Staff Report for Budget Committee of the Whole Meeting

Date of Meeting: May 28, 2024
Report Number: SRCFS.24.016

Department: Corporate and Financial Services
Division: Financial Services

Subject: SRCFS.24.016 – 2023 Investment Portfolio Results

Purpose:

To report on the performance of the City's Investment Portfolio for 2023, as required by Ontario Regulation 438/97 (as amended) of the *Municipal Act, 2001*.

Recommendation(s):

a) That staff report SRCFS.24.016 be received for information purposes.

b) That the updated Investment Policy be approved as provided in Appendix "D".

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 2023;
- 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
- Proposed updates in the Investment Policy.

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 experiencing one of the most aggressive interest rate hiking campaigns in history, there was more still needed to be done by global central banks to lower inflation. Even as supply chain dynamics largely normalized, tighter financial conditions was still warranted, in order to sustainably bring inflationary pressures back towards a common 2% target.

The U.S. being the largest economy has significant influence on the global economy and financial market conditions. This is especially relevant to Canada in terms of both growth and inflation, given the close integration between the two. Even with the highest policy interest rate in decades, the U.S. economy expanded at a pace of 2.5% (Source: U.S. Bureau of Economic Analysis), which was even faster than the prior year of 1.9%.

After a sharp rise in the prior year, it was widely understood that the percentage changes in the Consumer Price Index (CPI) would slow dramatically throughout 2023, as evidenced by much lower readings. In the U.S., it fell precipitously from 6.5%

beginning the year to 3.0% mid-year, mainly as a function of lower energy prices, before leveling off at 3.4% at year-end. (Source: U.S. Bureau of Labor Statistics).

Although there was substantial progress dampening inflation, many components outside of energy were still very elevated. The Federal Reserve raised the range of its policy rate by an additional 100 basis points through the course of the year, which brought it to 5.25% to 5.50%.

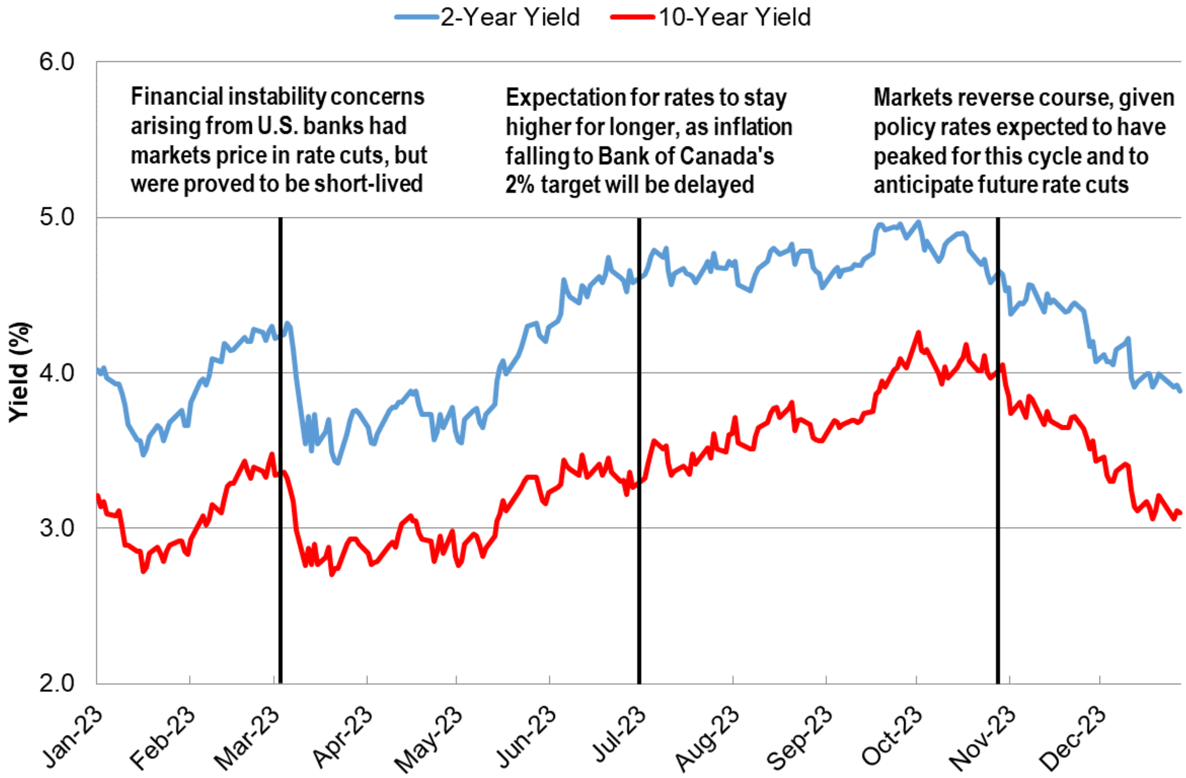
Resilient consumer spending filtered into better than expected corporate earnings, as input costs for companies subsided. The expectation of upcoming rate cuts fueled investor optimism, which drove strong positive returns in both fixed income and equity markets.

Contrary to the U.S., Canada has a higher sensitivity to interest rates due to housing, which weighed more heavily on its economic activity. This was reflected in its slower pace of growth compared to the previous year. The Canadian economy grew 1.1% in 2023 (Source: Statistics Canada), which was materially slower than the prior year of 3.4%. However, the pace of expansion was still much higher than expected, which was supported by strong demand in the U.S., especially given initial concerns of a shallow recession. The unemployment rate increased from 5.0% at the start of the year to 5.8% at year-end (Source: Statistics Canada), even as the labour market averaged approximately 36,000 new jobs per month. This was inherent of slower employment growth relative to the expansion of the labour force, which was supported by strong immigration.

Inflationary pressures receded as widely anticipated, as the CPI declined from 6.3% beginning the year and reached as low as 2.8% in June, before retracing back to 3.4% at year-end (Source: Statistics Canada). Although the rate of increase for average food prices were well-off their double-digit percentages at the end of 2022, they were still up 5% year over year. Shelter price inflation was up 6% annually, which includes both rent and mortgage interest, continued to exert the most upwards pressure, especially considering that it has a weighting of 28% in the overall CPI metric.

As excess demand still persisted and core inflation, which excludes food and energy prices, showed dissimilar improvement, even higher interest rates were essential. As a result, Bank of Canada followed through on additional rate hikes totaling 75 basis points, which further lifted its Overnight rate from 4.25% to 5.00%. It was then deemed that this level was restrictive enough and represented the ceiling of this interest rate tightening cycle to guide inflation back down towards its 2% target over time. However, it would also require interest rates to be held at these levels for an extended time period.

Chart 1 – 2 Year and 10 Year Government of Canada Bond Yields in 2023

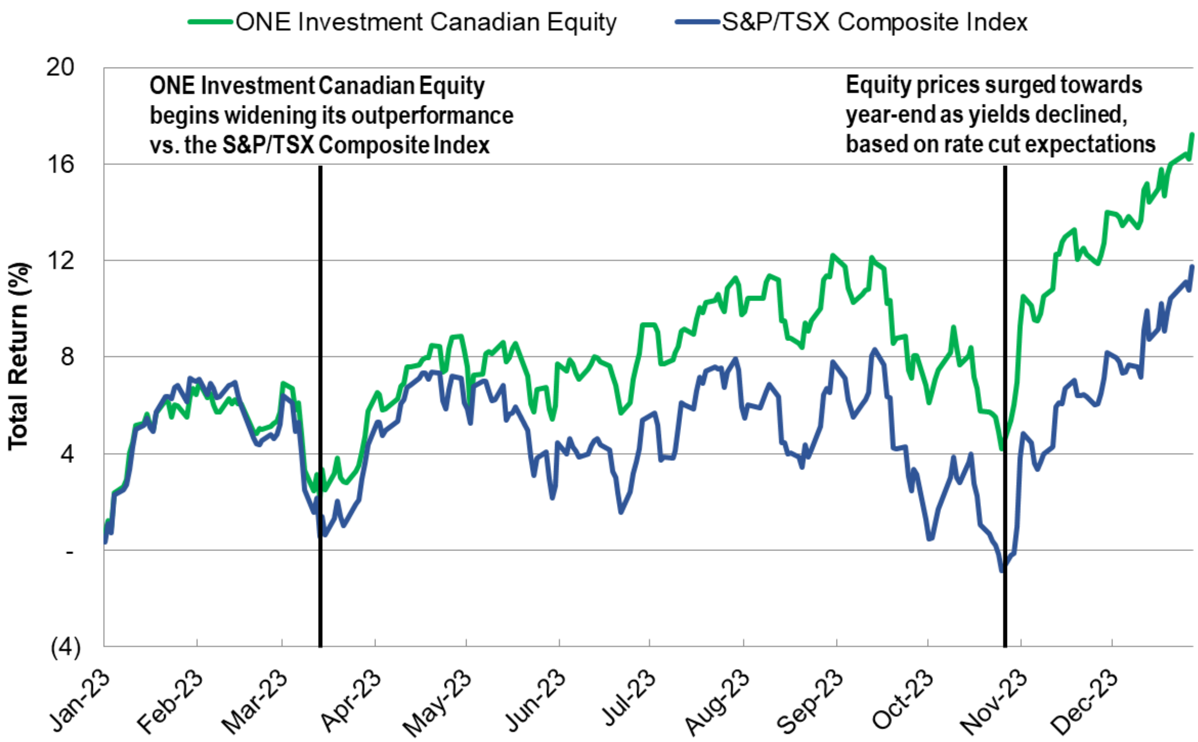


(Yields sourced from Bank of Canada)

As highlighted in the chart above, the yield curve stayed inverted for the entire year or simply, short term yields were higher than long term yields. Both short and long term interest rates trended higher throughout most of the year and reached new highs towards the end of the third quarter. This was grounded in the earlier assumptions that further tightening in monetary policy may be required and that rates would need to be held at their restrictive levels for a prolonged period. However, an abrupt pivot ensued as markets begun to price in future aggressive rate cuts from central banks. This was based on the expectation that economic activity would deteriorate further and inflation would decline much faster back towards 2%. Since both the 2 Year and 10 Year Government of Canada bond yields topped out in early October, they declined rapidly and ended the year at lower levels than where they started.

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. Credit spreads contracted considerably, as the outlook for corporations to refinance and service their debt at higher interest rates proved less of a concern, especially as economic activity remained resilient. This was the opposite of credit conditions that elapsed in the prior year, as rapidly rising interest rates posed a major concern for consumer spending, corporate outlooks and the economy as a whole.

Chart 2 – Canadian Equities Performance in 2023



(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 is managed by a 3rd party investment manager.

As illustrated in the chart above, the 'ONE Investment Canadian Equity' fund returned 17.2% (Source: ONE Investment) for the year on a total return basis, which included dividends reinvested. The S&P/TSX Composite Index, which represents the benchmark for the overall Canadian equity market, returned 11.8%. (Source: TMX Group). As a result, the fund outperformed the benchmark by 5.5%, which was largely attributed to positive sector allocation. This was most notable in information technology, industrials and consumer staples, which were among the top performing sectors that returned more than the index itself.

Investment Portfolio Results

In 2023, the City's investment portfolio realized total income of $26.4 million based on an average portfolio balance of $650.9 million, which resulted in an income return of 4.06%. The average balance is only used for the return calculation, as it provides the best 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 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.

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
2023	Short Term	188.1	10.4	5.55%
	Long Term	462.8	16.0	3.46%
		650.9	**26.4**	**4.06%**
2022	Short Term	170.6	4.1	2.43%
	Long Term	449.9	12.3	2.74%
		620.5	**16.5**	**2.65%**

The year over year increase in the average portfolio balance was more driven by purchases in short term investments. In anticipation of higher capital expenditures over the next few years and expectation for interest rates to stay higher for longer, the short term space within credit unions remained attractive.

Investment income earned on short term investments reached a new record, as the portfolio realized greater interest on cash balances and short term securities. This followed Bank of Canada’s three additional rate increases totaling 75 basis points, which sequentially lifted the banks’ prime rates higher as well. The City was also able to renegotiate its deposit interest agreement with its main bank, which further lifted its cash yield. Short term income was $6.3 million or 152% higher year over year. This captured a new peak rate earned on cash balances and yields locked on new purchases in short term securities. Long term income was $3.7 million or 30% higher year over year and can be volatile depending on whether any capital gains are realized.

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 2023, the total return of the investment portfolio was 8.68%, 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
2023	650.9	26.4	4.06%	30.0	8.68%
2022	620.5	16.5	2.65%	(35.5)	-3.07%

A year over year increase in investment income reflected the overall higher rate environment, primarily from short term investments through Bank of Canada's additional rate increases. The positive mark to market further enhanced the portfolio's performance, when incorporating the market value change of the underlying securities.

The strong positive mark to market and resulting portfolio total return in 2023 reflected an unwind of the challenging financial conditions from the prior year. As the economy successfully navigated a soft landing and better adapted to the higher interest rate environment, corporate earnings also fared much better than expected. The rebound in higher asset prices led to favourable returns in both fixed income and equity holdings of the portfolio.

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 for fixed income and equities. The total return of the City's benchmark was 7.39%, which the investment portfolio exceeded its benchmark by 1.29%, as presented in the next table.

Table 3 – Portfolio Total Return and Benchmark Total Return

Year	Portfolio Total Return	Benchmark Total Return	Difference
2023	8.68%	7.39%	1.29%
2022	-3.07%	-2.72%	-0.35%

One of the main factors that contributed to the outperformance against its benchmark were attributed to a higher portfolio duration. This translated to a higher sensitivity to changes in interest rates and resulted in greater returns compared to the benchmark, especially as yields declined sharply in the fourth quarter.

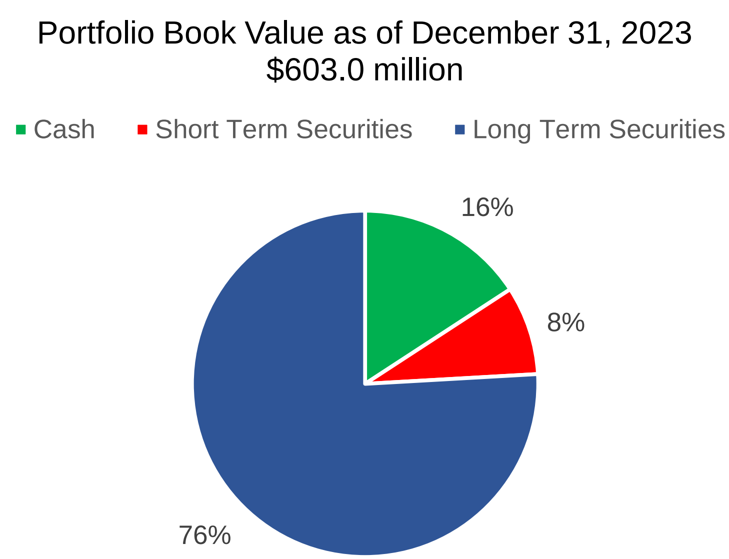
The added weighting to fixed income securities in the corporate sector relative to the government sector also benefited the portfolio. The sizable contraction in credit spreads led to greater returns in corporate debt.

Lastly, the portfolio added to its position in the 'ONE Canadian Equity' fund during periods of market declines, in order to continue building towards its 15% target weight for further portfolio diversification and long term capital growth. As highlighted in Chart 2, the 'ONE Canadian Equity' fund outperformed the S&P/TSX Composite Index by 5.5% and contributed favourably to the results.

The face value of total investments held at year-end was $630.0 million, which also incorporates the maturity value of bonds. This also acts as an ongoing measure to ensure compliance with the Investment Policy, which portfolio holdings and transactions undertaken, adhered to all minimum credit rating requirements and maximum sector exposure limits (Appendix "B").

The book value of total investments held at year-end, which represented the cost of all holdings (Appendix "A") was $603.0 million, which included cash balances totaling $95.3 million, short term holdings of $50.0 million and long term holdings of $457.7 million. This translated proportionately to the total portfolio balance of 16%, 8% and 76%, respectively and illustrated in the following chart.

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



The portfolio held a higher cash balance at the end of 2023 of $95.3 million than the prior year of $50.9 million. A year over year increase in cash balances corresponded with the decrease in long term investment holdings, which declined from 83% to 76% of the total portfolio. Given that Bank of Canada increased its policy rate by an additional 75 basis points in 2023, which totaled 475 basis points in this cycle, cash has since become a very competitive and attractive asset. Coupled with higher cash flow requirements for upcoming capital expenditures, it was prudent to maintain above average cash balances.

Investment Policy Update

The City's Investment Policy is reviewed at least annually and was last updated in June 2021 (Appendix "C"). Financial market conditions has since changed drastically and in response, staff are seeking to fine-tune the policy to ensure the portfolio is set up for ongoing success, while being prepared to capitalize on future opportunities.

The policy enhancements will provide more flexibility in making investment decisions that will benefit both short term and long term investments by generating more income and achieving greater capital growth potential.

All proposed updates are in accordance to the *Municipal Act* to ensure regulatory compliance. The focus is solely on increasing the portfolio limit on maximum sector exposures in credit unions and ONE Investment funds, per the following and in the updated Investment Policy (Appendix "D").

- Increase maximum sector exposure by 5%, to 15% in Credit Unions;
- Increase maximum sector exposures by 5% in ONE Investment funds, to 25% in for Money Market and to 20% for Canadian Government Bond, Canadian Corporate Bond and Canadian Equity;
- Increase total maximum sector exposure by 5%, to 40% for all ONE Investment funds combined.

There has been a dynamic change in the relationship between economic activity, the level of interest rates required to support employment growth, while striving to reach a 2% inflation target. There is a high degree of confidence that although interest rates will eventually settle at lower levels, they will still be elevated for an protracted period of time. This new environment is a reversal of the long term trend of declining interest rates experienced over the past decades and very unlikely to revert, or at least not anytime soon.

The current maximum sector exposure in the policy allowed for credit unions is 10%, which will be increased to 15%. Credit unions have consistently offered attractive yield premiums over banks and have been a valuable source of generating additional short term income beyond cash balances. Although the policy allows a maximum term limit of 5 years, recent investments have only targeted a term to maturity of 1 year and will remain as such. In addition, purchases are only directed towards the top 20 largest ranked issuers in Canada according to asset size and also satisfy the requirements and financial indicators outlined in Appendix 4 of the Investment Policy.

Even as interest rose at their fastest pace in decades and the economy has slowed, equity markets have performed exceedingly well, which the investment portfolio has been a significant beneficiary of, based on its exposure. This has exemplified the importance of the inclusion of equities in its portfolio for diversification benefits, hedging against inflation and capital appreciation. Although many municipalities do not disclose their total return for a better comparison, it is strongly believed that the City has outperformed many for this fundamental reason and expected to continue to do so over the long term. As a reference, the 'ONE Canadian Equity' fund has returned on a 1 Year, 5 Year and 10 Year basis of 17.2%, 10.4% and 9.0%, respectively (Source: ONE Investment).

Therefore, emphasis is on lifting the maximum sector exposure allowed in the 'ONE Canadian Equity' fund, which will be increased from 15% to 20%. The fund currently only comprises approximately 10% of the total portfolio and is geared towards a 15% target, the same as cited last time the policy was updated in June 2021. Hence, the investment strategy remains unchanged, however, the remaining 5% weighting will only be fulfilled conditional upon any significant negative market event, which causes major declines in equity prices. This would be utilized as a buying opportunity to raise allocation, which history has always proven as a major reward. The portfolio's exposure to equities will be frequently monitored and internal guidelines would direct rebalancing of the portfolio and reducing the weight back down to the usual 15% target. As a reference, the City of Toronto, which invests under its own 'Prudent Investor' standard, has a policy target of 20% and maximum limit of 30% for equities.

The portfolio only invests in the 'Canadian Corporate Bond' and 'Canadian Equity' funds with ONE Investment. However, the maximum sector exposures in the other funds and the total of all combined will also be adjusted. This is merely to maintain a consistent and proportionate limit structure among them.

Looking at 2024 and Moving Forward

Economic data overall continues to surprise on the positive side and the strength of the U.S. economy via its robust employment growth, will continue to spill over domestically and support the Canadian economy. Canada's GDP growth is forecasted to be 1.5% in 2024, slightly higher than the previous year, as population growth and a recovery in household spending ensues. The labour market has weakened, as the unemployment rate has increased from 5.8% at the start of the year to 6.1% ending April. (Source: Statistics Canada).

The Bank of Canada has kept its Overnight rate unchanged at 5% since July 2023 from its ongoing commitment to restore price stability. Although possible, it is highly improbable that will be an additional rate hike and that the attention has now pivoted to rate cuts. Given the major headway made by the central bank in slowing inflation, they have entered the period where it can better balance the risks of overly suppressing economic activity and sustaining its efforts to reach its 2% inflation objective. Further progress in CPI declining further has been evidenced by falling from 3.4% beginning of the year to 2.9% in March (Source: Statistics Canada). As the economy continues to operate in an excess supply environment, inflation is projected to maintain its downward momentum in reaching below 2.5% in the 2nd half of the year, before finally achieving its 2% target in 2025 (Source: Bank of Canada). Shelter costs including rents and mortgage interest remain at the forefront, as it is comprises a material weighting of the CPI basket and will continue to require time for a more meaningful slowdown.

The diverging inflation trajectory between Canada and U.S since beginning of the year where price pressures in the U.S. ticked higher while Canada continues to improve, underlines the varying impact of high interest rates on each respective economy. This recent disparity has signaled that the Bank of Canada will be the first to act on cutting interest rates. Although the timing and path of monetary policies may dislocate in the short term, it would not deviate too far given the close economic ties between the two countries. Even amidst upcoming interest rate cuts, they are expected to be few, far and between, as Bank of Canada will tread cautiously considering inflation risks still linger. The unintended consequence for inflationary pressures to reignite will reverse much of the progress made and create much more uncertainty.

As input costs have come down for companies, prices to the consumer has not entirely capture the difference and has a variable lag. This corporate pricing behaviour has yet to fully normalize, which is one of the ongoing areas of focus for Bank of Canada. Although inflation have come well off their highs from the last couple years, they are still have considerably high and prices overall have still increased tremendously on a cumulative basis. This inevitably continues to impact the City with its cost pressures, as it continues to maintain and build out its infrastructure, while upkeeping its high level of service to its residents

Financial market conditions based on a higher for longer interest rate norm will continue to deliver favourable investment income. The enhancements to the Investment Policy will also further optimize investment decisions and accentuate the City's commitment to fiscal sustainability and responsibility. 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 drive competitive returns.

Financial/Staffing/Other Implications:

The City's investment portfolio earned $26.4 million of investment income for 2023, which $10.4 million was from short term investments and $16.0 million was from long term investments.

Relationship to Strategic Plan:

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. This relates to Pillar 3, Strengthening our Foundations, especially around Priority 1 in supporting the City's capital investments, based on evidence-based and data-driven decisions within the context of long term financial sustainability.

Conclusion:

The City's investment portfolio realized investment income of $26.4 million, which equated to an income return of 4.06%. The Treasurer is of the opinion that the investment portfolio and all transactions undertaken in 2023 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 appendices, 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
- Appendix "C" – Existing Investment Policy
- Appendix "D" – Updated Investment Policy

Report Approval Details

Document Title:	SRCFS.24.016 - 2023 Investment Portfolio Results.docx
Attachments:	- SRCFS.24.016 - Appendix A - Portfolio Breakdown by Sector.docx - SRCFS.24.016 - Appendix B - Portfolio Breakdown by Term.docx - SRCFS.24.016 - Appendix C - Existing Investment Policy.docx - SRCFS.24.016 - Appendix D - Updated Investment Policy.docx
Final Approval Date:	May 14, 2024

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

Gigi Li - May 13, 2024 - 6:17 PM

Sherry Adams - May 14, 2024 - 1:39 PM

Darlene Joslin - May 14, 2024 - 2:18 PM