Staff Report for Budget Committee of the Whole Meeting

Date of Meeting: June 27, 2023
Report Number: SRCFS.23.030

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

Subject: SRCFS.23.030 – 2022 Investment Portfolio Results

Purpose:

To report on the performance of the City's Investment Portfolio for 2022, as required by Ontario Regulation 438/97 (as amended) of the *Municipal Act, 2001*.

Recommendation(s):

a) That staff report SRCFS.23.030 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, 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 2022;
- 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

The factors that enabled a robust economic recovery in 2021, supported by both fiscal and monetary stimulus, also became similar drivers that created new challenges for many western countries. The onset of inflationary pressures being much higher than initially anticipated required unprecedented action forced to be taken by global central banks.

Although a marked deceleration from the prior year, the U.S. economy still grew by 2.1% in 2022 (Source: U.S. Bureau of Economic Analysis), which was more in-line with the average pace of growth in the years leading up to the pandemic. The labour market remained resilient, which saw its unemployment rate decline from 3.9% beginning the year back to its record low of 3.6% at year-end (Source: U.S. Bureau of Labor Statistics).

The U.S. Consumer Price Index (CPI), which is the key metric in measuring inflationary pressures, maintained its upwards trajectory and surged as high as 9.1% on a year over year basis during mid-year, before declining to 5% at year-end (Source: U.S. Bureau of Labor Statistics). Geopolitical concerns arising from the Russia-Ukraine war, combined with uplifting of pandemic restrictions from China, provided some support to commodity prices.

Given the intense price pressures, global central banks were required to respond with extraordinary action. The Federal Reserve raised the range of its policy rate by 400 basis points throughout the year from 0.25%-0.50% starting in March to 4.25%-4.50% in December. This aggressive pace of increasing rates to a restrictive level through tighter financial conditions was necessary to slow the economy and reduce inflation.

The unclear path of how high interest rates needed to go and the duration at which they remain at those levels, resulted in a material repricing of all assets. Significant uncertainty on the economic outlook and recessionary fears caused major disruption in financial markets. This corresponded to overall negative returns incurred in both equities and fixed income.

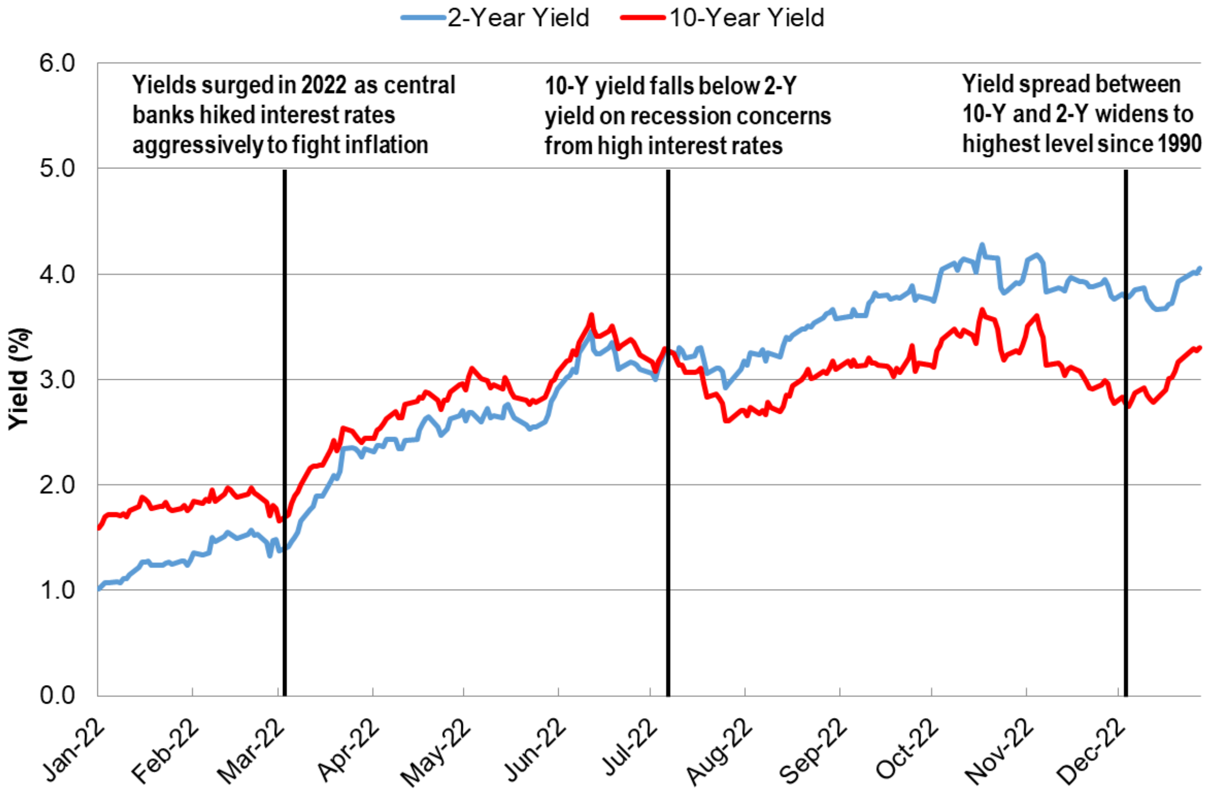
The Canadian economy expanded 3.4% in 2022 (Source: Statistics Canada), which was still a strong pace and well above its historical trend before the pandemic. Total employment levels exceeded expectations as the demand for labour remained robust, while the unemployment rate declined from 5.9% beginning the year to reach new record lows and ending at 5.0% in December (Source: Statistics Canada).

Inflation concerns in Canada was no exception and showed no signs of relief until the second half of the year. The Consumer Price Index (CPI) accelerated and was up as high as 8.1% year over year in June, before settling down at 6.3% at the end of the year with food, shelter and gasoline among the top contributors. Core CPI, which excludes the more volatile components such as food and energy, increased 5.2% year over year in December compared to 2.9% from the prior year. Both measures easily surpassed Bank of Canada’s inflation target of 2% and well beyond its control range of 1% to 3%.

Initial expectations for Bank of Canada to lift its policy rate into the ‘neutral’ territory of 2% to 3%, which it deemed neither stimulative nor restrictive to economic activity, proved inadequate given persistent inflationary pressures. In response, Bank of Canada lifted their Overnight rate by the same as the U.S. of 400 basis points throughout the year from 0.25% to 4.25%.

It was a challenging environment for municipalities, given the significant divergence experienced between the greater interest income realized from higher rates and compared to expenses, which increased at an even more rapid pace.

Chart 1 – 2 Year and 10 Year Government of Canada Bond Yields in 2022

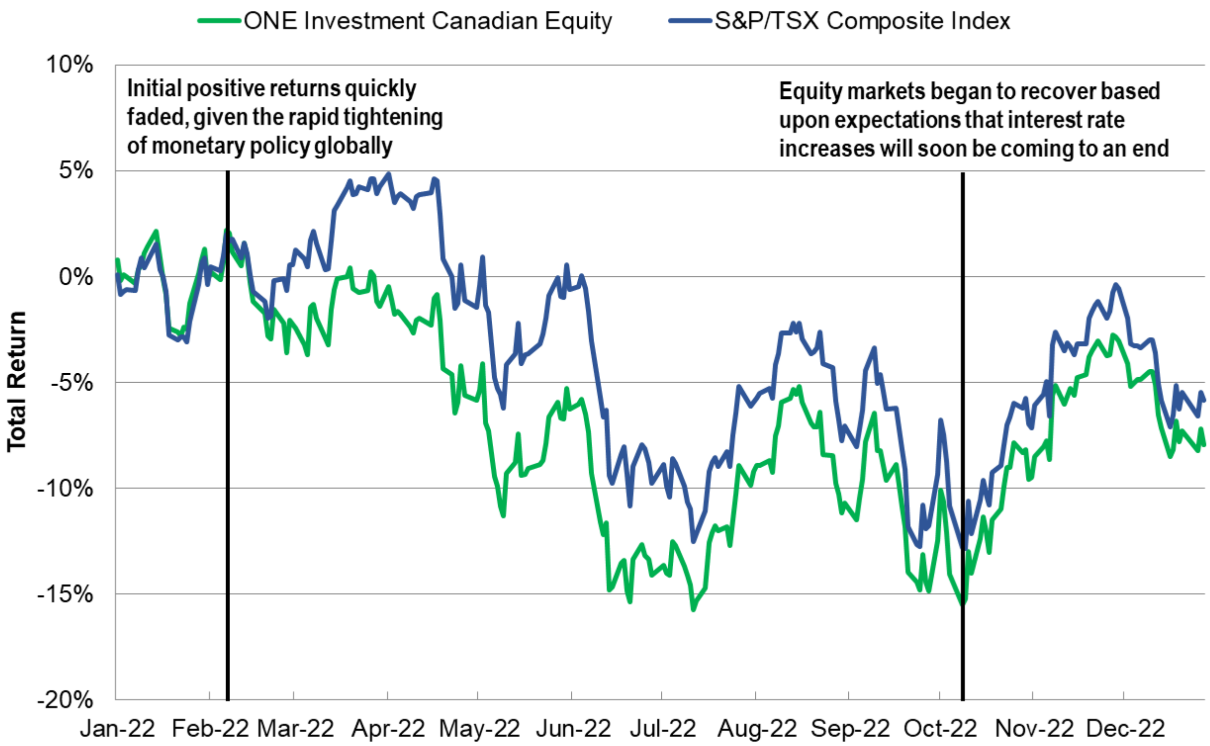


(Yields sourced from Bank of Canada)

As highlighted in the chart above, both short term and long term interest rates increased substantially corresponding to Bank of Canada and other global central banks' aggressive campaign of tightening monetary policy. The 2 Year and 10 Year Government of Canada bond yields surged continuously throughout the year and were up by 310 and 187 basis points, respectively. Based on front-loading the path to higher rates in the near term, this warranted a stronger response through larger and more frequent increases to reach a 'restrictive' stance.

The inverse relationship between higher interest rates and lower bond prices inevitably resulted in the Canadian bond market incurring a negative return and reflected in the investment portfolio's results. This became more pronounced in a much higher rate environment with a steeper decline in prices, especially when measuring from the prior year when interest rates were still very low.

Chart 2 – Canadian Equities Performance in 2022



(Prices sourced from ONE Investment and TMX Group)

ONE Investment is a co-mingled investment program that is specifically designed and catered to Ontario municipalities, which is jointly operated by LAS (Local Authority Services) and CHUMS Financing Corporation (a subsidiary of the Municipal Finance Officers' Association of Ontario). This is the only eligible investment vehicle the City can participate in to obtain direct exposure to equities and managed by a 3rd party investment manager.

As illustrated in the chart above, the ONE Investment Canadian portfolio declined 7.9% for the year on a total return basis, which includes dividends reinvested. The S&P/TSX Composite Index, which represents the benchmark for the overall Canadian equity market, declined 5.8%. (Source: TMX Group). As a result, the ONE Investment Canadian portfolio underperformed the benchmark by 2.1%, which was largely attributed to the difference in sector weightings. Although Canadian equities recorded its first year of negative return since 2018, it fared much better than other markets such as the U.S. that were down double-digit percentages.

Investment Portfolio Results

In 2022, the City's investment portfolio realized total income of $16.5 million based on an average portfolio balance of $620.5 million. This resulted in a favourable income return of 2.65%, while preserving capital and maintaining ample liquidity to meet higher expenses borne by inflationary pressures. 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
2022	Short Term	170.6	4.1	2.43%
	Long Term	449.9	12.3	2.74%
	Total	**620.5**	**16.5**	**2.65%**
2021	Short Term	186.0	1.6	0.88%
	Long Term	377.1	12.2	3.23%
	Total	**563.1**	**13.8**	**2.45%**

The year over year increase in the average portfolio balance was led by greater purchases in long term investments. This was to take advantage of opportunities higher in duration that were relatively much more attractive than short term securities at the time when compared to historical standards. In addition, a sell-off in the equity market also presented lower prices for staff to increase its position in the ONE Canadian Equity portfolio. The strategy to build towards an initial 10% target allocation and eventually 15% per the limit in the Investment Policy is fundamental to portfolio diversification and higher potential for capital appreciation over the long term.

Investment income earned on short term investments reached a high-water mark, which reflected a significantly higher interest rate environment. This was primarily attributed to deposit interest realized on the City's cash balances that immediately benefited from each successive rate increase from Bank of Canada and corresponding change in the banks' prime rates.

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 a performance assessment with a market benchmark based on industry standards.

In 2022, the total return of the investment portfolio was -3.07%, after incorporating a negative market impact. This negative return would only be realized if all securities were liquidated on December 31, 2022. However, as the investment strategy focuses more on a buy and hold approach, the total returns are expected to be positive over the long term, especially as security values recover and/or appreciates. 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
2022	620.5	16.5	2.65%	(35.5)	-3.07%
2021	563.1	13.8	2.45%	7.7	3.82%

A year over year increase in investment income clearly depicted the overall higher rate environment, particularly from short term. However, the material negative mark to market more than offsets the total income earned, when incorporating the market value change of the underlying securities.

The negative mark to market and portfolio total return in 2022 were simply a function of the reversal in highly accommodative financial conditions enacted at the inception of the pandemic. Higher interest rates and slowing economic growth were clear major headwinds across all asset classes that negatively impacted all holdings held in the investment portfolio. However, the investment landscape would set up for more favourable returns on a forward-looking basis.

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 -2.72%, which the investment portfolio declined more than its benchmark by 0.35%, as presented in the next table.

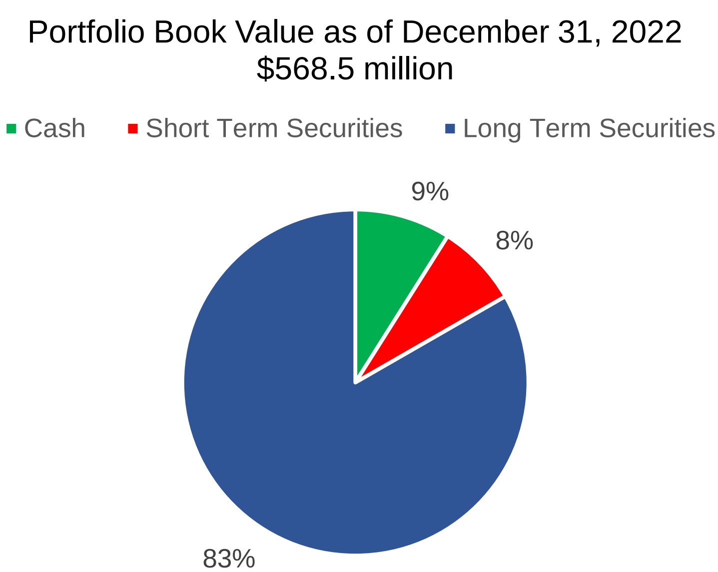
Table 3 – Portfolio Total Return and Benchmark Total Return

Year	Portfolio Total Return	Benchmark Total Return	Difference
2022	-3.07%	-2.72%	-0.35%
2021	3.82%	3.16%	0.66%

The main factors that contributed to the lower performance relative to its benchmark were attributed to a higher portfolio duration, which translates to a higher sensitivity to changes in interest rates. As a result, the portfolio slightly declined more than the benchmark. The Canadian Equity Portfolio with ONE Investment that is managed externally, underperformed the S&P/TSX Composite Index and also another element contributing to the negative difference. The portfolio total return was still deemed competitive, especially when other municipalities experienced much greater declines. The investment portfolio was still able to strike a delicate balance between preservation and security of capital, while optimizing revenue earned on investments to meet expenses that have increased exponentially.

The book value of total investments held at year-end, which represented the cost of all holdings (Appendix "A") was $568.5 million, which included cash balances totaling $50.9 million, short term holdings of $44.0 million and long term holdings of $473.5 million. This translated proportionately to the total portfolio balance of 9%, 8% and 83%, respectively and 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 2022 of $50.9 million than the prior year of $67.0 million. A year over year decline in cash balance including an increased weighting of 83% in long term investments compared to 75% the year prior, emphasizes the greater investment activity in securities maturing farther out than 1 year. The portfolio held its proportion of long term investments at its highest percentage relative to the total since 2017. This was based on the expectation that the expedited rate hike cycle was much closer to the end and long term yields were close to its peak. As a result, the term structure of the investment portfolio, based on its weighted average term to maturity, extended from 3.3 years to 4.3 years in 2022 (Appendix “B”).

Looking at 2023 and Moving Forward

After undergoing one of the fastest rate hike campaigns in history from many central banks, the global economy has remained resilient. However, economic activity has already moderated and are most evident in the interest-rate sensitive areas. The intended impact of much higher borrowing costs exhibited in mortgage rates and slowing goods production reflect the correction in home prices and lower commodity prices, respectively. There is also a considerable time lag of at least 6-12 months before the full effects of higher interest rates work its way through the entire economy.

The labour market still remains one of the brightest spots in the Canadian economy and has yet to see any major softening, as the unemployment rate stays near its record low and was 5.2% in May (Source: Statistics Canada). This underscores that the demand for labour still remains healthy, despite growing concerns of a greater slowdown.

Since inflation readings peaked in the middle of last year, they have dampened materially, which coincided with a slide in energy prices and improvements in the supply chain. The Canadian economy is still operating at a capacity with demand exceeding supply and forecasted to grow by 1.4% in 2023. (Source: Bank of Canada). As interest rates remain in restrictive territory, an important factor that will influence more consumption moderation are households renewing their mortgages at much higher rates.

Although the CPI in Canada have diminished from a year over year increase of 6.3% at the start of the year to 4.4% in April, they are still very persistent (Source: Statistics Canada). Bank of Canada expects CPI to decline quickly to around 3% in the middle of the year. The more gradual descent back to its 2% target by the end of 2024 has been acknowledged to be more difficult, given more pervasive factors such as elevated wage growth, inflation expectations, non-normalized corporate pricing behavior. Nonetheless, the central bank is assertive in its efforts to restore price stability back towards its goal. Bank of Canada has since increased its policy rate in January and in May by an additional 25 basis points each, bringing its Overnight rate to 4.75%.

A higher for longer interest regime is the new norm, which the investment portfolio will reflect from earning even higher investment income. As the Overnight rate is high as levels last seen in 2007, cash is now an attractive asset that offers a competitive yield. Any bigger declines in the equity market will also be utilized as opportunities to continue adding to the position in the ONE Canadian Equity portfolio. This is to achieve its portfolio allocation of 15%, which will align with supporting financial sustainability over the long term, based on a higher potential return on capital. This becomes essential when the City is confronted with expenses rising at a faster pace than revenues.

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 $16.5 million of investment income for 2022, which $4.1 million was from short term investments and $12.3 million was from long term investments.

Relationship to Council's Strategic Priorities 2020-2022:

The Investment performance demonstrated fiscal responsibility by effective use and application of the City's available monies through wise management of public funds. These results are reflected as positive based on preserving capital as a top priority, while maintaining a diversified portfolio to maximize current income and retaining growth potential to meet long term capital spending requirements.

Conclusion:

The City's investment portfolio realized investment income of $16.5 million, which equated to an income return of 2.65%. The Treasurer is of the opinion that the investment portfolio and all transactions undertaken in 2022 adhered to all required standards of the *Municipal Act,* Investment Policy and goals adopted by the City.

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.23.030 - 2022 Investment Portfolio Results.docx
Attachments:	- SRCFS.23.030 - Appendix A - Portfolio Breakdown by Sector.docx - SRCFS.23.030 - Appendix B - Portfolio Breakdown by Term.docx
Final Approval Date:	Jun 18, 2023

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

Gigi Li - Jun 18, 2023 - 10:05 AM

Sherry Adams - Jun 18, 2023 - 1:48 PM

Darlene Joslin - Jun 18, 2023 - 2:30 PM