REPORT

To: ONE Joint Investment Board
From: Keith Taylor, Chief Investment Officer, ONE Investment
Date: November 29, 2023
Re: Review of Investment Allocations Associated with the Outcomes Framework
Report: ONE JIB 2023-077

1. RECOMMENDATIONS

It is recommended that the Board:

1. Direct the Chief Investment Officer to prepare analysis to support a revision of investment allocations associated with the Outcomes Framework to increase fixed income allocations.

2. SUMMARY

Interest rates have increased dramatically since the ONE JIB was established in May 2020. The investment allocations of the Outcomes Framework that were established at that time were aligned with municipal goals and objectives. To attain reasonable returns, some investment risk was assumed to achieve the return goals of the Participating Municipalities.

Since ONE JIB was established, there have been significant changes in the economic outlook and the interest rate environment. Yields available on bonds are at least two percent higher than when the ONE JIB was established. As the returns available on investments are dramatically different today, a review of the allocations associated with the Outcomes Framework is appropriate. It is likely that the investment goals of Participating Municipalities can be achieved with heavier allocations to fixed income, which would also result in lower risk investment allocations. The Chief Investment Officer is recommending a review of these allocations in light of this.

3. BACKGROUND

The ONE JIB Outcomes Framework Policy provides principles for the review of the Framework and associated investment allocations

The Outcomes Framework Policy approved on September 6, 2023, details considerations that are relevant for the review of investment allocations associated with the framework. These considerations include:

- General economic conditions;
- The possible effect of inflation or deflation;
- The role that each investment or course of action plays within each outcome;
- The expected total return on investment and appreciation of capital; and
- Needs for liquidity, regularity of income and preservation or appreciation of capital based on the objectives of the outcome

The economic environment has changed significantly from when ONE JIB was launched, making it appropriate to review the investment allocations

The investment allocations used in the Outcomes Framework were established when ONE JIB was established in May 2020, when the economic and capital markets outlook was very different. Considering this, it is appropriate to evaluate whether the investment allocations of the Outcomes Framework remain appropriate or if they should be reviewed and updated.

The Outcomes Framework Policy provides for regular review of the investment allocations that include annual review, which can be accelerated based on the recommendation of ONE JIB members or the CIO.

The full details of the Outcome Framework Policy is available here: ONE JIB Outcomes Framework Policy

The ONE JIB was established in May 2020, shortly after a global pandemic emerged in and economic environment and capital market outlook that is dramatically different

During the Cororavirus-19 pandemic, to slow the spread of the virus, working from home became common, supported by government imposed stay at home orders. Employee working patterns and spending patterns suddenly changed. This created concerns that demand for goods and services would diminish, potentially causing a global recession. In the wake of the pandemic there were also concerns that prices of goods and services would fall, a situation known as deflation. Interest rates dropped dramatically in early 2020 as central banks intervened to bolster growth.

A recession was averted, but the fiscal and monetary stimulus provided to support economic activity led to a spike in inflation pressures, and in Canada, inflation peaked in mid-2022 at 8.1%. This led to aggressive rate hikes by the Bank of Canada and other global central banks, which have significantly changed the interest rate outlook. The Bank of Canada policy interest rate has increased from 0.25% in 2020 to 5.5% today. This dramatic increase in interest rates directly affects the returns available for the Participating Municipalities. These higher yields imply higher returns from fixed income. This changes the relative attractiveness of fixed income versus equities in the allocation. It may be appropriate to evaluate if the investment allocations should be revised to increase fixed income allocations to take advantage of this; larger allocations to fixed income may be appropriate.

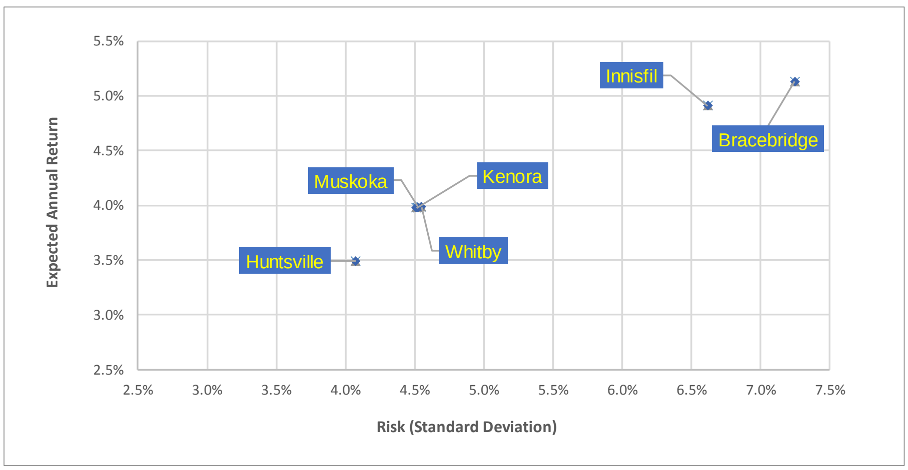
4. ANALYSIS

The return expectation provided by ONE to Founding Municipalities in May 2020 help to inform the investment goals of municipalities

ONE of the key reasons for municipalities to consider investing via the Prudent Investor regime was the prospect of higher returns. When ONE JIB was founded, long-term, forward looking return estimates were provided to the Founding Municipalities in ONE JIB reports. These estimates were typically higher than returns available in a Legal List portfolio with similar levels of investment risk. This was the primary reason for Founding Members to join ONE JIB: to attain higher risk-adjusted returns than are available under the Legal List. While there have been some changes in the circumstances of the Founding Municipalities, their investment goals and objectives are broadly similar today as they were when the ONE JIB was formed.

On May 20, 2020, a summary of the investment assumptions for Founding Municipalities, was included in the "Fund Offerings and Investment Managers Report". The returns provided in that report reflected the projected long-term returns expected from Founders' consolidated holdings based on the draft Investment Plans. The returns provided in that report are detailed in Chart 1 below.

Chart 1 – Projected returns from Founding Municipalities – as presented in May 2020 report



	Return	Std Dev
Bracebridge	5.1%	7.2%
Huntsville	3.5%	4.1%
Innisfil	4.9%	6.6%
Kenora	4.0%	4.5%
Muskoka	4.0%	4.5%
Whitby	4.0%	4.5%

Source: ONE Investment – Note that these projected returns are no longer valid.

This provides some perspective on the returns required to meet the investment goals of the Founding Municipalities at that time. These returns in May 2020 ranged from 3.5% to 5.1%. Arguably, the returns required to meet the municipal investment goals should be similar today. While the projected returns in Table 3 are very stale and no longer valid, it is interesting that all the returns that were presented at that time are at or below the yields that are currently available from fixed income investments.

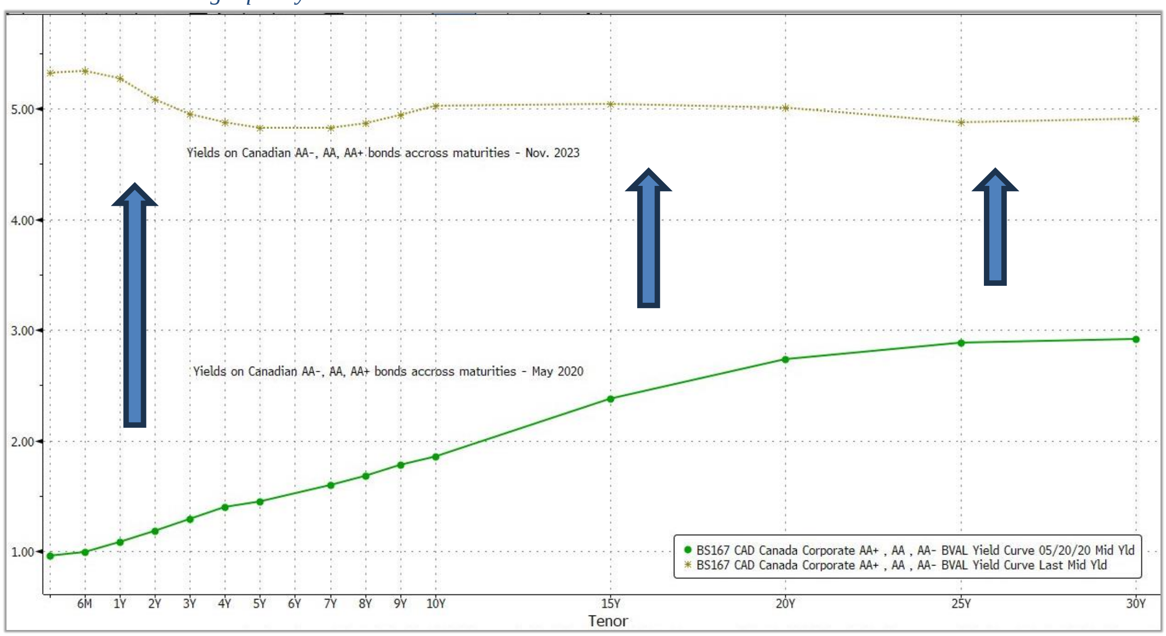
Yields have increased by more than 2% since ONE JIB was formed and now bond yields in excess of 5% are available from fixed income investments.

The asset allocation ranges of the Outcomes Framework were determined before the ONE JIB was launched in May 2020. At that time, bond yields were much lower than today, so to achieve the projected returns in Table 1 above, significant allocations to equities, which typically generate higher returns than fixed income, were required. Equities also tend to have much higher volatility and are considered higher-risk investments than bonds.

Bond yields at the time of ONE JIB's launch were in the range of 1% to 3%, depending on the bond maturity. Chart 2 below shows the bond yields at the time of the establishment of ONE JIB and also shows where yields are presently. Chart 2 shows the yield curve of Canadian AA-, AA and AA+ bonds across both long- and short-term maturities. Bond yields are at least 2% higher today across the whole curve, and for shorter bond maturities, yields have increased by about 4%.

A dramatic change in the yields available on fixed income should provide a strong reason to review the asset class allocations within the Outcomes Framework. If bonds have lower volatility than stocks, and yields have increased by 2% or more, increasing fixed income allocations may be able to attain expected returns at or above the 3.5%–5.1% range while simultaneously lowering the risk profile of all of the ONE JIB outcomes.

Chart 2 – Yields on high quality bonds around 5% across all maturities well above levels when ONE JIB was launched.



Source: Bloomberg LLP

ONE Investment pooled fixed income funds are already providing yields above 5%.

Table 1 below provides a summary of the key metrics for the ONE Investment fixed income pooled funds. The yield-to-worst metric in the table provides an indication of the return that the bonds in the funds would generate if they were held to maturity (or call). The average yield to worst for all ONE Investment fixed income-oriented funds currently exceeds 5%.

Table 1 – Yields and key characteristics of ONE Investment fixed income oriented funds

	ONE Global Bond Fund	ONE Canadian Government Bond Fund	ONE Canadian Corporate Bond Fund
Yield to Worst	5.32%	5.16%	5.32%
Duration (years)	5.23	1.02	4.83
Average Credit Rating	A/A-	AA	AA-
Canadian Dollar exposure	71.2%	100%	100%

Source: MFS Investment Management, Manulife Investment Management

Returns in excess of inflation levels is one of the goals of Participating Municipalities. Bond yields are currently well above inflation levels.

While some investors seek to maximize investment returns and are willing to assume high levels of risk to achieve this, municipal investors are typically very risk averse. It is appropriate to consider ways to meet their investment goals while emphasizing the minimization of risk. Inflation is a consideration for Participating Municipalities relevant to their investment goals. Being able to achieve returns that exceed inflation levels is one of the key investment objectives. Real returns, the returns in excess of inflation levels, are a key consideration, and for bond investors, this means real yields are relevant.

Interest rates have increased dramatically over the last 18 months, with yields much higher across the entire yield curve, but inflation has increased less. Real yields have increased as a result. Trends in real yields can be observed in inflation linked government bonds, as shown in chart 3 below. Real yields are currently above 2%, higher than they have been in over a decade. The implication is that bonds currently offer a return potential that significantly exceeds inflation levels. The goal of achieving returns in excess of inflation can be achieved with a heavier allocation to fixed income.

Table 1 – Canadian Real Return Bond Yields

Source: Bloomberg LLP

Increasing fixed income allocations should reduce the volatility of returns in investment allocations

Because bonds tend to have lower risk than equities and typically provide diversification benefits, their role in investment allocations is to provide more stability to investment returns. They help to dampen the overall volatility in returns for investment portfolios. The higher yields that they currently offer provide an opportunity to reduce risk levels in allocations while still achieving the key investment objective: growth in MNRI balances that outpaces inflation. The absolute returns that bonds currently offer are already at levels that should satisfy the objectives of Participating Municipalities, so larger allocations to fixed income should reduce risk, increasing the probability of client investment goals being achieved.

5. CONCLUSION

Due to the level of current interest rates (both nominal and real interest rates), the Chief Investment Officer is recommending that the ONE JIB investigate a revision of the investment allocations in the Outcomes Framework. Investment goals of the Participating Municipalities can be achieved by increasing allocations to fixed income, which would result in an overall reduction in the risk levels associated with Participating Municipality's investments. This should increase the probability of achieving the investment objectives of the Participating Municipalities.

Drafted by: Keith Taylor, Chief Investment Officer