To: Chair and Members
Audit and Administration Committee

From: Antonio D. Tollis
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Finance and Corporate Services

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Date: February 13, 2009

Re: Reserve/Revenue Fund Investment Performance Report – December 31, 2008 (FCS08082(b)) (City Wide)

Council Direction:
N/A.

Information:
The City’s Reserve/Revenue Fund investment portfolio (comprised of reserves/reserve funds, capital account balances and unused operating funds) had an earning rate of **3.61%** for the twelve (12) months ending December 31, 2008. Bond lending revenues of $84,071 are included in the earnings rate. Over the past five (5) years (2004-2008), the earning rate on investments has averaged **4.21%**. The overall return, which is impacted by increasing or decreasing asset prices, was **6.73%** for the twelve (12) months ending December 31, 2008. This underperformed the City’s benchmark by two hundred and forty-four (244) basis points. Over the past five (5) calendar years, this overall return has averaged **5.20%** per annum, underperforming the average benchmark return of **5.30%** by ten (10) basis points. The City’s portfolio has generated, on average over the past five (5) years, approximately $27.2 million in interest, realized capital gains and lending income. The dollars generated for 2008 totalled approximately $30.8 million. The duration of the portfolio at December 31, 2008, was 3.40 years compared to 3.91 years at December 31, 2007. The total value of the portfolio was $776,632,576 at December 31, 2008, which included $97.6 million in Asset-Backed Commercial Paper (ABCP) at par value.

The One Fund portfolios (offered by the Association of Municipalities of Ontario and the Municipal Finance Officers’ Association), for the year ended December 31, 2008 returned 8.08% for bonds, including unrealized gains/losses, and 4.00% for money market.
If the City’s policy had been used in these funds (i.e., 90.0% bonds and 10.0% money market), the overall return would have been 7.67% or ninety-four (94) basis points more than the actual return of 6.73% for the past twelve (12) months, which translates into approximately $7.0 million revenue decrease on an average portfolio balance of $751 million. This revenue decrease will be moderated by disbursements from the ABCP. For example, $2.7 million was received January 21, 2009 and more is expected within two (2) months. New securities with a principal value of approximately $87.0 million were received with the disbursement of $2.7 million. If the ABCP disbursement is included in the 2008 income, the earning rate would have increased to 3.99% from 3.66% and the overall return would have been 7.08% versus 6.73%. Total dollars generated in 2008 would increase to over $33.5 million from $30.8 million. An additional disbursement from the old securities, as well a maturity of $5.5 million, are expected to be paid in early 2009. Both of these items will increase earnings considerably for 2008 or 2009, depending upon allocation and auditor approval.

ABCP re-structured notes will not be compliant with the Municipal Act. Staff has contacted the Ontario Department of Housing and Finance in order to affect changes to the Act, allowing the holding of these assets. Full realization of value requires that these notes be held to maturity. These notes were compliant with the Act and rated AAA when purchased.

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<tbody>
<tr>
<td>Policy Target</td>
<td>9.17%</td>
<td>4.50%</td>
<td>3.91%</td>
<td>3.48%</td>
<td>5.23%</td>
</tr>
<tr>
<td>City’s Portfolio</td>
<td>6.73%</td>
<td>3.67% (1)</td>
<td>3.32%</td>
<td>5.90%</td>
<td>6.27%</td>
</tr>
<tr>
<td>The One Fund – Bonds</td>
<td>8.08%</td>
<td>3.84%</td>
<td>2.62%</td>
<td>2.09%</td>
<td>4.93%</td>
</tr>
<tr>
<td>The One Fund – Money Market</td>
<td>4.00%</td>
<td>4.39%</td>
<td>3.83%</td>
<td>2.52%</td>
<td>2.20%</td>
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<tr>
<td>Dex - Short Government</td>
<td>8.55%</td>
<td>4.54%</td>
<td>3.88%</td>
<td>2.23%</td>
<td>4.89%</td>
</tr>
<tr>
<td>Dex – Mid Governments</td>
<td>7.01%</td>
<td>4.52%</td>
<td>3.91%</td>
<td>5.43%</td>
<td>7.62%</td>
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<tr>
<td>Lending Revenue</td>
<td>$84,071</td>
<td>$61,220</td>
<td>$36,918</td>
<td>$44,596</td>
<td>$17,318</td>
</tr>
<tr>
<td>Earning Rate (Excludes Capital Gains/Losses)</td>
<td>3.61%</td>
<td>3.30% (1)</td>
<td>4.79%</td>
<td>4.71%</td>
<td>4.66%</td>
</tr>
<tr>
<td>City’s Return One Fund Investment (Equity)</td>
<td>-26.4%</td>
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The earning rate in 2007 was adjusted for an allowance of $14.4 million due to ABCP holdings. This allowance is an estimate only and actual results may differ due to realization from these holdings.

The performance of the City’s portfolio is explained by two primary factors. The Asset-Backed Commercial Paper held by the account has not been restructured, is non-performing, and carried at par. No interest was paid on these securities in 2008. As well, the account was biased to short duration and in order to maintain current earnings in anticipation of spread widening. A very high proportion of the account is in money market securities which earn lower rates, but meet the City’s liquidity requirements going forward, avoid spread loss, and capital loss. This strategy has worked well as annual earnings have been maintained and market value loss due to spread widening was avoided.

The City subscribed to the “One Funds” equity account last year. A program of depositing $200,000 per month into this fund started in order to average into equity holdings. The City has deposited $3.8 million into the account over the past nineteen (19) months and the return for the past nineteen (19) months is -28.37%. The return over the past twelve (12) months is -26.4%. Investment in this account will be cut to $100,000 per month for ten (10) more months due to the uncertainty of this recession.

Unrealized capital gains at December 31, 2008, totalled $21,422,155, resulting in a total portfolio value of $776,632,576. Capital gains of $4,425,585 were realized through the past twelve (12) months.

The City’s portfolio was 74.8% bonds and 25.2% money market securities at December 31, 2008, compared to 72.5% bonds and 27.5% money market at December 31, 2007. The portfolio’s money market holdings ranged from 21.8% to 42.6% through the past year, averaging 35.04%. The portfolio has increased to $776 million from $581 million with proceeds from tax levies, transfers, debt issuance and selected bond sales in the past year.

The following chart illustrates the changes in Canadian interest rates over the past twenty-four (24) months:

<table>
<thead>
<tr>
<th>Maturity Term: Canada Benchmark</th>
<th>Interest Rate January 2, 2009</th>
<th>Interest Rate January 2, 2008</th>
<th>Interest Rate January 2, 2007</th>
</tr>
</thead>
<tbody>
<tr>
<td>One Month (T-Bill)</td>
<td>0.83%</td>
<td>3.71%</td>
<td>3.17%</td>
</tr>
<tr>
<td>2 yr</td>
<td>1.10%</td>
<td>3.75%</td>
<td>3.81%</td>
</tr>
<tr>
<td>5 yr</td>
<td>1.70%</td>
<td>3.87%</td>
<td>3.89%</td>
</tr>
<tr>
<td>10 yr</td>
<td>2.69%</td>
<td>3.99%</td>
<td>3.97%</td>
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Current conditions in Canadian fixed income markets are dominated by the ongoing global credit crisis, a slowing economy, and a flight to US Treasury bonds and declining
commodity demand. Central Banks now face threats of very weak growth, extreme credit concerns for both corporate and government entities, and an extreme concern for liquidity. Credit has become increasingly scarce worldwide and world economies are entering a significant recessionary period in spite of extremely low interest rates. It appears that fiscal stimulus through increase borrowing and expenditure will be required to further stimulate the economy.

Over the first half of 2008, Central Banks’ actions in the U.S. and Canada reflected their view of the balance of risks between slower growth (first quarter) and rising inflation (second quarter). Both the U.S. Federal Reserve and the Bank of Canada cut rates in the first four (4) months of this year and left rates unchanged at two per cent (2%) and three per cent (3%) respectively in the third quarter. Inflation expectations declined through the second half of the year as commodity prices tumbled, including oil which closed around $45 versus its summer peak of $147.

The Fed Funds rate has declined to a range of zero to point twenty-five per cent (0-0.25%); the Canadian overnight rate to one per cent (1.0%). The credit crisis has spread to emerging countries and is influencing all countries. Globally, credit risk premiums are at historic levels and credit is more difficult to obtain. Loss of confidence has resulted in a dramatic flight to U.S. Treasury bonds/bills. Economic and credit conditions, and massive de-leveraging, have caused a significant downward trend in economic activity. The consensus outlook for 2009 is, at best, world growth at approximately two per cent (2%) - a recessionary level. Short-term rates are expected to decline further in Canada; however, U.S. rates are now at a range of zero to point twenty-five per cent (0-0.25%) and cannot drop further. Longer term rates are not declining as rapidly and will not unless long-term deflation unfolds.

The City’s investment portfolios are invested with duration of less than the index due to the uncertainty, possible long-term rate increases, credit concerns and liquidity concerns. Investment has been in the highest credit quality bonds issued by governments or major Canadian banks. Money market holdings, bank balances and/or short bond equivalents have remained high in order to remain flexible.

Actual interest in 2009 earnings should remain higher than short-term or bank rates at less than one per cent (1.0%) annually due to longer term bonds held.

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