REPORT FOR ACTION

City of Toronto Investment Report for the Year 2023

Date: May 31, 2024
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 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 managed by the Toronto Investment Board). The General Fund had a book return of 4.0 per cent and generated $444 million for the full year 2023.

As a result of the pandemic, the General Fund has held a larger position in the Short Term Fund (STF) 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 (LTF), was about 67 per cent of the overall General Fund in 2023 compared to 48 per cent 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 in recent years.

Staff re-assessed the City's liquidity position in late 2023 and advised the Chief Financial Officer and Treasurer (CFO&T) that excess funds within the Short Term Fund were available for longer term investment. At that time, a plan was set for $2 billion to be transferred from STF to the LTF in four quarterly installments during 2024. The CFO&T maintains the right to halt these transfers if circumstances change and there are higher needs for liquidity.

The City's Sinking Fund portfolio, which holds the investment funds for future debt repayments, had an earned income basis return of 1.2 per cent and generated $29.0 million for the twelve months ending December 31, 2023.

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. Investment portfolios of different asset classes have been progressively phased in to make use of the broader range of investments that have become available. Although, the potential for volatility in total returns over the short-term investment horizon still exist, the overall portfolio risk has been reduced through asset mix diversification. The overall risk-adjusted total returns over the long-term investment horizon are expected to be higher.

The Board currently provides oversight of four external fixed income managers and four external global equity managers that invest 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 per cent allocated to fixed income and 20 per cent to global equities.

As at December 31, 2023, approximately 90 per cent of both the Sinking Fund and the Long Term Fund were managed by external investment managers. The remaining 10 per cent of each fund will be allocated to real assets, which is currently in the contract negotiation phase with the Board's selected investment managers. Adding real assets to the current investment portfolios, which already compose of fixed income and global equity, will enhance the overall 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 to fulfill the target asset mix.

It is a legislative requirement that the Investment Policy be reviewed annually. Staff have reviewed the Investment Policy and no changes are recommended at this time given that policies have only been in place since 2018 and in that time we have experienced several years of volatility triggered by COVID-19 impacts. The City of Toronto Investment Policy can be reviewed in Attachment 1 of this report.

Although the prudent investor standard has only been in place for five years, and was carefully phased in, the change has been monitored for effectiveness versus the previous prescribed list (prior to 2018). This report also provides a comparison of returns between the previously used prescribed list versus the currently used prudent investor standard. The review shows the current regulation has been beneficial to the Long Term Fund by approximately $260 million over the five years it has been in place.

For the year 2023, all funds managed are compliant with the Investment Policy. KPMG LLP, the City's auditor, will conduct the Investment Policy audit during the second half of 2024.

The Toronto Investment Board has contracted a third-party data provider in order to monitor and report on the high-level Environmental, Social, and Governance (ESG) attributes of the City's long-term investment portfolio. This investment fund-level ESG reporting process will complement the existing corporate-level ESG performance report. At the end of 2023, the City's long-term investment portfolio's score is in the "Leader" category and is aligned with the selected market benchmark as depicted in the investment policy.

Subsequent to 2022, with a moderation of inflation and other related economic data, it would seem many central banks, such as the Bank of Canada, have now paused any further short-term interest rate increases. Since it would appear the actions of central banks are near a terminal point, with the prospect of lower interest rates in the future, long-term assets have rebounded to provide significantly higher returns in 2023.

RECOMMENDATIONS

The Chief Financial Officer and Treasurer 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 $444 million, of which $183.5 million was allocated to reserve funds in accordance with the Council-approved interest allocation policy. The remaining ($253 million) was allocated to the operating plan after Toronto Investment Board expenses in 2023 ($7.5 million) were deducted.

When recognizing only realized gains and losses, the City's Sinking Funds portfolio earned $29 million for the year 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 December 13, 14, 15, 2023 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 2023.
Agenda Item History - 2023.EX10.7 (toronto.ca)

At its meeting held on June 14, 2023 City Council received the report from the Chief Financial Officer and Treasurer for information. 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 2023

Generally, global equity markets had a strong year in 2023. A major reason for the resurgence was monetary policy pauses by the major central banks and increasing expectation of rate cuts in 2024 which would provide a boost to economic growth and activity which would benefit many companies. United States technology stocks have been boosted by the Artificial Intelligence theme, driving the performance of the U.S. equity market, which also skewed the results upward for the MSCI World index (up 19.5 per cent). This technology themed rally can change quickly and is unpredictable. Meanwhile, corporate earnings growth has slowed in other non-technology sectors globally over the past year and is indicating signs of corporate stress.

The fixed income market also rebounded from prior years, illustrated by the gain in the FTSE Canada Universe Bond Index in 2023 (up 6.7 per cent). The surge in Canadian federal bond yields came to a decisive end in the fourth quarter of 2023 as a pause by the Bank of Canada increased expectations of interest rate cuts in the near future. The U.S. Federal Reserve similarly triggered a rapid change in the bond market direction and sentiment with their pause in interest rate increases in late 2023.

Table 1 provides the results of several large Canadian pension funds with reputable track records which demonstrate the need to review investment returns over long periods. The results for the majority of the selected pension funds show a sub-par performance for a single year (2023) as compared to its longer term (10-year) track record. Most of the performance "drag" in 2023 was attributable to private equity and real estate market investments. According to the comments from these pension plans, the valuation on real estate investments appears to be near a low point. The City of Toronto is in the final stages of adding real asset investment managers and making progress towards the target asset mix.

Table 1 - Performance Comparison of Major Pension Funds

Pension Fund	10-year Return	2023 Return
Healthcare of Ontario Pension Plan (HOOPP)	8.4%	9.4%
Ontario Teachers' Pension Plan (OTPP)	7.6%	1.9%
Ontario Municipal Employees Retirement System (OMERS)	7.3%	4.6%
Canada Pension Plan Investment Board (CPPIB)	9.3%	1.3%*

*year-end is March 31, 2024.

Background on City of Toronto Investment Funds

Working capital and the amounts designated for reserves and reserve funds along with other deferred revenues 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 Ontario Regulation 360/15 the investment regulations 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 prescriptive and is used in situations where a trustee has fiduciary responsibility over funds that should be invested according to the beneficiaries' unique situation and to consider the risk and return profile of the entire portfolio rather than only of individual securities or asset classes. This change removed the previous investment limitations and allows the City to be responsible for its 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 change 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 and 20 percent to global equities 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 in 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 greater use of a broader range of investments that became available. Although portfolio risk continues to be reduced, the potential for volatility in short-term returns still exists.

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. The reserve receives funds in years when investment income exceeds budget and funds are withdrawn 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 with the target asset mix in the Investment Policy. Approximately 90 percent of the Long Term Fund and the Sinking Fund were managed by external investment managers selected by the Board by December 31, 2022.

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 reserved 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 to fulfill the target asset mix.

Prescribed List versus the Prudent Investor Standard - Comparison

Prior to 2018, the City of Toronto strictly adhered to investment regulations commonly known as the "prescribed list". In other words, the provincial regulations supplied a list of acceptable investments that primarily consisted of government bonds, and a few high-quality financial (bank) bonds. This changed in 2018 with the overhaul of the regulation that allowed for the "prudent investor standard" and the creation of the Toronto Investment Board and the hiring of professional money managers.

With five completed years of the new regulations, staff developed a simple comparison to assess the "prescribed list" against the "prudent investor standard". The assessment uses the Long Term Fund to determine whether the City of Toronto is further ahead given the changes in regulation. While there are still more investment managers to be added, there was an interest to see if there was a difference at this relatively early stage. Results are shown in Table 2.

Table 2 - Prescribed List versus the Prudent Investor Standard - Comparison

Year-End	Prescribed List Return[1] (%)	Prudent Investor Return[2] (%)	Difference[3] (%)
2019	6.42	6.20	-0.20
2020	8.69	10.30	1.61
2021	-2.97	2.00	4.97
2022	-11.69	-11.20	0.40
2023	6.69	9.30	2.61
Cumulative 5-Year Return	**6.67**	**15.97**	**N/A**
Compound Annual Growth Rate (5 year)	**1.30**	**3.01**	**N/A**

[1] FTSE Canada Universe Bond Index was used to replicate the Prescribed List

[2] Prudent Investor Return was the actual returns of the Long Term Fund

[3] Difference is the Prudent Investor Return minus the Prescribed List Return

The outperformance of the Prudent Investor Standard over five years is 1.7 per cent, or the equivalent of approximately $260 million in total dollar terms on the approximate $3 billion initially invested under the new regulation.

It would seem the Prudent Investor Standard is proving to be an effective tool for diversification of returns and improving the risk profile of the Long Term Fund. It is expected the gap in performance will continue to grow and compound over time and as the Investment Policy asset mix is fully implemented.

General Fund Total Return Performance for 2023

As shown in Table 3, the Short Term Fund (STF) has outperformed the benchmark by 30 basis points (0.3 per cent), the Long Term Fund (LTF) has underperformed the benchmark by 10 basis point (0.1 per cent) and together the General Fund has outperformed the benchmark return by 20 basis points (0.2 per cent) in the year 2023. From a longer investment horizon perspective, the General Fund has outperformed the market benchmark by 40 basis points (0.4 per cent) on a 4-year annualized return basis.

Table 3 –Total Returns versus Market Benchmarks (%) for the General Fund[1] as at December 31, 2023

	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 (%)	5.1%	9.3%	6.4%	2.4%	2.6%	2.5%
Benchmark Return (%)	4.8%	9.4%	6.2%	1.8%	2.8%	2.1%
Value Added (%)	0.3%	-0.1%	0.2%	0.6%	-0.2%	0.4%

[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 4, the General Fund, which is comprised of the Short Term Fund and the Long Term Fund, had an average total fund balance of $11.1 billion during 2023. When excluding unrealized gains and losses from the total return, the General Fund earned $444.0 million which we refer to as the "Earned Income". This equates to a 4.0 per cent "Earned Return on Capital" during 2023.

Table 4 - Investment Portfolio for the year 2023 ($ millions)

Portfolio	**Average Fund Balance**	**Earned Income**	**Earned Return on Capital**
1. Long Term Fund	$3,675.2	$66.9	1.8%
2. Short Term Fund	$7,395.2	$377.1	5.1%
Total General Funds	$11,070.4	$444.0	4.0%

Table 5 shows a breakdown in the attribution by earned income for the Long Term Fund for 2023.

Table 5 - Earned Income Attribution for Long Term Fund - 2023 ($ millions)

Long Term Fund Earned Income by Asset Class as at December 31, 2023 ($ millions)	
Fixed Income	32.5
Global Equities	14.5
Short Term Investments	19.9
Total Earned Income	**66.9**

Table 6 provides the total earned income (excluding unrealized gains and losses) in 2023 was $109.7 million higher than the budgeted income contribution to the operating budget. It should be noted that performance measured by earned income 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 5.

Table 6 - Actual and Budget Investment Earnings (Operating Budget) for 2023

Investment earnings ($ millions & Annualized Rate of Return)	**Actual**	**Budget**	**Over/Under Budget**
1. Long Term Fund	-$116.6	-$29.7	-$86.9
2. Short Term Fund	$377.1	$180.5	$196.6
Total General Funds	**$260.5**	**$150.8**	**$109.7**

Investment earnings ($444.0 million) were allocated to eligible reserve funds ($183.5 million) and the Operating Budget ($260.5 million) after deducting investment expenses ($7.5 million) in accordance with the Council-approved interest allocation policy.

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, including the short-term investments of the long term fund, was about 67 per cent of the overall General Fund in 2023 compared to 48 per cent 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. As shown in Table 6, the higher balance in the Short Term Fund in the rising interest rate environment provided much higher income than budgeted while allowing for protection and manage the pandemic financial impacts.

Staff continued to re-assess the City's liquidity position in late 2023 and advised the Chief Financial Officer and Treasurer (CFO&T) there are excess funds available for longer term investment. At that time a plan for a total of $2 billion is to be transferred from STF to the LTF in four quarterly installments during 2024. The CFO&T maintains the right to halt these transfers if circumstances change and there are insufficient amounts to meet the liquidity needs of the City.

Sinking Fund Total Return Performance in 2023

The City's Sinking Fund portfolio, which holds the investment funds for future debt repayments, had underperformed the weighted market benchmark by 0.6 per cent, with a 1.1 per cent annualized total return for the four year period ending December 31, 2023 as shown in Table 8. On a shorter-term basis, the fund had a total return of 10.0 per cent for the year 2023, outperforming the weighted market benchmark by 0.5 per cent (also shown in Table 8).

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.

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.

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 7 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 a rising rate environment as in 2023, these cash contributions are invested at higher yields which is beneficial to the fund.

Table 7 - As at December 31, 2023 - Duration for the Sinking Fund[1]

	Fixed Income Duration (years)
Portfolio Duration	12.5
Liability Duration	12.4

[1]From Aon Performance Review (Fixed Income)

Table 8 - Total Return versus Market Benchmark (%) for the Sinking Fund as at December 31, 2023[1]

	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 (%)	5.2%	11.0%	10.0%	2.5%	0.8%	1.1%
Benchmark Return (%)	4.8%	10.5%	9.5%	1.8%	1.7%	1.7%
Value Added (%)	0.4%	0.5%	0.5%	0.7%	-0.9%	-0.6%

[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 1.2 per cent ($29.0 million) for the year 2023 on a book income basis as shown in Table 9. The asset mix attribution of the book income is listed on Table 10. 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. Sinking Fund contributions made in 2023 and in early 2024 will be invested in fixed income securities at higher yields than the assumed required rate of return of the fund.

Table 9 - Sinking Fund Book Return as at December 31, 2023 ($ millions)

Portfolio	Average Weighted Capital Balance (Book Value)	Book Income	Book Return on Capital (Annualized)
Sinking Fund	$2,465.4	$29.0	1.2%

Table 10 - Earned Income Attribution for Sinking Fund - 2023 ($millions)

Sinking Fund Earned Income by Asset Class as at December 31, 2023 ($ millions)	
Fixed Income	-1.7
Global Equities	8.3
Short Term Investments	22.4
Total Earned Income	**29.0**

The investment portfolios have progressively phased into greater use of the broader range of investments that became 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 exists while the risk-adjusted total return over the long-term investment horizon are expected to be higher and sufficient to meet the debt repayments.

With regards to debt repayment, there was one debt maturity in 2023 in the amount of $300 million. The next maturity will be in May 2024 for an additional $300 million.

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 is 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 2023. The breakdown of each portfolio is shown in Attachment 4.

There were no exceptions to report for the year 2023.

The City's auditors, KPMG LLP, will conduct the annual investment policy compliance audit procedures for 2023 during the second half of 2024.

The Investment Policy has been reviewed by staff and no changes are recommended at this time.

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

When reviewing the update to the Investment Policy in June 2020, City Council 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 contracted a third-party data provider in order to monitor and report on the high-level Environmental, Social, and Governance (ESG) attributes of the City's long-term investment portfolio. This investment fund-level ESG reporting process will complement the existing corporate-level ESG performance report.

The overall ESG score has three categories: Leader, Average, and Laggard. At the end of 2023, the City's long-term investment portfolio's score is in the "Leader" category and is aligned with the selected market benchmark as depicted in the investment policy.

CONTACT

Randy LeClair, Director, Capital Markets
Tel: 416-397-4054; E-mail: Randy.LeClair@toronto.ca

SIGNATURE

Stephen Conforti
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