ANNUAL REPORT

The Management Committee of Punjab Pension Fund is pleased to present to Government of the Punjab the Annual Report for the year ended 30 June 2010.

FUND SIZE

- A summary of changes in fund size during the current financial year i.e. 2009-10 is given in the following table:

Rs. millions (rounded to the nearest million)

	July 2009 - June 2010
Beginning fund size	6,480
Add: contribution during the period	6,000
Less: transfer to Reserve Pension Fund	1,800
Add: gain/(loss) during the period	1,433
Less: expenses during the period	16
Ending fund size	**12,097**

The numbers exclude unrealized capital gains/losses.

FUND'S PORTFOLIO

- The Fund's exposures to different investment types are summarized as under:

Amounts: Rs. millions (rounded to the nearest million)
%: as percentage of Total Fund Size

	30 June 2009		31 Dec 2009		30 June 2010	
	Amount	%	Amount	%	Amount	%
PIBs	-	-	4,287	35.3	5,737	47.4
T-Bills	-	-	-	-	3,145	26.0
Short term bank deposits	3,439	53.1	7,844	64.5	3,015	24.9
Receivable from GoPb	3,000	46.3				
Corporate bonds/TFCs	-	-	-	-	176	1.5
Cash at bank	48	0.7	22	0.2	21	0.2
Other assets*	(7)	(0.1)	2	0.0	3	0.0
Total Fund Size	**6,480**	**100.0**	**12,155**	**100.0**	**12,097**	**100.0**

*Other assets include overdue or prepaid expenses for management of PPF and book value of fixed assets of PPF

- PPF has been increasing its exposure to long-term fixed-rate PIBs which are more suitable for the Fund considering the long-term nature of pension liabilities. As on 30 June 2010, long term PIBs constitute 47.4% of the Fund size.
  - Declining interest rates pose a major funding risk to PPF by raising the present value of pension liabilities which are long-term in nature

and thus highly sensitive to interest rates. During first half of FY 2009-10, external account showed considerable improvement and inflation & interest rates were declining. SBP reduced the discount rate twice between July-Nov 2009 to bring it down from 14% at end-June 2009 to 12.5% at end-Nov 2009. In order to partially hedge against further decline in interest rates, PPF built its long-term fixed-rate portfolio significantly during this period.

- However, during the second half of FY 2009-10, inflationary pressures reemerged on the back of higher than expected fiscal deficit & domestic borrowing by the government and a gradual worsening of the external account. SBP maintained the discount rate at 12.5% during this period and market interest rates increased slightly from their lows during the first half of FY 2009-10. During this period interest rates remained stable, therefore PPF built its long-term fixed-rate portfolio at a slower rate.

- PPF also started to build its Corporate bonds/TFCs portfolio during FY 2009-10. The yield on this portfolio is higher than government securities and bank deposits. Under its Investment Policy, PPF invests only in those bonds/TFCs where the entity as well as the issue rating is AA- or higher. As on 30 June 2010, Corporate bonds/TFCs constituted 1.5% of the Fund size.

- At the beginning of the year, the short-term investments were made in bank deposits. However, the relative attractiveness (yields) of short-term bank deposits vis-à-vis short-term T-bills kept changing during the year. PPF has, therefore, been switching exposure between T-bills & short-term bank placements in pursuit of higher rates of return.

FUND'S PERFORMANCE

- Time Weighted Return (TWR) earned by PPF is summarized as under:

Period	Annualized Return for the period			Long-term Benchmark
	Gross Return	Net Return*	CPI Inflation	CPI Inflation + 3%
FY 2008-09	15.21%	15.00%	13.14%	16.14%
FY 2009-10	13.79%	13.61%	12.69%	15.69%

*Net Return means the return after deducting expenses incurred on management of PPF

- Inflation rates over the last 2-3 years have been much higher than our long-term inflation expectations of 9%-10% p.a. Current interest rates are also higher than our long-term expectations. We consider this an opportunity to invest in long-term fixed rate instruments. As inflation and interest rates decline and revert to their long-term averages, the strategy to invest at fixed rates will pay off and the Fund will be able to earn an attractive real rate of return in accordance with its long-term objective.

GROWTH IN ASSETS vs. LIABILITIES AND FUNDING RATIO

- PPF has constructed a liability index on the basis of next 30-year pension-related cash outflows as projected by the Actuary of the Fund. The index captures the growth in market value of the liabilities i.e. the present value of next 30-year liabilities computed at market rates of interest.
- The following table summarizes the amount & growth of market value of Fund's assets vis-à-vis the amount & growth of market value of 30-year Pension liabilities of GoPb:

	During the period		End of period		
Period	Growth		Market Value (Rs. billions)		Funding Ratio
	Fund's Assets	Liability Index	Fund's Assets (a)	30-yr Pension Liabilities (b)	(a)/(b)
FY 2008-09	15.00%	28.01%	3.5	575.9	0.60%
FY 2009-10	13.21%	9.41%	12.1	621.7	1.94%
Jul 2008 - Jun 2010 (CAGR)*	14.10%	18.35%			

*CAGR means Compound Annualized Growth Rate

- Since the pension liabilities have very long maturities, their present value is highly sensitive to changes in interest rates. The following table illustrates this:

	Yield on 10-yr PIB (% p.a.)			
	Beg of period	End of period	Change during the period	Growth in liability index
FY 2008-09	13.29%	11.98%	-1.31%	28.01%
FY 2009-10	11.98%	12.84%	0.86%	9.41%

- During FY 2008-09, interest rates declined. Liability index grew by 28% during the period. The present value of liabilities increased sharply as the future liabilities were discounted at a lower rate.
- During FY 2009-10, interest rates increased. Liability index grew by a modest 9.41% during the period.
- **The above analysis highlights that the biggest risk exposure underlying the pension liabilities is a decline in interest rates. It can sharply increase the requirement of funds to meet the same liabilities and thus lower the Funding Ratio of the pension plan.**
- **The focus of the investment strategy of PPF should therefore be on managing the interest rate risk.**

INFLATION

- A summary of a few important measures of inflation during FY 2009-10 is given below:

	YOY Inflation		
	CPI (%)	NFNE[1] (%)	Trimmed[2] (%)
June 2010	12.7	10.4	11.7
12mma[3]	11.7	11.0	11.6
12m high	13.7	14.0	13.9
12m low	8.9	9.9	10.4

[1]NFNE stands for non-food non-energy measure of core inflation
[2]Trimmed Mean measure of core inflation excludes 20% of the items in the CPI basket showing extreme changes in price
[3]Twelve month moving average
Source: SBP

- Inflationary pressures eased during the first half but reemerged during the second half of the year driven mainly by food and energy prices.
    - Performance of major as well as minor crops remained weak during FY 2009-10. Both these subsector recorded negative growth in real terms which contributed to commodity price inflation.
    - The government continued to increase electricity prices in order to phase out the subsidies. This contributed to inflationary pressures.

- Core inflation measures especially NFNE recorded lower inflation compared with the headline CPI inflation which suggested that the economy was weak and inflationary pressures were easing in sectors other than food and energy.

INTEREST RATES

- A summary of (three important) interest rates for FY 2009-10 is given below:

	Yields (p.a.)		
	1-yr T-bill	10-yr PIB	6-m KIBOR
June 2010	12.38	12.84	12.37
12mma	12.23	12.52	12.41
12m high	12.56	12.84	12.84
12m low	11.83	11.84	11.99

Source: SBP, Reuters

- Interest rates declined during the first half of the financial year as SBP lowered the discount rate twice (a cumulative reduction of 1.5% from 14%

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at end June 2009 to 12.5% by end Nov 2009) on the back of lower Inflation and lower Current Account Deficit.

- Interest rates gradually rose during the second half of the financial year which was marred by some adverse developments including a resurgence of inflation, deterioration in Current Account Deficit and high domestic borrowing by the government (due to significant shortfall in foreign inflows budgeted by the government).

- On the whole, interest rates remained within a narrow range during FY 2009-10 which suggested that the economy was gradually reverting to a normal path.

OUTLOOK FOR FY 2010-11

- Events since the beginning of FY 2010-11 have worsened the macroeconomic picture.

- GDP Growth: For FY 2010-11, the government had originally set a GDP growth target of 4.5%. However, recent estimates by SBP project GDP growth in the range of 2%-3%. Reasons for the slowdown of the economy include:
    - Damage to crops, livestock, infrastructure, industry and economic activity in general, caused by floods;
    - Intensification of inflationary pressures due to
        - food shortages caused by floods
        - rising prices of petroleum products
        - rise in electricity tariffs
    - slowdown in borrowing and investment by the private sector due to a combination of slow economy, rising costs and high interest rates.

- Fiscal Balance: The government had initially set a budget deficit target of 4% for FY 2010-11. As per SBP's analysis, the budget deficit target shot up to 5.2% of GDP after the announcement of provincial budgets. Even that will be difficult to meet considering the enormity of prevailing fiscal imbalances. During the first half of FY 2010-11, the actual budget deficit has been 2.9% of GDP.

- External Account: Worsening of the trend in balance of payments during second half of FY 2009-10 suggested a potential widening of trade deficit in FY 2010-11. SBP initially projected the Current Account Deficit to rise in FY 2010-11 to $6.9 bn or 3.7% of GDP on the back of higher growth in imports compared with exports. However, actual growth in exports and foreign remittances during first half of FY 2010-11 has been much higher than expectations. Current Account Deficit for FY 2010-11 is now expected to be much lower than the initial estimates.

- Inflation: At the end of FY 2009-10, it seemed that a weak economy and tight monetary policy would keep inflation under control during FY 2010-11. The government had initially set the inflation target at 9.5% for FY

2010-11. However, with the strengthening of inflationary pressures in the aftermath of floods and continuation of high spending and borrowing by the Government, the revised inflation expectation is 15% for FY 2010-11. Major reasons for higher inflation in FY 2010-11 include:

- shortages, and hence very high increases in prices, of perishable food commodities as a result of devastating floods;
- hike in electricity prices as the government phases out the subsidy being provided to the sector; and
- the strengthening of international commodity prices in general and crude oil prices in particular.

- Interest rates: Interest rates are expected to remain high during FY 2010-11 considering the trends in inflation and government borrowing. It seems that, in the near future, Pakistan will continue to face the double whammy of low GDP growth on one hand and high inflation & interest rates on the other.

INVESTMENT STRATEGY

- Average inflation (CAGR) over the 19 year period from July 1991 to June 2010 has been 8.8% p.a., long-term inflation expectation for the future is in the range of 9-10% p.a. A fixed rate of return of 12.5% p.a. or above on investments is consistent with Fund's long-term return objective of 'inflation + 3%'.

- The current inflation rate is too high and will gradually revert to its long-term average. Since above-average inflation has led to above-average interest rates also, Fund's strategy is to invest at fixed rates of return for longer periods.

- Considering the higher yields on Corporate bonds/TFCs, a small allocation of 5% of Fund size has been made to corporate bonds/TFCs.

- A major limitation of investments in floating-rate TFCs is that their yields are vulnerable to a decline in interest rates. In order to manage the interest rate risk underlying the floating-rate investments, the Fund may consider entering into fixed-for-floating Interest Rate Swaps so that the Fund can convert its floating-rate investments into fixed-rate investments.

- An allocation of 20% of Fund size has been made for long-term placements with banks having minimum credit rating of AA-. However, there has been no breakthrough in negotiations with commercial banks for long term placement of funds. The banks are generally reluctant to take fixed deposits for periods longer than one year. In future, this portion may be reallocated to other avenues such as corporate bonds/TFCs, T-bills, Short-term TDRs, PIBs, Saving Schemes or Stocks etc.

- The Fund is only making debt investments until now. No allocation has so far been made to equity investments.

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MANAGEMENT COMMITTEE MEETINGS

Four meetings of the Management Committee have taken place during the year ended 30 June 2010. Attendance of the members in Management Committee meetings is appended below:

	Designation / Name of Member	Attendances
1.	Finance Minister, Government of the Punjab	4
2.	Chief Secretary, Government of the Punjab	3
3.	Chairman, Planning and Development Board	4
4.	Finance Secretary, Government of the Punjab	4
5.	Secretary Law, Government of the Punjab	4
6.	Secretary Services, Government of the Punjab	4
7.	General Manager, Punjab Pension Fund	4
8.	Mr. Muhammad Arif Yaqub	3
9.	Mr. Asim Zulfiqar Ali	4
10.	Mr. Tariq Iqbal Khan	3
11.	Mr. Adnan Afaq	3

AUDITORS

Government of the Punjab appointed M/S KPMG Taseer Hadi & Co., Chartered Accountants, as auditors of the fund. The auditor has completed the audit for the year ended 30 June 2010 and has submitted its report to the Management Committee.

ACKNOWLEDEMENT

The Management Committee takes this opportunity to thank its members for valuable contributions to the Fund.

The Management Committee also wishes to place on record its appreciation for the hard work and dedication shown by the employees of the fund.

23.6.11

Place: Lahore
Dated: 30 May 2011

Sirdar Zulfiqar Ali Khan Khosa
Chairman