



Bringing Our Vision To Life

INVESTMENT COMMITTEE
ANNUAL REPORT
2012



INVESTMENT COMMITTEE ANNUAL REPORT 2012

The Investment Committee oversees the City of Edmonton's investments, balancing the desire for maximum return with a prudent level of overall risk. By continually monitoring the City's investment program and implementing changes as necessary (see Key Projects in 2012 on page 12), the committee ensures that the funds are well-positioned and appropriately invested to meet their objectives.

More information on the Investment Committee and the role of City Council is available on pages 11-13. The City's Investment Policy and Procedures, including asset allocation policies, investment principles and guidelines can be found at www.edmonton.ca/investmentpolicy.

Overview

- In contrast to the declines seen during the previous year, the world's major markets posted positive returns in 2012.
- Performance of the City of Edmonton funds ranged from a low of 1.2% (Money Market Fund) to a high of 9.9% (Ed Tel Endowment Fund), depending on each fund's asset mix (see Fig. 3-2, page 3).
- All of the funds outperformed their benchmarks in 2012.
- On a four-year basis, absolute returns have been strong and relative returns have been good with most of the investment funds outperforming their policy benchmarks (see Fig. 3-3, page 3).
- Dividends of approximately \$28 million were paid to the City from the Ed Tel Endowment Fund in 2012.
- Since 1995, the Ed Tel Endowment Fund has:
 - earned a compound annual rate of return of 7.6% versus the benchmark return of 6.8%,
 - grown its principal from \$465 million to \$619 million, and
 - paid \$589 million in dividends to the City.



CAPITAL MARKETS OVERVIEW AND OUTLOOK

Four years after the start of the Great Recession, 2012 ended with remarkable double-digit returns in global equity indices. However, the path to recovery was marked by continued volatility, as headlines of persistent political and economic challenges dominated financial markets. Nonetheless, by the end of the year, Canadian equities, as represented by the TSX Index, gained 7.2%. Moreover, many foreign equity indices surged even higher. While notably positive, foreign gains to a Canadian investor were somewhat tempered once translated back into Canadian dollars. Finally, Canadian fixed income securities (bonds) returned a

modest 3.6% in 2012, reflecting the low yields that currently exist (See Fig. 3-1, page 3 to compare the rates of return for various capital markets).

Although global economic growth is expected to remain moderate, monetary policy around the world continues to remain accommodative. Many of the risks initially triggered by the recession will continue to hover over the markets in 2013, but, on balance, an ongoing recovery should support the overall investment climate ahead.

Performance Benchmarks

- The rate of return for each City asset class is compared with the published total return of its corresponding broad-market index. The broad-market index used for each asset class is listed below.
- These indices, weighted by the Policy Asset Mix, are used to calculate the performance benchmark for the total fund.
- The benchmark is used as a point of reference by which the investment performance of the total fund is evaluated.

Cash: DEX 91 Day Treasury Bill Index (91 Day T-Bills)

Bonds: DEX Universe Bond Index (DEX Universe)

Canadian Equity: TSX Composite Index (TSX)

U.S. Equity: Standard & Poor's 500 Index (S&P 500)

International Equity: Morgan Stanley Capital International Inc. Europe, Australasia, Far East Index (MSCI EAFE)

Global Equity: Morgan Stanley Capital International Inc. World Index excluding Canada (MSCI World ex-Canada)

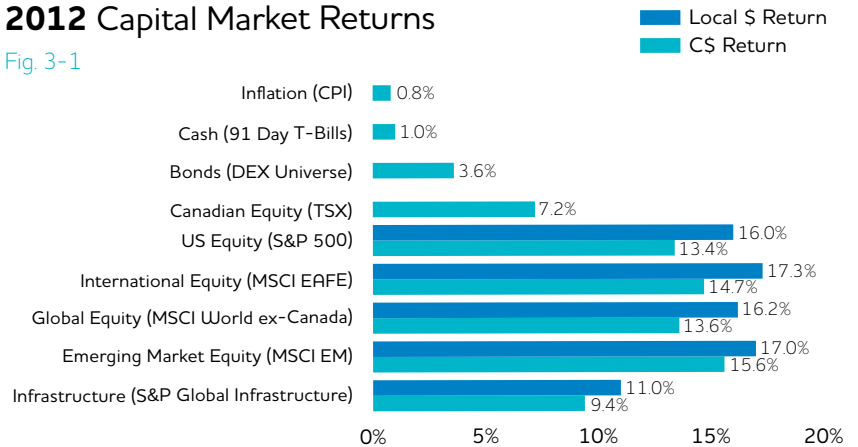
Emerging Market Equity: Morgan Stanley Capital International Inc. Emerging Markets Index (MSCI EM)

Infrastructure: Standard & Poor's Global (Listed) Infrastructure Index (S&P Global Infrastructure)

- Industry standard is to present investment performance returns before deducting management fees.

2012 Capital Market Returns

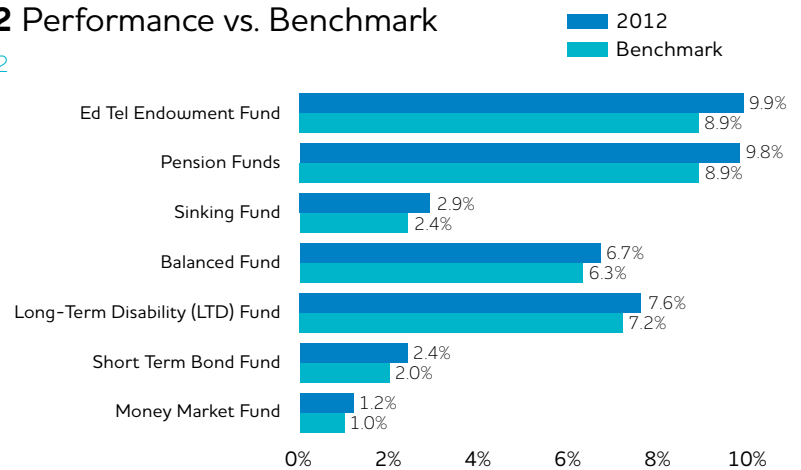
Fig. 3-1



Local \$ Return represents returns expressed in the associated foreign currencies. C\$ Return reflects the return converted to Canadian dollars.

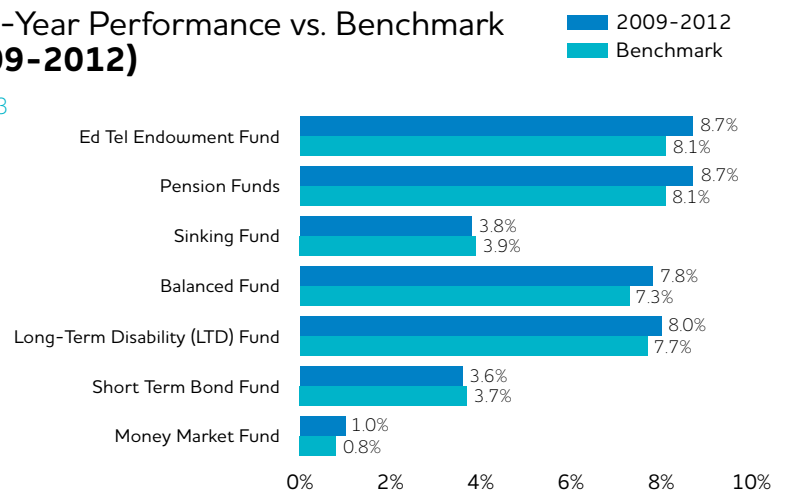
2012 Performance vs. Benchmark

Fig. 3-2



Four-Year Performance vs. Benchmark (2009-2012)

Fig. 3-3



THE CITY OF EDMONTON INVESTMENT PROGRAM AND THE IMPORTANCE OF ASSET MIX

Empirical evidence suggests that the most important determinant of investment returns and risk is asset mix. As a result, the City establishes an asset allocation policy for each of its investment funds in order to meet the specific objectives for each one, while remaining consistent with the fund's risk profile and investment time horizon.

Within the various asset classes, diversification is enhanced even further by using multiple external investment managers who are then paired with internal management (see Investment Management on page 5). Different investment styles and strategies offer additional risk control and greatly reduce the possibility of investment losses, while also ensuring that fund objectives are met. Furthermore, the City of Edmonton has certain comparative advantages, such as liquidity, the ability to invest long term and a cost-effective investment program, which allow the opportunity to earn a significant incremental return over time. As an example, the City typically falls within the high value-added and low-cost category in an annual survey of institutional investment managers around the world.

The guiding principles used in determining the broad investment structure and strategy for the City's various funds are called *Investment Beliefs* (see Investment Beliefs on page 13). One of the main beliefs is that over the long term, equities will outperform bonds to compensate for their higher risk. While equity returns are expected to be greater than bonds over the long run, they are also more volatile. For this reason, equity investments are only suited for investment portfolios with longer-term (for example, more than five years) investment horizons. Accordingly, only the Ed Tel Endowment Fund and the Pension Funds have significant equity allocations (each has 60% equity). Conversely, the investment funds with a lower tolerance for risk and shorter-time horizons (for example, working capital

funds) are not invested in equities and consequently are sheltered from the higher volatility of the equity markets.

Finally, as part of an annual review process, a formal risk assessment of the City's investment program ensures the various risk mitigation strategies and controls in place are appropriate and consistent with industry standards.



Asset Mix/Allocation

The mix of asset classes in a fund is called the Asset Mix. For example, a fund could have an asset mix of 30% bonds, 25% Canadian equity, 30% global equity, 5% emerging market equity and 10% infrastructure.

The asset mix reflects the investor's underlying goals and objectives for the fund in terms of risk and reward.

The Policy Asset Mix is the long-term target asset mix of the fund, as stated in the Investment Policy. This mix, over a long period of time, should allow the fund to meet its stated investment objectives. Over shorter time periods, the returns may fall short or exceed the investment objectives.

INVESTMENT MANAGEMENT

External Fund Management

The City's investment structure combines active and passive investment strategies. Active strategies are used where there is higher potential to surpass the established benchmark by actively selecting securities. Passive strategies, which cost less, are used in markets where active management has generally not outperformed the benchmark.

The Ed Tel Endowment Fund, Pension Funds, Long-Term Disability (LTD) Fund and Balanced Fund all share the same investment managers.

Canadian Equity

AMI Partners

Greystone Managed Investments

State Street Global Advisors

Triasima Portfolio Management

Canadian Fixed Income

City of Edmonton Investment Management Section (Internal)
TD Asset Management

Global Equity and Emerging Market Equity

Arrowstreet Capital

U.S. Equity

Rainier Investment Management

International (EAFE) Equity

Pyramis Global Advisors

Infrastructure

RARE Infrastructure (Listed)

Internal Fund Management

The Sinking Fund, Money Market Fund and the Short Term Bond Fund are all managed internally by the City of Edmonton Investment Management Section. It is worth noting that the annual fee savings from managing a portion of the City's financial assets in-house are approximately \$1.5 million. Compared to having these assets managed externally, this has resulted in upwards of \$15 million in total savings to the City over the last 10 years.

Active Management

Active managers try to exceed performance benchmarks by selecting securities believed to be superior to those in the benchmark index.

The selection of securities is usually based on a specific theory or investment style.

Passive Management

Passive managers fully replicate (by buying securities in the same proportion) a broad market index such as the TSX or S&P 500.

This approach ensures returns are virtually the same as the published index returns. It minimizes the risk of underperformance, but correspondingly, it also means there is little opportunity for outperformance.

Fees and expenses are significantly lower than those for active management.

INVESTMENT FUNDS

Ed Tel Endowment Fund

Fund Management: Multiple Investment Managers
(see page 5)

Market Value: \$619 million (Dec. 31, 2012)

Performance (Rate of Return):

Over one year (2012): +9.9%

Over four years (2009-2012, per annum): +8.7%

Performance against Policy Benchmark:

Over one year (2012): +1.0%

Over four years (2009-2012, per annum): +0.6%

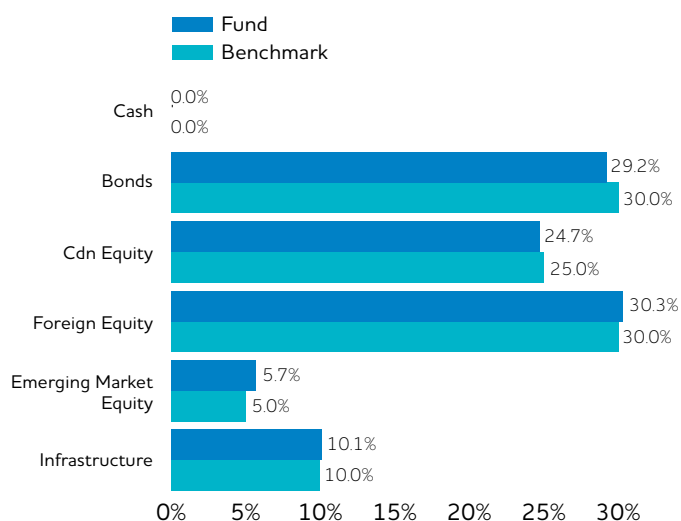
Description/Purpose:

The Ed Tel Endowment Fund was created in 1995 to hold the financial assets generated by the sale of Edmonton Telephones to Telus Corporation. The objective of an endowment fund is to provide a source of income in perpetuity while ensuring the real purchasing power is maintained. The Ed Tel Endowment Fund is considered a financial legacy for future generations that delivers a stable, sustainable and growing dividend for the City.

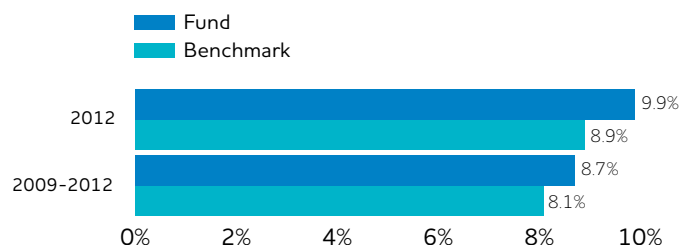
Other Information:

The Ed Tel Endowment Fund's dividend formula (see page 7) paid a dividend of \$28 million in 2012. As a result of the significant market weakness experienced in 2008, the dividend paid from the fund was reduced. The annual dividends from the Ed Tel Endowment Fund since inception are illustrated in the accompanying chart.

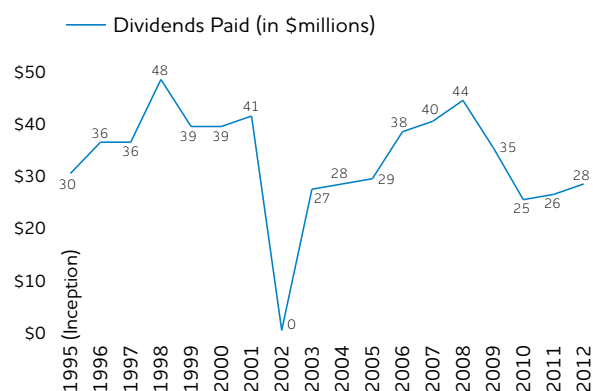
Ed Tel Endowment Fund Asset Mix vs. Policy Mix



Ed Tel Endowment Fund Performance vs. Benchmark



Ed Tel Endowment Fund Annual Dividend Payments



Ed Tel Endowment Fund Bylaw

The Ed Tel Endowment Fund Bylaw incorporates the following key features:

- **Inflation Indexing:** Maintaining the “Inflation Adjusted Principal” of the fund is a primary objective to ensure that real purchasing power is not eroded.
- **Spending Rate:** The percentage of the fund paid out annually as dividends is currently set at 5% and is determined in accordance with the fund’s investment policy.
- **Smoothing Mechanism:** A formula is used in the calculation of the dividend in order to minimize the effects of volatile investment returns. It provides for a more stable and predictable annual dividend from the fund.



Investment Funds (continued)

Pension Funds

Fund Management: Multiple Investment Managers
(see page 5)

Market Value: \$162 million (Dec. 31, 2012)

Performance (Rate of Return):

Over one year (2012): +9.8%
Over four years (2009–2012, per annum): +8.7%

Performance against Policy Benchmark:

Over one year (2012): +0.9%
Over four years (2009–2012, per annum): +0.6%

Description/Purpose:

Pension Funds consist of the Firefighters' Supplementary Pension Plan, the Fire Chief and Deputy Fire Chiefs' Supplementary Pension Plan, and two closed pension plans with only a few beneficiaries each. Over time, the smaller plans will be wound up.

Long-Term Disability (LTD) Fund

Fund Management: Multiple Investment Managers
(see page 5)

Market Value: \$96 million (Dec. 31, 2012)

Performance (Rate of Return):

Over one year (2012): +7.6%
Over four years (2009–2012, per annum): +8.0%

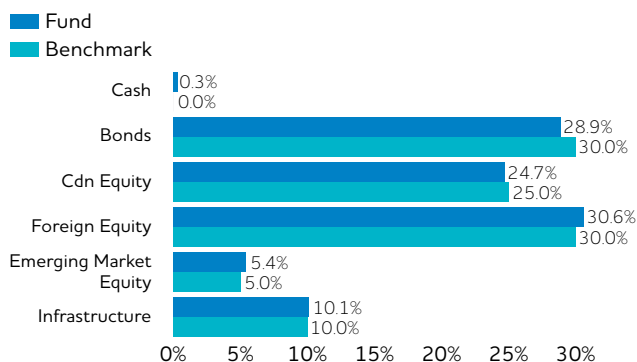
Performance against Policy Benchmark:

Over one year (2012): +0.4%
Over four years (2009–2012, per annum): +0.3%

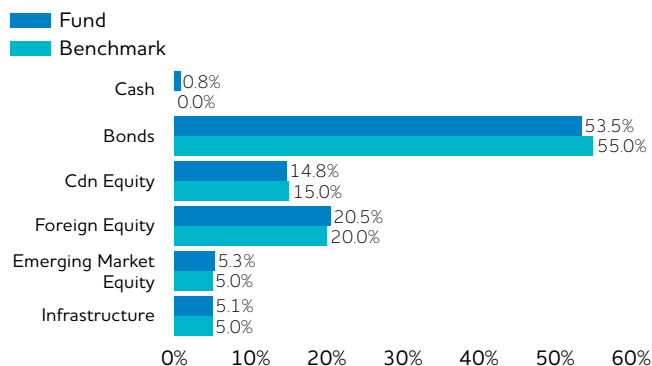
Description/Purpose:

The LTD Fund holds investments for five City of Edmonton long-term disability plans.

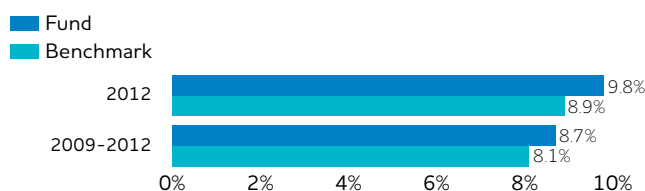
Pension Funds Asset Mix vs. Policy Mix



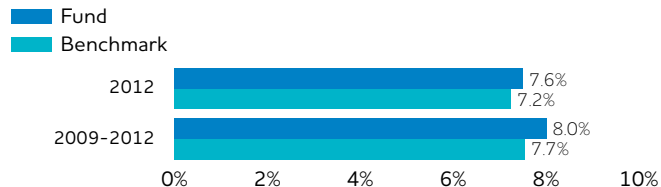
LTD Fund Asset Mix vs. Policy Mix



Pension Funds Performance vs. Benchmark



LTD Fund Performance vs. Benchmark



Sinking Fund

Fund Management: City of Edmonton Investment Management Section (Internal)

Market Value: \$163 million (Dec. 31, 2012)

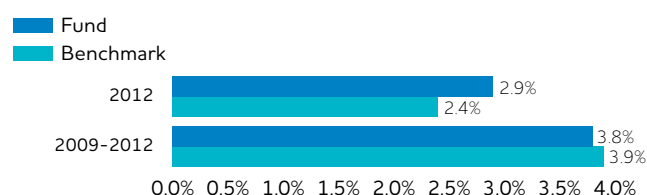
Performance (Rate of Return):
Over one year (2012): +2.9%
Over four years (2009-2012, per annum): +3.8%

Performance against Policy Benchmark:
Over one year (2012): +0.5%
Over four years (2009-2012, per annum): -0.1%

Description/Purpose:

The Sinking Fund was established to meet the needs of various public debenture issues (borrowings) that require monies be set aside regularly for the eventual redemption of these debenture issues. There are two outstanding debenture issues for which the Sinking Fund is accumulating assets. These debenture issues mature in 2013 and 2018.

Sinking Fund Performance vs. Benchmark



RESERVES AND WORKING CAPITAL FUNDS

The Money Market Fund and Short Term Bond Fund (see page 10) together represent the City's working capital.

Money Market Fund

Fund Management: City of Edmonton Investment Management Section (Internal)

Market Value: \$225 million (Dec. 31, 2012)

The City's significant revenue streams are cyclical; the fund value peaks each July at approximately \$600 million.

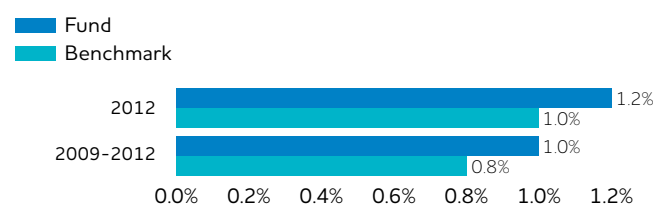
Performance (Rate of Return):
Over one year (2012): +1.2%
Over four years (2009-2012, per annum): +1.0%

Performance against Policy Benchmark:
Over one year (2012): +0.2%
Over four years (2009-2012, per annum): +0.2%

Description/Purpose:

The Money Market Fund represents the excess or shortfall in the daily operating requirements of the City. The purpose of the fund is to ensure that sufficient cash and liquid assets are available to cover the City's short-term obligations. The time horizon of the fund is one year or less, depending on the City's forecast of commitments.

Money Market Fund Performance vs. Benchmark



Reserves and Working Capital Funds (continued)

Short Term Bond Fund

Fund Management: City of Edmonton Investment Management Section (Internal)

Market Value: \$101 million (Dec. 31, 2012)

Performance (Rate of Return):

Over one year (2012): +2.4%
Over four years (2009-2012, per annum): +3.6%

Performance against Policy Benchmark:

Over one year (2012): +0.4%
Over four years (2009-2012, per annum): -0.1%

Description/Purpose:

The Short Term Bond Fund provides an investment vehicle for working capital that is not currently needed to fund City operations, but will be needed in less than five years. The investment horizon, accordingly, is less than five years.

Balanced Fund

Fund Management: Multiple Investment Managers (see page 5)

Market Value: \$495 million (Dec. 31, 2012)

Performance (Rate of Return):

Over one year (2012): +6.7%
Over four years (2009-2012, per annum): +7.8%

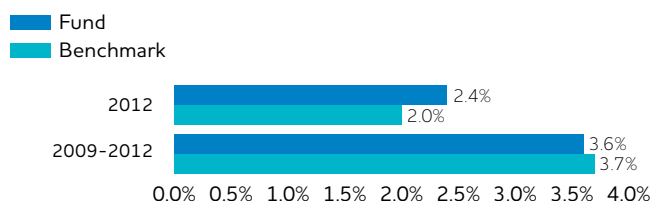
Performance against Policy Benchmark:

Over one year (2012): +0.4%
Over four years (2009-2012, per annum): +0.5%

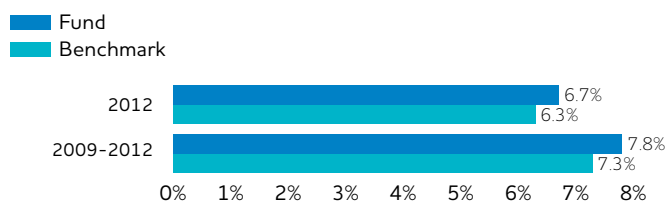
Description/Purpose:

The Balanced Fund has a time horizon of greater than five years and is a long-term investment vehicle for operating and capital reserve funds, deferred revenue accounts and other similar funds. Because it is a longer-term investment, it has a risk tolerance that permits owning some equities.

Short Term Bond Fund Performance vs. Benchmark



Balanced Fund Performance vs. Benchmark



Investment Committee Members

Lorna Rosen *Chairperson*
Chief Financial Officer and Treasurer
City of Edmonton

Todd Burge *Secretary*
Branch Manager, Client Financial Services
City of Edmonton

Aaron Brown
Plan Board Investment Officer
Alberta Pensions Services Corporation

Tamara Chivers
General Counsel
Civic Service Union 52

Ron Helmhold
Chief Financial Officer
WCB – Alberta

Jack Mulkins *(part year)*
Former Partner (Retired)
KPMG LLP

Savvas Pallaris *(new member)*
Lecturer in Finance
Alberta School of Business

Robert Seidel *(new member)*
Managing Partner
Davis LLP

Gary Smith *(part year)*
Executive Professor in Finance
Alberta School of Business

THE INVESTMENT COMMITTEE

The Investment Committee was established by the City Manager to oversee the investment of the City's financial assets. Members are selected to bring both investment and business expertise to the Committee.

Governance is extremely important in ensuring proper oversight, as well as assuring citizens that their City government takes the management of investment funds very seriously. It also assures taxpayers that policies, procedures and controls are being developed to maximize investment returns at a prudent level of overall risk.

The Investment Committee roles and responsibilities are clearly defined in the Investment Committee Terms of Reference. The key responsibilities are to:

- Review the Investment Policy and Procedures and Terms of Reference and recommend changes as necessary;
- Review investment strategies, capital market assumptions, manager structure, services of external managers and other consultants;
- Monitor all reported investment activities for compliance with City policy and statutory requirements;
- Meet with external investment managers, performance measurement advisors, external auditors and other consultants as required;
- Monitor investment performance versus established performance benchmarks; and
- Assist the Chief Financial Officer and Treasurer in preparing an annual report on investment performance for recommendation to the City Manager and City Council.

Key Projects in 2012

- **Implementation of the unlisted infrastructure strategy.** The investment management agreement was finalized and assets will be transitioned to the unlisted infrastructure strategy over time (see text box below).
- **Fixed income structure review.** A review of the City's current fixed income structure was completed to identify areas where potential enhancements could be made. The City will begin moving to a new structure in 2013 (see Future Work section).
- **Investment mandate revisions.** The City's Investment Manager Mandates were revised to incorporate the various policy and legislation changes that have occurred.
- **Treasury system upgrade.** The internal treasury system for fixed income securities, excluding money market, was replaced. The system records, tracks and controls investment activity. The upgrade addressed several issues, such as enabling the use of Straight-Through Processing (STP), in order for the City to move toward the industry standard of electronic settlement of investment transactions.
- **Appointment of new Investment Committee members.** As per the Terms of Reference, external members can only serve two consecutive three-year terms on the Investment Committee. Two committee members' second terms ended in 2012. Accordingly, two new members were appointed to the Investment Committee. This ensures continued good governance of the City's financial assets.

Future Work

The Investment Committee will monitor the following key projects in 2013:

- **Completing asset allocation studies for the Ed Tel Endowment Fund, the Pension Funds and the Long-Term Disability (LTD) Fund.** The analysis will determine whether each fund continues to have an appropriate asset mix in relation to its objectives, time horizon and risk tolerance.
- **Fixed income structure implementation.** As a result of the review undertaken in 2012, the transition to a new fixed income structure will occur. Steps will include completing the manager search for the global fixed income strategy, finalizing the investment management agreement, and transitioning the assets to the new strategy. The new structure should provide added value by increasing the amount of active management as well as improve diversification by introducing a global bond mandate to the overall fixed income allocation.



Infrastructure

- Infrastructure is defined as large-scale projects that provide essential services to society. Examples include toll roads, airports and utilities and may involve developing, operating and/or maintaining the asset.
- The infrastructure asset class is a global market. Investments can be made either through unlisted (private) or listed (publicly-traded) securities. Possible opportunities for investors are expected to expand significantly over the next 10 years.

RESPONSIBLE PROXY VOTING

- Owning common stock confers certain rights. These include the right to propose and vote on corporate policies through the shareholder resolution process (proxy voting).
- The City's Investment Policy and Procedures contain a commitment for the City of Edmonton to support social and ethical business practices through proxy voting. A proxy voting agent is retained to vote the City's ballots for the hundreds of companies in which the City owns shares. The voting service adheres to the City's guidelines through careful analysis of each voting issue.
- During 2012, the City of Edmonton exercised its shareholder rights and voted its proxies in accordance with the Investment Policy and Procedures.

RESPONSIBILITIES OF CITY COUNCIL

The role of City Council, as senior governing fiduciaries, is to periodically receive reports and recommendations from the City Manager and to approve the Investment Policy.

The Investment Policy and Procedures establish the following:

- investment objectives
- investment beliefs
- permitted investment categories
- asset allocation (policy mix and permitted ranges)
- performance benchmarks
- implementation strategies
- proxy voting guidelines
- monitoring and controls
- reporting requirements

Investment Beliefs

1. The investment return on the funds is a function of capital market returns, asset allocation, manager structure and individual managers.
2. There is a relationship between risk and return – higher returns generally require taking higher risk.
3. In the long term, equities will outperform bonds to compensate for their higher risk.
4. The long-term asset mix is the most important component of a portfolio's risk and return.
5. Active management can add value, but with added costs and effort which must be assessed along with the passive alternative, whenever changes are made.
6. Alternative strategies/asset classes may be appropriate and will be evaluated based on their liquidity, the management time needed to monitor the investment and the level of transparency.
7. Market timing at the policy level is an inefficient strategy for consistently increasing returns.
8. Diversification of asset classes, implementation strategies and security selection can improve the risk and return characteristics of the funds.
9. Asset mix rebalancing generally adds value relative to buy and hold strategies.
10. Effective manager structure can improve the net returns and lower the risk of the funds.

For more information, contact:

Financial Services and Utilities
5th Floor, Chancery Hall
3 Sir Winston Churchill Square
Edmonton, Alberta T5J 2C3

780-496-4944

www.edmonton.ca