3
2006 ANNUAL INVESTMENT REPORT

The Finance and Administration Committee recommends the adoption of the recommendation contained in the following report, January 11, 2007, from the Commissioner of Finance:

1. RECOMMENDATION

It is recommended that:
1. This report be received for information.

2. PURPOSE

This report is to provide information regarding investment portfolio activities undertaken during the year 2006, as required by Ontario Regulation 438/97 (as amended) of the *Municipal Act* and the Region's Investment Policy.

3. BACKGROUND

The Policy, Risk and Treasury Branch of the Finance Department manages two investment portfolios which had a combined maturity value of approximately $1,124 million as of December 31, 2006 (*see Attachment 1*).

The General Fund, with a value of $1,122 million at year-end ($983 million in 2005), is comprised of investments held for the reserves and reserve funds, working capital and other funds of the corporation. All investments in 2006 were made in accordance with the Investment Policy approved by Council in May 2006. Consideration was given to the following objectives that are set out in the Investment Policy:

- Adherence to statutory requirements;
- Preservation of capital;
- Maintaining liquidity; and
- Earning a competitive rate of return.

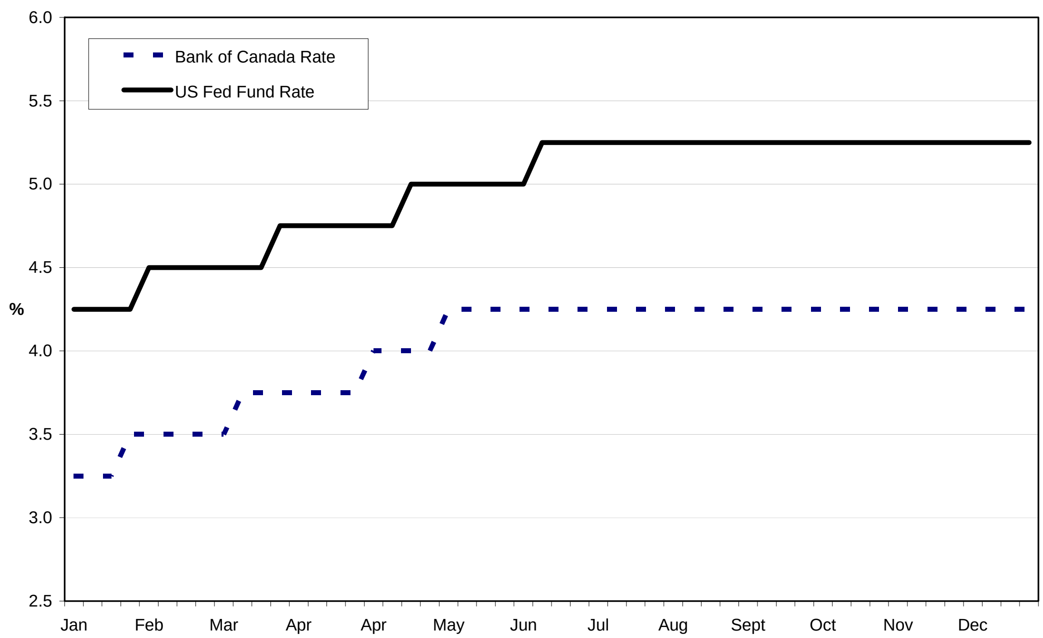
As well, all investments met eligibility requirements set out by Ontario Regulation 438/97 (as amended) of the *Municipal Act*.

The Sinking Fund, with a par value of $2 million at year end, consists of investments held in trust on behalf of the Town of East Gwillimbury for the repayment of Sinking Fund debentures. Sinking Fund investments are made in accordance with a policy established by the Sinking Fund Committee which is similar to that of the Investment Policy. While the Region earns interest on its reserves, it does not earn (or budget for) interest income on property tax receipts forwarded to it by area municipalities, since these are paid in arrears. This delay in receiving tax money actually results in a need for working capital to fund the day-to-day operations of the corporation. Working capital requirements are funded first through the Working Capital Reserve, which currently has a non-interest bearing balance of approximately $36.9 million. Any shortfalls are borrowed from reserves at a rate equivalent to the prevailing rate of return of the portfolio. In 2006 the budgeted cost of financing working capital deficiencies not funded by the Working Capital Reserve, was approximately $428,000.

4. Analysis and Options

Interest rates moved higher in Canada and the United States through the first half of 2006 continuing a trend that began in the second half of 2005. Central Banks in both countries were concerned about inflationary pressures in economies that were running at close to full capacity. The Bank of Canada raised its bank rate from 3.25% at the end of 2005 to 4.25% by the end of May 2006. Meanwhile, the US Federal Reserve was raising rates from 4.25% to 5.25% by the end of June. For the rest of the year both Central Banks continued to express their concern over inflation and growth but chose to leave rates unchanged as they waited for their interest rate hikes to slow the economy, in particular the red hot US housing market, and squeeze out inflation.

Graph 1
Central Bank Rates - 2006

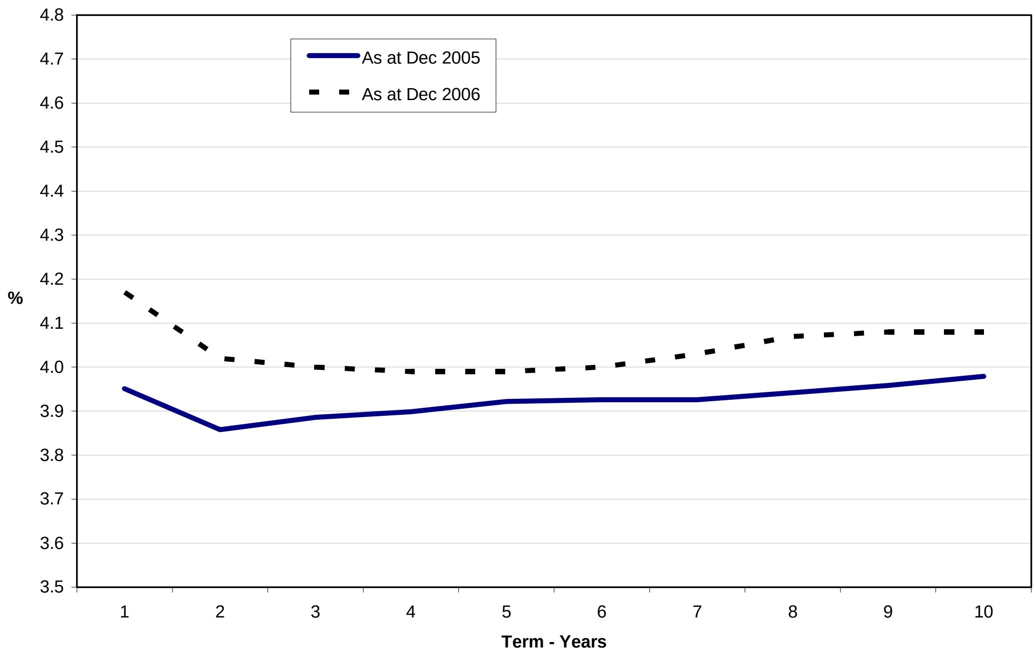


Longer term rates also continued to climb though the first half of the year in response to the short term rate increases. In Canada, the 10-year yield reached a high of 4.60% by the end of June having started the year at 3.98%. By mid year the market was seeing clear signs of slowing in the US housing market and began to anticipate that the Central Banks would begin lowering rates. This caused 10-year rates to drop to as low as 3.85% by the end of November before pulling back to 4.08% by year end.

As a result, we ended the year with yields slightly higher than the beginning of the year and a yield curve that was slightly inverted by 9 basis points between 1 year and 10 year rates. This contrasts with a slightly positive curve last year of 6 basis points.

The flat yield curve reduced opportunities for trading gains this year.

Graph 2
Canadian Yield Curve
2005 vs 2006



4.1 Investment Strategy - 2006

In October 2002, Council approved an update to the Investment Policy which broadened the parameters of the Region's investment program. These enhanced investment powers allowed the Region to diversify its portfolio holdings in terms of both credit and term exposure thereby providing greater opportunities to increase investment returns.

In 2003 and 2004 the investment strategy for the General Fund focused on prudently extending term to take advantage of higher long term rates while emphasizing preservation of capital and maintaining liquidity. Emphasis was also placed on improving the overall credit quality of the portfolio by diversifying credit exposures and by increasing holdings of government debt.

For 2005 the investment program continued the management style put in place in 2003 and 2004 but also began to pursue a more active approach to term management, reducing and extending term as opportunities presented themselves. This process continued during 2006 resulting in a current portfolio which has a wide range of credit and term exposures.

This past year, the term of the portfolio went from 694 days at the beginning of the year to 932 days by mid year as yields were increasing. The average term was increased to 1137 days by year end in anticipation of future expected Central Bank rate cuts. Credit exposure also increased at mid year as the portfolio took advantage of interest rate spreads widening for non-Government of Canada securities.

4.2 Investment Results 2006

During 2006, the interest earned by the General Fund was $39.3 million which equates to a rate of return of 4.24%. In addition, the total market value of the portfolio compared to its book value increased by $2.9 million dollars which added an additional 31 basis points to the yearly return. On a total return basis therefore, the portfolio earned a return of 4.55%. After factoring in the cost of operating the Region’s investment program of approximately $488,000 (ie. staff, safekeeping, market monitoring services, transaction costs, etc.) the net rate of return for the General Fund was 4.50%, a net difference of approximately 5 basis points.

Over the same period, Sinking Fund investments earned about $0.1 million for a return of approximately 5.75% (compared to $0.1 million and 5.85% in 2005). Table 1 summarizes the investment returns for both the General and Sinking Funds for the years 2005 and 2006.

Table 1
York Region Investment Portfolios – 2005/2006

Year	Fund	Assets (million)	Income (million)	Net Rate of Return
2006	General	$927.3	$41.7	4.50%
	Sinking	$1.8	$0.1	5.75%
2005	General	$875.4	$33.7	3.85%
	Sinking	$1.6	$0.1	5.85%

The proactive investment management program generated trading gains of over $2.1 million which improved the overall performance of the portfolio by approximately 23 basis points.

The earning results for the General Fund compare favourably to other industry benchmarks. For instance, the General Fund earned .75% more than the composite return of the ONE Fund Money Market Fund and ONE Fund Bond Fund (using a 50% weighting for both). These funds are sponsored by AMO an MFOA for Ontario municipalities and are the primary benchmarks. Commencing in 2006, the portfolio returns are also compared to a composite return combining Scotia Capital 91-day Money Market, Short Term Government Bond and Mid-Term Government Bond Indices (weightings of 50%, 25% and 25% respectively). Portfolio returns exceed this benchmark by .57%.

Table 2
Comparison of General Fund Investment Returns

Year	York General Fund Return	ONE Fund Composite Benchmark		Scotia Capital Debt Indices Benchmark	
		Return	Increase	Return	Increase
2006	4.50%	3.75%	.75%	3.93%	.57%
2005	3.85%	2.31%	1.54%	2.76%	1.09%

As at December 31, 2006, approximately 9.1% of the total portfolio was invested in Region of York securities compared to 8.1% as at December 31, 2005. This change was the result of net investments of $55.4 million in Region of York debentures during the year for the General Fund. Information regarding these transactions is presented in *Attachment 2.*

The Region's portfolio as at December 31, 2006 consisted of securities issued by the Federal and Provincial governments (44%), Canadian financial institutions (33%), as well as securities issued by Ontario municipal governments and other approved institutions (23%). (*see Attachment 3).* Furthermore, these investments had an average remaining term to maturity of approximately 1,137 days. The maturity distribution of these investments is shown in *Attachment 4.*

4.3 Investment Strategy – Outlook 2007

The North American economy is continuing to expand but at a slower rate than in the past. Both Central Banks have paused in their rate hike programs awaiting the impact of these higher rates on the economy. The consensus view is that the significant slowdown in the US housing market, as a result of these higher rates, is negatively impacting the economy and will continue to do so. This will lead to Central Bank easing later this year. The Bank of Canada is particularly concerned about the economy in central Canada as slowing demand for the Big Three auto markers and a stronger Canadian dollar have increased the effects of the US slowdown.

We would expect to see a steeper yield curve developing as rates are cut in the short end in response to a slowing economy. Longer term rates are expected to decline but not as quickly or as far as short rates as there continues to be concerns in the market that inflation is running at higher than acceptable levels. This steeper yield curve will be favourable for the portfolio's active investment program and should lead to enhanced returns in 2007.

For 2007 the Region's investment program will seek to take advantage of this market view. We will continue to maintain a diversified term and credit exposure within policy guidelines to enhance portfolio returns.

Yield enhancement is expected to be derived from the following activities:

- Term management via the timely purchase and sale of longer-dated securities;
- Continued diversification of portfolio holdings where demonstrable yield advantage is available;
- Generation of capital gains through active portfolio management.

5. FINANCIAL IMPLICATIONS

The careful management of the General Fund generated net investment returns (interest plus capital appreciation) of $41.7 million in 2006 which represented approximately $7.0 million in additional return versus a similar sized investment with the ONE Funds and $5.3 million versus the Scotia Capital Indices. Investment revenues contribute to reserves and help in defraying York Region's service costs over the longer-term.

6. LOCAL MUNICIPAL IMPACT

While returns on the Region's investments have no direct impact on area municipalities, the extra revenue earned contributes to the Region's reserves and decreases the longer-term need for taxes and development charges.

7. CONCLUSION

The Region's General Fund investment portfolio performed well in 2006 with a return of .75% or $7.0 million (net of costs), above the Region's principal benchmark, the ONE Funds. The additional income reduces the need for tax or development charge revenues. All investments met the requirements of the Region's Investment Policy.

The Senior Management Group has reviewed this report.

(The attachments referred to in this clause are attached to this report.)