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2007 ANNUAL INVESTMENT REPORT

The Finance and Administration Committee recommends the adoption of the recommendation contained in the following report, January 14, 2008, 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 2007, 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 $1,245 million as of December 31, 2007.

The General Fund, with a maturity value of $1,224 million at year-end ($1,122 million in 2006), is comprised of investments held for the reserves and reserve funds, working capital and other funds of the corporation. All investments in 2007 were made in accordance with the Investment Policy last updated and 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*.

At December 31, 2007 the General Fund's portfolio consisted primarily of fixed income (interest producing) investments *(see Attachment 1)*. With the objective of diversification

and enhanced returns, the General Fund also invested $10 million during 2007 in the ONE Fund Equity Fund, a fund sponsored by AMO and MFOA.
The Sinking Fund, with a maturity value of $21 million at year end, *(see Attachment 1)* consists of investments held in trust on behalf of the City of Vaughan, the Town of East Gwillimbury and the Region of York 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 $37.0 million. Any shortfalls are borrowed from reserves at a rate equivalent to the prevailing rate of return of the portfolio. In 2007 the budgeted cost of financing working capital deficiencies not funded by the Working Capital Reserve, was approximately $450,000.

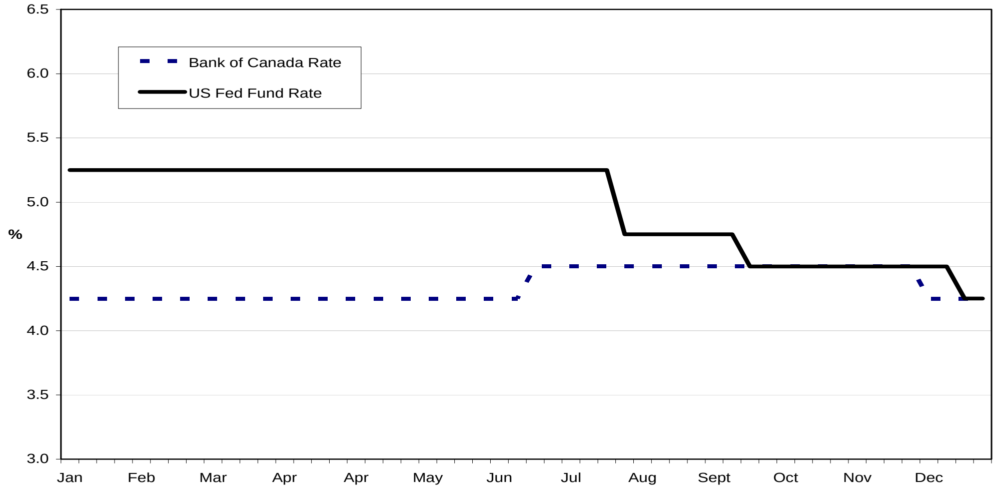
4. ANALYSIS AND OPTIONS

4.1 2007 Market Environment

Through the first half of 2007 administered rates in Canada and the US continued the stable trend witnessed in the second half of 2006.In Canada the Bank Rate was 4.25% and in the US the Fed Funds Rate was 5.25% through this period. Both Central Banks were concerned about the potential for an economic slowdown related to the US housing market but were becoming increasingly worried about inflation pressures as the larger economy seemed immune to the housing problems. As the US dollar continued to depreciate inflation began to creep into the economy through increased fuel, food and imported goods costs. In Canada inflation pressures were coming from tight labour and red hot housing markets, particularly in the West.

At the beginning of July, the Bank of Canada raised the Bank Rate to 4.5% and market expectations were that the next move by the Fed would be to raise rates. This sentiment quickly reversed itself over the summer and into the fall. The value of securities linked to the deteriorating US housing and mortgage markets was suddenly being questioned and a dramatic widening of credit spreads along with market liquidity concerns focused central banks efforts away from inflation and on to trying to stabilize capital markets. One of the tools both Banks used was interest rate cuts. The Fed cut rates 100 basis points to 4.25% by year end and the Bank of Canada cut 50 basis points from the Bank Rate which also ended the year at 4.25%.

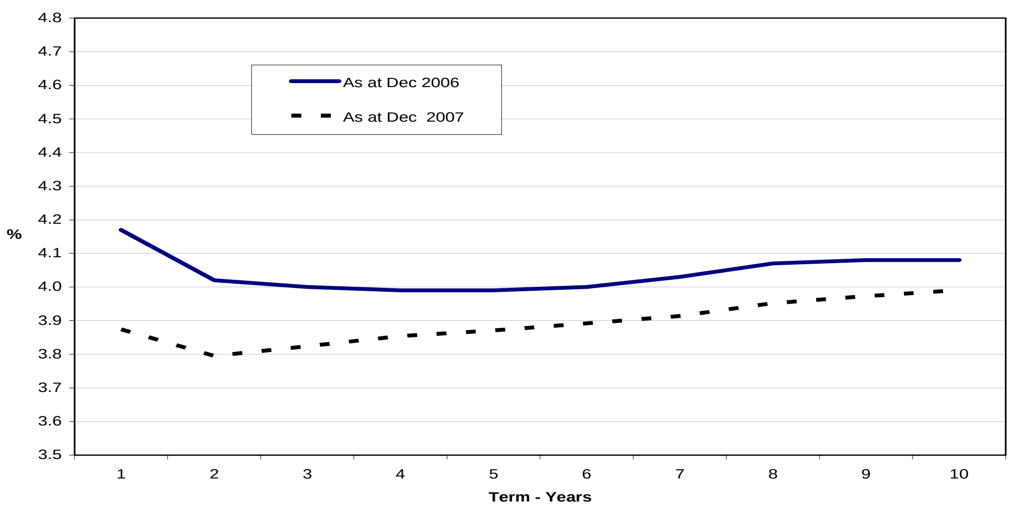
Graph 1
Central Bank Rates - 2007



Longer term rates reflected the same concerns and followed a similar pattern. In Canada the 10 year bond yield rose to 4.78% by mid-year having started the year at 4.08%. Rates dropped in the second half of the year as it became obvious that the housing and capital market problems were starting to slow down the rest of the economy. 10 year rates in Canada were 3.98% at year end.

As a result, Canada yields ended the year slightly lower than at the beginning of the year with a yield curve that was positive by 12 basis points between 1 year and 10 year as depicted in Graph 2 below. This contrasts with a slightly negative curve at the end of 2006 of 9 basis points. Also of note, credit spreads were significantly wider at the end of the year compared to the beginning of the year.

Graph 2
Canadian Yield Curve
2006 vs 2007



4.2 Investment Results 2007

In 2007 the General Fund earned $44.5 million – on an average portfolio balance of $1,070 million equating to a rate of return of 4.16%. Due to adverse market conditions, the total market value of the portfolio compared to its book value declined by approximately $0.9 million dollars (equal to 8 basis points). On a total return basis (marked-to-market) therefore, the entire portfolio earned approximately 4.08%. After factoring in the cost of operating the Region's investment program of approximately $424,000 (ie. staff, safekeeping, market monitoring services, transaction costs, etc.) the net rate of return for the General Fund was 4.04%, a net difference of 4 basis points.

Over the same period, Sinking Fund investments earned about $0.3 million for a return of 5.02% (compared to $0.1 million and 5.75% in 2006). Table 1 summarizes the investment returns for both the General and Sinking Funds for the years 2006 and 2007.

Table 1
York Region Investment Portfolios – 2006/2007

Year	Fund	Assets (million)	Income * (million)	Net Rate of Return
2007	General	$1070.2	$43.2	4.04%
	Sinking	$5.2	$0.3	5.02%
2006	General	$927.3	$41.7	4.50%
	Sinking	$1.8	$0.1	5.75%

*net of investment expenses and adjusted on a market-to-market basis.

Compared to industry benchmarks, the General Fund's portfolio earned marginally more than (0.08%) the composite return of the ONE Fund Money Market Fund and ONE Fund Bond Fund (weightings of 33% and 67% respectively). These funds are sponsored by AMO and MFOA for Ontario municipalities and are the primary benchmarks. Commencing in 2006, the portfolio returns have also been compared to a composite return of the DEX (formally Scotia Capital) 60-day Money Market, Short Term Bond and Mid-Term Bond Indices (equal weightings of 33%). Portfolio returns exceed this benchmark by 0.47%. These results are summarized on Table 2 below.

Table 2
Comparison of General Fund Fixed Income Investment Returns

Year	York General Fund Return	ONE Fund Composite Benchmark		DEX Debt Indices Benchmark	
		Return	Increase/Decrease	Return	Increase
2007	4.04%	4.02%	0.02%	3.57%	0.47 %
2006	4.50%	3.75%	0.75%	3.93%	0.57%

As at December 31, 2007, approximately 12% of the total fixed income portfolio was invested in Region of York securities compared to 9.1% as at December 31, 2006. This change was the result of net investments of $46.0 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 fixed income portfolio as at December 31, 2007 consisted of securities issued by the Federal and Provincial governments (43%), Canadian financial institutions (28%), as well as securities issued by Ontario municipal governments and other approved institutions (29%) (*see Attachment 3).* It should noted that the Region's portfolio does not have, nor has it ever had any exposure to non-bank Asset Backed Commercial Paper.

The average remaining term to maturity of the portfolio at year-end was approximately 1,064 days. The maturity distribution of these investments is shown in *Attachment 4.*

4.2.1 Equity Investment

This year was the inauguration of the ONE Fund Equity Fund which was created as a result of changes to provincial regulations in 2006. In May 2006, Council authorized investments in shares or equities of Canadian corporations provided such investments were done through the ONE Fund.

In January 2007, the Region made its first such investment of $10 million representing approximately 1% of the Region's overall investment portfolio and well within Council's approved limit of ten percent of portfolio holdings. This investment has realized a rate of return of 7.78% in 2007 which has been incorporated in the overall return of the Region's investment portfolio. This return compares favourably to the overall return of the TSX composite (7.16%).

In the report to Council in May 2006, recommending investment in the ONE Fund Equity Fund, it was noted that "The ability to invest in shares provides the Region with an asset class that can provide opportunities to enhance investment returns over the long-term and support growth in capital reserves to meet future replacement/refurbishment needs. Investment in shares will be part of the long-term portfolio and would therefore be considered longer term investments. This will reduce the risk associated with short-term fluctuations in share prices".

It is anticipated that as the Region's long term capital replacement reserves grow, more funds will be invested in the ONE Fund Equity Fund dependent on market opportunities.

4.3 Investment Strategy – Outlook 2008

Fallout from the U.S. housing and sub-prime mortgage crisis will continue to impact the North American and other foreign economies in 2008. These two interrelated factors have led many economists and market forecasters to predict a major slowdown in the U.S. economy if not an outright recession.

As sited, these concerns have compelled the U.S. Federal Reserve and other central banks to dramatically lower interest rates over the past several months. Central bank rates are forecast to fall further over the next several months and this trend has already been reflected in market interest rates. Many investors have become focussed on maintaining liquidity and have sold less marketable corporate securities and sought shelter in government-backed bonds. This trend has pushed corporate bond yields much higher than government bonds of comparable terms.

We anticipate that these liquidity concerns will dissipate by the second half of 2008 and that the economy should then begin to recover. As the economy resumes a more normal growth rate, investor concerns will shift from trying to maintain liquidity (preserve capital) to yield enhancement and move back into the corporate bond sector. This should help corporate yield spreads narrow compared to government bond.

Focus will also be placed on the inflationary impact of the current low bond yield policy of central banks. Inflation pressures had already been building in 2006 and 2007 due to higher energy, food and wages costs. These pressures have not gone away and may cause interest rates generally to rise by the end of 2008.

For 2008, the Region’s investment program will seek to take advantage of this market view. Portfolio holdings currently reflect both a diversified term and credit experience in compliance with the Region’s Investment Policy guidelines.

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

- Dynamic term management through the timely purchase and sale of longer-dated securities;
- Diversification on switching of portfolio holdings where demonstrable yield advantage is available.

5. FINANCIAL IMPLICATIONS

The careful management of the General Fund generated net investment returns (interest plus capital appreciation) of $43.2 million in 2007 which represented approximately $0.2 million in additional return versus a similar sized investment with the ONE Funds and $5.0 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. The availability and size of reserves support the overall fiscal strengths of the Region and has been cited by the credit rating agencies as a key factor in the Region maintaining its AAA credit rating. This rating also minimizes the Region's and area municipalities' cost of long term borrowing.

7. CONCLUSION

The Region's General Fund investment portfolio performance in 2007 returned $0.2 million (net of costs), above the Region's principal benchmark, the ONE Funds, and $5.0 million versus the DEX Indices. 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.)