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INVESTMENTS IN ONE FUND EQUITY FUND

The Finance and Administration Committee recommends the adoption of the recommendation contained in the following report, May 29, 2006, from the Commissioner of Finance, together with the following additional recommendation:

2. the Commissioner of Finance report to the October 5, 2006 meeting of the Committee providing an update on the Region's involvement in the ONE Fund.

1. RECOMMENDATION

It is recommended that:

1. Council authorize investments in the proposed equity fund to be operated by the ONE Fund Group of Funds (the "ONE) Fund in accordance with the Investment Policy.

2. PURPOSE

This report discusses the rationale for investing in an equity fund to be operated by the ONE Fund. It also discusses the proposed terms of reference and the guidelines for the proposed equity fund.

3. BACKGROUND

At its meeting of May 25, 2006, Council adopted a revised Investment Policy for the investment of reserves and surplus cash. Included in the report was a recommendation that would authorize the investment in shares of Canadian corporations provided such investments are made through the ONE Fund. However, prior to the initial investment, staff were directed to report back to the Finance and Administration Committee in order to provide details on the equity fund's guidelines and the rationale for the Region's investment in this class of securities.

The ONE Fund is a professionally managed group of investment funds that meet the eligibility criteria established by regulation under the *Municipal Act*. It is jointly operated by the Local Authorities Service Limited (a subsidiary of the Association of Municipalities of Ontario) and by the CHUMS Financing Corporation (a subsidiary of the Municipal Finance Officers' Association). It currently operates a money market fund and a short-term bond fund and is in the process of establishing two new funds – a corporate bond fund and an equity fund. All funds are or are proposed to be operated by highly qualified investment management firms. Each fund is governed by a mandate and guidelines which adhere to provincial regulations.

4. ANALYSIS AND OPTIONS

4.1 Need for Equity Investment

The Region's investment portfolio is comprised mainly of reserves and reserve funds including development charge receipts. These reserves have grown substantially over the last 10 years (see Table 1), and with the exception of development charges, are anticipated to either be maintained or grow over the foreseeable future.

Table 1
Reserves and Reserve Funds
($millions)

Type of Reserve	1996	2001	2005
Capital	65.2	251.2	331.3
Corporate	12.5	103.6	150.1
Development Charges	96.1	342.7	507.9
Total	173.8	697.5	994.3

In a report to Council in February 2006 entitled "Long Range Fiscal Planning Strategy" the Commissioner of Finance identified the need to develop a Capital Asset Management Plan "to address the required reserve allocations and contributions to ensure that the investment in capital assets is appropriately protected and managed on a long term basis".

The report estimates the current value of the Region's capital asset inventory at approximately $6.3 billion including many assets which have a life cycle of 30 years and longer. Funds contributed into capital replacement reserves will be held for extended periods of time and therefore the investment strategy for managing these funds must also be long term focussed.

The Region's investment strategy over the past several years has been to extend term on a timely basis in order to enhance portfolio returns. While this process is expected to continue, the historically low interest rates which we are currently experiencing, between 4% and 5%, will limit the ability to grow these investments appreciably. Investing in shares of Canadian corporations (equities) provides the Region with the opportunity to both diversify its portfolio holdings and potentially realize investment returns greater than those provided by fixed income securities alone. Although returns on equities can vary over the short run, as Table 2 below illustrates, their returns have historically outperformed fixed income securities over most time horizons

Table 2
Historic Investment Returns
Money Market, Bonds and Equities

Type of Fund	3 Year	5 Year	10 Year	20 Year
Money Market	2.70%	2.90%	3.75%	6.17%
Bonds	5.35%	5.95%	6.80%	8.42%
Equities	26.00%	11.70%	11.20%	9.72%

The Investment Policy authorizes investing up to ten percent of the portfolio holdings in an equity fund. However, it is anticipated that planned investments in an equity fund would be phased-in based on the rate of future contributions to the long-term capital replacement reserves. Therefore, the authorized limit for investments in equities would not be reached for several years depending upon the Region's capital needs as well as economic and market conditions. As with all Region investments, staff would closely monitor performance and risk relating to its equity investment and if necessary, reduce exposure when warranted.

4.2 Proposed Equity Fund

The proposed ONE Fund equity fund will be operated by a professional investment management firm. In addition, the ONE Fund's Advisory Committee will also provide oversight to the equity fund. This committee is comprised of senior municipal financial officials including the Director of Policy, Risk and Treasury from the Region of York The ONE Fund is currently in the process of finalizing its investment guidelines for the equity fund. Discussions with ONE Fund officials noted that the following key elements will be included in the fund's mandate:

- All investments must meet statutory requirements for Ontario municipalities;
- Investments will be in predominately well-capitalized Canadian corporation;
- Investment will be mainly liquid and marketable;
- The fund will avoid over concentration in any particular sector, industry or individual company; and
- The manager will be required to report on portfolio holdings and performance at least monthly.

The management and investment philosophy will therefore be tailored to match the risk tolerances and investment objectives of Ontario municipalities including York Region.

5. FINANCIAL IMPLICATIONS

Over the past 20 years, investment returns derived from Canadian equities have exceeded average returns from money market and bond securities by approximately 2.4% annually. Although past performance cannot be guaranteed, assuming equity returns continue to match this performance, an investment of $100 million in the equity fund could result in excess returns of $2.4 million per year.

Any excess returns derived from investment in shares of Canadian corporations over money market or bond investments will help reduce future funding requirements from tax and user rates.

6. LOCAL MUNICIPAL IMPACT

There is no direct impact from this recommendation on local area municipalities.

7. CONCLUSION

The ability to invest in shares of Canadian corporations, as recently allowed by provincial regulations, provides the Region with an important investment alternative. Historically this class of securities has provided superior returns compared to money market and bond investments. Enhanced returns from these investments could alleviate funding requirements for the replacement and refurbishment of the Region's current and future capital infrastructure.

The Senior Management Group has reviewed this report.