

INVESTMENT POLICY AMENDMENT REPORT

EXECUTIVE SUMMARY

Pursuant to The City's Investment Governance Policy (CFO001), the Investment Advisory Committee (IAC) is mandated to provide investment management oversight, review The City's Investment Policy (CFO007), and recommend amendments or revisions to the Investment Policy as required. The Investment Policy is regularly reviewed and updated to ensure it meets The City's investment requirements and is consistent with industry best practices.

The IAC recently completed an in-depth Investment Strategy and Asset Mix Review. As a result, amendments to the Investment Policy are proposed to optimize investments. While the amendments are not considered to be major or wholesale in nature, they are important changes designed to enhance investment strategies, portfolio diversification, and risk management of City investments.

Attachment 1 summarizes the rationale for the proposed policy amendments and Attachment 2 contains a Blackline version that highlights the policy changes for comparison purposes.

ADMINISTRATION RECOMMENDATIONS:

That the Priorities and Finance Committee recommend that Council:

1. Approve the proposed amendments to the Investment Policy CFO007 (Attachment 2), and
2. Direct Administration to incorporate the approved amendments into the Council Policy Template in accordance with the Council Policy Program CC046 prior to being forwarded to Council, and
3. That this report be forwarded to the 2016 July 25 Regular Meeting of Council, as an item of Urgent Business

PREVIOUS COUNCIL DIRECTION/POLICY

The Investment Policy (PFC2013-0356) of The City was last revised on May 27, 2013. Revisions included Permitted Investments, Quality of Fixed Income investments, and Performance and Reporting, and were approved by Council at that time.

BACKGROUND

City funds are invested in a diversified investment portfolio of financial assets consisting of money market securities, short term and long term government and corporate bonds, and global and Canadian equity investments, to meet the investment objectives of City Funds. This includes return and liquidity requirements as well as to match funds with longer-term time horizons.

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Administration recently undertook an Investment Strategy and Asset Mix Review of City funds and investments. Towers Watson's investment advisory group was utilized to assist with the project and provided significant financial modelling and analysis of alternative asset mixes and investment strategies/products to determine an appropriate asset mix to meet the City's investment objectives.

INVESTIGATION: ALTERNATIVES AND ANALYSIS

The low interest rate and return environment that the global economy faces, requires institutional investors to review their asset mix and investment strategy to optimize investment risk and return.

The sustained secular decline in interest rates and bond yields has reduced the attractiveness of bonds as an asset class. Most public bond markets look expensive, however global yields are likely to remain low in 2016 as the Central banks in most developed nations continue to drive down interest rates and bond yields to stimulate economic growth and inflation.

Canada is no exception and interest rates are expected to trend lower in 2016 due to weak global and domestic economic conditions. Also, the outlook for publically traded equities is somewhat sanguine as corporate earnings are declining and the currently high price/ earnings (P/E) multiples contract due to lower than normal global economic growth.

As part of the aforementioned review, Administration conducted rigorous analysis of City funds and obligations including reserves, capital deposits, employee benefit obligations (EBO) and working capital, in order to fully understand the characteristics including liquidity requirements, risk tolerance, and time horizons of these funds. For example, some of the fund's obligations are shorter term in nature and require short term more liquid (i.e. less volatile) investments, while others have a longer life and therefore benefit from longer term, return-seeking assets.

Financial modelling was utilized to optimize investments. The modelling examined alternative investments and asset mixes to determine if there are other portfolios and investments that offer superior risk/return characteristics than The City's current asset mix. The analysis indicated that by making an additional allocation to private infrastructure investments and private investment grade debt that the portfolio's total return increased by about 50 basis points (0.5%) or \$20 million annually. In addition, the changes also enhanced the portfolio's risk/return characteristics (i.e. a higher return per unit of risk) than the status quo portfolio.

If the recommended changes are adopted the new Asset Mix would be as follows:

Asset Policy Mix

<u>Asset Class/Portfolio</u>	<u>Current Mix</u>	<u>New Mix</u>
Working Capital/Short Term	35%	35%
Short Term Bonds	20%	20%
Longer Term Bonds	35%	30%
Public Equities	<u>10%</u>	10%

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Infrastructure investments		<u>5%</u>
Total Portfolio	<u>100%</u>	<u>100%</u>

It should be noted that The City is primarily a fixed income investor with a 90% allocation to short term money market securities and bonds. In 2008, Council authorized a 10% allocation weighting in total to Canadian and Global equities which have provided a return of 10.34% since inception versus about 6.5% for bonds. With the proposed 5% allocation to infrastructure investments, The City's asset mix would be 85% fixed income and 15% in equity - like investments.

PROPOSED AMENDMENTS

Based on the results of the Investment strategy and Asset Mix Review, together with robust empirical analysis and research, Administration is proposing Investment Policy amendments that will broaden investment opportunities and enhance portfolio risk management. The proposed policy changes and rationale are listed below:

Section VI - Permitted Investments

- i. Fixed Income Portfolio Constraints:
This change specifies the inclusion of a non material amount of high yield, non-investment grade fixed income securities in diversified fixed income pooled funds and/or portfolios, which will provide enhanced portfolio diversification benefits as well as opportunities for higher portfolio returns in an ultra low interest rate environment.
- ii. Infrastructure Investments:
A 5% allocation to private infrastructure funds will complement the City's current equity allocation of 10%. Investment in global infrastructure businesses is designed to provide steady returns with less market volatility than publically traded equity investments. These investments generate stable cash returns with inflation pricing protection, as well as portfolio diversification (risk reduction) attributes.
- iii. Foreign Currency Management:
It is recommended to amend the investment policy to provide for more active and dynamic management of foreign currency (FX) assets in the portfolio. In 2009, when the City entered the global equity market, the investment policy required a 90% static or passive hedge ratio. This means that 90% of the currency exposure in foreign denominated assets (equity and bond holdings) is required to be automatically hedged back to Canadian dollars. Empirical analysis and best practice indicates that this is not an optimal solution for a Canadian investor with the objective of diversification and preservation of capital in global portfolio management.

Rather than passively hedge all foreign currency equally as is done now, a superior approach is to examine relative valuations of different currencies vis-a-vis the Canadian dollar and hedge based on future expected valuations. It should be noted that FX hedging will still take place but on a more active and dynamic basis which is expected to reduce

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FX return volatility and sustain positive returns in the City's foreign denominated investments.

iv. Pooled Funds:

This change specifies that Administration will review a pooled fund for appropriateness and consistency of the fund's guidelines with City Investment Policy. The City can invest in pooled funds and accepts the pool's guidelines. This amendment recognizes the unique nature of each pooled fund's guidelines and provides for the City to invest in pooled funds that are consistent with the City's Investment Policy.

v. Derivatives Use:

The proposed amendment provides clarity with respect to how portfolio managers can utilize financial derivative instruments to manage risk related to interest rate, market, credit, and foreign currency exposure. Financial derivatives can be used for security replication, portfolio adjustment and implementation purposes in order to provide a risk framework that is in line with the current Investment Policy. The amendment specifies that the use of derivatives must be in accordance with the Prudent Investor Rule and that speculation and leverage are not permitted.

Section VII - Quality of Fixed Income Investments

vi. Investment Grade Private Debt:

It is recommended that Private Debt investments that are unrated by a credit rating agency are permitted investments as long as they are rated investment grade by the portfolio manager. Portfolio managers should be using rating methodology of a credit rating agency approved in the City's Investment Policy. Private Debt is expected to increase portfolio diversification, reduce volatility and increase the City's fixed income returns.

vii. Other- Counterparty Credit Ratings:

This amendment is required for The City to be able to transact directly (or via external portfolio managers) with Canadian bank counterparties. Counterparty ratings for derivative transactions are changed to R-1 low and/or A due to recent rating downgrades in the Canadian banking industry.

Section IX - Performance and Reporting

viii. Benchmarks:

This change is administrative in nature and reflects the current name of the City's Fixed Income benchmarks used for performance and reporting purposes: "DEX" will be replaced by "FTSE TMX" which purchased the DEX brand.

vii. Valuation of Securities:

The recommended wording on securities valuations is designed to provide clarity on how to value investments using industry standards. This includes alternative valuation methods for investments that do not have a public market price. The change is consistent with industry best practice.

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IMPLICATIONS

Stakeholder Engagement, Research and Communication

Key investment stakeholders include citizens of Calgary, City Council and the business units with an interest in specified capital deposits, reserves and other funds invested.

The City's Investment Governance Policy delineates the governance framework for City investments and sets out accountability, reporting, and compliance requirements for all investment activity. It establishes the roles and responsibilities of Council, Investment Advisory Committee (IAC), Administration, and investment managers regarding management of City investments. No changes to the Governance Policy are required at this time.

The IAC provides oversight of City investments to ensure that funds are optimally invested and in compliance with all applicable policies and regulations. In its role, the IAC is mindful of stakeholders and beneficiaries of City investments.

Strategic Alignment

The management of The City's investment portfolios follows industry best practice and aligns with prudent stewardship of financial resources and sustainability of The City.

Social, Environmental, Economic (External)

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. It is believed that by acting as an engaged and responsible investor, The City is able to enhance the long term return/risk performance of its investment portfolios.

Prudent and responsible investment of City investments provides necessary financial resources and generates sustainable investment income in support of City operations. The proposed Investment Policy amendments are consistent with the City's investment objectives, risk tolerance and industry best practices.

Financial Capacity

Current and Future Operating Budget:

Total investment income realized in 2015 was \$96.6 million. Investment income directly impacts the growth of City reserves and the operating budget. The recommended changes support the sustainment of current operating and future budgets which should benefit from potential increased investment income.

Current and Future Capital Budget:

Reserves and capital deposits eligible to receive investment income will benefit from proposed policy revisions that enhance diversification and investment returns, which in turn can fund capital projects.

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Risk Assessment:

The City manages investment risk through a sound governance framework and a comprehensive Investment Policy. The Investment Policy incorporates the requirements of the Alberta MGA and its Investment Regulations and establishes industry best practice guidelines and controls for management of investment portfolios. Investment managers apply rigorous analysis and mitigate risk by investing in portfolios that are diversified among asset type, issuers, industry sectors, and geographically by country.

The City has sufficient working capital/short term investments to meet its cash flow requirements. The proposed amendments provide enhanced diversification, risk mitigation benefits, inflation protection, and superior time horizon matching with City reserves and capital deposits, while meeting the City's liquidity requirements.

REASON(S) FOR RECOMMENDATION:

The Investment Policy is a key Council policy that guides the strategies, risk oversight, and constraints pertaining to the investment portfolio of The City. The recommended policy changes and investment initiatives will broaden the set of investment opportunities available to the City and provide higher expected returns and enhance diversification relative to the current asset mix, for the benefit of stakeholders.

ATTACHMENTS:

1. Proposed Investment Policy Amendments - Summary Table
2. Amended Investment Policy (Blackline version)