BWC Board of Directors

INVESTMENT COMMITTEE

Wednesday, June 15, 2011 10:00 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 Chan Cochran Kenneth Haffey Nicholas Zuk, ex officio
Other Members Present:	Peggy Griffith, Dave Johnson, Stephen Lehecka, Jim Matesich, Dewey Stokes
Members Absent:	None
Counsel Present:	Janyce Katz, Assistant Attorney General
Staff Present:	Bruce Dunn, Chief Investment Officer Lee Damsel, Director of Investments Donald Berno, Board Liaison
Consultants Present:	Guy Cooper, Senior Consultant, R.V. Kuhns Robert Palmeri, Senior Consultant, R.V. Kuhns Dan Krivinskas, Consultant, R.V. Kuhns Scott Krouse, Consultant, R.V. Kuhns
Scribe:	Linda Byron, Staff Attorney, Legal Division, BWC

CALL TO ORDER
Mr. Smith called the meeting to order at 10:21 a.m.

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

APPROVE MINUTES OF THE MAY 26, 2011 MEETING

Upon motion of Mr. Palmer, seconded by Mr. Haffey, the minutes of the May 26, 2011 meeting were approved as written. The vote was carried unanimously.

AGENDA
Upon motion of Mr. Caldwell, seconded by Mr. Palmer, the agenda was approved as written. The vote was carried unanimously.

NEW BUSINESS/ACTION ITEMS:
INVESTMENT MANAGER CONTRACT RENEWAL RECOMMENDATION
Before discussing the investment manager renewal recommendation, Mr. Smith discussed how the leadership, responsiveness and advice of the Bureau's Chief Investment Officer and the Bureau's outside consultant firm, R. V. Kuhns (hereinafter RVK) had been instrumental in assisting the Investment Committee and the Board of Directors in developing initiatives and determining best practices. Mr. Smith indicated that although he and Mr. Palmer are the Board's sole investment experts, all members of the Board of Directors are encouraged to participate in the discussions and ask questions. He pointed to a study that had been performed by a colleague from his office. The study discussed the seven elements of the best performing pools of endowment money. Those elements included: a strong rigor for investment decision-making, a commitment to learning, a focus on the mission, openness to new ideas, reflective decision-making, respect for investment expertise and an understanding of the expected risks and returns. Mr. Smith indicated that with liabilities of $32.0 billion, undiscounted, it is essential for the Bureau's Investment Committee to incorporate all seven elements. Mr. Caldwell thanked Bruce Dunn, the Bureau's Chief Investment Officer (CIO), Lee Damsel, the Bureau's Director of Investments and Guy Cooper, Senior Consultant with RVK, for providing the assistance and education that allowed the Bureau to make remarkable progress.

Mr. Dunn mentioned a memo from Ohio Treasurer of State Josh Mandel to Ohio Attorney General Mike DeWine that discussed the launching of an investigation into foreign exchange trading. The investigation includes Ohio's state pension funds as well as the Ohio Bureau of Workers' Compensation. The dispute focuses on best market execution, specifically currency exchange rate issues. It began with the State of California and State Street, its custodian. The dispute has grown to include other states and other custodians, such as BNY Mellon. Mr. Dunn noted that the Bureau's assigned custodian is the Treasurer of the State of Ohio. The Treasurer of the State of Ohio chose J.P. Morgan Chase Bank (Chase) as its sub-custodian for the invested assets of the Bureau. The Bureau began investing in international equities again in 2009. That was the first time that the Bureau had invested in international equities since 2005. The Bureau's international equities are represented in a commingled fund account structure with BlackRock serving as investment manager of such commingled fund. The custodian of that fund is State Street. BlackRock is responsible for making decisions on foreign exchange and trades. Mr. Dunn indicated that he and Ms. Damsel conduct quarterly reviews and attend quarterly meetings with BlackRock. Ms. Damsel noted that they also question State Street's CEO on foreign exchange practices on a yearly basis and have been satisfied with the company's responses. Mr. Dunn emphasized that other states, including California, continue to use State Street as a custodian executing foreign exchange transactions, despite the investigations. Mr. Palmer asked if the Bureau's arrangements were different from the arrangement of the other pension funds. Ms. Damsel replied in the affirmative and indicated there are different custodial platforms for domestic versus international investments. As a result, many funds have multiple custodians. She added that she would expect that the Ohio investigation would include all custodians servicing Ohio pension funds and the Bureau.

Mr. Smith referred to the Contract Renewal Recommendations memo of the Bureau's CIO dated June 9, 2011 pertaining to the Commingled Passive Intermediate Duration Fixed Income Index Manager for the Public Work-Relief Employees' Fund/Marine Industry Fund. The memo is incorporated into the minutes by reference and was provided to the Committee in advance of the meeting. The current investable assets of the combined funds are approximately $45 million. Mr. Smith noted that the estimated annual fee for State Street to manage the Public Work-Relief Employees' Fund and the Marine Industry Fund combined was approximately $17,000 or 3.8 basis points (bps) of asset market value. Mr. Dunn indicated that rather than having final defined expiration terms in investment management contracts, the terms are now being written to allow for periodic extensions contingent on satisfactory performance. The new investment management contracts will contain better quoted terms on management fees because of the lack of non-renewal termination contract dates. The Bureau will also avoid the long, arduous Request for Proposals (RFP) process at the expiration of the contract. Mr. Dunn noted that the Bureau will continue a disciplined approach where each manager would go before the Board at the expiration of the contract in order to review its performance and determine if renewal is recommended. Guy Cooper, Senior Consultant for RVK, the Bureau's investment consulting firm, noted that this is common practice for institutions in contracting with external investment managers. Mr. Smith indicated that he appreciated the fact that approval would still be reviewed by the Board. Mr. Zuk inquired if the Bureau anticipated a continuation of the five percent discount on fees from State Street with minimum invested assets under management of $4.0 billion. Mr. Dunn responded in the affirmative.

Mr. Palmer made a Motion of the Investment Committee to Recommend Renewal of the Current Investment Management Agreement with State Street Bank and Trust Company and to Amend the Contract to Allow for Optional Two Year Extensions of the Terms of the Contract at the Discretion of BWC with the Approval of the Board, seconded by Mr. Caldwell as follows: I move that the Investment Committee of the Workers' Compensation Board of Directors Recommend to the Board of Directors of the Bureau of Workers' Compensation ("Board") that the Board renew the current investment manager agreement with State Street Bank and Trust Company ("State Street") for continued participation as investors in the State Street managed intermediate duration U.S.

Government/Credit Bond index commingled fund for an additional two-year term commencing July 1, 2011 and ending June 30, 2013 and that the existing investment management agreement with State Street be amended to allow the Bureau of Workers' Compensation ("BWC") the option to extend the term of the contract for additional two-year terms beyond June 30, 2013 without limit at the discretion of BWC, with the specific approval of the Board for each additional two-year term extension. The motion was approved unanimously.

DISCUSSION ITEMS:
CIO RECOMMENDED ASSET CLASS REVISIONS
As an overview, Mr. Smith pointed out that the addition of real estate in the portfolio is intended to increase returns and diversification. He added that 70% of the State Insurance Fund (SIF) is invested in fixed income. Real estate should lower overall portfolio risk as well. Robert Palmeri, Senior Consultant with RVK, emphasized that his firm is an independent advising consultant. He added that RVK will be heavily involved in discussions on asset classes and external investment manager selection for the Bureau. Mr. Dunn referred to the State Insurance Fund Asset Allocation Review memo from RVK, dated May 26, 2011. The memo is incorporated into the minutes by reference and was provided to the Committee in advance of the meeting. Mr. Palmeri noted that the addition of real estate in the Bureau's State Insurance Fund portfolio is expected to increase returns by 20 bps and reduce risk as measured by expected standard deviation of returns from 8.50% to 8.45%. Mr. Zuk pointed out that the risk, or standard deviation for real estate was higher than several of the Bureau's other investment asset classes. Mr. Palmeri responded that the key was the negative correlation between real estate and several of the Bureau's other investments. When combined, this results in smoother returns. Mr. Smith noted that the inclusion of real estate actually increases overall returns while decreasing overall risk in the portfolio. Mr. Cooper added that they looked at the risk of adding real estate as well as how real estate correlates with the Bureau's current investments. Mr. Dunn pointed out that core real estate has a much higher expected return and a similar standard deviation when compared to long government bonds. Mr. Lehecka asked about the underlying distribution in real estate and whether or not the diversity created a bell curve. Dan Krivinskas, consultant with RVK, responded that as with stocks, real estate will have some winners and some losers, but that overall, there was enough diversification in real estate to resemble the bell curve. Mr. Smith asked how much diversification there would be in real estate. Mr. Krivinskas replied that small private funds hold 20-25 individual properties and large private funds hold 250-350. Mr. Cooper estimated that the Bureau would hold around 500 individual properties. Mr. Krivinskas added that value-added has more diversification, which could produce close to 1,000 properties when added to core real estate. Mr. Palmeri added that real estate also creates regional diversity. Mr. Palmer asked if there could be overlap with two different managers holding the same property. Mr. Krivinskas answered that RVK would watch to

make sure that the Bureau would not have overlap to any degree of properties in different private real estate funds.

R.V. KUHNS PRESENTATION ON REAL ESTATE AS AN ASSET CLASS

Mr. Smith referred to the Private Real Estate Recommendation-State Insurance Fund memo from RVK, dated April 28, 2011. The memo is incorporated into the minutes by reference and was provided to the Committee in advance of the meeting. Mr. Krivinskas introduced Scott Krouse, a consultant from RVK who works in the Cleveland office. Mr. Krivinskas referred to RVK's Real Estate Educational Presentation, dated June 15, 2011. The presentation is incorporated into the minutes by reference and was provided to the Committee just before the commencement of the meeting. Mr. Krivinskas discussed the benefits of having RVK as an investment consultant including its focus on risk and its governance rating system for real estate managers. Mr. Krivinskas discussed the type of real estate that the Bureau would be investing in, emphasizing that the properties would be commercial. Income and appreciation are the key components. Eighty percent of real estate returns come from income. Mr. Krivinskas added that the Bureau can be invested in equity and debt. He noted that real estate benefits include: low correlation with fixed income and common stock investments, inflationary hedging and liability matching. He emphasized that 70% of the Bureau's investments are in fixed income. Real estate provides income throughout the period of ownership while the value of the building is also increasing. Mr. Palmer pointed out that rental rates increase as inflation increases. Mr. Smith asked about the duration of the bond portfolio. Mr. Dunn replied that the bond duration for the SIF portfolio currently is 9.2 years while liabilities in the funds listed in the Bureau's Statement of Investment Policy and Guidelines (IPS) are 10-11 years. Mr. Dunn noted that fixed income assets and liabilities are reasonably well matched for SIF, but not perfectly matched. Also, the U.S. Aggregate bond index was introduced into the SIF portfolio in 2009 in order to reduce the duration of its fixed income portfolio. Long Credit bonds have the highest yield of the SIF bond portfolios which is currently 5.7%. Core real estate's income yield is comparable to this Long Credit bond portfolio yield. Mr. Smith emphasized that real estate is a long duration investment which will work well with the Bureau's long duration liabilities. Mr. Cooper added that the value of bonds will decrease as interest rates rise. Mr. Smith pointed out that the unrealized losses from bonds can be significant. Mr. Dunn noted that all bonds comprising the Barclays Capital Long Credit and Long Government indexes have a bond maturity of at least ten years. Since the Bureau's bond portfolio is completely passively managed, long duration passive managers are forced to sell any bond when its maturity falls below ten years and is therefore eliminated from the benchmark index.

Mr. Zuk pointed out that if interest rates rise, then the principal value of real estate could decrease, but the Bureau would still be getting a higher return over a lower base. Mr. Krivinskas added that traditionally investors who have both core and value-added properties have recovered the value of their portfolio with the income produced. The overall value might decrease, but the income remains the same. If the value then increases, the investor gets the benefit of the continued income and the increased value. Mr. Cochran stated that the case for diversification is abundantly clear. He then asked how the investment consultants chose real estate as opposed to other investments. Mr. Cooper replied that the investment consultants had looked at around 30 different types of new investments for the Bureau. He indicated that the other investments were too exotic or complicated and they did not have the benefits of real estate. Additionally, real estate seemed appropriate based on the current economic climate. Mr. Smith added that the Bureau had also investigated other types of real estate investments such as distressed and opportunistic properties, but chose not to use these other investment options. Mr. Cooper agreed.

Mr. Cochran indicated that he had done some personal research and there seems to be a dispute as to whether real estate had reached the bottom. He also added that he had seen properties with low occupancies. He asked RVK to address some of the downside issues. Mr. Krivinskas replied that they will be targeting properties that are not affected by low occupancies. The properties will be blended to have no more than 25% debt. He added that demand will continue for places to live and shop. Mr. Palmeri emphasized that the implementation process for private real estate fund investing will take over four years, essentially making it equivalent to dollar-cost averaging. This will have the advantage of smoothing fluctuations in real estate purchase pricing. Mr. Palmer added that the Bureau not only decided on real estate because it was at the bottom, but also due to the negative correlation and the decreased risk and increased returns. Mr. Smith noted that it provided similar returns to some exotic investments, but was less complicated. Mr. Cooper stated that all large pools of public investment funds should have some real estate. Mr. Smith asked about the traditional percentage. Mr. Cooper replied that most large public funds start with five percent and go no higher than 15%. Mr. Smith noted that the percentage recommendation would likely be different if the Bureau's portfolio included other exotic investments. Mr. Lehecka wondered why other private insurance companies typically avoid real estate. He decided that this was based on their tax issues, their accounting structure and the investment costs. Mr. Dunn added that the other companies might have shorter liabilities where liquidity is the main focus. He added that the Bureau has catastrophic reinsurance for outlier situations. He stated that the Bureau looks at the expense and the timing of the expenses with the premiums coming in. Mr. Smith explained that many people believe that the Bureau has a "pay as you go" system, but in fact, the current premiums are used to pay for claims that have already been made but not paid. Mr. Caldwell admitted that he has previously had difficulty embracing new investment vehicles due to his cautious nature. He added that he now embraces the differences between the Bureau and other private insurance companies and can accept the addition of real estate based on the discussions.

Mr. Stokes indicated that he understood RVK's role to be to find the best properties and attract quality managers who will not make risky investments. He added that investigations from the previous and the current Board showed that RVK had a good track record. Mr. Smith pointed out that RVK will be responsible for finding managers who have a good track record in the selection and management of core and value-added properties. He emphasized that real estate is a long term investment. Mr. Krivinskas emphasized that RVK is not a real estate investor, but rather an advisor. Any manager who is chosen will come before the Board and the Board will do the oversight. Mr. Stokes pointed out that other pensions are invested in real estate and have not done well in recent years. He asked about the projected return for the Bureau over ten years with the slow implementation process. Mr. Krivinskas responded that the average will be eight percent. Mr. Stokes noted that although property values have declined, rental values are increasing. Mr. Krivinskas emphasized that the majority of the return from real estate comes from rental income. The goal of buying value-added properties is to turn them into core real estate. Primarily, value-added real estate is found in the coastal areas of the United States. It can take 2-4 years to invest capital in value-added real estate. Mr. Johnson noted that everyone has heard news reports on the bad real estate market with both residential and commercial. He asked about the worst case scenario. Mr. Krivinskas explained that the most recent recession demonstrates the worst case scenario. Mr. Cooper indicated that he would imagine a second depression that affects all asset classes to be the worst case scenario. Mr. Krivinskas added that the recovery is here and commercial real estate has already recovered 40% of its decline. He added that even with a lower value, real estate will continue to provide income. Mr. Stokes recapped that the Bureau would be investing approximately $1.2 billion in real estate over a 4-5 year implementation period and the majority of the investments would be in core real estate.

MONTHLY AND FISCAL YEAR-TO-DATE PORTFOLIO VALUE COMPARISONS

Mr. Dunn referred to the Invested Assets Market Value Comparison-Total Funds chart, dated June 14, 2011. The report is incorporated into the minutes by reference and was provided to the Committee at the start of the meeting. Mr. Dunn indicated that all assets are mark-to-market. In May 2011, the net investment return of the portfolio was positive 0.6% or $135 million. This increase was fueled by bonds. Mr. Dunn pointed out that in the last 11 months of the current fiscal year, the Bureau has only experienced one month of negative returns. Equities experienced negative returns for May 2011 due to slower economic growth than expected as well as concerns over Greece and other countries. Long government bonds were the best performer for the month of May 2011. In the fiscal year-to-date ending May 2011, net investment income was approximately $2.6 billion. This represented a positive return of 13.6% for the portfolio. In the fiscal year-to-date, long credit bonds had a positive return of 8.5% while long government returned positive 1.1% in the same period. Currently, U.S.

equity makes up 2/3 of the total equity portfolio while international accounts for the remaining 1/3 of equities or 10% of the total portfolio. The fluctuation in the U.S. Dollar has been very important to the Bureau's equity returns. The fiscal year-to-date return on the all cap U.S. only equity portfolio was 35.4% while the non-U.S. equity portfolio return was 31.7%. International stocks returned positive 17.7% overall in terms of their respective local currencies so that the U.S. Dollar weakness when compared to other foreign currencies accounted for the remaining 14.0% positive return fiscal year-to-date.

MONTH-END PORTFOLIO ASSET ALLOCATION VALUES
Ms. Damsel referred to the Investment Asset Allocation-Combining Schedules as of April 30, 2011, dated June 1, 2011 and the Investment Asset Allocation-Combining Schedules as of May 31, 2011, dated June 14, 2011. The charts are incorporated into the minutes by reference and were provided to the Committee in advance of the meeting. She noted that the Bureau's IPS contains the asset allocations for each fund. All funds were within their guidelines.

MONTH-TO-DATE PORTFOLIO VALUE AND PERFORMANCE UPDATE
Mr. Dunn referred to the BWC Invested Assets as of June 14, 2011 chart. The chart is incorporated into the minutes by reference and was provided to the Investment Committee just prior to the June 15, 2011 Investment Committee meeting in order to reflect the most current portfolio valuations. In the month-to-date as of June 14, 2011, bonds returned negative 0.7%. Equities returned negative 3.9% in the same period. Overall, the portfolio had a negative return of 1.7% month-to-date.

CIO REPORT
Mr. Dunn referred to the CIO Report for May 2011, dated June 9, 2011. The report is incorporated into the minutes by reference and was provided to the Committee in advance of the meeting. Mr. Dunn noted that the CIO report includes updates on the two outstanding RFPs. Both are in the blackout period so there should be no contact between Board members and potential applicants. Currently, 1% of the SIF is to be shifted to a Manager-of-Managers (MoM) for selection of Minority-or-Women-Owned (MWBE) managers. A RFP has also been issued for active managers of long credit fixed income. It was noted that consultants from RVK, Mr. Dunn and Ms. Damsel have all been very engaged in these RFPs. The RVK consultants helped draft the questions for the active long credit fixed income managers RFP. There will be a RFP for core real estate managers if that asset class is approved.

COMMITTEE CALENDAR
Mr. Smith referred to the 12-month Investment Committee Calendar, dated June 9, 2011. The calendar is incorporated into the minutes by reference and was provided to the Committee in advance of the meeting. Mr. Smith indicated that with several new Board and Committee members, it was unlikely that a vote on

real estate as an asset class would take place in July. The first educational session on U.S. Small/Mid Cap Equity active management will be moved to August 2011 due to the significant agenda for July 2011.

ADJOURN

A motion to adjourn the meeting at 12:22 p.m. was made by Mr. Caldwell and seconded by Mr. Haffey. The vote was carried unanimously.