DECISION REPORT

Asset Allocation Study

ISSUE

This report provides an update on the Research on Equity Investments Project and seeks Committee and City Council direction on various asset mix options which include different allocations to fixed income, equities, and alternative investments.

BACKGROUND

2.1 History At its regular meeting on March 14, 2022, the Standing Policy Committee on Finance resolved:

> "That the Administration report back further on equities and Environmental, Social and Governance (ESG) investing including the benefits, challenges and experiences in other cities which have moved into these types of investments."

At its regular meeting on June 29, 2022, City Council resolved:

> "1. That the Administration hire a consultant to assist with researching equity investments by determining an optimal asset allocation to enhance return and minimize risk while supporting Environmental, Social and Governance investments; and
>
> 2. That the Administration initiate a capital project in the amount of $50,000, funded through the Asset Financial Management Capital Reserve."

2.2 CURRENT STATUS

The Administration has been working with Eckler Ltd. (Eckler) to determine the optimal asset allocation for the City of Saskatoon's (City) investments. Eckler was the successful proponent to the City's competitive process and was chosen by the Administration to conduct this study. The goal is to provide advice on how the City can proceed with updating the investment policy to improve return potential while minimizing risk of a negative return and to develop a Request for Proposal (RFP) to hire an external investment manager to help mange the new asset mix. By using the City's investment return objectives and risk tolerance Eckler provided the Administration with a list of various asset mixes which include different allocations to fixed income, equities, and alternative investments. A summarized version of their research can be found in Appendix 1.

This report provides an overview of Ecklers research as well as the Administration's decision-making process to arrive at the preferred asset allocation. Sixteen options were highlighted by Eckler as having the potential to improve the return to the City without exposing the City to unnecessary amounts of risk. Table 1 outlines the sixteen options (E0 to C30) and Table 2 illustrates the potential returns for each option.

Table 1 – Options % Allocation

Option	Fixed Income (Bonds)	Equities	Alternative Investments
E0	100%	0%	0%
E10	90%	10%	0%
E20	80%	20%	0%
E30	70%	30%	0%
A0	90%	0%	10%
A10	80%	10%	10%
A20	70%	20%	10%
A30	60%	30%	10%
B0	80%	0%	20%
B10	70%	10%	20%
B20	60%	20%	20%
B30	50%	30%	20%
C0	70%	0%	30%
C10	60%	10%	30%
C20	50%	20%	30%
C30	40%	30%	30%

Note 1 – The 0, 10, 20, 30 options represent the % invested in equities. For example, E10, A10, B10 and C10 would all include a 10% allocation to equities.
Note 2 – The E, A, B, and C options represents the % invested in alternative investments such as real estate (E = 0%, A = 10%, B = 20% and C = 30%). For example, A0, A10, A20 and A30 would all include a 10% allocation in alternative investments.
Note 3 – The remaining % allocation would continue to be invested in fixed income (bonds). For example, a B10 allocation would include a 10% allocation to equities and a 20% allocation to alternative investments with the remaining 70% invested in fixed income.

Table 2 – Options with 0% probability of negative return over 10 years

	Annualized Return Statistics															
	E0	E10	E20	E30	A0	A10	A20	A30	B0	B10	B20	B30	C0	C10	C20	C30
Expected Return (10-Year Annualized)	3.6%	4.0%	4.5%	4.9%	3.9%	4.3%	4.8%	5.2%	4.2%	4.6%	5.0%	5.4%	4.5%	4.9%	5.3%	5.7%
Downside Return (10-Year Annualized)	2.7%	2.8%	2.6%	2.2%	3.0%	3.1%	2.8%	2.4%	3.2%	3.2%	3.0%	2.6%	3.3%	3.3%	3.1%	2.7%
Standard Deviation	2.3%	2.6%	3.6%	4.8%	2.2%	2.6%	3.6%	4.9%	2.2%	2.8%	3.8%	5.1%	2.5%	3.1%	4.2%	5.4%
Probability of a Negative Return (Annual)	4.4%	3.5%	9.2%	15.7%	1.6%	2.6%	8.3%	15.1%	1.4%	3.1%	8.8%	14.7%	1.9%	4.0%	10.0%	15.4%
Probability of a Negative Return (10-Year Annualized)	0.0%	0.0%	0.0%	0.5%	0.0%	0.0%	0.0%	0.4%	0.0%	0.0%	0.0%	0.4%	0.0%	0.0%	0.0%	0.3%

As per City Policy No. C12-009, Portfolio Management, the City is currently investing in high quality investment grade Canadian bonds. The issuers of these bonds consist of the Government of Canada, agencies of the Government of Canada, Canadian Provinces, Canadian Municipalities and Canadian Corporations all with a credit rating of A or better. The City's investment policy is representative of the E0 option with 100% of the portfolio invested in fixed income (bonds).

A 10% investment in equities as seen in the E10 option is expected to not only increase the potential return but also decrease the risk of a negative return over a 10-year period. This simple example further supports the potential move towards a more diversified portfolio.

When reviewing the various options presented by Eckler which will be used to build the future investment policy, the Administration has continued to prioritize the preservation of capital or minimizing the potential for investment losses while at the same time maximizing the potential return. As such, the Administration reviewed options that would decrease the probability of a negative return over a 10 year period to 0% while at the same time produce expected returns greater than 4.5%. The returns presented by Eckler are all after investment management fees are paid so they represent what the City can potentially receive on investments. Applying this lens reduced the number of potential options from 16 to 4 leaving A20, B20, C10 and C20 as potential options.

These four options were then further reviewed. While C20 projects to have the highest potential returns (5.3% per year over 10 years) a transition to 30% alternative investments was viewed as a significant shift for the City to take on its first steps away from fixed income. This coupled with a rising interest rate environment and significant inflation placed additional uncertainty on such a significant allocation to alternative investments at this point. Through this lens, both C10 and C20 were eliminated from potential options leaving A20 and B20.

Upon review of the final two options, B20 which would include a 20% allocation to equites, a 20% allocation to alternative investments and a 60% allocation to fixed income was viewed as the most suitable option to move towards with expected 10 year returns of 5.0% per year and a 0.0% probability of a negative return over 10 years.

If the expected returns were to be realized, this could result in additional revenue of approximately $70 million over the course of 10 years assuming $500 million in holdings and the expected return differential of 1.4% between the current policy of E0 (3.6%) and B20 (5.0%).

2.3 City of Saskatoon's Current Approach

As per City Policy No. C12-009, Portfolio Management, the City is currently investing in high quality investment grade Canadian bonds. The issuers of these bonds consist of the Government of Canada, agencies of the Government of Canada, Canadian Provinces, Canadian Municipalities and Canadian Corporations all with a credit rating of A or better. As mentioned earlier in this report the City's investment policy is representative of the E0 option with 100% of the portfolio invested in fixed income (bonds). These investments are managed internally by the City's Investment Manager with investment custody services currently provided by the Royal Bank of Canada Investor Services group.

2.4 Approaches in Other Jurisdictions

Other Canadian municipalities have expanded their investment policies to allow for a portion of their portfolio to be invested in equities and alternative investments. Cities such as Regina, Edmonton, Calgary, and Toronto have all updated investment policies to allow for these investments and have been able to improve on the return potential of their portfolio.

The City of Edmonton is a great example of a successful program which has benefited from the inclusion of equities and alternative investments in the asset mix. In 1995, the City of Edmonton sold the City-owned Edmonton Telephones company for $465 million and used the funds to start the Ed Tel Endowment Fund. The fund invests in a mix of assets including fixed income, equities, and alternative investments. Since its inception the fund has grown to over $893 million as of December 31, 2022, and has paid out $969 million in dividends to the City of Edmonton.

OPTIONS

Option 1 - Maintain Current Investment Policy

This option would not require any further action by the Administration as the current investment policy would be maintained. The Administration would continue to invest in high quality investment grade bonds in accordance with Policy No C12-009, Portfolio Management, that are low risk but generate a lower return to the City. As per Table 2, this option is estimated to generate a 3.6% return per year over a 10-year period.

Option 2 – Proceed with option B20 supplied by Eckler Ltd.

This option would require the Administration to continue working with Eckler on the second phase of the Asset Allocation project. The next steps would be to draft a new investment policy to allow for the new asset mix which would allocate up to 60% to fixed income, 20% to equities and 20% to alternative investments. Next, the Administration will work with Eckler to draft a RFP to hire an external investment manager to manage the portion of the investments that are allocated to equities and alternative investments. Lastly, the Administration will work with Eckler to draft an RFP for investment custody services. These services are provided by a bank to assist with the settlement, safekeeping and reporting of the investments made by the investor. The City will require these services for the new asset mix. The expected return for this option is estimated at 5.0% and is expected to have a 0% probability of negative return over a 10-year period.

Option 3 – Proceed with an Alternative Asset Allocation

This option would involve using one of the other asset mixes which Eckler presented in Page 12 of Appendix 1. These are alternative allocations that could improve the return potential of the portfolio without exposing the City to unnecessary amounts of risk. Option E0 would represent the policy the City is currently using and is Option 1 of this report, and option B20 is Option 2 of this report. If any option other than Option E0 is chosen it would have the same requirements as Option 2 where the Administration would need to draft new investment policy to allow the chosen asset mix. The Administration will also need to draft an RFP to hire an external investment manager to manage the portion of investments that are allocated to equities and alternative investments. Lastly, the Administration will work with Eckler to draft an RFP for investment custody services.

RECOMMENDATION

That the Standing Policy Committee on Finance recommend to City Council that the Administration proceed with Option 2.

RATIONALE

Option 2 provides for a higher potential return than the current investment policy while also minimizing the potential of a negative return over 10 years.

ADDITIONAL IMPLICATIONS/CONSIDERATIONS

The returns and probabilities of a negative return generated by Eckler are not a guarantee of future investment performance. This exercise is a way to display the potential for a portfolio if it were to include the various asset mixes. It allows investors to get a sense of what the optimal asset allocation would be given their return objectives and risk tolerance. Updating the investment policy to include equities and alternative investments will help the City to meet today's needs while not compromising the ability to meet the needs of future generations. It is expected that for each 1.0% increase in return the City will receive approximately $5 million of additional investment income per year as the City currently has over $500 million of investments.

<u>Operationalization of a new Investment Policy</u>

It is important to note, if a new investment policy is approved it will likely take several years to fully transition to a B20 model. This is due to a variety of factors, including:

1. The time it will take to RFP and award a contract to an investment manager;
2. Current bond holdings will likely be held until maturity to minimize losses by selling them earlier than the maturity date; and
3. Investments into the market will likely be staged to diversify risk in terms of timing when the City enters the market and to take a cautious approach.

Annual investment updates presented to the Standing Policy Committee on Finance will continue to provide return information as well as status updates on the City's transition.

<u>Operating and Capital Budget Plan</u>

In terms of how the City's returns will be utilized from a budget perspective, the City's current operating budget requires $13.79 million in annual returns. An investment policy which includes equities and alternative investments has the probability of experiencing a loss of 8.8% in any one given year. Therefore, it is inevitable that although the portfolio will likely earn higher returns over the long term, it will have years with under performance. As such, the Administration is proposing the following from a budget perspective:

1. The $13.79 million annual allocation to the operating budget be maintained and grow by an inflationary amount each budget year. This allocation will be provided by the portfolio regardless of annual returns; and
2. Returns bigger or smaller than the budgeted operating allocation be held in a reserve and that dividends be declared from time to time as balances allow which will be utilized for one-time purposes.

Through this methodology the operating budget will continue to be provided with returns to lessen potential property tax impacts and provide the opportunity for one-time funding (projected to be $70 million over 10 years) which never existed under the previous model. If returns were to be fully allocated to the operating budget, it would create the risk that in years of negative returns the City would be faced with a significant shortfall/deficit which would require unacceptable options (such as transfers from other operating reserves) to offset. Future reporting will include potential changes to existing reserves in order to accommodate the proposed investment returns approach.

Public Notice
Public Notice is required before initially considering an investment policy as per *The Cities Act* Section 101(2). Although the City already has an Investment Policy, this recommendation is a substantial change to the current policy therefore, Administration determined it necessary to provide a Public Notice. As shown in Appendix 2, the following notice was given:

- Posted on the City's website on Friday, October 20, 2023; and
- Advertised in the Saskatoon StarPhoenix on Saturday, October 21, 2023.

NEXT STEPS
If Option 2 is approved, Administration will establish a revised Investment Policy for future City Council consideration.

APPENDICES
1. Eckler Ltd. Asset Allocation Study
2. Copy of Public Notice – Recommendation to Update Investment Policy

REPORT APPROVAL
Written by:	Spencer Janzen, Investment Manager
Reviewed by:	Jeremy Meinema, Senior Financial Business Partner
	Mike Voth, Director of Corporate Revenue
	Kari Smith, Director of Finance
Approved by:	Clae Hack, Chief Financial Officer

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