Clarington

Staff Report

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Report To:	General Government Committee		
Date of Meeting:	October 15, 2019	**Report Number:**	FND-028-19
Submitted By:	Trevor Pinn, Director of Finance/Treasurer		
Reviewed By:	Andrew C. Allison, CAO	**Resolution#:**	
File Number:		**By-law Number:**	
Report Subject:	Prudent Investor Standard for Municipal Investments – Update and Options Analysis		

Recommendations:

1. That Report FND-028-19 be received;
2. That Staff continue to work with ONE Investment to bring information back to Council related to a new Investment Policy Statement (IPS) and agreements associated with establishing a new Joint Investment Board (JIB) and implementing the Prudent Investor (PI) regime; and
3. That all interested parties listed in Report FND-028-19 and any delegations be advised of Council's decision.

Report Overview

This report outlines the benefits of investing under the Prudent Investor regime as well as options for implementing a change in investment regime. This report is a second step and update to Council on the process to move to the Prudent Investor standard for investing.

1. Background

Initial Direction to Explore Prudent Investor Standard

1.1. Investing under the *Municipal Act, 2001* and O. Reg. 438/97 (the "Regulation") is divided into the prescribed list of securities (the "legal list") and the recently added Prudent Investor regime ("PI").

1.2. The new PI regime removes restrictions on municipal investments but also includes a legislated governance model. Control and management of money not required immediately under the new PI regime is to be given to a municipal service board referred to as an Investment Board ("IB") or a Joint Investment Board ("JIB") for investment on behalf of the municipality.

1.3. Report FND-014-19 provided Council with additional information on the recent changes to municipal legislation allowing for municipalities to move to the PI standard. The report also detailed the differences between the current "Legal List" approach and the new "Prudent Investor" approach.

1.4. At the GGC meeting of May 6, 2019 Council approved option A which included direction to Staff to develop an agreement to establish ONE Joint Investment Board ("ONE JIB"), together will all related matters such as codes, policies and appointments and to adopt the prudent investor regime when these items are in place.

1.5. It was initially expected that the establishment of the ONE JIB would be completed by December 2019; however, at a recent meeting of potential founding members it was determined that an establishment date of April 2020 was more realistic and preferable.

1.6. At the time of Report FND-014-19, the only municipality with the Prudent Investor Standard adopted was the City of Toronto under the *City of Toronto Act*. As at the date of this report, there are no municipalities in Ontario which have adopted the Prudent Investor Act under the Regulations.

Benefits of Prudent Investor (PI) Regime

1.7. The PI regime expands municipal investment opportunities which may enable better risk-adjusted returns meaning that risk can be carefully balanced with returns.

1.8. The restrictions placed on legal list investments can create concentration risk into the investment portfolio. The legal list currently restricts investments to deposit instruments at Canadian chartered banks, certain Canadian corporate bonds rated A or better (ie. banks), municipalities and senior levels of government. The impact is that realistically a municipality's investments are heavily concentrated in Canadian banks which does not allow for appropriate diversification.

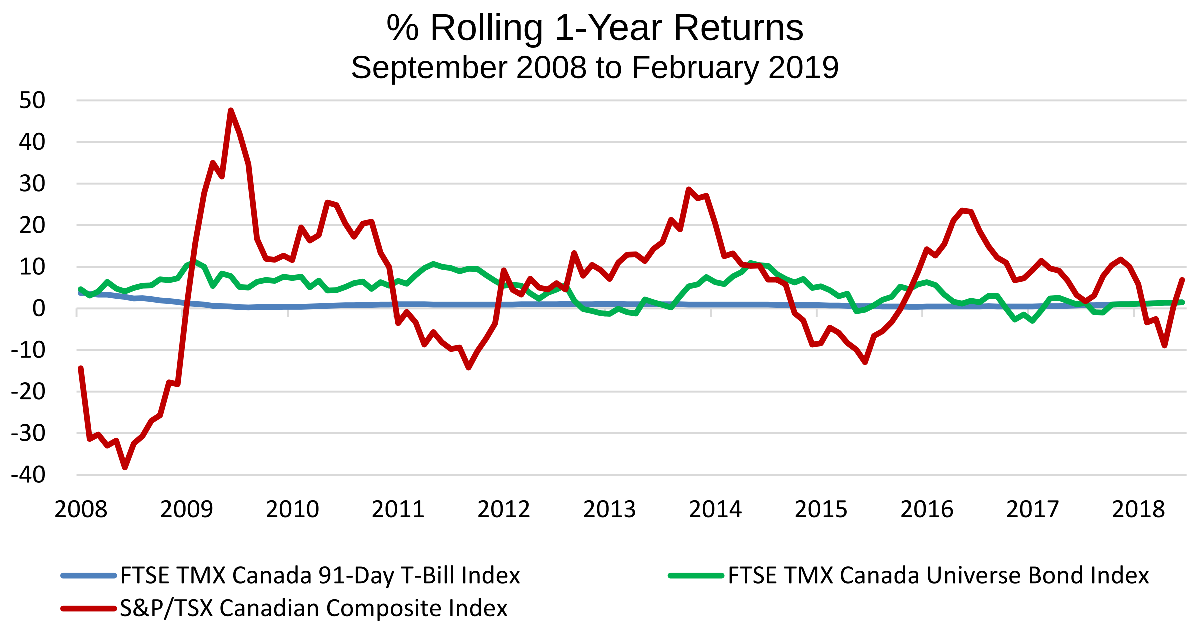
1.9. The diversification of available investment products and the removal of geographical limitations which are only available under the PI regime may mitigate concentration risk.

2. Risks, Returns and Diversification

Risk Adjusted Returns

2.1. In general, for municipalities as stewards of public funds, preservation of capital is a key priority that needs to be balanced with the need for returns. Municipal budgets are under tremendous pressure to maximize revenues while minimizing the need for property tax increases. As municipalities seek to diversify revenues to put less pressure on property taxes, investment revenue becomes more important as an underused alternative revenue stream. Figure 1 below demonstrates the effect of "safe investments" on return potential. It shows the percentage returns on a rolling 1-year basis for Canadian stocks (red), Canadian Fixed Income (green) and short-term treasury bills (blue). When a municipality puts a heavy priority on capital preservation, it will often invest in short-term treasury bills, guaranteed investment certificates (GIC), term deposits, or High Interest Savings Accounts (HISA), which ensures little to no losses due to the lack of volatility. However, you will note from Figure 1 below the low returns on short-term investments which over the 10-year time-period did not even keep up with inflation. Average annual inflation from 2008-2018 was 1.97% using the Consumer Price Index (2.55% using the Non-Residential Building Construction Price Index.)

Figure 1: Rolling 1-Year Returns Across Asset Classes



Sources: S&P, FTSE

Diversification

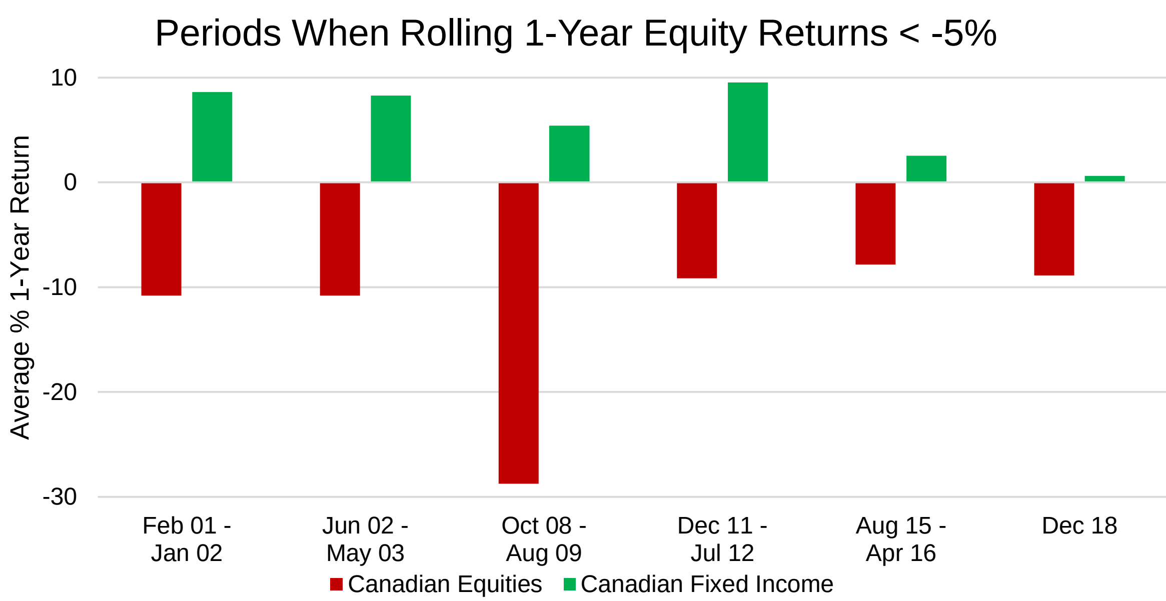
2.2. By removing investment restrictions, the PI regime allows the municipality to better diversify its investments. Concentration risk arises when investments are made in closely related securities; this can be by asset class, geographic location, or sector. Where a portfolio has many securities of the same type, the whole portfolio can be exposed to a single risk event. Research shows that when investing over longer time frames diversification allows investors to better manage portfolio risk.[1] By investing funds in multiple different markets, sectors and products a municipality can better protect itself from losses incurred in one of its investments.

[1] Asness, Clifford S., Isrealov, Ron, and John M. Liew. (2011). "International Diversification Works (Eventually)" Financial Analysts Journal Volume 67, Number 3.

Diversification by Asset Class

2.3. The PI regime will enable the Municipality of Clarington to invest in a broader array of investment products facilitating the building of a more diversified investment portfolio. This concept of diversification is one of the basic principles used to reduce overall portfolio risk. Figure 2 shows the risk-mitigating effect of diversification by asset class or product type. The figure looks only at periods when Canadian stock returns fell below negative 5%. Between 2008 and 2018, the Canadian stock markets (red bars) experienced six periods where values declined by greater than 5%; however, in each of those periods fixed income products (green bars) experienced positive returns. If an investor held both Canadian stocks and fixed income during these periods the total decline in stocks would have been partially or potentially fully offset by a positive return on fixed income

Figure 2: Offsetting effect of portfolio diversification by asset class



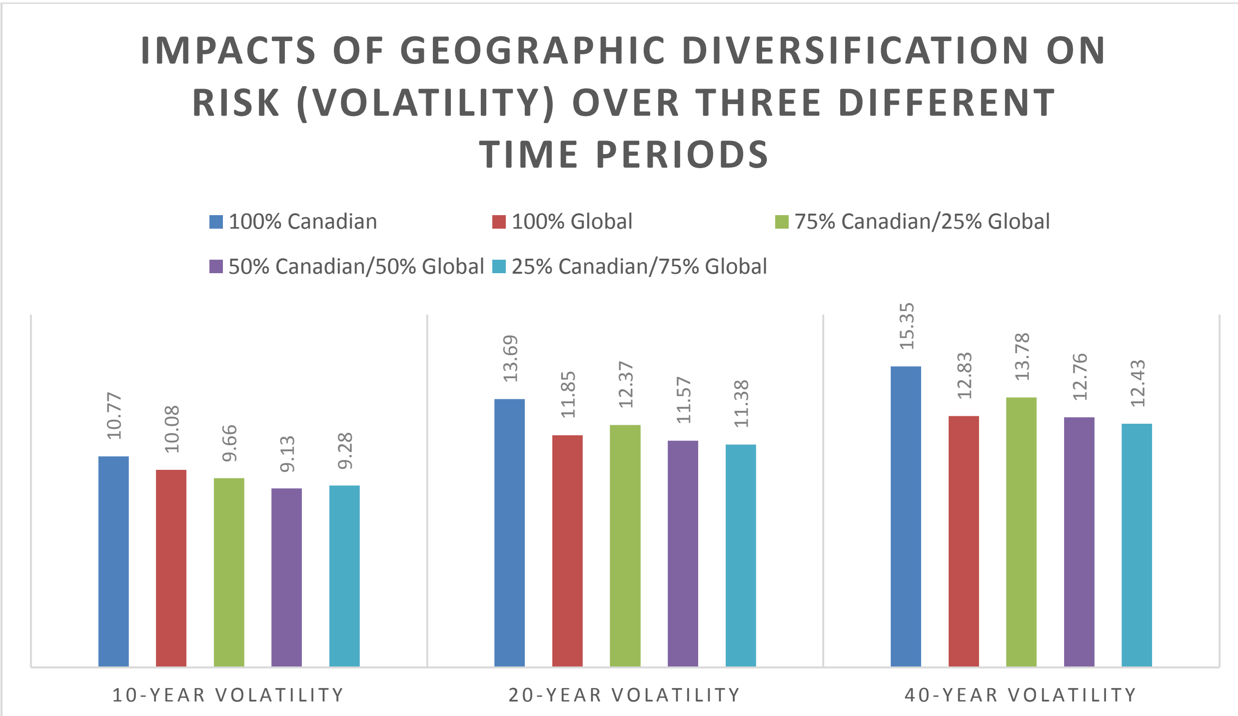
Geographical Diversification

2.4. The PI regime allows the Municipality to invest in the Global markets. Securities prices in equities and fixed income markets outside of Canada will be influenced by a different set of factors than apply to Canadian securities. Typically, different economic fundamentals and political circumstances drive returns from investments outside of Canada. For this reason, the pattern of returns from Global stocks and fixed income will be differentiated in comparison to returns for Canadian securities, which provides a basis of diversification benefits, which in turn tend to reduce overall portfolio risk. Under the current legal list, the Municipality can only buy Canadian equities (which are only available through ONE Investment) which exposes municipalities to the risk of a downturn in the Canadian market. The Canadian economy is highly exposed to global demand for, and the prices of, certain primary commodities (e.g. oil & gas, metals, agriculture). It is also dependent on exports and trade, particularly with the United States.[2] Canadian equity markets represented less than 3% of global equity markets at the end of 2018.[3]

2.5. In looking at historical data (10, 20, and 40-year time periods) using different levels of geographic diversification, investors would have experienced less volatility if they held an asset mix that included both Global and Canadian stocks. Volatility is a common way to measure risk in investments – it represents swings in market value – so the higher the number the less stable the investment[4]. Figure 3 below shows the volatility of five different levels of geographic mix. The 100% Canadian stock mix was the most volatile, or risky, investment in all three time periods. The least volatile geographic mixes were those that had a combination of Canadian and Global stocks in most instances (See Appendix 2 for more detail on this analysis).

[2] Source: See remarks of Stephen S. Poloz, Governor, Bank of Canada "Opening Statement", January 9, 2019 and Bank of Canada Monetary Policy Report July 2019, "Key inputs to the base-case projection."
[3] Source: The World Bank. Canadian equity markets had total market capitalization of USD $1.938 Trillion, vs total world market cap of USD $68.654 Trillion.
[4] The measure of volatility used throughout this document is standard deviation.

Figure 3: Volatility and Geographic Diversification



Higher-yield Securities

2.6. If a municipality can better manage risk through diversification it can use that tool to pursue greater returns by tolerating a greater level of risk over a small portion of its investments. Over a longer period, small differences in returns can have significant impacts. For example, while the difference of a 0.5% return may not sound like a lot, over long periods of time the financial impact in dollars can be substantial. Table 1 shows how 0.5% in returns compounds into dollars over ten years, depending on the starting value. The compounding effect of a 0.5% return over a 10-year period for $5 million would contribute $256,000 in additional revenue. For a $100 million investment that additional 0.5 % would contribute $5,114,000 to the municipality.

Table 1: Compounded Value of 0.5% (50 bps) over 10 Years

Starting Investment Value	Incremental Return
$5 million	$256,000
$20 million	$1,023,000
$50 million	$2,557,000
$100 million	$5,114,000
$250 million	$12,785,000
$500 million	$25,571,000
$1 billion	$51,140,000

2.7. Increasing returns by an amount as small as 0.5% over a 10-year period can have major impacts on a municipality's budget.

2.8. There are two ways to attain higher returns:

1. Identify inefficiencies in the market (i.e., identify mispriced investment opportunities); and

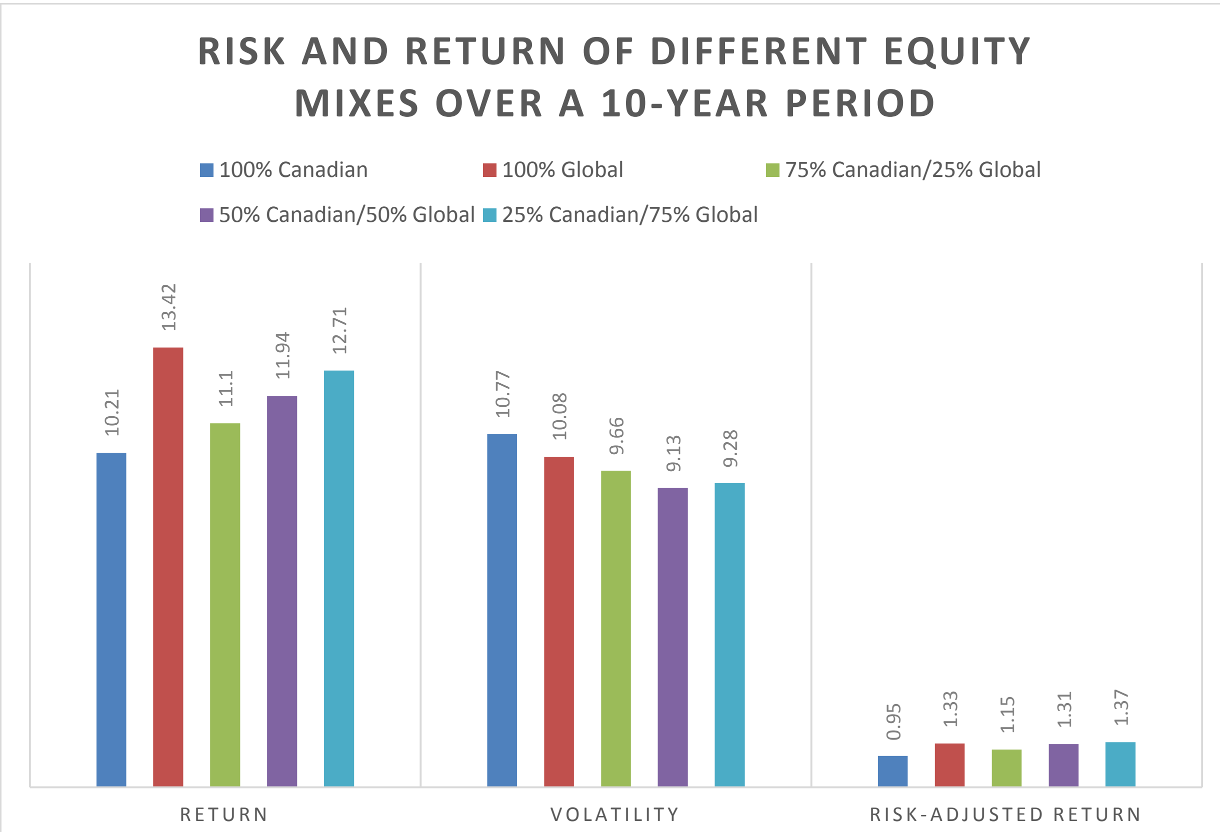
2. Accept a higher level of risk.

2.9. Portfolio managers often try to identify inefficiencies in the market. They conduct research and analysis to identify investments they believe are incorrectly valued or identify themes that are not correctly reflected in securities prices. They then position their investments accordingly.

2.10. Changing investment allocations typically is done with the intent to achieve higher returns, but any change in investment allocations also changes the level of risk in the portfolios. It is for this reason that evaluating investments based on return potential alone is not prudent. Investment managers should always keep overall portfolio risk in mind. Often, they will focus on risk-adjusted returns in their analysis. The risk-adjusted return refers to the ratio of percentage returns to the percentage risk (volatility). This measure will help identify whether the amount of additional return that they expect by purchasing a security is worth the incremental risk involved.

2.11. Figure 4 – Risk Adjusted Returns Over a 10-Year Period compares the different levels of geographic diversification over a 10-year time frame. A 100% holding in Global stocks would have produced the highest return (13.42%); however, except for the 100% Canadian holding, it had the highest level of volatility during the period. The three diverse mixes have lower levels of volatility. The increased returns come at a cost of increased risk. If investors consider only the risk, they may miss out on potential returns. If investors consider only returns, they could expose themselves to significant risk. If we look at the two together (risk-adjusted returns) we get a more complete picture of which is the better investment, or how much the returns cost in terms of risk. Of the levels of geographic diversification, an investor would have achieved a better risk-adjusted return (1.37%) during this time period by using the 25% Canadian: 75% Global stock mix – while it would have achieved slightly lower returns, it would have done so at a lower risk exposure. The goal here is to maximize the upside while minimizing the downside.

Figure 4: Risk Adjusted Returns Over a 10-Year Period



2.12. Many of the risks outlined above can be managed or mitigated depending on the mechanism or avenue through which the municipality chooses to implement the PI regime. These mechanisms and avenues will be examined in the options analysis below.

Comparing Legal List vs Prudent Investor under ONE

2.13. ONE Investment's PI offerings will be a mix of its current Legal List options and two new funds that will only be available to PI investors – a Global Equity fund and a Global Bond fund. The sample allocation provided is a relatively conservative mix of 80% bonds (fixed income) and 20% stocks (equities). Modelling data provided by ONE

Investment and conducted by AON Hewitt show that under these asset allocations at the same risk level (-5.0% worst case annual return), the expected annual return for PI is 1.3% higher than under legal list: 4.3% vs 3.2% respectively (Table 2).

Table 2: Modelling expected returns of ONE Offerings[5]

Assumed Asset Allocations	Legal List	Prudent Investor
Money Market Portfolio	45%	
Bond Portfolio	15%	20%
Unconstrained Global Bonds		60%
Universe Corporate Bond Portfolio	20%	
Total Fixed Income	**80%**	**80%**

[5] Modelling conducted by AON Hewitt and data provided by ONE Investment

Assumed Asset Allocation	Legal List	Prudent Investor
(Canadian) Equity Portfolio	20%	5%
Global Equity		15%
Total Equity	**20%**	**20%**

	Legal List	Prudent Investor
Expected return before value add	2.90%	3.80%
Expected value added by managers	0.30%	0.50%
Expected return	3.20%	4.30%
Expected worst case annual return	~-5.0%	~-5.0%

2.14. Because the two new PI offerings have an existing client base and track record, it is possible to compare the actual past performance of a PI asset allocation to a comparable legal list asset allocation. Comparing past performance of the funds (figure 5), over a five-year period from 2014 to 2018 the PI option would have outperformed the legal list option in four of the five years. In 2015, the PI option would have outperformed legal list by almost 7%. The average annual difference over the five years would have been a 2.69% in favour of the PI option. However, it should be noted that in 2018 the legal list option would have outperformed PI by 0.12%. This demonstrates that moving to PI does not guarantee better returns year over year and that past performance is not always a reliable indicator of future performance.

Figure 5: Historical Rates of Return for ONE Investment Offerings (2014 – 2018) [6]

	Money Market	Bond Portfolio	Univers Corporate Bond	Equity Portfolio	Global Bond	Global Equity	**Legal List Allocation**	**Prudent Investor Allocation**
2018	1.65%	1.95%	1.60%	-1.90%	-0.50%	5.70%	**0.97%**	**0.85%**
2017	0.84%	0.32%	2.62%	10.76%	4.60%	19.10%	**3.10%**	**6.23%**
2016	0.70%	1.17%	2.24%	15.29%	5.40%	0.90%	**4.00%**	**4.37%**
2015	0.94%	2.29%	3.70%	0.29%	7.70%	23.10%	**1.56%**	**8.56%**
2014	1.11%	3.45%	9.35%	20.24%	9.90%	15.90%	**6.94%**	**10.03%**

Investment Allocations

	Money Market	Bond Portfolio	Univers Corporate Bond	Equity Portfolio	Global Bond	Global Equity
PI		20.00%		5.00%	60.00%	15.00%
LL	45.00%	15.00%	20.00%	20.00%		

2.15. Staff believes that when taking the projected future modelling results in conjunction with the past performance comparisons, that the PI option offers greater opportunity for increased returns while more effectively managing concentration risk.

3. PI Governance Options

3.1. Municipalities that decide to adopt the PI regime must transfer control and management of their investments to an IB or JIB. There are three available options:

- Establish an independent investment board (IB);
- Establish a joint investment board (JIB) with one or more municipalities with ONE Investment; or
- Join an existing IB or JIB.[7]

[6] Historical data provided by ONE Investment

[7] This option is not currently available as to date the City of Toronto is the only municipality that has established an IB and it is not currently prepared to have its IB invest for other municipalities.

Establish a Municipality of Clarington Investment Board

3.2. Under the Act a municipality can create its own IB if it has, in the opinion of the treasurer, at least $100M in money and investments that it does not require immediately, or $50M in net financial assets.

3.3. As the Municipality of Clarington, does not currently meet either of these requirements, this option will only be briefly described.

3.4. An IB is a municipal service board as defined by the Act and is governed by the procedural requirements of the Act (sections 194 to 202). All the required services provided to a municipal service board would need to be provided to the IB (e.g. committee secretary, closed meeting support).

3.5. As municipalities are required to delegate their investment powers to the IB, a high priority must be placed on appointing qualified experts, which will come at a cost. Additionally, as staff does not possess the in-house expertise required, it would be necessary to acquire that expertise either on a full-time basis from an employee of the municipality or seek expert advice externally. These cost factors are explored below, along with the option of founding a JIB.

3.6. To date, the City of Toronto is the only municipality to establish its own IB. Toronto has invested under the PI regime under the *City of Toronto Act, 2006*, for a full year before the option of investing under the PI regime was extended to other municipalities that are subject to the *Municipal Act, 2001*. The City has yet to transition all its investments to its IB.

Establish a Joint Investment Board

3.7. As noted in the previous report to Council ONE Investment is the only organization which is actively working to establish a JIB. While the establishment of another JIB may be available in the future, this option does not exist today and hasn't been included in the options analysis. Staff have been working with ONE Investment staff and seven other municipalities, listed below, to become founding municipalities of a JIB.

Municipality of Clarington	Town of Whitby
County of Essex	Town of Bracebridge
District of Muskoka	Town of Innisfil
Town of Huntsville	Town of Aurora
City of Kenora	City of Thunder Bay

3.8. There are several factors to consider when evaluating the two available options which are outlined in Appendix 3 – Detailed Comparison of Prudent Investor Options. This analysis will focus on the cost structure. Establishing an IB or JIB can be costly both in terms of the initial set-up and ongoing costs both direct and indirect. Costs include legal fees, (J)IB member remuneration, fund manager research, consultants for investment expertise and other investment services (e.g. asset allocation studies), committee secretary, closed meeting support.

3.9. Table 3 shows the costs incurred by both the City of Toronto and ONE Investment to date. ONE Investment has not yet established its JIB but expects to do so by April 2020. The City of Toronto spent over $1.1M setting up its IB and is still incurring set up costs. ONE Investment has spent approximately $1.9M to date setting up its JIB – this higher number is due to the coordination and legal complexity of dealing with many municipalities; however, once it is set up the ongoing maintenance costs are expected to be lower and will be shared among all municipalities that invest under the PI regime through ONE JIB.

Cost	City of Toronto[8]	ONE Investment's Joint Investment Board
Manager search	$200,000	$150,000
External Legal Fees	100,000	1,000,000
Investment Policy Statement Development	100,000	See above
Internal staff support, including legal	220,000	325,000
Staff time working with other municipalities to create the Joint Board	0	365,000
Board Remuneration	72,500	95,000
Tax Advice	100,000	0
Undisclosed Costs	307,500	0
Total	**$1,100,000+**	**$1,935,000**

3.10. Expert advice would also be required to guide staff and Council on appropriate investment strategies. Additionally, the staff and Council would require expert investment advice and potentially legal advice when developing an investment policy. These items would add to the set-up costs of an IB. ONE Investment has received an exemption from the Ontario Securities Commission (OSC) that allows them to provide

[8] Costs provided by Director, Capital Markets - City of Toronto

that expert advice. ONE Investment has also hired a Chartered Financial Analyst with over 25-years of experience in institutional investing.

3.11. ONE Investment has prepared a report (Appendix 4) detailing the process for establishing ONE JIB, the roles of the municipality and ONE JIB, and the benefits and risks of being a founding municipality. The document notes that many of the risks are mitigated through processes and procedures developed for ONE JIB.

Joining an Existing IB or JIB

3.12. At present this option is presented for information purposes only because there are no existing IBs or JIBs through which a municipality can invest. [9]

Risks and Potential Drawbacks of the Prudent Investor Regime

3.13. The new governance structure for the PI regime has some associated risks. A municipality that passes a by-law to adopt the PI regime cannot revoke that by-law. This means that municipalities who adopt the PI regime cannot go back to investing money that is not required immediately in accordance with the legal list unless a regulation authorizing the municipality to do so is made by the Lieutenant Governor in Council.

3.14. Additionally, a municipality must delegate its powers to investment money not required immediately to an IB or JIB. As per the Regulation, Councillors and municipal staff cannot be appointed as members of the IB or JIB, except for treasurer(s) provided that the treasurer(s), does/do not make up more than 25% of the members of the IB or JIB.

3.15. These control risks, however, are mitigated by the investment policy statement (IPS), which allows Council to define its “objectives for return on investment and risk tolerance” and its “need for liquidity.” Council must review and, if necessary, amend the IPS at least once per year. Through the IPS, Council maintains strategic control over its investments.

3.16. If Council decides to proceed with the PI regime, staff will need to determine what constitutes “money that it does not require immediately” and control and management of that money must be given to the IB or JIB for the purposes of investing. Any money that remains with the municipality will remain under the control and management of the

[9] The City of Toronto is not currently prepared to have its IB invest for other municipalities.

municipality. The City of Toronto, in its investment policy, established a time-based threshold of 18 months to determine the money that it does not require immediately.[10]

3.17. There is no guarantee of better returns as a result of investing under the PI regime. A broader array of investments exposes the investor to a broader array of risk and past performance is not indicative of future results. Moreover, there is no assurance that better performance will offset the initial cost of transitioning to the PI regime and any ongoing costs after a municipality adopts the PI regime.

3.18. Under the PI regime the municipality gives up management and control investing money not required immediately. The municipality is relying on the expertise, experience, good faith and diligence of ONE JIB and ONE Investment staff. Municipal staff believe that these individuals have the requisite experience and expertise, and such individuals are required to act in good faith and in the best interests of the municipality.

3.19. Staff believe, based on the available evidence, that moving to the PI regime is the preferred course of action.

4. Steps to Adopt the PI Regime as a Founding Municipality via ONE Joint Investment Board (ONE JIB)

ONE JIB

4.1. The Municipality of Clarington is one of several municipalities which are working on forming a joint investment board ("JIB") in order to mutually enter into adopt the Prudent Investor Standard. It is not financially feasible for the Municipality to establish its own investment board nor are there any other JIBs being contemplated.

4.2. The combined balances from the above municipalities would meet the $100 million threshold for establishing the ONE JIB. Once established other municipalities may, subject to the JIB agreement, join the ONE JIB.

[10] Statement of Investment Policy and Procedures for the City of Toronto Investment Funds. https://www.toronto.ca/legdocs/mmis/2018/ex/bgrd/backgroundfile-116242.pdf

4.3. The Municipality of Clarington will pass an authorizing by-law ("Authorizing By-Law"), the passage of which will be co-ordinated with the passage of an Authorizing By-Law by the other founding municipalities.

4.4. The Authorizing By-Law will authorize:

(i) the entering into of an initial formation agreement establishing ONE JIB;

(ii) the completion of the Municipality of Clarington's Municipal Client Questionnaire;

(iii) the adoption of the Municipality of Clarington's Investment Policy Statement; and

(iv) the entering into of an agreement with ONE JIB and the other founding municipalities under which ONE JIB will invest the money and investments of the founding municipalities under the PI regime and of other municipalities that may subsequently agree to invest through ONE JIB (the "ONE JIB Agreement").

4.5. After all the founding municipalities have passed an Authorizing By-Law and signed and completed the various documents authorized by such by-law, ONE JIB will hold a meeting and sign the ONE JIB Agreement. Thereafter, each founding municipality can pass its prudent investor enabling by-law (the "Prudent Investor Enabling By-Law") to officially opt into the PI regime as at the effective date set out in its Prudent Investor Enabling By-Law.

4.6. It is anticipated that an Authorizing By-Law will be passed by all the founding municipalities before the initial ONE JIB meeting in mid-March 2020. After the ONE JIB meeting, Council can pass its Prudent Investor Enabling By-Law in May 2020.

5. Concurrence

Not Applicable.

6. Conclusion

6.1. It is respectfully recommended that given the opportunity for risk reduction and greater returns, the PI regime is an opportunity that the Municipality should pursue. ONE Investment is in the process of establishing ONE JIB, so the costs of set-up to the Municipality are greatly minimized.

6.2. The Municipality of Clarington, through cost sharing with other municipal investors, would have access to the necessary expert investment and municipal finance advice. Additionally, the ongoing maintenance costs would be shared with all municipal investors making it an affordable option.

6.3. Being a founding municipality would give the Municipality access to benefits that it would not get if it waits to adopt the PI regime until after ONE JIB is established. There is a trade off as the Municipality would be an early adopter and would not have the benefit of other municipalities' experiences with the adoption process.

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Attachments:

Attachment 1 – Impacts of Diversification on Risk

Attachment 2 – Detailed Comparison of Prudent Investor Options

Attachment 3 – ONE Investment Detailed Update

Interested Parties:

The following interested parties will be notified of Council's decision:

6.4. Municipal Finance Officers Association of Ontario (MFOA)

6.5. Association of Ontario Municipalities (AMO)

6.6. ONE Investment