# INFORMATION REPORT

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| **TO:** Chair and Members<br>Audit, Finance and Administration Committee | **WARD(S) AFFECTED:** CITY WIDE |
| **COMMITTEE DATE:** September 21, 2011 | |
| **SUBJECT/REPORT NO:**<br>Reserve/Revenue Fund Investment Performance Report - June 30, 2011 (FCS11075) (City Wide) | |
| **SUBMITTED BY:**<br>Roberto Rossini<br>General Manager<br>Finance & Corporate Services Department<br>**SIGNATURE:** | **PREPARED BY:**<br>Gerald T. Boychuk 905-546-4321<br>Rosaria Morelli 905-546-2424 Ext. 1390 |

**Council Direction:**

Not Applicable.

**Information:**

The investment portfolio for the City of Hamilton's (City's) Reserve/Revenue Fund (comprised of reserve/revenue funds, capital account balances and unused operating funds) had an earnings rate of **3.54%** for the 12 months ending June 30, 2011, and an average earnings rate of **3.66%** over the past five years. Bond lending revenues of **$63,957** are included in the earnings rate of **3.54%.** The earnings rate includes interest and lending revenues but excludes realized and unrealized capital gains/losses.

The City's portfolio generated approximately **$35.2** million in bond interest, net realized capital gains, lending revenue and bank interest over the last 12 months ending June 30, 2011. The average dollar amount generated over the last five years is **$33.8** million. Earnings in the year ending June 30, 2011 were buoyed by **$10.1** million in net realized capital gains, the bulk of which were realized over the period June 30, 2010 to December 31, 2010. The total return of **$35.2** million was realized on an average investment at a cost of **$657,552,200**. The percentage return on asset cost over this period was **5.35%**. Net unrealized capital gains totalled **$15.9** million as at June 30, 2011.

For the 12 months ending June 30, 2011, the overall return (which includes bond interest, bond lending revenues, realized and unrealized capital gains/losses) was **3.33%;** whereas the benchmark return was **3.04%**, resulting in an out-performance by **29** basis points. Over the past five years, the overall return has averaged **4.59%** per annum, outperforming the average benchmark return over the same five-year period of **4.46%** by **13** basis points.

By comparison, the overall returns for the ONE Funds (offered by the Association of Municipalities of Ontario and the Municipal Finance Officers' Association), over the 12 month period ending June 30, 2011 were **2.77%** for bonds and **1.08%** for money market. If the City's Policy had been invested in these funds (i.e. 90% bonds and 10% money market), the overall return would have been **2.60%** or **73** basis points less than the actual return of **3.33%**. On an average portfolio market value of **$682.3** million, an increase of **0.73%** return translates into a revenue increase of approximately **$4.98** million.

Table 1 summarizes the investment return indicators:

**Table 1**

**Investment Return Indicators (for information purposes only)**

| | **12 Months ended 6/30/2010** | **12 Months ended 12/31/2010** | **12 Months ended 12/31/2009** | **12 Months ended 12/31/2008** | **12 Months ended 12/31/2007** |
|---|---|---|---|---|---|
| | | | | | |
| Policy Target | 3.04% | 3.89% | 1.72% | 9.17% | 4.50% |
| **City's Portfolio** | **3.33%** | **4.29%** | **4.92%** | **6.73%** | **3.67%(1)** |
| | | | | | |
| The One Fund – Bonds | 2.77% | 3.00% | 3.35% | 8.08% | 3.84% |
| The One Fund – Money Market | 1.08% | 0.65% | 0.75% | 4.00% | 4.39% |
| Dex - Short Government | 2.79% | 3.29% | 1.94% | 10.16% | 4.53% |
| Dex – Mid Governments | 4.37% | 6.51% | 1.57% | 11.66% | 4.52% |
| | | | | | |
| Lending Revenue | $63,957 | $69,350 | $97,365 | $84,071 | $61,220 |
| | | | | | |
| **Earnings Rate (Excludes Capital Gains/Losses)** | **3.54%** | **3.57%** | **4.26%** | **3.61%** | **3.30%(1)** |
| **City's Return ONE Fund Investment (Equity)** | **15.84%** | **11.91%** | **31.18%** | **-19.04%** | **-0.15%** |

(1) The earnings rate in 2007 was adjusted for an allowance of $14.4 million due to ABCP holdings. This allowance is an estimate only and actual results may differ due to realization from these holdings.

The investments in the portfolio over the year ending June 30, 2011, consist of 100% bonds and 0% money market. Over the year ending June 30, 2011, rather than invest in money market securities for the City's short term cash flow requirements, the City chose to retain the funds in the bank account because the interest rate earned in the bank account was higher than the rate earned on short term (less than 6 months) money market securities such as Treasury Bills and Banker's Acceptances. Additionally, in place of money market investments, the City remains invested in a modest amount of floating rate notes.

As at June 30, 2011, the duration of the portfolio was **3.6** years compared to **4.0** years as at December 31, 2010. The total market value of the portfolio was **$701,112,010** an increase of **$33.9** million compared to December 31, 2010.

The total market value of the portfolio includes **$76.3** million (attributed cost) of restructured MAV Notes and **$9.9** million in Devonshire Trust Asset Backed Commercial Paper which was not restructured. The MAV Notes were received in exchange for the previously held ABCP. In 2007 and 2008 the City took a reserve loss position of **$12.9** million against all the restructured MAV Notes. The Devonshire Trust ABCP is still the subject of litigation between the Investment Industry Regulatory Organization of Canada and the Ontario Securities Commission, and between the City and Deutsche Bank in an independent litigation. The Devonshire Trust ABCP has an allowance for loss of **$5.5** million.

In June 2007, the City began subscribing to the ONE Funds Equity Account. Over a period of 49 months ending June 30, 2011, the City has deposited a total of **$6.0** million with the ONE Funds Equity Account. As of June 30, 2011 the market value of the City's holdings in the Account is approximately **$6.4** million (about 0.9% of the market value of the City's total investment portfolio). Over the past twelve months ending June 30, 2011, the City's one-year return on the ONE Funds Equity Account was **15.84%.**

The performance of the City's portfolio relative to its benchmark is mostly attributed to its slightly longer duration and holdings of Schedule I Canadian bank deposit Notes and Provincial bonds both in the five and ten year term to maturity.

Table 2 illustrates the changes in Canadian interest rates over the past 18 months:

**Table 2**

| **CANADIAN INTEREST RATES** | | | |
|---|---|---|---|
| **Maturity Term: Canada Benchmark** | **Interest Rate June 30, 2011** | **Interest Rate January 4, 2011** | **Interest Rate January 4, 2010** |
| | | | |
| One Month (T-Bill) | 0.91% | 0.91% | 0.14% |
| 2 yr | 1.59% | 1.70% | 1.45% |
| 5 yr | 2.33% | 2.46% | 2.76% |
| 10 yr | 3.11% | 3.17% | 3.61% |

At the end of the six month period ending June 30, 2011, the Canadian federal bond yields were approximately unchanged, except for bonds with two to five year maturities whose yields declined moderately. During the second quarter of 2011, weaker economic data in the U.S. and Canada emerged, putting into question the durability of the recovery which up until now was mostly driven by fiscal and monetary stimuli. Compared to year end 2010, credit spreads on Provincial bonds, Canadian Schedule I Deposit notes and Canadian Agency bonds, in general, were roughly unchanged except for those with term to maturity less than five years where spreads in general declined moderately. Commodities were up 1.6%; crude oil was up 4.4%; gold was up 6.6% closing at 1500.35; and the Canadian dollar relative to the U.S. dollar strengthened further to 1.0380. The Bank of Canada left the policy interest rate (at 1%) unchanged at each of its four policy meetings in the first half of 2011.

Recently, the escalating debt crisis in Europe, the weaker international growth outlook (especially in the U.S.) and the Federal Reserve's conditional commitment to keep its benchmark rate near zero until at least 2013, have prompted many private sector forecasters to push forward their expectations for the Bank of Canada to raise the policy rate.

In July 2011, the Bank of Canada revised down its forecast for global growth in 2011 to 3.9% from 4.1% and projected Canadian real GDP to be 2.8% in 2011. Risks to the outlook are that growth does not pick up in the balance of 2011, a possible double dip recession in the U.S. and deflation or stagflation.