ATTACHMENT B

INVESTMENT STRATEGY FOR THE MANAGEMENT OF SURPLUS FUNDS

Investment Strategy

Purpose

The annual Investment Strategy sets out Council's investment goals and targets for the coming year. The aim of the strategy is to guide the management of Council's investment portfolio over the short to medium term to:

- achieve a balanced and diversified portfolio, in terms of allowable investment products, credit ratings and maturation terms that will outperform the benchmark indices
- ensure liquidity when required for Council's operational and capital **expenditure** needs.

Scope

The *Investment Strategy* applies to all managers and employees who actively manage the investment of surplus funds or have responsibility for employees who actively manage the investment of surplus funds.

This strategy should be read in conjunction with the *Investment Policy*.

Context

The City's investment strategy is determined after taking into consideration a review of the following issues:

- global and domestic economic investment environments
- investment policy and legislative constraints
- current composition of Council's investment portfolio
- long, medium and short term financial plans.

Global and domestic investment environments

Financial and investment environments, both globally and domestically, continue to improve at different rates across various regions. The global financial recovery process has been aided by a more standardised international regulatory process with more stringent capital adequacy requirements for financial institutions.

In Australia, a history of prudent regulation of the financial institutions by the Australian Prudential Regulation Authority (APRA) has meant that Australian based regulated financial institutions have already operated for an extended period under stringent capital adequacy and liquidity requirements. Council's investments all fall under APRA regulation with the result that the portfolio is conservative and secure.

Interest rates have remained low for a number of years and began to rise marginally in the US towards the end of 2015 for the first time in over eight years. In Australia the slow rate of expansion of the domestic economy is expected to temper the pace at which local interest rates rises will occur.

Legislative environment

Council's investment opportunities are constrained by a combination of legislation, regulation and any directions and guidelines issued by the Minister or the Office of Local Government.

There has been no change to the investment legislative environment for a number of years and the most recent Ministerial Investment Order released in January 2011 continues to limit Council's investment options to:

- term deposits with Approved Deposit-taking Institutions (ADIs)
- other ADI senior ranked securities
- investments with NSW Treasury Corporation (T-Corp)
- funds or securities issued or guaranteed by the Commonwealth or any State or Territory.

Composition of Council's investment portfolio

The conservative nature of Council's Investment Strategy is clearly reflected in the structure of the portfolio, where 100% of the portfolio is invested with APRA-regulated ADIs.

Council's current portfolio is as follows:

Investment	Split
Big Four banks	56%
Australian mid-tier banks	39%
Foreign controlled Australian based ADIs	5%
Total APRA-regulated ADIs	**100%**

The allocation of assets within the portfolio is with very secure institutions. In the past year, Council has diversified the portfolio with further selected investment into the Australian mid-tier banks as they continue to reflect strength and stability.

Investment strategy

Council's investment portfolio will continue to be prudently managed in accordance with:

- Council's Investment Policy and related legislative and regulatory requirements
- documented risk management procedures to preserve capital
- Council's operational and capital funding requirements.

Objectives

Council's investment strategy for the period is to maintain the highly secure profile of the portfolio, provide liquidity and deliver competitive investment returns commensurate with the portfolio structure.

Risk profile

The risk profile for the Council's investment portfolio is based on the principles of being prudent, conservative and risk averse. This is achieved by managing the diversity and creditworthiness of investments in accordance with the Investment Policy and other relevant requirements.

Council's capital funding requirements will continue to increase over the next few years, including the funding of infrastructure development for Green Square, the City Transformation and partial funding of the NSW State Government light rail project in George Street. As a result, the maturity profile of the investment portfolio is becoming more concentrated in the short and medium term rather than the longer term.

As a consequence, the proportion of longer dated floating rate notes in the portfolio is reducing while the proportion of short to medium dated term deposits and floating rate notes is increasing. All of these investments are with APRA regulated financial institutions so that credit risk remains minimal. The maturity profile of the investments is adequately spread over those periods to ensure that liquidity and maturity risks are also kept to a minimum.

The most favourable market for term deposits is mainly with the APRA regulated Australian mid-tier banks with the result that these banks comprise between 35 to just over 40% of the portfolio and provide diversity within the portfolio.

Liquidity / Maturity

The majority of the City's cash and investments portfolio is held as internally restricted and externally restricted cash reserves to satisfy the City's legislative responsibilities and to set aside specific funds for Council's funding commitments to the major initiatives within the Sustainable Sydney 2030 Community Strategic Plan, including the City Transformation, the Green Square Town Centre and sustainable energy projects. In addition, there is also partial funding of the NSW State Government light rail project in George Street.

There are presently increased demands for funding of capital projects with the result that within the maturity profile of the investment portfolio there is a responsive shift of funds from the longer term to the short and medium terms.

To ensure the City has available funds to meet both these commitments and its short-term operational and capital cash commitments, the following liquidity targets are set in accordance with the Investment Policy.

Investment period	Cumulative Minimum % of total portfolio	Maximum % of total portfolio
1 month	10% or $50M	100%
2 to 12 months	40%	80%
1 to 3 Years	55%	40%
3 to 5 Years	90%	35%
> 5 Years	Nil	10%

The City's liquidity will be monitored on an ongoing basis to ensure the City's cash requirements are met and that liquidity parameters remain within allowable limits set out in the *Investment Policy*.

Return / Income

The City uses the following benchmarks to measure investment performance, in relation to both current month and 12-month rolling returns, against its return/income objectives:

- Bloomberg AusBond Bank Bill Index
- 30 day Bank Bill Rate.

The City aims to achieve returns equal to or above these benchmark rates for the period. However, this achievement remains secondary to the critical strategies of maintaining a prudent and conservative risk profile and in meeting Council's liquidity needs.

The City's current cash balances are applied in meeting immediate operational and capital commitments as well as future year's capital commitments. The City has during the past few years taken the opportunity to invest the funds that are required for future years into long term secure higher yielding investments before the interest rates relating to those investments began to decline. This strategy is one of the main reasons as to why the City currently delivers income returns in excess of the benchmark rates. However, this gap is continuing to narrow over time as these higher yielding investments mature and new investments are made at the currently offered lower yields.

In 2014, the City decided to measure the impacts of this strategy by introducing an additional strategic benchmark rate by measuring its investment performance by exceeding the 30 day benchmark returns by at least 40 additional basis points (0.4% p.a.). The 40 basis point increase was based on the average increased credit spreads (or margins) over bank bill rates on offer in relation to 30–90 day investments at the time. The 30-90 bank bill rates represented a reflective benchmark for investment if the risk of long-term investment at fixed rates and margins was removed from the portfolio. In 2015, the increased credit spreads over 30-90 bill rates for this investment period sit within a range of 10 to 50 basis points, with averages in the 45 basis point range. It is recommended that 2016, the strategy of applying an increased spread be raised to a 45 basis point spread as it currently continues to provide a good measure of balancing the diminishing higher yield investment returns against very low yielding call funds where the call fund yields are well below the 45 basis point benchmark. However, if the average spread begins to decline during 2016, this position may need to be reviewed.

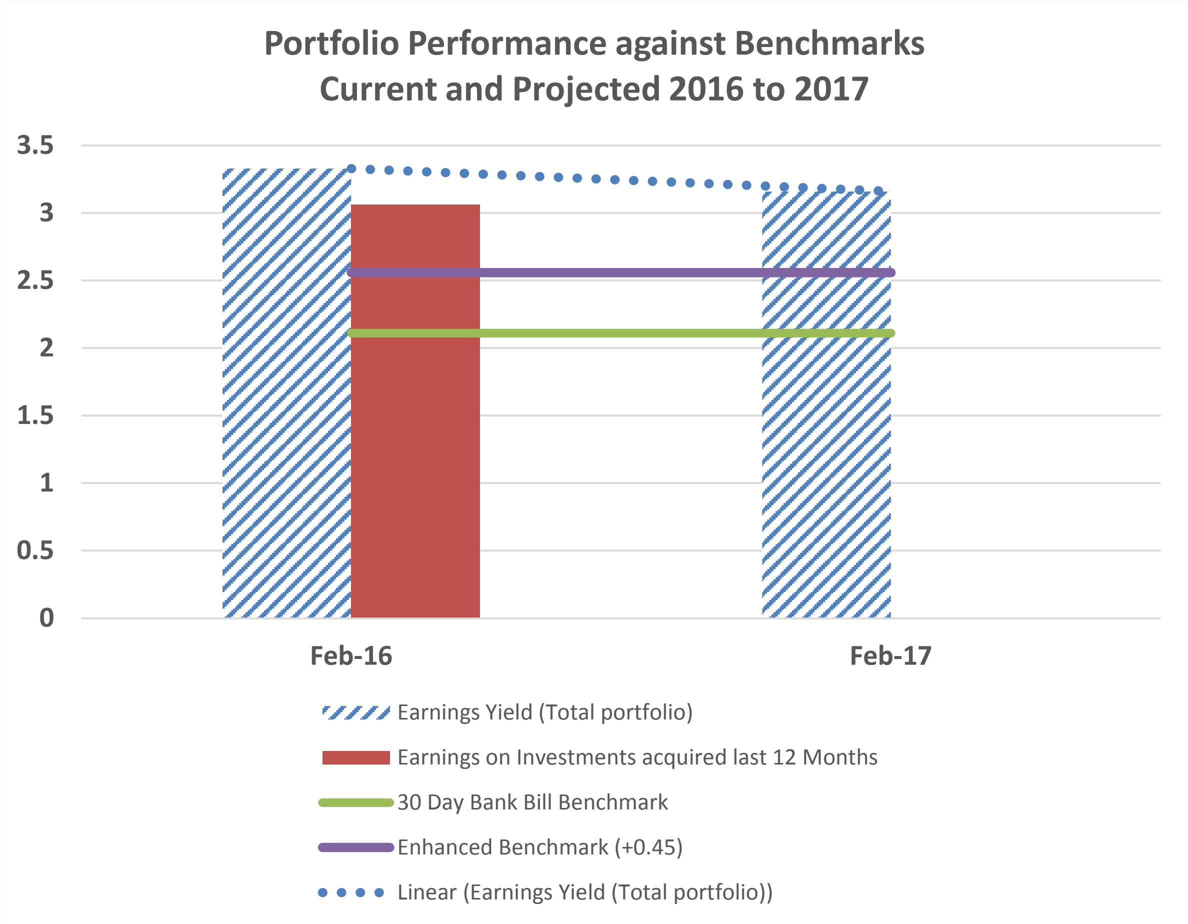
Additionally, 2016 will present challenges to the City in delivering higher investment income returns, including the following:

- Interest rates continue to remain at low levels and expectations are that in the medium-term over the next 3 years they could remain at these levels.

- The increasing level of capital expenditure is resulting in the maturity profile of the investment portfolio reducing in the long-term and being reinvested in the short to medium term where interest yields are lower.

- A number of long-term investments that are locked in the higher rates offered in previous years continue to mature and decline in quantity at a steady pace. As these funds can now only be reinvested at the current low yields, overall earnings will continue to fall.

The following chart illustrates how earnings yields are expected to reduce over the coming year as a result of the above factors. The narrowing of the gap between actual investment returns and the investment benchmarks is evident. Additionally, the chart also reflects the current lower earnings yield on investments acquired during the last 12 months when interest rates have been at historically low levels.



Unrealised Investment Gains

As previously mentioned, Council previously acquired a number of secure investments in the form of high yielding fixed and floating rate notes in anticipation of future declining interest rates.

A positive consequence of holding these secure high yielding investments is that once interest rates did go into decline, the market value of these investments rose since they were the only investments offering the higher interest yields. The increase in market value creates an unrealised investment gain which means that although there is a gain to be made on the investment, it can only be realised through a physical sale of the investment at its high market price. On the other hand, if the investment were instead held to maturity, the unrealised gain steadily reverses because the maturity value of the investment is its face value, not its market value. The flip side to this position is that if the investment were to be sold, the proceeds would then have to be reinvested in the investments currently on offer which are those earning much lower rates of return.

The question of whether to sell or hold an investment in such a situation has been resolved through a strategy that has been adopted for a number of years. The strategy is now **formally** included in this document.

The strategy in managing significant unrealised investment gains is to compare the following amounts:

- If an investment with a significant unrealised investment gain was to be sold to realise the gain, its earning potential becomes the sum of (a) the unrealised gain now realised and (b) the estimated future interest earnings of the proceeds of sale up to the maturity date of the original investment sold. A key consideration is that since the unrealised gain was the result of a decline in interest rates, the interest yields on the reinvesting of the proceeds of sale will be less than the yields of the original investment up to the time of maturity of the original investment.

- If the investment with a significant unrealised gain was to be held to maturity it would mature at its face value with the result that the unrealised investment gain will reverse steadily to its maturity date. On the other hand, the investment will continue to earn interest income to maturity at yields that are higher than those currently available in the market.

Consequently, investments with significant unrealised gains will be retained in the portfolio unless A exceeds B where:

A = the sum of unrealised investment gain plus future interest earnings to maturity date at the lower interest yield

B = the total amount of the future interest to maturity at the current higher interest yield

The total unrealised investment gain at the end of 2015 was around $1.9M.

In accordance with accounting standards, the unrealised investment gain and any subsequent increase or decrease in the amount is required to be recognised in Council's financial results. Consequently, if unrealised gains reverse as losses in the future, it means that these losses are more than offset by the interest income earned on those investments because of their respective higher interest rates.

Environmentally and Socially Responsible Investments

Council remains limited in acquiring sustainable investments for the following reasons:

- the structure of ~~most~~ compliant **that meet the City's SRI criteria** investments remain prohibited under the current Ministerial Investment Order
- the global financial crisis resulted in significant declines in the valuation of assets that comprise these investments with the result that they have all retracted to conservative positions of preserving capital and producing little or no income.

Council will explore opportunities for supporting environmentally and socially responsible investments within these constraints. For example, preference may be given to Environmentally and Socially Resonsible Investments, when evaluating investment opportunities, if they meet with legislative and policy requirements as well as the investment objectives set out in this strategy.

References

Laws and standards	• Local Government Act 1993 • Local Government (General) Regulation 2004 • Ministerial Investment Order • Local Government Code of Accounting Practice and Financial Reporting • Australian Accounting Standards • Office of Local Government Circulars
Policies and procedures	• Investment Policy

Approval

The Council approved the Investment Strategy on 21 March 2016.

Review

Review period	Next review date	TRIM reference
The Code of Accounting Practice & Financial Reporting requires Council to undertake an annual review of its Investment Policy and Investment Strategy.	March 2017	2013/100234