MUNICIPAL INVESTMENT INCOME POTENTIAL WITH PRUDENT INVESTOR

2018 AMO Conference

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TODAY'S MENU

- ***Appetizer*** Existing Duty of Care
- ***Main*** Process – Not Result
- ***Dessert*** Being Prudent is not new - 1830

SO …

1. A word about today's world
2. Prudent Investor – what is it?
3. How it works – in practice
4. Application to a Municipality

NOTA BENE – I am not a lawyer!

THE CURRENT RULES

- The Legal List
- Safe harbour - of a sort!
- BUT – you still have to be ‘careful’

WHAT IS PRUDENT INVESTING?

‘All that can be required of a trustee is, that he shall conduct himself faithfully and exercise a sound discretion. He is to observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income as well as the probable safety of the capital to be invested… Do what you will, the capital is at hazard.’

Extract of Harvard College vs Amory (1830) 26 Mass (9 Pick) 446

And in English – That Means

- Use ‘prudence, discretion and intelligence’
- ‘Manage their own affairs’
- ‘Do what you will, the capital is at hazard’!

The last one tells you it is about PROCESS – not RESULT

PRUDENT - FOR MUNICIPALITIES

Ontario Municipal Act, as amended

S. 418.1 (8) In investing money under this section, a municipality must exercise the care, skill, diligence and judgment that a prudent investor would exercise in making such an investment.

ENOUGH OF THE LEGAL STUFF

What do you actually do?

- Analyse needs
- Identify an investment solution
- Implement an investment plan

Pension Plans have been doing this for years!

THE PRUDENT PROCESS

For Municipalities that ‘qualify’

- Council passes a By-Law
- Council adopts an Investment Policy
- The Investment Board prepares an Investment Plan
- The Results are reported to Council at least annually

HOW NEEDS ARE ANALYZED

- Cash flow forecasting
- Asset management plans

Goal is to identify:

- Time horizon
- Liquidity needs
- Risk tolerance

A Word About Risk!

- Downside – loss of capital
- Return volatility
- Liquidity
- Taxing power
- Reputational

The investor must
- understand risk and
- define what risk is to them

INVESTMENT OPTIONS

Examples of Investment Needs

1. Cash needed in 2/3 years, high degree of certainty about timing and amount and no appetite for capital loss
2. Cash being set aside annually for a capital project in 5-7 years – but project may be delayed to 10 years. Council prepared to take risk for a higher return – but has a small tax base
3. Cash set aside for a 30 year sinking fund to retire debt. Initial pool of 10% with annual planned contributions. Council willing to take investment risk

Final Thoughts

- Today's Menu!
  - Appetizer — Existing duty of care
  - Main — Process – not Result
  - Dessert — It is nothing new

- What is the difference between investing this portfolio and pension fund – under the Prudent Investor Rule?

NOTHING – It is just the same!

Today's Menu

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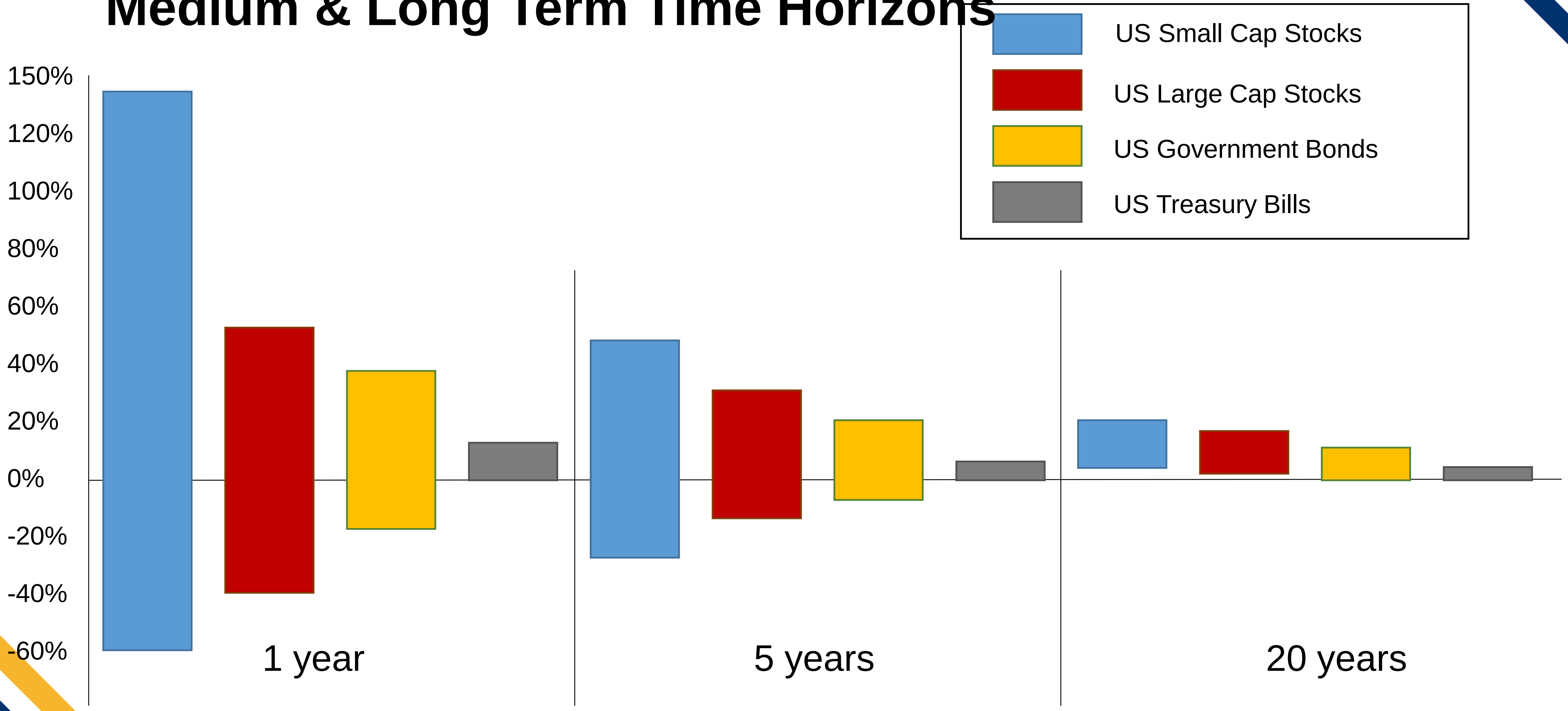
- ***Dessert*** Being Prudent is not new – 1830
- ***Coffee/Tea?*** Practical Applications of Being Prudent

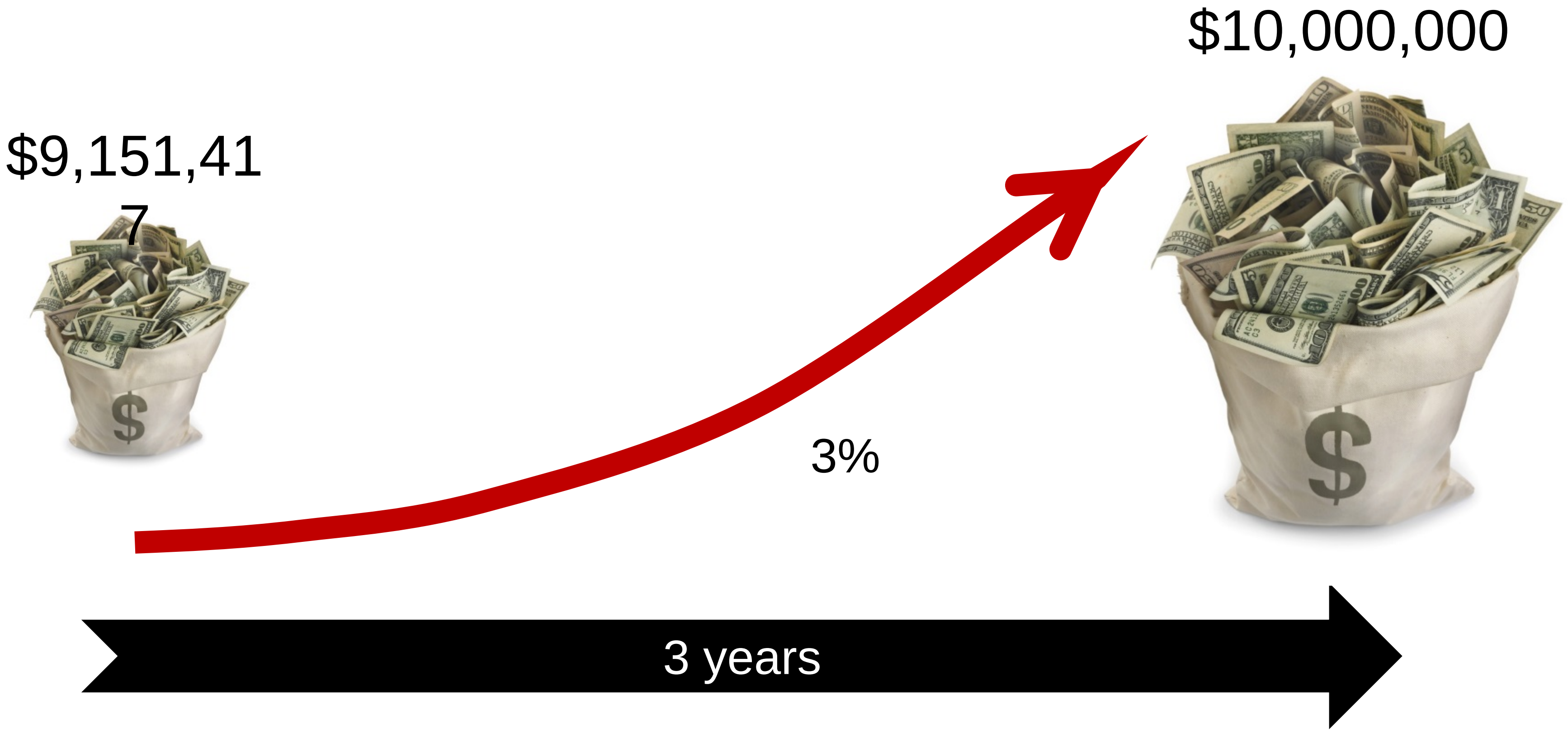
Range of Annualized Returns Over Short, Medium & Long Term Time Horizons



Approximation of the range of annualized Asset Class Returns between 1926-2010


Art
Science

SIMPLE BULLET PORTFOLIO



ASSET CLASSES

Cash or Cash Equivalents:

- Least volatile / safest
- Most liquid
- Lowest potential returns

Examples include:

- High Interest Savings Accounts (“HISA”)
- Liquid or Short term: GICs, Bonds, Money Market Securities
- Money Market Mutual Funds / ETFs

ASSET CLASSES

Fixed Income:

- Moderately volatile
- Risk / return are very issuer dependent:
  - Gov't debt considered risk free but lower returns
  - Corporate debt may offer greater returns but with increasing levels of risk.

Examples Include:

- Mid or Long term GICs & Bonds
- Mortgage funds,
- Principal Protected Notes ("PPN")
- Preferred Shares

ONE INVESTMENT

ASSET CLASSES

Equities or Stocks:

- Highest volatility,
- Highest potential returns over time.
- Risk /return are directly associated with the individual issuers business executions, economic cycle, etc.

Examples Include:

- Common Shares
- Equity Mutual Funds / ETFs

EXAMPLES OF INVESTMENT NEEDS

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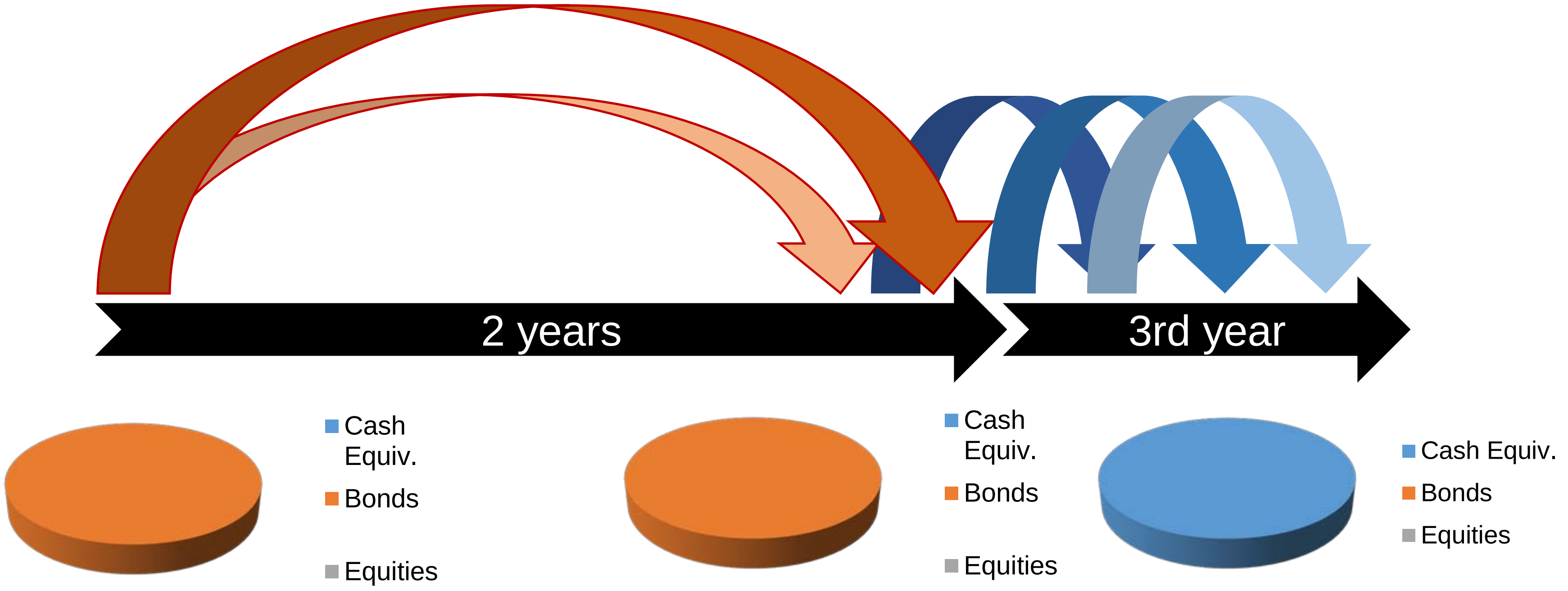
Example #1 Summary:

- **Time** - Cash needed in the next 2/3 years
- **Liquidity** - high degree of certainty about timing and amounts
- **Risk** - no risk appetite for loss of capital

Potential Products Utilized:

- 1-2 Year Fixed & Floating Rate **Bonds / GICs** issued by low risk issuers
- Target maturities around the 2- year mark to ensure funds are available
- If not initially required at 2-year mark use of **HISA, Short-term or Liquid GICs, Money Market Securities** to reinvest until needed

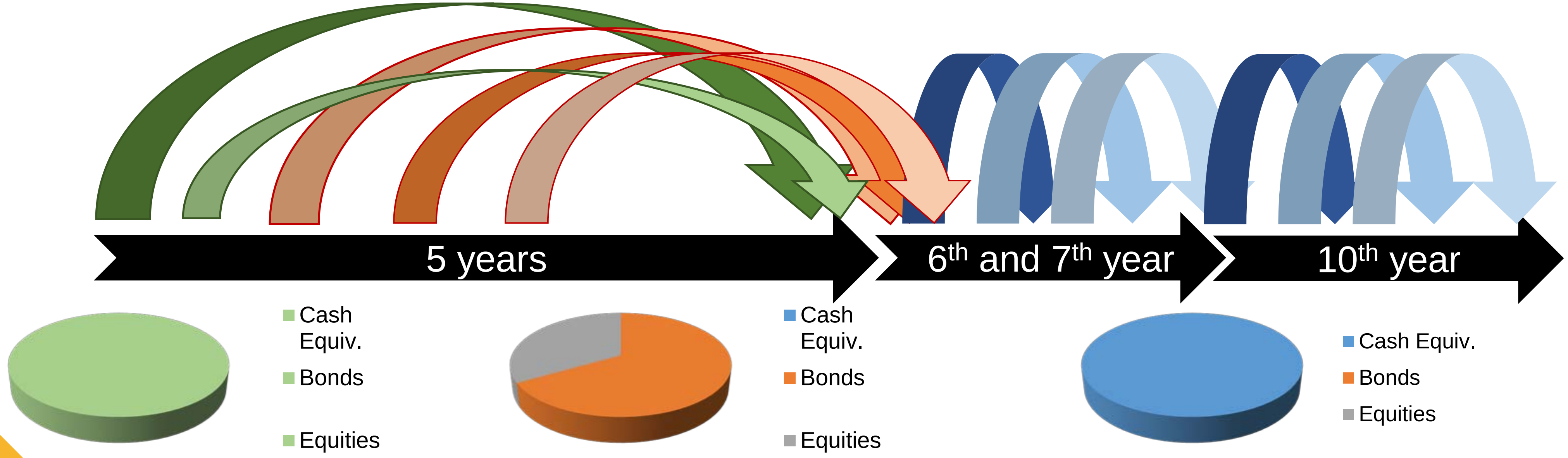


Example #2 Summary:

Time – Annual contributions for capital project in 5-7 years, *potentially 10 years*
Liquidity – Not initial required but increasing in 5th year out to potentially the 10th year
Risk – Open to risk to enhance return but sensitive to losses given overall financial flexibility.

Potential Products Utilized:

- Initial purchase of low **Risk/Blue Chip Equities** with first 1 or 2 annual contributions
- 3rd -5th contributions in **Fixed & Floating Rate Bonds / GICs** with maturities around the expected draw date.
- If not initially required in the 5th year use **HISA, Short-Term/Liquid GICs, Money Market Securities until drawn**



Example #3 Summary:

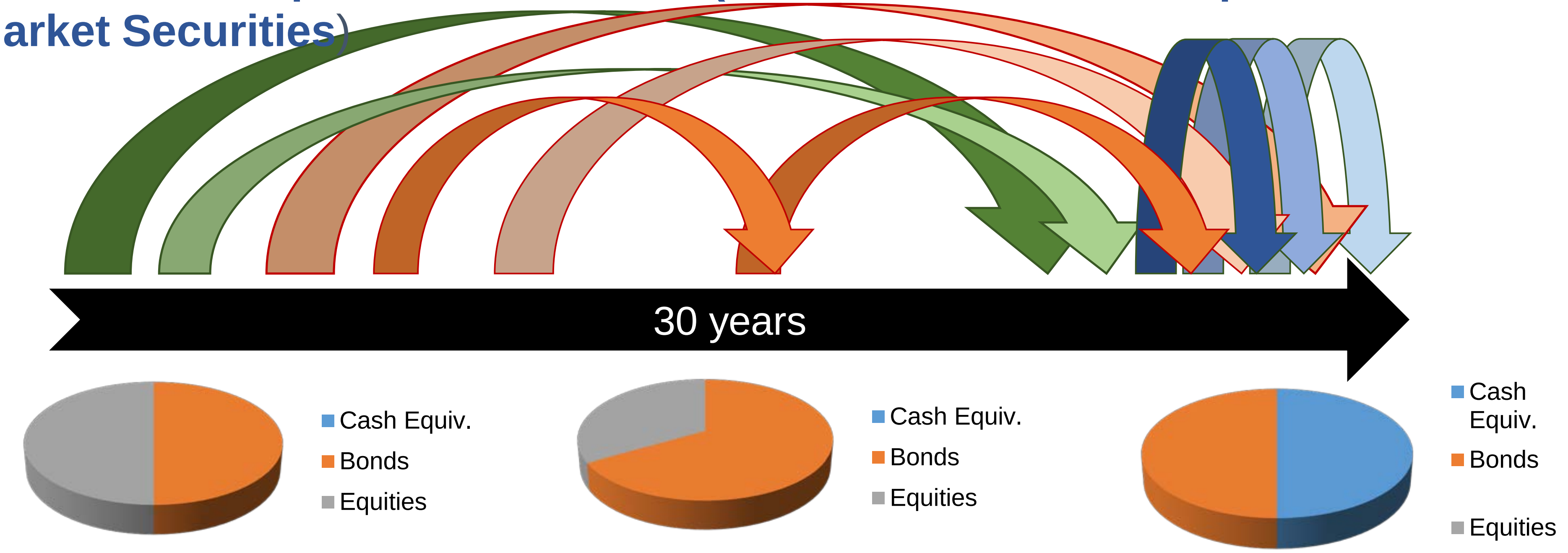
Time – Annual sinking fund contributions for a bond due in 30 years.

Liquidity – Low/ hopefully nonexistent given only on default will the funds be required early.

Risk – Conservative return assumption used.

Potential Products Utilized:

- Initial 10-20 years of purchases a combination of **Low Risk/Blue Chip Equities** and **Bonds** with a good portion of the maturities matching the debt maturity, with the equity purchases subsiding over time.
- In the last 10 years the equity portion of the portfolio should be replaced with **Short Term Bonds** & **Cash Equivalent Securities (HISA, Short-Term or Liquid GICs, Money Market Securities**)



FINAL THOUGHTS

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- ***Coffee/Tea?*** Practical Applications of Being Prudent

What does the introduction of the Prudent Investor Rule mean to the investment solutions available to Municipalities?

Just more colors for your inner-artist to create the right Investment Solution for your unique Investment Needs

ONE INVESTMENT

ONE's New Business Model - Prudent

Access to prudent investing via new pooled funds for small, rural, northern municipalities

Transition to the new investment through educational tools:

- Newsletters on new legislation and prudent investor standard
- Investment Basics seminars
- Communications through your municipal associations - AMO and MFOA

ONE's New Business Model - Prudent

Work with experts (retired municipal treasurer + CFA Charterholder) who will advise on:

- By-Law change (required*) for opting in to Prudent Investor Standard
- Asset Management, Cash Flow planning: building a capital financing strategy
- Investment education
- Recording risk tolerance, investment knowledge, financial position for best investment outcomes
- Investment Policy Statement (IPS) (required*): target asset allocation and allowed range

* Required by legislation

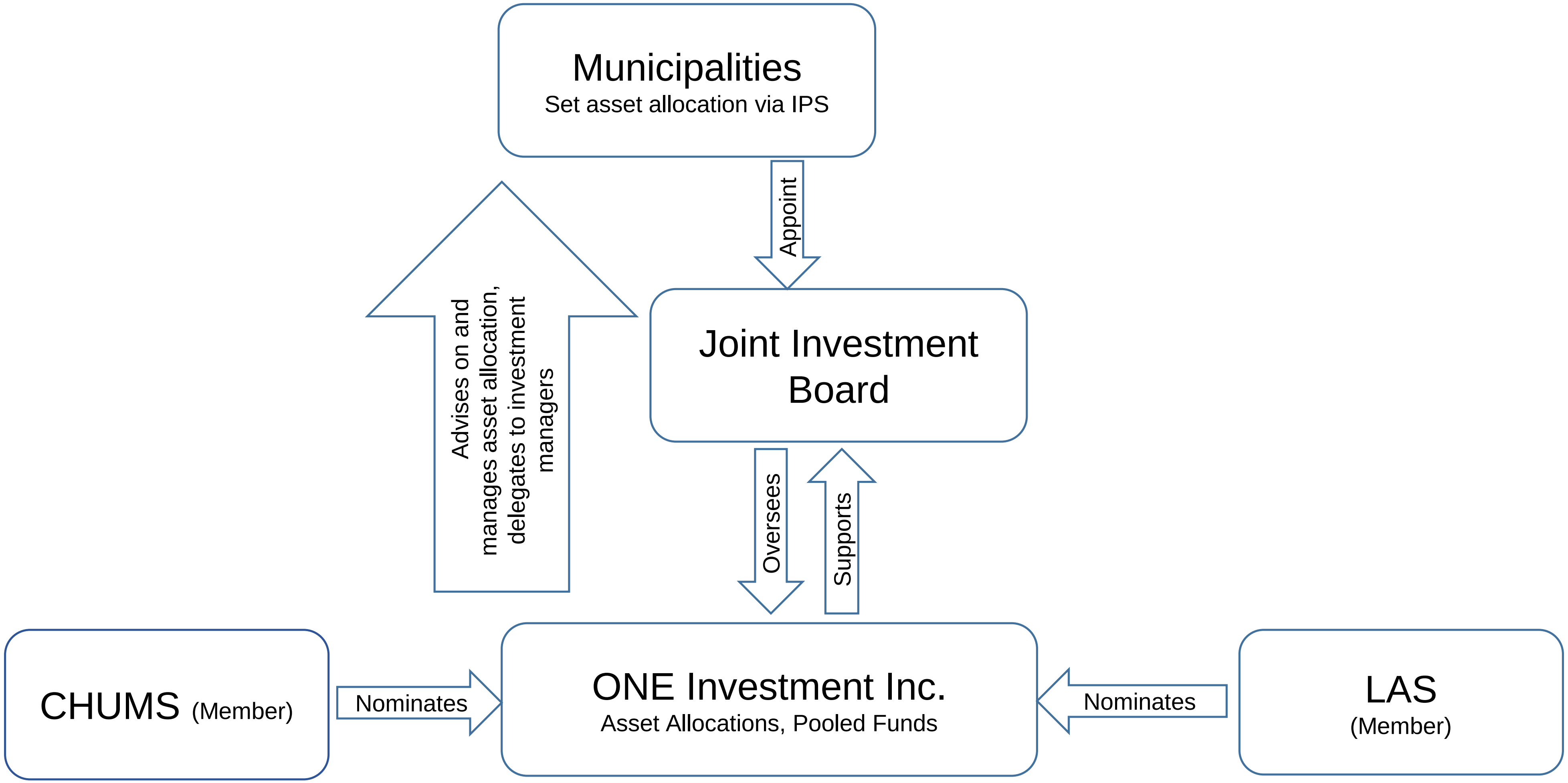
ONE'S NEW BUSINESS MODEL - PRUDENT

Establish a Joint Investment Board (JIB) who will:

- Ensure adherence to the IPS
- Develop, implement an Investment Plan (required*) showing target holdings and timing
- Develop asset class strategies and oversee investment managers

* Required by legislation

Prudent Investor Governance



WHAT SHOULD YOU DO ABOUT INVESTING?

Council- ask questions when:

- Reviewing municipal investments, the investment policies and municipal investment objectives
- Reviewing the municipal asset management plan

Staff:

- Anticipate council questions
- Monitor the ONE Investment newsletters
- Don’t feel rushed to have to decide about prudent investor standard
- Don’t put it on the back burner – this is a lot of work!

Contact us if you have any questions/issues

THANK YOU

QUESTIONS?