REPORT FOR ACTION

Asset Mix Update

Date: May 17, 2021
To: Toronto Investment Board
From: Director, Capital Markets
Wards: All

SUMMARY

At its meeting on March 9, 2021, the Toronto Investment Board ("Board") requested the Investment Consultant, in consultation with relevant City staff to compile information to help inform a conversation at the next meeting of the Toronto Investment Board on a potential asset mix study and report to the next meeting of the Board. This report aims to inform a conversation on a potential asset mix study.

Subsequent discussions with the investment consultant, City staff, and the Board Chair led to a request to review various sections of the Investment Policy (Attachment 1) and the Investment Plan (Attachment 2). An updated version of the Investment Plan with clarifying wording changes along with a summary of changes is provided.

RECOMMENDATIONS

The Director, Capital Markets recommends that:

1. The Toronto Investment Board maintain the current asset mix as provided in the City Council-approved Investment Policy (Attachment 1); and

2. The Toronto Investment Board agrees to review the asset mix after all investment managers (including those in the real assets category) have been funded and four years of performance have been completed; and

3. The Toronto Investment Board agrees to complete any further asset mix reviews at a time after the pandemic, or other major global events; and

4. The Toronto Investment Board adopt the clarifying word changes in the updated Investment Plan as provided in Attachment 2 of this report.

FINANCIAL IMPACT

There is no financial impact to the City's operating or capital budgets as a result of this report.

DECISION HISTORY

At its meeting on March 9, 2021, the Toronto Investment Board received a report that provided an update regarding the risk and return profile of the current asset mix in light of the current market conditions as a result of events that happened during 2020 relating to COVID-19. The Toronto Investment Board requested the Investment Consultant, in consultation with relevant City staff to compile information to help inform a conversation at the next meeting of the Toronto Investment Board on a potential asset mix study and report to the next meeting of the Board.
http://app.toronto.ca/tmmis/viewAgendaItemHistory.do?item=2021.IB11.5

At its meeting on June 29 and 30, 2020, City Council adopted the amended Investment Policy.
http://app.toronto.ca/tmmis/viewAgendaItemHistory.do?item=2020.EX14.2

At its meeting on March 9, 2021, the Toronto Investment Board adopted an amended Investment Plan.
http://app.toronto.ca/tmmis/viewAgendaItemHistory.do?item=2021.IB11.3

COMMENTS

Review of Select Sections of the Current Investment Policy (EX14.2)

Attachment 1 provides the current Investment Policy ("policy") adopted by City Council. It should be noted this policy includes not only the funds which are controlled by the Board, but it also covers all funds controlled by City staff such as the Short Term Fund.

Certain sections may be misunderstood when reviewed in isolation and taken out of context. The policy and its various sections should be read in its entirety to avoid any confusion or misrepresentation.

The asset mix is a part of this policy and is derived from the various sections.

Section 2.1 Investment Objectives - (a) Safety of Principal - Investments shall be undertaken in a manner that seeks to ensure the preservation of capital in the overall portfolios.

This objective, viewed on its own, would seem to suggest the entire portfolio should be invested in "risk-free assets" (example: Government of Canada T-Bills). However other sections of the policy provide more information about various segments of the overall portfolio.

Understanding the Liabilities of the Long Term Fund and the Sinking Fund

Section 1.4 defines and provides an overview of each of the portfolios. More specifically, it describes both the Long Term Fund (LTF) and the Sinking Fund (SF) which are under the control of the Board. Important guidelines about the underlying liabilities, time horizon, and risk tolerance are provided below.

Section 1.4 (b) - Long Term Fund (LTF)

i) The Long Term Fund will be used to meet the longer-term liabilities of Reserves and Reserve Funds, and other surplus funds not immediately required.

iv) The portfolio investment horizon will be in line with the nature of the underlying liabilities, currently 10 years (approximately). The risk tolerance to capital losses is to be minimized while weighing the benefits of higher expected returns over a longer investment horizon. The portfolio can consist of liquid and illiquid assets based on future cash flow requirements. Consequently, an Asset Mix consisting of several permissible investments will be maintained for the portfolio.

To summarize, the LTF represents longer-term liabilities of the City's Reserve and Reserve Funds (R&RF) which are not immediately required. The nature and purpose of these underlying funds are wide ranging. There are over 200 individual R&RF. It is also difficult to pinpoint the exact date when these funds may be needed, however it is estimated at approximately 10 years. Current balance of the R&RF (as at September 2020) is approximately $7.2 billion.

Section 1.4 (c) - Sinking Fund (SF)

i) The SF allows for the orderly repayment of debt issued by the City.

v) The portfolio investment horizon will be in line with the nature of the underlying liabilities, currently 5 years (approximately). The risk tolerance to capital losses is to be minimized while weighing the benefits of higher expected returns over a longer investment horizon. The portfolio can consist of liquid and illiquid assets based on future cash flow requirements. Consequently, an Asset Mix consisting of several permissible investments will be maintained for the portfolio.

The SF has a sole purpose of being used to retire the outstanding debt issues of the City. The liabilities and time horizon are easy to define and calculate given the set maturity dates and amount of debt issues.

Side Note - Section 1.4 (a) - Short Term Fund (STF)

While this part of the City's overall portfolio is managed by the City staff and not the Board, we felt it important to note these funds provide the necessary liquidity for the City to function on a day-to-day basis. Current value of the STF stands at approximately $4.75 billion as at April 30, 2021.

At this point in time, the Board should not have any concern that funds will be required from the LTF to meet short-term obligations of the City.

Table 1 - Breakdown of Overall Portfolio (April 30, 2021)

Investment Portfolio	Approximate Value as at April 30, 2021 (billions)	Percentage of Overall (%)
Short Term Fund (STF)	$4.75	45
Long Term Fund (LTF)	$3.75	35
Sinking Fund (SF)	$2.14	20
Total Overall Portfolio	$10.64	100

Attachment 3 provides a summary overview table of the three main investment portfolios that comprise the overall investment portfolio.

Investment Policy - Measuring Performance

Another section of the policy which should be considered with regard to the asset mix is Section 5.2 Performance Measurement.

In order to avoid any knee-jerk reactions due to short-term performance, the policy outlines that performance of investment managers should be done over rolling 4-year terms:

a) For purposes of evaluating the performance of the Investment Managers, all market rates of return are evaluated over moving four-year periods with returns being calculated on a quarterly basis. Return objectives include realized gains or losses and changes in unrealized capital gains or losses plus income from all sources.

Given that the longest serving investment managers have only been in place for two years, and the shortest serving investment manager for approximately six months, it would be advisable to maintain the current mix and continue to measure performance for a minimum of four years before making adjustments.

In addition, the Board currently has not deployed approximately 10 percent of the LTF and the SF which remains in cash and earmarked for the Real Asset category of the asset mix.

Evaluating the Current Recommended Asset Mix

The Recommended Asset Mix currently used by the Board was formulated in 2017 through an Asset Mix Study and assessment that was initially provided by Morneau Shepell and later confirmed by the Board's investment consultant, Aon.

The initial study incorporated the City's investment objective priorities and modeled projections spanning 25 years, resulting in an examination of 2,000 economic scenarios. The study also conducted additional stress testing scenarios that investigated isolated and combined shocks to several financial and economic factors.

Aon provided risk and return figures for the Recommended Asset Mix over a 10-year period that produced portfolio characteristics based on Aon's Capital Market Assumptions as of December 31, 2017. These are shown in Table 2 below.

Table 2 - Recommended Asset Mix Portfolio Characteristics (Aon - December 2017)

10-Year Annualized Nominal Return	3.8%
Average Annual Standard Deviation	5.0%
Average Annual CTE*	-6.4%
10-Year Annualized Nominal CTE*	1.0%

*CTE is an abbreviation for Conditional Tail Expectation. The CTE shown here represents the average of the worst 5% of returns, averaged over all 10 years of the projection.

To state it another way, it appears that there may not be sufficient historical evidence at this time to effectively evaluate the performance of investment managers, the original Capital Market Assumptions, and thus the asset mix.

Updating the Current Recommended Asset Mix

At the last meeting of the Board, the investment consultant provided an update to the current Recommended Asset Mix based on Aon's most recent Capital Market Assumptions. Table 3 below updates the information in Table 2.

It should be noted that the Capital Market Assumptions used for this exercise were influenced by current global events - most notably a pandemic. This single event may have produced misleading results.

Table 3 - Updated Recommended Asset Mix Portfolio Characteristics (Aon - March 2021)

10-Year Annualized Nominal Return	2.9%
Average Annual Standard Deviation	5.5%
Average Annual CTE*	-8.1 %
10-Year Annualized Nominal CTE*	0.01%

*CTE is an abbreviation for Conditional Tail Expectation. The CTE shown here represents the average of the worst 5% of returns, averaged over all 10 years of the projection.

Tactical Versus Strategic Investing

There is an old expression that says "strategic" investing is about *time in the market*, while "tactical" investing is about *timing the market*.

While there is some truth to this statement, the Board should carefully consider their function from an operational standpoint.

Strategic investing is about focusing on long-term goals of the funds under management. The preceding sections of this report should provide some detailed information in this regard.

Tactical investing responds to current market conditions. It looks at the present and the short term. A tactical investor attempts to shift the composition of a portfolio to manage risk exposure or to take advantage of new opportunities. It is a very "hands-on" approach that requires the investor to be very nimble.

Operationally, it would be difficult for the Board to be a tactical investor as it only meets four times a year. Also, given the time it takes for the City to negotiate and sign contracts with investment managers (12-18 months), the ability to be tactical would be very difficult to achieve.

Therefore, a more strategic approach is both preferable and practical at this time as it also aligns with the longer-term view outlined in the Council-approved Investment Policy.

Updating the Investment Plan to Align with the Investment Policy

The Investment Plan is a document that can be changed solely at the Board's discretion and does not require City Council approval. While it should align with the general guidelines set out in the policy, it is useful as a document that can provide further clarification and details of how the Board will implement the policy.

As part of the asset mix review, the Investment Plan was also compared to the Investment Policy. Table 4 provides a summary of the suggested changes made to the Investment Plan (Attachment 2) that will provide some clarification.

Table 4 - Summary of Changes to the Investment Plan

From (current state)	To	Reason of change
2.01 Plan Objective	2.01 - Investment Principles	Changed title to "Investment Principles" to avoid having two sections of Objectives. The first point in this section is "Safety of Principal". It may be too strict as an objective in that it does not tolerate losses.
2.02 Return Objective	2.02 - Return Objectives	Made "Objective" plural to "Objectives". Otherwise no change.
2.04 Recommended Asset Mix	2.03 - Recommend Asset Mix	Reordered for priority of importance.
2.03 Rebalancing	2.04 - Rebalancing Asset Mix	Added "Asset Mix" to clarify what's being rebalanced and reordered from 2.03 to 2.04

Conclusion

This review of selected sections of the Investment Policy should provide clarification of how the asset mix was established along with the purpose of each of the investment portfolios. The Board's focus should remain on strategic long-term investing with a long investment horizon and performance measurement based on moving four-year periods.

It is recommended the next asset mix review be completed after all asset categories have been funded (including Real Assets) and actual versus estimated performance can be compared. Future asset mix review should also be completed at a time when global events have minimal impact on return assumptions and calculations.

CONTACT

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SIGNATURE

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ATTACHMENTS

Attachment 1 - Current Investment Policy June 2020 (EX14.2)

Attachment 2 - Updated Investment Plan

Attachment 3 - Summary Table of Investment Portfolio