Appendix 1

Business Case for Equities

A Submission for Equity Investment Approval

Investment Committee

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Introduction

This business case will provide an overview of key considerations in regard to updating the City of Saskatoon's investment policy to include equities. This analysis will include:

- An overview of the returns generated from the City of Saskatoon's (City) current Portfolio Management Policy (Council Policy No. C12-009);
- Examples of other Canadian municipalities and Canadian entities that invest in equities and the returns those portfolios have generated;
- How Canadian municipalities and Canadian entities incorporate an ESG framework within their equity strategy;
- Benefits and risks of equity investments for the City to consider by using an example from the University of Saskatchewan's long-term fund; and
- Recommendations on how the City can move forward in updating the current policy to allow equity investments within an ESG framework.

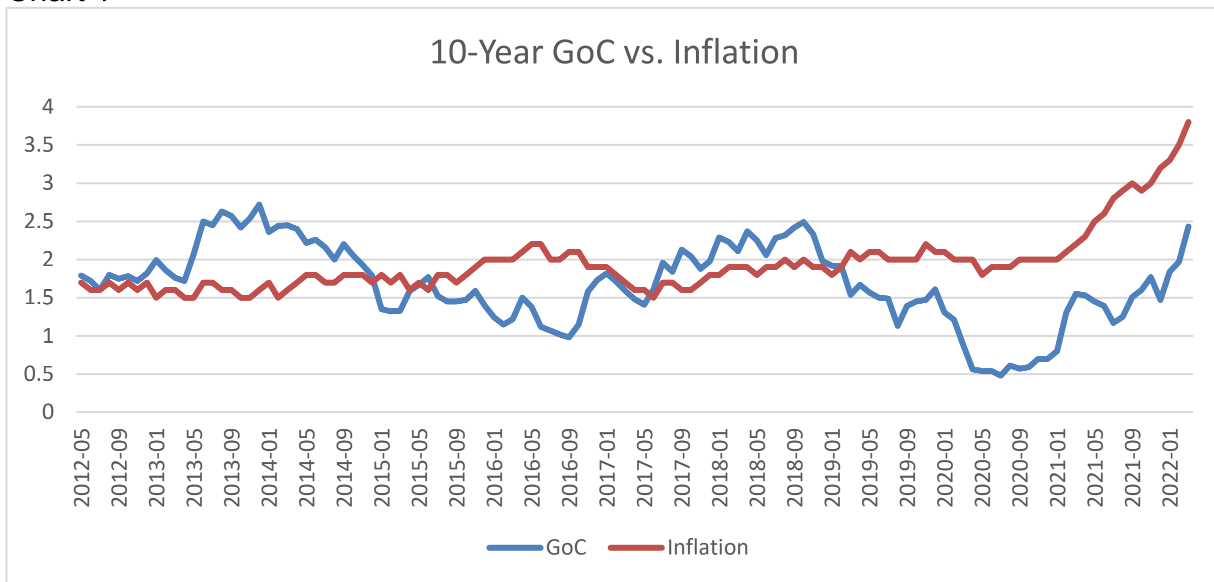
Background

The City's current Portfolio Management Policy allows the following fixed income investments:

- Bonds issued by the Government of Canada (GoC) or an agency of the GoC;
- Bonds issued by a Province of Canada or Crown corporation carrying the guarantee of its province;
- Bonds issued by a Canadian municipal government; and
- Bonds issued by a Canadian Corporation that hold an "A" rating or better.

The City's investments provide approximately $10 million to $12 million of investment revenue each year and has provided an average annual return of 2.73% over the last 10 years. In the past, bonds have provided a sufficient return on investment while carrying little risk to investors. However, as Chart 1 shows, when compared to inflation in recent years bonds have not been providing investors with enough of a return to improve or even maintain purchasing power over time.

Chart 1



Data sourced from the Bank of Canada website: 10-year Government of Canada Bond Historical Data and Consumer Price Index

The rate of inflation is the rate that prices are increasing in an economy and represents the decrease in purchasing power or value of money. Basically, a 2% rate of inflation would indicate that in one year $102 would be required to purchase what $100 is currently able to purchase. As Chart 1 shows since 2012 the rate of inflation in Canada has averaged around 1.95%, whereas during that time the 10-year GoC Benchmark bond has averaged 1.69%. From a real return perspective, which is the return earned on an investment after accounting for inflation, some bonds have been providing a negative real return to investors who are essentially losing purchasing power over time.

Historically low interest rates and very aggressive expansionary fiscal policy in response to events such as the 2008-09 Financial Crisis and more recently the Covid-19 pandemic have contributed to this lower rate environment for bond investors. Central bank activity has increased in 2022 with the Bank of Canada (BoC) hiking rates 75 basis points or 0.75%. This has been in response to the increase in inflation since the onset of the pandemic in 2020, and bond returns have benefited from these rate hikes. However, due to favorable borrowing rates Canadian household debt has been increasing in recent years presenting a risk for the BoC to monitor as higher rates will put a strain on the incomes of households thereby forming a ceiling of how high rates can rise. Plus, with the number of Canadians approaching retirement age soon it is expected that demand for bonds will remain high as retirement accounts prefer to invest in bonds over equities and will further contribute to keeping bond returns around current levels.

Portfolios such as the City's must either accept a lower return on invested funds or update the investment policy to take on more risk while enhancing the return potential. This investment approach can also incorporate an ESG framework, allowing the City to support ESG initiatives through its investment portfolio just like other Canadian

municipalities and Canadian entities have done. This will be accomplished by mandating in the investment policy that all proxies be voted in a manner which is ESG friendly, and that investments be made with ESG initiatives in mind. Any external investment manager that is used will be required to have their own ESG framework for conducting their investment process.

Other Canadian Municipalities

Edmonton

The City of Edmonton is one example of a municipality that has adjusted its investment policy to accept greater risk to generate a higher return by investing in equities within an ESG framework. In 1995, the Ed Tel Endowment fund was established with an initial value of $465 million. At the time, the municipally owned Edmonton telephone company was sold for $465 million because of growing industry competition. City Council made the decision to use the proceeds from the sale of the company to setup the Ed Tel Endowment Fund. The fund has grown to a value of $789 million since then and has paid out an additional $785 million in dividends to the City of Edmonton which are used annually to support civic operations. Since its establishment, the fund has been managed by an external investment manager and produced a 7.9% compound rate of return to the City of Edmonton compared to its benchmark return of 7.0%. In 2021, this fund generated a 14.1% return compared to a benchmark return of 12.1%.

Toronto

In 2017, the City of Toronto established an investment board, which became effective in January 2018 and with it a new investment policy that allows for investment in equities in a manner that is ESG friendly to be managed by an external investment manager. This new policy consists of three pools of capital: (1) a short-term fund consisting of 100% bonds; (2) a long-term fund consisting of a 20% target for global equities (30% maximum) and a 10% target for real estate and infrastructure (15% maximum); and (3) a Sinking Fund with similar asset allocations as the long-term fund. In 2020, the long-term fund generated a 4.1% return to the City of Toronto net of management fees.

Calgary

The City of Calgary also allows equities in its investment policy and has mandated to support investments which are ESG friendly. The policy consists of three different bond pools and one equity pool which accounts for only 10% of its overall portfolio. This equity pool is restricted to high-quality companies, including global companies, and is managed by an external investment manager. In 2021, the equity portion of Calgary's portfolio generated a return of 12.07%.

Regina

The City of Regina began the process of researching and updating their investment policy back in 2020. At the time, Regina's investment policy was similar to the City's by only allowing investment in bonds or fixed income securities. However, with the help of an outside consultant Regina was able to research the best practices of other municipalities and develop a plan for moving forward with equity investments. Furthermore, the consultant was able to help develop a new policy and RFP for

selecting an external investment manager to oversee the investment portfolio. Regina has yet to begin investing in equities to date, but the new investment policy was approved by City Council in late 2021 along with the selection of the external investment manager.

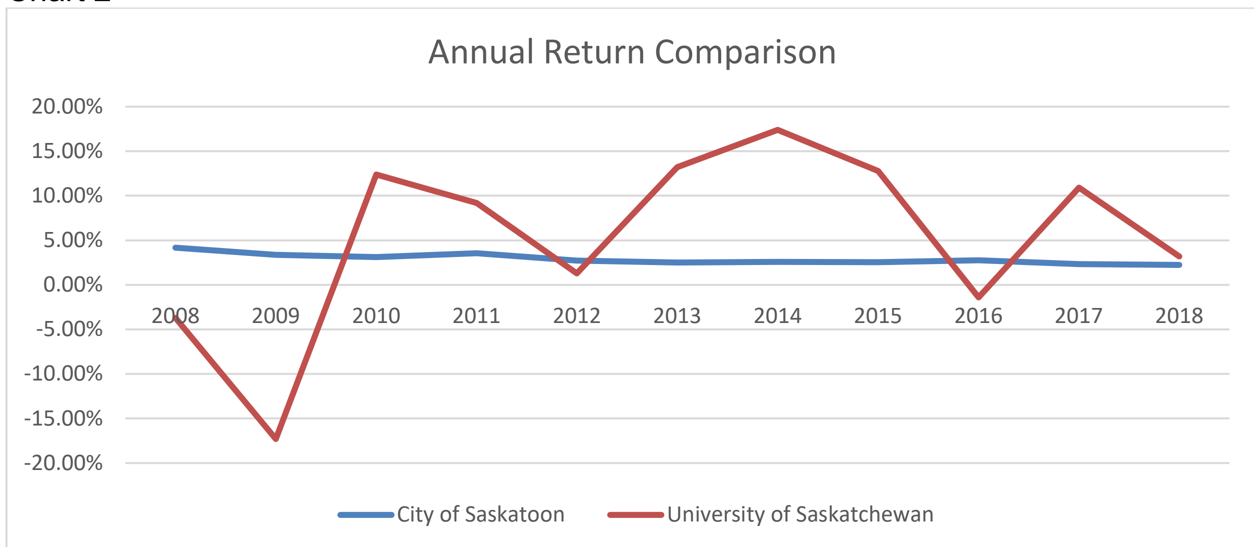
Other Examples
Two other examples of municipalities that invest in equities include the City of Medicine Hat and the City of Moose Jaw. The City of Medicine Hat has a long-term investment portfolio composed of 40% money market and fixed investments and 60% equities which generated a 6.21% return to the City in 2020. The City of Moose Jaw has a portfolio composed of 2% cash and cash equivalents, 26% fixed income and 72% equities. This portfolio generated returns of 9.92% and 9.70% respectively in 2020 and 2021.

Benefits, Opportunities and Risks of Equities

Equities have historically provided investors with favourable returns compared to bonds and are a natural hedge against the effects of inflation. As inflation increases, so does a company's earnings which positively impacts the company's stock price in the long run. Over the past 100 years, the S&P 500, which is an index that tracks the performance of 500 large companies in the US, has returned on average 10% to investors. Simply put, an investor would have been able to invest in an Exchange Traded Fund (ETF) that tracks the S&P 500 index and generated a 10% annual return over this period.

In 2019, RBC delivered a presentation to the Administration which highlighted opportunities for municipalities to update investment policies to include equities. Included in the presentation was an example from the University of Saskatchewan's (USask) Long-Term Balanced Pool. For the years 2008 to 2018, this portfolio generated an annualized return of 5.70% for USask, net of investment management fees. During this same time the City's bond portfolio generated an average return of 2.73% as seen in Chart 2. The Financial Crisis that started in 2008 saw a decline in major stock indices of more than 50% before the market began to recover. During that year, the Long-Term Fund generated a negative 17.6% return to USask; however, in the long run the portfolio recovered and still outperformed the City's bond portfolio. The USask investment policy also has a mandate for funds to be invested in an ESG friendly manner and is managed by an external investment manager.

Chart 2



Equities do expose investors to higher levels of risk, but investors are also compensated for this higher risk through greater return potential. There are times when equities underperform bonds in the short term, but over the long-term equities have proven to be a have a higher return for those with a long-time horizon. This is one characteristic of organizations like the City. Time horizon refers to the time an investor needs to hold investments to achieve their goals and indicates when those investments will be needed to fund operations. The longer the time horizon the more aggressive an investor can be in creating their investment portfolio. This will allow the investor to ride out low points in the market just like during the Financial Crisis. The City would be able to setup a long-term fund where investments are expected to be held for periods of 10 years or more.

Having a good investment income stabilization policy will also help the City in managing any poor returns experienced in low years by utilizing some of the returns from good years. An investment income stabilization policy will determine the annual flow of funds to the operating budget while still supporting the long-term goals of the fund. Some initial options considered that will be further explored in future reports include:

- Interest/Investment Stabilization Reserve – This approach would utilize the existing Interest Stabilization Reserve to fund Interest Income budgetary shortfalls. This reserve would be funded by investment income surpluses that exceed budget up to a certain cap. Once the Interest Stabilization Reserve reaches a set cap, dividends could be declared to be utilized on municipal projects.
- Linking Investment Returns to Capital Programs – Capital programs are more able to grow or shrink based on the amount of funding received. An option to mitigate years that have interest income returns less than budget would be to link it to a program such as the $30 million road maintenance/rehabilitation program to remove the risk from the operating budget. This approach would mean the road program would carry the risk and fluctuate from year to year based on

investment returns. While the annual investment may vary based on investment income, the long-term service level would likely be able to be met as the longer-term return with equities have historically been reliable.

Use of a good spending rule can also help to smooth the returns paid out from the fund from year-to-year. Many endowments and investment funds make use of this in an attempt to grow the overall value of the fund while also providing a payment for the operations of the organization. This rule will account for inflation so the fund does not lose purchasing power overtime and will attempt to smooth the amounts paid out over time. Table 1 provides an example of how a spending rule would work. The returns in the table are those from the USask long term investment fund and the following formula is a general spending rule that has been used by funds.

Spending = 70% x (Spending for fiscal $year_{t-1}$ + inflation) + 30% x (4% x market value at beginning of $year_{t-1}$)

Table 1

Year	Return	$ 50,000,000.00	Payout	Inflation
2007	12.60%	$ 56,300,000.00	$ 2,252,000.00	
2008	-3.70%	$ 51,964,900.00	$ 2,289,360.68	2.37%
2009	-17.30%	$ 40,685,611.62	$ 2,230,938.93	0.30%
2010	12.37%	$ 43,487,482.84	$ 2,077,682.09	1.78%
2011	9.20%	$ 45,410,649.17	$ 2,018,549.64	2.91%
2012	1.30%	$ 43,982,437.97	$ 1,979,389.91	1.52%
2013	13.20%	$ 47,808,729.87	$ 1,926,386.58	0.94%
2014	17.40%	$ 54,201,062.30	$ 1,947,931.15	1.91%
2015	12.80%	$ 59,190,867.12	$ 2,029,372.69	1.13%
2016	-1.40%	$ 56,332,822.29	$ 2,151,165.31	1.43%
2017	10.90%	$ 60,321,934.61	$ 2,205,902.63	1.60%
2018	3.20%	$ 60,046,333.88	$ 2,303,046.85	2.27%
		Total	**$ 25,411,726.47**	

With a current investment portfolio of approximately $500 million, the City has an opportunity to utilize some of the current balances to increase returns to fund operations. For example, using 10% of the City's current portfolio value in a fund that generates an average annual return of 5.7% like the USask's long-term fund would provide $2.85 million in revenue on $50 million of invested funds. This would be more than double the $1.365 million that is currently being generated on 10% of the portfolio at an average annual return of 2.73%. The greater the allocation to equities the greater the return potential, but that will also mean a larger portion of the City's cash is invested in a riskier asset.

Additional details on the benefits and drawbacks of both equities and bonds are shown in Appendix A, and Appendix B provides a Risk Register for equity investments.

Recommendation

The main challenge with updating the investment policy to allow equities is determining the optimal asset allocation. Asset allocation is an investment strategy that balances risk with return by determining how much of the portfolio to allocate between the three asset classes—equities, fixed income, and cash and cash equivalents. This is accomplished by setting up an investor's portfolio based on their goals, risk tolerance and investment time horizon. Other municipalities hired a consultant to assist in determining this for their investment policy and in doing so were able to determine the optimal asset allocation required to enhance return potential while minimizing risk.

It is recommended that the Administration initiate a capital project in the amount of $50,000 funded through the Asset Financial Management Reserve to hire a consultant to assist in further research of equity investments. A consultant will be able to setup different models of allocations using the City's investment goals, risk tolerance and time horizon. Using these models, the consultant will be able to perform simulations and tests to show the risk/return profile of each allocation. This information will help determine the optimal allocation for the City among the three asset classes as it will show the best option for the City to enhance returns while minimizing risk.

Should the City decide to move forward with investing in equities the consultant will be able to further assist in drafting a new investment policy and developing an RFP to select an external investment manager to oversee the equity portion of the City's portfolio. Just like other municipalities have benefited from the external management of funds invested in equities so to would the City. Fees for using an external investment manager usually range from 0.5%-1.5% and are paid out via returns generated from invested funds. Despite the added costs, municipalities that invest in equities have been able to improve the overall return potential of their portfolio.

Appendix A – Equities vs. Bonds: Pros and Cons

Equities		Bonds	
Pros	**Cons**	**Pros**	**Cons**
Natural hedge against inflation	Can experience large fluctuations in market value	Provides a stable income for investors	Fixed return that can lose real purchasing power over time
Infinite return potential	Company can go bankrupt causing the equity to be worthless	A contractual obligation of the issuing entity providing more safety to the investor	Lower yields in recent years means lower returns which may not exceed inflation
Has historically provided investors with a greater return than bonds	Usually paid out last in the event a company liquidates all its assets due to bankruptcy	Prices fluctuate less than equities	Can be impacted by fluctuations in value due to changes in interest rates set by the Bank of Canada
Opportunity to generate compounding returns over a long-time horizon	No guaranteed return		Has historically provided a lower return than equities
Can provide dividend payments			Capped return potential
Equity represents a stake of ownership in the company providing the equity holder with voting privileges in board decision-making providing a degree of control over the company			

Appendix B – Risk Register

Risk Description	Cause	Consequence	Mitigation Strategy – Reduce Probability	Mitigation Strategy – Reduce Impact
Management fees increase	External manager has generated superior returns and is requesting higher fees as a result, or needs to charge more because their business has been lacking	Higher fees and lower returns from the fund	• Continuously monitor the fees • Publicly tender the contract with set fees and a contract under which fee increases will be addressed	• Ensure contract addresses what options there are if the manager is underperforming • Leave the option open to switch managers if one is underperforming or has high management fees
Liquidity risk	Investments cannot be sold without conceding value due to a lack of market for the securities or an event to the entity that causes demand for their stock to diminish	The need to realize losses in the portfolio as a position needs to be liquidated to stay in compliance or raise cash for the organization	Invest in high-quality companies and products that have good long-term prospects	Ensure the portfolio is well-diversified to reduce the impacts of poor performing investments
Governance structure is inappropriate, inefficient	Roles and responsibilities are not clearly defined	Poor, inappropriate, or wrong decisions	Ensure governance structure is up to date and reviewed on a continual basis by the Investment Committee	Follow structures that have worked for other municipalities
Short-term market volatility: decrease	General economic conditions, sudden shock/event, interest rate fluctuations, currency/exchange rate fluctuations	Decrease in portfolio value, erosion of invested capital, unrealized/book value losses, decrease/elimination of dividend income for reinvestment	Ensure the portfolio is invested in multiple industries to diversify the City's exposure	• Develop a spending rule that smooths the payout from year-to-year • Update the policy for the Interest Stabilization Reserve • Reinvest a portion of returns back into the fund to help maintain the long-term real purchasing power of the fund

Short-term market volatility: increase	General economic conditions, sudden shock/event, interest rate fluctuations, currency/exchange rate fluctuations	Increase in portfolio value, growth of invested capital, unrealized value gains, policy caps reached/ exceeded triggering action, reduced reliance on property taxes and user fees	Ensure the portfolio is invested in multiple industries to diversify the City's exposure	• Develop a spending rule that smooths the payout from year-to-year • Update the policy for the Interest Stabilization Reserve • Reinvest a portion of returns back into the fund to help maintain the long-term real purchasing power of the fund
Real value of investment decreases	Inflation rate exceeds rate of return	Erosion of invested capital	Invest in securities that are a natural hedge against inflation	• Invest in a well-diversified portfolio
Short-term cash flow demands exceed available funds	• Unexpected expenditures • Significant decrease/delay in revenue	Investments must be sold	Maintain a good balance between bonds and equities in the portfolio so the City is not over invested in risky assets that have a higher potential to drop in value from time to time	Sell assets that are selling at a premium in the market, so the City does not lose value on invested funds
Equity investment loses all value	Insolvency, bankruptcy, or delisting from stock exchange	Loss of invested capital	Invest in high-quality companies and products that have good long-term prospects	Ensure the portfolio is well diversified to reduce unsystematic risk
Actual returns do not meet investment objectives	• Asset mix is not optimized/ appropriate/current/ updated • Investment management fees exceed expectations	Unnecessary risk may be taken with little/no benefit (if lower risk investments yield same/similar returns)	• Policy must clearly define what is an acceptable portfolio. • Contract with external manager must address the portfolio that they can invest in • Investment Committee is responsible for reviewing reporting from external manager to ensure compliance	Contract must address what happens if external manager deviates from approved strategy

Voting privileges are not exercised/ exercised properly.	Investment Manager neglects the City's proxy voting (ethical responsibility)	• Board members may be elected that do not operate the company in the best interest of the shareholders • Repercussions of unethical decisions	Ensure the policy includes expectations from the portfolio manager on voting privileges	Follow up regularly with Portfolio Manager to ensure voting is carried out in the City's best interest
Internal fraud	Opportunity for employees to exploit a flaw(s) in the security measures	• Financial loss to the City • Public's loss of trust/confidence in City	• Investment Committee oversight • Regular reporting on performance • Delegation of authority • Must confirm any updated settlement instructions via phone call	Internal controls will be reviewed on an ongoing basis and updated as new risks may emerge in the industry
External fraud	• Weakness in external manager's policies • Spam or phishing email gains private information from the City	• Financial loss to the City • Public's loss of trust/confidence in the City	• What is the structure of the external manager? • How do they control risk and fraud? • What level of cyber and IT protection do they utilize?	Ensure the external manager has sufficient insurance to cover any potential financial losses to the City due to fraud