



Report to: General Committee

Meeting Date: February 1, 2021

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<b>SUBJECT:</b>	2020 Investment Performance Review
<b>PREPARED BY:</b>	Mark Visser, Senior Manager, Financial Strategy & Investments

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**RECOMMENDATION:**

- 1) THAT the reports dated February 1, 2021 entitled “2020 Investment Performance Review” be received;
- 2) AND 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 2020 budget for Income Earned on Investments was \$11.0 million based on an estimated average general portfolio balance of \$440.0M invested at an average rate of 2.50%. The budget was set based on what was deemed to be sustainable over the next several years. As discussed during the 2020 budget process, any interest earned in 2020 in excess of \$11.0 million in 2020 will be transferred to reserves.

For the year ending December 31, 2020, the City of Markham's Income Earned on Investments was \$14.014 million, representing a \$3.014 million favourable variance to budget.

Both the actual average portfolio balance and average rate of return were higher than budgeted. The details of these two factors will be discussed below.

### Interest Rate

In an effort to reduce the COVID-19 related impacts to the economy, the Bank of Canada reduced the Prime Rate from 3.95% to 2.45% through a series of cuts in March. Due to anticipated potential cash flow issues, the City did not make many investments in 2020, so the decreased rates have not played a major factor yet. However, as investments mature, the ability to reinvest at similar rates is diminished. As well, the cuts to the Prime Rate reduced the City's interest earned on its bank balances.

In 2020, the City's investments had an average rate of return of 2.60%, 10 basis points higher than the budget. Furthermore, the City earned \$1.163 million in capital gains, thereby increasing the annual rate of return to 2.84%, 34 basis points higher than budget.

The difference in the rate of return accounts for a favourable variance of \$1.657 million.

### Portfolio Balance

The forecasted average portfolio balance for 2020 was \$440.0 million. The actual average general fund portfolio balance (including cash balances) for 2020 was \$494.3 million. This was partially due to the Province extending that tax remittance deadlines by three months for the June and September installments. The higher portfolio balance accounts for a favourable variance of \$1.357 million.

### Variance Summary

	<u>Budget</u>	<u>Actual</u>	<u>Variance</u>
Portfolio Balance	\$440.0m	\$494.3m	\$54.3m
Interest Rate	2.50%	2.84%	0.34%
Investment Income	\$11.000m	\$14.014m	<b>\$3.014m</b>
Portfolio Balance Variance Impact			<b>\$1.357m</b>
Interest Rate Variance Impact			<b>\$1.657m</b>

### Portfolio Composition

All investments made in 2020 adhered to the City of Markham Investment Policy. At December 31, 2020, 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, 2020 marketable securities portfolio was comprised of the following instruments: Bonds 46%; GICs 17%; and Principal Protected Notes 37%. (Exhibit 2)

At December 31, 2020, the City's portfolio balance (all funds excluding Development Charges) of \$296.4 million was broken down into the following investment terms (Exhibit 3):

	<u>2020</u>	<u>2019</u>
Under 1 month	28.8%	31.9%
1 month to 3 months	5.4%	4.4%
3 months to 1 year	10.7%	14.7%
Over 1 year	55.0%	48.9%
Weighted average investment term	2,194 days	2,103 days
Weighted average days to maturity	1,265 days	1,222 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 2020 was 0.44% (source: Bank of Canada). Non-DCA Fund money market investments held by the City of Markham in 2020 (including bank balances) had an average return of 1.30%.

Therefore, the City's money market investments outperformed 3-month T-Bills by 86 basis points. See Exhibit 4 for all Money Market securities held by the City of Markham in 2020.

### Bond Market Performance

At December 31, 2020, the City held 23 bonds and 15 Principal Protect Notes in the general fund portfolio. The amortized value of these investments at year-end was \$192.0 million. The market value of these investments at December 31, 2020 was \$206.5 million. This translates into \$14.5 million of unrealized gains at year end.

### Principal Protected Notes (PPNs)

Principal Protect Notes 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%.

The City’s PPN holdings performed very well in 2020 as the equity markets reacted positively to the various COVID-19 stimulus packages.

At December 31, 2020, the City owned 15 PPNs with a combined face value of \$78.0 million. The market value of these PPNs at December 31, 2020 was \$87.3 million. This translates into \$9.3 million of unrealized gains at year end.

See Exhibit 5 for all 2020 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	\$494,300,000	\$14,014,000	2.84%
Reserve Funds (+ve balances)	\$262,800,000	\$3,391,000	1.29%
Reserve Funds (-ve balances)	(\$239,100,000)	(\$6,581,000)	2.75%
Trust Funds	\$2,450,000	\$53,000	2.16%
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	\$29,600,000	\$244,000	0.82%

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 net 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 the immediate need for tax increases; 2) bond market rates are more stable which

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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 \$239.1 million of interest bearing reserves with a negative balance were charged \$6.581 million of interest (average interest rate of 2.75%). 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:**

#### **Outlook**

It is expected that interest rates will remain at these low levels well into 2022 as the economy tries to recover from the impacts of COVID-19. As the City’s existing investments mature, the proceeds will likely have to be reinvested at lower rates. As well, the equity markets are currently strong, thereby limiting the upside on PPNs. As such, the strategy in 2021 will likely be to keep new investments to shorter durations until interest rates bounce back to pre-COVID levels. The City still has approximately \$163 million in bonds and PPNs locked in past 2021 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 Markham.

### **FINANCIAL CONSIDERATIONS:**

The 2021 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 2021 will be transferred to reserves at the end of the year.

### **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 – 2020 Money Market Investments
- Exhibit 5 – 2020 Bond Market Investments
- Exhibit 6 – 2020 DCA Fund Investments