

Information Report



Service Area	Corporate Services
Date	Friday, April 28, 2017
Subject	2016 Year-end Investment Performance Report
Report Number	CS-2017-08

Executive Summary

Purpose of Report

To report on the 2016 investment portfolio performance and holdings as required by Ontario Regulation 438/97 of the Municipal Act, 2001, and the City of Guelph's Council approved Investment Policy.

Key Findings

The City earned \$7.1 million in investment income for the year-ended December 31, 2016 (includes capital gains of \$1.0 million). This is \$3.1 million favourable compared to the 2016 budget and \$0.8 million less than 2015 at \$7.9 million. Calculated according to the City's Reserve and Reserve Fund Policy, an allocation of \$4.3 million of the earned investment income was transferred to the obligatory and capital reserve funds at year-end.

The City's perpetual cash flow model continues to enable staff to identify and act on timely opportunities for investing (within the City's investment policies), with the intent to optimize the returns on available cash throughout the year.

As reported in the Q2 Interim report, the City earned \$1.0 million in capital gains on the sale of investments made prior to their maturity dates, in order to capitalize on the volatile bond market. No additional capital gains were realized during the remainder of the year.

The average rate of interest return in 2016 declined to 1.74% from 1.97% in 2015, affected by the reduction in interest rates announced by the Bank of Canada on January 21, 2015 and July 17, 2015. These decreases affected the daily interest rates on the City's operating account as well as all short/long term investments that are connected to market rates. Adjusting for the capital gains of \$1.0 million, the average rate of return improved to 2.05% vs. 2.89% in 2015 when \$2.5 million was realized.

The City has managed its investment portfolio in accordance with Ontario Regulation 438/97 of the Municipal Act, 2001 and in accordance with the current

City of Guelph's Council-approved Investment Policy with the exception of the item listed in ATT-1 item 4 related to Master Asset Vehicle notes.

Financial Implications

Investment income reduces the amount otherwise required from property taxation to finance City services, as well as increasing the value of reserve funds used to finance capital projects.

Report

BACKGROUND

Ontario Regulation 438/97 of the Municipal Act, 2001, requires a municipality to adopt a statement of investment policies and goals and requires an investment report to be provided to Council at least annually. This report has been prepared in compliance with this regulation.

The primary objectives of the investment policy are as follows:

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

Provincial legislation requires that the Treasurer submit an investment report to Council annually at a minimum. The City's current Investment Policy requires a report on the financial position, investment performance, market value, and compliance status of the portfolio at least twice per year. Additionally, the Investment Policy was revised, updated, and approved by Council in September 2015 as is required at every change in Council and/or as needed.

Definitions

Carrying Value – Also known as book value. The portion of an asset's value that is not depreciated. Carrying value is not market value, which is determined by market forces, such as stock prices.

Face Value - Also called par value. The value of a bond or another type of debt instrument at maturity.

Market Value - The price at which a security currently can be sold.

A. Statement of Performance

The cash and investment positions (carrying value) of the City are as follows:

	Dec 31, 2016 (Carrying Value)	Dec 31, 2015 (Carrying Value)
Long-term*	\$ 216,673,892	\$ 187,419,480
Short-term	56,115,834	40,051,308
Total Investments	\$ 272,789,726	\$ 227,470,788
Cash	43,909,175	16,530,864
Total	\$316,698,901	\$244,001,652

*Does not include the year-end re-class of long-term to short-term for investments maturing within one year or the Master Asset Vehicle II impairment provision of \$157,664 in both 2015 & 2016.

The total investment and cash market value as at December 31, 2016 was \$318.5 million (2015-\$247.0 million). The details of the City's specific investment portfolio as at December 31, 2016 are attached in the Investment Portfolio by Issuer (ATT-3(a)) and the Investment Portfolio by Security (ATT-4).

Interest earned on investments and cash as of December 31, 2016 was \$6.1 million generating a favourable variance vs. budget of \$2.1 million and \$700 thousand more than 2015 earnings of \$5.4 million (+14%). Additionally, the City realized unbudgeted capital gains in the first half of the year of \$1.0 million which helped to offset other unplanned losses such as low interest rates and foreign exchange. In accordance with the City's General Reserve and Reserve Fund Policy, the net income earned on investments and cash balances was allocated to the reserve and reserve funds at year-end in proportion to their average balances.

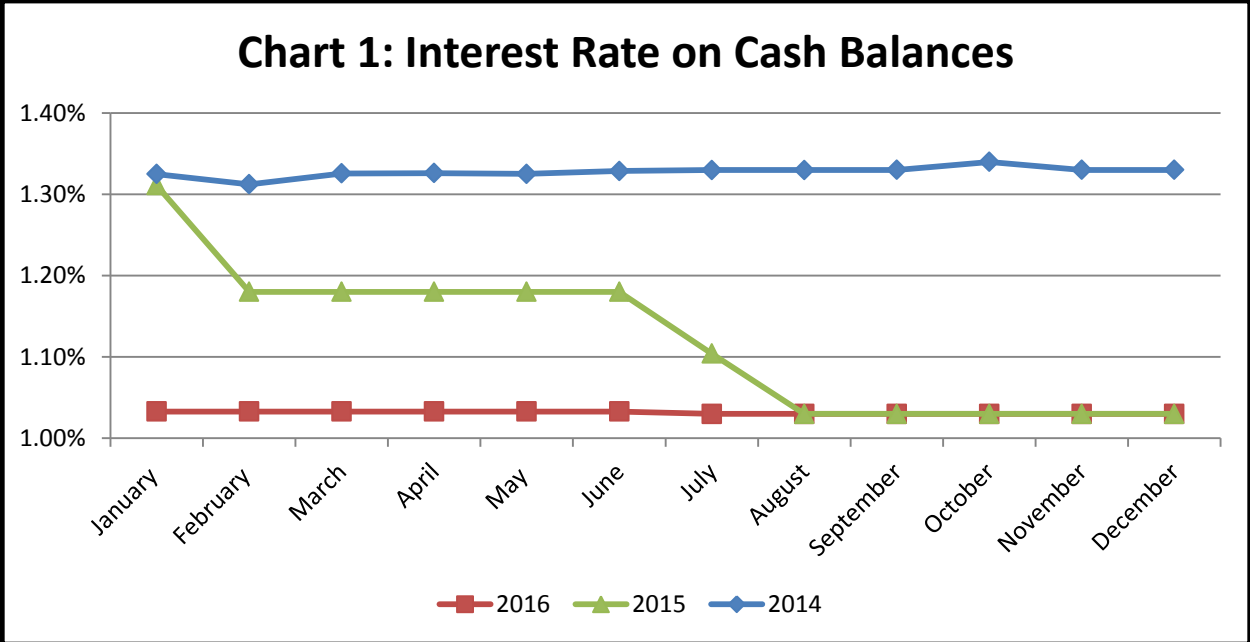
The carrying value of the total investment portfolio on December 31, 2016 was \$272.8 million, plus cash holdings of \$43.9 million totalling \$316.7 million. This computes to an average rate of return for the year of 1.74% (2015 - 1.98%). With the inclusion of the capital gains, the average rate of return for 2016 increased to 2.05% (2015 - 2.89%). However, Finance management cautions against benchmarking performance against capital gain returns as these are unique in nature due to the market conditions at the time and not reliable indicators of expected future returns.

As in previous years, City staff made the decision to sell certain investments in 2016 prior to their maturity in order to capitalize on the volatile bond market. Given this volatile environment, and the lack of predictability going forward, staff assessed and engaged in an opportunity to invest a conservative amount of available surplus cash (\$5.0 million) in the secondary market during the fourth quarter. This portfolio, managed by one of the City's wealth management firms,

consists of both Cash/Cash Equivalents (5%) and Fixed Income GICs (95%), and offers diversity in both short and long-term holdings across multiple issuers. The average interest rate for the Fixed Income investments held at year-end was 2.2% with an overall yield of 1.7%. The secondary portfolio option, on a comparative basis, exceeds the next best primary market offers by 0.2%–0.4% on average. Finance management is pleased with the decision to proceed with this investment choice as an alternative and will continue to consider going forward.

2016 Interim Investment Activity – Cash

As previously reported, the Bank of Canada announced a cut in the prime business rate twice in 2015 (January 21st from 3.0% to 2.85% and July 17th from 2.85% to 2.70%). This drop in prime rate affected the City’s cash earnings in its operating account as compared to 2015 and 2014 as see below in Chart 1.



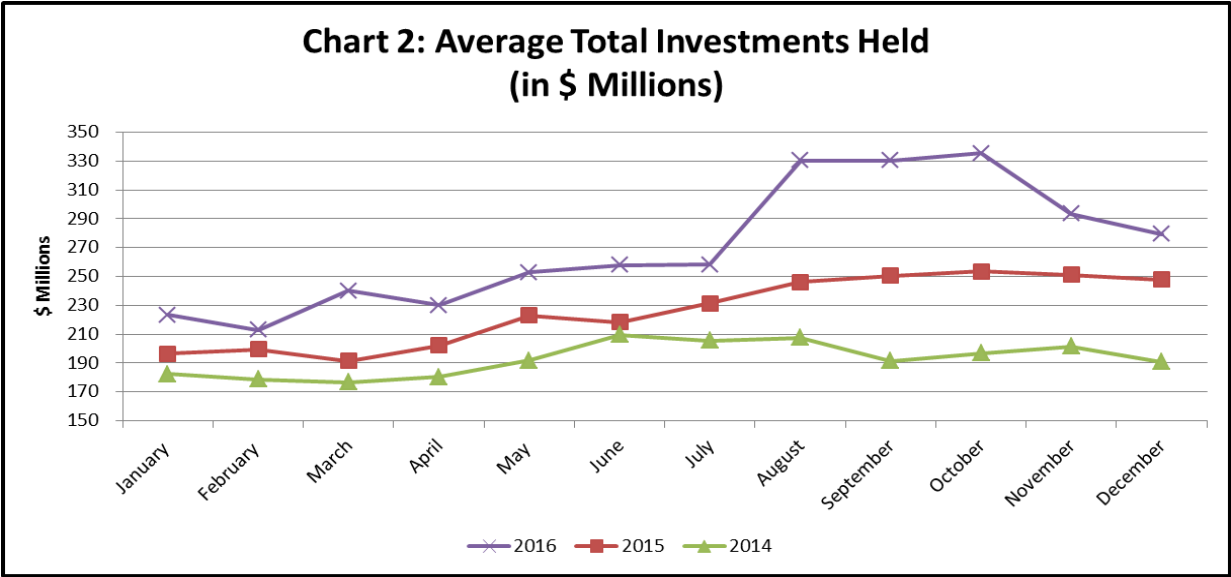
This low interest rate environment has been negatively affecting the City’s investment returns and has City staff continuing to analyze and manage the City’s investment portfolio in order to optimize earnings and risk in the present climate.

2016 Yearend Investment Activity – Investment Portfolio

The City earned a total of \$6.1 million (excluding capital gains of \$1.0 million) from its cash and investments portfolio. This represents a return of 1.74% on average for the year vs. 1.98% in 2015. As indicated, interest earned during the first seven months of 2016 continued to be negatively affected by the reductions in the Bank of Canada interest rate during 2015. See This low interest rate environment has been negatively affecting the City’s investment returns and has city staff continuing to analyze and manage the City’s investment portfolio in order to optimize earnings and risk in the present climate.

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RISK / OPPORTUNITY IDENTIFICATION

Following are the risks and opportunities for the City in the current low interest environment;

- i) The City of Guelph currently holds two investments valued at \$30 million purchased in 2013 and 2014 which were to provide higher than normal interest returns. These notes are investment vehicles that were specially designed for the municipal sector and feature the following attributes:
 1. They are 100% principal guaranteed at maturity;
 2. They have a 10-year maturity but can be sold at market value at any time;
 3. They pay interest quarterly on a fixed step-up schedule;
 4. They are subject to early recall by the bank at any time;
 5. They are subject to banker’s acceptance interest rates with both lower and upper limits. If the market rate is outside the limits, interest is not paid.

With the drop in the Bank of Canada prime rate, these investments are no longer within the lower limit of the note terms and are therefore not earning any additional return. In 2013 and 2014 these investments earned the City approximately 3.5% annually with the prospect of this increasing in 2015 forward due to the step-up factor in the rates. The unexpected lowering of prime in January and July of 2015, have put these investments in a holding position, earning no additional interest.

Given that the principal is guaranteed and interest was earned early on, the City's strategy for these investments has been to retain them until the market rates improve and earnings resume, consistent with other municipalities having similar investments. As such, the 2016 budget was reduced to reflect this impact. Both notes improved to a 99 cent trading value by the end of the year up from 95 cents on the dollar at the end of June.

ii) In this lower interest rate environment, the Canadian Bond Market is trading at a premium. The City's Investment Policy has ensured a diverse portfolio and, as such, the City of Guelph holds a number of Municipal and Provincial bonds that pay a coupon/strip rate above current market. This means that the market value of these bonds is significantly higher than when purchased and can be sold to realize a one-time capital gain.

The City proceeded with this strategy again in 2016 as it did in 2015, selling Strip Bonds/Corporate Bonds that were purchased earlier and generated the \$1.0 million capital gain, contributing to the higher investment return overall for the year.

Asset-Backed Commercial Paper (ABCP) Restructuring

The last quarter of 2016 provided a favourable outcome regarding the City's holdings of the Master Asset Vehicle II notes versus what had been anticipated over the past few years (see ATT-2 Background on Asset-Backed Commercial Papers for the associated historical perspective). Communication was issued by the investment firm now managing these Master Asset Vehicles that the required agreements were secured between the related parties and that the Master Asset Vehicle II Class A-1, Class A-2, and Class B Notes would be paid down in full in January, 2017. For the City, this meant a full recovery of the carrying value of its Class A & B holdings and most of its Class Cs. For 2016, these assets were adjusted only for a partial payout received in October (\$192 thousand) with no change to the impairment provision of \$157,664.

The year-end carrying values and redemptions received in January 2017 for these investments as follows:

Class	Maturity	Rating	Carrying \$ at Dec 31, 2016	Redemption \$ Jan 24, 2017	Remaining \$ in 2017
MAV II A-1	07/15/2056	A+	310,941	310,941	--
MAV II A-2	07/15/2056	BBB+	1,270,940	1,270,940	--
MAV II B	07/15/2056	Not Rated	230,711	230,711	--
MAV II C	07/15/2056	Not Rated	62,043	45,966	16,077
Total			1,874,635	1,858,558	16,077

B. Own Securities

The City has not invested in its own long-term or short-term securities.

C. Investment Policy and Regulation Investment Standard Compliance

To aid in the achievement of the primary objectives of the Investment Policy, the policy places restrictions and limitations on investment quality, diversification, and term. The current portfolio is in compliance with the Municipal Act and Ontario Regulation 438/97 and within the targets set out in the current City Investment Policy in all but the following respects (the Master Asset Vehicle II notes 99% redeemed as of Jan/17):

- Under Ontario Regulation 438/97, a municipality **shall not invest in a bond, debenture, promissory note or evidence of indebtedness with a Dominion Bond Rating Service Limited (DBRS), or equivalent, rating lower than AA (low)**. As outlined above, most of the Master Asset Vehicle II notes acquired in January of 2009 under Asset-Backed Commercial Paper restructuring do not meet this requirement. At the time of purchase these notes were rated above AA (low).
- Under the current policy, the **City shall not invest in a security with a DBRS or equivalent bond rating lower than A**. As outlined above, most of the Master Asset Vehicle II notes acquired in January of 2009 under Asset-Backed Commercial Paper restructuring do not meet this requirement. At the time of purchase these notes were rated above A.
- Under the current policy, the **maximum term** for asset-backed securities is five years. As outlined above, the Master Asset Vehicle II notes acquired in January of 2009 and maturing in 2056 do not meet this requirement.

In all other respects, investments are fully consistent with the investment policies and goals adopted by the City.

Financial Implications

Investment income reduces the amount otherwise required from property taxation to finance City services, as well as increasing the value of reserve funds used to finance capital projects

Consultations

n/a

Corporate Administrative Plan

Overarching Goals

Financial Stability

Service Area Operational Work Plans

Our Services - Municipal services that make lives better

Our Resources - A solid foundation for a growing city

Attachments

- ATT-1 Investment Reporting Requirements
- ATT-2 Background on Asset-Backed Commercial Papers
- ATT-3(a) City of Guelph Investment Portfolio by Issuer - Short-term at December 31, 2016
- ATT-3(b) City of Guelph Investment Portfolio by Issuer - Long-term at December 31, 2016
- ATT-4 City of Guelph Investment Portfolio by Security at December 31, 2016

Departmental Approval

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Investment Reporting Requirements

These investment reporting requirements are in accordance with Ontario Regulation 438/97 of the Municipal Act, 2001.

1. Statement of Performance

The City of Guelph earned an average return of 2.05% on its investment and cash for the year ended December 31, 2016.

2. Investments in Own Securities

None of the 2016 investments of the City have been invested in its own long-term or short-term securities.

3. Record of Own Security Transactions

None of the 2016 investments of the City have been invested in its own long-term or short-term securities.

Statement of Treasurer re: City of Guelph Investment Policy Compliance

I, Tara Baker, CPA, CA, GM Finance and City Treasurer for the City of Guelph, hereby state that:

\$1,874,635 in Master Asset Vehicle II notes acquired in January of 2009 and maturing in 2056 exceed the maximum term of five years for asset backed securities.

The remaining investments have been made in accordance with the investment policies adopted by the City of Guelph.

Statement of Treasurer re: O.R. 438/97 Investment Standard Compliance

I, Tara Baker, CPA, CA, GM Finance and City Treasurer for the City of Guelph, hereby state that:

All investments have been made in accordance with the O.R. 38/97.

Tara Baker

April 28, 2017

Tara Baker, CPA, CA
GM Finance and City Treasurer

Date

Background on Asset-Backed Commercial Papers

Background:

Asset-Backed Commercial Papers are a form of commercial paper that is backed by collateral such as real estate, autos and other commercial assets. Asset-Backed Commercial Papers carry a higher risk, but they are desirable because they typically have a higher return. The financial crisis of 2007 and 2008 led to a collapse of the Asset-Backed Commercial Papers market since the mortgages within the Asset-Backed Commercial Papers had a higher worth than the physical real estate. With an estimated value of thirty-three billion in Asset-Backed Commercial Papers across Canada, the Bank of Canada stepped in and negotiated a solution that converted the Asset-Backed Commercial Papers into long-term bonds called Master Asset Vehicle notes. In the fall of 2008, this restructuring plan, the largest restructuring plan in Canadian history, was completed to match the maturity of the investments to their underlying assets.

Asset-Backed Commercial Papers at the City of Guelph:

At the time of the City's original investment in 2006 the Asset-Backed Commercial Paper security was rated AAA and was widely accepted and purchased by numerous other investors including municipalities. The initial investment was \$2.25 million of the City's total portfolio. The restructuring plan was implemented to convert short term asset-backed commercial paper to long term notes of various classes (II A-1, II A-2, II B, II C, and II 3) with terms matching the maturity of the underlying assets. As a result of the conversion, the City recorded the new carrying value (increase of \$64,197) but recognized the highly speculative nature of any ultimate payment of principal at maturity by booking a 25% provision for impairment of \$578,155.

During 2011, notice was received that the principal amount of Master Asset Vehicle II 3 notes, with a book value of \$245,818, had been reduced to zero, and the value of these assets were written off against the provision in 2011.

The remaining Master Asset Vehicle II notes as of December 31, 2011, had a face value of \$2.06 million and a market value of \$1.32 million, leaving a difference of \$742,529. Therefore, the provision for impairment was further adjusted at the end of 2011 in order to make the net carrying value equal to the market value.

The investments market value from 2012 through 2014 improved and as a result the asset impairment provision had decreased but due to the poor market conditions in 2015, the impairment once again had to be raised.

The following table illustrates the effect that the improved market value has had on the impairment provision:

<u>Year</u>	<u>Impairment Provision Amount</u>
2011	\$742,529
2012	\$373,490
2013	\$213,352
2014	\$ 94,925
2015	\$157,664
2016	\$157,664 (no change)

As of December 31, 2016, the asset-backed securities represented 0.6% (2015: 1.0%) of the total investment holdings.

Current Status:

During 2016, the City continued to retain these investments with the intention to minimize the impairment loss while working with an investment advisor on a strategy to divest of them. In late 2016, as indicated above, confirmation was received from the asset management firm responsible for the Master Asset Vehicle II that liquidation was to occur and, as of January 24, 2017, 99% of the City's \$1.9 million carrying value has been received. As such, the \$158 thousand impairment provision still on the books will not be required other than potentially for the remaining Class Cs for a maximum of only \$16 thousand. In order to reduce the risk of a similar situation occurring in the future, the experience of the Asset-Backed Commercial Papers and associated learning from it resulted in adjustments being made to the City's investment policy.

**City of Guelph
Investment Portfolio by Issuer
As at December 31, 2016**

Short-Term Investment Portfolio

Issuer	Yield	Maturity Date	Carrying Value \$	Term to Maturity (Days)		
				At 31/12/16	Max	Exceeded
Meridian Credit Union	1.25%	Liquid	105,855	N/A	365	-
Meridian Credit Union	1.85%	04-May-17	8,000,000	124	365	-
Meridian Credit Union	1.75%	03-Mar-17	17,000,000	62	365	-
Meridian Credit Union	1.50%	08-Aug-17	7,000,000	220	365	-
RBC Dominion Securities	0.05%	Liquid	263,613	Current	365	-
Bank of Nova Scotia	2.01%	23-Jan-17	44,930	23	365	-
Bank of Nova Scotia	2.25%	21-Feb-17	25,607	52	365	-
Bank of Nova Scotia	1.75%	23-Sep-17	38,157	266	365	-
TD Mortgage Corp	2.15%	15-May-17	5,636	135	365	-
Bank of Nova Scotia	1.55%	26-Mar-17	2,047,040	85	365	-
BMO Nesbitt Burns	2.40%	06-Jul-17	28,514	187	365	-
Montreal Trust Cda	2.25%	24-Jun-17	85,473	175	365	-
National Bank of Cda	1.65%	17-Jul-17	702,028	198	365	-
National Bank of Cda	2.75%	17-Apr-17	65,949	107	365	-
Royal Trust Corp	1.60%	17-Jul-17	703,032	198	365	-
BMO Nesbitt Burns	1.70%	05-May-17	10,000,000	125	365	-
Bank of Nova Scotia	1.70%	28-Jul-17	10,000,000	209	365	-
Short-term Investment Total			\$ 56,115,834			

**City of Guelph
Investment Portfolio by Issuer
As at December 31, 2016**

Long-term Investment Portfolio

Issuer	Yield	Maturity Date	Carrying Value \$	Term to Maturity (Years)		
				At 31/12/16	Max	Exceeded
CIBC	2.25%	21-Jan-21	14,500,000	4.1	10	-
Bank of Nova Scotia	1.60%	17-Apr-17	20,000,000	0.3	10	-
Bank of Nova Scotia	1.81%	15-Apr-19	10,000,000	0.9	10	-
Bank of Nova Scotia	2.50%	06-Jan-20	15,000,000	3.0	10	-
Bank of Nova Scotia	1.75%	29-Nov-17	20,000,000	0.9	10	-
Bank of Montreal	3.07%	02-Dec-22	5,000,010	5.9	10	-
Bank of Montreal	1.90%	07-May-18	10,000,000	1.3	10	-
RBC	1.50%	06-Aug-18	5,000,000	1.6	10	-
RBC	2.01%	06-Dec-19	18,861,639	2.9	10	-
RBC Discretionary Funds- Secondary Market (various)	1.6%- 2.5%	22-Dec-17- 31-Dec-19	998,808	< 4.3	10	-
TD Bank	4.00%	15-Jul-21	12,000,000	4.5	10	-
TD Bank	2.05%	13-Aug-25	10,000,000	8.6	10	-
TD Bank	3.65%	09-May-23	18,000,000	6.4	10	-
Provincial	3.30%	02-Dec-24	7,809,564	7.9	20	-
Provincial	4.08%	02-Dec-26	6,914,591	9.9	20	-
Joint Municipal Investments - One Fund	2.20%	Liquid	40,714,645	Current	N/A	-
Master Asset Vehicle II CL A/B/C Notes	--	15-Jul-56	1,874,635	39.6	5	34.6
Long-term Investment Total			\$216,673,892			
Total Short-term and Long-term Investments			\$272,789,726			

**City of Guelph
Investment Portfolio by Security
as at December 31, 2016**

Securities	Investment \$ Value	Investment % of Holdings	Policy Maximum Portfolio Percentage Limit
Federal			
Government of Canada			100%
Federal Guarantees			50%
Provincial Governments & Provincial Guarantees	\$19,724,165	6%	75%
Country Other than Canada			5%
Municipal			
City of Guelph			50%
Other Municipalities & OSIFA - AAA & AA			50%
Other Municipalities & OSIFA - A			10%
School Board, Ont. University, Local Board, Conservation Authority, Public Hospital, Housing Corp.			20%
Financial Institutions			
Schedule I Banks	\$222,279,602	70%	75%
Schedule II and III Banks			25%
Loan or Trust Corporations, Credit Union	\$32,105,855	10 %	10%
Supranational Financial Institution or Government Organization			25%
Asset-Backed Securities	\$1,874,635	1%	25%
Corporate Debt			25%
Commercial Paper			15%
Joint Municipal Investment Pools -One Fund	\$40,714,644	13%	15%
TOTAL	\$316,698,901	100.00%	