

MUNICIPALITIES AS PRUDENT INVESTORS

September 20, 2019

Keith Taylor, CFA
Investment Manager, ONE Investment

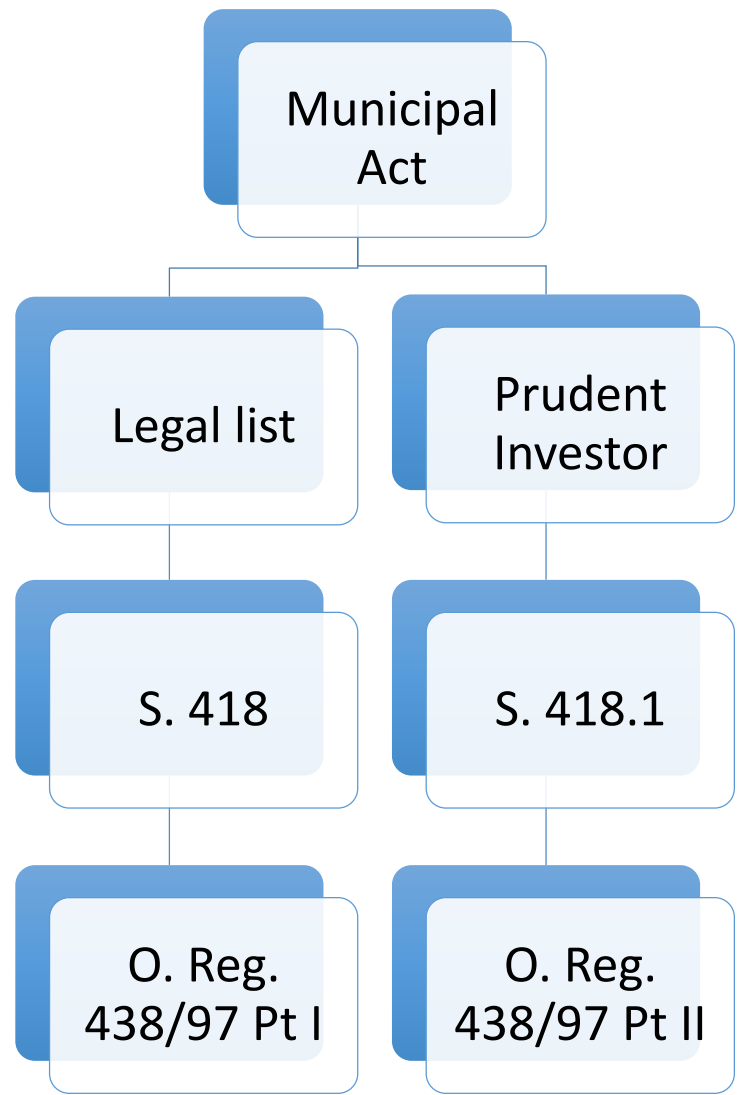
Colin Macdonald
Manager - Investment Services MFOA

CONTENTS

- Prudent Investor vs. the Legal List regime
 - Benefits and risks of PI
- Prudent Investor Governance Model

- Prudent Investor Through ONE Investment
 - Who is ONE Investment?
 - How is ONE Investment implementing the PI governance model?
- Questions?

OVERVIEW OF MUNICIPAL INVESTING - TWO WAYS TO INVEST



LEGAL LIST RESTRICTIONS

- Issuer
- Credit Rating:
 - Issuer
 - Debt instrument
 - Municipality
- Time Frame:
 - <5 years Corporate Bonds = municipality
 - >5 years Corporate Bonds = ONE

MFOA SUMMARY OF ELIGIBLE MUNICIPAL INVESTMENTS UNDER PART I OF O. REG. 438/97 AS AMENDED (HEREAFTER REFERRED TO AS THE "REGULATION")

LAST REVIEWED: MARCH 2018 NTD: 1) References to "a term of more than 2 years" means a 'remaining term to maturity greater than 2 years'.
 2) References to "a term of 2 years or less" means a 'remaining term to maturity of 2 years or less'.
 3) Eligible investments for the proceeds of the sale of shares of the City of Ottawa's corporation incorporated under section 142 of the *Electricity Act, 1998* are not included.

Eligible Investment (and regulatory authority) Security	Issuer	Conditions	Minimum Security Ratings	Minimum Municipal Debt/Credit Rating or Other Requirement	
Section 2, paragraph 1. Bonds, debentures, promissory notes or other evidence of indebtedness issued or guaranteed by:	i. Canada, a province or a territory of Canada	• Applies to all municipalities			
	ii. an agency of Canada, a province or territory of Canada	• Applies to all municipalities			
	iii. a country other than Canada	<ul style="list-style-type: none"> • Applies to all municipalities • Securities must be rated • Must sell within the expected timelines set out in the Workout Plan¹⁴ if investment falls below standard 	<ul style="list-style-type: none"> • DBRS: AA(low) • Fitch: AA- • Moody's: Aa3 • S & P: AA- 		
	iv. a municipality in Canada, including the municipality making the investment	• Applies to all municipalities	3(6)	3(1)	
	v. a school board or similar entity in Canada	• Applies to all municipalities			

- Amount of investment (Credit Unions)
- Canadian Equity – only through ONE Investment
- When in doubt - Get Legal Advice

PRUDENT INVESTOR STANDARD

THE PRUDENT INVESTOR STANDARD

Section 418.1 requires the municipality to consider:

- Economic conditions
- Inflation or deflation
- Role that each investment in the portfolio
- The expected total return
- Need for liquidity, regularity of income, preservation or appreciation of capital



THE PRUDENT INVESTOR STANDARD

Requires everyone involved to be careful, sober, informed (prudent).

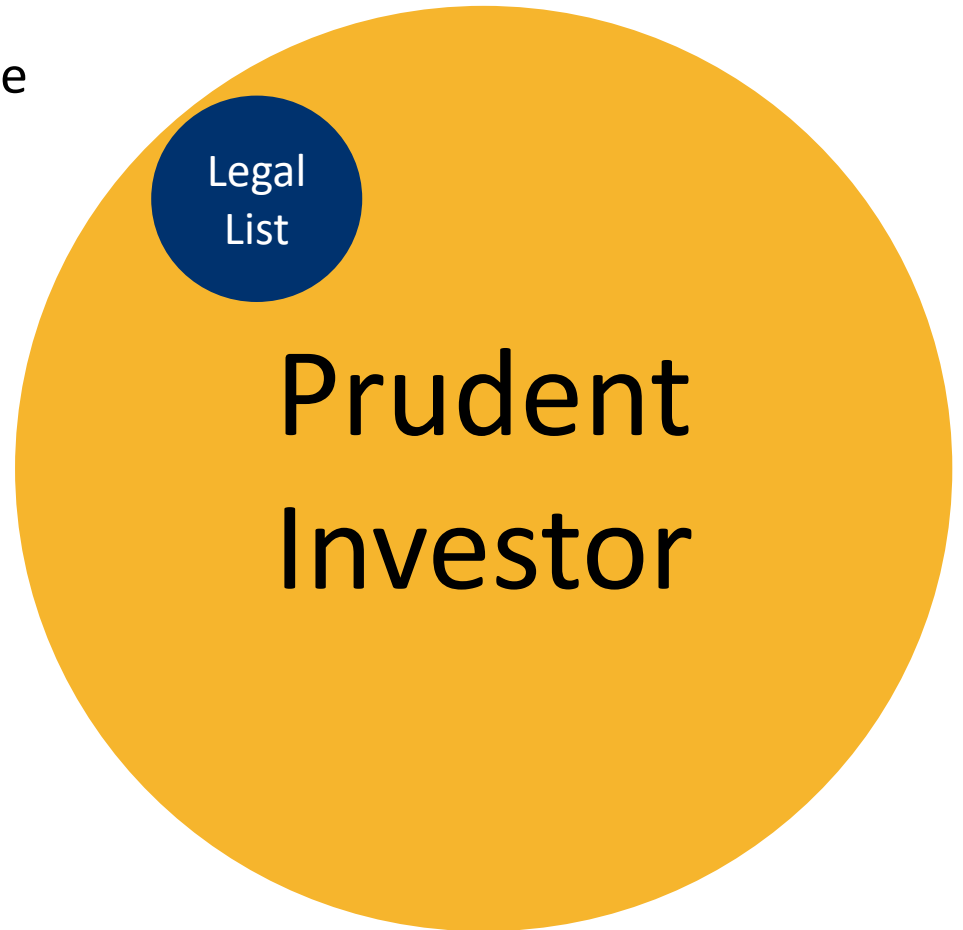
A resulting portfolio that is more diverse may:

- Be less risky with the same/better returns as the Legal List
- Be in a broader variety of securities (Legal List still available)
- Section 418.1(8) - Must exercise the care, skill, diligence, judgment that a prudent investor would use
- Section 418.1(9) - Duty to obtain the advice
- Section 418.1(10) - Consider the investment planning criteria (previous page)
- Section 418.1(11) - Diversify to an extent that is appropriate to general economic and investment market conditions

PRUDENT INVESTOR VS. LEGAL LIST

LEGAL LIST VS PRUDENT INVESTING

- Prudent Investing: more diverse portfolio
- Greater choice, flexibility
- Ability to adjust to changes in financial environment or need
- Potential for better returns



PORTFOLIO LEVEL THINKING

Legal List

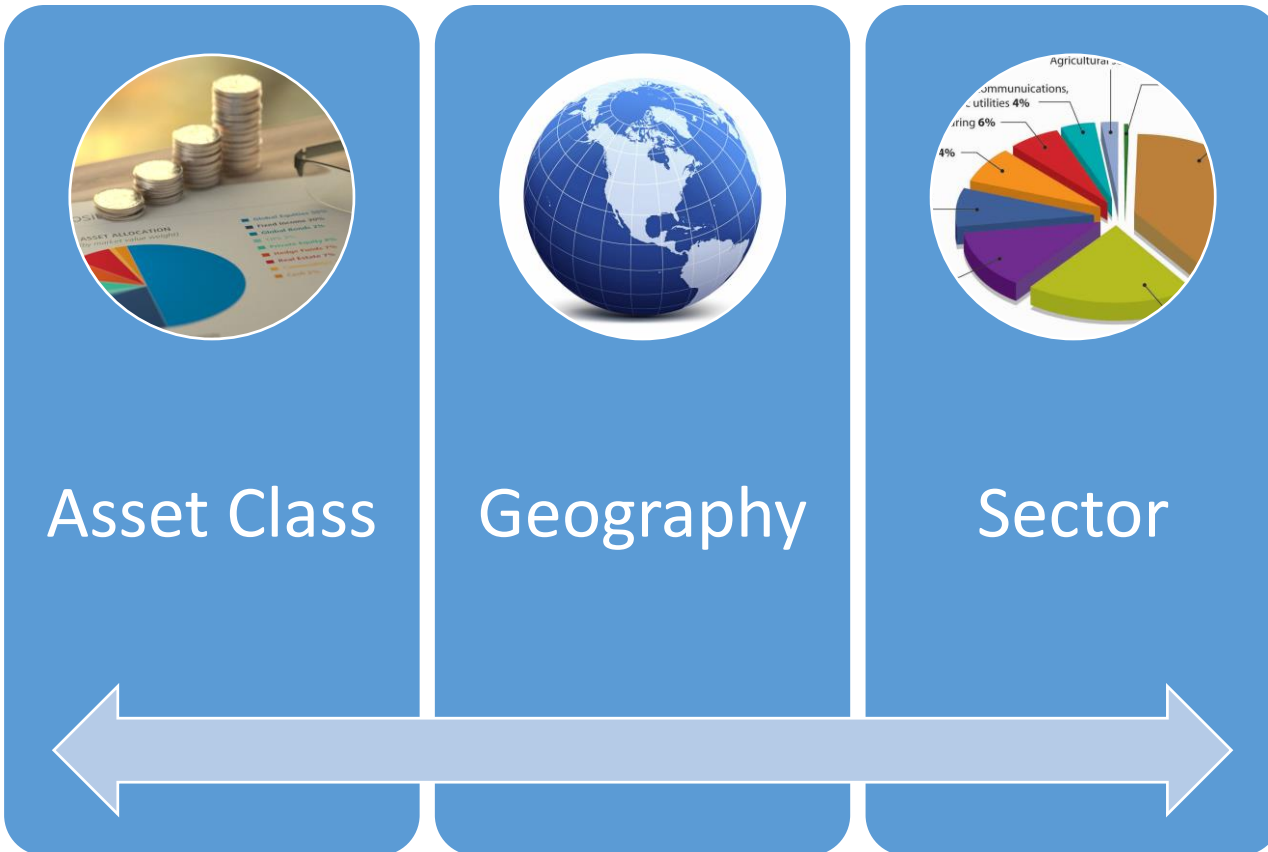
- Council develops investment policy statement (IPS); staff implements
- Manages risk of buying a poor security, ***not the risk of meeting obligations***
- Risk controlled at the security level; limited ability to diversify
- Based on Legal List defined by regulation under the Municipal Act
- Evolution dependent on changes in regulation

Prudent Investor Standard

- Council develops IPS; ONE JIB develops Investment Plan and implements
- ***Emphasis on overall investment outcomes and meeting long-term needs***
- Risk controlled at the portfolio level; broad ability to diversify
- Entails independent due diligence on securities
- Investment managers adapt to capital markets as they unfold

CONCENTRATION RISK

Arises when investments are made in closely related securities



RISK MANAGEMENT: DIVERSIFICATION

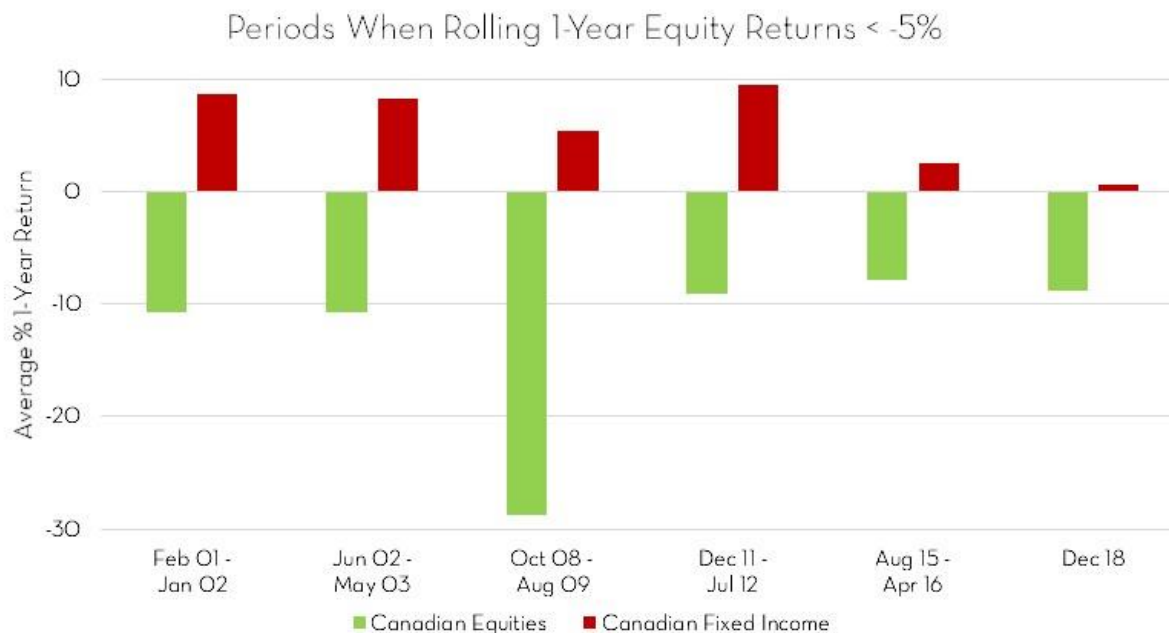
What's Behind Prudent Investor Regulation: Modern Portfolio Theory

- A driving force behind portfolio management since introduced by Markowitz in 1952
- We can identify a series of optimal portfolios that maximize ***expected return*** for a given level of risk
- Investors can reap the benefits of diversification; this can be measured

Expected return is the profit or loss an investor anticipates on an investment.

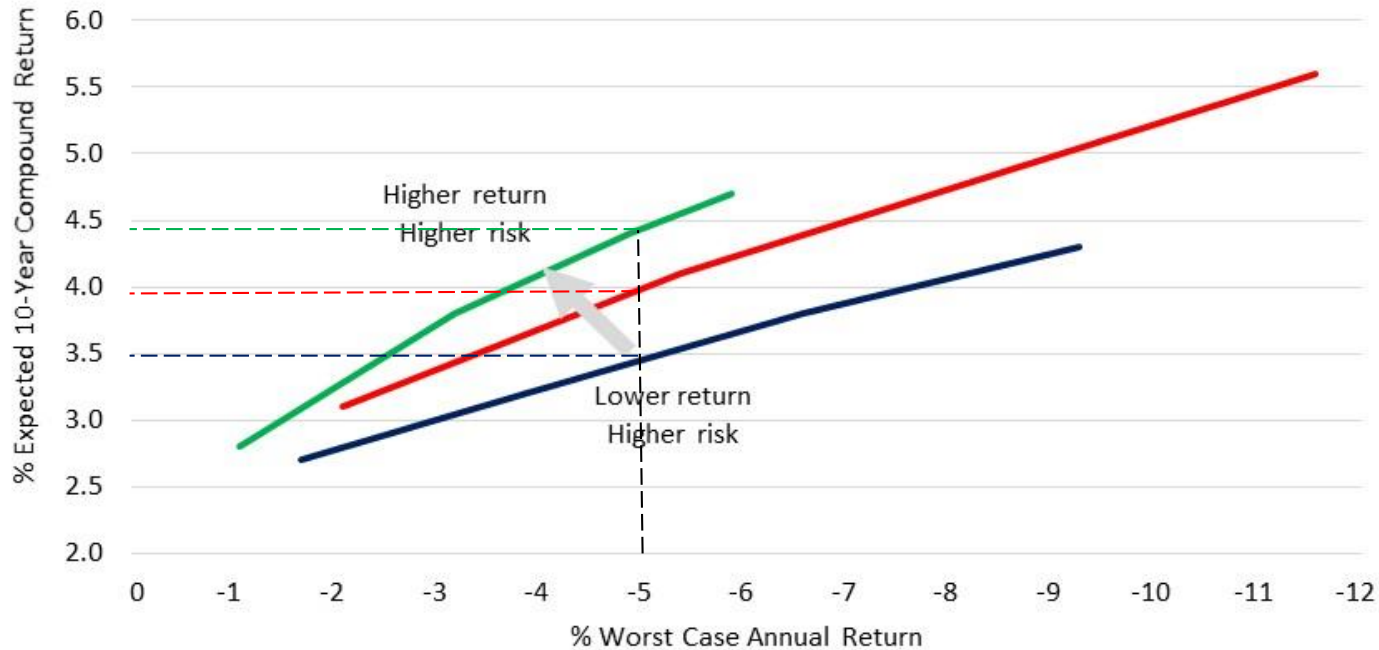
SAMPLE PORTFOLIO LEVEL THINKING

- Chart below shows periods between 2000 and 2018 when Canadian equity returns fell below -5%
- Canadian equities (green), fixed income (red)
- In every period, fixed income had an offsetting positive return
- ***Combining the two helps reduce total portfolio risk by diversification***



RISK ADJUSTED RETURNS

Aim to Move to a Frontier that is Higher and to the Left
Efficient Frontiers Generated by Aon's Asset Allocation Study



- 1. From the universe of investments available under Legal List
- 2. From the universe of investments available to Prudent Investors
- 3. From ONE's Prudent Investor offerings

THE PRUDENT INVESTOR GOVERNANCE MODEL

THE PRUDENT INVESTOR GOVERNANCE MODEL

- Investment power delegated to an IB/JIB = municipal service board
- Staff, council excluded except treasurers of investing municipalities up to 25% of the board

Municipality:

- Adopts, maintains investment policy
- Reviews policy at least annually
- Monitors performance and compliance by the IB/JIB

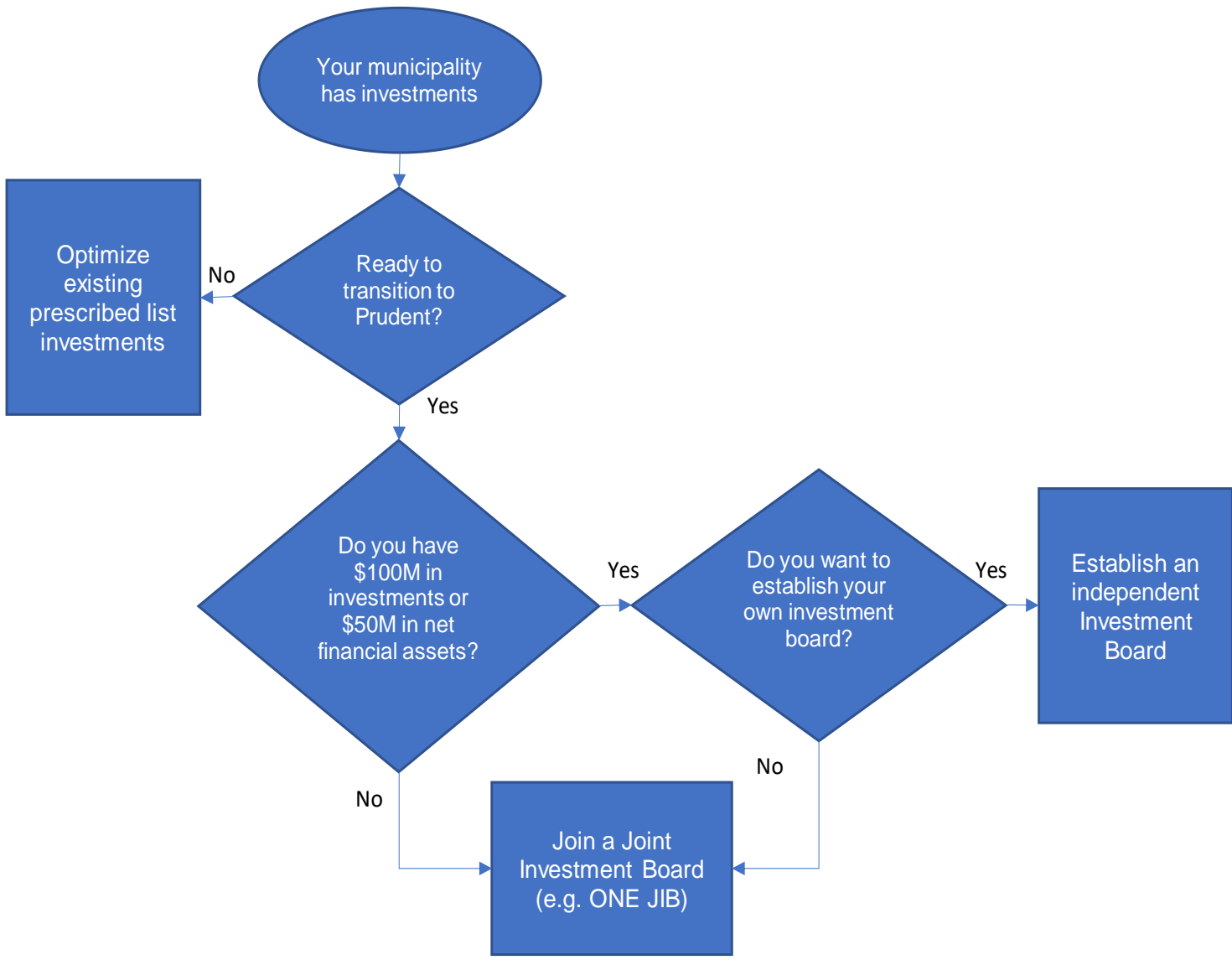
IB/JIB:

- Adopts, maintains investment plan
- Monitors, reports performance
- Updates plan to comply with the investment policy
- May engage agents to manage investment funds

WHAT CAN MUNICIPALITIES DO?

- Continue with the Legal List; or
- Move to the PI standard by appointing an investment board (IB) or joint investment board (JIB) with other municipalities
- Move from the Legal List to the PI standard if it meets the requirements.
- Cannot move back to the Legal List without a regulation





PI GOVERNANCE – “CONTROL AND MANAGEMENT” ISSUES

Control

- How can Council “control” municipal investment?
- **Solution:** Investment Policy Statement

- What if Council needs money immediately?
- **Solution:** Municipality determines the amount of the “money it does not require immediately”

Management

- Council has the authority to select and appoint members to the IB/JIB (subsection 17(4) of Regulation)
- No officer, employee or member of Council can be a member of IB/JIB (subsection 17(4) of Regulation)
- **EXCEPT** Treasurer but can not make up more than one quarter of the IB/JIB (subsection 17(5) of Regulation)

PI GOVERNANCE - “CONTROL AND MANAGEMENT”

Control

Can the municipality ensure that it can obtain funds from the IB or JIB to deal with any number of unforeseen circumstances? and to what extent, if at all, can the municipality direct the manner in which its portfolio is rebalanced?

(paragraph 2 of each of subsections 17(1), 17(2) and 17(3) of the Regulation)

Management

Municipalities have the authority to select and appoint members of the IB. However, the regulations restrict this authority, as officers, employees or a member of the council of any municipality cannot be a member of the IB.

(subsection 17(4) of the Regulation)

The exception to this restriction is the treasurer of the municipality, who is permitted to be appointed as a member of the IB.

(subsection 17(5) of the Regulation)

When dealing with JIBs, the same restrictions apply, though municipal treasurers cannot make up more than one quarter of the members of the JIB.

(subsection 17(5) of the Regulation)

PI GOVERNANCE – MUNICIPALITY - INVESTMENT POLICY

- The Investment Policy must include requirements with respect to the municipality's:
 - i. return on investment
 - ii. risk tolerance
 - iii. need for liquidity, including:
 - the municipality's anticipated needs for funds for planned projects
 - the municipality's needs to have funds available for unanticipated contingencies.

(subsection 18(2) of the Regulation)
- ~~Include any other requirements with respect to investment matters that council considers to be in the interests of the municipality.~~

~~(subsection 18(3) of the Regulation)~~
- Municipalities must diversify their investments to an extent that is appropriate to general economic and investment market conditions.
(418.1(11) of the Act)

PI GOVERNANCE - MUNICIPALITY (CONT')

- Monitor its investment performance
- Ensure that the investment plan executed by the IB or JIB is consistent with the policy
- At least annually, the Investment Policy must be reviewed by the municipal council
 - after which the IB or JIB must then review the Investment Plan and update it, as necessary, to ensure continuing compliance.

“MONEY NOT REQUIRED IMMEDIATELY”

Cash Planning

Short-Term Funds

Required Immediately



- Less than 12-18 months*
- Managed by municipality
- Compliance with Legal List

Long-Term Funds

Not Required Immediately



- Longer than 18 months*
- Managed, controlled by Investment Board (IB)/Joint IB
- PI standard

* Suggested best practice based on City of Toronto approach

PRUDENT INVESTOR THROUGH ONE INVESTMENT

WHAT IS ONE INVESTMENT?

- Established in 1993
- Commingled portfolios designed specifically for the municipal and broader Ontario public sector
- Consistent strong rates of return
- Governed by CHUMS and LAS
- Advised by Investment Advisory Committee, Peer Advisory Committee (municipal customers), third-party investment consultant

ONE'S BUSINESS PHILOSOPHY

- Full compliance with all legislation
- Committed to investment industry best practices, e.g.,
 - Risk management via diversification and other strategies
 - Manage costs
- Need for flexibility with changing needs, timeframes
- Education and capacity building
- Turnkey service, especially for smaller municipalities
- Municipal commitment to timely communication

ONE'S INVESTMENT BELIEFS

- Most important risk to manage is the timing of investment returns vs cash needs
- ***This is not pension money!*** Flexibility, liquidity key as timeframes may easily change
- Asset allocation is the main driver of returns
- Market timing at the total portfolio level unlikely to add value
- Rebalancing is an important way to manage risk
- 3 Key outcomes cover most municipal objectives; different risk levels
- Range of offerings expected to expand over time

ONE - POOLED PI SOLUTION

- Access prudent investor standard through pooled arrangements
- Full support of the JIB, as a municipal services board, as contemplated by the Municipal Act
 - Procedure by-law
 - Code of conduct
 - Committee secretary
 - Closed meeting support and more.
- Team of experts to provide investors advice on:
 - Investments and portfolio structure
 - Building investments into a capital financing strategy

A NEW SERVICE DELIVERY MODEL



MUNICIPALITY'S ROLE UNDER PI

- Adopt by-laws to join ONE JIB, move to Prudent Investing
- Adopt Investment Policy Statement (IPS), update annually
 - Define short- & long-term funds, objectives and risk tolerances
- (ONE JIB does not approve IPS, but may advise if asked)
- Keep ONE informed via Client Questionnaire; update annually, more often if needs change
- Minimum annual reporting to Council on results

ONE JIB'S ROLE

- Municipal Service Board with full clerical functions, public meetings
- Define investment beliefs and principles
- Advise on asset allocation, if desired by municipality
- Invest to meet municipal IPS objectives
 - For those without a target asset mix: define asset mixes for typical target outcomes
 - For those with a target asset mix: implement the defined mix
- Delegate to agents and oversee them
 - Legal
 - Consulting
 - ONE Investment on advice, implementation
 - Investment managers

ONE INVESTMENT'S ROLE

- If desired, advise on investments within parameters defined by ONE JIB
- Create annual Investment Plans informed by IPS, Client Questionnaire
- Include transition plans that incorporate existing PPNs, GICs, preferences not to realize gains/losses on certain bonds
- Implement Investment Plans by:
 - Creating investment products
 - Monitoring, rebalancing asset allocation within prescribed ranges
 - Monitoring portfolio managers
- Support municipal staff if needed with templates & presentations
- Provide reporting
- Support ONE JIB with research, scheduling and logistics
- Define, manage business parameters including pricing, feasible size for customization

COUNCIL'S RISK TOLERANCE FOR LONG-TERM INVESTMENTS

- Council defines acceptable risk in IPS which governs how funds are invested
- Assign target outcomes, risk levels to reserves and reserve funds
- Examples of things that affect risk tolerance:
 - Timing of outcome
 - Priority of the outcome
 - Flexibility to find other sources of funds
 - Ability to defer the expenditure
- Review following pages for tolerability of return patterns
- Seeking Council's approval of proposed risk levels for investments

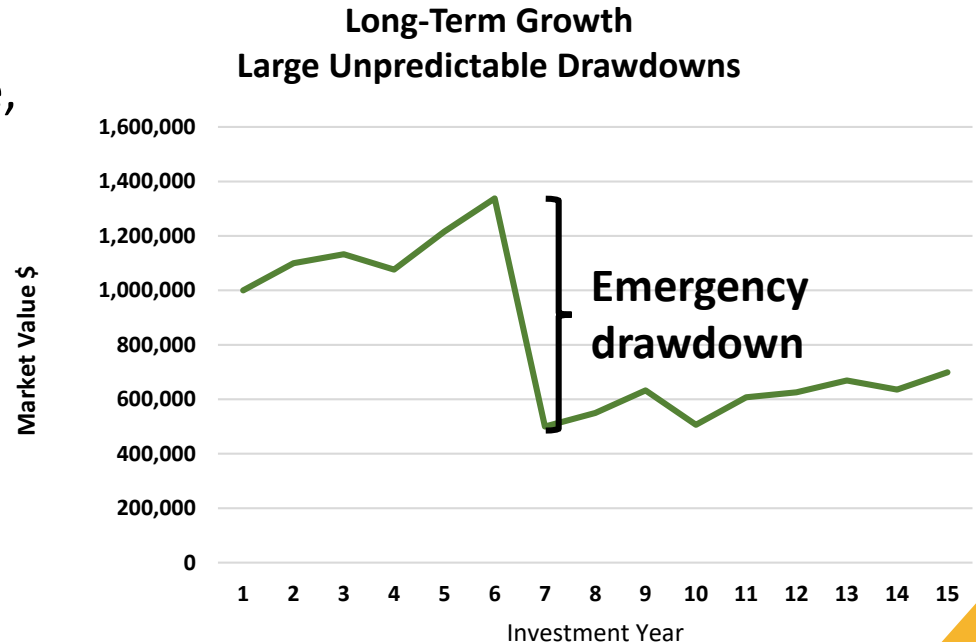
AIMING FOR INVESTMENT OUTCOMES

Outcome investing: A pattern of payments that meets a specific need.

1. **Contingency:** Stabilization and long-term growth
2. **Stable Return:** Regular, reliable returns to fund operations
3. **Target Date:** Projects ie. 10-year capital plan

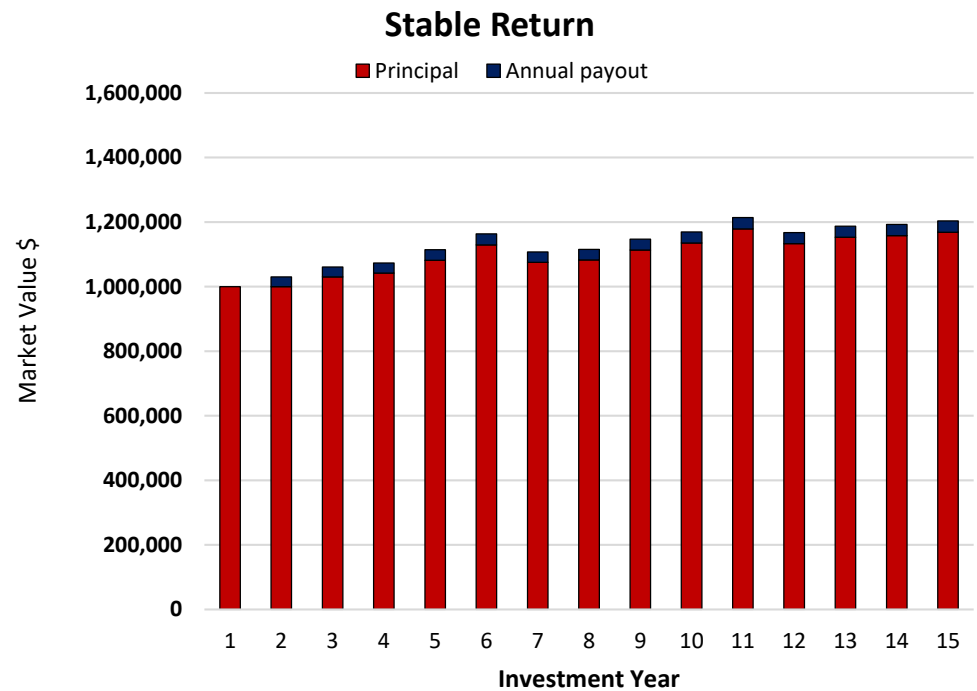
1. CONTINGENCY OUTCOME

- Used for tax or fiscal stabilization, reserves, e.g., winter maintenance
- Used for savings used like an insurance protection
- Exogenous unpredictable shocks, e.g., natural disasters that affect infrastructure
- May know a problem will arise, but not when (e.g., flooding)
- Unpredictable, infrequent, probably large lump sum payments



2. STABLE RETURN OUTCOME

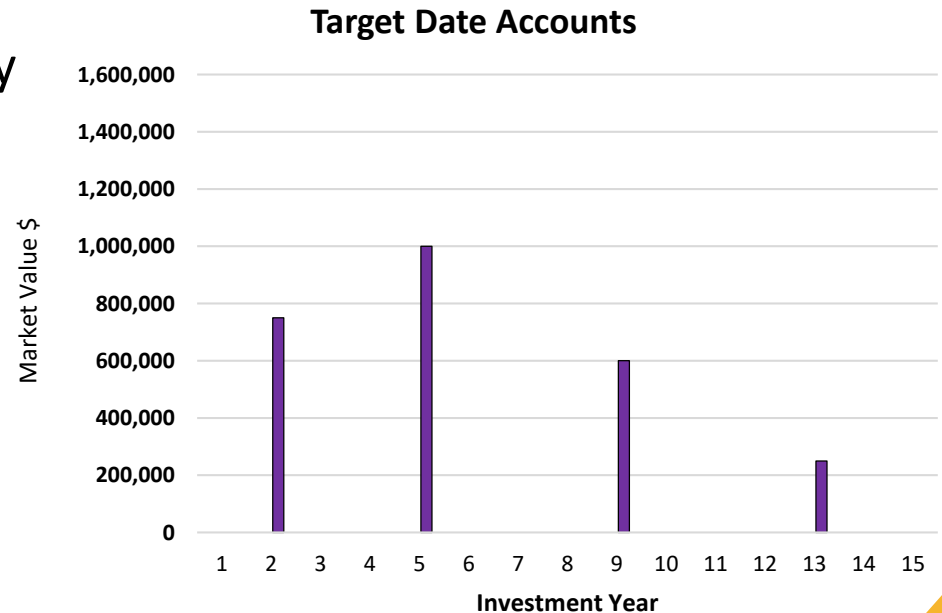
- Also called float, legacy fund, endowment model
- Generates regular, reliable returns used for maintenance needs
- May be needed at different risk levels, sizes of income
- Do you have an assumed return on consolidated reserves for capital projects e.g., 2.5%?



3. TARGET DATE OUTCOME

Example: Development Charges or Capital Plan

- Savings for specific capital projects, maintenance or building infrastructure
- Lump sums that are paid out in a particular year
- May be short-term for projects funded by DCs in high growth areas
- Challenges entailing flexibility
 - Timing of grants, DCs
 - Practical challenges, e.g., inflation, project scope change
 - 4-year Council cycle



CURRENT & UPCOMING OFFERINGS

Current offerings through Legal List (accessible to Prudent Investors)

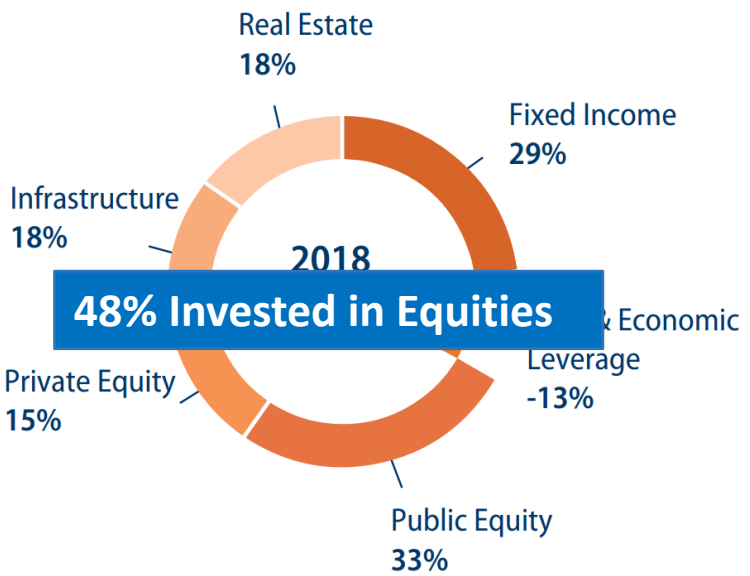
- High Interest Savings Account
- Money Market Portfolio
- Bond Portfolio
- Universe Corporate Bond Portfolio
- Equity Portfolio

Upcoming offerings through Prudent Investor

- **NEW: Global stocks**
- **NEW: Global fixed income**
- **LATER: Private and other asset classes as need**

BONUS: ARE EQUITY HOLDINGS SAFE PUBLIC SECTOR INVESTMENTS?

ARE THESE ASSET ALLOCATIONS “SAFE” PUBLIC SECTOR INVESTMENTS?



“SAFE” SHORT-TERM INVESTING

- Most important risk: match investments to spending needs
- Over 10+ years, money market did not keep up with inflation
- Investors did not lose money, but also did not make enough
- How safe is that?

	Annualized Return	Risk*
Stocks	4.5%	13.1%
Bonds	4.4%	3.7%
T- Bills	0.9%	0.2%

* Risk is defined as standard deviation based on monthly returns.



Sources: S&P, FTSE

SO... SHOULD YOU INVEST IN EQUITIES?

Equity Investment: Long Term History (Jan 1956 to May 2019)

Total Return (Includes Dividends) Based on S&P/TSX Composite History

Length of Investment (in Yrs)	Total Return Based on S&P/TSX Composite History									
	Rolling 1 Yr	Rolling 2 Yrs	Rolling 3 Yrs	Rolling 4 Yrs	Rolling 5 Yrs	Rolling 6 Yrs	Rolling 7 Yrs	Rolling 10 Yrs	Rolling 25 Yrs	
Total # of Periods	749.00	737.00	725.00	713.00	701.00	689.00	677.00	641.00	461.00	
# of Negative Periods	200.00	127.00	78.00	30.00	15.00	1.00	0.00	0.00	0.00	
% Of Negative Periods	26.70%	17.23%	10.76%	4.21%	2.14%	0.15%	0.00%	0.00%	0.00%	
Highest Period Returns	86.93	54.58	39.27	33.24	27.76	24.68	21.04	19.50	13.76	
Lowest Period Return	-39.16	-22.15	-11.10	-5.50	-1.91	-0.38	1.94	2.84	6.95	
Average Period Return	10.30	9.56	9.43	9.35	9.42	9.39	9.39	9.41	10.01	

Source: Bloomberg

As the investment horizon lengthens,
volatility decreases

QUESTIONS?

CONTACT INFORMATION

MFOA/CHUMS

- Colin Macdonald – Manager, Investment Services colin@mfoa.on.ca

ONE Investment

- Keith Taylor, CFA – Investment Manager ktaylor@amo.on.ca
- Wardah Mir – Client Services Representative wmir@amo.on.ca