



Report to: General Committee

Meeting Date: January 31, 2022

SUBJECT: 2021 Investment Performance Review
PREPARED BY: Mark Visser, Senior Manager, Financial Strategy & Investments

RECOMMENDATION:

- 1) THAT the report dated January 31, 2022 entitled “2021 Investment Performance Review” be received;
- 2) THAT the \$1.577 million investment interest income surplus be transferred to the City’s Lifecycle Replacement & Capital Reserve Fund;
- 3) 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 2021 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%.

For the year ending December 31, 2021, the City of Markham's Income Earned on Investments was \$12.577 million, representing a \$1.577 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 2020. The Prime Rate remained at 2.45% throughout 2021.

In 2021, the City's investments had an average rate of return of 2.35%, 15 basis points lower than the budget. However, the City earned \$1.752 million in capital gains, thereby increasing the annual rate of return to 2.73%, 23 basis points higher than budget.

The difference in the rate of return accounts for a favourable variance of \$1.079 million.

Portfolio Balance

The forecasted average portfolio balance for 2021 was \$440.0 million. The actual average general fund portfolio balance (including cash balances) for 2021 was \$459.9 million. The higher portfolio balance accounts for a favourable variance of \$0.498 million.

Variance Summary

	<u>Budget</u>	<u>Actual</u>	<u>Variance</u>
Portfolio Balance	\$440.0m	\$459.9m	\$19.9m
Interest Rate	2.50%	2.73%	0.23%
Investment Income	\$11.000m	\$12.577m	\$1.577m
Portfolio Balance Variance Impact			\$0.498m
Interest Rate Variance Impact			\$1.079m

It is recommended that the \$1.577 million favourable variance be transferred to the City's Lifecycle Replacement & Capital Reserve Fund.

Portfolio Composition

All investments made in 2021 adhered to the City of Markham Investment Policy. At December 31, 2021, 37% of the City's marketable securities portfolio was comprised of government issued securities and 63% 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, 2021 marketable securities portfolio was comprised of the following instruments: Bonds 46%; GICs 14%; and Principal Protected Notes 40%. (Exhibit 2)

At December 31, 2021, the City's portfolio balance (all funds excluding Development Charges) of \$379.9 million was broken down into the following investment terms (Exhibit 3):

	<u>2021</u>	<u>2020</u>
Under 1 month	40.5%	28.8%
1 month to 3 months	3.2%	5.4%
3 months to 1 year	9.9%	10.7%
Over 1 year	46.3%	55.0%
Weighted average investment term	1,891 days	2,194 days
Weighted average days to maturity	1,136 days	1,265 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 2021 was 0.11% (source: Bank of Canada). Non-DCA Fund money market investments held by the City of Markham in 2021 (including bank balances) had an average return of 0.96%. Therefore, the City's money market investments outperformed 3-month T-Bills by 85 basis points. See Exhibit 4 for all Money Market securities held by the City of Markham in 2021.

Bond Market Performance

At December 31, 2021, the City held 25 bonds and 19 Principal Protect Notes in the general fund portfolio. The amortized value of these investments at year-end was \$216.8 million. The market value of these investments at December 31, 2021 was \$252.2 million. This translates into \$35.4 million of unrealized gains at year end. The majority of these gains are attributable to the City's Principal Protected Note holdings.

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 over the past few years as the equity markets reacted positively to the various COVID-19 stimulus packages.

At December 31, 2021, the City owned 19 PPNs with a combined face value of \$93.0 million. The market value of these PPNs at December 31, 2021 was \$125.7 million. This translates into \$32.7 million of unrealized gains at year end.

See Exhibit 5 for all 2021 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	\$459,900,000	\$12,577,000	2.73%
Reserve Funds (+ve balances)	\$314,200,000	\$3,008,000	0.96%
Reserve Funds (-ve balances)	(\$278,700,000)	(\$6,827,000)	2.45%
Trust Funds	\$2,460,000	\$46,000	1.87%
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	\$56,400,000	\$423,000	0.75%

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 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 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 \$278.7 million of interest bearing reserves with a negative balance were charged \$6.827 million of interest (average interest rate of 2.45%). 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

As inflation rates are well above the normal targets, it is expected that the Bank of Canada will increase interest rates multiple times in the next 24 months. The strategy in 2021 was to reduce the portfolio’s weighed average length to maturity in order to take advantage of the market when interest rates increase. As well, as equity markets continue to be strong, an opportunity exists to sell some PPNs for capital gains when the timing is right.

FINANCIAL CONSIDERATIONS

The 2022 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 2022 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:

X

Joel Lustig
Treasurer

X

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 – 2021 Money Market Investments
- Exhibit 5 – 2021 Bond Market Investments
- Exhibit 6 – 2021 DCA Fund Investments