BWC Board of Directors

INVESTMENT COMMITTEE

Wednesday, February 23, 2011 10:30 a.m.
William Green Building
30 West Spring Street, 2nd Floor (Mezzanine)
Columbus, Ohio 43215

Members Present:	Robert Smith, Chair Mark Palmer, Vice Chair David Caldwell Kenneth Haffey Larry Price Nicholas Zuk, ex officio
Other Members Present:	James Hummel, Stephen Lehecka, Jim Matesich, Thomas Pitts, Dewey Stokes
Members Absent:	None
Counsel Present:	Janyce Katz, Assistant Attorney General Jason Rafeld, Bureau Chief Legal Officer
Staff Present:	Stephen Buehrer, Administrator Bruce Dunn, Chief Investment Officer Lee Damsel, Director of Investments Donald C. Berno, Board Liaison
Consultants Present:	Kweku Obed, Senior Associate, Mercer Consulting
Scribe:	Linda Byron, Staff Attorney, Legal Division, BWC

CALL TO ORDER
Mr. Smith called the meeting to order at 10:27 a.m.

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

APPROVE MINUTES OF THE DECEMBER 15, 2010 MEETING
Upon motion of Mr. Caldwell, seconded by Mr. Haffey, the minutes of the December 15, 2010 meeting were approved as written. Roll call was taken and the motion passed 6-0.

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

NEW BUSINESS/ACTION ITEMS:
BWC MWBE MANAGER OF MANAGERS SEARCH
Before discussing Manager-of-Managers specifically, Mr. Smith discussed a study that had been performed by a colleague from his office who was working to obtain a Ph.D. from Case Western Reserve. The study researched high performing investment committees and discussed the seven elements of a strong investment committee. Those elements included: a strong rigor for investment decision-making, a commitment to learning, a focus on the mission of the organization, open mindedness, reflective of prior decisions, the support of complementary investment experts and consistent reviews of investment returns expectations. Mr. Smith indicated that the Bureau's Investment Committee incorporated all seven elements into its work.

Mr. Smith referred to the BWC Minority-Owned and/or Women-Owned Business Enterprises Manager-of-Managers Program Request for Proposals Issuance Recommendations report, dated February 14, 2011, prepared by the Chief Investment Officer. The report is incorporated into the minutes by reference and was provided to the Committee in advance of the meeting. Mr. Bruce Dunn, the Bureau's Chief Investment Officer, pointed out the Request for Proposals (RFP) timeline for the Manager-of-Managers (hereinafter MoM) investment services. During its September 24, 2010 meeting, the Board approved a revision to the Bureau's Statement of Investment Policy and Guidelines (IPS) for the purpose of initiating a Minority-Owned and/or Women-Owned Business Enterprise (MWBE) Investment Manager program. Mr. Dunn indicated that the MWBE managers would be overseen by a MoM. It was recommended that 1% of the Bureau's State Insurance Fund (SIF) total invested assets or approximately $185 million be invested in the MoM program initially. The Board approved five specific asset classes to be managed by the MoM program: large cap equities, mid cap equities, small cap equities, non-U.S. equities and core fixed income. Mr. Dunn indicated that this decision was reached through discussions with Mercer, the Bureau's investment consulting firm. He noted that most MWBE firms tend to focus on equities rather than fixed income. Mr. Dunn added that the Investment Division reviewed RFPs from other public funds as well as Mercer's research obtained in order to gather information to help draft the Bureau's related RFP. The RFP to select MWBE MoM firms is targeted to be issued on March 17, 2011. Thereafter, five weeks will be given to submit proposals. Mr. Dunn indicated that extensive due diligence would be performed on the RFP semifinalist respondents emerging after initial grading which will include interviews with all semifinalists and on site interviews with finalists. The preference is to select more than one MWBE MoM firm who have differing management styles. The final selections are to be presented to the Board during the July 2011 and August 2011 meetings based on the recommendations of the Evaluation Committee which includes Bruce Dunn, Lee Damsel, the Bureau's Director of Investments, and Greg Stought, a Bureau Investment Manager. The Bureau will also be considering the opinion of the Bureau's new investment consultant. Mr. Smith added that Mercer, the Bureau's current investment consultant, had advised the Bureau in October 2010 that the firm would be discontinuing its consulting business for advisement of public funds. Mr. Kweku Obed, Senior Associate of Mercer Consulting, indicated that the new investment advisor would likely support the MoM recommendation. He added that the size of the Bureau's investment portfolio and its desire to begin active management supported the MoM format.

Mr. Dunn pointed out that the fee scoring weighting can vary by RFP, but 15% had been assigned to the proposed fees for the MWBE MoM RFP. Once the MoM is approved, complete discretion will be given to the MoM to choose the underlying MWBE firms. Mr. Dunn added that the Bureau will meet the representatives of underlying investment management firms chosen by MWBE MoM firms managing Bureau assets sometime in the future. As required by the Ohio Revised Code, federal and state background checks will be performed on the chosen MWBE MoM firms as well as all of the underlying managers chosen by such MoM firms. Mr. Palmer clarified that the underlying managers could manage both equities and fixed income.

Mr. Pitts asked for specifics on why the MoM format had been chosen. Mr. Dunn answered that the MoM format would spread out the Bureau's exposure and risk. Additionally, the IPS limits the maximum amount that can be invested with one investment manager. Mr. Dunn added that the MoM structure would increase management fee costs. Mr. Stokes asked if any contract terms dealt with the termination of a manager. Mr. Dunn answered that all Bureau investment contracts allow for termination on very short notice with no specified reason. He also added that the MoM format easily allows assets to be reallocated to other managers. Mr. Hummel clarified that the RFP would reference more than one manager. Mr. Matesich asked that the blackout period be defined. Mr. Dunn explained that once an RFP is issued, the staff and Board are prohibited from discussing the RFP with outside parties and asked to limit discussions with internal parties. The purpose is to limit contact with potential candidates. Mr. Dunn indicated that the blackout period goes beyond the approval period up until final contracting is completed in case an alternative candidate must be chosen. Mr. Price mentioned that previous meetings had discussed a plan to begin with MWBEs that are monitored by MoM firms with the intention of bringing the MWBE in as the Bureau's direct manager later. Mr. Obed noted that many public plans use a MoM to find the best, high quality managers in order to establish a relationship that might lead to direct management of the portfolio. Mr. Dunn added that several questions in the RFP are directed to the graduation program whereby the MWBE firms could move from being involved with the MoM to direct investment management with the Bureau. The second stage interviews would discuss that process as well. Mr. Dunn pointed out that management fees could decrease with direct management of Bureau assets by MWBE firms. Mr. Zuk clarified that the MoM managers would have the ability to choose all underlying MWBE investment firms.

Mr. Palmer made a Motion of the Investment Committee to Recommend Issuance of a RFP for Manager-of-Managers Services of Minority-Owned and/or Women-Owned Business Enterprise (MWBE) Investment Management Firms, 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 authorize the Administrator to issue a Request for Proposals ("RFP") pursuant to section VIII of the Investment Policy and Guidelines for the services of one or more experienced and qualified Manager-of-Managers of Minority-Owned and/or Women-Owned Business Enterprise (MWBE) investment management firms to implement and manage the specific Minority-Owned and/or Women-Owned Business Enterprise investment managers investment strategy and further recommend that the Board direct the Administrator to consult with the Chief Investment Officer regarding the scope of services to be defined in the RFP as outlined in the February 16, 2011 memorandum of the Chief Investment Officer and that the Board direct the Administrator to do the same. Roll call was taken and the motion passed 6-0.

DISCUSSION ITEMS

PORFOLIO PERFORMANCE

Mr. Obed referred to the Ohio Bureau of Workers' Compensation Investment Performance Summary Fourth Quarter 2010 report, prepared by Mercer. The report is incorporated into the minutes by reference and was provided to the Committee in advance of the meeting. He indicated that although the market saw some significant movement during the fourth quarter of 2010, the Bureau's portfolio did not have any asset transitions in that same period. The estimated, as well as the actual, Gross Domestic Product (GDP) for the fourth quarter of 2010 was positive 3.2%. The interest rate curve flattened slightly. Intermediate bonds had a slight increase in rates. Unemployment was 9.4% at the end of the fourth quarter 2010. That rate has since decreased to 9.0%. Mr. Smith indicated that at the beginning of the recession, the United States lost approximately 8.4 million jobs. Of those, approximately 1.5 million have been recovered. Mr. Obed noted that due to the stimulus spending, the net yield spread between nominal Treasuries and TIPS has widened, which will have an inflationary impact. Mr. Obed pointed out the one year, three year and fourth quarter 2010 returns for domestic equity. Overall, small cap equities outperformed large cap equities. International equity returns were strong during the fourth quarter 2010. The Barclay's U.S. High Yield Index gained 3.2% in the fourth quarter 2010. Mr. Obed stated that future actions in Libya will affect commodity prices. Mr. Smith pointed out that by now, most investors' equity portfolios were back to their 2007 pre-recession balances. At the end of the fourth quarter 2010, the Bureau's Total Fund balance was $20.19 billion and the SIF balance was $18.49 billion. Both balances were lower than the prior quarter's due to higher net cash outflows. All of the Bureau's investment managers tracked their benchmarks for the fourth quarter 2010. Mr. Obed noted that a tracking error of 10 basis points (bps) of the benchmark is considered to be acceptable. He added that TIPS had a higher tracking error due to pricing differences, rather than performance. The long duration government index and the long duration credit index did not closely track the benchmark due to pricing differences and cash flow differences. Mr. Obed assured the Committee that over time, the pricing differences would be corrected.

In November, Mercer representatives met with all four of the Bureau's investment managers: State Street, BlackRock, Mellon Capital Management and Northern Trust Global Investments. Mr. Obed noted that since the Bureau is invested passively, the usual investment manager grading systems for active management do not apply. However, Mercer has created its own system to rate the Bureau's investment managers. All of the Bureau's investment managers have been rated by Mercer as preferred providers. Mr. Obed pointed out that the majority of the Bureau's assets are allocated to the SIF. The SIF makes up 91.6% of the Bureau's total assets. Mr. Smith noted that the Bureau's allocation of 30% equity and 70% fixed income is typical of an insurance company portfolio. Mr. Pitts asked for an explanation of the Bureau's separate designated funds. Mr. Dunn responded that the Bureau is required to keep certain separate accounts for certain designated groups of workers. The State Insurance Fund (SIF) is the largest fund. The other funds are the Disabled Workers' Relief Fund (DWRF), the Coal Workers' Pneumoconiosis Fund (also called the Black Lung Fund or BLF), the Public Work-Relief Employees' Fund (PWRF), the Marine Industry Fund (MIF) and the Self-Insuring Employers Guaranty Fund (SIEGF). Mr. Dunn added that the cash flows and liabilities for all accounts are closely monitored. Additionally, asset/liability studies were completed recently on several funds and investment strategies were recommended. Mr. Obed noted that the SIF portfolio performance had tight tracking of the benchmark during the fourth quarter 2010. No major issues were seen with any of the returns. Mr. Obed pointed out that the three year return for the total Fund was 5.4% and the five year return was 5.8%. Mr. Smith pointed out that the current returns are based on a completely passive portfolio while the addition of the MWBE firms would add an active component to the investing strategy.

MONTHLY AND FISCAL YEAR TO DATE PORTFOLIO VALUE COMPARISONS

Mr. Dunn referred to the Invested Assets Market Value Comparison-Total Funds report, dated January 18, 2011. The report is incorporated into the minutes by reference and was provided to the Committee in advance of the meeting. Mr. Dunn indicated that December 2010 was a strong month for performance. He also added that the investment asset value figures in the report would not match the figures in the Bureau's Enterprise Report since the Investment Division Board report nets out accounts receivable/payable amounts. Mr. Dunn explained that the index managers must wait until the end of the month to conduct rebalancing trading in order to match the index activity and track the benchmark as closely as possible. In the month of December 2010, stocks performed well and bonds declined in value. In the month of December 2010, equities returned positive 7.1% with approximately $423 million in net realized/unrealized gains. Bonds had a net monthly return of negative 1.4% in the same period with over $255 million in net realized/unrealized losses. These amounts included significant operating redemptions from both stocks and bonds in December 2010. Operating cash increased by $20 million in December 2010. Traditionally, the months of December and January have strong cash outflows for the Bureau. Mr. Dunn assured the Committee that these cash outflows are cyclical and predictable.

Mr. Dunn referred to the Invested Assets Market Value Comparison-Total Funds chart, dated February 16, 2011. The chart is incorporated into the minutes by reference and was provided to the Committee in advance of the meeting. In the month of January 2011, net investment income was $45 million. Bonds returned negative 0.5% with approximately $117 million in net realized/unrealized losses. Stocks returned positive 1.8% in January 2011. Mr. Dunn explained that the portfolio valuation is calculated using a marked to market value system. He indicated that in the fiscal year 2011 to date, the Bureau has only experienced one month of negative returns. In the fiscal year 2011 to date, the net portfolio return is positive 7.9% and the net investment income is approximately $1.5 billion. Bonds had a net realized gain of $161 million in the fiscal year 2011 to date due to transitions. Mr. Smith added that normally the amount of realized gains resulting from a transition would be important for tax purposes, but the Bureau's investment accounts are tax exempt. Mr. Dunn noted that the long government portfolio is underperforming the long credit, the U.S. Aggregate fixed income and TIPS portfolios for the SIF account. Mr. Smith added that normally the solution would be to shorten up on duration, but the Bureau must keep long durations due to its long duration liabilities. In fiscal year 2011 to date, equities had approximately $1.35 billion in net realized/unrealized gains. The equity portfolio is indexed to the Russell 3000 which represents 99% of the value of the U.S. market. International equities returned over 26.0% which translates to a positive 16.0% in local currency amounts, illustrating a depreciation of the U.S. Dollar compared to other combined currencies of 10%. Mr. Dunn indicated that non-U.S. equities returns for the Funds are sensitive to the exchange rate value of the U.S. Dollar. Mr. Smith added that international equities are a hedge against the U.S. Dollar. Mr. Dunn mentioned the majority of the market value of the Bureau's international stock portfolios are valued as Japanese Yen, Euros or U.K. Pounds before being translated to U.S. dollars for accounting valuation purposes. Mr. Dunn pointed out that the Bureau's international portfolio consists of all commingled funds. This allows the Bureau to avoid holding local currencies directly, making the investments more efficient and easier from a custodian and accounting viewpoint.

QUARTER-END PORTFOLIO TARGET ASSET ALLOCATION RESULTS AND VARIANCES

Lee Damsel, the Bureau's Director of Investments referred to the Investment Asset Allocation by Fund-Target Variance as of December 31, 2010 chart, dated January 13, 2011. The report is incorporated into the minutes by reference and was provided to the Committee in advance of the meeting. Ms. Damsel noted that the target variance chart is presented to the Board four times per year. Rebalancing is performed once per quarter, if necessary. No rebalancing was required at the end of December 2010. Ms. Damsel indicated that all asset allocations were within the IPS ranges at the end of December 2010.

MONTH-END PORTFOLIO ASSET ALLOCATION VALUES

Ms. Damsel referred to the Investment Asset Allocation-Combining Schedule as of November 30, 2010 report, dated December 14, 2010. The report is incorporated into the minutes by reference and was provided to the Committee in advance of the meeting. She also referred to the Investment Asset Allocation-Combining Schedule as of December 31, 2010 report, dated January 18, 2011. The report is incorporated into the minutes by reference and was provided to the Committee in advance of the meeting. Ms. Damsel pointed out the bond and stock allocations in the Investment Asset Allocation-Combining Schedule as of January 31, 2011 report, dated February 16, 2011. The report is incorporated into the minutes by reference and was provided to the Committee in advance of the meeting. Ms. Damsel noted that the SIF bond allocation decreased from 68.5% at the end of November 2010 to 67.0% at the end of December 2010. Bonds further decreased to 66.6% by the end of January 2011. Stocks increased during the same period for the SIF portfolio. At the end of November 30, 2010, stocks were 30.7%. They increased to 32.1% by the end of December 2010 and increased further to 32.6% by the end of January 2011. Mr. Smith noted that the Bureau remained committed to following its investment strategy by rebalancing, even during economic downturns.

Mr. Dunn referred to the BWC Invested Assets as of February 22, 2011 chart. The chart is incorporated into the minutes by reference and was provided to the Investment Committee just prior to the February 23, 2011 Investment Committee meeting in order to reflect the most current portfolio valuations. As of February 22, 2011, bonds increased in market value slightly from prior month-end, giving the month to date bond portfolio a positive return. In the month to date February 2011, bonds had a positive 0.2% return, an increase of approximately $22.0 million. In the same period, equities had a positive 2.5% return, an increase of approximately $161 million in market value from prior month-end. In the month to date February 2011, the total portfolio increased by approximately $183 million in market value for a total return of positive 0.9%. The fiscal year 2011 total portfolio return through end of January 2011 was positive 7.9%. Mr. Dunn responded that the U.S. domestic stock market value allocation for the SIF portfolio had been above its upper ownership range target for several consecutive trading days until one day before the meeting. The ownership allocation target is 20% of the overall invested assets. Mr. Dunn indicated that currently U.S. domestic stock was at 22.7%, but if it increased to more than 23.0% at the end of March 2011, portfolio rebalancing for SIF would be necessary.

CIO REPORT

Mr. Dunn referred to the CIO Report December 2010/January 2011, dated February 15, 2011. The report is incorporated into the minutes by reference and was provided to the Committee in advance of the meeting. Mr. Dunn mentioned the fiscal year 2011 goals of executing the IPS goals, implementing investment strategies and establishing controls and compliance procedures. Mr. Dunn indicated that a RFP to locate a new investment consultant was issued in November 2010. There were eight responses to the RFP. Interviews in Columbus, Ohio and on site interviews will take place before the finalist is recommended at the March 2011 meeting. Mr. Dunn mentioned that $110 million was redeemed in December 2010 from SIF U.S. equity funds managed by Northern Trust. The U.S. domestic stocks had outperformed all other invested asset classes for SIF in recent months. As a result, it was the asset class most above the target allocation at the time of the redemption made to meet operations funding needs. This redemption resulted in minimal stock trading commission costs. The liquidation created approximately $15.0 million in realized gain. From the SIF long credit bond portfolios, Mr. Dunn indicated $65 million of redemptions occurred between the end of November 2010 and early January 2011 to fund SIF operations. Mr. Dunn emphasized that all asset class allocations were in compliance with the IPS at the end of both December 2010 and January 2011.

LONG DURATION CREDIT ACTIVE MANAGEMENT

Mr. Dunn referred to the Chief Investment Officer Investment Policy Recommendation-Long Duration Credit Fixed Income Active Management, State Insurance Fund memo dated January 12, 2011 and prepared by the Chief Investment Officer. The memo is incorporated into the minutes by reference and was provided to the Committee in advance of the meeting. In May 2009, the Board approved a split of the SIF long duration fixed income portfolio from the long government/credit index into separate long government and long credit indexed funds. The goal of the split was to separate the two asset classes and to emphasize long credit over long government in order to generate more investment income. At the time, over 40% of the Bureau’s total assets were invested in Treasury bonds, including TIPS. Mr. Dunn emphasized that the decision was very timely. From August 2009 through the middle of February 2011, the long credit index had returned positive 12.7% while the long government index had returned positive 3.6%. The transition of approximately $1.6 billion from long government to long credit bonds for SIF has returned approximately $145 million in additional incremental investment income for SIF. The transition of long government to long credit bonds resulted in long credit bonds being the largest SIF asset class mandate whereby 28% of the SIF portfolio was allocated to long credit. The long credit portfolio is currently approximately $5.4 billion in market value. Mr. Dunn indicated that the expected tracking error for passive management of the long credit index was 25-30 bps for its largest index manager State Street.

Mr. Dunn stated there are many challenges that are faced by a long credit index passive manager. There are 1,300 issues in the long credit index, but not all trade and some are illiquid. A passive manager must retain all credits already owned if they remain in the benchmark index, even if they are declining in quality and value. A passive manager can only sell a bond once it leaves the index. Mr. Dunn pointed out that there is a lot of movement in corporate credit quality up and down, but only an active manager can overweight credits that are improving in quality and sell credits that are declining in quality if such credits remain in the benchmark index. In studies, active management of long credit outperformed the index by 1.0% gross of fees. Mr. Obed added that in Mercer's performance study on active management of long credit; all median managers outperformed the benchmark. Mr. Dunn indicated that State Street and BlackRock, the Bureau's passive managers of the long credit index, have both underperformed the benchmark by an average of 25 bps, gross of fees. Additionally, the annual fees for passive management of the long credit index are high at currently approximately 8.5 bps for BlackRock and 3.5 bps for State Street, due to the difficulties of passive management to this challenging benchmark index. In comparison, the annual index management fee for U.S. Equities is 1.0bps. The Mercer study found that the management fee for active long credit fixed income management is 15-16 bps. The difference in fees between active management and passive management for this asset class is small compared to other fixed income and especially equity benchmarks. Additionally, the IPS limits the maximum percentage of Bureau assets that can be managed by one passive index firm to 50%. The Bureau's proposed expected return after fees is 0.25% above the benchmark for active management of long credit, as reflected in the proposed language change of the Bureau's investment policy statement as presented by Mr. Dunn. It is expected that contracts with each active manager chosen will address specific investment guidelines, rather than the IPS. This allows the Bureau to remain protected without stifling specific investment styles designed to outperform benchmark indexes. Mr. Smith indicated there will be a second reading of Mr. Dunn's recommendation for active investment management of long credit next month with the intent of having a motion to vote on this recommendation.

COMMITTEE CALENDAR

Mr. Smith referred to the 12-month Investment Committee Calendar, dated February 16, 2011. The calendar is incorporated into the minutes by reference and was provided to the Committee in advance of the meeting. Mr. Dunn referred to the Recommended Phase I & II Strategies- Investment Committee Estimated Timetable, dated February 23, 2011. The timetable is incorporated into the minutes by reference and was provided to the Committee in advance of the meeting. It was noted that the Committee Calendar has been revised. Mr. Dunn indicated that one or two educational sessions will occur for each investment strategy before any related IPS revisions are made. The IPS changes will be approved by the Investment Committee and Board before a RFP is requested by the CIO to be issued. Mr. Dunn pointed out that a RFP will be issued for each proposed strategy reflected in this Timetable. There is a reasonable period of time between the issuance of the RFP and the recommendation of any finalist investment managers.

ADJOURN

A motion to adjourn the meeting at 12:08 p.m. was made by Mr. Haffey and seconded by Mr. Caldwell. Roll call was taken and the motion passed 6-0.