

The Ohio Bureau of Workers' Compensation
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Bob Taft
Governor

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Tina Kielmeyer
Administrator/CEO

1-800-OHIOBWC

Memorandum

To: Governor Taft

From: Tina Kielmeyer 

Date: June 7, 2005

Re: MDL Fund

Background

In May 1998, BWC recommended the approval of MDL to the Oversight Commission as part of a request for proposal for fixed-income investment managers. The Oversight Commission approved and BWC subsequently allocated \$55 million for MDL to create a long bond account.

Between its inception and September 2003, MDL had an average annual return of 6.85 percent; during this period, the fund's performance mirrored the Lehman Aggregate Bond Index, the relative benchmark for this asset class. Because of its solid performance, BWC subsequently provided an additional \$300 million for MDL to manage.

Issue

In September 2003, MDL proposed the creation of the "Active Duration Fund" (ADF) which would take short positions on the long bond and reduce BWC's overall risk in the fixed income arena. Former Chief Financial Officer Terry Gasper signed the contract and reallocated \$100 million from the long account to create the ADF. Gasper did not notify former Administrator James Conrad of this investment, and it's questionable as to whether this investment correlated with the bureau's investment policy. Eventually, another \$125 million was reallocated from the long account to the ADF in two installments, the last of which was made on September 25, 2004.

On September 27, 2004, then BWC Assistant and now Interim Administrator Tina Kielmeyer received a phone call from a staff member advising an investment with MDL had lost significant dollars. Kielmeyer informed Conrad, who immediately contacted McLean to ascertain the severity of the situation.

Subsequently, McLean told Conrad that, in March 2004, the fund lost approximately \$7 million, which raised a red flag. However, the fund managers said they did not take a short position on the long bond, resulting in the loss. The fund managers assured McLean that going forward they would exclusively take a short position. While the ADF recovered slightly in May, its performance dropped sharply over the next two months, and because the managers leveraged the fund beyond contractual risk parameters, the \$225 million investment had no value at the end of September.

Action

BWC ordered MDL to close the fund within 60 days. In addition, the bureau requested the Attorney General's office appoint special counsel; ultimately, Schottenstein, Zox, and Dunn were appointed. Lastly, Gasper was told to either resign or be fired; on October 6, 2004, he resigned.

On November 3, 2004, MDL successfully paired off the last trades and recovered approximately \$9 million of the investment, resulting in an aggregate loss of approximately \$215 million.

Afterward, BWC asked Callan and Associates, its external investment consultant, to examine the factors that lead to the losses. Callan reported that nearly 85 percent of the losses resulted from the investment manager leveraging the account beyond the risk parameters established in the contract. Based on that information, BWC asked Crowe Chizek to conduct a forensic audit; a report is expected later in June. Finally, after initially freezing all trading activity in the long account, BWC terminated the account last week. Pending the Crowe Chizek report, it is possible BWC will seek legal action against the fund manager if the audit confirms actions were taken outside the scope of the contract.

Conclusion

Despite the losses incurred by the ADF, BWC still had an aggregate return of 8.5 percent in 2004, which surpassed the State Insurance Fund's benchmark of 5.65 percent. Additionally, BWC granted \$610 million in dividends to public and private employers during 2004. BWC anticipates the forensic audit will confirm the losses were due primarily to the fund manager acting outside the scope of the contract; accordingly, BWC will take any appropriate civil and/or criminal legal action against the appropriate parties.

MDL Timeline

- 5/14/98** MDL Capital Management (MDL) hired via RFP to manage fixed income assets; original funding: \$55 million
- 7/17/02** Additional allocation: \$100 million
- 6/17/03** Additional allocation: \$200 million
- 9/12/03** Re-allocated \$100 million from the original "long" fund to the newly created "Active Duration Fund" (ADF)
- 3/04** Fund value drops: BWC investment staff discover a \$6.9 million lost on a monthly report; BWC asks for more detailed reports regarding ADF as losses seemed inconsistent with bond movements
- 5/21/04** ADF receives additional \$100 million allocation from the long fund approved by former CFO
- 9/23/04** Final re-allocation from long to ADF: \$25 million
- 9/27/04** Former Administrator/CEO learns of fund for first time
- 9/29/04** BWC requests fund manager terminate ADF
- 10/6/04** CFO resigns
- 10/8/04** BWC asks Attorney General's Office to appoint special counsel to review activities of fund manager
- 11/2/04** Schottenstein, Zox, and Dunn retained
- 1/21/05** Callan and Associates, BWC's external investment consultants, determine majority of losses can be attributed to fund manager's actions
- 3/28/05** SZD and BWC agree to a forensic audit
- 4/11/05** Forensic auditor Crowe Chizek hired
- 6/3/05** BWC requests fund manager to terminate the original long account
- 6/05** Crowe Chizek report expected at end of month

Elbel Brady & Suttman Asset Management	BWC Private Fund	01-May-03	Domestic Equity	Mid Cap Value	\$144,152,979.97	\$194,810,136.98	\$40,657,158.99
Fairport Asset Management, LLC	BWC Private Fund	18-Aug-03	Fixed	Intermediate	\$20,265,739.05	\$20,411,387.34	\$145,648.29
Fifth Third Bank	BWC Private Fund	01-Mar-01	Domestic Equity	Large Cap Growth	\$45,870,778.96	\$49,213,536.54	\$3,242,759.19
Fort Washington Private Equity Investors III	BWC Private Fund	18-Jun-01	Private Equity	Fund of Funds	\$9,356,562.00	\$9,356,562.00	\$0.00
Fortaleza Asset Management, Inc.	BWC Private Fund	07-Aug-03	Domestic Equity	Small Cap Growth	\$5,287,045.04	\$5,985,837.97	\$698,792.93
Freshman Spogill & Co.	FES Equity Partners V, LP	08-Dec-03	Private Equity	Middle Market	\$4,796,894.00	\$4,796,894.00	\$0.00
Fremont Partners	Fremont Partners III, LP	28-Jan-02	Private Equity	Venture	\$2,173,732.00	\$2,173,732.00	\$0.00
Gearty & Company	BWC Private Fund	13-Jul-98	Domestic Equity	ADRs	\$23,404,894.21	\$29,150,135.37	\$5,745,441.16
Great Northern Asset Management, Inc.	BWC Private Fund	26-Jun-98	Domestic Equity	Small Cap Growth	\$26,723,606.73	\$33,012,462.71	\$6,288,855.98
Gries Financial, LLC	BWC Private Fund	01-Jul-99	Domestic Equity	Mid/Large Cap Growth	145415500.43	15456173.89	\$914,673.46
GW Capital, Inc.	BWC Private Fund	16-Jun-99	Domestic Equity	Small Cap Growth	\$46,787,534.43	\$54,762,082.08	\$7,974,427.65
Halberrn, Denney & Co.	Halberrn & Denney-III, LP	27-Dec-00	Private Equity	Venture	\$11,378,786.00	\$11,378,786.00	\$0.00
Harbourvest Partners	Harbourvest Partners VII - Buyout Partnership Fund LP	17-Mar-03	Private Equity	Buyout	\$3,246,175.00	\$3,246,175.00	\$0.00
Harbourvest Partners	Harbourvest Partners VII Venture Partnership LP	17-Mar-03	Private Equity	Venture	\$1.00	\$1.00	\$0.00
Holland Capital Management	BWC Private Fund	23-Jan-98	Fixed	Core Intermediate	\$58,794,930.92	\$59,343,738.88	\$548,807.96
Hughes Capital Management	Hughes Capital Fund	11-May-98	Fixed	Core Intermediate	\$180,210,176.46	\$179,100,238.13	(\$1,109,938.33)
ING	BWC Private Fund	10-Apr-01	International Equity	Growth	\$96,889,640.00	\$105,536,850.66	\$8,648,210.66
ING Investment Management	BWC Private Fund	01-Mar-99	Domestic Equity	Large Cap Growth	\$790,293,840.33	\$935,071,187.98	\$144,777,347.25
Invesco Global Asset Management (N.A.), Inc.	BWC Private Fund	04-Apr-01	International Equity	Value	\$307,835,683.22	\$366,491,032.70	\$57,655,348.48
Invesco Private Capital, Inc.	INVECO US Buyout & Expansion Capital Fund III, LP	10-Dec-01	Private Equity	Fund of Funds	\$2,807,847.00	\$2,807,847.00	\$0.00
Invesco Private Capital, Inc.	Chancellor V, LP	26-Dec-01	Private Equity	Buyout	\$9,214,390.94	\$9,214,390.94	\$0.00
Invesco Private Capital, Inc.	INVECO Venture Partnership III	05-Jun-01	Private Equity	Venture	\$5,069,662.88	\$5,069,662.88	\$0.00
Invesco Private Capital, Inc.	Chancellor Biotech	05-Jun-01	Private Equity	Venture	\$1.00	\$1.00	\$0.00
Ironwood Capital Management, LLC	BWC Private Fund	13-Aug-03	Domestic Equity	Small Cap Value	\$12,335,385.03	\$13,828,832.30	\$1,494,457.27
Janus Investment Research, Inc.	BWC Private Fund	30-Jul-98	Domestic Equity	Small/Mid Cap Value	\$39,683,750.72	\$55,273,189.83	\$15,589,448.11
John Hancock Advisers, LLC	BWC Private Fund	09-Feb-98	Fixed	Core Aggregate	\$1,340,839,501.89	\$1,351,834,694.16	\$11,195,102.28
JPMorgan Investment Corporation	BWC Private Fund	23-Jan-98	Fixed	Core Intermediate	\$989,898,297.41	\$969,834,131.32	(\$20,064,166.09)
JPMorgan Investment Management, Inc.	JPMorgan US Government Money Market Fund Capital	01-May-03	Domestic Equity	Mid Cap Growth	\$81,549,756.96	\$70,541,531.90	\$8,991,744.94
Kirland Capital Partners	Kirland Capital Partners IV (KCP IV)	20-May-03	Private Equity	Mid/Large Market	\$569,734.00	\$569,734.00	\$0.00
Lakelight Investment Partners	BWC Private Fund	11-Aug-03	Domestic Equity	Large Cap Growth	\$10,509,926.79	\$11,849,926.39	\$1,340,333.60
Lazard Asset Management	BWC Private Fund	01-Aug-03	Domestic Equity	Large Cap Growth	\$18,086,757.05	\$17,608,938.40	\$1,520,181.35
Legg Mason Canada	BWC Private Fund	17-Apr-01	International Equity	Core Canada	\$107,579,793.71	\$131,365,982.48	\$23,786,188.77
Levine Leichtrman Capital Partners, Inc.	Levine Leichtrman Capital Partners II, LP	26-Oct-02	Private Equity	Buyout	\$3,489,892.39	\$3,489,892.39	\$0.00
Lexington Partners	Lexington Capital Partners V, LP	01-Mar-02	Private Equity	Venture	\$11,991,371.00	\$11,991,371.00	\$0.00
LM Capital Group, LLC	BWC Private Fund	08-May-98	Fixed	Core Aggregate	\$146,810,614.83	\$148,380,399.41	\$1,569,784.78
Lombard Odier, Inc.	BWC Private Fund	21-Mar-01	International Equity	Core	\$202,152,455.65	\$212,987,131.31	\$10,814,675.66
Loomis Sayles & Co., L.P.	BWC Private Fund	21-Apr-98	Domestic Equity	Small Cap Value	\$102,018,279.33	\$126,563,963.85	\$24,547,674.52
Lynmar Capital Group, Inc.	BWC Private Fund	14-Aug-03	Domestic Equity	Large Cap Growth	\$5,508,525.42	\$5,665,770.18	\$547,244.78
MCM Capital Partners	MCM Capital Partners II	14-May-04	Private Equity	Venture	\$87,221.00	\$87,221.00	\$0.00
MDL Capital Management, Inc.	BWC Private Fund	14-May-99	Fixed	Active Duration	\$163,414,992.50	\$163,471,741.69	\$56,749.19
Meritage Private Equity II	Meritage Private Equity II, LP	07-Sep-01	Private Equity	Venture	\$5,674,451.96	\$5,674,451.96	\$0.00
Meritech Capital Partners II	Meritech Capital Partners II LP	11-Dec-00	Private Equity	Venture	\$5,972,832.19	\$5,891,477.74	(\$81,354.45)
Midwest Economic Opportunity	Northcast Fund II, L.P.	22-Dec-00	Private Equity	Venture	\$4,127,513.01	\$4,127,513.01	\$0.00
MKK Capital Management, LLC	MKK Capital, LP	03-Oct-03	Private Equity	Private Equity	\$1,758,156.00	\$1,758,156.00	\$0.00
Morgan Stanley Investments LP	BWC Private Fund	20-Feb-98	Fixed	Active Duration	\$753,994,017.00	\$772,615,259.50	\$18,621,242.50
MWV Private Management Co.	MWV Private Fund	08-Oct-04	Private Equity	Venture	\$723,003.59	\$723,003.59	\$0.00
National City Investment Management Co.	BWC Private Fund	01-Mar-01	Domestic Equity	Large Cap Growth	\$51,189,413.45	\$53,429,042.98	\$2,239,629.51
New Amsterdam Partners, LLC	BWC Private Fund	28-Jul-99	Domestic Equity	Large Cap Growth	\$63,841,722.69	\$73,852,589.63	\$10,210,866.94
Northingall Investment Advisors, Ltd.	BWC Private Fund	08-Aug-03	Domestic Equity	Large Cap Value	\$5,532,663.18	\$5,874,067.95	\$341,404.17
Opicis International Advisors, LLC	BWC Private Fund	20-Feb-01	International Equity	Growth	\$186,175,072.25	\$208,991,166.38	\$22,816,094.13

Opus Capital Management, Inc.	BWC Private Fund	09-Jun-99	Domestic Equity	Small Cap Value	\$23,339,494.18	\$30,828,910.48	\$7,490,426.30
Paradigm Asset Management	BWC Private Fund	06-May-99	Domestic Equity	Large Cap Value	\$217,833,124.07	\$234,089,788.00	\$16,147,671.93
Penn Capital Management Co, Inc.	BWC Private Fund	12-Aug-03	Domestic Equity	Small Cap Value	\$14,374,300.48	\$16,751,440.62	\$2,377,140.14
Perseus-Soros Biopharmaceutical Fund	Perseus-Soros Biopharmaceutical Fund LP	14-Jun-02	Private Equity	Venture	\$2,898,548.00	\$2,854,180.73	(\$230,367.27)
Perseus Capital Group	Perseus Capital Partners, LP	28-Feb-01	Private Equity	Venture	\$4,290,595.50	\$4,290,595.50	\$0.00
Piedmont Investment Advisors, LLC	BWC Private Fund	18-Aug-03	Fixed	Core Aggregate	\$10,845,738.98	\$10,853,058.14	\$107,321.16
Primo Capital Advisors	BWC Private Fund	07-Jul-99	Fixed	Core Aggregate	\$498,952,207.78	\$499,978,393.59	\$1,026,191.83
Primo Venture Partners	Primo Venture Partners V, LP	28-Dec-00	Private Equity	Venture	\$9,067,853.28	\$9,067,853.28	\$0.00
Prospector Equity Capital, LP	Prospector Equity Capital, LP	13-Nov-02	Private Equity	Venture	\$8,856,722.74	\$8,856,722.74	\$0.00
Pugh Capital Management	BWC Private Fund	08-May-98	Fixed	Mortgage Securities	\$30,351,622.05	\$30,450,278.94	\$98,656.89
Pulnam Advisory Company, Inc.	BWC Private Fund	13-Apr-99	Domestic Equity	Large Cap Value	\$299,872,060.95	\$336,241,030.23	\$36,368,969.28
Pulnam Advisory Company, LLC	BWC Private Fund	02-Apr-01	International Equity	Core	\$211,317,630.56	\$235,549,927.09	\$24,232,196.52
Pulnam Institutional Management	BWC Private Fund	13-Apr-98	Domestic Equity	Mid Cap Growth	\$50,856,133.78	\$56,942,709.50	\$16,006,575.72
Qued C Advisors	Qued C Advisors VI, LLC	03-Jul-01	Private Equity	Venture	\$12,085,065.00	\$12,085,065.00	\$0.00
Quantum Legacy Capital Management, LLC	BWC Private Fund	05-Aug-03	Domestic Equity	Small Cap Growth	\$5,980,026.18	\$6,810,803.96	\$830,777.78
R. Meeder & Associates	BWC Private Fund	18-Jun-98	Domestic Equity	Small Cap Value	\$59,174,764.72	\$65,311,996.98	\$6,137,232.16
Reams Capital Management, LLC	BWC Private Fund	01-Jan-98	Fixed	Active Duration	\$204,937,343.43	\$204,254,049.15	(\$683,294.28)
Renaissance Investment Management	BWC Private Fund	06-Aug-03	Domestic Equity	Small Cap Growth	\$11,945,252.92	\$14,806,818.03	\$2,961,565.21
Reservoir Venture Partners	Reservoir Ventures Partners LP	10-Oct-03	Private Equity	Venture	\$1,422,835.98	\$1,422,835.98	\$0.00
River Cities Capital	BWC Private Fund	25-May-02	Private Equity	Venture	\$1,751,235.00	\$1,751,235.00	\$0.00
Riverbridge Partners LLC	BWC Private Fund	08-Aug-03	Domestic Equity	Small Cap Growth	\$5,275,969.59	\$6,204,780.53	\$928,810.94
Rosemont Investment Partners, LLC	Rosemont Partners I, LP	01-Dec-00	Private Equity	Venture	\$2,371,308.36	\$2,371,308.36	\$0.00
Rosemont Investment Partners, LLC	Rosemont Partners II, LP	23-Apr-05	Private Equity	Venture	\$510,530.33	\$510,530.33	\$0.00
Rufind Dickson Asset Management	BWC Private Fund	16-Jun-98	Domestic Equity	Large Cap Growth	\$20,699,075.12	\$24,439,327.37	\$3,740,252.25
Savoca Partners	Savoca Fund	01-Nov-04	Private Equity	Mortgage Securities	\$300,000.00	\$300,000.00	\$0.00
Smith Graham Management	BWC Private Fund	29-Jun-98	Fixed	Mezzanine	\$118,271,494.74	\$118,054,720.73	(\$216,774.01)
Smith Whitley & Company	Smith Whitley Company Fund I	11-Mar-99	Private Equity	Mezzanine	\$9,358,282.53	\$9,358,282.53	\$0.00
Smith Whitley & Company	SW Palham Fund II, LP	05-Sep-03	Private Equity	Mid to Late Stage	\$115,130,887.32	\$115,130,887.32	\$0.00
State Insurance Fund	Short Term Cash	N/A	N/A	N/A	N/A	N/A	\$0.00
Stirling Capital Partners	Stirling Capital Partners, LP	20-Jun-03	Private Equity	Buy Out	\$8,714,381.00	\$8,714,381.00	\$0.00
Sturdevant & Company, Inc.	BWC Private Fund	08-Jul-98	Domestic Equity	Large Cap Value	\$52,341,002.05	\$59,418,396.87	\$7,077,394.82
Sweathome Group	BWC Private Fund	22-Jun-98	Domestic Equity	Large Cap Growth	\$62,284,782.96	\$69,543,266.06	\$7,258,483.10
Tainco Capital Partners LLC	BWC Private Fund	01-Aug-03	Domestic Equity	Small Cap Value	\$12,373,841.78	\$13,153,992.85	\$780,350.87
Tappin, Carleia & Haberdt	BWC Private Fund	18-May-98	Fixed	Core Intermediate	\$239,175,008.87	\$244,331,073.82	\$5,156,064.15
TCW Crescent Mezzanine III, LLC	TCW/ Crescent Mezzanine Partners III, LP	27-Jul-01	Private Equity	Mezzanine	\$8,095,138.36	\$8,095,138.36	\$0.00
TCW London International, Limited	BWC Private Fund	22-May-01	International Equity	Growth	\$231,434,319.45	\$237,112,861.81	\$5,678,342.18
Technology Venture Partners	TVP Fund I	27-Jun-04	Private Equity	Mezzanine	\$3,771,072.85	\$3,771,072.85	\$0.00
Thayer Capital Partners	The Thayer Equity Investors V, LP	08-Dec-00	Private Equity	Mid to Late Stage	\$4,617,951.00	\$4,617,951.00	\$0.00
Tradition Medical Ventures	Tradition Medical Partners, LLC	17-Aug-04	Private Equity	Venture	\$904,545.28	\$904,545.28	\$0.00
UBS Global Asset Management, Inc	BWC Private Fund	01-May-03	Domestic Equity	Small Cap Growth	\$72,143,138.15	\$91,839,415.69	\$19,696,277.54
Union Heritage Capital Management	BWC Private Fund	27-May-98	Domestic Equity	Large Cap Value	\$27,228,407.47	\$34,504,594.03	\$7,276,186.56
Valenzuela Capital Partners, LLC	BWC Private Fund	30-Jun-98	Domestic Equity	Large Cap Value	\$31,484,144.56	\$37,994,810.45	\$6,510,665.89
Varexas Asset Management	BWC Private Fund	01-May-03	Domestic Equity	Small Cap Growth	\$14,560,120.85	\$99,394,231.81	\$14,824,109.96
Victory Capital Management Inc.	BWC Private Fund	08-Feb-02	Domestic Equity	Large Cap Value	\$284,050,891.23	\$278,222,051.70	\$14,161,800.47
Vintage Coins & Cards	Capital Coin Fund I	3/2/1998	Private Equity	Precious Metals	\$29,350,587.53	\$28,350,587.53	\$0.00
Vintage Coins & Cards	Capital Coin Fund II	7/30/2001	Private Equity	Precious Metals	\$28,576,282.40	\$28,576,282.40	\$0.00
Wasner, Schroeder and Company, LLC	BWC Private Fund	18-Aug-03	Fixed	Core Aggregate	\$10,910,148.70	\$10,933,897.89	\$23,189.19
Western Asset Management	BWC Private Fund	10-Feb-98	Fixed	Core Aggregate	\$1,494,742,157.84	\$1,525,301,857.27	\$30,559,699.43
Wind Point Partners	Wind Point Partners V, LP	16-Aug-02	Private Equity	Late Stage	\$5,917,273.00	\$5,917,273.00	\$0.00

Woodford Capital Management, LLC	BWC Private Fund	10-MD-98	Domestic Equity	Large Cap Growth	\$71,647,514.24	\$76,644,696.99	\$5,197,676.75
				TOTAL	\$13,551,984,770.19	\$14,301,430,623.46	\$749,445,852.27

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