TORONTO

# STAFF REPORT ACTION REQUIRED

# City of Toronto 2009 Investment Report and Policy Update

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| **Date:** | April 27, 2010 |
| **To:** | Executive Committee |
| **From:** | Deputy City Manager and Chief Financial Officer |
| **Wards:** | All |
| **Reference Number:** | P:\2010\Internal Services\Cf\Ec10022cf (AFS #10693) |

## SUMMARY

This report provides a review of the City of Toronto's 2009 annual bond fund and money market investment returns for all internally managed portfolios, i.e. invested in respect of the City's reserve funds and operating budget. Amounts invested in other funds are reported separately, specifically, those in sinking funds, pension funds and trust funds.

In compliance with Ontario Regulation 610/06 Financial Activities of the *City of Toronto Act, 2006*, a record of each transaction in its own securities is listed in this report.

Due to various amendments and issues that need to be addressed arising from the 2008 Investment Policy Compliance Report from Ernst & Young LLP and the internal review of the Policy for various enhancements, minor amendments to the City's Investment Policy are recommended in report.

## RECOMMENDATIONS

**The Deputy City Manager and Chief Financial Officer recommends that:**

1. The changes in the City's Investment Policy as outlined in Appendix B be approved.

2. Authority be granted to staff to incorporate the changes into the City's Investment Policy document.

**Financial Impact**

Investment earnings on the City's general funds in 2009 totalled $160.6 million and averaged a 4.7% annual rate of return. Including the Toronto District School Board's net interest earnings resulted in total investment earnings of $161.2 million, which were allocated to the operating budget ($152.0 million) and reserve funds ($9.2 million) per Council approved policy.

The operating budget component exceeded the budgeted revenues in the Non-Program account by $69.6 million and contributed to the 2009 operating surplus. This was due to a combination of favourable market conditions and a positive impact of historically low interest rates on the portion of investments allocated to Reserve Funds.

| 2009 Budget | 2009 Actual | Earnings in Excess of Budget |
|---|---|---|
| $82.4 million | $152.0 million | $69.6 million |

There is no financial impact resulting from the recommendations in this report.

## DECISION HISTORY

The annual investment report is required to be presented to Council on an annual basis under Ontario Regulation 610/06 Financial Activities of the *City of Toronto Act, 2006.*

In February 2009, Council adopted a revised Investment Policy. The revisions primarily responded to changes in the Financial Activities Regulation under the *City of Toronto Act*, the Audit Recommendations Report from the Auditor-General's Office (dated Nov 4, 2008) as well as the 2007 Investment Policy Compliance Report from Ernst & Young.

## ISSUE BACKGROUND

The Capital Markets section of the Corporate Finance Division is responsible for the internal investment management of several City investment portfolios. In accordance with the Council-approved directive, the section manages the City's funds in a manner that provides the highest investment return consistent with the maximum security of principal. This strategy is applied in meeting the cash requirements of the City while conforming to all legislation governing the investment of City funds.

Fund management must incorporate both the legislative constraints and the risk profile of each portfolio. Investment policies and procedures approved by Council act as the governing guidelines for each of the individual portfolios under management.

Although specific policy limits with respect to issuer names and credit quality limits vary between the portfolios, the primary objectives, in priority order, for all City investment activities are:

1. Ensure Safety of Principal

2. Maintain Adequate Liquidity, i.e. funds are available as cash when needed
3. Maximize Rate of Return while conforming to the other objectives

## COMMENTS

### Investment Portfolios

The City manages several investment portfolios, each which has specific objectives. Two individual portfolios that are managed interactively are the Bond and Money Market Funds. The Bond Fund is positioned towards funding the City's future reserve and reserve fund requirements and therefore takes a longer view of the market. The Money Market portfolio is primarily focused on ensuring that adequate liquidity is maintained to meet the immediate cash flow requirements of the City's daily operations.

When combined, these portfolios provide the necessary diversification required in managing the City's total cash flow needs and the exposure to interest rate changes. Current revenues can be held in short term investments until such time when the movement to longer dated securities proves more suitable. Likewise, longer dated securities can be sold to meet short term expenditures if the opportunity to realize capital gains presents itself. Traditionally, the Bond Fund provides an opportunity to obtain higher investment yields.

### Credit Quality

The City's bond portfolio (Table 1 below) continued to exhibit high credit quality and liquidity as shown by the distribution of the credit ratings of its holdings. The City did not hold any bond investments with less than an "A" credit rating, consistent with practices over the past three years.

**Table 1. Credit Ratings of the Bond Portfolio Holdings**

| | AAA/AA | A | BBB | <BBB |
|---|---|---|---|---|
| Dec 31, 2009 | 83.4% | 16.6% | 0% | 0% |
| Dec 31, 2008 | 84.4% | 15.6% | 0% | 0% |
| Dec 31, 2007 | 83.1% | 16.9% | 0% | 0% |

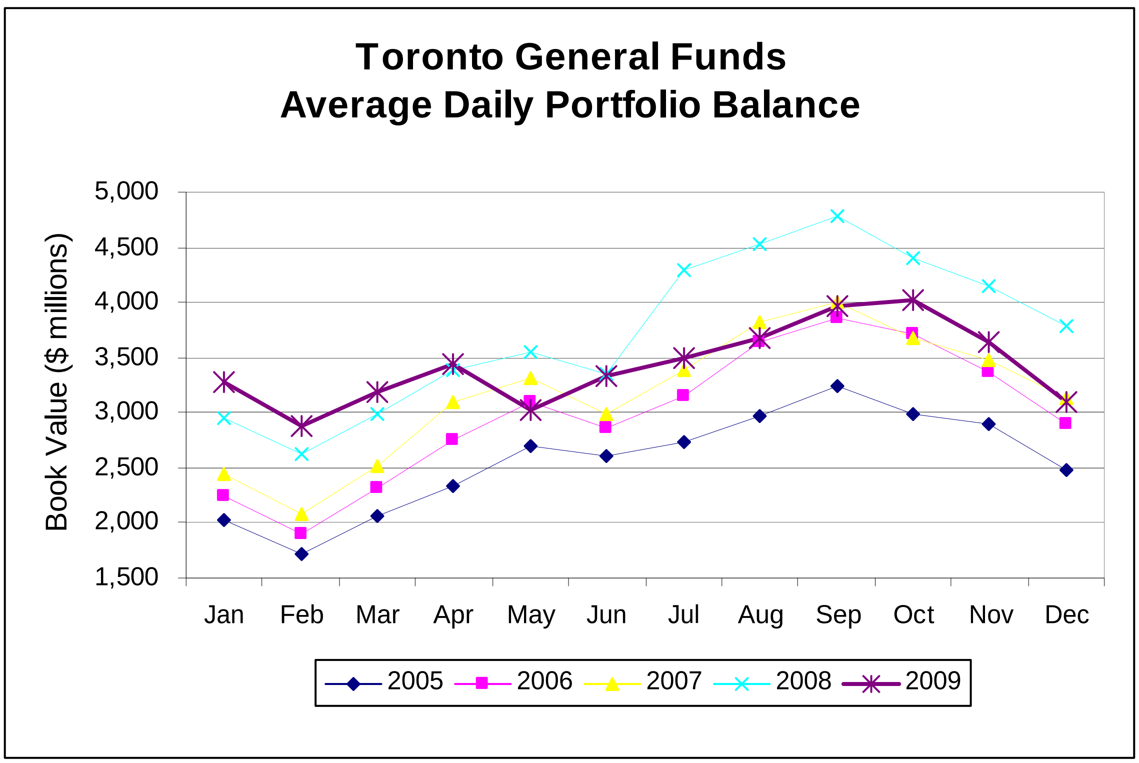
### Portfolio Returns

The average daily balances were reduced in 2009 to $3.419 billion after three years of consecutive increases. The portfolio balance peaked at approximately $4.0 billion in October 2009 but the impact of the recession on the City's social service costs, increasing costs for the delivery of some of the City's largest services (transit, police and fire), combined with lower than expected revenues and various other factors have resulted in a lower average daily balance in 2009.

The average portfolio balance is expected to further decrease in the next three years due to a draw-down in the Reserves and Reserve Funds, mainly for funding planned capital expenditures such as the Water and Wastewater Capital Projects.

The financial crisis that negatively affected financial markets in 2008 extended into 2009. Central banks committed billions of dollars in liquidity measures and spending initiatives in their efforts to unfreeze the credit markets and offset the impact of a deepening worldwide recession.

Despite a lower portfolio balance and historically low interest rates environment, the City earned overall investment returns of 4.7% ($160.7 million) in 2009 versus 4.6% ($171.6 million) in 2008. This result was achieved by minimizing the time that funds were held in lower-yielding money market securities while retaining investments that were held in the Bond Fund for as long as possible through active cash management, forecasting and taking advantage of market opportunities to increase yields.




Note: The dip in May 09 was mainly due to an increase in social assistance payments and a drawdown from operating reserves approved as part of the 2009 operating budget.

The investment return is based on earned revenues, which is comprised of earned interest income, realized capital gains/losses and amortized premiums/discounts.

The 2009 distribution of investment earnings and their respective annual investment return is summarized in the following chart:

**Table 2. Investment Portfolio Income For the year 2009 ($ 000's)**

| Portfolio | Average Portfolio Book Value | Earned Income | Investment Return |
|---|---|---|---|
| 1. Bond Fund | $2,930,319 | $159,378 | 5.4% |
| 2. Money Market | $488,223 | $2,236 | 4.6% |
| Total General Funds | $3,418,542 | $160,614 | 4.7% |

Annual income allocated in support of the City's operations is comprised of the following sources:

| | Millions |
|---|---|
| General Funds investment income | $160.6 |
| Toronto District School Board net interest earnings | 0.6 |
| Total Income Earnings | $161.2 |

The total income earnings of $161.2 million were distributed to the City's operating budget ($152.0 million) and to the City's reserve funds ($9.2 million). Net interest earnings pertaining to the Toronto District School Board (TDSB) represent interest received from TDSB for capital advances and any interest applied against operating cash positions held on deposit with the City.

## Market Value Performance

Another measurement of portfolio performance is a comparison of the total market value return to an established industry index. The market value return (Table 3) is often different from the investment return (Table 2). While the investment return comprises of earned interest income, realized capital gain/losses and amortized premiums/discounts, the market value return is based on the current quoted price of the investments as if securities was bought or sold in the financial markets at a given point in time. The measurement of investment return is for budget allocation purposes. The relevance of market value measurement is dependent upon the similarities between the investment policies and objectives governing the management of the City's funds and that of the selected industry index.

The following table compares the annualized market value performance of the City's General Fund Money Market and Bond portfolios to their respective benchmark indices as of December 31, 2009 in order to present the most recent markets returns that are generated by Royal Trust Dexia, the City's custodian, that were available when this report was prepared:

**Table 3. Market Value Performance**
**Annualized One-Year Return ('000)**
As at Dec 31, 2009

| General Funds | Book Value Dec 31, 2009 | Market Value Dec 31, 2009 | Market Value Returns | Benchmark Returns | Benchmark |
|---|---|---|---|---|---|
| Bond Fund | $2,974,637,145 | $3,096,569,955 | 4.17% | 1.57% | DEX All Governments |
| Money Market | $15,491,700 | $15,743,464 | 0.48% | 0.37% | DEX 30 Day T-Bill |

The bond portfolio of the General Funds is measured against the DEX Government Index. As of December 31, 2009, the market value of the City's Bond Portfolio reflected a year-over-year return of 4.17% compared to the index return of 1.57%, or 260 basis points above the benchmark. In comparison to the benchmark index, based on the portfolio's average book value during the period of $2.9 billion, the impact of a 260 basis point translates into an incremental $76.2 million in market value. The appreciation in the portfolio market value and the outperformed returns were attributable to primarily several factors:

- a market with substantial credit spread tightening reflected the recovery from the flight-to-quality environment
- strategic asset mix targets and duration positioning (selection of portfolio term structure), and
- active bond trading programs.

The money market component of the General Funds produced an annualized market value return of 0.48% as of December 31, 2009, compared to the DEX 30 Day T-bill Index return of 0.37%, or 11 basis points above the benchmark. Based on an average book value of $488.2 million during the period, the 11 basis points translate into an additional $0.5 million in investment income generated by this portfolio.

The appreciation in the portfolio market value and the outperformed returns were attributable to factors including:

- maximize investment term through active cash management and
- strategic selection of issuers.

The City's General Funds returns exceeded independent benchmarks by $76.7 million. This market value return represents a value-added by the Capital Markets section of 224 basis points in 2009 compared to the benchmark indices.

During 2009, the flight-to-quality phenomenon has started to reverse as soon as there were early signs of the economic recovery. Looking forward, yields are expected to push substantially higher and credit spread strength to continue but at a far more modest pace. For 2010, the high investment-grade characteristics of the City's portfolio should benefit its book yields but could affect the market rates of returns as compared to the excellent performance achieved in 2009.

## Record of Transactions in City of Toronto Debentures

In 2009, the City of Toronto sold a principal value of $17,694,000 on a net basis of its own Securities in the secondary market for the Sinking Fund and the General Fund.

In compliance with Ontario Regulation 610/06 Financial Activities of the *City of Toronto Act, 2006*, the City maintains a record of each transaction in its own securities, including a statement of the date and the purchase or sale price of each security transaction. The details pertaining to the 2009 transactions are documented in the attached Appendix A.

## Investment Policies

The investment policy updates recommended in Appendix B address issues that were noted in the 2008 Ernst and Young's annual Investment Compliance audit. The audit issues mainly include establishing clear guidelines on authorization of policy exceptions and limits on credit ratings and exposure. Also, the updates extend the investment terms for some high quality issuers to 30 years to accommodate the sinking fund needs as the City issued 30 years debt. The updates also include two new issuers that are authorized under the governing legislation and suitable for the City of Toronto's portfolios. Other recommended changes to the Investment Policy would help to ensure compliance with Ontario Regulation 610/06 Financial Activities under the *City of Toronto Act, 2006.*

The governing legislation for the investment of municipal funds outlines the criteria of permitted investments. Although the City of Toronto Act states specific criteria for permitted issuers within these broad categories, the City of Toronto's Investment Policy is more selective and detailing the quality, term and total portfolio exposure to meet the specific objectives and mandates of each fund. The proposed two issuers, Ontario Infrastructure Projects Corporation (OIPC) and Central One Credit Union (C1CU) are within the list of permitted investments under the City of Toronto Act.

## CONTACT

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## SIGNATURE

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Cam Weldon
Deputy City Manager and Chief Financial Officer

## ATTACHMENT

Appendix A – City of Toronto Debenture Purchases and Sales during 2009
Appendix B – Recommended Changes to The City of Toronto's Investment Policy

# Appendix A

## City of Toronto Debenture Purchases and Sales during 2009

**From Jan 01, 2009 To Dec 31, 2009**

**1. Purchases**

| Portfolio | Maturity | Coupon | Principal | Price $ |
|---|---|---|---|---|
| 4% Sinking Fund | 7/28/2016 | 4.850% | 1,015,000 | 103.894 |
| 4% Sinking Fund | 7/18/2017 | 5.050% | 5,000,000 | 102.475 |
| 4% Sinking Fund | 5/20/2015 | 4.550% | 14,545,000 | 105.444 |
| 4% Sinking Fund | 9/27/2016 | 8.000% | 2,804,000 | 126.350 |
| 4% Sinking Fund | 5/20/2015 | 4.550% | 2,300,000 | 105.900 |
| 4% Sinking Fund | 5/20/2015 | 4.550% | 5,218,000 | 105.520 |
| 5% Sinking Fund | 9/25/2010 | 4.750% | 4,201,000 | 104.623 |
| 5% Sinking Fund | 8/3/2010 | 6.250% | 640,000 | 105.113 |
| 6% Sinking Fund | 9/27/2016 | 8.000% | 2,300,000 | 126.342 |
| BOND | 6/8/2015 | 8.650% | 883,000 | 126.166 |
| Total | | | **38,906,000** | |

**2. Sales**

| Portfolio | Maturity | Coupon | Principal | Price $ |
|---|---|---|---|---|
| 4% Sinking Fund | 6/27/2018 | 4.950% | 3,955,000 | 105.650 |
| 4% Sinking Fund | 6/27/2018 | 4.950% | 4,045,000 | 105.130 |
| 4% Sinking Fund | 8/3/2010 | 6.250% | 9,746,000 | 106.470 |
| 5% Sinking Fund | 8/3/2010 | 6.250% | 4,945,000 | 106.470 |
| 5% Sinking Fund | 8/3/2010 | 6.250% | 1,000,000 | 106.470 |
| BOND | 10/29/2014 | 4.900% | 1,000,000 | 108.230 |
| BOND | 12/18/2018 | 5.600% | 8,400,000 | 110.900 |
| BOND | 11/29/2012 | 5.450% | 5,320,000 | 108.990 |
| BOND | 6/27/2018 | 4.950% | 5,000,000 | 104.906 |
| BOND | 9/27/2016 | 4.500% | 2,704,000 | 105.361 |
| BOND | 10/29/2014 | 4.900% | 1,440,000 | 108.230 |
| BOND | 10/28/2015 | 4.375% | 3,000,000 | 105.090 |
| BOND | 7/18/2017 | 5.050% | 5,000,000 | 107.280 |
| BOND | 6/27/2018 | 4.950% | 1,045,000 | 105.650 |
| Total | | | **56,600,000** | |

# Appendix B

## Recommended Changes to the City of Toronto Investment Policy

## Approved list of Issuers and limits

**1.** The proposed two issuers to be added to the Policy, Ontario Infrastructure Projects Corporation (OIPC) and Central One Credit Union (C1CU) are within the list of permitted investment under the City of Toronto Act (Ontario Reg. 610/06).

Description of the proposed issuers and corresponding limits:

Ontario Infrastructure Projects Corporation (OIPC)

Infrastructure Ontario is incorporated as the Ontario Infrastructure Projects Corporation (OIPC) and issues debt under the name of OIPC (formerly named as Ontario Strategic Infrastructure Financing Authority). Infrastructure Ontario is a crown corporation of the Ontario government dedicated to the renewal of Ontario's infrastructure.

OIPC debt is not guaranteed by the Province of Ontario but it has a high support level from the Province in the form of a very long term subordinated debt (66% of outstanding loans). This support reflects the strategic importance of OIPC in delivering a provincially mandated program and the perceived risk to the province's reputation if OIPC were to default. OIPC also has a large reserve fund providing liquidity. The Province has ultimate control over the reserve fund, a characteristic that closely links OIPC to the province. In addition, OIPC has a unique "intercept mechanism" on borrowers' grants from the Province whereby provincial grants destined to a public sector entity that has missed a payment would be redirected to OIPC.

OIPC is included in the Provincial Sector of the DEX Bond Index which enhances its market liquidity. Since OIPC is not a provincial-guaranteed despite its credit enhancement, a higher credit ratings requirement comparing to provincial-guarantees is assigned. The minimum credit rating required is AA- by S&P, Aa3 by Moody's or AA (low) by DBRS. Due to its nature of lower liquidity than provincial debt, they are assigned a lower limit than the Province of Ontario.

Central 1 Credit Union

Credit Union Central of British Columbia (CUCBC) was renamed Central 1 Credit Union (C1CU) and acquired substantially all of the assets and liabilities of Credit Union Central of Ontario Limited (CUCO) in July 2008. C1CU's main purpose is to become the liquidity provider for both B.C. and Ontario credit union systems with its combined assets of C$8.7 billion. It provides payment, banking, treasury and trade services to more than 196 credit unions in the two provinces that serve 2.8 million members. C1CU's commercial lending portfolio is comprised of member credit union loans that are fully secured.

The minimum credit rating required is A-1 by S&P, R-1(mid) by DBRS or P-1 by Moody's. Due to the lower liquidity of C1CU's short-term securities as compared to Bank's money market instruments, it has been assigned a lower limit than Banks in the City's portfolio.

**Table 1: Term and Exposure Limit**

| | Toronto Group General Funds | | Sinking Fund | |
|---|---|---|---|---|
| | Maximum % | Term Limit | Maximum % | Term Limit |
| OIPC | 10% | 30 years | 10% | 30 years |
| Central 1 Credit Union | 10% | 1 year | 10% | 1 year |

2. In accordance to the Ontario Regulation 610/06 Financial Activities of the *City of Toronto Act, 2006 Part IV-44,* the City shall not invest more than 25 percent of the total amount in all sinking funds of the City, as estimated on the date of the investment, in short-term (<365 days) debt issued or guaranteed by the City.

3. As the City plans to issue 30 years debt in 2010, approved investments for the sinking fund need to have appropriate term limits in order to match new debt requirements. It is recommended that the term limits of the following issuers be extended to 30 years: Province of Manitoba, New Brunswick, Quebec, Saskatchewan and their guarantees respectively, as well as Canadian Regions/Municipalities that are rated AA- or higher and Canadian School Boards that are rated AA- and higher.

## Credit Rating

1. In accordance to the Ontario Regulation 610/06 Financial Activities of the *City of Toronto Act, 2006 Part IV-43,* an investment is required to meet a minimum credit rating (rated by either DBRS, Moody's or S&P) as set in the City of Toronto policy.

## Exception and Compliance Reporting

1. Subsequent Council approvals have higher authority than the Council-authorized Investment Policy.

2. Exceptions are determined at the time of purchase (settlement date). To align with industry norm, the time of purchase is defined as the settlement date instead of the trade date.

3. Exception Reports shall be reviewed and approved by the Investment Advisory Committee and Sinking Fund Committee respectively at least bi-annually.

4. If the over-limit exceeds 5% of the limits, the City shall sell the portion that is beyond the 5% over-limit within 90 days after the day the investment becomes above 5% over-limit. The intent of this clause targets the case where there is a large sinking fund repayment which causes over-limit in percentage. This policy would allow time for the City to rebalance the portfolio to align with the Policy. If there is a reason why it would be beneficial for the City to extend the 90 days period due to unusual circumstances or market condition, Capital Markets manager should seek written approval from the Deputy City Manager and Chief Financial Officer within the 90 day period.

5. The exception report must be prepared by the Capital Markets staff, reviewed and authorized by two Capital Markets signing authorities. The report should be submitted to the Investment Advisory Committee and Sinking Fund Committee for review and approval, respectively, at least bi-annually.

6. If the exception, in the Treasurer (DCM/CFO)'s opinion, represents inconsistency to the policy, the Treasurer shall report the inconsistency to Council within 30 days after becoming aware of it in accordance to the Ontario Regulation 610/06 Financial Activities of the *City of Toronto Act, 2006 Part IV- 50*.

7. In the case an asset mix strategy that is temporary outside of the long-term target range is deemed appropriate by the Capital Markets Manager due to market conditions and investment opportunities, the rationale shall be documented and presented at the appropriate Investment Advisory Committee and Sinking Fund Committee meetings.

8. Staff be authorized to amend the Policy with respect to the roles and responsibilities of Committee and Staff to align with the policy regarding compliance and exception reporting as outlined above.