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### 2008 ANNUAL INVESTMENT REPORT

**The Finance and Administration Committee recommends the adoption of the recommendation contained in the following report dated January 14, 2009, from the Commissioner of Finance.**

#### 1. RECOMMENDATION

It is recommended that:

1. This report be received for information.

#### 2. PURPOSE

This report is to provide information regarding investment portfolio activities undertaken during the year 2008, as required by Ontario Regulation 438/97 (as amended) of the *Municipal Act* and the Region's Investment Policy.

#### 3. BACKGROUND

The Policy, Risk and Treasury Branch of the Finance Department manages two investment portfolios on behalf of York Region that had a combined maturity value of approximately \$1,232 million as of December 31, 2008.

The General Fund, with a maturity value of \$1,193 million at year-end (\$1,224 million in 2007), is comprised of investments held for the reserves and reserve funds, working capital and other funds of the corporation. All investments made in 2008 were in accordance with the Investment Policy last updated and approved by Council in May 2006. Consideration was given to the following objectives that are set out in the Investment Policy:

- Adherence to statutory requirements;
- Preservation of capital;
- Maintaining liquidity; and
- Earning a competitive rate of return.

As well, all investments met eligibility requirements set out by Ontario Regulation 438/97 (as amended) of the *Municipal Act*.

As at December 31, 2008 over 98% of the General Fund's portfolio consisted of fixed income or interest producing investments. The remainder, less than 2% consisted of

equity investments managed by the ONE Fund Equity Fund, a fund sponsored by AMO and MFOA. The rate of return earned for the General Fund, after expenses, was 6.71% in 2008 compared to 4.04% in 2007.

The Sinking Fund, with a maturity value of \$39 million at year end, (*see Attachment 1*) consists of investments held in trust on behalf of the City of Vaughan, the Town of East Gwillimbury and the Region of York for the repayment of Sinking Fund debentures. Sinking Fund investments are made in accordance with a policy established by the Sinking Fund Committee which is similar to that of the Investment Policy.

While the Region earns interest on its reserves, it does not earn (or budget for) interest income on property tax receipts forwarded to it by area municipalities, since these are paid in arrears. This delay in receiving tax money actually results in a need for working capital to fund the day-to-day operations of the corporation. Working capital requirements are funded first through the Working Capital Reserve, which currently has a non-interest bearing balance of approximately \$37.0 million. Any shortfalls are borrowed from reserves at a rate equivalent to the prevailing rate of return of the portfolio. In 2008 the budgeted cost of financing working capital deficiencies not funded by the Working Capital Reserve, was approximately \$400,000.

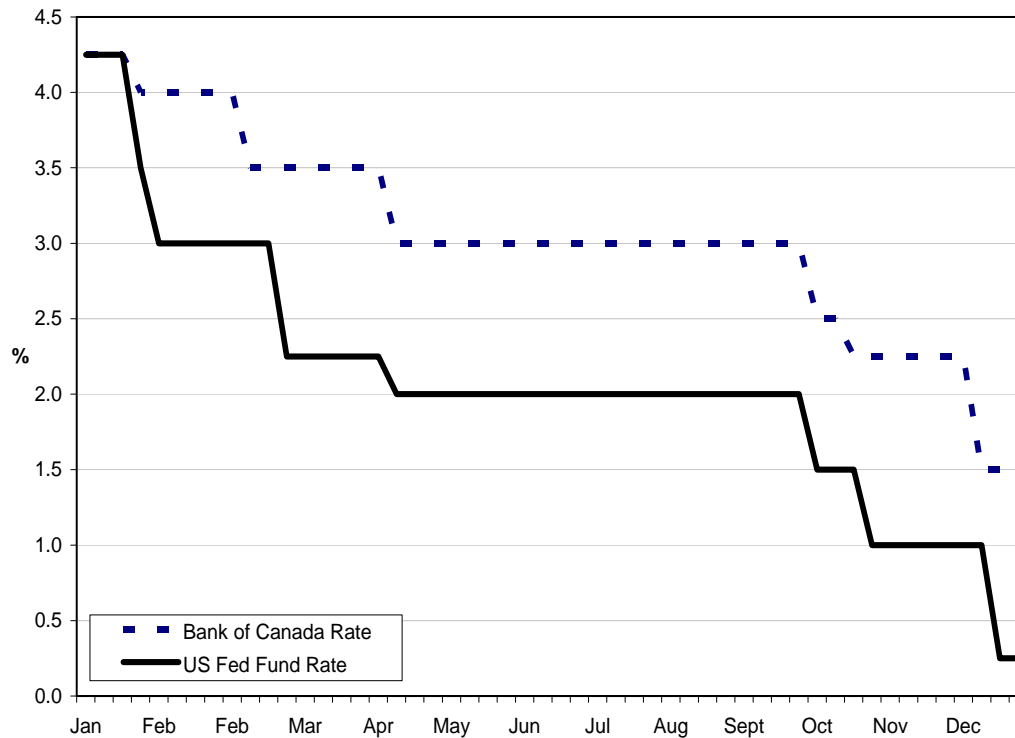
#### **4. ANALYSIS AND OPTIONS**

##### ***Conditions Were Challenging***

North American and world economies continued to slow significantly in 2008 as the two major economic themes from 2007, the U.S. housing crash and the financial markets credit crisis, continued to play out across the financial landscape. Central banks globally and particularly the U.S. scrambled to try and contain these problems before they leaked into the general economy.

In a series of interest rate cuts the U.S. moved their Fed Funds rate from 4.25% at the beginning of the year to essentially zero (a range of 0.0% to 0.25%) by year end. The Bank of Canada was not as aggressive but also dramatically lowered rates through a series of six cuts from 4.25% to 1.5%. (see Graph 1).

**Graph 1**  
**Central Bank Rates - 2008**



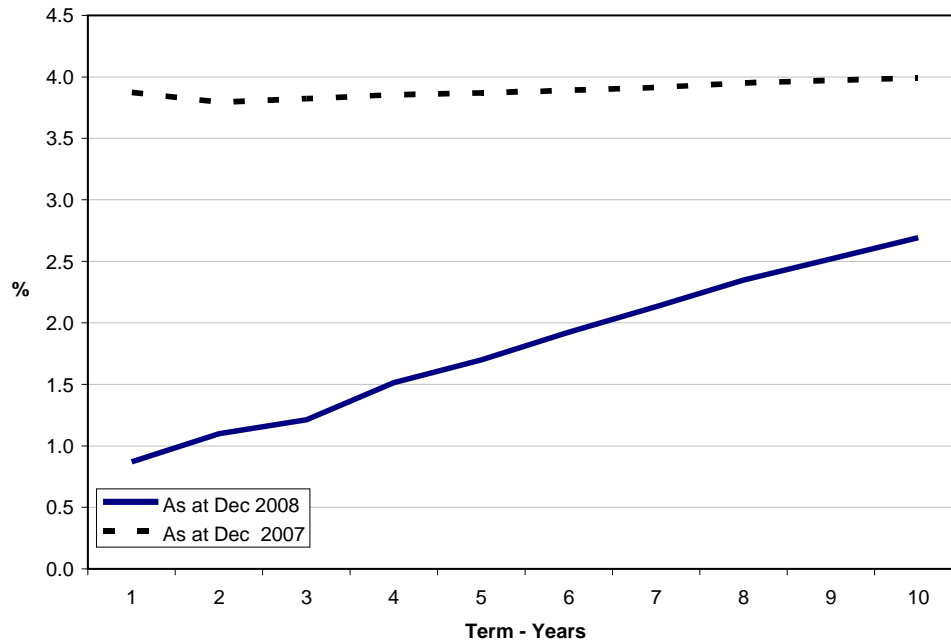
The first half of the year was highlighted by the failure, takeover or bailout of a number of large U.S. financial institutions. The U.S. government, in addition to interest rate cuts, introduced numerous innovative financial funding options to different segments of the financial marketplace in an effort to keep the broader credit markets working. To a lesser extent the Bank of Canada introduced some similar measures to try to keep credit flowing in Canada. Investors increasingly became more risk averse.

The second half of the year provided clear evidence that the housing and credit problems were dragging the larger economy into a recession. Unemployment in both countries rose dramatically and most measures of economic activity deteriorated. Stock markets worldwide sold off dramatically. By year end governments were committing themselves to large fiscal stimulus packages in an effort to kick start their economies.

Against this background of generally lower rates in Canada, the drop in administered short term rates was not matched as aggressively by longer term rate decreases. The ten year rate started the year at 3.98% and dropped to 2.69% by year end. This resulted in a much steeper yield curve than at the beginning of the year. The Canadian curve was 182

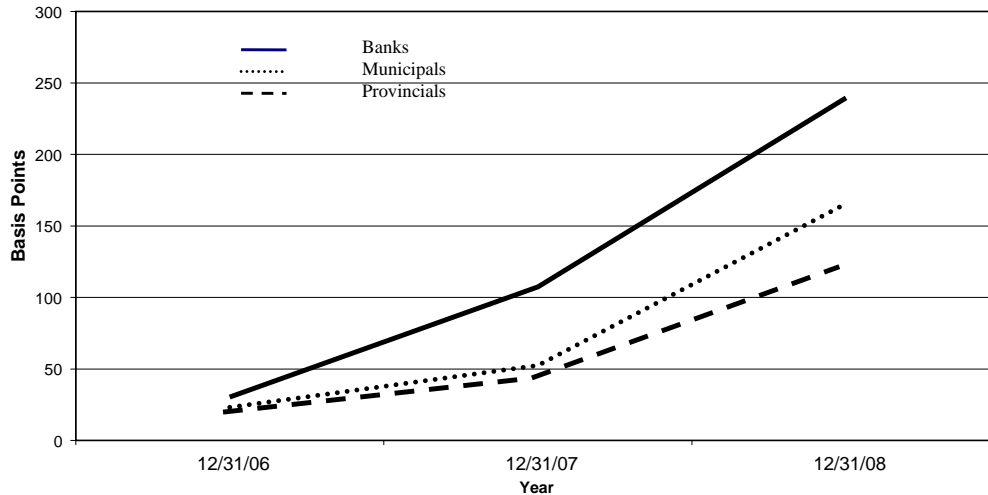
basis points positive between 1 year and 10 year at year end compared to only 12 basis points positive at the beginning of the year. (see Graph 2).

**Graph 2**  
**Canadian Yield Curve**  
**2007 vs 2008**



Throughout 2008 investors became increasingly focused on preservation of capital and maintaining liquidity. Preference was therefore placed on sovereign credits and accordingly the interest rate spread between the Government of Canada bonds and all other credits widened dramatically. Five year Ontario spreads, which were 39 basis points over Government of Canada rates at the beginning of 2008, widened to 117 basis points by year end. Five year bank spreads followed the same pattern, increasing from a spread of 107 basis points to 240 over the course of 2008. (see Graph 3 below).

**Graph 3  
5 Year Credit  
Spreads**



### ***Investment Strategy Focused on Government Bonds***

The investment strategy coming into 2008 as identified in the 2007 Annual Investment Report contained the following themes or assumptions:

1. The fallout from the U.S. housing crisis would continue to impact the financial markets and economy during 2008.
2. Central banks globally would have to lower short term rates further.
3. Corporate bonds would underperform government bonds during the first half of 2008.
4. The economy would stabilize during the latter half of the year.

Although the first three themes had for the most part unfolded as expected, the depth and pervasiveness of the financial crisis has been far worse than originally anticipated.

As the year progressed however, it did become apparent that the economy and financial markets would be in a state of turbulence and turmoil for an extended period. The investment strategy therefore emphasized preservation of capital and the maintenance of adequate liquidity. Implementation of this strategy was carried out by effectively managing term and credit exposures.

The average term of the General Portfolio remained relatively static compared to 2007 at approximately three years. However, sufficient investments were held in short-term

maturities to ensure all Regional expenditures and financial obligations could be met without being compelled to unnecessarily sell any security prior to its maturity date.

In order to improve the overall credit exposure of the portfolio, more investments were concentrated in government securities (federal and provincial) rather than corporate bonds or commercial/bank money market securities. Corporate securities which made up 35% of the General Portfolio in 2007 were reduced to only 25% during 2008. Investments in riskier sectors such as asset backed securities, commercial banks with U.S. parent and non-financial corporate bonds were either reduced or avoided entirely.

As in prior years, an important aspect of the strategy focussed on identifying value added opportunities to provide enhanced returns based on active portfolio management. Given the added volatility in the market place during 2008, there were numerous opportunities identified which resulted in over \$11 million of realized capital gains. Additionally, as part of the value added focus the decision was made to increase the equity component of the portfolio by \$10 million as the dramatic sell-off experienced in the stock market was considered to provide a good long-term investment opportunity.

### ***Investment Results Outperformed Benchmarks***

The General Fund investment portfolio is divided into two distinct asset classes: fixed income and equities. The fixed income component (money market securities and bonds) represents 98% of the overall portfolio and is managed in house by staff of the Finance Department. The equity component which at year end represents less than 2% of the portfolio is managed by an outside professional investment firm under the oversight of the ONE Fund group which is sponsored by AMO and MFOA.

In 2008, the General Fund earned interest income and realized capital gains totalling \$56.4 million on an average portfolio balance of \$1,127 million. This equates to a realized rate of return of 5.00%. Due to strong fixed income market conditions that offset losses in our equity holdings, the total market value of the portfolio compared to its book value increased by approximately \$19.7 million dollars in 2008, representing an additional 175 basis points of unrealized earnings for the portfolio. On a total return basis (marked-to-market) therefore, the entire portfolio earned approximately 6.75%. After factoring in the cost of operating the Region's investment program of approximately \$438,000 (staff, safekeeping, market monitoring services, transaction costs, etc.) the net rate of return for the General Fund was 6.71%, a net difference of 4 basis points.

Over the same period, Sinking Fund investments earned about \$0.9 million for a return of 4.78% (compared to \$0.3 million and 5.02% in 2007). Table 1 summarizes the investment returns for both the General and Sinking Funds for the years 2007 and 2008.

**Table 1**  
York Region Investment Portfolios – 2007/2008

<b>Year</b>	<b>Fund</b>	<b>Assets (million)</b>	<b>Income * (million)</b>	<b>Net Rate of Return</b>
2008	General	\$1,127.0	\$75.7	6.71%
	Sinking	\$18.0	\$0.9	4.78%
2007	General	\$1,070.2	\$43.2	4.04%
	Sinking	\$5.2	\$0.3	5.02%

\* net of investment expenses and adjusted on a marked-to-market basis.

Investment performance of the General Fund Portfolio is compared to two different types of benchmarks, a managed fund benchmark and an index fund benchmark.

Both benchmarks are considered appropriate as they reflect the nature and scope of the mandate of the Region's investment program as intended by the Region's Investment Policy.

The managed fund benchmark is represented by the weighted composite returns of the LAS ONE Fund's Money Market, Bond and Equity Fund portfolio. Each of these funds is professionally managed by a different investment management firm as selected and monitored by the LAS ONE Fund which is sponsored by AMO and MFOA for Ontario municipalities. The composite return of these funds in 2008 was 5.64%. The returns of the Region's General Fund as stated above were 6.71% resulting in excess returns over this performance indicator of 1.07%.

The index-based benchmark is comprised of the weighted composite returns of the DEX (formally Scotia Capital) Money Market, Short Term Bond, Mid-Term Bond and Long-Term Bond indices and the TSX Index return. These indices reflect the returns based on passive investments in these types of securities and asset sectors. The composite returns for these indices in 2008 were 4.73% and therefore the Region's portfolio returns exceeded this benchmark by 1.98%. These results and comparisons for the prior three years are summarized in Table 2.

**Table 2**  
Comparison of General Fund Total Investment Returns

Year	York General Fund Return	ONE Fund Composite Benchmark		DEX Indices Benchmark	
		Return	Outperformance	Return	Outperformance
2008	6.71%	5.64%	1.07%	4.73%	1.98%
2007	4.04%	4.02%	0.02%	3.57%	0.47 %
2006	4.50%	3.75%	0.75%	3.93%	0.57%
2005	3.85%	2.31%	1.54%	2.76%	1.09%

***Investment Strategy for 2009 Will be Defensive but Opportunistic***

The credit crisis and economic slowdown/recession will continue to play out for much of 2009. Many analysts and economists feel that full recovery may not happen until the middle of 2010 or later. Although drastic fiscal and monetary measures have been and will continue to be implemented, their impact will require considerable time to be effective. Short-term interest rates are therefore apt to stay lower longer than originally anticipated. Long-term rates however, may be much more volatile as investors begin to focus on the long-term inflationary aspect of the unprecedented amount of stimulative measures being implemented by central banks and governments around the world.

We believe the global economy will stabilize and that the credit crisis and liquidity concerns will dissipate perhaps as early as the second half of 2009. The fixed income and equity markets are both looking forward, so improvement in the stock market and corporate borrowing spreads could occur well before the global economies bottom out.

For 2009, the Region's investment program will be managed under the following themes:

1. Preservation of capital by keeping defensive term exposures with the expectation that later in 2009 interest rates may generally increase.
2. Maintain liquidity as the Region's ability to borrow to fund its long term capital program may be restricted in the first part of the year.
3. Seek value added investment opportunities by:
  - a) increasing allocation to corporate borrowers in anticipation of spread contraction.
  - b) timely equity investments.

***Holdings of Own Debt Declined in 2008***

As at December 31, 2008, approximately 9% of the total fixed income portfolio was invested in Region of York securities compared to 12.1% as at December 31, 2007. This change was the result of maturities and sales of Region of York debentures exceeding

purchases by \$39.0 million during the year for the General Fund. Information regarding these transactions is presented in *Attachment 2*.

The Region's fixed income portfolio at December 31, 2008 consisted of securities issued by the Federal and Provincial governments (47%), Canadian financial institutions (23%), as well as securities issued by Ontario municipal governments and other approved institutions (30%) (*see Attachment 3*).

The average remaining term to maturity of the portfolio at year-end was approximately 1,248 days. The maturity distribution of these investments is shown in *Attachment 4*.

## **5. FINANCIAL IMPLICATIONS**

The careful management of the General Fund generated net investment returns (interest income plus capital appreciation) of \$75.7 million in 2008 which represented approximately \$12.1 million in additional return versus a similar sized investment with the ONE Funds and \$22.3 million versus the DEX Indices. Investment revenues contribute to reserves and help in defraying York Region's service costs over the longer-term.

## **6. LOCAL MUNICIPAL IMPACT**

While returns on the Region's investments have no direct impact on area municipalities, the extra revenue earned contributes to the Region's reserves and decreases the longer-term need for taxes and development charges.

## **7. CONCLUSION**

The Region's General Fund investment portfolio performance in 2008 returned \$12.1 million (net of costs), above the Region's principal benchmark, the ONE Fund, and \$22.3 million versus the Scotia Capital Indices. The additional income reduces the need for tax or development charge revenues. All investments met the requirements of the Region's Investment Policy.

For more information on this report, please contact David Williams, Manager Treasury and Reserves at Ext. 1620.

The Senior Management Group has reviewed this report.

*(The three attachments referred to in this clause are attached to this report.)*