RICHMOND HILL
INCORPORATED 1873

Staff Report for Council Meeting

Date of Meeting: June 28, 2022
Report Number: SRCFS.22.014

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

Subject: SRCFS.22.014 - 2021 Investment Portfolio Results

Purpose:

To report on the performance of the City's Investment Portfolio for 2021, as required by Ontario Regulation 438/97 (as amended) of the *Municipal Act, 2001*.

Recommendation(s):

a) That staff report SRCFS.22.014 be received for information purposes.

Contact Person:

Bernard Yu, Financial Management Advisor, Ext. 5430

Report Approval:

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

Approved by: Darlene Joslin, Interim City Manager

All reports are electronically reviewed and/or approved by the Division Director, Treasurer (as required), City Solicitor (as required), Commissioner, and City Manager. 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. This is to provide an update on the status of the investment holdings including an analysis of the investment activity undertaken in the preceding fiscal year. The report contains the following:

- A statement about the performance of the investment portfolio during the calendar year 2021;
- 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.

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

After a tumultuous environment created by the onset of the pandemic in early 2020, including multiple waves of COVID-19 variants, the global economy underwent a major recovery in 2021. This was driven by the increasing uptake of vaccinations and additional fiscal stimulus, while central banks remained highly accommodative. This was accomplished by maintaining low borrowing costs through near zero policy interest rates and ongoing liquidity provided to financial markets through their bond-buying programs.

The economic recovery was not always in-sync across the globe and especially more uneven across different sectors and industries due to renewed shutdowns enacted by governments. Small businesses and specifically those industries centered on travel, tourism, retail and hospitality did not experience the same pick up in activity, given the similar capacity constraints and restrictions faced during the early stages of the pandemic. However, households and individuals have since largely adjusted to the new environment, while a ramp up in vaccinations spurred greater confidence in keeping consumer spending intact.

Building on the momentum in the early stages of a business cycle recovery, the U.S. economy expanded by 5.7% in 2021 (Source: U.S. Bureau of Economic Analysis), which was the fastest pace in many decades. This rapid pace of growth was strongly supported by an additional round of pandemic relief measures legislated back in March, in order to continue providing financial aid to individuals, businesses and state and local governments. As the economy reopened, the labour market experienced a strong rebound, which saw its unemployment rate decline from 6.7% beginning the year to 3.9% at year-end (Source: U.S. Bureau of Labor Statistics).

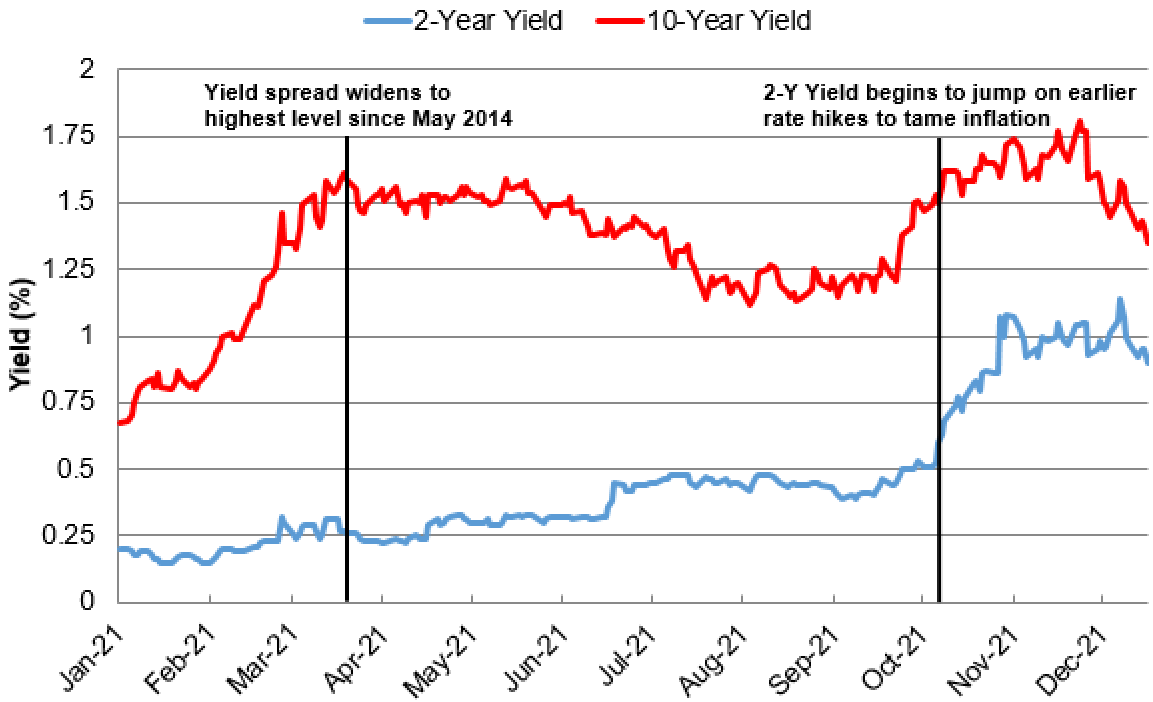
As the global macroeconomic backdrop continued to improve, risk assets such as equities reacted favourably, given the rebound in corporate earnings and the reiterated guidance from central banks on easy monetary policy. This reinforced their objective of prioritizing employment recovery and economic growth rather than taming inflation, based on the initial expectation that price pressures will be transitory. However, the supply-demand imbalances of goods persisted throughout the entire year, given the long lead times for production to ramp up in meeting resilient demand. The impact was most pronounced in the auto industry, which experienced multiple waves of production shutdowns due to shortages in semiconductor chips and fueled a dramatic rise in used car prices.

The most important contributors to input costs for companies stem from wages and raw materials and typically passed through to consumers in finished goods. This was evident from significant price gains seen across the commodities complex, such as energy, metals and agriculture. Labour shortages in transportation and logistics further pressured supply chains, which also required higher wages offered to attract workers. This Consumer Price Index (CPI), when measuring year over year change, accelerated from 1.4% beginning the year to 7% at year-end (Source: U.S. Bureau of Labor Statistics).

As an exports-oriented economy, Canada also reaped the benefits of higher commodity prices such as in crude oil, which allowed it to achieve its largest annual trade surplus since 2008. The Canadian economy grew by 4.6% in 2021 (Source: Statistics Canada), as it also gained from the additional fiscal stimulus in the U.S., given they represent the nation's largest trading partner. This was in addition to its own federal support programs that carried over from the prior year, including new measures launched to continue extending support to small businesses and those of the hardest hit industries. The labour market staged a more than full recovery, as total employment exceeded its pre-pandemic level by over 240,000 jobs, while the unemployment rate declined from 8.8% to 6.0% (Source: Statistics Canada).

Although Canada did not encounter the same magnitude of price pressures compared to the U.S., its Consumer Price Index (CPI) still jumped from 0.7% in January to 4.8% in December, with higher food, shelter and gasoline costs among the top contributors. Bank of Canada utilizes a target range of 1% to 3% with a mid-point focus of 2% to control inflation, which was clearly exceeded. In response, they gradually tapered its bond-buying program and ended it in October for the lack of need to continue adding liquidity to the financial system, given the significant progress witnessed in the economy and inflation trending beyond its expectations. Despite maintaining its Overnight rate at 0.25%, the central bank signaled an earlier timetable for a liftoff in its policy rate.

Chart 1 – 2 Year and 10 Year Government of Canada Bond Yields in 2021

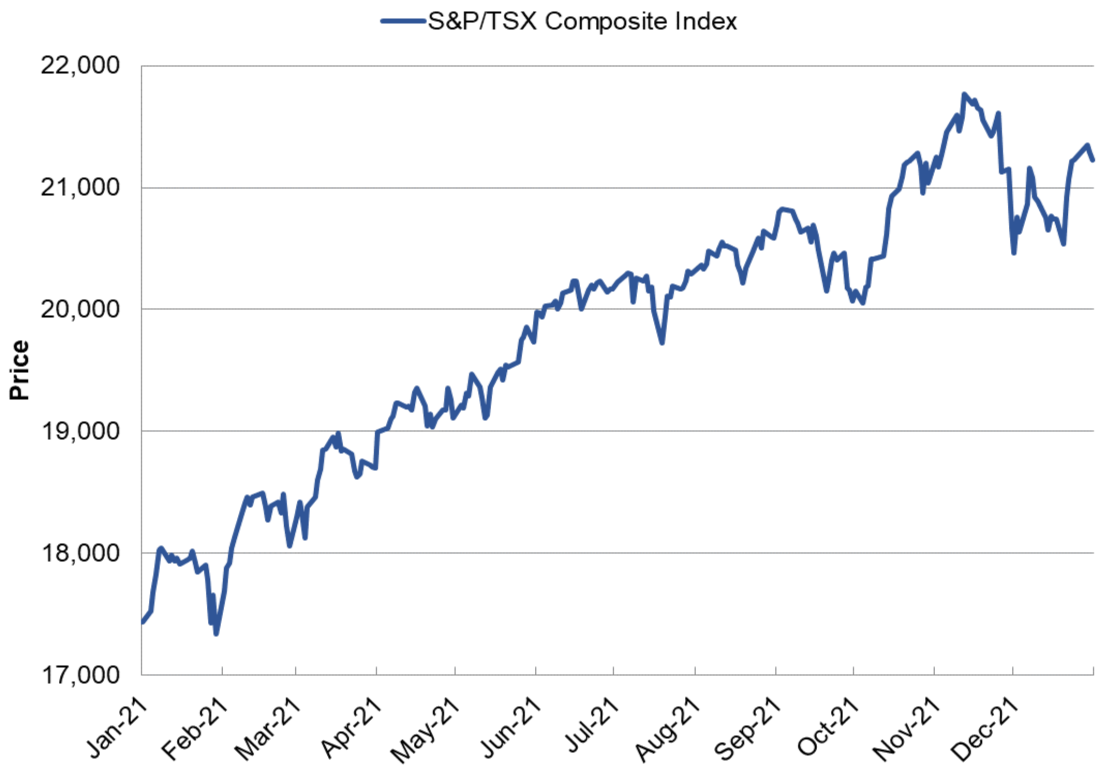


(Yields sourced from Bank of Canada)

As highlighted in the chart above, long term yields such as the 10 year Government of Canada Bond, surged in the early part of the year in anticipation of a strong economic reopening and higher inflation to materialize from vaccinations and the large U.S. fiscal support package. Short term yields such as the 2 year Government of Canada Bond, gradually trended higher throughout the year, before jumping in October to reflect Bank of Canada's updated guidance for its first rate increase to come sooner.

Credit spreads measure the difference between bonds of similar maturity, but different credit quality and quantifies the credit risk of corporations over risk-free securities such as Government of Canada bonds. This financial indicator remained tight and reached new record lows, which implied a robust economic recovery and a favourable economic outlook for corporations. However, the overall Canadian bond market incurred a negative return from lower bond prices, as yields ended the year materially higher.

Chart 2 – S&P/TSX Composite Index Performance in 2021



(Prices sourced from TMX Group)

As illustrated in the chart above, the S&P/TSX Composite Index, which represents the benchmark for the overall Canadian equity market, gained 21.74% on a price return and 25.09% on a total return basis, which include dividends (Source: TMX Group). This resulted in the second best year in performance for Canadian equities overall since 2009, as corporate profits more than recovered, within an improving global macroeconomic environment. Higher yields and energy prices rewarded financials and energy among the top performing sectors, which were also the two largest weighted sectors comprising the index.

Investment Portfolio Results

In 2021, the City's investment portfolio realized total income of $13.8 million based on an average portfolio balance of $563.1 million. This resulted in an income return of 2.45%. 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 any 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.

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

Table 1 – Summary of Portfolio Income Return

Year	Investment Term	Average Balance ($ millions)	Investment Income ($ millions)	Portfolio Income Return
2021	Short Term	186.0	1.6	0.88%
	Long Term	377.1	12.2	3.23%
	Total	**563.1**	**13.8**	**2.45%**
2020	Short Term	159.7	2.0	1.28%
	Long Term	377.3	11.7	3.10%
	Total	**537.0**	**13.7**	**2.56%**

The year over year increase in the average portfolio balance was led by greater short term investments and primarily attributed to higher revenues received from property taxes and development charges, especially when compared to 2020 with the onset of the pandemic. Investment income earned on short term investments marked a new low and reflected the full year impact of the lowest interest captured on the City's cash balances. However, the decline in investment income from short term investments was offset by an increase derived from long term investments, which originated from favourable capital gains realized from its position in the Canadian Equity Portfolio with ONE Investment.

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. In 2021, the total return of the investment portfolio was 3.82%, 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
2021	563.1	13.8	2.45%	7.7	3.82%
2020	537.0	13.7	2.56%	17.2	5.76%

The positive mark to market and portfolio total return in 2021 was entirely accredited to the portion of long term investments, where its return exposure is linked to the performance of equities. In fact, if the portfolio were composed only of fixed income securities, the mark to market would have been negative, due to lower prices. This clearly demonstrated the importance of having an allocation to equities, as part of portfolio diversification.

As outlined in the Investment Policy, the most suitable benchmark is a combination of the 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. The total return of the City's benchmark was 3.16%, which the investment portfolio exceeded its benchmark by 0.66%, as presented in the next table.

Table 3 – Portfolio Total Return and Benchmark Total Return

Year	Portfolio Total Return	Benchmark Total Return	Difference
2021	3.82%	3.16%	0.66%
2020	5.76%	5.37%	0.39%

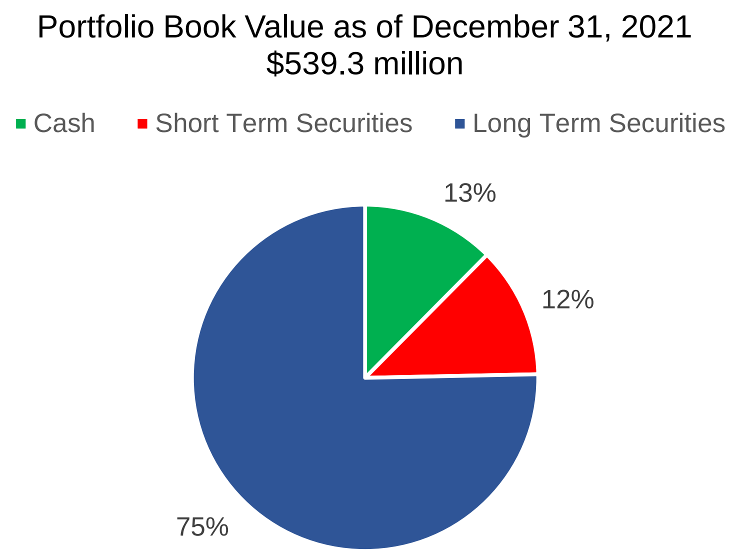
The main factors that contributed to the greater performance relative to its benchmark were attributed to adding exposure to longer term securities when yields reached near the highs and more importantly, increasing the portfolio's allocation to equities.

Although the Canadian Equity Portfolio with ONE Investment underperformed the broader market such as the S&P/TSX Composite Index, it still returned 20.62% on a total return basis. Staff took advantage of periodic declines in equity prices and increased its position, which benefited portfolio performance. This followed the investment policy update that Council approved in June 2021, which incorporated a key measure to increase the maximum allowable exposure from 5% to 15% in the ONE Canadian Equity Portfolio. As cited in the staff report at the time, the initial policy target was set at 10%, based on strategically adding upon market opportunities. As a result, the weight of ONE Canadian Equity Portfolio relative to the total portfolio was increased from 5% to approximately 8%.

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 $539.3 million, which included cash balances totaling $67.0 million, short term holdings of $66.0 million and long term holdings of $406.3 million. This translated proportionately to the total portfolio balance of 13%, 12% and 75%, respectively, which is illustrated in the following chart.

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



The City held a lower cash balance at the end of 2021 of $67.0 million than the prior year of $91.2 million, which 2020 prioritized greater liquidity and cash requirements as a buffer for pandemic uncertainty. The year over year decline reflected in greater investment activity by reallocating cash to securities, as yields trended higher. As a result, the term structure of the investment portfolio, based on its weighted average term to maturity, extended from 2.7 years to 3.3 years in 2021 (Appendix "B").

A greater portion of cash was shifted into short term securities during the second half of the year, as 1 year term rates began to climb. The portfolio held its highest amount in short term investments since 2016, in preparation of a new rate hike cycle, which would then shift more funds into longer term securities when more attractive opportunities present itself through higher yields.

Looking at 2022 and Moving Forward

The economic uncertainty brought on by the COVID-19 pandemic has largely subsided, particularly in the developed countries, given the shift in to an endemic phase. Households and businesses have adapted to the new operating environment with preset expectations of intermittent case flare-ups as the new normal. This was witnessed in the temporary economic shortfall that was easily recouped through the recent Omicron variant. As most countries have fully reopened, consumer spending habits have transitioned from purchasing goods to re-engaging outdoor experiences through travel, dining and entertainment, given the strong pent-up demand accumulated over the last 2 years.

The U.S. economy continues to see strong domestic demand, but confronted with ongoing labour shortages, as their employment rate declined back to 3.6% ending March (Source: U.S. Bureau of Labor Statistics), its lowest level since June 2019.

A major factor that formed the initial belief of many central banks last year regarding high inflation being transitory, was related to supply chain disruptions that would eventually abate. Although there were some signs of easing, recent lockdowns of major cities in China that serve as manufacturing hubs, have further delayed the progress, based on their zero COVID policy.

Inflationary pressures have accelerated since the beginning of the year and only worsened since the Russian invasion of Ukraine, which has caused a further jump in commodities, most notably in crude oil, natural gas, wheat, corn and overall food prices. The April Consumer Price Index (CPI) in the U.S., which captured the initial impacts from the war, reached a year over year increase of 8.3%, its fastest pace in 40 years (Source: U.S. Bureau of Labor Statistics).

Global central banks have arguably underestimated the speed of the economic recovery and the surge in inflation from the combination from large fiscal spending and ultra-accommodative monetary policy. In late recognition to an overheating economy in the U.S. through multi-decade high inflation and an extraordinarily tight labour market, the Federal Reserve has undergone a major pivot in its monetary policy. This is in direct response to restoring price stability back to its 2% target by adopting its most aggressive stance through more frequent and larger interest rate increases. In addition, they have initiated their “Quantitative Tightening” process in May, which is simply the reversal of the tool used at inception of the pandemic, but instead to remove liquidity from the financial system. Collectively, these measures are required to tighten financial conditions with higher borrowing costs, in order to pare back demand and better align with the supply side.

The Canadian economy is strong and forecasted to grow by 4.25% in 2022, before settling lower at 3.25% in 2023, as cited by Bank of Canada in their April interest rate announcement. Even as the unemployment rate reached its lowest point since 1976 of 5.3% (Source: Statistics Canada), businesses still face labour shortages due to excess demand and continue to pass on higher input costs to consumers. The prevalence of high inflation is a global phenomenon, which although is less rampant in Canada than in the U.S., prices continued to accelerate with the April Consumer Price Index (CPI) spiking to year over year increase of 6.8% (Source: Statistics Canada). As a result, we have seen swift actions taken from Bank of Canada by hiking its Overnight Rate totaling 75 basis points since beginning of the year, which included a 50 basis point increase in April. A front-end loaded approach to tightening monetary policy is now the new norm, given the expeditious need to bring the policy rate to a ‘neutral’ territory by year-end.

Bank of Canada deems this range to be between 2% to 3%, which it considers as neither simulative nor restrictive to the economy.

The confluence of many global macroeconomic headwinds such as elevated inflation, the Russia-Ukraine war and an abrupt pull-forward in tightening of monetary policy, underscores a highly uncertain economic outlook. The ultimate goal of global central banks is increase rates and tighten financial conditions enough to engineer a soft landing for their economies. However, there is increasing concern that the Federal Reserve and Bank of Canada in particular, may overstep and cause a recession.

Interest rates across the board have risen sharply since the start of the year, as markets reprice inflation expectations and the extensive measures global central banks will be required to take. This in turn has dramatically soured investor sentiment given the weakness seen in global equity markets, including one of the worst sell-offs in the 1st quarter of 2022 for the bond market, due to a global rate shock.

The investment portfolio is well positioned to take advantage of a rising rate environment, given a much higher allocation to short term securities and above average cash balances compared to prior years, in order to capture better reinvestment opportunities. However, this does not insulate the portfolio from a significant negative market impact from a decline in both equity and fixed income security prices, which is atypical and incredibly challenging. This will more than offset total realized investment income and result in a negative portfolio total return and will principally depend on the extent of the sell-off in both fixed income and equity markets.

Although a rising interest rate environment will increase investment income over time, it will not adequately compensate for even higher cost pressures faced by the City on both its operating and capital expenditures. 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.

Financial/Staffing/Other Implications:

The City's investment portfolio earned $13.8 million in investment income for 2021, which $1.6 million was allocated to the operating budget and remaining $12.2 million to reserve funds.

Relationship to Council's Strategic Priorities 2020-2022:

The Treasurer is of the opinion that the investment portfolio and all transactions undertaken in 2021 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.

Climate Change Considerations:

Climate change considerations are not applicable to this staff report, as it is not factored in the investment decision-making process. This is due to the strict requirements prescribed under the *Municipal Act,* which already strictly limits the scope of eligible investments. However, climate change considerations are part of the ‘Environmental, Social and Governance’ (ESG) framework that is incorporated in the analyses and research conducted by the fund managers that oversees the Canadian Corporate Bond Canadian Equity Portfolios that the City is invested in through ONE Investment.

Conclusion:

The City’s investment portfolio realized investment income of $13.8 million, which equated to an income return of 2.45%. These results are reflected as positive amid the increasing, but still low interest rate environment in 2021, given that capital preservation remains as the top priority.

Attachments:

The following attached documents may include scanned images of appendixes, maps and photographs. All attachments have been reviewed and made accessible. If you require an alternative format please call the contact person listed in this document.

- Appendix “A” – Portfolio Breakdown by Sector
- Appendix “B” – Portfolio Breakdown by Term

Report Approval Details

Document Title:	SRCFS.22.014 – 2021 Investment Portfolio Results.docx
Attachments:	- SRCFS.22.014 - 2021 Investment Portfolio Results.docx - SRCFS.22.014 - Appendix A - Portfolio Breakdown by Sector.pdf - SRCFS.22.014 - Appendix B - Portfolio Breakdown by Term.pdf
Final Approval Date:	Jun 3, 2022

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

Gigi Li - Jun 3, 2022 - 12:32 PM

Sherry Adams - Jun 3, 2022 - 1:04 PM

Darlene Joslin - Jun 3, 2022 - 3:45 PM