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2005 ANNUAL INVESTMENT REPORT

The Finance and Administration Committee recommends the adoption of the recommendation contained in the following report, January 12, 2006, 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 2005, 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 for the Region which had a combined maturity value of approximately $985 million as of December 31, 2005 (*see Attachment 1*).

The General Fund, with a value of $983 million at year-end ($986 million in 2004), is comprised of investments held for the reserves and reserve funds, working capital and other funds of the Corporation. All investments in 2005 were made in accordance with the Region's Investment Policy approved by Council in October 2002. 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*.

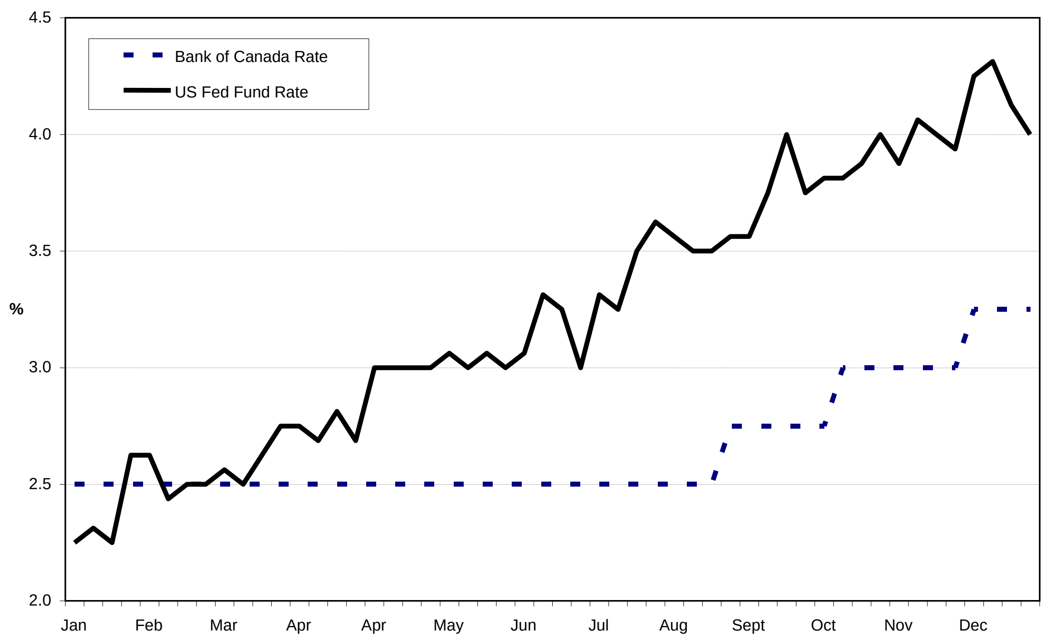
The Sinking Fund, with a par value of $2 million at year end consists of investments held in trust on behalf of the Town of East Gwillimbury for the repayment of Sinking Fund debentures. Sinking Fund investments are made in accordance with a policy established by the Sinking Fund Committee which is similar to that of the Region's 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 $36 million. Any further shortfalls are borrowed from reserves at a rate equivalent to the prevailing rate of return of the portfolio. In 2005 the budgeted cost of financing working capital deficiencies not funded by the Working Capital Reserve, was approximately $400,000.

4. Analysis and Options

Short-term interest rates in Canada moved sharply higher in the latter half of 2005 as the Bank of Canada became concerned about future inflationary pressures. Although the US Federal Reserve has been increasing rates at every meeting since June 2004, the strong Canadian dollar acted as a counter-inflationary factor allowing the Bank of Canada to postpone any interest rate hikes well into 2005. However, increased inflationary fears driven by higher oil prices, an economy running close to full capacity and the possibility of increased wage demands led to the bank rate being raised from 2.5% in September to 3.25% by the end of the year. As a result of these increases the short-term interest rates were dramatically higher by the end of 2005 compared to the end of 2004.

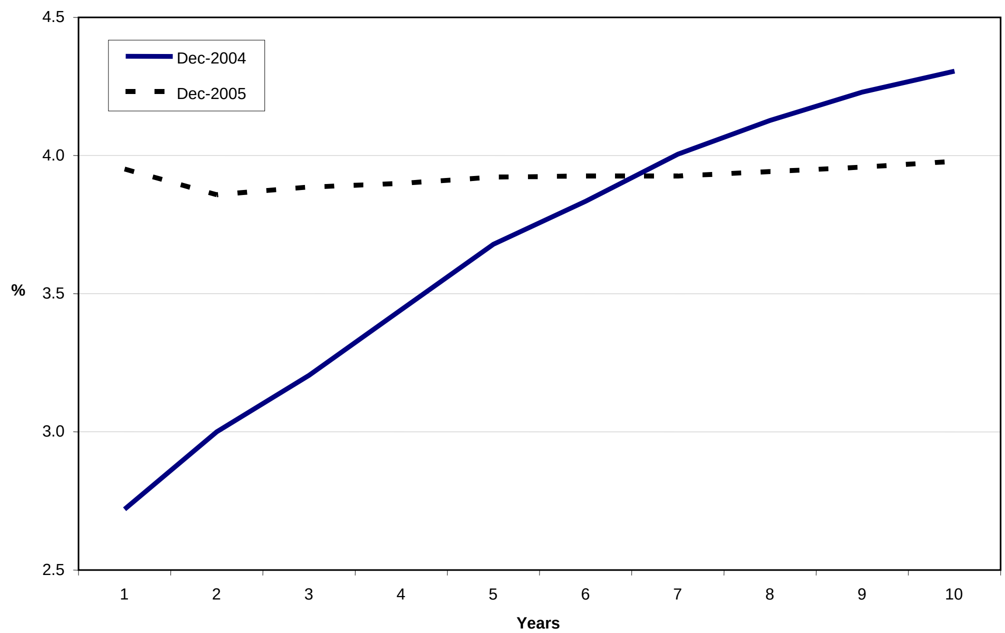
Graph 1
Central Bank Rates - 2005



However longer maturities did not react as strongly. The 10-year yield reached a high of almost 4.50% in March 2005 as it followed the US markets, but started to decline to a low of almost 3.70% in June. This low was again reached in early September as the market anticipated a sharp downturn in the US economy in the aftermath of Hurricane Katrina. As these fears proved unfounded, longer-term rates started moving higher as the Central Bank raised short-term rates.

As a result the yield curve flattened considerably in 2005 with a mere 6 basis points difference between the 1 year and 10 year rate on December 30, 2005. This stands in sharp contrast to 170 basis point difference at the end of 2004 (Graph 2).

Graph 2
Canadian Yield Curve
December 2004 vs 2005



4.1 Investment Strategy - 2005

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 to pursue an active management policy building on the successes achieved in the previous two years. Over the course of 2005 several opportunities to reduce and extend term were identified which provided the means to significantly enhance returns. The average term of the portfolio began the year at approximately 430 days and increased to over 700 days by the end of March as interest rates rose. Over the course of the spring and summer interest rates declined significantly and in response the term of the portfolio was reduced to under 500 days as bond holdings were sold in order to realize capital gains. Again, as interest rates increased in the latter part of the year, the term of the portfolio was lengthened to end the year at approximately 694 days.

4.2 Investment Results 2005

During 2005, the interest earned by the General Fund was $34.3 million which equates to a gross rate of return of 3.93%. After factoring in the cost of operating the Region's investment program of approximately $574,000 (ie. staff, safekeeping, market monitoring services, transaction costs, etc.) the net rate of return for the General Fund was 3.86%, a net difference of approximately 7 basis points.

Over the same period, Sinking Fund investments earned about $0.1 million for a return of approximately 5.85% (compared to $0.1 million and 5.96% in 2004). Table 1 summarizes the investment returns for both the General and Sinking Funds for the years 2004 and 2005.

Table 1
York Region Investment Portfolios – 2004/2005

Year	Fund	Assets (million)	Income (million)	Net Rate of Return
2005	General	$875.4	$33.7	3.86%
	Sinking	$1.6	$0.1	5.85%
2004	General	$867.4	$27.3	3.27%
	Sinking	$1.4	$0.1	5.96%

The proactive investment management program generated trading gains of over $6.6 million which improved the overall performance of the portfolio by approximately 75 basis points.

The earning results for the General Fund compare favourably to other industry benchmarks. For instance, the General Fund earned 1.34% (compared to 1.05% in 2004) more than the return achieved by the ONE Fund, a pooled investment fund sponsored by AMO and MFOA for Ontario municipalities, and the primary benchmark used by the Region. Furthermore, these results significantly exceeded returns earned by private sector money market mutual funds. A survey of approximately 220 Canadian money market mutual funds conducted by the Globe and Mail indicated that the average returns after costs was 1.57%. Therefore compared to these funds, the Region's portfolio earned 2.29% (1.88% in 2004) additional rate of return. Table 2 compares the investment returns of the General Fund to those realized by the ONE fund and private sector fund managers.

Table 2
Comparison of General Fund Investment Returns

Year	General Fund	ONE Fund		Private Sector	
		Returns	Difference	Returns	Difference
2005	3.86%	2.52%	1.34%	1.57%	2.29%
2004	3.27%	2.20%	1.07%	1.39%	1.88%

As at December 31, 2005, approximately 8.1% of the total portfolio was invested in Region of York securities compared to 4.8% as at December 31, 2004. This change was the result of net investments of $67.7 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, 2005 consisted of securities issued by the Federal and Provincial governments (56%), Canadian financial institutions (25%), as well as securities issued by Ontario municipal governments and other approved institutions (19%). (*see Attachment 3).* Furthermore, these investments had an average remaining term to maturity of approximately 694 days. The maturity distribution of these investments is shown in *Attachment 4.*

4.3 Investment Strategy – Outlook 2006

The North American economy which is now in its fourth year of growth continues to show resilience, despite the US Federal Reserve's tightening program which started in June 2004 and has seen short-term interest rates in the US increase by 3.25%. The consensus view, however, is that this tightening campaign will draw to an end as early as spring 2006. The Bank of Canada is still focused on the Canadian dollar and its impact particularly on the economy of central Canada and will likely follow the Federal Reserve's lead and limit any rate increases.

Market forces are therefore in relative equilibrium awaiting signs of the strength of the economy going forward and the risks of escalating inflationary pressures. There is concern on the one hand over the impact of higher interest rates on the North American housing market, as home equity loans have been a leading source of financing consumer spending. On the other hand, there is concern that inflationary pressures are continuing to build based on capacity constraints, higher commodity prices and the declining US dollar. Interest rates generally reflect these opposing views with short-term rates both in Canada and the US being almost equal to long-term rates (a flat yield curve).

For 2006 the Region's investment program will be focused on continuing to diversify both credit and term exposures on a risk adjusted basis to further enhance portfolio returns. Yield enhancement is expected to be derived from the following activities:

- Term extension via the timely purchase of longer-dated securities;
- 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 interest income of $33.7 million in 2005 which represented approximately $11.7 million in additional return versus a similar-sized investment with the ONE Fund and $20.0 million versus the average return of private sector mutual funds. Investment revenues contribute to reserves and help in defraying York Region's service costs over the longer-term. It should be noted that the interest income of $33.7 million does not include lost earnings on expenditures relating to the Region's Quick Start initiative paid upfront by the Region, that are to be funded by the Provincial and Federal governments. These costs, which by the end of 2005 totalled approximately $98 million, have in the interim, been borrowed from the Region's reserves resulting in approximately $2.4 million in foregone interest income.

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 2005 with a return of 1.34%, or $11.7 million (net of costs), above the Region's principal benchmark, the ONE Fund. 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 attachment referred to in this clause is attached to this report.)