RICHMOND HILL
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Staff Report for Budget Committee of the Whole Meeting

Date of Meeting: **June 23, 2020**
Report Number: **SRCFS.20.019**

Department: **Corporate and Financial Services**
Division: **Financial Services**

Subject: SRCFS.20.019 – 2019 Investment Portfolio Results

Purpose:

To report on the performance of the City's Investment Portfolio for 2019, as required by Ontario Regulation 438/97 (as amended) of the *Municipal Act, 2001.*

Recommendation(s):

That staff report SRCFS.20.019 be received for information purposes.

Contact Person:

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Report Approval:

Submitted by: Sherry Adams, Commissioner of Corporate and Financial Services

Approved by: Mary-Anne Dempster, City Manager

All reports are electronically reviewed and/or approved by the Division Director, Treasurer (as required), City Solicitor (as required), Commissioner, and Chief Administrative Officer. Details of the reports approval are attached.

Background:

In accordance with reporting requirements of the *Municipal Act* and the City's Investment Policy, the Commissioner of Corporate and Financial Services and/or Treasurer is required to provide an investment report to Council at least annually, in order to provide an update on the status of the investment holdings including an analysis of the investment activity undertaken in the preceding fiscal year. This report contains the following:

- A statement about the performance of the investment portfolio during the calendar year 2019;
- A description of the estimated proportion of the total investments that are invested between long term and short term holdings and a description of the change, if any, in that estimated proportion since the previous year's report;
- A statement by the Treasurer as to whether or not, in his or her opinion, all investments are consistent with the Investment Policy and goals adopted by the City; and
- Updates on the Prudent Investor Standard.

The City's investments are governed by the *Municipal Act* and its Investment Policy, which establishes the guidelines in ensuring effective and professional management of all of the City's funds.

The objectives of the City's Investment Policy, in order of priority are:

1) Compliance to statutory requirements;
2) Preservation and security of capital;
3) Maintenance of necessary liquidity; and
4) Realizing a competitive rate of return.

Economic Conditions and Financial Markets

Global recessionary fears that emerged towards the end of 2018 were related to higher borrowing costs due to a rising interest rate environment and ongoing uncertainty surrounding global trade. Although concerns on the economic outlook quickly subsided beginning 2019 due to better than expected economic data, which coincided with stabilization of financial markets, expectations of a slowdown in global growth still lingered.

As a result of the duration and political processes involved in resolving global trade conflicts, specifically between U.S. and China, the global macroeconomic backdrop in 2019 largely mirrored to that of the prior year, when the dispute initially began. This recurring theme dominated the headlines throughout the entire year, due to back and forth negotiations between the two largest economies in the world. Trade tensions continued to flare up intermittently from ongoing discussions between the two countries, resulting in a temporary breakdown in communications during the middle of the year. This led to an escalation by means of additional tariffs being imposed on goods from one another and was inevitably met with bouts of volatility in financial markets, but to a much lesser degree than compared to the final months of 2018. This was attributed to market skepticism, as to whether a resolution could actually be reached between the two parties. However, signs of progressive deterioration seen in economic indicators such as global manufacturing data, including risks of a greater spillover to other parts of the global economy, eventually resulted in a trade agreement verbally reached in the latter part of the year.

The inception of 'Brexit' back in June 2016, which entered into its third year of negotiations between the U.K. and European Union in 2019, also added uncertainty to the global business outlook. Multiple extensions to the official departure date occurred throughout the year, which finally led the U.K. to formally leave the European Union, but not until January 2020.

Even in the midst of global trade uncertainty overshadowing majority of the year, U.S. economic growth remained well intact, dispelling the earlier concerns of an impending recession. U.S. real GDP growth in 2019 was 2.3%, marking a mild deceleration from the 2.9% pace recorded in 2018 (Source: U.S. Bureau of Economic Analysis). This was supported by a resilient labour market, as the unemployment rate reached a 50-year low of 3.5% through consistent job gains, including healthy wage growth. Collectively, this enabled consumer spending to stay robust, which is highly important, given that this metric accounts for more than two-thirds of economic growth.

In light of the weaker segments of the economy, particularly those related to global trade, such as business investments and exports, this led to a pivotal shift in the interest rate environment. This was evidenced by the change in direction of monetary policy from the U.S. Federal Reserve. After going through the most aggressive period of its tightening cycle in the previous year by its four quarterly 25 basis point increases on its federal funds rate, 2019 marked a swift reversal in the central bank's stance. They reduced their policy rate by 25 basis points on three consecutive instances in July, September and October. This was justified as preemptive insurance, in order to sustain the economic expansion, at the same time when material inflationary pressures were absent and core readings drifting further below their 2% target.

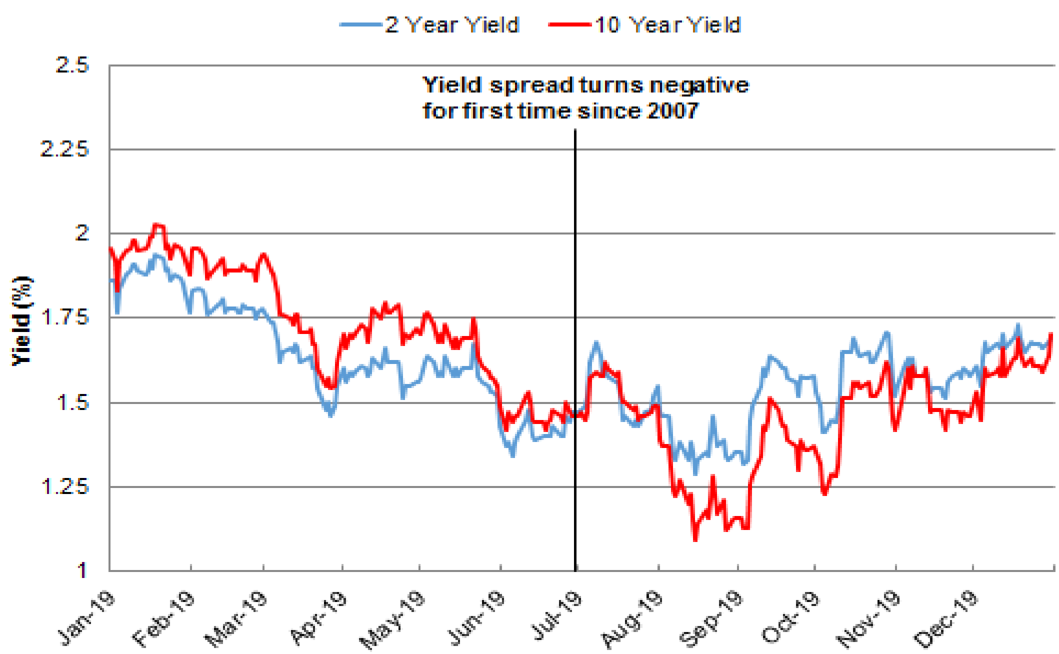
Canada continued on its trajectory of slowing economic growth, resulting in another lower pace of expansion of 1.6% in 2019, down from 2.0% in 2018 (Source: Statistics Canada). In addition to global trade tensions that exerted downward pressure on the economy, other negative factors that hindered growth, particularly towards the end of the year, were attributed to pipeline shutdowns, railroad strikes and disruptions in auto manufacturing from U.S. auto strikes. However, pockets of domestic strength were still visible in the Canadian economy, in areas similar to that of the U.S., as reflected through strong employment, improving housing markets and stabilization in household spending. The unemployment rate reached 5.5%, which was the lowest in 40 years.

The interest rate environment in Canada for 2019 was highly unique, in terms of Bank of Canada maintaining a hold position on its policy rate of 1.75%. By not following through on any rate cuts, this was in stark contrast to the U.S. Federal Reserve. This resulted in Bank of Canada having the highest policy rate among developed nations, as its rationale to not deviate on its monetary policy, centered on inflation consistently meeting their 2% target and elevated household debt levels.

Although the overnight rate was unchanged at 1.75%, Government of Canada bond yields, which peaked in October 2018, before precipitously declining on initial recessionary concerns, resumed its downtrend throughout 2019. As yields declined from rising bond prices due to their inverse relationship, this was reflective of strong investor demand for safe assets such as government bonds, as well as corporate bonds. As a result, the overall Canadian bond market experienced one of their best annual returns in over a decade.

Overall, short term and long term Government of Canada bond yields trended lower throughout 2019. The spread between the 2 year yield and 10 year yield turned negative in mid-year, the first occurrence since 2007, as shown in the following chart.

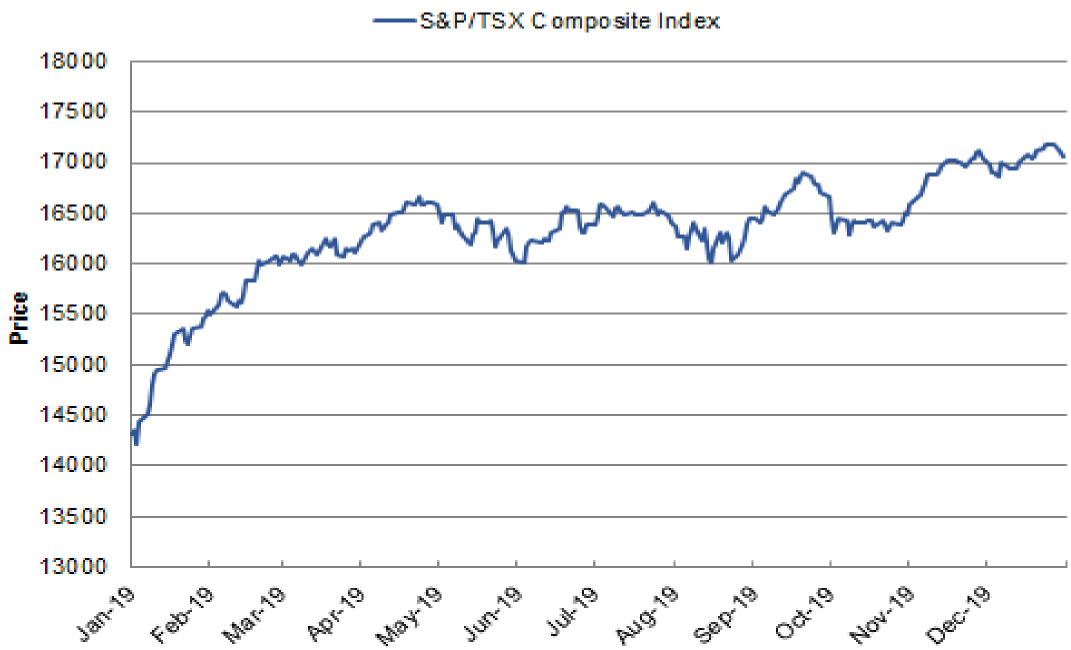
Chart 1 – 2 Year and 10 Year Government of Canada Bond Yields in 2019



(Yields sourced from Bank of Canada)
Although the 2 year yield and 10 year yield ended the year at similar levels, they reached as low as 1.29% and 1.09% in August, respectively.

On the contrary, global equity markets did not convey the same expectations of a weaker economic outlook, as earmarked by the strong returns seen in equity prices. The S&P/TSX Composite Index, which is shown in the following chart, represents the benchmark for the overall Canadian equity market and posted its best annual performance since 2009, as the Index was up 19% for the year.

Chart 2 – S&P/TSX Composite Index Performance in 2019



(Prices sourced from TMX Group)

The divergence in the direction of bond yields (lower) compared to equity prices (higher) or alternatively, bond prices and equity prices both moving higher are uncommon, considering they are typically perceived as safe and risk assets, respectively. However, this market dynamic enabled the City's investment portfolio to capture favourable returns.

Investment Portfolio Results

In 2019, the City's investment portfolio realized total income of $15.9 million based on an average portfolio balance of $547.5 million. This resulted in an income return of 2.90%. The average balance is only used for the return calculation, as it provides the most accurate measure by incorporating the number of days the balance was held at specific levels during the calendar year. This incorporates the amount and timing of all cash flows related to investment purchases, maturities and sales. The income return reflects investment income earned on all investments and directly translates to the amount of interest allocated between the operating budget and reserve funds.

The following table provides a summary of the breakdown for investment income realized between short term and long term investments. Short term investments have a term of 1 year or less including cash balances and over 1 year as long term.

Table 1 – Portfolio Income Return and Year over Year Comparison

Year	Investment Term	Average Balance ($ millions)	Investment Income ($ millions)	Portfolio Income Return
2019	Short Term	161.0	4.0	2.48%
	Long Term	386.5	11.9	3.08%
	Total	**547.5**	**15.9**	**2.90%**
2018	Short Term	128.5	2.7	2.14%
	Long Term	402.5	11.9	2.96%
	Total	**531.0**	**14.6**	**2.76%**

The interest income earned on the City's cash balances is based on a variable interest rate structure that is directly linked to RBC's prime rate. Since Bank of Canada's policy rate was unchanged for the entire year, this also equated to no change in RBC's prime rate and remained at 3.95% for all of 2019. Since the global financial crisis in 2008, this was the highest it has ever been, following five interest rate increases of 25 basis points each beginning July 2017. As a result, the investment portfolio was able to maximize the deposit interest earned on cash balances. However, the greater decline in longer term yields, as illustrated earlier with the change in the yield curve, continued to limit yields that could be captured on long term investment purchases.

In order to facilitate objective performance measurement, the second method of evaluation is total return. This combines realized investment income with Mark-to-Market adjustments, which reflects the change in market values of the underlying securities in the investment portfolio. This provides an assessment in measuring how the investment portfolio performed against a market benchmark based on industry standards.

As outlined in the Investment Policy, the most suitable benchmark is a combination of FTSE (Financial Times Stock Exchange) Canada Debt Market Indices and the S&P/TSX (Standard & Poor's/Toronto Stock Exchange) Composite Index. Both are leading indicators used in measuring Canadian market performance in fixed income and equities, respectively.

In 2019, the total return of the investment portfolio was 5.26%, after incorporating a positive market impact. The following table provides a summary of the breakdown.

Table 2 – Summary of Portfolio Total Return

Year	Average Balance ($ millions)	Investment Income ($ millions)	Portfolio Income Return	Mark-to-Market ($ millions)	Portfolio Total Return
2019	547.5	15.9	2.90%	12.9	5.26%
2018	531.0	14.6	2.76%	(3.4)	2.11%

The large positive Mark-to-Market impact in 2019 was mainly attributed to strong returns from both fixed income and equity markets. Based on internal analysis and expectations of a less favourable market outlook in 2020, staff took the opportunity to realize gains on a portion of its long term investments, where returns are linked to the performance of equity markets. In addition to portfolio rebalancing, this was also part of reallocating the proceeds into safer securities, while capturing longer term yields, based on the view at the time that interest rates would decline even further. Collectively, these investment decisions added value and enhanced the positive Mark-to-Market and resulting Portfolio Total Return.

The total return of the City's benchmark was 5.08%, which the investment portfolio exceeded its benchmark by 0.18%, as presented in the next table.

Table 3 – Portfolio Total Return versus Benchmark Total Return

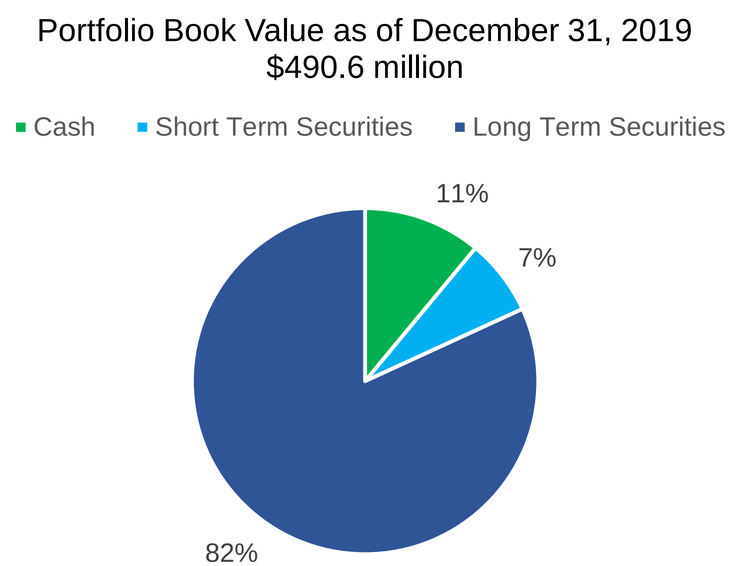
Year	Portfolio Total Return	Benchmark Total Return	Difference
2019	5.26%	5.08%	0.18%
2018	2.11%	0.91%	1.20%

A major factor that supported the greater performance of the investment portfolio relative to its benchmark was deposit interest earned on cash balances. This was due to the City's attractive variable interest rate structure on its main deposit account with RBC's prime rate maintained at its highest level for all of 2019, since the last rate increase in October 2018. This enabled it to realize a much more competitive yield, than compared to money market instruments such as the Government of Canada 3-month T-bill. The other value added component was related to extending the investment portfolio's duration through purchases on much longer term fixed income securities. As a result, favourable market returns were captured from higher prices due to their greater sensitivity to changes in interest rates, especially as longer term yields declined more than short term yields.

Year-end Investment Portfolio Metrics

The book value of total investments held at year-end, which represented the cost of all holdings (Appendix "A") was $490.6 million, which included cash balances totaling $54.0 million, short term holdings of $35.0 million and long term holdings of $401.6 million. This translated proportionately to the total portfolio balance of 11%, 7% and 82%, respectively. The City held a lower cash balance at the end of 2019 of $54.0 million compared to the prior year of $70.1 million, which still provided ample liquidity to support ongoing working capital requirements entering 2020. The following chart displays the breakdown of the total portfolio.

Chart 3 – Portfolio Breakdown of Cash, Short Term and Long Term Holdings



As cash plays an integral role in the overall asset mix, the City continued its focus on maintaining optimal levels of liquidity through its effective cash management process. This enabled the portfolio to maximize investment income while adequately meeting financial obligations related to both operating and capital expenditures.

The term structure of the investment portfolio was extended from a weighted average term to maturity of 2.3 years to 3.6 years in 2019, in order to capture higher yields and to better align with the Capital Forecast needs (Appendix "B"). This was reflected in the lower cash balances maintained at year-end and portfolio extension through longer term investment purchases.

Prudent Investor Standard

The "Prudent Investor" regime is directed towards broadening municipal investment powers in order to better support the maintenance and growth of its infrastructure based on funds not immediately required. Municipalities will have the opportunity to invest into a much greater selection of investment vehicles as well as the ability to obtain exposure in global markets. This is in significant contrast to the existing prescribed list of eligible securities, which the Investment Policy is established upon. A municipality is required to pass a By-law in order to start investing according to the new standard. An 'Investment Board' or 'Joint Investment Board' will need to be established to exercise oversight, control and management of the funds being invested.

The financial conditions to be met are either independently having $100 million in investable funds not required immediately, or a combined total of $100 million as a group with one or more municipalities. Although 'funds not required immediately' has no specific timeframe defined and is up to each municipality to determine, ONE's legal counsel has established 18 months as a general benchmark.

The ONE Joint Investment Board was established on May 19, 2020. The six founding municipalities of this new arrangement are The Corporation of the Town of Bracebridge, The Corporation of the Town of Huntsville, The Corporation of the Town of Innisfil, The Corporation of the City of Kenora, The District Municipality of Muskoka, and The Corporation of the Town of Whitby.

At this time, it is expected that other municipalities are awaiting new developments before deciding whether to move towards the new standard. The ONE Joint Investment Board is the first after City of Toronto, and that one cannot simply opt out of the arrangement without regulatory approval. At the end of 2019, City of Toronto's Investment Board was still in the process of completing its transition plan related to its funding schedule for investment managers, in order to achieve its target asset allocations.

Staff will continue to monitor any new developments and report back in 2021 with any further information.

Looking at 2020 and Moving Forward

The market environment and financial outlook beginning the year, started off on a more positive note than the prior year, largely due to the official signing of an initial trade agreement between U.S and China on January 15, 2020. However, the financial market narrative took a sudden turn to the downside, as COVID-19 became an increasingly serious concern. This becoming a global health pandemic was an unforeseen event, especially at a time when majority of countries were not fully equipped and prepared to deal with such a crisis. Necessary containment measures such as school, restaurant and non-essential business closures, including travel bans and social distancing, were all required to ensure public health safety. However, the unfortunate trade-off would be a severe self-induced negative impact on each respective economy, as the global economy essentially grinds to a halt.

An imminent global recession has caused extreme volatility across all asset classes in financial markets, given much uncertainty with respect to the length of time and magnitude that COVID-19 will have. These unprecedented times have led to global coordinated action among governments and central banks. Significant fiscal and monetary stimulus packages are already being deployed, with potentially more to come, as concerted efforts are required to mitigate the economic impact as much as possible.

Global interest rate cuts, including the Bank of Canada swiftly reducing its policy rate to 0.25%, have correspondingly led to banks such as RBC, also lower their prime rate to 2.45%. This will have an immediate and significant negative impact on deposit interest the City earns on its cash balances and income it can earn on new short term investments. The financial impact on short term investment income is projected to decline by up to $2.5 million in 2020.

Long term yields and equity markets have also significantly declined recently, which will impair our ability to achieve favourable returns in long term investments in the near term, including those securities linked to the performance of equity markets. However, it is important to note that the City's investment portfolio is largely concentrated in fixed income investments for capital preservation, including Principal Protected Notes, as referenced in the name.

There is certainly much investor panic, fear and pessimism market mirroring the last recession, considering the initial health crisis, and has expanded into an economic crisis. However, massive fiscal and monetary stimulus packages have already been deployed to preemptively mitigate the economic damage. Notable fiscal measures include the Canada Emergency Response Benefit (CERB) and Canada Emergency Wage Subsidy (CEWS), which provides temporary income support and wage subsidization to employers and employees.

On the monetary front, aside from rate cuts and other various measures, Bank of Canada has already expanded its Government Bond Buyback Program, lowered the capital buffer requirements for Canada's largest 6 banks and launched multiple funding facilities. Collectively, all these tools are aimed at providing sufficient liquidity to the Canadian financial system, such that it continues to flow through the economy. This is required to support consumer and business confidence and to ensure all businesses, particularly small and medium sizes, continue to have access to funds, especially at a time when funding needs are increased and credit conditions have tightened significantly.

Staff will continue to monitor the global macroeconomic environment and market conditions to adjust accordingly in balancing out risks and opportunities to preserve capital and realize competitive returns. More importantly, we are also monitoring ongoing developments and prepared to make any necessary adjustments in the investment portfolio to prioritize liquidity and cash requirements, as part of supporting the residents, businesses and the community.

Financial/Staffing/Other Implications:

The City's investment portfolio earned a total of $15.9 million in investment income for 2019 of which $5.0 million was allocated to the operating budget and the remaining amount of $10.9 million allocated to reserve funds.

Relationship to the Strategic Plan:

The Treasurer is of the opinion that the investment portfolio and all transactions undertaken in 2019 adhered to all required standards of the *Municipal Act,* Investment Policy and goals adopted by the City. The Investment performance demonstrated effective use and application regarding all of the City's available monies through wise management of public funds.

Conclusion:

The City's investment portfolio generated a total realized investment income of $15.9 million, which equated to an income return of 2.90%. These results are reflected as positive amid the low interest rate environment, given that capital preservation remains as the top priority.

Attachments:

The following attached documents may include scanned images of appendices, maps and photographs. If you require an alternative format please call the contact person listed in this document.

- Appendix "A" – List of Portfolio Holdings
- Appendix "B" – Portfolio Breakdown by Term

Report Approval Details

Document Title:	SRCFS 20 019 - 2019 Investment Portfolio Results.docx
Attachments:	- SRCFS.20.019 - Appendix A - List of Portfolio Holdings.docx - SRCFS.20.019 - Appendix B - Portfolio Breakdown by Term.docx
Final Approval Date:	Jun 8, 2020

This report and all of its attachments were approved and signed as outlined below:

David Dexter - Jun 8, 2020 - 11:23 AM

Sherry Adams - Jun 8, 2020 - 12:00 PM

MaryAnne Dempster - Jun 8, 2020 - 2:59 PM