He indicated that additional analysis and further discussion would be needed and that the issue was too premature to bring to the Board next month. Mr. Dunn asked about the statement made by Mr. Obed that the fees for external active managers can be negotiated. Mr. Smith replied that he was concerned about negotiating fees due to Most Favored Nation (MFN) status clauses that managers may hold with other large institutional investors. Typically under an MFN provision, an investment manager will automatically provide an investor the most favorable terms or conditions that it has provided similar institutions. He added that the Bureau would need to determine which resources were needed for active management. Ms. Falls pointed out that the asset classes should be prioritized and the size of the mandate with respect to each class should be considered. Mr. Dunn asked if alternative investment classes should be reviewed. Mr. Smith responded that it was his belief that the Investment Committee should stay focused on the public securities side for now. Mr. Dunn asked how high yield bonds should be handled since Mercer is recommending them. Mr. Smith replied that they should be discussed at some point, but noted that Mercer had noted that they would be discussed later. Mr. Smith instructed Mr. Dunn to provide "straw man" recommendations for discussion at the next Investment Committee meeting, focusing only on which existing SIF asset classes and recommended asset size should be considered for active management. Such recommendations should also consider prioritization of implementation. Ms. Falls asked about when the discussion on MWBE managers would be discussed. Mr. Dunn replied that the discussion was scheduled for June.

ADJOURN

A motion was made by Mr. Haffey, seconded by Ms. Caldwell to adjourn the meeting at 12:04 p.m. Roll call was taken and the motion passed 6-0.

Prepared by: Linda Byron, Staff Attorney, Legal Division, May 5, 2010