BWC Board of Directors

INVESTMENT COMMITTEE

Thursday, September 23, 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:	Jim Harris, James Hummel, Thomas Pitts
Members Absent:	None
Counsel Present:	John Williams, Assistant Attorney General James Barnes, BWC General Counsel
Staff Present:	Marsha Ryan, Administrator Bruce Dunn, Chief Investment Officer Lee Damsel, Director of Investments
Consultants Present:	Guy Cooper, Mercer Consulting Jordan Nault, Mercer Consulting Kweku Obed, Mercer Consulting
Scribe:	Linda Byron, Staff Attorney, Legal Division, BWC

CALL TO ORDER
Mr. Smith called the meeting to order at 9:37 a.m.

ROLL CALL
Roll call was taken. All members were present.

APPROVE MINUTES OF THE AUGUST 26, 2010 MEETING
Upon motion of Mr. Caldwell, seconded by Ms. Falls, the minutes of the August 26, 2010 meeting were approved as written. Roll call was taken and the motion passed 6-0.

AGENDA

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

DISCUSSION ITEMS:

MONTHLY AND FISCAL YEAR TO DATE PORTFOLIO VALUE COMPARISONS

Mr. Dunn, the Bureau's Chief Investment Officer, referred to the Invested Assets Market Value Comparison-Total Funds chart dated September 16, 2010. The chart is incorporated into the minutes by reference and was provided to the Committee in advance of the meeting. In the month of August, 2010, the portfolio had a net return of 1.0%, representing $199 million in net investment income. Bonds outperformed stocks in the month of August 2010. The bond portfolio had a net monthly return of positive 3.1% in August 2010, representing an increase of $322 million. The equity portfolio had a monthly net return of negative 3.7% in the same period, representing a market value decrease of $114 million. The Bureau experienced a net **realized** gain of approximately $95 million in the bond portfolio and a net **realized** loss of approximately $27 million in the equities portfolio for the month of August 2010 due primarily to the transition of the Coal Workers' Pneumoconiosis Fund (BLF) and Disabled Workers' Relief Fund (DWRF). The transition led to closure of separate account funds consisting of TIPS and long duration bonds. A commingled stock account managed to the S&P 500 index was also closed due to the transition. All funds were transferred in kind. In all, net **realized** gains totaling $70.8 million in bonds and $56.1 million in stocks were incurred as a result of the transition. For the month of August 2010, long government bonds returned 6.6% and long credit bonds returned 4.3%. The TIPS portfolio in the same month returned a positive 1.6%. The U.S. aggregate fixed income portfolio had a positive return of 1.3%. Mr. Dunn indicated that the yield curve is flattening. The market saw a flight to long government fixed income during August 2010. The equity market was significantly challenged during the same period. Cash increased $272 million during August 2010 due to increased operating cash from premium collections.

In fiscal year 2010 to date, the Bureau's total portfolio net investment income had a positive return of 3.9%, representing an increase of $755 million. The bond portfolio returned 4.3% over July and August 2010 to date while the equity portfolio returned 3.6% during the same period. For the first time in the history of the Bureau, the market value of the investment portfolio increased to over $20.0 billion at the end of August 31, 2010. This amount is net of receivables and payables. The market value of the Bureau's investment portfolio almost reached $20.0 billion in April 1998 when it totaled $19.984 billion.

MONTH-END PORTFOLIO ASSET ALLOCATION VALUES

Mr. Dunn referred to the Investment Asset Allocation-Combining Schedules as of July 31, 2010, dated August 18, 2010 and as of August 31, 2010, dated September 16, 2010. The schedules are incorporated into the minutes by reference and were provided to the Committee in advance of the meeting. The bond allocation in the State Insurance Fund (SIF) increased from 69.5% to 69.9% in the month of August 2010. In that same month, the stock allocation in the SIF decreased 2.0%. Cash in the SIF portfolio increased significantly from 1.3% to 2.8%.

Mr. Dunn referred to the BWC Invested Assets chart as of September 22, 2010, prepared by the Chief Investment Officer. The chart is incorporated into the minutes by reference and was provided to the Investment Committee just prior to the September 23, 2010 Investment Committee meeting in order to reflect the most current portfolio valuations. Mr. Dunn pointed out that the total Bureau portfolio returned 1.9% in September 2010 to date, reflecting an increase of approximately $400 million in market value of stocks and bonds. Bonds decreased in market value by $54.0 million, while stocks returned a positive 8.2% this month to date. The increase in market value of equities so far in September reflected strong corporate earnings, increased investor confidence due to increased corporate buybacks, the reduction of yields in the bond market and the increased issuance of dividends. Companies are also making strides in eliminating debt. Mr. Haffey added that he has personally observed an increase in smaller public companies which have restructured and initiated buybacks of common shares. Mr. Harris commended the Bureau's investment staff and Mercer Consulting, the Bureau's investment consulting firm, (hereinafter referred to as Mercer or Mercer Consulting) on exceeding $20.0 billion in total investment assets.

CIO REPORT- SEPTEMBER 2010

Mr. Dunn referred to the CIO Report-August 2010, dated September 17, 2010. The report is incorporated into the minutes by reference and was provided to the Committee in advance of the meeting. He indicated that the BLF and DWRF transitions are completed. All transitions for the two funds were completed in one day of trading with the exception of the transition of the U.S. aggregate fixed income. This strategy minimized transition costs. The transition of the DWRF funds from 20% to 30% in equities took place on August 9, 2010 when bonds were weak and equities were strong. The transition of the U.S. aggregate fixed income, with over 9,000 securities was most challenging, with a representative sample of bonds being purchased over seven days by the transition manager. The U.S. aggregate fixed income portfolio was then able to be transferred to State Street Global Advisors as the target manager. During the transition period, the U.S. aggregate fixed income benchmark returned positive 1.0%, the TIPS benchmark returned positive 1.2% and the Russell 3000 equity index returned a negative 6.3%. Ms. Falls commended the Bureau's investment staff and the Board, emphasizing that the transition illustrates that they are as serious about their fiduciary duty toward the specialty funds as they are with the SIF. Mr. Dunn then provided an update of the ACWI ex-US indexed assets passively managed by BlackRock. As of July 31, 2010, the amount of passively managed commingled funds managed by BlackRock that were benchmarked to the ACWI ex-U.S. had increased by $3.0 billion since December 31, 2009 to $20.1 billion. The specific fund that the Bureau has invested in is a commingled, non-ERISA fund which prohibits securities lending. Mr. Dunn noted that there are challenges to finding investors for this type of fund. He added that two other individual BlackRock clients, are invested in this fund. The Bureau's investment represents 89% of the total assets in that specific commingled fund. Ms. Falls asked for an update every six months on BlackRock's progress in enticing other interested investors. Guy Cooper, Partner with Mercer Consulting, added that Mercer is not concerned that the Bureau is one of three investors in the fund.

CIO RECOMMENDATIONS
Mr. Dunn referred to the CIO Recommendations-BWC New Investment Strategy Considerations for the State Insurance Fund report, dated September 14, 2010. The report is incorporated into the minutes by reference and was provided to the Committee in advance of the meeting. He pointed out that there are seven potential investment strategies with a recommended two phase implementation process. The report includes an implementation timeline. Mr. Dunn added that the investment strategy considerations, the timelines and the priorities are subject to change. It is anticipated that Phase 1 will be completed within eighteen months if the implementation begins early in 2011. The process will begin by issuing a Request for Proposal (RFP) for a manager. Mr. Dunn and Lee Damsel, the Bureau's Director of Investments, reviewed the staff resources before establishing the timeline. Mr. Dunn noted that the timeline is fairly ambitious. Mr. Smith inquired if the timeline could be sped up. Mr. Dunn responded in the negative. Ms. Falls asked if additional staff would be needed. Mr. Dunn replied that two new employees would be hired during the 2012 fiscal year. The new employees would be hired six months apart for training purposes. He also added that undoubtedly more staff would be required to monitor active management. Ms. Falls indicated that the timeline would depend on the recruiting and training of the new staff. Mr. Haffey asked if the scope of the Board's relationship with Mercer would be changing. Mr. Cooper answered that the contract was very flexible and anticipated these types of changes. Mr. Smith added that the implementation timeline might need to be extended since the RFP for the investment advisor would need to be issued soon.

Mr. Dunn pointed to the Priority One-Phase I Long Credit Fixed Income proposal. The Long Credit Fixed Income is the largest SIF portfolio asset class. Mr. Dunn emphasized that one concern with passive management of this asset class is the requirement that all credits must be held, including ones that are eroding in value. He added that the holding of just a few defaults can destroy returns. These losses can be avoided with active management with the added benefit of being able to over/underweight certain names and sectors. It is recommended that 20% of the current 28% target allocation in Long Credit Fixed Income be allotted to active management. Mr. Smith pointed out that Mercer's database showed active management returns that exceeded the benchmark. He added that there is an active debate regarding passive and active management, stating that when the mandate is being considered, the actual individual manager outperformance and information ratio should be reviewed. Mr. Dunn replied that there is real opportunity to beat the benchmark with Long Credit Fixed Income. For example, the passive indexed long duration fixed income manager of the Bureau for the DWRF and BLF funds underperformed the benchmark index by 60 basis points (bps) for fiscal year 2010.

Ms. Falls observed that in her experience, working with analysts in the bond arena, she has found the market to be very efficient and public information prevalent. She noted that she would consider all information presented on the subject, but added that she thought it would be difficult to find one manager who could consistently beat the market in this area. Mr. Price asked for thoughts from the Mercer representatives. Mr. Cooper responded that this topic is very hotly debated. He stated that he was personally waiting to hear the educational presentations before making a decision. Mr. Price indicated that he felt that 20% seemed like a lot of money to start out with for this strategy. Mr. Pitts clarified that the amount invested would be 20% of total assets of the total SIF portfolio allocation. Mr. Lhota asked Ms. Falls if she was concerned that the efficiency of the market would make it difficult to outperform the index or if she was concerned about underperformance. Ms. Falls replied that she was concerned about both. She reiterated that an active manager must anticipate when a company is failing and get out of that market before the other investors and must recognize when a company is beginning to prosper in order to enter that market before the other investors. Essentially, the active manager is using the bonds' duration and making interest rate bets. She added that many research tools have been available since 1990 to provide information on fixed income, reiterating that spreads tend to tighten quickly. Mr. Lhota asked Mercer Consulting to respond to Ms. Falls' comments. Mr. Cooper agreed that manager outperformance could be based on changing duration. He added that the Board would need to discuss if changing duration would be allowed and to what extent. Mr. Smith indicated that the Board would need to decide how much tolerance it had for placing limitations on an active manager. Mr. Dunn pointed out that the Board would have the ability to place tight restrictions on the duration. Mr. Caldwell noted that from the beginning, he has been uncomfortable with the Bureau investing in new areas due to the increased risk. He added that by seeing the success of the current investment strategies and through education on the new areas, he has become more open to new investments. However, he expressed heightened apprehension towards active management due in part to the debate among the Board members. He indicated that he would need to be shown the potential for outperformance and the extent of the risk. Mr. Smith responded that there is much less risk in the bond market.

Mr. Dunn referred the Board to the Priority Two-Phase I Minority and Women Business Enterprise (MWBE) investment managers' strategy. Mr. Dunn strongly recommends moving forward with a Manager of Manager (MoM) approach to get MWBE managers. A RFP will be issued to find one or more MoM's who will, in turn, hire the MWBE managers. The Board will not approve the specific selection of MWBE managers nor restrict the managers. That will be the responsibility of the MoM. To begin this strategy, Mr. Dunn recommended that 1% of the SIF invested assets, or approximately $180 million is to be invested with the MoM. Mr. Caldwell pointed out that the Board would need to look at the fees for hiring the MoM before making the final decision. Mr. Harris clarified that the MoM chooses the MWBE. Mr. Dunn responded that there will be no constraints on the MoM when it comes to choosing the MWBE. The MoM will be responsible for overseeing the portfolio, creating alpha and beating the benchmark. The Bureau Investment Division will closely oversee the MoM. Mr. Smith agreed with the targeted 1% based on the learning curve needed. Mr. Price added that a lot of work would be needed to learn about MoMs. He asked for an opinion from the Mercer representatives. Mr. Kweku Obed, Senior Associate with Mercer Consulting, replied that 1% is in line with what other plans do. The amount of the initial investment is usually determined by the time horizon, appetite for risk, the objective for MWBE and their intention for growing the program. If the intent is to eventually graduate the MWBE manager into the portfolio, then 1% is reasonable. Ms. Falls noted that usually a range is set for investing in a new area. She added that a range might have some advantages since the program would not begin for another year and the portfolio value would likely be different. Mr. Smith observed that in previous Administrations, it had been difficult for the Investment Division to oversee all of the investments. He asked about the change in dynamics with the addition of MWBE. Mr. Dunn indicated that the MoM format was chosen to minimize the additional pressures on the staff. Marsha Ryan, the Bureau Administrator, added that the MoM choice allows the Bureau to become involved more quickly with MWBE managers.

Mr. Dunn referred the Investment Committee to the Priority Three-Phase I cash overlay strategy. Under the strategy, part of the cash assets, approximately 1%, would remain in a money market account while the remainder would be transferred to a cash manager. That manager would then invest it in very liquid derivative contracts of benchmark indexes of the Bureau in order to earn higher expected returns. The returns could add an additional 10 or 12 bps to the total portfolio or $15-$20 million per year. A strategy of constantly rebalancing the portfolio with the trading of physical securities instead, would lead to much higher transaction fees.

With Priority Four-Phase I, the real estate strategy, the Bureau would invest in real estate as a way to hedge against inflation. Mr. Dunn noted that real estate returns are higher than bond returns traditionally and can even exceed equity returns, if inflation increases. Mr. Cooper added that initially the Bureau would focus on core open end funds. Eventually, the Bureau would move into closed end funds and REITS. This would take approximately 3-5 years. This strategy is not recommended for a RFP. Mr. Smith asked how the process would work since state law required a RFP. Mr. Dunn replied that an exception would be requested from DAS. Mr. Price indicated that he understood why only 1% of the target allocation was to be invested with MWBE since this money would be invested in a new area; however he was concerned that a 2.5-3.0% allocation was being proposed for real estate, another new investment area. He added that investing in real estate seemed riskier and that he felt that the targets should be the same. Mr. Dunn responded that real estate actually diversifies the portfolio because it is not correlated to stocks or bonds; it provides a good steady income and protections against inflation. He added that the Bureau would choose top quality property in good locations that were well leased. Mr. Smith added that real estate is an asset class while MWBE is not, explaining some of the lack of correlation in target asset classes. Mr. Cooper reiterated that investment in real estate reduces risk. Mr. Smith added that active management by MWBE added more risk. Mr. Caldwell asked if MWBE could be added to manage the real estate asset class. Mr. Obed replied that there was good representation of MWBE in real estate. He added that the California PERS (CALPERS) plan obtained good MWBE representation by investing in real estate. Ms. Falls asked if the timeline was going to be approved after the second reading or if the top two priorities would be chosen by looking at all of the alternatives. She recommended choosing the priorities because voting on the timeline would encourage more debate. Mr. Smith added that he felt that cash overlay should be a first priority. Mr. Price commended the Administrator, Mercer Consulting and the Investment Division on their hard work. He added that he would like to review the percentage being allocated to the MWBE managers to determine if a higher percentage would lead to more success and better returns.

Mr. Dunn referred the Investment Committee to the Phase II Priorities for active management. The first priority involves investing in small and mid cap equities where there are more stocks to choose from. Mr. Dunn added that this asset class included an impressive number of active managers whose returns were higher than the median. It is recommended that all of the approximately $725 million of, in effect, the current small and mid cap allocation for SIF be invested with an active manager. Mr. Dunn reiterated that this area provides significant opportunity for outperformance and higher returns. He estimates annual incremental returns of $8-16 million with a median manager. In non-U.S. equity, there is a good opportunity to overweight and underweight countries. The recommended allocation for active management of non-U.S. equity is 5% or one-half of the 10% currently allocated or approximately $900 million. Mr. Dunn indicated that U.S. Aggregate Fixed Income is not as large as the long credit mandate, but he added that certain bond sectors are significantly challenged and there are opportunities to overweight and underweight those bond sectors. Additionally, there are more bond sectors to choose from in the U.S. Aggregate benchmark index when compared to the Long Credit benchmark index. Mr. Dunn reiterated that he was concerned that index managers must hold all declining credits, but added that active management of this core fixed income area would add more modest value compared to long credit fixed income, so it is the last priority. It is recommended that 9% of the current 15% allocation to U.S. Aggregate Fixed Income be allocated to active management.

MWBE INVESTMENT POLICY RECOMMENDATIONS

Mr. Smith referred to the memorandum from Mercer Consulting entitled Suggested Investment Policy Changes-Section VIII and dated September 23, 2010. The report is incorporated into the minutes by reference and was provided to the Committee in advance of the meeting. The recommendations include revising the MWBE and qualifying Ohio managers' language in the Bureau's Investment Policy Statement (IPS). The recommendation is a joint recommendation from Mercer and the Bureau's Chief Investment Officer. Mr. Dunn pointed out that the MWBE investment manager must be a registered investment advisor based on the added language. He noted that this was an extremely important addition. Mr. Price asked if 1% could bring enough MoMs to bring in MWBE. He added that the portfolio was over $20.0 billion, so he felt that more than 1% should initially be invested with MWBE. He asked for periodic reports in order to add more money to MWBE. Mr. Smith asked if it was possible for a MoM to be a MWBE. Mr. Obed responded that MoMs tend to be MWBE firms. Mr. Cooper added that the plan was to hire two MoM firms. Mr. Smith asked how many managers would be hired under the MoM firm. Mr. Obed replied that it varies by asset class. Mr. Price indicated that he trusted the Board and the investment staff with the initial recommendation for investment with MWBE. Mr. Lhota asked why the Ohio manager language was being changed. Mr. Dunn responded that the language had been changed for clarity so that the requirements would be clearer. Mr. Lhota asked if MWBE firms would also be Ohio firms. Mr. Dunn responded that the MWBE firms might not also be Ohio firms. Mr. Smith indicated that the language regarding Ohio firms was not new language in the IPS. Mr. Pitts pointed out that transaction fees would dilute alpha. Mr. Dunn noted that the MoM would be responsible for overseeing both transaction fees and outperformance of the benchmark. Ms. Falls inquired about the three bullet point requirements for qualified Ohio investment managers and asked if they were based on legislative requirements or if they were Bureau specific. James Barnes, the Bureau's General Counsel indicated that the language was based on the Ohio Retirement Study Council's research results. Ms. Falls asked why the eligible assets classes did not include real estate, but did include large cap equities although they had not been recommended for active management. Mr. Cooper replied that the list was added in order to add specificity to the statement. Mr. Caldwell indicated that the statement was well thought out. Mr. Dunn pointed out that the IPS was revised to include investment managers, but remove the word brokers. He added that the Bureau will not choose an investment broker. Mr. Lhota pointed out that active management was not to take place until the second quarter of 2011. He asked if anything would be done before the October 2010 meeting that would warrant waiving the second reading of the revisions. Mr. Smith responded that the

waiving of the second reading would not change the timeline, but would show that the Board was moving forward.
Mr. Smith made a Motion of the Investment Committee to Waive the Second Reading of the Proposed Amendment of the Investment Policy Statement Regarding Qualified Minority and/or Women-Owned Investment Managers and Qualified Ohio Investment Managers, seconded by Mr. Price, as follows: I move that the Investment Committee of the Workers' Compensation Board of Directors waive the second reading of the proposed amendment to section VIII of the Statement of Investment Policy and Guidelines ("IPS") regarding fair consideration for qualified minority-owned and/or women-owned investment managers and qualified Ohio managers. Roll call was taken and the motion passed 6-0.

Mr. Price made a Motion of the Investment Committee to Recommend Amendment of the Investment Policy Statement Regarding Qualified Minority and/or Women-Owned Investment Managers and Qualified Ohio Investment Managers, seconded by Mr. Haffey, as follows: I move that the Investment Committee of the Workers' Compensation Board of Directors recommend to the Board that it amend current section VIII of the Statement of Investment Policy and Guidelines ("IPS") regarding fair consideration for qualified minority-owned and/or women-owned investment managers and qualified Ohio managers to fulfill BWC's investment objectives, for the reasons set forth in the memorandum of BWC's Chief Investment Officer dated September 15, 2010. The recommended amendments to the IPS are shown in the red-lined version of section VIII of the IPS prepared by Mercer Investment Consulting and the BWC Investment Division and will be incorporated by reference into the minutes of this meeting of the Committee. Ms. Falls added that she is in full support of the recommendation, but she would like to know about the changes to section B of the IPS and when the study was performed that provided the basis for the recommended changes. If that Ohio Retirement Study Council research was not current, she recommended reconsideration of the proposed revisions. Roll call was taken and the motion passed 6-0.

COMMITTEE CALENDAR
Mr. Smith directed the Committee to the 12—month Investment Committee Calendar, dated September 15, 2010. The calendar is incorporated into the minutes by reference and was given to the Committee prior to the meeting. The real estate presentation from Mercer Consulting was rescheduled for the October 2010 Investment Committee Meeting.

ADJOURN
A motion was made by Ms. Falls, seconded by Mr. Haffey to adjourn the meeting at 11:38 a.m. Roll call was taken and the motion passed 6-0.