TORONTO

REPORT FOR ACTION

City of Toronto Investment Report for the Year 2021

Date: May 25, 2022
To: Executive Committee
From: Chief Financial Officer and Treasurer
Wards: All

SUMMARY

The purpose of this report is to provide the following information:

1. Performance of the Funds for the year 2021
2. General Market Update and Benchmark Performance
3. City of Toronto Investment Policy and Procedures

Equity markets strengthened during 2021, exceeding the pre-pandemic level, and broke the record highs amid higher market volatility during the last quarter of 2021. Long term interest rates, despite noticeable volatility throughout the year, also returned to the pre-pandemic levels by the end of 2021. The City of Toronto invests with a longer term view and investment horizon and has experienced solid returns over the 4-year period (annualized) ending December 31, 2021.

The City's General Group of Funds ("General Fund") hold the working capital and amounts designated for the City's reserves and reserve funds. The Long Term Fund portion of this portfolio managed by external managers returned 2.8 percent for the year 2021 and 5.1 percent on an annualized basis for the four year period ending on December 31, 2021. Overall, including the Short Term Fund, the fund had a total return of 1.6 percent for the year 2021, and a 3.1 percent total return on a 4-year annualized return basis, outperforming the weighted market benchmark by 0.6 percent and 0.4 percent respectively. When the unrealized gains and losses are excluded from the total return, the book return for the General Fund was 1.2 percent (earned $107.0 million) for the year 2021. During the pandemic, the General Fund has held a larger position in the Short Term Fund to enhance the liquidity and to generally lower the overall risk (risk management) while accepting some lower investment returns. On average, the Short Term Fund was about 58.6% of the overall General Fund in 2021 compared to 47.7% from the pre-pandemic level in 2019.

The City's Sinking Fund portfolio, which holds the investment funds for future debt repayments, earned a 6.0 percent annualized total return for the two year period ending December 31, 2021. On a shorter term basis, the fund had a total return of 2.0 percent for the year 2021, outperforming the weighted market benchmark by 0.6 percent. When

excluding the unrealized market gains and losses, the City's Sinking Fund portfolio earned 0.9 percent (earned $18.5 million) for the year 2021 on a book income basis. The customized benchmark index used for this portfolio as required by the Investment Policy does not yet have enough history for the 4-year measurement.

Since January 1, 2018, the City's long-term investments have been managed by the Toronto Investment Board ("Board") under a Council adopted Investment Policy which is based on the prudent investor standard. The investment portfolios have been progressively phased in to use of the broader range of investments that have become available. Although the overall portfolio risk has been reduced through asset mix diversification, the potential for volatility in total returns over the short term investment horizon still exist while the risk-adjusted total returns over the long term investment horizon are expected to be higher.

It is a legislative requirement that the Investment Policy be reviewed annually. The Toronto Investment Board completed an asset mix review during the first six months of 2021 given the impact of the pandemic. The Board decided not to recommend any changes to the asset mix at this time. Staff has also reviewed the Investment Policy and are not recommending any changes as well. A copy of the current Investment Policy is included as Attachment 1 to this report which was last adopted by Council in December 2021.

In total, there are now four fixed income managers and four global equity managers engaged in managing the long-term investments under the Toronto Investment Board. Both fixed income and equity investment classes are fully funded in accordance with the target asset mix in the Investment Policy with 70 percent allocated to fixed income and 20 percent to global equities. As at December 31, 2021, approximately 90 percent of both the Sinking Fund and the Long Term Fund were managed by external fund managers with the remaining 10 percent to be allocated to real assets. The Board continues to evaluate opportunities in the real asset category. Adding real assets to the current investment portfolios, which already compose of fixed income and global equity, will help to enhance the portfolios' risk-adjusted investment return and align with the Council-approved policy target asset mix.

For the year 2021, all funds managed are compliant with the Investment Policy. The City's auditor, KPMG LLP, will perform the Investment Policy audit during the second half of 2022.

The Toronto Investment Board is in the process of hiring a third-party data provider in order to monitor and report on whether or not external investment firms hired are compliant with the terms of the Investment Policy governing Environmental, Social, and Governance (ESG) Factors. This process has taken longer than expected due to unforeseen issues. Capital Markets staff continue to collaborate with the City's procurement team and the prospective vendor to resolve these issues. It is anticipated this information and data regarding climate change risk from these reviews be available for the next investment report and will continue to be reported to City Council on a semi-annual basis. This investment fund-level ESG reporting process will complement the existing corporate-level ESG performance report.

Although the Russian invasion of Ukraine occurred in February 2022 and was a subsequent event to the time period covered by this report, it should be noted that all contracts with external investment managers include clauses prohibiting investment in sanctioned companies and countries. These contracts also include clauses that focus on anti-terrorism and anti-money laundering policies and prohibiting dealing with any sanctioned companies or countries in this regard. More specific to the Russia/Ukraine situation, the Board has started to monitor the City's investment portfolios in regard to direct holdings in Russia and exposure to companies specifically named in sanctions, and there were none reported as of March 31, 2022.

RECOMMENDATIONS

The Chief Financial Officer and Treasurer recommends that:

1. City Council receive this report for information.

FINANCIAL IMPACT

In 2021, when unrealized gains and losses are excluded from the total return, the City's General Group of Funds ("General Fund") earned $107.0 million. These earnings were allocated to the Operating Budget ($93.7 million) and reserve funds ($13.3 million) according to the Council-approved interest allocation policy.

The Long Term Fund earned $69.3 million in gross investment income, which was $58.4 million lower than budgeted. However, it should be noted there is over $200 million of unrealized gain available as of December 31, 2021 that is excluded from the book investment income for budget purposes. While both equity and fixed income managers outperformed their respective market benchmarks, the overall fixed income market generated negative market returns.

The Short Term Fund earned $37.7 million which was $18.2 million above budget. The variance was mainly due to higher than forecasted cash balances for the purpose of ensuring increased contingency liquidity during the pandemic.

Combining the Long Term Fund and the Short Term fund resulted in a total gross book investment income for 2021 was $107.0 million.

Board expenses in 2021 were $8.5 million ($0.9 million lower than budgeted). The underspending was mainly due to Board's decision to delay investment in real assets during the pandemic as the underlying conditions for real assets could be changing. Also, the $13.3 million of investment income allocation to reserve funds was $1.7 million lower than budgeted due to lower ending reserve fund balances. As a result, total investment income less Board expenses and contribution to eligible reserve funds was $38.5 million less than budgeted.

The City's Sinking Funds portfolio earned $18.5 million for the year 2021. These earnings are retained within the Sinking Funds and must be used for the purpose of retiring debenture debt at maturity.

DECISION HISTORY

At its meetings held on December 15, 16, and 17, 2021, City Council received the report from the Chief Financial Officer and Treasurer for information. This report provided the performance and compliance for the six month period ending June 30, 2021.
http://app.toronto.ca/tmmis/viewAgendaItemHistory.do?item=2021.EX28.4#

At its meeting held on July 17, 2021, City Council received the report from the Chief Financial Officer and Treasurer for information. This report provided the performance and compliance for the year 2020.
http://app.toronto.ca/tmmis/viewAgendaItemHistory.do?item=2021.EX25.6

At its meetings held on December 16, 17, and 18, 2020, City Council received the report from the Chief Financial Officer and Treasurer for information. This report provided the performance and compliance to the six month period ending June 30, 2020.
http://app.toronto.ca/tmmis/viewAgendaItemHistory.do?item=2020.EX19.8

At its meetings held on July 28 and 29, 2020, City Council received the report from the Chief Financial Officer and Treasurer for information. This report provided the performance and compliance to year-end 2019 and the three months ending March 31, 2020.
http://app.toronto.ca/tmmis/viewAgendaItemHistory.do?item=2020.EX15.10

At its meetings held on June 29 and 30, 2020, City Council adopted the Investment Policy Update report with amendments.
http://app.toronto.ca/tmmis/viewAgendaItemHistory.do?item=2020.EX14.2

At its meeting held on December 17, 2019, City Council received for information the Investment Report for the Year 2018 and the Six Month Period Ending June 30, 2019
http://app.toronto.ca/tmmis/viewAgendaItemHistory.do?item=2019.EX11.15

COMMENTS

Working capital and the amounts designated for reserves and reserve funds are held for investment in the City's General Group of Funds ("General Fund"). The General Fund is comprised of two sub-funds known as the Short Term Fund and the Long Term Fund. Given the specific purpose of the Sinking Fund (debt retirement), it is managed separately from the General Fund but adheres to the same primary investment beliefs and objectives. Attachment 2 provides a short background on the City's investment funds.

In November 2015, the province amended the investment regulations under the City of Toronto Act, 2006 (Ontario Regulation 360/15) which replaced the prescribed list of investments with what is known as the prudent investor standard. The prudent investor standard is not specific and is used in situations where there is a trustee that has a fiduciary responsibility over funds that should invest according to the beneficiaries' situation and to consider the risk and return profile of the overall portfolio. This change removed the previous limitations and allows the City to be responsible for its own investment decisions as a prudent investor. The change required the City to establish an independent local board that would have fiduciary duty over the City's funds that were not immediately required. This local board can hire agents (external investment managers) which would carry out the fiduciary duty of the board.

Although this new provincial regulation was announced in late 2015, the effective date for this new regulation was January 1, 2018. During this transition period the City created the Toronto Investment Board ("Board") and appointed six independent members. In addition, City Council had approved a new Investment Policy that allowed for allocations to fixed income as well as new asset classes which included global equities and real assets.

As at December 31, 2017, the City's investments were all managed internally by City staff and were limited to a prescribed list of eligible investments set by the province in the legislation. This prescribed list limited the City investments to primarily government bonds and some high quality bonds of financial institutions.

During 2018, the Board chose eight external investment managers to manage the fixed income (70%) and global equity (20%) allocations as outlined in their Investment Plan. The new investment policy and plan, in conjunction with the investment consultant and investment managers, are expected to result in improved investment returns over the longer-term while also reducing overall portfolio risk.

Initially, there was a transition period before reaching the long-term target asset mix and realizing optimal long-term returns. During this time the investment portfolio phased in a greater use of the broader range of investments that became available. Although the portfolio risk continued to be reduced, the potential for volatility in short-term returns would still exist.

In June 2018, Council approved the creation of the Investment Income Stabilization Reserve. This reserve was established for the purpose of stabilizing investment income contributions to the operating budget by minimizing in-year variances through receiving funds in years when investment income is in excess of the amount expected in the operating budget and withdrawing funds in years when investment income is below budget.

During 2019, invested assets in both the Long Term Fund and the Sinking Fund are managed by four external fixed income investment managers (70%) and two global equity pooled fund managers (7%).

The third global equity pooled fund manager was added in February 2020 for both the Long Term Fund and the Sinking Fund. The fourth and final global equity pooled fund manager was added in December 2020 and January 2021 for the Long Term Fund and the Sinking Fund respectively.

Both fixed income and equity asset classes are fully funded in accordance to the target asset mix in the Investment Policy. As at December 31, 2021, approximately 90 percent of both the Long Term Fund and the Sinking Fund were managed by external investment managers selected by the Toronto Investment Board.

The four fixed income investment managers are Connor, Clark & Lunn Investment Management ("CC&L") and Leith Wheeler Investment Counsel Ltd ("LW") for the Long Term Fund, as well as Fiera Capital ("Fiera LDI") and Addenda Capital ("Addenda") for the Sinking Fund.

The four global equity pooled fund managers are Oakmark Global Pooled Fund II ("Oakmark"), Pier 21 WorldWide Equity Pool ("Pier 21"), Fiera Capital Common Contractual Fund ("Fiera CCF"), and Legal & General Investment Management ("LGIM") for both the Long Term Fund and the Sinking Fund.

The remaining cash holdings are for future investment in real assets and upcoming debt repayment. Toronto Investment Board continues to evaluate investment opportunities in real assets.

General Fund Total Return Performance for the year 2021

As shown in Table 1 below, the General Fund (Short Term Fund and Long Term Fund) has outperformed the weighted market benchmark by 60 basis points (0.6 percent) in the year 2021. Also, from a longer investment horizon perspective, the General Fund has outperformed the market benchmark by 40 basis points (0.4 percent) on a 4-year annualized return basis.

Table 1 – 2021 - Total Returns vs. Market Benchmarks (%) for the General Fund[1]

	1 year (Year-over-Year)			**4 year (annualized)**		
	Short Term Funds[2]	Long Term Fund	General Fund[3]	Short Term Funds[2]	Long Term Fund	General Fund[3]
Portfolio Return (%)	0.7%	2.8%	1.6%	1.6%	5.1%	3.1%
Benchmark Return (%)	0.1%	2.2%	1.0%	0.9%	5.2%	2.7%
Value Added (%)	0.6%	0.6%	0.6%	0.7%	-0.1%	0.4%

[1]Calculated from RBCIS Performance Analytics and Aon, Performance Review

[2]Including cash portion of the Long Term Fund

[3] Weighted by average market value of the Short Term Funds and Long Term Fund

Staff continue to manage the Short Term Fund to meet City's liquidity needs while maximizing investment return. To date, the Toronto Investment Board had selected and entered into agreements with two fixed income investment managers and four global equity pooled fund managers to invest the Long Term Fund.

As demonstrated in Table 2 below, the General Fund, which is composed of both the Short Term Fund and the Long Term Fund, had an average total fund balance of $8.9 billion during the year. When unrealized gains and losses are excluded from the total return, the General Fund earned $107.0 million (1.2% annualized rate of return on capital) over the year 2021.

Table 2 - Investment Portfolio for the year 2021 ($millions)

Portfolio	Average Fund Balance	Book Income	Book Return on Capital
1. Long Term Fund	$3,695.7	$69.3	1.9%
2. Short Term Fund	$5,238.5	$37.7	0.7%
Total General Funds	$8,934.2	$107.0	1.2%

As shown in Table 3 below, the total book income earned (excluding unrealized gains and losses) in 2021 was $38.5 million lower than the budgeted income contribution to the operating budget. However, there is over $200 million of unrealized gain available as of December 31, 2021. It should be noted that performance measured by book value is for the accounting and budget purposes only while the total return (market value) truly reflects the current value of the portfolio. The City is in the process of reviewing its valuation accounting methodology from book value to market value. Historical allocation of gross investment earnings is shown in Attachment 5.

Table 3 - Actual and Budget Gross Investment Earnings (Operating Budget) for the year 2021

Book Investment earnings ($ millions & Annualized Rate of Return)	Actual	Budget	Over/Under Budget
Total General Fund	**$93.7 (1.9%)**	**$132.2**	**-$38.5**
Short Term Fund	$37.7 (0.7%)	$19.5	$18.2
Long Term Fund[1]	$56.0 (1.9%)	$112.7	-$56.7

[1]Includes income allocation to Reserve Fund, which was $1.7M lower than budgeted for the year 2021 due to lower than forecasted Reserve Fund balances.

The sharp drop in interest rates in 2020 resulted in some unusually large market returns (including unrealized gains) for fixed income. However, this trend was reversed in the first quarter of 2021 which had an adverse effect on the portfolio. While the recent increase in yields did not totally erase the gains seen in 2020, the reversal was significant during the first three months of 2021.

Since January 1, 2018, the City's long-term investments in the General Fund have been managed by the Toronto Investment Board under a Council adopted Investment Policy which is based on the prudent investor standard. The investment portfolios have progressively phased into greater use of the broader range of investments that become available. Although the overall portfolio risk has been reduced through asset mix diversification, the potential for volatility in total return over the short term investment horizon still exist while the risk-adjusted total return over the long term investment horizon are expected to be higher.

In addition, the City's Short Term Fund that mainly holds City's working capital is currently at a higher level to ensure sufficient liquidity during the pandemic at the cost of some investment returns. On average, the Short Term Fund was about 58.6% of the overall General Fund in 2021 compared to 47.7% from the pre-pandemic level in 2019. On average, the Short Term Fund was about 58.6% of the overall General Fund in 2021 compared to 47.7% from the pre-pandemic level in 2019. We expect the short term balance to return to pre-COVID levels once the pandemic is over and post-pandemic impact is assessed.

Sinking Fund Total Return Performance in 2021

The City's Sinking Fund portfolio, which holds the investment funds for future debt repayments, saw external investment managers have a 6.0% annualized total return for the two year period ending December 31, 2021 as shown in Table 4. On a shorter term basis, the fund had a total return of 2.0 percent for the year 2021, outperforming the weighted market benchmark by 0.6 percent (also shown in Table 4).

To date, the Toronto Investment Board ("Board") had selected and entered into agreements with two fixed income investment managers and four global equity pooled fund managers to invest the Sinking Fund. The investment managers use a customized benchmark index that more appropriately reflects the updated fixed income strategy (LDI - Liability Driven Investment) based on the required cash flows to fund future liabilities. The customized benchmark index does not have enough history for the 4-year measurement.

Table 4 - As of December 31, 2021 - Total Return vs. Market Benchmark (%) for the Sinking Fund[1]

Sinking Fund	**1 year**	**2-year (annualized)**
Portfolio Return	2.0%	6.0%
Benchmark Return	1.4%	6.5%
Value Added	0.6%	-0.5%

[1] Aon Performance Review

When excluding the unrealized market gains and losses, the City's Sinking Fund portfolio earned 0.9% ($18.5 million) for the year 2021 on a book income basis as shown in Table 5 below. Similar to the General Fund, the Sinking Fund also has an unrealized gain of over $100 million as at December 31, 2021. These funds will be used to pay the City's long-term debt obligations at maturity and the shorter term performance volatility should not affect the longer term purpose of these funds.

Table 5 - Sinking Fund Book Return as of December 31, 2021

Portfolio	Average Weighted Capital Balance (Book Value)	Book Income	Book Return on Capital (Annualized)
Sinking Fund	$2,172.8	$18.5	0.9%

The investment portfolios have progressively phased into greater use of the broader range of investments that become available. Although the overall portfolio risk has been reduced through asset mix diversification, the potential for volatility in total return over the short term investment horizon still exist while the risk-adjusted total return over the long term investment horizon are expected to be higher and sufficient to meet the debt repayments.

Table 6 below shows the duration of the invested assets closely matches the duration of the liabilities. Bond duration is measurement of interest rate risk. It is a way of measuring how much bond prices are likely to change if and when interest rates move. By matching the duration of the assets and liabilities, investment managers can substantially manage the interest rate risk in the portfolio. In effect, the external managers are working to "immunize" the portfolio to ensure the fund with have cash available when the obligation comes due.

Table 6 - As of December 31, 2021 - Duration for the Sinking Fund[1]

(Years)	Fixed Income Duration
Portfolio Duration	13.9
Liability Duration	13.9

[1]From Aon Performance Review (Fixed Income)

In 2021, the Sinking Fund repaid the principal amount of debt totalling $650 million. A principal repayment of a $150 million maturity was made in July and another $500 million in December was made in accordance with the by-law repayment schedules for each of these debt issues. There are no debt maturities in 2022. The next maturity will be in September 2023 for $300 million.

General Market Update for 2021

The global economic recovery continued in 2021. While the health crisis remains far from over with continued waves of various dominant variants, and the potential for more variants in the future, there are highly effective vaccines and treatments that have limited the severity of health impact. Over 9 billion doses have been administered worldwide in 2021, and global vaccine production is forecasted to double to about 22 billion doses in 2022.

In many aspects, the world is in a better state than it was a year ago. The market focus has shifted from containing the pandemic to managing the inflation and the economic recovery. Listed below are the key economic and financial themes in 2021:

- Strong inflation: The re-emergence of inflation was the biggest economic focus in 2021, overtaking the pandemic. In the beginning of 2021, the market consensus was 2% inflation or less in 2021. Instead, the year ended with 7% headline inflation in the U.S., and about 5% across Europe and Canada.

- Recovered energy prices: After the deep decline in 2020, energy was the top-performing equity market sector for both the S&P 500 and the TSX in 2021, mainly supported by The Organization of the Petroleum Exporting Countries Plus (OPEC+) discipline and a revival in demand. Most energy prices were up 40% to 50% in 2021, a big factor to the global inflation rebound.

- Supply chain shortages: The widespread supply chain issues, which started in late 2020 with the chip shortages, is one of the biggest inflation drivers. Supply is operating at all-time high but still cannot keep up with the stimulus-led spending.

- Interest rate increases: In Canada, with GDP growth almost at 4%, the unemployment rate back down to under 6%, and the government tapering quantitative easing, the interest rate curve has started to flatten while expecting aggressive interest rate increases in 2022.

- Record high global equity markets: Equity markets had another very strong year in 2021, benefiting from the ongoing extraordinary government and monetary policy support during the pandemic. In Canada, the S&P/TSX Composite Index gained 21.7% and broke through the 21,000 level for the first time ever

- Strong housing market: The House Price Index (Canadian Real Estate Association) rose at a record pace of 26.6% in 2021, supported by extremely strong demand and historically low interest rates that significantly outpaced the homes supply.

As this report is being considered in first half of 2022, major central banks have already started to aggressively increase interest rates to manage inflation in the face of strong growth. While inflation is expected to stay high for the remainder of 2022, the central banks are expected to remain vigilant and continue to increase short term interest rates for the remainder of the year. New virus variants could further add to inflation through supply chain disruptions. Unemployment is expected to continue to fall, although may experience a reversal given an uncertain growth backdrop with governments withdrawing their policy support, risks surrounding the new virus variants continue, and the impact of continued higher interest rates.

Although the Russian invasion of Ukraine occurred in February 2022 and was a subsequent event to the time period covered by this report, it should be noted that all contracts with external investment managers include clauses prohibiting investment in sanctioned companies and countries. These contracts also include clauses that focus on anti-terrorism and anti-money laundering policies and prohibiting dealing with any sanctioned companies or countries in this regard. More specific to the Russia/Ukraine situation, the Board has started to monitor the City's investment portfolios in regard to direct holdings in Russia and exposure to companies specifically named in sanctions, and there were none reported as of March 31, 2022.

Record of Transactions in City of Toronto Debentures

To comply 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. A listing of these transactions are found in Attachment 3.

Compliance with the Investment Policy Guidelines

All the City's funds were within the Asset Mix requirements set out in the Council-approved Investment Policy for the year 2021. The breakdown of each portfolio is shown in Attachment 4.

There were no exceptions to report for the year 2021.

The City's auditors, KPMG LLP, will perform the annual investment policy compliance audit procedures for 2021 during the second half of 2022.

Reporting on Environmental, Social, and Governance (ESG) Performance

When reviewing the update to the Investment Policy in June 2020, City Council had requested the Chief Financial Officer and Treasurer, and the Toronto Investment Board to consider and incorporate internationally-recognized best practices for Environmental, Social and Governance.

The Toronto Investment Board is in the process of hiring a third-party data provider in order to monitor and report on whether or not external investment firms hired are compliant with the terms of the Investment Policy governing Environmental, Social, and Governance Factors. This process has taken longer than expected due to unforeseen issues. Capital Markets staff continue to collaborate with the City's procurement team and the prospective vendor to resolve these issues. It is anticipated this information and data regarding climate change risk from these reviews be available for the next investment report and will continue to be reported to City Council on a semi-annual basis. This investment fund-level ESG reporting process will complement the existing corporate-level ESG performance report.

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SIGNATURE

Heather Taylor
Chief Financial Officer and Treasurer

ATTACHMENTS

Attachment 1 - City of Toronto Statement of Investment Policy and Procedures
Attachment 2 - Background on the Funds
Attachment 3 - Record of Transactions in City of Toronto Debentures
Attachment 4 - Breakdown of the Portfolios by Sectors and by Credit Ratings
Attachment 5 - Historical Allocation of Gross Investment Earnings