1967

QUEBEC DEPOSIT AND INVESTMENT FUND

SECOND ANNUAL REPORT

Bodies authorized by an act of
the provincial legislature
to deposit moneys with the
Quebec Deposit and
Investment Fund

Quebec Agricultural Marketing Board

Quebec Crop Insurance Board

Quebec Deposit Insurance Board

Quebec Pension Board

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Board of directors

Claude Prieur, *Chairman*
General Manager,
Quebec Deposit and Investment Fund

Robert De Coster, *Vice-Chairman*
President,
Quebec Pension Board

Marcel Cazavan*
Deputy Minister of Finance,
Government of Quebec

Raymond Lavoie
Associate General Manager,
Crédit Foncier Franco-Canadien

E. A. Lemieux*
General Manager,
Finance and Accounting, Hydro-Quebec

Charles B. Neapole
President,
Montreal Stock Exchange &
Canadian Stock Exchange

Roland Parenteau
General Director,
Quebec Economic Advisory Council

Jacques Parizeau
Professor,
Ecole des Hautes Etudes Commerciales
de Montréal

Marcel Pepin
National President,
Confederation of National Trade Unions

Maurice Turgeon*
Vice-President,
Quebec Municipal Commission

**Associate member*

Management

General Manager
Claude Prieur

Investment Department

Bonds
Gérard H. Cloutier

Jean-Michel Paris

Stocks
Pierre Arbour

Etienne de Kosko, C.F.A.

Mortgages
Patrick O. Wells

Treasury Department
Jean-Marie Côté, C.A.

Secretariat
Gérard J. Blondeau

Law Department
Paul Martel, LL.L.

Quebec Deposit and Investment Fund

CLAUDE PRIEUR
CHAIRMAN OF THE BOARD
AND GENERAL MANAGER

Quebec City, March 14, 1968.

The Honourable Paul Dozois,
Minister of Finance,
Government of Quebec.

Dear Sir:

In accordance with the provisions of the charter of the Quebec Deposit and Investment Fund, 13-14 Elizabeth II, ch. 23, I am transmitting herewith our second annual report for the year ended December 31, 1967.

This report comprises an outline of investment policy, a summary of our activities, and statements of accounts duly verified by the Provincial Auditor, along with the required related statistical data.

Yours very truly,

Claude Prieur

Report of management

During its second financial year which closed on 31st December 1967, the assets of the Quebec Deposit and Investment Fund grew from $183.3 million to $418.6 million and its annual income rose from $5.1 million in 1966 to $18.7 million. The amounts on deposit reached a total of $412.7 million thus showing a growth of $234.2 million for the period.

Three Provincial Government Boards were, during the year, authorized by acts of the Legislature to make deposits with the Quebec Deposit and Investment Fund. These were the Quebec Agricultural Marketing Board, the Quebec Crop Insurance Board and the Quebec Deposit Insurance Board. One of these bodies had made an initial deposit by the close of the year.

The near totality of the funds at present on deposit is for the account of the Quebec Pension Board. While the Fund will in time have an increasing number of depositors, the Quebec Pension Board will in all likelihood remain the largest depositor. It is interesting to note that the deposits of the Quebec Pension Board, during the first two years of operation, were approximately 12% greater than originally forecast.

Review of economic conditions

The second year of operations of the Fund should be viewed against the background of a sixth consecutive year of expansion of the national economy. However, the rate of economic growth was somewhat less than that of the preceding year and some tensions began to appear. The increase in real terms in the Gross National Product was only about a third of that achieved during 1966, investment in the private sector barely kept pace with the rate for the previous year, and corporate profits declined while prices and interest rates responded to inflationary pressures.

To avoid too sudden a slow-down in an already unstable economy the Canadian Government, with the co-operation of the Bank of Canada, pursued a policy of fiscal and monetary expansion for the greater part of the year, refraining on the one hand from taking fiscal measures that would have bridged a budget deficit of $740 million while on the other allowing an unprecedented growth in the money supply.

To the extent that this policy aimed at facilitating government and corporate financing, it enjoyed a measure of success. Although high interest rates were paid, governments did succeed in financing their exceptionally high deficits and some corporations, particularly during the first half of the year, while perhaps not financing new investments, were able to restore their liquidity. Meanwhile, investors, increasingly aware of inflationary trends, exhibited considerable prudence in their assessment of the market. From the outset of the year the prospect of massive government borrowings warranted this cautious attitude inasmuch as the economy had hardly recovered from a period of credit restriction.

Except during the first three months of 1967, long-term bond yields continued the rise begun in 1965. The average yield on long-term Government of Canada bonds rose from 5.76% at the beginning of 1967 to 6.54% at the close of the year. This rise of 0.78% which followed rises of 0.36% in 1966 and 0.41% in 1965, brought about a substantial decline in the market value of outstanding bonds. For example, as a result of the increase in yields during 1967, the price of Government of Canada 5¾% bonds due September 1st 1992 fell from 100⅛ to 90⅜, a loss of close to 10% in market value in one year.

This deterioration of financial markets was a reflection of identical trends in the United States resulting from continued economic and financial uneasiness. The events of the year seem to bear witness to the increasing influence of the economy of the United States on that of Canada. In this connection, it has become evident that the fixed rate of exchange for the dollar and the arrangements existing with the United States concerning the level of Canadian reserves, have the effect of subordinating economic and monetary policies in Canada to overriding continental influences.

Although the budgetary and fiscal problems of the United States together with their balance of payments complications are at the root of current difficulties, other factors do have their origin in Canada itself. During 1967, wage and other production cost increases unaccompanied by matching gains in productivity resulted in lower margins. As higher costs were only partially matched by price increases, corporate earnings declined in the manufacturing industries.

In the stock markets, prices rose until the end of the third quarter of 1967, the Dow Jones and Montreal Stock Exchange indices showing a rise of approximately 25% over the lows of October of the previous year. This improvement reflected a general expectation that, after the monetary crisis of 1966, a climate more favourable to business would prevail beginning with the second half of 1967. In the summer months it became increasingly evident that the renewal in economic activity would not be accompanied by proportionate increases in corporate earnings. Furthermore, corporate financing proved to be more expensive than in 1966. By mid-September, the uncertainty which this developing situation generated caused stock market prices to drop across the board. In Canada, some shares dropped as much as 40% in price. In the last few weeks of the year a renewal of interest had a stabilizing effect on stock market prices in Canada and a modest recovery of the Dow Jones index was recorded in the United States.

The financial market in the Province of Quebec, while a part of the overall Canadian market, was more adversely affected during 1967. The magnitude of this phenomenon can be clearly seen in the steadily widening spread, during the past few years, between yields on long-term Quebec bonds and those of Canada or Ontario. These spreads in yields between long-term Canada and Quebec bonds fluctuated between 0.46% and 0.61% in 1965, between 0.45% and 1.06% in 1966 and between 0.77% and 1.27% in 1967. A comparison of yields between Quebec bonds and Ontario bonds reveals, for the same years, fluctuations in spreads of

0.23% to 0.36%, of 0.17% to 0.67% and of 0.37% to 1.03%. In order to take up Quebec Provincial bonds the market has, therefore, exacted an ever widening yield premium in recent years. This is evidence of a continual decline in the Canadian demand for Quebec bonds, a decline remarkable not only for its sharpness but also for its disturbing implications for the future.

This situation can be traced in part to the high rate of borrowing by the Government of the Province of Quebec. Over a seven year period the per capita debt of the Province rose from $216 to $773 while that of Ontario rose from $516 to $688. In absolute terms, the direct and indirect debt of the Province of Quebec increased from $1.1 billion to $4.5 billion. The placing of these $3.4 billion of new debt of which more than one third was for the account of Hydro-Quebec, had the effect of progressively saturating the portfolios of a growing number of lending institutions.

The onus for the present unsatisfactory situation cannot be entirely attributed to the volume and frequency of provincial borrowings. In fact, it is beyond question that the discussions and polemics on constitutional matters in the Province, the uncertainty regarding the future political status of Quebec and the publicity that these questions have received continue to maintain a climate of unrest among investors. At the moment, however, this uncertainty appears to be limited to Canadian investors as witnessed by the relatively narrow spread of about 0.15% existing until now in the United States market between the yields of Quebec bonds and those of Ontario.

While it is impossible to measure the extent of this malaise, it is equally impossible not to take cognizance of it as it becomes increasingly manifest in its effects on the market.

Investment policy

On the basis of actuarial studies and past experience the Fund anticipates that the amounts on deposit for the account of its principal depositor, the Quebec Pension Board, will continue to increase until 1990, or for the next 22 years. Mindful that the Fund is but a trustee for its depositors, it therefore pursues an investment policy oriented towards the foregoing long-term needs.

In the bond market the Fund continued during 1967 its programme of acquiring long-term bonds of high quality. It also lent considerable support to the direct and indirect borrowings of the Province. During the year the Fund also participated substantially in long-term financing by Municipalities and School Boards; in this connection a special effort was made to achieve a distribution of these investments throughout the various regions of the Province. In the field of corporate bonds, the Fund stepped up its investments in issues of prime quality; apart from geographic and industrial diversification, the extent of the contribution to the economic development of the Province remained a determining factor in the selection of these investments.

During 1967 the Fund began to acquire stock. The purpose in establishing such a portfolio was to participate in the growth of the economy while at the same time protecting to a certain extent a part of its assets against the erosion of the purchasing power of money.

Continuing its policy of diversification of investments, the Fund took the first steps in the commercial and industrial real estate and mortgage fields. At the close of the year, a department had been formed to begin operations and various transactions were under negotiation.

Investment operations

During the second financial year the bond portfolio almost doubled, increasing in nominal value from $159,880,500 to $331,504,500 while its yield increased from 6.44% to 6.67%.

A significant key to the operation of the Fund in the bond field was the market's reaction to the seven new issues of Quebec and Hydro-Quebec bonds in Canada during 1967. Conscious of its close identity with the Province, the Fund, while adhering to its long-term investment policy, was able to give solid support by purchasing close to 40% of these new issues in Canada. The Fund, by its trading operations, was also active, from time to time, in helping to maintain a more orderly market in Quebec bonds.

In July and August the Fund, believing the North American financial outlook to be uncertain, increased its short-term holdings. Further, during September, anticipating the deterioration of the financial markets which in fact began in the fall, the Fund took advantage of the favourable market still prevailing to sell Government of Canada bonds, thus seeking to move into a more defensive position in case a possible financial crisis might jeopardize the borrowing programme of the Province. These operations were not only profitable but proved by events to have been most opportune. These steps contributed to a considerable improvement in the liquid position of the Fund. Short-term holdings reached $47,975,000 by year end but of this amount more than half was already earmarked for delayed delivery transactions.

At the close of 1967, direct and indirect long-term bonds of the Province for a total of $246,778,000 were held by the Fund. This represented 74.4% of the total long-term bond portfolio compared with 77.3% for the previous year. The average yield in this category increased from 6.44% to 6.63% during the period.

The holdings of Municipal and School bonds increased considerably during the year, their total moving from $16,630,500 to $39,556,500 while the average yield on these rose from 6.91% to 7.07%. This category represented 11.9% of the bond portfolio compared with 10.4% the previous year. These holdings included bonds of 72 Municipalities and 30 School Boards comprising in all 158 issues. The Fund did not limit its activities to purchasing new issues but traded actively in municipal bonds with dealers who wished to replenish their inventories. This made it possible for the Fund to participate in a larger number of new issues and to distribute over a period bonds that the market could not have absorbed at the time of issue.

The Fund's activity in the corporate bond field was limited to the first half of the year because new issues suitable for its portfolio were largely confined to that period. Holdings by the Fund of this category of bonds reached $21,425,000 at the close of the year and the yield on these assets was 6.86%. It should be pointed out that bond issues secured by provincial grants, reported in the amount of $9,770,000, are almost exclusively hospital bonds.

The stock operations of the Fund were begun in February 1967 with the object of acquiring a core of good quality stocks with a defensive potential. In selecting these stocks, the Fund followed a policy of avoiding as much as possible cyclical industries such as pulp and paper, the building industry, agricultural and industrial machinery, etc., such industries being particularly vulnerable at the time. The purchases were scheduled in such a way as to take advantage of stock market swings. Some preference was shown for Quebec based companies of prime quality, especially bank stocks. It should be pointed out that the Fund acquired a limited number of preferred convertible stocks which improve the stability and yield of the portfolio.

The stock portfolio of the Fund totalled $47,551,487 by year end and showed an expected average yield of 3.74%. Public utility stocks represent 24.4% of the portfolio and include telephone, natural gas and electric power companies. These industries usually enjoy regular growth at a rate higher than that of the economy as a whole. Financial institutions hold second place in the stock portfolio and account for 21.4% of the total. Changes introduced into the Bank Act in 1967 seem to offer greater scope and promise for the banking business. Next in order of importance in the portfolio are mines and metals accounting for 18.9% of the total; these basic industries justify their place in the portfolio in view of their long-term growth prospects. Finally 12.8% of the portfolio consists of gas and oil stocks, a promising segment of the Canadian economy.

The year's results

The gross earnings of the Fund, expressed as a yield on the average balances on deposit during the year, increased from 6.22% in 1966 to 6.23% in 1967. This slight increase was recorded despite the acquisition of $47,551,487 in stock on which the yield is naturally lower than that on bonds. There was however a somewhat greater improvement in the net yield which rose from 5.99% in 1966 to 6.08% in 1967. This was made possible by a relative reduction in the incidence of operating costs of the Fund which dropped from 0.23% in 1966 to 0.15% in 1967.

Demand deposits with the Fund averaged $26,527,756 during the year. Interest paid on these demand deposits in the amount of $1,248,197 was at a rate fluctuating between 4.10% and 6.03% with an average for the year of 4.71%. Notice deposits which averaged $274,048,573 during the year, earned revenues of $17,030,412 equivalent to an interest rate of 6.21%. The Fund has thus paid interest at a rate of 6.08% on its total deposits in 1967 as compared with 5.99% during the preceding year.

The Fund is an active trader in the security markets. In the bond section, trading operations are undertaken to improve the yield or the quality of the securities held, to realize a trading profit and, in some situations, to help maintain an orderly market in Quebec bonds. Stock trading aims at improving book values. The bond and stock trading operations produce at times a profit and at times a loss. The recorded loss at year end was $13,067 bringing the accumulated deficit in these operations to $158,503.

The Board of Directors

On the 4th April 1967, the Fund learned with great regret of the death of Mr. A. Hamilton Bolton who had been a member of the Board since its inception. His knowledge of the stock market and his profound understanding of economic matters earned him the highest respect of the members of the Board. His loss was sincerely regretted.

To succeed Mr. Bolton on the Board, the Lieutenant-Governor in Council, on July 18, 1967, appointed Mr. Charles B. Neapole, President of the Montreal and Canadian Stock Exchanges.

Staff

As was forecast in last year's annual report, the staff has nearly doubled during 1967. At the close of the year there was a total of 38 employees including 9 at management level. The Fund will see a further expansion in its staff in the coming year, though at a slower pace, so as to broaden again its investment activities.

It is recognized that for its successful operation, the Fund relies heavily on the devotion and loyalty of the staff and the Board extends its thanks and appreciation for their continuing co-operation.

On behalf of the Board of Directors,

Claude Prieur

Chairman.

Quebec City, March 8, 1968.

FINANCIAL STATEMENTS

Quebec Deposit and Investment Fund

BALANCE SHEET

As at December 31, 1967

ASSETS

	1967	1966
Portfolio (book value)		
Bonds	$317,258,056	*$153,253,884*
Preferred shares	2,353,602	—
Common shares	45,197,885	—
Short term investments	47,975,000	*27,583,250*
	$412,784,543	*$180,837,134*
Current assets		
Cash on hand and in bank	$ 41,874	*$ 8,691*
Accrued interest	5,572,743	*2,329,675*
Dividends receivable	11,522	—
Accounts receivable	—	*2,932*
	$ 5,626,139	*$ 2,341,298*
Fixed assets		
Leasehold improvements	$ 95,327	*$ 74,386*
Office furniture and equipment	72,762	*46,068*
	$ 168,089	*$ 120,454*
Less: depreciation	17,490	—
	$ 150,599	*$ 120,454*
Other assets		
Guarantee deposits	$ 2,050	*$ 2,000*
Prepaid expenses	1,951	—
	$ 4,001	*$ 2,000*
	$418,565,282	*$183,300,886*

LIABILITIES

	1967	1966
Current liabilities		
Accounts payable	$ 28,494	*$ 14,534*
Demand deposits	43,709,894	—
Accrued interest on demand deposits	317,707	—
Interest payable on notice deposits	5,680,507	*4,916,788*
	$ 49,736,602	*$ 4,931,322*
Notice deposits		
Depositor's account	$368,987,183	*$178,515,000*
Profit (loss) on sale of investments	(158,503)	*(145,436)*
	$368,828,680	*$178,369,564*
	$418,565,282	*$183,300,886*

STATEMENT OF INCOME AND EXPENDITURE

for the year ended December 31, 1967

	1967	1966
Income		
Interest on bonds	$ 16,144,209	*$ 4,064,734*
Dividends on shares	688,941	—
Net interest on short term investments	1,887,845	*1,039,481*
Sundry	12,904	*2,931*
	$ 18,733,899	*$ 5,107,146*
Expenditure		
Directors' fees and expenses	$ 5,033	*$ 7,626*
Salaries	276,789	*116,685*
Travelling expenses	11,333	*2,896*
Legal and professional fees	6,636	*18,122*
Rent	48,828	*17,083*
Bank charges	31,356	*10,366*
Office equipment rental	14,193	*316*
Electricity, telephone and insurance	11,593	*4,038*
Financial publications and services	7,764	*2,453*
Stationery and printing	12,235	*5,239*
Depreciation	17,490	—
Other expenses	12,040	*5,534*
	$ 455,290	*$ 190,358*
Net operating income	$ 18,278,609	*$ 4,916,788*
Less:		
Interest on demand deposits	1,248,197	—
Net income	$ 17,030,412	*$ 4,916,788*

Distribution of net operating income and amounts allocated during the year

	Interest on		
	Demand Deposits	*Notice Deposits*	*Total*
Net Operating Income	$ 1,248,197	$ 17,030,412	$ 18,278,609
Add: Interest payable on January 1, 1967	—	4,916,788	4,916,788
	$ 1,248,197	$ 21,947,200	$ 23,195,397
Less: Interest paid during 1967	930,490	16,266,693	17,197,183
Interest payable on January 1, 1968	$ 317,707	$ 5,680,507	$ 5,998,214

Deposit accounts – summary of transactions

	Demand Deposits	*Notice Deposits*	*Total*
Balance at beginning of year	$ —	$178,515,000	$178,515,000
1967: Deposits	216,984,894	—	216,984,894
Transfers	(173,275,000)	173,275,000	—
Interest paid	—	17,197,183	17,197,183
Balance at end of year	$ 43,709,894	$368,987,183	$412,697,077

Auditor's report

In accordance with section 43, 13-14 Elizabeth II, chapter 23, I have examined the balance sheet of the Quebec Deposit and Investment Fund as at December 31, 1967 and the statement of income and expenditure for the period ended on that date. My examination included a general review of the accounting procedures and such tests of accounting records and other supporting evidence as I considered necessary in the circumstances.

In my opinion, the operations of the Fund during the year have been carried out in conformity with the law, and the accompanying balance sheet and statement of income and expenditure present fairly the financial position of the Quebec Deposit and Investment Fund as at December 31, 1967 and the results of its operations for the period ended on that date, in accordance with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Gustave-E. Tremblay, C.A.,
Provincial Auditor.

Quebec City, February 29, 1968.

Yield on deposits

	Amount	Yield equivalence on average deposits [1]
Gross Income	$ 18,733,899	6.23%
Expenses	455,290	0.15%
Net Operating Income	$ 18,278,609	6.08%

[1] Average deposits were $300,576,329.

Average interest rate paid on deposits

	Average Deposits	Interest paid or due	Average yield
Demand Deposits	$ 26,527,756	$ 1,248,197	4.71%
Term Deposit [1]	—	—	—
Notice Deposits	274,048,573	17,030,412	6.21%
Total	$300,576,329	$ 18,278,609	6.08%

[1] No Term Deposit received during the year.

Bond portfolio summary as at December 31, 1967

	Face Value	
	Amount	Percenta
Government of Canada	$ 13,975,000	4.2
Government of Quebec and Guarantees	246,778,000	74.4
Guaranteed by Provincial Grants	9,770,000	3.0
Municipal and School	39,556,500	11.9
Corporate	21,425,000	6.5
	$331,504,500	100.0

(1) Investments in bonds are taken at amortized cost.

(2) Where no active market exists, bonds are valued on a yield basis.

(3) Weighted average of yields as at December 31, 1967.

Book Value [1]	Market Value [2]	Yield [3]
$ 13,056,349	$ 11,869,625	5.807%
236,715,135	209,691,153	6.632%
9,529,231	8,649,598	6.911%
36,886,958	33,516,435	7.073%
21,070,383	19,651,256	6.863%
$317,258,056	$283,378,067	6.673%

Stock portfolio summary as at December 31, 1967

	Book Value [1]
Preferred Shares	$ 2,353,602
Common Shares	
Public Utilities	11,622,688
Banks and Financial	10,179,243
Food, Beverages and Services	3,794,639
Machinery and Equipment	3,277,950
Oil and Gas	6,104,273
Mines and Metals	9,006,312
Forest Products	1,212,780
	$ 47,551,487

[1] Investment in stocks are taken at cost.

[2] The excess of book value over market value, in the amount of $1,357,631, does not take into account a net cumulative profit of $740,328 realized on sale of such securities.

Percentage	Market Value	Yield on Book Value
4.95%	$ 2,576,524	5.67%
24.44%	11,251,808	3.42%
21.41%	10,036,482	4.54%
7.98%	3,749,676	3.02%
6.89%	2,703,888	3.88%
12.84%	6,637,208	1.80%
18.94%	8,325,170	3.37%
2.55%	913,100	4.25%
100.00%	$ 46,193,856 [2]	3.74%