City of Burnaby

Meeting 2021 Nov 17

COMMITTEE REPORT

TO:	CHAIR AND MEMBERS FINANCIAL MANAGEMENT COMMITTEE	**DATE:**	2021 November 09
FROM:	DEPUTY CHIEF ADMINISTRATIVE OFFICER & CHIEF FINANCIAL OFFICER	**FILE:**	7500-01

SUBJECT: **EXPANDING INVESTMENT OPPORTUNITIES**

PURPOSE: To provide an update on alternative asset class investing with the Municipal Finance Authority of British Columbia.

RECOMMENDATION:

1. **THAT** the Financial Management Committee recommend Council receive this report for information.

REPORT

1.0 INTRODUCTION

On 2019 April 29, Council approved the submission of a resolution for the 2019 Union of Municipalities British Columbia (UBCM) convention, seeking changes to section 183 of the Community Charter to allow municipalities increased investment flexibility beyond the prescribed legislated methodology. The goal being the expansion of asset class investments through prudent investment standards as a means of reducing portfolio risks while ensuring long term municipal financial sustainability.

While ultimately declining to make a change to the Community Charter, the Ministry of Municipal Affairs and Housing noted in their response the prescribed list of investments for municipalities which are available through the Municipal Finance Authority of British Columbia (MFA) pooled investment funds. Municipalities should work with the MFA to identify ways of meeting our investment needs and goals. In anticipation of this response, the MFA and City of Burnaby began the engagement process, obtaining a legal opinion and exploring options for the creation of a new pooled investment fund under the existing legislation. After the UBCM response, the team held multiple meetings with the Inspector of Municipalities, Provincial Ministry, Department of Finance, and other municipalities and local governments to provide information and communicate the intention to create the new fund under the existing prudent standard legislation available through the MFA Act and Trustee Act in British Columbia.

City of Burnaby staff have been engaged with the MFA for over four years to provide feedback, input, support, and risk mitigation measures for the creation of a sanctioned and diversified asset class fund for all British Columbia local governments. Council received updated reports on the progress of the provincial review and activities related to the creation of the new fund on 2020 March 11, 2020 October 14, and the 2020 investment review memorandum dated 2021 February 22.

2.0 POLICY SECTION

Goal

- A Connected Community
  - Partnership –
    Work collaboratively with businesses, educational institutions, associations, other communities and governments
- A Dynamic Community
  - Economic opportunity –
    Foster an environment that attracts new and supports existing jobs, businesses and industries
  - Community development –
    Manage change by balancing economic development with environmental protection and maintaining a sense of belonging
- A Thriving Organization
  - Financial viability –
    Maintain a financially sustainable City for the provision, renewal and enhancement of City services, facilities and assets

3.0 DIVERSIFIED MULTI ASSET CLASS FUND

3.1 Fund Governance

An agreement in principal has been reached between the MFA and the Provincial Government for the creation of a new investment pooled fund called the Diversified Multi Asset Class (DMAC) Fund. It has been agreed that existing legislation provides MFA with the authority to create this diversified asset class fund based on prudent investment standards. An understanding between the MFA and the Province sets out guidelines and controls for the monitoring, participation and parameters for which a municipality or local government can invest in the new fund.

The diversified fund is not precluded from investing in any investment types or geographical exposures and can therefore invest in assets such as global equities, bonds, mortgages, infrastructure debt, private equity, and other fixed income products and assets. This diversification is purposeful as it mitigates inherent risks in such a portfolio, and risk is further mitigated through an intended long-term holding period by an investor. This means a municipality must have a clear understanding of their short and long term operating and capital costs and reserves, and enter into such an investment for a period of ten years minimum. In addition, the fund will set a maximum investment limit of 25% of a municipality’s eligible reserves for municipalities with a population greater than 10,000 residents.

The MFA has set up a list of criteria and questionnaires to help ensure that a municipality has a clear understanding that the fund is intended only for long-term investments and will exhibit higher short-term volatility in returns with the benefit of higher expected long-term returns. This criteria includes updated municipal policies and procedures, a review of reserves and reserve balances, and a long-term capital forecast. It is important to emphasize that as professional institutional investors, the ultimate responsibility for suitability of any investment lies with the local government. It is therefore critically important that municipal staff and Council discuss and be keenly aware of the risks of such investments and the need to commit funds for the long term. One of the biggest risks in investing for the long term in growth assets such as equities is the propensity for investors to panic during inevitable market corrections and sell the funds prior to when they were intended to be used, thereby crystalizing paper losses. Updating internal policies and providing ongoing communications to the current and future Councils will be key components to ensure transparency; and to ensure the City's long-term investment timeframe and goals for investing in the DMAC is maintained, even during turbulent markets.

3.2 Fund Creation and Management

In 2021 April, a Request for Proposal (RFP) was issued by the MFA seeking a firm to act as the Outsourced Chief Investment Officer (O-CIO) for the new investment fund. The MFA currently offers municipalities and local governments five investment pooled funds to invest, all currently managed by PH&N, a subsidiary of Royal Bank of Canada.

- Money Market Fund - For investments 0 to 24 months.
- Govt. Focused Ultra-short Bond Fund - For investments 0 to 24 months.
- Short-term Bond Fund - For investments 2 to 5 years
- Fossil Fuel Free Short-term Bond Fund - For investments 2 to 5 years
- Mortgage Fund - For investments 3 plus years

The RFP process has been a collaborative effort conducted by a team of MFA staff, the Capital Regional District, the City of Burnaby and a consultant. Ultimately, the final responsibility for hiring an O-CIO/Asset Manager based on recommendations from this RFP advisory team is that of the MFA Trustees. The RFP team conducted an exhaustive process to find the best possible firm/manager for this new fund, taking into consideration many factors including fees and costs, historical performance, risk management and breadth of knowledge and offered investment products. A total of sixteen O-CIO's and Asset Managers responded with varying models and strategies including fund of funds approach and diversified asset management representing both passive and active approaches to investing.

Respondents to the RFP were required at a minimum to manage at least $10 billion in assets, be a United Nations Principles for Responsible Investment (UN PRI) signatory, and be Global Investment Performance Standards compliant. The RFP also required proponents to submit their recommended portfolio mix to achieve an expected return of 5.5% per annum over the long run and to provide comment and data related to investing based on responsible investing strategies, whether through investment exclusion or other guidelines and metrics.

The DMAC fund will be managed under an Environmental Social and Governance (ESG) framework using the United Nations Principals for Responsible Investing (PRI), which is the world's leading proponent of Responsible Investing. Signatories of the PRI follow six key principles and incorporate those into their processes. ESG factors must be incorporated into the fabric of the investment selection process for the DMAC in addition to the financial review when evaluating potential stocks for a portfolio. Other responsible investing strategies will also be employed, including an active stewardship program and proxy voting where a Corporate Governance & Responsible Investment group monitors company governance issues and conveys the asset manager's views on material concerns.

The MFA Board of Trustees has announced the hiring of PH&N as the Asset Manager for the new DMAC Investment Pool Fund. PH&N was founded in Vancouver, BC in 1964 specifically to provide investors with active investment management, transparency of operations, and a more modest fee structure on assets invested; thus providing investors with more options and lower costs than the existing landscape of brokerage and insurance firms. In 2008, PH&N was acquired by the Royal Bank of Canada, expanding the depth and breadth of liquid and alternative investment strategies available to investors. Today, PH&N oversees over $130 billion in assets globally for clients, utilizing over 300 investment professionals and 23 investment teams. PH&N is a UN PRI signatory and will incorporate ESG review for each investment in the DMAC fund.

Preliminary discussions with PH&N and the Trustees for portfolio asset diversification has identified the opportunity for the DMAC fund to hold 44% of the portfolio in fossil fuel free investments by employing an exclusionary screen without compromising expected return or risk. This is a great opportunity to include this strategy at inception and align with the City's views on climate risk, while ESG and Socially Responsible Investment (SRI) standards continue to develop for a consistent set of metrics utilized by all asset managers globally.

The behind the scenes work will continue, completing asset build, negotiations, signing agreements, setting up custodianship, authorizations, settlement and many other components needed to operate and report on the fund net asset value. The target go-live for the DMAC is 2022 January.

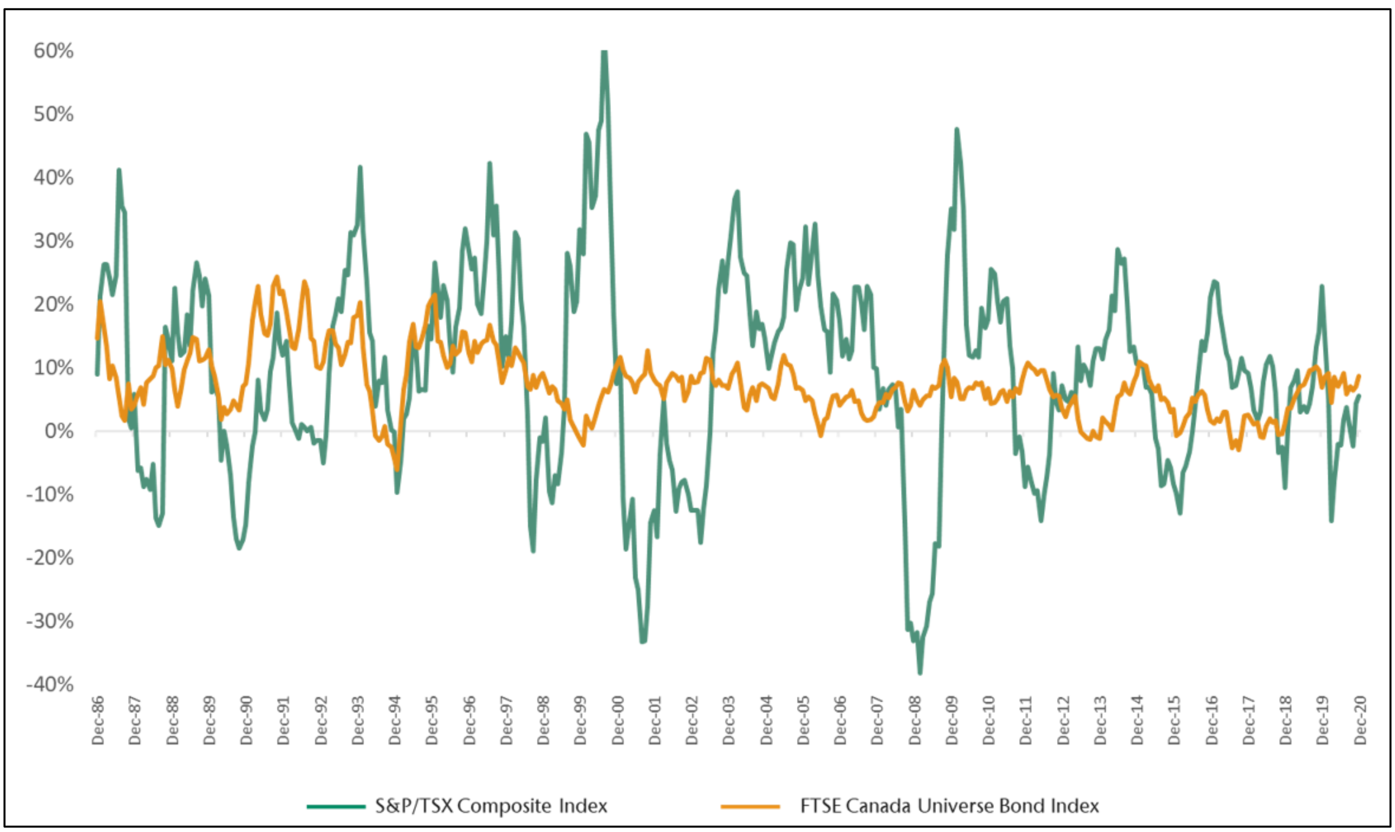
3.3 Markets, Risks and Investing

As supported by Council nearly three years ago, the exhaustive and collaborative work of the RFP team and MFA to create a new investment fund with additional asset class diversification is coming to fruition. While the City will be the seed investor into this fund, the nature of the underlying assets can now provide for long term portfolio growth and financial stability of all local governments throughout BC, not just the City of Burnaby.

Any fund or investment, but especially one comprised of global growth assets, will be more volatile in the short term than over the long term. If one is able to ignore the short term volatility and understand the history of capital markets and investments over the long term, one can attain improved risk adjusted returns that beat inflation expectations, and risks can be mitigated. The annual targeted returns for this fund over ten years is 5.5% per annum. As an investor, the City must take into account that money in the DMAC is no longer available to assist for short-term liquidity purposes and is committed to a longer time horizon.

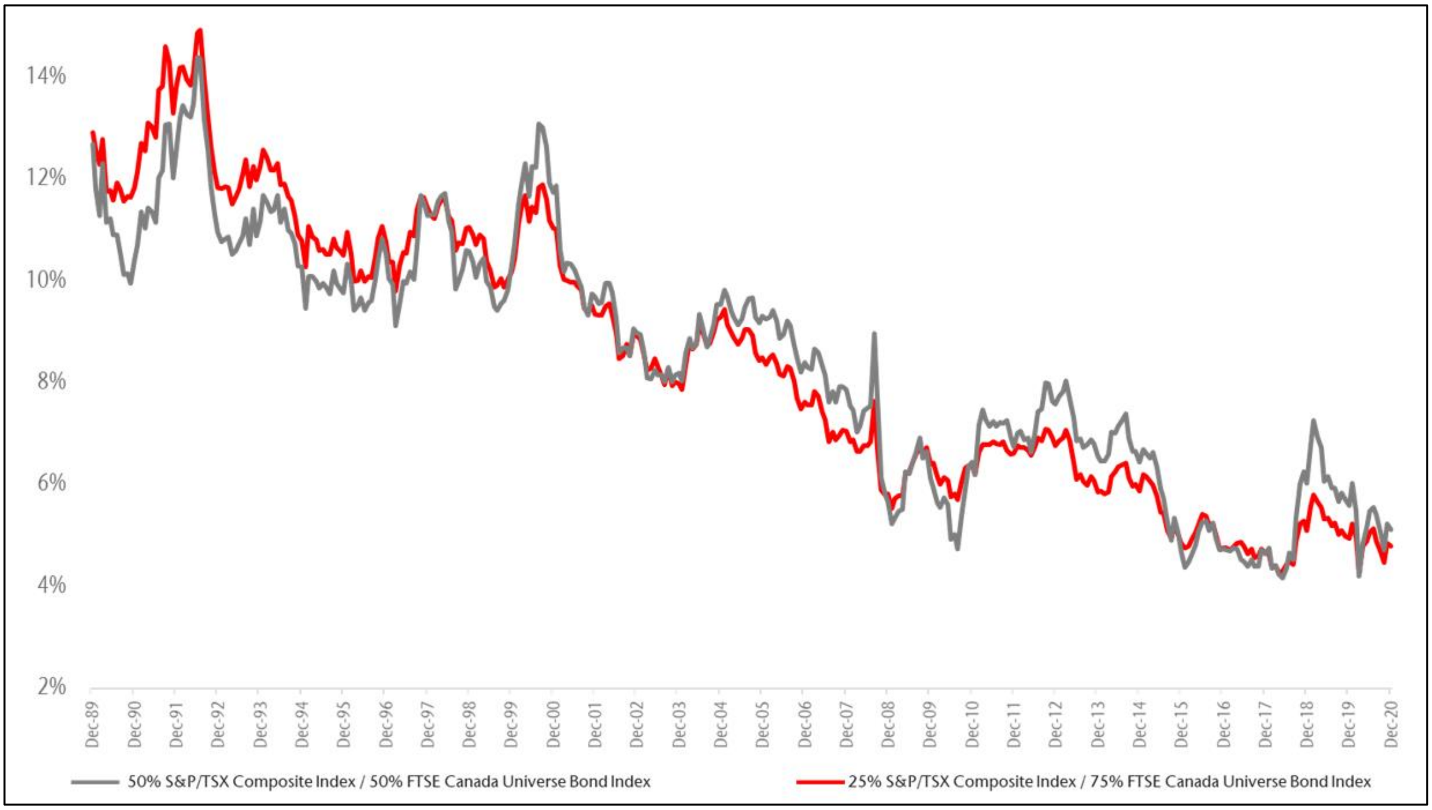
Graph 1 shows the comparison between Rolling 1-Year Periods of Stock and Bonds. The green line represents the S&P/TSX Composite Index (stocks) and the yellow line represents the FTSE Canada Universe Bond Index. Stocks shown on a 1-year rolling period can have significant volatility where as a pure bond index has less volatility.

Graph 1: Rolling 1-Year Periods



Looking at these distinctly different asset classes returns over short time periods can naturally lead most local governments to focus primarily on fixed income securities in order to minimize the possibility of extreme gains and losses. However, if one does not need funds for the long term, and can effectively mitigate the risk of selling early, investments in growth assets such as equities are best suited to offer returns above inflation – which is certainly not the case with bonds in the current ultra-low rate environment. A great way to illustrate this point is to look at historical returns over longer periods. As shown in Graph 2, the rolling 10-year returns remove the daily, monthly and annual volatility to show long term investment returns of equities.

Graph 2: Rolling 10-Year Periods



As experienced in 2020 March, equities and other investment assets dropped significantly, between 30% and 40%, depending on the index and sector. As asset prices started dropping, skittish investors fled the market, which increased market volatility and compounded the continued downward spiral. History has taught us time and time again that selling investments during these sharp contraction periods is ill advised, yet history is also full of stories of both retail and sophisticated investors making impulse decisions to sell and crystalize losses. In March/April of 2020, like many time periods in the past, those investors that stayed the course and stuck to their original investment goals of holding for the long term have seen their growth assets recover and grow more. In the most recent case, it took just 18 months.

Investors with professional portfolio managers benefited from leaving the funds fully invested and many further benefited from allowing portfolio adjustments made by the managers during the difficult period. Many good managers shifted holdings – within client predetermined guidelines – into more equities to capitalize on lower share prices of well managed companies. This is critically important to understanding that less sophisticated asset owners will want to sell during these panic periods, but staying the course will provide long-term financial benefits and compounding of interest and returns.

Various metrics and valuation methods – such as Value at Risk (VaR), Conditional Value at Risk (CVaR), Standard Deviation, Sharpe Ratio, and others - are calculated and analysed when building a diversified portfolio such as the DMAC. Previous results of the model portfolio and future projections are stress tested using multiple market scenarios. Such statistics are used to measure the designed portfolio risk over a period of time. Usually for a long term fund like the DMAC, a period of one year is used to define the risk variance. For an increase in expected return, there is an increase in risk and volatility. These metrics provide the fund Trustees and investors a gauge to determine acceptable levels of portfolio risk.

For example, VaR is a risk measure which helps us understand how much value a portfolio might lose in a worst-case scenario in a given year – such as a 12% loss of value over the next one year period in the worst 5% of possible market outcomes. The Sharpe Ratio is a measure of how efficient a portfolio is taking risk. Sharpe is a volatility-adjusted performance measure which incorporates both expected return and VaR and CVaR values. These measurements are important because many variations of portfolio holdings can then be compared side by side to find the appropriate level of risk for a given target return of 5.5%. Determining an appropriate threshold for these metrics will be a key decision for the MFA Trustees to reach a consensus on. It will serve as the bedrock in determining the acceptable level of risk that the proposed fund may be willing to accept. While a final portfolio has not yet been determined, as tools to measure risk, the asset manager will continue to communicate risks associated with an evolving fund and these risk measurements for the entire duration of the fund. It is a constant measure and re-measure of risk mitigation and strategy. MFA staff, its Pooled Fund Advisory Committee and its Trustees will be actively monitoring these risk metrics, market developments, and the performance of its chosen asset manager for the DMAC fund.

Global diversification is especially important to maximize risk-adjusted returns in growth portfolios. The Canadian capital markets are very concentrated, representing less than 3% of global domestic product. A global approach is more diversified and less risky than a narrow or country-specific one. A global approach accounts for performance rotation, with sectors exhibiting differing growth opportunities over time and uncorrelated country-specific economic cycles. No region or asset class is inherently superior and leadership rotates frequently. A global approach increases opportunities to outperform and mitigates country-specific risk factors, like political, economic or legislative risks.

A well-diversified portfolio, which may be comprised of stocks, bonds and hard assets like real estate and commodities, is critically important. Spreading invested funds across multiple market sectors and asset classes allows an investor to ride out downturns with less volatility than that experienced in more narrow investment asset classes. It is also important that investors have a certain amount of liquidity available within an investment portfolio. The City has set aside and maintains liquidity in both short term and sellable fixed income products – and so will be able to "ride out" performance variability in the DMAC fund. The DMAC will also itself maintain some liquidity, which will not overly limit growth potential, but in fact leaves adequate flexibility for the asset manager to increase returns. However, that liquidity is maintained within the fund and will not be available to investors unless they sell units of the DMAC. A combination of investing into the DMAC as well as the other MFA pooled funds and maintaining our current directly invested portfolio management strategies - can bring long term benefits to overall value of the City's investment portfolio – in terms of enhancing returns and managing overall risks

Once invested in the DMAC, the City's financial statements will be modified slightly to meet Public Account Board Standards reporting guidelines. The statements will emphasize any gains or losses of the DMAC holdings at the end of the fiscal year based on fair market value. These requirements provide transparency for the assets held. It is in this reporting that the short term volatility of long term holdings will show most prevalent. It is a snapshot in time that may not always represent the long-term investment vision positively when a market correction has occurred. Staying the course will be paramount.

As the lead investor into the DMAC fund, the City of Burnaby will invest $350 million which represents 18% of the City's total investment portfolio. This amount is under the Province's guidelines for a maximum of 25% reserve investment by a municipality. As we get closer to the initial investment date, the City, the MFA, and asset manager PH&N will discuss the current investment environment and economic cycle to determine the best deployment strategy of the City's funds. This may be an immediate investment the first week or an approach that may prolong full investment over a few months.

Other municipalities have shown keen interest in diversifying their holdings and the fund is expected to grow over time. While the total size of the future portfolio is unknown, it is estimated the fund could reach $750 million to over $1 billion in assets within a few years.

4.0 SUMMARY

From the initial request to Council in 2019 April for the support of a UBCM resolution to introduce further portfolio asset diversification, the MFA, City staff, and other partners have worked diligently to create a new MFA pooled fund. Sixteen proponents responded to the RFP with PH&N being selected as the DMAC fund asset manager.

While the investment firm has been selected, there is plenty of work to complete before the fund goes live which is targeted for 2022 January. Portfolio design, risk measurement, custodianship, reporting, investor limits and controls, and many more aspects of the DMAC will be decided in the coming weeks. These decisions include the opportunity for fossil fuel exclusion screening for approximately 44% of the portfolio; which is in addition to the required Environmental, Social and Governance framework using the United Nations Principals for Responsible Investing.

The City of Burnaby will be investing $350 million of our reserve funds into the DMAC in 2022. The deployment of these funds has yet to be determined and may be on the go-live date or over an extended period of weeks or months. We will not be trying to "time" the market, but will rely on the asset managers suggested approach and guidance based on current market conditions and investment theory.

This report has been provided for information purposes.

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Copied to: Chief Administrative Officer