

# **2014 Annual Investment Report**

**The City of Calgary**

**Chief Financial Officer's Department**

**Finance & Supply / Treasury**

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## I - Investment Overview

- As at December 31, 2014, total investments under management were \$3.96 billion, up from \$3.52 billion in 2013 and generated \$81 million of realized investment income for The City.
- Investments (including internally and externally managed assets), returned 3.33%, compared to the benchmark return of 3.05%.
- Although equity market performance was not as strong as in 2013, Canadian equities posted solid returns of 11.31% in 2014. In addition, global equities returned 11.65% in Canadian dollar terms during the year.
- Short and longer term bonds displayed positive returns of 3.66% and 7.15% respectively in 2014, due to continued declining bond interest yields during the year.
- Short-term interest rates remained low throughout 2014, with internally managed fixed income portfolios returning an average yield of 1.54%.
- All asset class portfolios outperformed their respective benchmarks during the year.

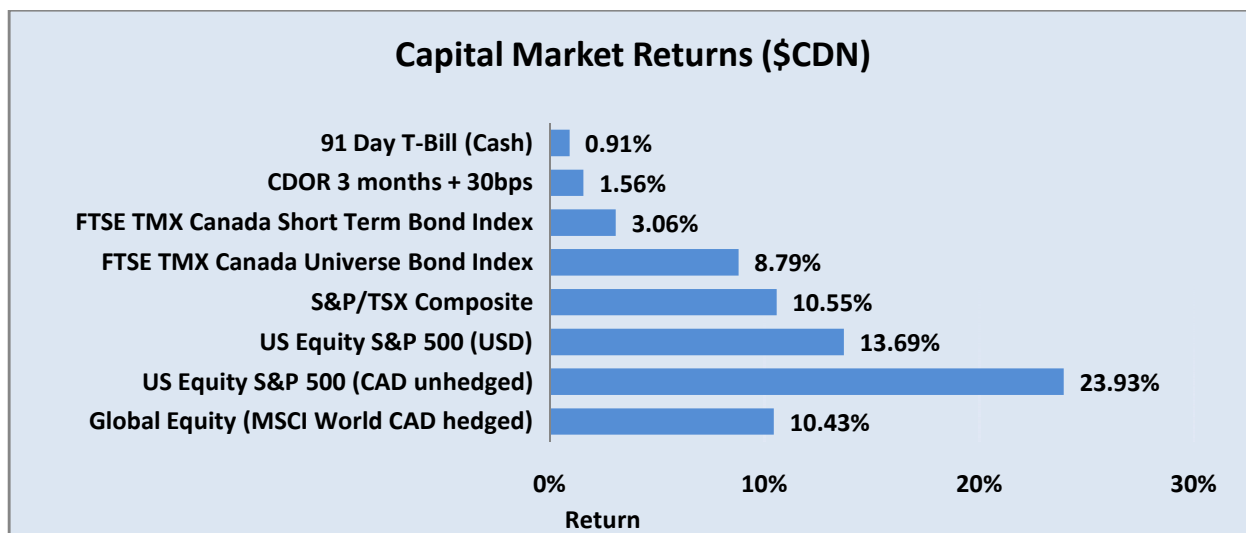
### 2014 Capital Markets Review

Early expectations, for investment returns in 2014, were positive for equities based on the prospect for a pickup in global economic growth and conversely negative for bond returns due to the expectation of rising interest rates particularly in the faster growing U.S. However, a surprise was the significant decline in global bond yields which boosted both equity and bond returns during the year.

In Canada, money market interest rates remained low in 2014 and The Bank of Canada maintained its short term overnight interest rate at 1%. While bond yields increased during 2013 and early 2014 on prospects of stronger U.S. economic growth, they dropped significantly later in the year. The \$U.S. surged upwards in 2014 with a broad-based appreciation against most major world currencies. As a result, the Canadian dollar lost over 8% versus the \$U.S. Also, plummeting oil and commodity prices negatively impacted the Canadian dollar which hit a low, against the \$U.S. of 0.8620 USD/CAD as at Dec 31, 2014.

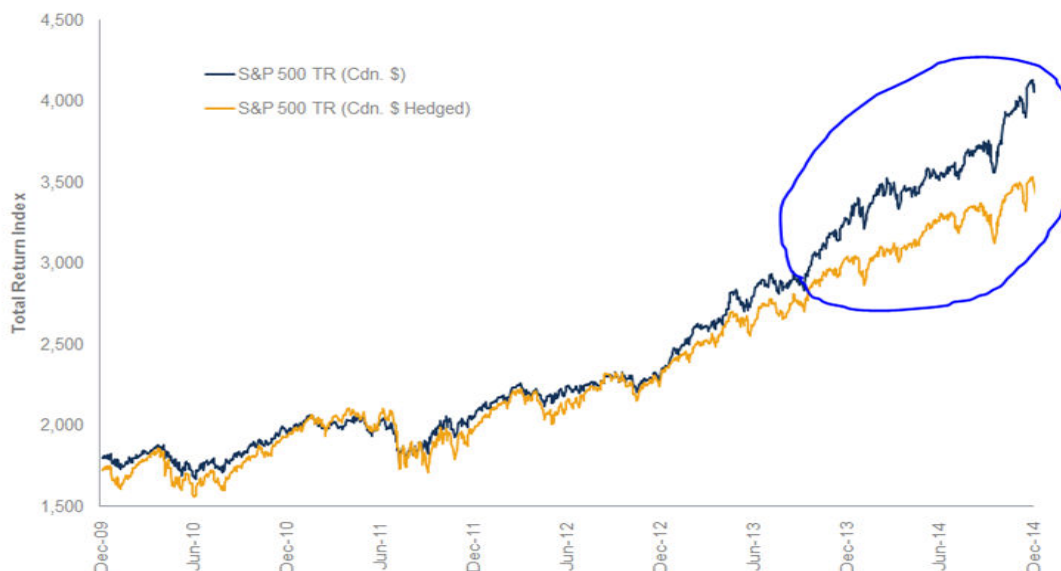
With falling interest rates and growing corporate profits, global equities posted strong returns in excess of 10% in foreign currency terms during the year. The weaker Canadian dollar improved returns for unhedged Canadian investors by 4.0%. The divergence in global economic performance was reflected in stock market returns as the faster growing economies, particularly the U.S., had the biggest gains. As illustrated in Figure 1 and Graph 1 below, U.S. equities posted returns of 13.7% (\$ U.S.) and 23.9% in Canadian dollar terms, during the year while slower growing European and Emerging market stocks underperformed.

**Figure 1: 2014 Capital Market Returns**



**Graph 1**

**S&P 500 Index – Hedged vs. Unhedged  
Total Returns as of December 31, 2014**



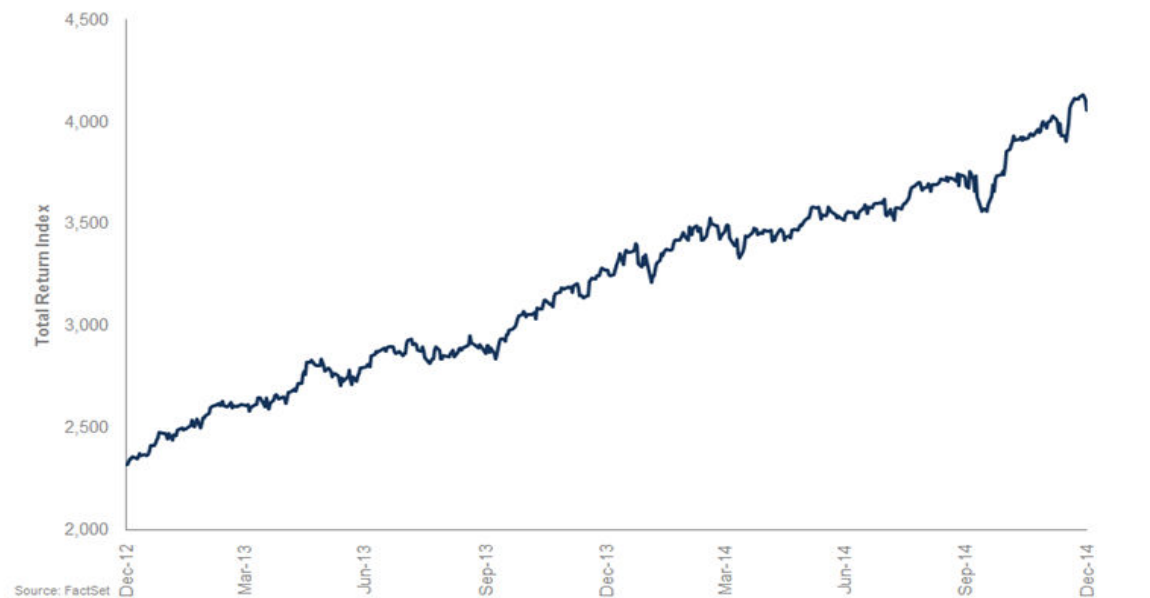
Source: FactSet

Equity markets had a strong performance in 2014 with the first half of the year characterized by low volatility and a strong appetite for risk from investors. Higher volatility and the large drop in oil prices (by over 45%) were the key themes in the second half of the year.

As indicated in graph 2 and 3, the U.S. S&P 500 index (in Cdn.\$) and the Canadian S&P/TSX Composite index returned 23.93% and 10.55% respectively for the year.

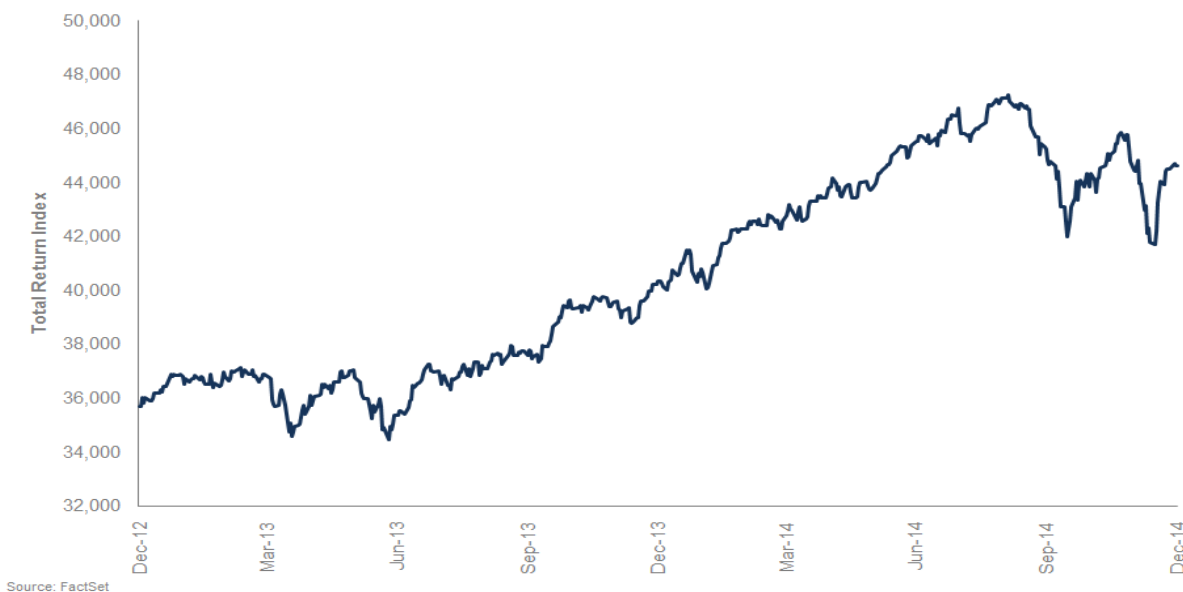
**Graph 2**

**S&P 500 Total Return Index (Cdn. \$)**  
**Index of Performance to December 31, 2014**



**Graph 3**

**S&P TSX Composite Total Return Index (Cdn. \$)**  
**Index of Performance to December 31, 2014**

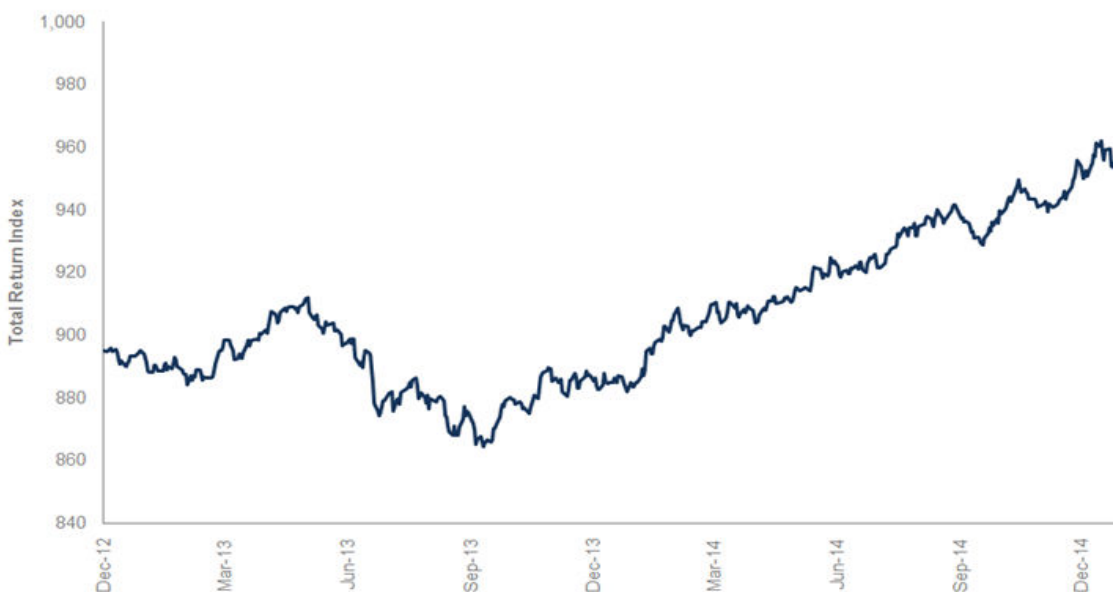


As illustrated in graph 4 and 5, fixed income investments had a surprisingly strong year in 2014, led by a significant decline in Canadian bond yields which fell back to historically low levels during the year:

**Graph 4**

**FTSE TMX Canada Universe Bond Total Return Index (Cdn. \$)  
Total Returns as of December 31, 2014**

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Source: FTSE TMX Global Debt Capital Markets

**Note:** Total Return Index tracks the performance of both the income and capital appreciation of an index of stocks or bonds, over time, and assumes that any cash distributions, such as dividends, are reinvested back into the index.

Market expectations suggested a continued increase in Canadian bond yields in 2014. However in contrast, bond yields declined sharply during the year.

**Graph 5**  
**10 Year Government of Canada Yield**  
**Market Expectations vs. Actual**



**Capital Market Outlook**

Global economic growth is targeted around 3% in 2015, up slightly from 2.6% in 2014. Growth in the global economy is expected to be driven by a sustained pick up in the U.S. economic activity and a recovery in the European region. Low inflation, coupled with the recent spectacular decline in oil prices, is expected to provide global policymakers with more flexibility to stimulate their domestic economies. While the U.S. and U.K. have ended their quantitative easing (bond buying) programs, a new wave of monetary easing in Japan, Europe and China is emerging. In some countries, bond yields have fallen below zero in response to this economic stimulus resulting in historically low interest rates and compressed risk premia that have pushed asset values of most asset classes towards record highs.

In future, we expect a more volatile global financial market and a challenging environment to find attractive investment returns. Bond yields are at record lows and may be slow to increase. If they do rise in 2015, it will likely occur on a gradual measured basis. Equities are fairly valued in North America. European equities should benefit from a weaker Euro and the quantitative easing launched by the European Central Bank. The search for yield will likely intensify, fuelling global capital markets and increasing return volatility and overall investment risk.

## II - Investment Objectives

- **Preservation of Capital**
  - Primary objective for total portfolio
- **Risk Mitigation**
  - Diversification (asset class and security holdings)
  - Policy constraints and limits
- **Investment Returns**
  - Maximize returns relative to risk
  - Liquidity and investment time horizon considerations

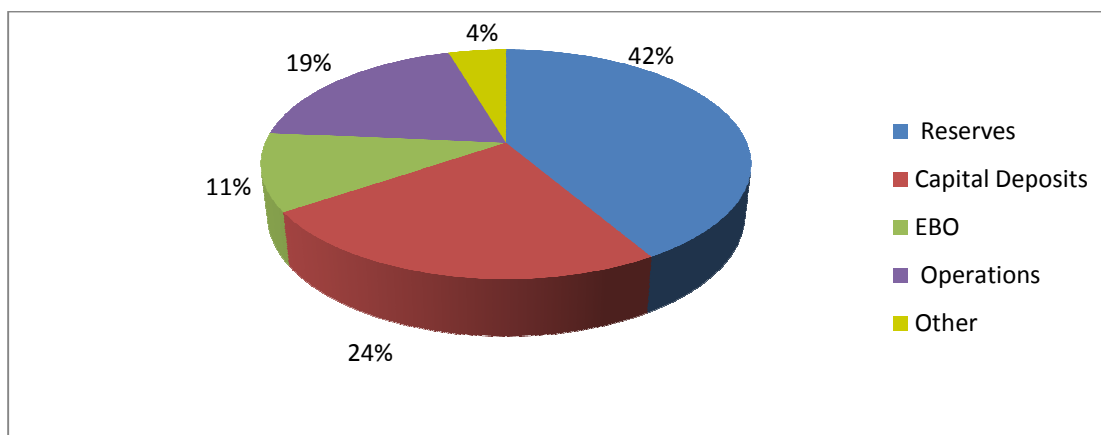
In keeping with The City's investment objectives, investments generated a total return of 3.33% in 2014, which exceeded the portfolio's benchmark return of 3.05% and generated \$81 million of income for the City.

## III - Source of Investments

The City of Calgary invests funds that stem primarily from the following sources:

- Reserves (operating & capital)
- Capital Deposits
- Funded Employee Benefit Obligations (EBO)
- General Operations; and
- Other (Trusts & affiliated entities)

**Figure 2: Source of Investments**





The funds are invested in a diversified portfolio of assets consisting of money market instruments, short term and long term government and corporate bonds, and equity investments, to meet The City's cash flow/liquidity requirements, as well as to match funds with longer-term time horizons.

## **IV- Investment Governance**

The City's Investment Governance Policy delineates the governance framework for the management of City investments. It sets out the accountability, reporting, and disclosure requirements for all investment activity. The Governance Policy establishes the roles and responsibilities of Council, the Investment Advisory Committee (IAC), Administration, and investment managers regarding management of portfolio investments. The IAC oversees The City's investment program, to ensure that investments are effectively managed in accordance with Council approved policy. In 2015, the IAC is planning a major examination of The City's investments and strategy to optimize returns in the low return environment.

### **Environmental, Social, and Governance (ESG) Considerations**

The City applies prudent investment management practices to achieve its designated investment objectives to preserve capital and maximize investment returns subject to an appropriate level of risk. ESG refers to environmental, social, and corporate governance factors relevant to an investment which can financially impact investment value. It involves integrating ESG into the investment process to enhance analysis and risk considerations of a company or government.

While investment managers do not create explicit screens to include or exclude certain investments or industries based on non-financial criteria, they look at ESG factors that can lead to long term sustainable companies. These are businesses that generate appropriate financial returns while pursuing positive social and environmental impact. Therefore, as part of the investment process, portfolio managers often look for companies that embrace ESG principles and demonstrate long term corporate sustainability. An important component of ESG and sustainable investing is corporate engagement with company management and shareholder activism, including proxy voting, to encourage sound ESG practices. As a shareholder, The City has the right to vote on corporate policies and initiatives which are exercised via the proxy voting process.

Also, fixed income managers often consider a company's ESG practices as part of the credit analysis process and assessing the political and financial risk of sovereign debt when making investment decisions. They also can invest in Green bonds that provide investors with a competitive return while addressing climate change. Corporations and governments issue Green bonds in the capital market and use the borrowing proceeds to fund capital projects with environmental benefits.

## **Risk Management**

The City manages investment risk through a sound governance framework and a comprehensive Investment Policy. The Investment Policy incorporates the requirements of the Alberta Municipal Government Act and its Investment Regulations and establishes appropriate guidelines and controls for the management of The City's investment portfolios including: investment objectives; eligible asset classes and security instruments; investment strategies; quality and quantity constraints; and appropriate diversification requirements.

Investment managers apply rigorous investment analysis and practices and invest in quality investment grade securities that are diversified among security types, maturity dates, issuers, industry sectors, and geographically by country and regions. This reduces the overall impact on the portfolio, if performance from any one category is adversely impacted.

## **Compliance**

Compliance statements from investment managers are received quarterly. During the year, all investments were in compliance with the Municipal Government Act and The City of Calgary Investment Policy. However in December 2014, following its merger with Burger King, Tim Hortons' bonds held by The City (\$2.3 million) were downgraded below investment grade. On December 15, the company announced the redemption of the bonds at \$101 per \$100 to take place on January 13, 2015. In accordance with Investment Policy and after careful financial analysis, it was economically favourable to hold the bonds on a temporary basis until January 2015, when the bonds were redeemed by the issuer at a premium.

## **V- Summary of City Investments**

As at December 31, 2014 the market value of The City's total investment portfolio was \$3.96 billion, up from \$3.52 billion in 2013.

The City's investment structure consists of internally and externally managed portfolios. Internal portfolios are managed to provide liquidity to meet City requirements and, as such, are invested in money market securities and shorter term bonds. In addition to the Working Capital portfolio, the Treasury group also manages a \$236 million short term laddered bond portfolio, specifically structured to fund the capital cash flow requirements of the recreation centres' construction project.

Funds that are suitable for investment for longer periods are invested in the externally managed Short Term Bond, Long Term Bond, and Equity portfolios.

The City's external bond managers are currently Bissett Investment Management (Bissett), Connor Clark & Lunn Investment Management (CC&L), Phillips Hager & North Investment Management (PH&N) and Pacific Investment Management Company (PIMCO). The equity portfolio managers include Scheer Rowlett & Associates, Pyramis Global Advisors (Pyramis) and TD Asset Management (TDAM).

**Figure 3: Investment Portfolios under Management**

Market Value as at December 31, 2014 (000,000s)						
(includes cash & accrued interest)	Working Capital	ST Bonds	LT Bonds	Equities	Total 2014	Total 2013
<b>Internal Management</b>						
Working Capital	\$1,835				\$1,835	\$1,957
ST Bonds	\$236				\$236	\$250
Trust Investments	\$92				\$92	\$87
<b>External Management-Bonds</b>		\$663	\$872		\$1,535	\$989
<b>External Management-Equities</b>				\$264	\$264	\$237
<b>Total</b>	<b>\$2,163</b>	<b>\$663</b>	<b>\$872</b>	<b>\$264</b>	<b>\$3,962</b>	<b>\$3,520</b>

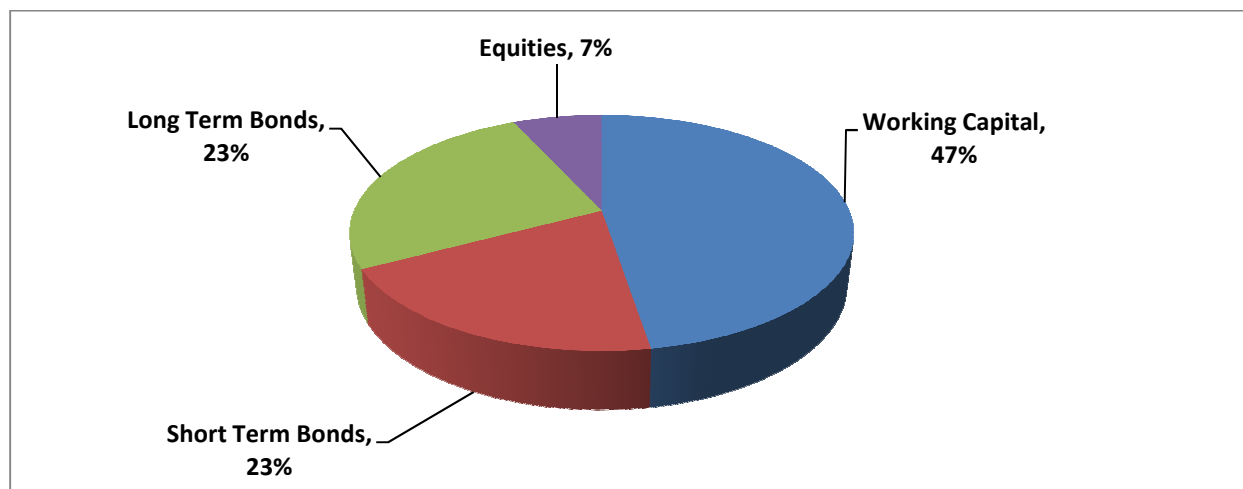
**Investment Asset Mix**

**Figure 4: Asset Mix**

Asset Class	Current Mix	Policy Mix Range	Long Term Target
Working Capital	47%	30-50%	35%
Short Term Bonds	23%	0-30%	20%
Long Term Bonds	23%	25-40%	35%
Equities	7%	5-10%	10%
<b>Total Portfolio</b>	<b>100%</b>		<b>100%</b>

Figure 5 below illustrates The City’s current asset mix as at December 31, 2014.

**Figure 5: Asset Mix as at December 31, 2014**



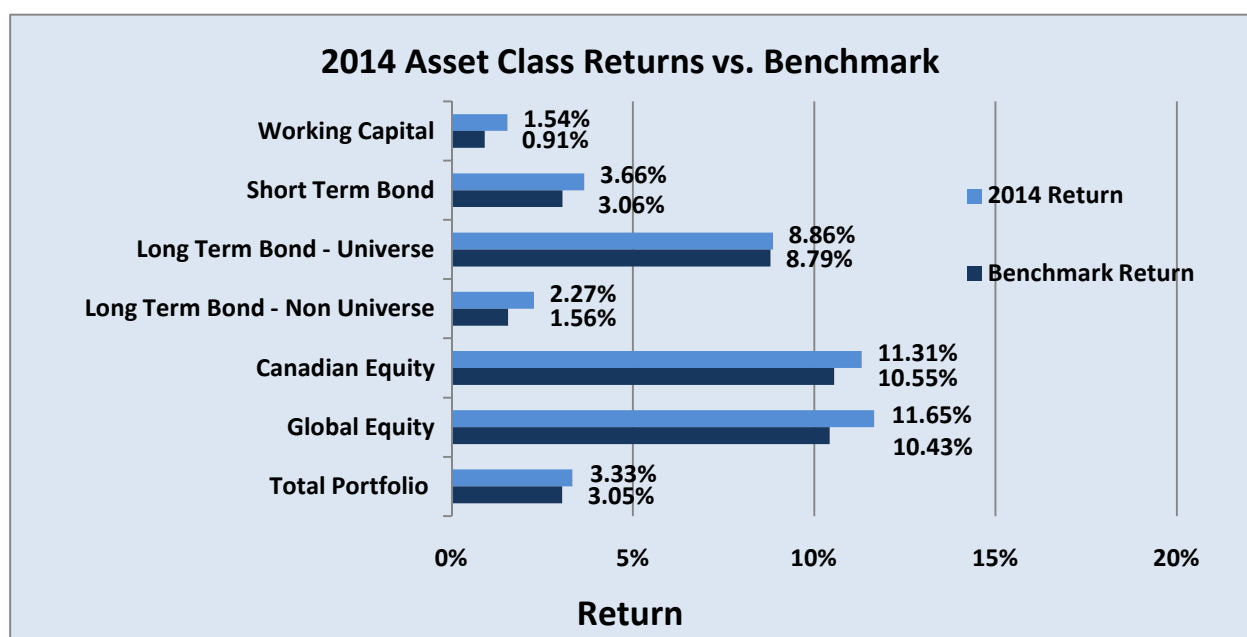
## VI - Investment Performance

As illustrated in Figure 6 below, The City of Calgary's total portfolio (including internally and externally managed portfolios), returned 3.33%, compared to the benchmark return of 3.05% in 2014. Short-term interest rates remained low throughout 2014; the internally managed portfolios returned a higher average yield of 1.54% in 2014 compared to 1.32% in 2013.

Long term bonds (Universe and Non Universe) returned 7.15% and outperformed Short term bonds (3.66%) in 2014, due to the combined effect of declining yields and longer duration exposure. Both short and long term portfolios exceeded their performance benchmarks over all time horizons over the past 5 years as illustrated in Figure 7 below.

The City's Global equity portfolio generated strong returns of 11.46% in 2014, with Canadian and Global equities providing roughly similar performance. Our Canadian equity mandate and our Global equity mandate delivered attractive returns of 11.31% and 11.65% respectively. Equity portfolios also outperformed their respective benchmarks in 2014, and over five years as indicated in Figure 7.

**Figure 6: 2014 Asset Class Returns vs. Benchmark**



**Figure 7: Historical Annualized returns**

<b>Annualized Rates of Return As at December 31, 2014 (%)</b>					
	<b>1 Year</b>	<b>2 Years</b>	<b>3 Years</b>	<b>4 Years</b>	<b>5 Years</b>
Working Capital Return	1.54*	1.43	1.38	1.34	1.23
Working Capital Benchmark	0.91	0.96	0.98	0.98	0.89
*includes Recreation Centre bonds					
Short Term Bond Return	3.66	2.83	2.82	3.12	3.33
Short Term Bond Benchmark	3.06	2.40	2.27	2.86	3.00
Long Bond Return – Universe bonds	8.86	4.06	4.16	5.36	5.79
Long Term Bond Benchmark	8.79	3.68	3.65	5.13	5.45
Long Bond Return – Non Universe	2.27**	-	-	-	-
Benchmark	1.56	-	-	-	-
**mandate started in May 2013					
Canadian Equity Return	11.31	13.21	11.85	5.84	7.96
Canadian Equity Benchmark	10.55	11.77	10.22	5.15	7.53
Global Equity Return	11.65	20.14	19.66	12.10	11.62
Global Equity Benchmark	10.43	19.61	18.36	11.85	11.32
Return on Total Portfolio	3.33	2.82	2.69	2.58	2.52
Benchmark	3.05	2.51	2.33	2.25	2.19

### Performance Measurement Benchmarks

Investment performance of all funds is reported to the Chief Financial Officer and the Investment Advisory Committee on a quarterly basis and presented annually to the Audit Committee of The City. Investment benchmarks are used for comparison purposes to assess the actual performance of our various investment managers versus their respective performance benchmarks. Investment managers are expected to generate higher returns than the benchmark measured over a business cycle.

The designated asset class benchmarks are:

<b>Working Capital:</b>	FTSE TMX Canada T-bill 91 day Index
<b>Short-term Bond:</b>	FTSE TMX Canada Bond Short Index
<b>Long Bond - Universe:</b>	FTSE TMX Canada Bond Universe Index
<b>Long Bond – non Universe:</b>	CDOR* 3 months + 30 basis points (bps)
<b>Canadian Equity:</b>	S&P/TSX Composite Index
<b>Global Equity:</b>	MSCI World Index (hedged to \$CAD)

\*Canadian Dollar Offered Rate

## Working Capital Portfolio

Manager: The City of Calgary, Treasury Division

Mandate: To effectively manage short term securities and liquidity for The City's operations and reserves within the constraints of daily cash flow requirements.

The portfolio is invested in a combination of corporate paper, and short term government and corporate bonds with the majority of investments maturing in less than two years. In addition to the Working Capital portfolio, Treasury also manages a \$236 million laddered bond portfolio specifically structured to fund the cash flow requirements of the recreation centres' construction project.

### Working Capital Portfolio Annualized Rates of Return

As at December 31, 2014 (%)					
	1 Year	2 Years	3 Years	4 Years	5 Years
<b>Working Capital Portfolio</b>	1.54*	1.43	1.38	1.34	1.23
FTSE TMX Canada T-bill 91 day Index	0.91	0.96	0.98	0.98	0.89
*includes Recreation Centre bonds					

In 2014, the internally managed portfolio generated a return of 1.54% during the year compared to 1.32% in 2013.

## Short Term Bond Portfolio

Managers: Phillips, Hager & North  
Connor Clark & Lunn

Mandate: Investment in a diversified portfolio of short term fixed income securities with an average term to maturity of three to five years.

The combined portfolio balance among the two managers was \$663 million in 2014. The portfolio is invested in a combination of government, corporate bonds and mortgages.

### Short Term Bond Annualized Rates of Return

As at December 31, 2014 (%)					
	1 Year	2 Years	3 Years	4 Years	5 Years
<b>City of Calgary</b>	3.66	2.83	2.82	3.12	3.33
FTSE TMX Canada Bond Short Index	3.06	2.40	2.27	2.86	3.00

The portfolio had a one year return of 3.66% for 2014. On a combined manager basis, the portfolio exceeded the return of the benchmark over all periods reviewed.

## Long Term Bond Portfolio

Managers: Bissett Investment Management  
Connor Clark & Lunn  
Phillips, Hager & North  
PIMCO

Mandate: Investment in a diversified portfolio of fixed income securities with an average term to maturity of seven to ten years.

### Long-term Bond Annualized Rates of Return

As at December 31, 2014 (%)					
UNIVERSE Bonds	1 Year	2 Years	3 Years	4 Years	5 Years
City of Calgary	8.86	4.06	4.16	5.36	5.79
FTSE TMX Canada Bond Universe Index	8.79	3.68	3.65	5.13	5.45

Longer term bond yields declined significantly in 2014, generating high single digit returns. The portfolio ended the year with an 8.86% return and exceeded the benchmark by 0.07%.

As at December 31, 2014 (%)					
*mandate started in May 2013					
NON-UNIVERSE Bonds	1 Year	2 Years	3 Years	4 Years	5 Years
City of Calgary	2.27*	-	-	-	-
CDOR 3 month + 30 bps	1.56*	-	-	-	-

This is a tactical bond strategy to outperform money market returns without taking duration risk. The manager is able to extend duration at its discretion.

## Canadian Equity Portfolio

Managers: Scheer Rowlett & Associates  
Pyramis Global Advisors  
TD Asset Management

Mandate: To seek long-term capital appreciation by investing in a diversified portfolio of large capitalized Canadian equities.

### Canadian Equity Annualized Rates of Return

As at December 31, 2014 (%)					
	1 Year	2 Years	3 Years	4 Years	5 Years
City of Calgary	11.31	13.21	11.85	5.84	7.96
S&P/TSX Composite Index	10.55	11.77	10.22	5.15	7.53

Canadian equities posted strong results in 2014 and finished the year with an annual return of 11.31 % versus the benchmark return of 10.55%.

## Global Equity Portfolio

Managers: TD Asset Management  
Pyramis Global Advisors

Mandate: Investment in a diversified portfolio of large capitalized international equities located in developed markets.

## Global Equity Annualized Rates of Return

As at December 31, 2014 (%)					
	1 Year	2 Years	3 Years	4 Years	5 Years
City of Calgary	11.65	20.14	19.66	12.10	11.62
MSCI World Index (hedged to \$CAD)	10.43	19.61	18.36	11.85	11.32

Although 2014 provided lower returns than in 2013, the global equity market as measured by the MSCI World Index generated solid returns of 10.43% during the year. The Global equity portfolio's performance was hindered by hedging of foreign currencies (mostly from the rising U.S. dollar vis a vis the Canadian dollar).

## Evolution of the Equity Portfolios since inception

Portfolio	Initial Investment (000's)	Market Value (000's) December 31, 2014
Canadian Equities	*\$95,000	\$146,106
Global Equities	**\$75,000	\$117,528
<b>Total</b>	<b>\$170,000</b>	<b>\$263,634</b>

\*initial \$50M 2009, additional \$20M July 2011, additional \$25M August 2013; \*\*initial \$50M 2009, additional \$25M August 2013