

To: Governor Bob Taft
From: Bureau of Workers Compensation Management Review Team
Subject: Interim Report
Date: August 22, 2005
CC: Workers Compensation Oversight Commission
Tina Kielmeyer, Interim Administrator

On June 3, 2005, you appointed Ms. Tina Kielmeyer as Interim Administrator of the Bureau of Workers Compensation and named a Management Review Team. The members of the Management Review Team (MRT) include Laurie Hacking, Executive Director of OPERS, Jim Nichols, Treasurer of The Ohio State University and Ohio Lottery Director Tom Hayes. The primary mission of the MRT was to assist Ms. Kielmeyer with her transition to Administrator and to conduct a thorough review of the BWC investment portfolio. As part of this assignment you requested an Interim Report to insure that as issues were identified, BWC took appropriate action on any recommendations.

The following is presented as an Interim Report on the progress of the MRT and our efforts to date to stabilize and improve the investment program at BWC. When the MRT was formed we were charged to do the following:

- Complete a systematic review of the BWC investment portfolio, including a review of internal audit and control systems.
- Contract, if necessary, with independent evaluators to assist with the investment review.
- Assess the BWC investment management and audit staffing.
- Consult on these matters with the BWC Oversight Commission.
- Cooperate fully with all ongoing investigations.

The Consultant retained for this project, EnnisKnupp + Associates (EK), is in the process of conducting a systematic review of all of the investment managers to determine which should be retained and which should be terminated. Their initial focus is on those managers that deal in marketable securities which comprise over 97% of the BWC portfolio. It is anticipated that this work will be completed by the end of September 2005. EK is also working on a review of the private equity partnerships but this analysis will take longer as each partnership must be reviewed and compared to the terms and conditions of the individual contract. It is anticipated that this work will be completed by the end of November 2005. The results of all of these reviews have been and will continue to be publicly reported as action is taken with any individual investment manager.

The MRT and EK have also been looking at the overall management of the investment function at BWC and a number of actions, recommendations and options are highlighted in this report.

The MRT participated in the previous two WCOC meetings and presented a report on our progress and observations to the Commission members. The MRT Chairman met with

Inspector General Tom Charles on two occasions and briefed him on our findings. The BWC administration is also working closely with all agents of the Attorney General and the Auditor of State as they complete their reviews of the various issues pertaining to the BWC Investment Department.

For purposes of clarity, this report is divided into three parts. The first part, Governance, tries to address the confusing organizational structures that lead, in part, to some of the current difficulties at the BWC. In this section we will propose alternatives to increase oversight of the BWC Investment Department and to insure that decision can be made in an objective manner based on independent financial advice.

The second section, Assessment of Investment Operations, focuses on the problems that we observed when our assignment began. This is followed by either the actions taken to resolve the problems or the recommendations for addressing the problems in the future.

The third section, Future Action Steps, discusses alternatives to the current operating organization for the BWC Investment Department. This section is based on the realization that the BWC, based on current staffing levels and expertise is not currently capable of managing its investment portfolio internally, nor is it likely to be able to do so in the near future.

It is recognized that this report does not represent all of the work done to date but merely the highlights of those issues that directly lead to the problems confronting the BWC Investment Department. In addition to input from the MRT members portions of this report were prepared with the assistance of EK+A and Internal Audit Manager Keith Elliot.

Governance

The governance structure for BWC investments is a critical, foundational element for insuring that BWC's investment program is run properly in the future. A proper governance structure should clearly delineate what individuals/entities have the authority to make investment decisions and what process is to be followed in making those decisions.

BWC's assets constitute a trust fund, meaning that funds are held in trust and are to be invested for the exclusive benefit of the beneficiaries of BWC's worker compensation programs. The persons responsible for investing the funds are fiduciaries and, therefore, must assure that assets are invested properly and for the exclusive benefit of BWC beneficiaries. Fiduciaries are accountable to the beneficiaries of the fund and the sponsors of the fund (employers). As fiduciaries, those responsible for investing the funds must use the prudent expert standard in making investment decisions.

HB 66, as recently enacted, has clarified that the Workers Compensation Oversight Commission (WCOC) members are fiduciaries and will be held to a high standard of care

in investing BWC assets. To support and reinforce the WCOC's fiduciary role, the MRT is making a number of recommendations outlined below.

BWC Investment Board Recommendation

Under the recently-revised law, responsibility for investments remains with WCOC, however, two new investment experts have been added to the Commission, recognizing the need for increased focus and expertise for overseeing BWC investments.

We believe the investment and oversight of a portfolio of BWC's size is a demanding and complex task. Therefore, we recommend an approach similar to what was suggested by Governor Taft two months ago -- that is, creation a new, separate and independent investment board composed of seven members -- five investment experts, two appointed by the Treasurer, one by the Governor and two by the General Assembly (one each appointed by the majority and minority leaderships) and two from the WCOC, one representing employees and one representing employers. Those appointed should be more than experts in the financial field, but more appropriately, experts in institutional investing. These individuals should have no conflicts of interest and no financial or business ties to firms which do business or potentially would do business with BWC (as outlined in HB 66). Their appointments should be subject to advice and consent of the Ohio Senate.

An alternative to a separate Investment Board would be to keep WCOC responsible for investments, but add two to four more investment experts. The WCOC would then create a special WCOC Investment Committee composed of the additional investment experts and one member of WCOC. This alternative could be created immediately by resolution of the WCOC and could serve until authority to create the separate Investment Board contemplated above makes its way through the legislative process.

BWC Investment Board Authority and Responsibilities

Once organized the new Investment Board (or alternative WCOC Investment Committee) responsibilities should include:

1. Hiring an independent investment consultant/advisor responsible for advising the board on the investment of BWC assets. Using an outside consultant would allow the board to establish a system of checks and balances to verify proper operation of the investment program. It is important that this consultant have no financial ties to money managers, brokers or other investment providers. The consultant should be selected by and report directly to the Investment Board. The consultant should be expected to collaborate with Investment Division staff. The consultant and/or the investment staff in conjunction with the consultant should be responsible for the following:
 - Regular reporting to the board on investment performance
 - Conducting periodic asset liability studies in coordination with BWC's actuary
 - Assisting the board with developing comprehensive investment policies and procedures which clearly delineate roles and responsibilities of all key parties (Board, Board Chair, CIO, staff, investment consultant)

- Guiding the board in developing policies and strategies for each asset class and the total fund
 - Assisting the board with selecting managers, developing manager retention policies, and negotiating manager fees
 - Monitoring compliance with the board's investment policies and procedures
2. Hire a highly competent Chief Investment Officer who would report directly to the Investment Board, rather than to the BWC Administrator.
 3. Develop and adopt a board code of conduct and ethics policy.
 4. Review and approve the Investment Department's budget, staffing levels and salaries to assure that adequate resources are devoted to investments and that competitive salaries are paid to attract and retain competent staff.
 5. Working with its investment consultant, the Investment Board should assure that adequate staff, IT, accounting, custody, control systems and auditing structures are in place to support the Investment Department and allow proper oversight and accounting of assets.
 6. Commission a fiduciary performance audit within three years of completing the governance restructuring and at least every five years thereafter.
 7. Regularly report to the WCOC and General Assembly on investment performance.

Related Recommendations

1. BWC's in-house legal and internal audit staff should have sufficient number of specialized personnel dedicated to the Investment Department, given the complex nature of the investments and the need for adequate oversight and controls.
2. BWC's actuary should regularly report to the Investment Board regarding the nature of BWC's liabilities and adequacy of its financial reserves. The actuary should be involved in periodic asset liability studies.
3. BWC's Internal Auditor should report directly (dotted line) and regularly to the Investment Board on investment-related audit activities. BWC's external auditor should report in the same manner regarding investments and the financial statements.
4. The Investment Board should establish a policy and practice for regular fiduciary and investment education to maintain the high prudent expert standard of fiduciary and investment knowledge and skill.
5. BWC and the WCOC should select an investment consultant in the near future with the understanding that this is an interim appointment and that the appointing authority arising out of the alternative governance structures contemplated above could change consultants at a later date.
6. The new investment consultant could tackle most of what we had outlined in Phase 2 of the MRT's Scope and Methodology document. It is critical that Phase 2 be carried out collaboratively with the new WCOC or Investment Board. Those recommendations need to be developed with full participation by WCOC/Investment Board, not imposed upon them from outsiders.

7. In addition to the new governance structure for the investment program, the WCOC should create a committee structure including, but not limited to an Audit Committee and an Actuary Committee.

Assessment of Investment Operations

Organizational Deficiencies

Powers of Attorney were granted to two members of the investment staff, Terry Gasper and Bob Cowman, giving them complete authority to conduct transactions and to enter into contracts on behalf of BWC

Action: All powers of attorney were rescinded by order of the Interim Administrator

Investment staff were required to report through various levels of the administration before reaching the Administrator. This served to stifle staff from raising questions and concerns they may have about the practices in the Investment Department.

Action: The Investment Department was made a direct report to the Administrator by the Interim Administrator

The investment consultant, Callan & Associates, reported to BWC Investment Department, not to the WCOC, on investment performance and evaluation of managers. As a result, WCOC was denied independent advice and verification of investment performance.

Action: The WCOC will direct the hiring of a new investment consultant who will report directly to the Commission providing it with better checks and balances on the performance of managers and the total portfolio.

The Investment Department did not follow the usual policies and procedures of BWC when entering into contracts. Although it is understood that on a short term, emergency basis that services will be provided outside of the normal procurement process in an effort to stabilize the fund, an appropriate procurement process must be established and utilized going forward.

Action: The Interim Administrator now requires the Investment Department to follow all existing procedures for contracting and procurement including a review by the Law Department. In addition, the Interim Administrator directed staff that she would sign all contracts in the future and will develop long term financial relationships through a competitive procurement process.

The contracts with the Investment Managers did not contain a restriction on campaign contributions as required under ORC 3517.13. Beginning in 2001, RFPs contained the 3517.13 restrictions but they were only incorporated into the contract by reference. BWC's previous position was that these contracts were competitively bid and therefore exempt from the requirements of the law.

Action: The Interim Administrator has directed staff to include the restrictions of ORC 3517.13 in all contracts regardless of the method of procurement.

The current staff of the BWC Investment Department is both understaffed and under trained to carry out the mission of the Department.

Recommendation: The BWC should immediately hire experienced and credentialed investment professionals to assist in the management of the portfolio. In addition, the BWC should examine alternative organizational structures including moving away from the in-house management of the BWC investment portfolio.

The Treasurer of State, through an RFP process, selects one of the six Ohio banks to serve as the custodial bank for BWC. Although input is sought by the TOS the BWC has no role in evaluating the RFPs or selecting the custodial bank. The BWC recently terminated a number of Investment Managers for poor performance, including two of the six banks that will be considered to serve as the BWC custodial bank. This could place the BWC in the unusual position of being assigned a custodial bank in July 2006 that it terminated as an investment manager in 2005.

Recommendation: The BWC should be permitted to participate in the selection process for its custodial bank and granted right of refusal to prevent any bank that was terminated as an Investment Manager during the previous four years from serving as the BWC Custodial Bank.

Investment Management and Internal Controls

Once a decision is made to terminate an Investment Manager there was no appropriate place to temporarily place the money until the appropriate investment decision could be made.

Action: At the last WCOC meeting the Interim Administrator received authority to contract with Barclay's Global Investors or State Street Global Advisors to serve as passive index fund managers for the BWC. A contract is being prepared to secure the services of State Street Global Advisors.

The Ancillary Investment Portfolio is currently managed by the investment staff and suffers from a lack of well defined guidelines for the successful management of the assets in this fund and staff lack appropriate supervision.

Recommendation: The BWC should follow the recommendation of EK and contract with an existing BWC fixed income manager, to assume responsibility for the management of the \$1.3 billion in assets in the Ancillary Fund. This arrangement should continue until the BWC has the opportunity to competitively bid the service.

The BWC Internal Auditor is understaffed and is therefore required to rely on the work product of external investment consultants to audit fund manager

performance and to audit the criteria and procedures for the selection of fund managers. The Internal Auditor's reports were not shared with the WCOC. As early as May 18, 2000, Manager of Internal Audit Keith Elliot voiced significant concerns with the operations of the Capital Coin Fund by memorandum to the former CFO and CIO. Unfortunately, the WCOC never saw this document.

Recommendation: Increase the staff of the Internal Auditor and its independence by having all reports sent directly to the WCOC or newly-created Investment Board, the Auditor of State (AOS) and the Administrator. Auditing staff should include staff dedicated and trained in investments.

The BWC Internal Auditor was discouraged from conducting a full audit of the Capital Coin Fund. The former CFO and CIO, according to the Internal Auditor, did not want to place an "undue burden" on Tom Noe and therefore would not allow the Internal Auditor direct access to the Capital Coin Fund (CCF) Investment Manager. As an alternative the CCF Investment Manager accepted a set of "agreed upon procedures" for valuing the assets.

Recommendation: The Internal Auditor must be given free and unfettered access to all investment managers to insure that all managers are operating in a manner consistent with their contract and generally accepted accounting principles.

In the Capital Coin Investment, the lack of audited financial statements reduced BWC's ability to become aware of internal control and other issues in a timely manner.

Recommendation: BWC should require all private equity funds and other similar investments to provide audited financial statements annually, which are prepared in accordance with U.S. Generally Accepted Accounting Principles. In addition, based on discussions with the BWC Chief Investment Officer, BWC may also want to consider requiring SAS 70 reports for these funds/investments.

The Internal Auditor was not given direct access to the internal investment data and accounting system (QED) due to the cost of physically running a line between floors. This prevented the Internal Auditor from having access to the tools necessary to perform a thorough, unconstrained review of the actions of the Investment Department.

Recommendation: The Internal Auditor should be given immediate and direct access to the QED system and the Oracle financial system.

The current investment policy requires Oversight Commission approval of investment managers, but not of all investment funds. Since MDL Active Duration was a new fund with an existing manager, the existing control did not appear to require such approval based solely on the creation of the second fund. However, the BWC Investment Policy indicates "...The investment activities of an approved Fund Manager may not vary from the scope of activities previously

approved by the Oversight Commission without the prior approval of the Oversight Commission." The initial investment documentation reviewed and approved by the Oversight Commission did not include or permit the use of leverage. As such, the creation of the new fund should have required this approval. Unfortunately, there were no controls in place to ensure compliance with this requirement;

Recommendation: The BWC Investment Policy should be modified to require Oversight Commission (or Investment Board) review and approval of all Investment Funds, in addition to Fund Managers. This approval documentation should accompany all initial funding requests to provide evidence of proper approval. The Internal Auditor should be charged with responsibility to for auditing compliance with this policy.

The Investment Department generates the requests for the transfer of funds and is also the contact with the Treasurer to have the funds transferred. Failure to have another party outside of the Investment Department act as the contact with the Treasurer may present control issues.

Recommendation: BWC should consider improving segregation of duties for the process of requesting fund transfers for investments. This would help ensure that all such requests were properly approved and that any related subscription agreements received the proper review and approval from the Administrator, the Chief Investment Officer and any other appropriate members of BWC management.

The current funding process does not require more than one signature on requests for funding of investments. Currently, the Chief Financial Officer, Chief Investment Officer, and/or one of the Senior Investment Officers can execute these requests with no additional authorization. Permitting transfers of funds based on signatures of only one individual increases the potential for inappropriate activity.

Recommendation: BWC should modify internal procedures for funding investment managers to require two signatures on the requests for funding, one of which should be from the Administrator and CIO.

The Quarterly Investment Reports did not include detailed reporting to the Oversight Commission, and other members of BWC management, regarding all investment managers, the nature of their respective investments, the cumulative amounts funded, current market values and cumulative performance for each manager. Instead, only summary information is presented by asset classification or type of investment. In addition, failure to present the cumulative funding of the various managers, current market values, and total gains and losses for the individual investment managers decreases the ability to readily identify investment managers with significant losses.

Recommendation: The Quarterly Investment Reporting Process should be modified to conform to current investment industry standards and should include a comprehensive listing of all investments, including the nature of

the investment, the primary investment manager, the cumulative amounts funded, current market values and the performance net of fees since inception of the manager. Such a requirement will help identify investments with significant losses and will increase the transparency of reporting of all BWC investments. Oversight would be improved by requiring that these reports be prepared or reviewed by the independent investment consultant hired by the WCOC/Investment Board.

The manager for MDL did not have any experience managing a hedge fund, despite investment policy requirements that managers have such experience. Existing controls were not effective in ensuring that before the investment was funded someone outside of investments validated that the manager met all eligibility requirements.

Recommendation: When a new manager is approved for funding, documentation substantiating that the manager meets all required eligibility and experience requirements should be prepared and forwarded to an independent party outside of the Investment Department to review and validate prior to funding the investment.

In both the MDL and Capital Coin scenarios, BWC's investment represented 99%-100% of the total investment managed by the respective fund. The lack of other investors in investment funds increases risk to the agency. Where other investors are active in the funds selected, BWC benefits from a spreading of risk among multiple investors and from the indirect mitigating control resulting from the other investors due diligence in evaluating the appropriateness of the investment and the adequacy of controls.

Recommendation: BWC should consider establishing limits on the percentage BWC's investments can constitute of the total investment in a private equity or joint venture fund (e.g., 5%, 10% of the total investment). Such limitations will ensure that other investors are involved in the investments chosen, which will serve as an indirect mitigating control via the due diligence the other investors will perform regarding the merits of the investment and adequacy of control procedures.

Cash management was managed by BWC investment staff and was invested without any standards, policies or supervision.

Action: Cash management function was moved to the BWC custodial bank, JP Morgan/Chase. A policy will be established governing cash management.

The BWC's Custodial Bank, JP Morgan/Chase also currently serves as an Investment Manager for BWC running a mid cap domestic equity portfolio on behalf of the BWC. While we recognize that JP Morgan/Chase has performed well in both of their current capacities, serving in both could create a conflict. One of the functions of the custodial bank is to participate in the valuation of the

assets of the BWC and therefore could place the custodial bank in the unusual position of evaluating its own performance.

Recommendation: The WCOC should amend their investment policies to either restrict the custodial bank from also serving as an investment manager or develop an alternative, independent method of evaluating their performance.

Consultant Services

At the direction of BWC Investment Department, Callan & Associates was required to conduct an asset liability study using the “total return” method only and not a liability driven approach that would match asset allocation with future liabilities. The result of this action would provide the BWC with an incomplete view of its future obligations and could result in an asset allocation plan that is inappropriate to meet the future liability needs of the BWC.

Action: Callan & Associates were requested to include the liability driven approach when preparing their asset allocation study.

Recommendation: Once the BWC and the WCOC have completed their RFP and selected a new Investment Consultant, that consultant should review the work completed by Callan and either confirm their recommendations or conduct a new study.

Callan & Associates were restricted in their ability to fully evaluate the investment portfolio because the scope of their engagement was limited to the top 30-45 investment managers.

Recommendation: A new investment consultant should be retained to replace Callan & Associates. The new Investment Consultant should operate in a manner consistent with investment industry best practices and the investment policies of the WCOC and offer an independent and unbiased evaluation of all the investment managers in the portfolio. The Investment Consultant should answer only to the WCOC or an Investment Board/Committee as required.

Investment staff provided the rates of return they received from the individual investment managers to Callan & Assoc. Callan did not perform any independent verification of returns making it impossible for Callan to provide an independent and unbiased evaluation as required by the Investment Policy.

Action: Interim Administrator has decided not to extend the contract of Callan & Associates as the BWC investment consultant. A new investment consulting firm will be selected through an RFP process and will report to the WCOC. The contract for the new investment consultant will specify how returns are to be computed and reported in accordance with industry best practices.

BWC staff did not have access to a fiduciary counsel to assist them in establishing appropriate investment policies, in making investment decisions, and in helping them deal with Private Equity Investment Managers.

Action: BWC retained the services of Ian Lanoff of the Groom Law Group to advise BWC on all fiduciary and investment matters.

Returns on investments for BWC are not calculated by netting out the management fees. This gross-of-fee calculation method overstates rates of return, runs the risk of inattention to fee levels and does not conform to best practices and industry standards.

Recommendation: The BWC should require the new investment consultant to calculate rates of return both gross of management fees and net of management fees and present them directly to the WCOC or Investment Board once per quarter.

Investment Policies

The BWC Investment Department invested in hedge funds before it was authorized to do so by the WCOC.

Action: By order of the Interim Administrator all hedge funds are being liquidated and contracts terminated.

The BWC Statement of Investment Policy and Guidelines requires that all large cap stock transactions requested by investment managers be conducted through the BWC Trading Desk. This process is inefficient and could result in increased costs for brokerage fees and an opportunity cost for delaying a transaction and therefore not securing the best execution in trading.

Recommendation: Require all Investment managers to be responsible for their own trading on all classes of equities. The investment managers should be required to obtain best execution cost and strongly encouraged to conduct these transactions electronically whenever possible which will significantly reduce the transaction price per share. It is our understanding that this matter will be considered by the WCOC on August 25.

The BWC Investment Department receives “soft dollars” in the form of rebates and other incentives from brokers (\$780,000 in 2004) to purchase unbudgeted goods and services. This is not an industry best practice. It blurs accountability for costs and could result in a competitive advantage for a broker who participates in the rebate scheme.

Action: The BWC Interim CIO and CFO recently terminated this practice and now require all expenditures for goods and services be done using properly appropriated hard dollars.

Future Action Steps

Internal Versus External Management

Three models exist for managing large public investment portfolios: internal investment management (exclusively), external investment management (exclusively), or a hybrid approach.

Internal Investment Management. This is the approach traditionally taken with large public investment portfolios. Under this approach, all investment functions are handled internally. These include: overall investment policy design, investment research and analysis, portfolio management, trading, proxy voting and investment accounting and reporting. In some instances, securities custody is also accomplished through the state treasurer. The principal advantage of this approach is its low cost. A fund the size of the State Insurance Fund could be managed for less than 10 basis points (1/10 of 1% of the value of assets) annually. Public funds have gravitated away from internal management. The main reason is out of concern for keeping investment management activities competitive. The salary structure in governmental employment and the budgetary controls that are common have prevented most public entities from building state-of-the-art investment operations. Consequently, 100% internal investment management of large public funds has largely become a thing of the past. (The State of New Jersey Division of Retirement, long the most prominent holdout on internal management, has begun moving assets to external investment managers.)

External Investment Management. External investment management is characterized by the absence of internal investment research, portfolio management, and trading. Under external management, private sector investment management firms are retained to manage investment portfolios on a fully-discretionary basis, meaning they are charged with selecting securities, trading, voting proxies, and performing certain investment reporting functions. Additionally, an institutional custodian bank is retained to perform key infrastructure-type services, such as securities custody, income collection, investment accounting, securities lending, cash management, and performance (basic rate-of-return) calculations.

Even with 100% external management, a small internal staff is required to supervise and administer an investment program the size of BWC's program. The supervisory staff would carry out these functions:

1. Ensure adherence to the statement of investment policy. Periodically reallocate funds among external managers as necessary to accomplish compliance.
2. Monitor the performance of investment managers as well as their adherence to investment guidelines.
3. In conjunction with the consultant, monitor all investment managers and limited partnership (LP) investments. Responsibility for hiring and firing managers should rest with the WCOC or Investment Board.
4. Work with and monitor the activities of the custodian.
5. Prepare periodic reports for the WCOC/Investment Board and meet with the WCOC/Investment Board on a regular basis.
6. Monitor and maintain appropriate short-term investment balances.

7. Periodically develop proposals for the WCOC/Investment Board relating to investment policy, need for additional asset managers, and other programmatic changes.

These are representative functions; the list is not meant to be all inclusive.

The Investment Department for a \$15 billion fund with no internal management would typically comprise six to ten persons, including a CIO. These positions might be expected to include, in addition to the CIO, three or four experienced investment professionals, two to four junior investment professionals, and an administrative staff of one or two persons.

There has been discussion of the ability of BWC to pay a competitive salary for a CIO. Here are some facts from the National Association of State Investment Officers (NASIO) 2004 compensation survey of 47 state funds, primarily pension systems:

- Pay levels vary with asset size and whether or not there is internal management. Median pay among all systems is \$150,000. For systems with assets over \$25 billion, it is \$210,000. Median pay when there is internal management is \$234,000.
- For externally managed funds, top quartile funds pay \$158,730. The median pay is \$114,200. Bottom quartile pay is \$98,280.
- Premiums for size and internal management are significant. A doubling of assets tends to increase pay 19%. Internal management adds 44%, on average.

Based on these data, it would appear that BWC could recruit a CIO for \$150,000 or less, however, this salary does not include a bonus package based on rates of return which may be needed to attract a quality candidate.

EnnisKnupp estimates that the total cost of an externally managed approach, including manager fees, custodian fees, consultant fees and the cost for a 6-10 person staff would be in the range of 25 to 45 basis points annually, depending on the extent to which the fund employs low cost indexing as an investment strategy.

Hybrid of Internal and External Management

Some large public funds use a combination of external management and internal management. The goal is to insure access to state-of-the-art capabilities while seeking to lower the cost of operation. Funds such as OPERS, STRS and OSU have evolved to some form of a hybrid approach. While a hybrid approach involves a larger internal staff, including research and trading professionals, the total cost can actually be lower by virtue

of the lower salary structure of public employment compared with the private sector. EnnisKnupp estimates that BWC, with a hybrid approach, might be able to reduce its costs (compared to 100% external investment management) by about 5 basis points.

Conclusion

Although this is an Interim Report we find ourselves at a fork in the road on three issues, Governance, Trading and Internal vs. External Investment Management. A decision one way or another on each of these issues at this time will change our work plan over the next 45 days.

Governance of the investment department is at a decision point. Ultimately we believe that a statutory change is necessary to create a Workers Compensation Investment Board that is separate and distinct from the WCOC. In the interim, while this issue proceeds through the legislative process we suggest that a committee be established by the WCOC, containing members of the WCOC and additional investment professionals to help manage the BWC investment portfolio.

The second issue of the Trading Desk at BWC is an easy decision. The days when the BWC had to manage every trade has long past. For a number of categories of equities the investment managers already perform their own trading. The current system of requiring all large cap and some mid cap stock trades be processed through the BWC Trading Desk is inefficient, and costs the BWC in increased transaction costs and opportunity costs by delaying the transaction and thereby reducing an investment managers ability to manage the trade in the most cost-effective manner. The only action needed to effect this change is for the WCOC to modify their investment policy. It is my understanding that this action will be considered at the WCOC meeting in August.

Finally, the issue of running an in-house investment operation or using external management should be decided in the near future. The BWC currently does not have the capacity to manage the investment portfolio in-house. It is short on staff, both quantity and quality, and does not have the information infrastructure to operate a modern investment operation. Upon weighing all the relevant factors, including the cost of the alternative approaches, we recommend that BWC use external investment management exclusively, as described in the section above. The increased staffing recently authorized is consistent with this approach as are actions underway to shutdown internal investment management and trading activities and to rely more heavily on the corporate custodian, JP Morgan, for cash management and other such support activities.

We look forward to discussing these matters with you in the future.