



Report to: General Committee

Meeting Date: Feb 18, 2020

SUBJECT: 2019 Investment Performance Review
PREPARED BY: Mark Visser, Senior Manager, Financial Strategy & Investments x. 4260

RECOMMENDATION:

- 1) That the reports dated February 18, 2020 entitled “2019 Investment Performance Review” be received; and,
- 2) That staff be authorized and directed to do all things necessary to give effect to this resolution.

EXECUTIVE SUMMARY:

Not applicable

PURPOSE:

Pursuant to Regulation 438/97 Section 8, the Municipal Act requires the Treasurer to “prepare and provide to the Council, each year or more frequently as specified by Council, an investment report”.

The investment report shall contain,

- (a) a statement about the performance of the portfolio of investments of the municipality during the period covered by the report;
- (b) a description of the estimated portion of the total investments of a municipality that are invested in its own long-term and short-term securities to the total investment of the municipality and a description of the change, if any, in that estimated proportion since the previous year’s report;
- (c) a statement by the Treasurer as to whether or not, in his opinion, all investments were made in accordance with the investment policies and goals adopted by the municipality;
- (d) a record of the date of each transaction in or disposal of its own securities, including a statement of the purchase and sale price of each security;
- (e) such other information that the Council may require or that, in the opinion of the Treasurer, should be included.

BACKGROUND:

The 2019 forecast for Income Earned on Investments was \$13.760 million based on an estimated average general portfolio balance of \$430.0M invested at an average rate of 3.20%. As discussed during the 2019 budget process, this amount may not be sustainable in future years as the Prime Rate is the highest it has been since 2008. As such, the 2019 Income Earned on Investments budget was set at \$11.0 million. Any interest earned in 2019 in excess of \$11.0 million in 2019 was to be transferred to reserves.

For the year ending December 31, 2019, the City of Markham's Income Earned on Investments was \$14.720 million, representing a \$0.960 million favourable variance to forecast and a \$3.720 million favourable variance to budget.

The 2019 forecast assumed an average general fund portfolio balance of \$430.0 million to be invested at an average rate of return of 3.20%. Both the actual average portfolio balance and the average rate of return were higher than the budgeted levels. The details of these two factors will be discussed below.

Interest Rate

The Prime Rate was stable at 3.95% throughout 2019. Although the Prime Rate continues to be at its highest levels since 2008, it was not being reflected in long term interest rates. During 2019, 10-year Canada bonds had an average yield of only 1.59%, reaching a low of 1.09% in August.

In 2019, the City's investments had an average rate of return of 3.29%, 9 basis points higher than the forecast. Furthermore, the City earned \$460,000 in capital gains, thereby increasing the annual rate of return to 3.40%, 20 basis points higher than forecast.

The difference in the rate of return accounts for a favourable variance (to forecast) of \$0.848 million.

Portfolio Balance

The forecasted average portfolio balance for 2019 was \$430.0 million. The actual average general fund portfolio balance (including cash balances) for 2019 was \$433.5 million. The higher portfolio balance accounts for a favourable variance of \$0.112 million.

Variance Summary

| | <u>Forecast</u> | <u>Actual</u> | <u>Variance</u> |
|-----------------------------------|-----------------|---------------|-----------------|
| Portfolio Balance | \$430.0m | \$433.5m | \$3.5m |
| Interest Rate | 3.20% | 3.40% | 0.20% |
| Investment Income | \$13.760m | \$14.720m | \$0.960m |
| Portfolio Balance Variance Impact | | | \$0.112m |
| Interest Rate Variance Impact | | | \$0.848m |

Portfolio Composition

All investments made in 2019 adhered to the City of Markham Investment Policy. At December 31, 2019, 38% of the City's marketable securities portfolio was comprised of government issued securities and 62% of the portfolio was made up of instruments issued by Schedule A Banks. All of these levels are within the targets established in the City's Investment Policy. (Exhibit 1).

The December 31, 2019 marketable securities portfolio was comprised of the following instruments: Bonds 53%; GICs 16%; and Principal Protected Notes 31%. (Exhibit 2)

At December 31, 2019, the City's portfolio balance (all funds excluding Development Charges) of \$319.0 million was broken down into the following investment terms (Exhibit 3):

| | <u>2019</u> | <u>2018</u> |
|-----------------------------------|-------------|-------------|
| Under 1 month | 31.9% | 35.7% |
| 1 month to 3 months | 4.4% | 3.9% |
| 3 months to 1 year | 14.7% | 17.6% |
| Over 1 year | 48.9% | 42.7% |
| Weighted average investment term | 2,103 days | 1,893 days |
| Weighted average days to maturity | 1,222 days | 1,044 days |

Money Market Performance

The City of Markham uses the 3-month T-bill rates to gauge the performance of investments in the money market. The average 3-month T-bill rate for 2019 was 1.65% (source: Bank of Canada). Non-DCA Fund money market investments held by the City of Markham in 2019 (including bank balances) had an average return of 2.28%. Therefore, the City's money market investments outperformed 3-month T-Bills by 63 basis points. See Exhibit 4 for all Money Market securities held by the City of Markham in 2019.

Bond Market Performance

At December 31, 2019, the City held 27 bonds and 15 Principal Protect Notes in the general fund portfolio. The amortized value of these investments at year-end was \$204.6 million. The market value of these investments at December 31, 2019 was \$211.8 million. This translates into \$7.2 million of unrealized gains at year end.

Principal Protected Notes (PPNs)

Principal Protected Notes are a relatively new form of investment and are a safe way for municipalities to participate in the equity market. PPNs are notes of indebtedness issued by a bank, which provide a return profile based on an index (i.e. the TSX Low-Volatility index) or basket of equities without requiring direct ownership in the underlying indexes or equities (the underlying holdings are owned by the issuing bank). PPNs are fixed-income securities that guarantee a minimum return equal to the investor's initial

investment if held to maturity. In other words, the principal is protected and the City can never lose its initial investment amount.

PPNs often have a low (or no) annual interest component. However, the upside can be quite significant depending on the “participation rate”. The participation rate is percentage that the PPN holder receives compared to the overall increase of the underlying indexes or equities. For example, if a \$5 million PPN has a 60% participation rate, that means if the underlying index increased by 50% over the duration of the investment, the holder would receive \$6.5 million upon maturity, for a \$1.5 million net gain [calculated as: \$5 million * (1+ (50% increase * 60% participation rate))].

The participation rate is often determined based on a function of duration and annual coupon payments (i.e. the guaranteed interest amount). The lower the coupon and longer the duration of the note, the higher the participation rate. The highest participation rate of a PPN owned by Markham is 448%.

At December 31, 2019, the City owned 15 PPNs with a combined face value of \$74.2 million. The market value of these PPNs at December 31, 2017 was \$78.4 million. This translates into \$4.2 million of unrealized gains at year end.

See Exhibit 5 for all 2019 Bond/PPN transactions and holdings.

Reserve Funds and Other Interest

The following table outlines the interest earned on investments for all major City funds and reserves.

| | <u>Average Balance</u> | <u>Interest Earned</u> | <u>Average Rate</u> |
|------------------------------|------------------------|------------------------|---------------------|
| General Portfolio | \$433,500,000 | \$14,720,000 | 3.40% |
| Reserve Funds (+ve balances) | \$230,900,000 | \$5,362,000 | 2.32% |
| Reserve Funds (-ve balances) | (\$205,600,000) | (\$8,122,000) | 3.95% |
| Trust Funds | \$2,450,000 | \$58,000 | 2.37% |
| Alectra Promissory Note | \$67,900,000 | \$2,994,000 | 4.41% |
| MEC/District Energy Loans | \$16,800,000 | \$872,000 | 5.19% |
| Development Charge Reserves | \$24,000,000 | \$539,000 | 2.20% |

Because of the large swing in portfolio balances throughout the year (due to the timing of the collection and disbursement of taxes), there will always need to be a significant portion of the City’s funds invested in the money market.

The negative rate of return on the reserve funds is a combination of two factors:

- 1) The City’s Interest Allocation Policy (as approved by Council) stipulates that money market rates be allocated to the interest bearing reserves and bond interest be allocated to the general portfolio. The reasons for this are 1) over the long term, bond rates generally outperform money market rates, therefore the City is able to achieve higher rates of return in its general portfolio and thereby reducing

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- the immediate need for tax increases; 2) bond market rates are more stable which allows for smoother budgeting; and 3) reserves and reserve funds can more easily absorb these money market rate fluctuations as the requirements for these funds are longer term in nature.
- 2) The Interest Allocation Policy also stipulates that “any reserves or reserve funds with negative balances will be charged at a rate of prime.

The \$205.6 million of interest bearing reserves with a negative balance were charged \$8.122 million of interest (average interest rate of 3.95%). Note: a negative rate of return simply means that the general portfolio is earning a return by “lending” funds to reserves in a negative balance.

OPTIONS/ DISCUSSION:

Surplus

The \$3.720 million surplus (to budget) will be transferred to The Life Cycle Replacement and Capital Reserve Fund, as per the City’s Reserve policy.

Outlook

As the yield curve is fairly flat at the moment, there is little incentive to invest in long duration bonds. The strategy in 2020 will be to keep new investments to shorter durations, except with PPNs where there are incentives of greater participation rates for longer durations. The City still has approximately \$185 million in bonds and PPNs locked in past 2020 at generally favourable interest and participation rates, and will continue to search for opportunities to buy and sell when deemed in the best interests of the Markham.

The 2020 investment income forecast is expected to be approximately \$14 million. The budget is set at \$11 million as that is considered to be a minimum level that will be sustainable in the long term. Any interest income earned over the \$11 million budget in 2020 will be transferred to reserves at the end of the year.

FINANCIAL CONSIDERATIONS

Not applicable

HUMAN RESOURCES CONSIDERATIONS

Not applicable

ALIGNMENT WITH STRATEGIC PRIORITIES:

Not applicable

BUSINESS UNITS CONSULTED AND AFFECTED:

Not applicable

RECOMMENDED BY:

Joel Lustig, Treasurer

Trinela Cane, Commissioner,
Corporate Services

ATTACHMENTS:

Attachment 1:

- Exhibit 1 – Investment Portfolio by Issuer
- Exhibit 2 – Investment Portfolio by Instrument
- Exhibit 3 – Investment Terms
- Exhibit 4 – 2019 Money Market Investments
- Exhibit 5 – 2019 Bond Market Investments
- Exhibit 6 – 2019 DCA Fund Investments