TORONTO

REPORT FOR ACTION

City of Toronto Investment Report for the Six Month Period Ending June 30, 2023

Date: November 9, 2023
To: Executive Committee
From: Controller
Wards: All

SUMMARY

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

1. Performance of the Funds for the six month period ending June 30, 2023
2. General Market Update and Benchmark Performance
3. City of Toronto Investment Policy and Procedures

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 General Fund is comprised of two pools of investments: (a) the Short Term Fund (liquidity funds managed internally), and (b) the Long Term Fund (funds not immediately required are managed by the Toronto Investment Board). The General Fund had a book return of 3.6 percent and generated $187.4 million for the six months ending June 30, 2023.

Since the start of the pandemic in 2020, the General Fund has held a larger balance in the Short Term Fund to enhance the liquidity and to generally lower the overall risk (risk management). On average, the Short Term Fund, including the short-term investments of the Long Term Fund, was about 65% of the overall General Fund in 2022 compared to 48% from the pre-pandemic level in 2019. This higher weighting in the Short Term Fund provided significant protection, as well as increased returns as short-term rates moved higher.

The City's Sinking Fund portfolio is separate from the General Fund and holds the investment funds for future debt repayments. For the six months ending June 30, 2023, the Sinking Fund had a book return of 2.3 percent and generated $27.3 million in income.

Since January 1, 2018, the City's long-term investments (Long Term Fund and Sinking Fund) 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 make 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.

The Board manages four external fixed income managers and four external global equity managers engaged in managing the long-term investments. 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 of June 30, 2023, approximately 90 percent of both the Sinking Fund and the Long Term Fund were managed by external fund managers. The remaining 10 percent will be allocated to real assets, which is currently at the contract negotiation phase with the Board selected investment managers. 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. The Board continues to evaluate opportunities in the real asset category.

The Long Term Fund has an asset mix of both equity investments and fixed income investments. Following the weak and volatile second half of 2022, the first half of 2023 was calmer with strong returns in both the equity and fixed income markets. For example, the major fixed income and global equity markets benchmarks, FTSE Canada Universe Bond Index and MSCI ACWI, had a 1-year return of 3.1 percent and 20.2 percent respectively as of June 30, 2023.

In response to the City Council's request to the Toronto Investment Board and the Chief Financial Officer and Treasurer to monitor and report on the performance of the external investment firms as contracted by the Board with respect to Environmental, Social, and Governance ("ESG") factors, the Board has engaged an independent third-party ESG rating service provider, MSCI ESG Research LLC ("MSCI"). This investment fund-level ESG reporting process complements the existing corporate-level ESG performance report. MSCI ESG overall score has three categories: Leader, Average, and Laggard. As measured by MSCI, the City's ESG overall score is in the "Leader" category and is aligned with the selected market benchmark as depicted in the investment policy. The Board will continue to review the independent third-party reports from MSCI on a regular basis and investigate external investment managers that may not align with current ESG standards.

For the year 2022 and during the first six months of 2023, all funds managed are compliant with the Investment Policy. The City's auditor, KPMG LLP, performed the Investment Policy audit during the second half of 2023 and no issues were noted.

RECOMMENDATIONS

The Controller recommends that:

1. City Council receive this report for information.

FINANCIAL IMPACT

From an operating budget perspective, when recognizing only realized gains and losses, the General Fund earned $187.4 million and will be allocated between the eligible reserve funds and operating budget in accordance with the Council-approved interest allocation to reserve funds policy after the year end when all the required data becomes available.

When using only realized gains and losses the City's Sinking Funds portfolio earned $27.3 million for the first half year of 2023. 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 June 14, 2023, City Council adopted the report City of Toronto Investment Report for the Year 2022. This report provided the performance and compliance for year 2022.
Agenda Item History - 2023.EX5.4 (toronto.ca)

At its meetings held on June 15, 16, 2022 City Council received the report from the Chief Financial Officer and Treasurer for information. This report provided the performance and compliance for year 2021.
https://secure.toronto.ca/council/agenda-item.do?item=2022.EX33.6

At its meetings held on December 15, 16, 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 meetings 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 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

COMMENTS

General Market Update for six months ending June 30, 2023

During the first half of 2023, markets have generally rebounded due to anticipation of completed or nearing completion of the interest rate increases. For example, the major fixed income and global equity markets benchmarks, FTSE Canada Universe Bond

Index and MSCI ACWI, had a 1-year return of 3.1 percent and 20.2 percent respectively as of June 30, 2023.

While resilient economic data supported corporate earnings and the equity markets, inflation remained persistently high, and the central banks on a global basis resumed or accelerated interest rate hikes. The Bank of Canada increased the overnight lending rate twice during the first half of 2023 to a level of 4.75% on June 30, 2023. At that time, they also indicated that rate hikes were not over and subsequently had another increase of 25 basis points to move the overnight lending rate to its current level of 5.00%. As a result, bond yields, led by short term rates, increased significantly since the second quarter of 2023, resulting in a yield curve "inversion" where short-term rates are higher than long-term interest rates. The level of this inversion has not been seen in more than two decades.

During the first half of 2023, the economy had demonstrated that it can withstand the rate hikes and the ongoing high inflation to date. However, as of the date of this report, inflation data seems to have hit a peak and started to move lower although still outside of the target rate that most central banks focus on. As a result, the general market consensus was expecting fewer expected rate cuts through 2025 and expecting rates to remain "higher for longer". The capital markets remain very sensitive to economic data especially the inflation and employment data.

Background on City of Toronto Investment Funds

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 1 provides a short background on the City's investment funds.

In November 2015, the province amended the investment regulations, Ontario Regulation 360/15, under the City of Toronto Act, 2006 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 allowed 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 who have substantial knowledge and experience in the financial markets. In addition, City Council approved a new Investment Policy reflecting a target asset mix with 70 percent allocated to fixed income, 20 percent to global equities, and 10 percent to real assets to diversify the investment risk. Prior to the creation of the Board, 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.

While the Board would be responsible for "funds not immediately required", internal staff continue to manage the Short Term Fund to meet City's liquidity needs while maximizing investment return in accordance to the regulation.

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. A comparison of the results under the prudent investor standard versus a theoretical prescribed list appears later in this report (Table 2).

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, City 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 were 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 June 30, 2023, approximately 90 percent of both the Long Term Fund and the Sinking Fund were managed by external investment managers selected by the 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. The Board has selected two real asset investment managers to date (currently under contract negotiation) and will continue to evaluate investment opportunities in real assets.

General Fund Total Return Performance in the six month period ending June 30, 2023

As shown in Table 1 below, for one year horizon, the Short Term Fund (STF) has outperformed the benchmark by 10 basis points (0.1 percent), the Long Term Fund (LTF) has outperformed the benchmark by 100 basis points (1 percent), and together the General Fund has slightly outperformed the benchmark return by 40 basis points (0.4 percent). From a longer investment horizon perspective, the General Fund has outperformed the market benchmark by 10 basis points (0.1 percent) on a 4-year annualized return basis.

Table 1 –Total Returns versus Market Benchmarks (%) for the General Fund[1] as at June 30, 2023

	YTD (annualized) June 30, 2023			1 year (Year-over-Year)			4 year (annualized)		
	Short Term Funds[2]	Long Term Fund	General Fund	Short Term Funds[2]	Long Term Fund	General Fund	Short Term Funds[2]	Long Term Fund	General Fund
Portfolio Return (%)	4.8%	4.5%	4.7%	4.1%	7.9%	5.3%	1.7%	1.6%	1.7%
Benchmark Return (%)	2.2%	4.6%	2.9%	3.7%	6.9%	4.7%	1.4%	2.1%	1.6%
Value Added (%)	2.6%	-0.1%	1.8%	0.1%	1.0%	0.4%	0.3%	-0.5%	0.1%

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

[2]Including cash portion of the Long Term Fund

[3] Weighted by Market value of the Short Term and Long Term funds

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 $10.5 billion during the year. When excluding unrealized gains and losses from the total return, the General Fund earned $187.4 million (3.6% annualized rate of return on capital) over the six month period ending June 30, 2023.

Table 2 - Investment Portfolio for the six month period ending June 30, 2023 (in millions of dollars)

Portfolio	Average Fund Balance	Book Income	Book Return on Capital
1. Long Term Fund	$3,669.5	$27.2	1.5%
2. Short Term Fund	$6,802.4	$160.2	4.8%
Total General Funds	$10,471.9	$187.4	3.6%

Table 3 below shows that all asset classes generated positive book return in the first half of 2023.

Table 3 - Book Income Attribution for Long Term Fund for the six month period ending June 30, 2023 ($millions)

Long Term Fund Earned Income by Asset Class as at June 30, 2023 ($ millions)	
Fixed Income	$16.1
Global Equities	$1.8
Short Term Investments	$9.3
Total Earned Income	**$27.2**

In Table 4 below the total book income earned (excluding unrealized gains and losses) for the six months period ending June 30, 2023 was $50.9 million higher than the investment income forecasted for the purpose of preparing the 2023 investment income contribution to the operating budget. It should be noted that performance measured by book value is for the accounting and budget purposes only while the total return (market value) reflects the current value of the portfolio. Historical allocation of gross investment earnings is shown in Attachment 4.

Table 4 - Actual and Budget Investment Earnings (Operating Budget) for the six month period ending June 30, 2023

Book Investment earnings (in millions of dollars & Annualized Rate of Return)	Actual	Forecast (for budget)	Over/Under Budget
1. Long Term Fund	$27.2	$51.2	-$24.0
2. Short Term Fund	$160.2	$85.3	$74.9
Total General Funds	**$187.4**	**$136.5**	**$50.9**

The General Fund earned $187.4 million and will be allocated between the eligible reserve funds and the operating budget in accordance with the Council-approved interest allocation to reserve funds policy after the year end when all the required data becomes available.

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 and continuing post-pandemic issues. For example, funding from the other levels of government relating to pandemic related budget pressures remain uncertain. On average, the Short Term Fund, including the short-term investments of the long term fund, was about 65% of the overall General Fund in 2022 compared to 48% from the pre-pandemic level in 2019.

The Short Term Fund balance is expected to return to pre-pandemic levels once the uncertainty surrounding these financial pressures are contained. As shown in Table 4 above, the higher balance in the Short Term Fund during the recent rising interest rate environment provided much higher income than budgeted while allowing for protection and manage the related financial impacts.

Sinking Fund Total Return Performance in the six month period ending June 30, 2023

The Sinking Fund portfolio, which holds the investment funds for future debt repayments, had underperformed the weighted market benchmark by 1%, with a 0.1 percent annualized total return for the four year period ending June 30, 2023 as shown in Table 6. On a shorter term basis, the fund had a total return of 8.1 percent for the 1 year period, outperforming the weighted market benchmark by 0.8 percent (also shown in Table 7).

The blended benchmark for the total sinking fund is calculated based on the weighted average return of the target asset mix including real assets, the plan is currently transitioning towards the target asset mix and is not fully allocated at this point. Excluding the cash set aside for the upcoming investment in real assets, the externally managed invested assets (long term fund portion of the sinking fund) outperformed the weighted market benchmark by 0.4 percent for the 1-year period.

The 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.

Liability Driven Investment ("LDI") is very different than the active strategy used for the Long Term Fund. With the LDI strategy, an investment manager focuses on the debt repayment (liability) and match the asset purchases to those maturity dates. This is similar to how insurance companies and pension funds manage their risk.

Table 5 below shows the duration of the invested assets closely matches the duration of the liabilities in the Sinking Fund. 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.

In addition, the Sinking Fund receives regular contributions throughout the year in accordance with the regulations and by-laws when debt is issued. In the current rising rate environment, these cash contributions are invested at higher yields which is beneficial to the fund.

Table 5 - As at June 30, 2023 - Duration for the Sinking Fund[1]

(Years)	**Fixed Income Duration**
Portfolio Duration	12.3
Liability Duration	12.3

[1]From Aon Performance Review (Fixed Income)

Table 6 - Total Return versus Market Benchmark (%) for the Sinking Fund for the six month period ending June 30, 2023

	1 year (Year-over-Year)			4 year (annualized)		
	Short Term Sinking Funds	Long Term Sinking Fund	Total[2] Sinking Fund	Short Term Sinking Funds	Long Term Sinking Fund	Total[2] Sinking Fund
Portfolio Return (%)	4.3%	8.7%	8.1%	2.0%	-0.2%	0.1%
Benchmark Return (%)	3.7%	7.9%	7.3%	1.4%	1.0%	1.1%
Value Added (%)	0.6%	0.8%	0.8%	0.6%	-1.2%	-1.0%

[1]Calculated from RBCIS Performance Analytics and Aon, Performance Review
[2] Weighted by market value of the Short Term and Long Term Funds

When excluding the unrealized market gains and losses, the Sinking Fund portfolio earned 2.3% ($27.3 million) for the six month period ending June 30, 2023 on a book income basis as shown in Table 7 below. The asset mix attribution of the book income is listed in Table 8 below. These funds will be used to repay 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. There was a $300 million debt maturity in September 2023 with another $300 million maturity payment in May of 2024.

Table 7 - Sinking Fund Book Return for the six month period ending June 30, 2023

Portfolio	Average Weighted Capital Balance (Book Value)	Book Income	Book Return on Capital (Annualized)
Sinking Fund	$2,397.6	$27.3	2.3%

Table 8 - Book Income Attribution for Sinking Fund for the six month period ending June 30, 2023 (millions of dollars)

Sinking Fund Earned Income by Asset Class as at June 30, 2023 ($ millions)	
Fixed Income	$17.2
Global Equities	$1.0
Short Term Investments	$9.1
Total Earned Income	**$27.3**

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 is expected to be higher and sufficient to meet the debt repayments.

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 list of these transactions is found in Attachment 2.

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 first half of the year 2023. The breakdown of each portfolio is shown in Attachment 3.

There were no compliance exceptions to report for the six months ending June 30, 2023.

The City's auditors, KPMG LLP, has performed the annual investment policy compliance audit procedures for 2022, no issues were noted.

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 has recently contracted a third-party ESG Ratings Service provider, MSCI Inc. and its subsidiary MSCI ESG Research LLC (MSCI) in order to monitor and report on the high-level Environmental, Social, and Governance (ESG) performance of the City's investment portfolio. This investment fund-level ESG reporting process will complement the existing corporate-level ESG performance report. On a consolidated basis, MSCI has three categories for investment portfolios: Leader, Average, and Laggard. The ESG overall score for the City's investment portfolios is in the "Leader" category and is aligned with the market benchmark as depicted in the investment policy. . The detailed information from MSCI is proprietary and confidential.

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SIGNATURE

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ATTACHMENTS

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