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 2011.

FUND SIZE

- A summary of changes in fund size during FY 2010-11 is given in the following table:

Rs. millions (rounded to the nearest million)

	July 2010 - June 2011
Beginning fund size	12,097
Add: contribution during the period	-
Less: transfer to Reserve Pension Fund	-
Add: gain/(loss) during the period	1,630
Less: expenses during the period	(19)
Ending fund size	**13,708**

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		30 June 2010		30 June 2011	
	Amount	%	Amount	%	Amount	%
PIBs	-	-	5,737	47.4	8,942	65.2
T-Bills	-	-	3,145	26.0	1,254	9.1
Short term bank deposits	3,439	53.1	3,015	24.9	3,002	21.9
Receivable from GoPb	3,000	46.3	-	-	-	-
Corporate bonds/TFCs	-	-	176	1.5	501	3.7
Cash at bank	48	0.7	21	0.2	8	0.1
Other assets*	(7)	(0.1)	3	0.0	1	0.0
Total Fund Size	**6,480**	**100.0**	**12,097**	**100.0**	**13,708**	**100.0**

*Other assets include prepaid operating expenses and book value of fixed assets of PPF.

- Long-term investments consist of PIBs and TFCs whereas short-term investments consist of T-bills and bank deposits.

- 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 2011, long term PIBs constitute 65.2% of the Fund size.
    - During first half of FY 2010-11, the macroeconomic situation was adversely affected by the unprecedented floods. Food shortages and transportation problems created high food inflation. International Oil Prices also rose due to a combination of factors including better-than-expected growth in

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emerging economies and political unrest in Middle East and North Africa (MENA) region. Overall CPI inflation increased sharply driven mainly by high food and energy prices. SBP increased the discount rate from 12.5% to 14% during the first half of FY 2010-11.

- However, during the second half of the financial year, inflationary pressures eased a little bit as food shortages & transportation/supply chain problems were resolved to some extent and oil prices also retreated from their highs. The External Current Account performed better than expectations throughout the year and closed the year at a surplus of USD 0.5 bn after remaining in deficit continuously for six years. During second half of FY 2010-11, SBP maintained the discount rate at 14%.

- Higher discount rate resulted in higher yields on bonds/fixed income instruments of all types and maturities. In order to lock-in high yields and partially hedge against a future decline in interest rates, PPF expanded its long-term fixed-rate portfolio (consisting mainly of PIBs) significantly during the last quarter of the financial year.

- PPF also expanded its Corporate bonds/TFCs portfolio during FY 2010-11. Exposure to Corporate bonds/TFCs increased from 1.5% of Fund size at the beginning of the year to 3.7% of Fund size at the end of the year. The yield on this portfolio is higher than government securities or 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.

- Short-term investments typically consist of 3-month bank deposits or 3-month T-bills. The relative attractiveness (yields) of short-term bank deposits vis-à-vis short-term T-bills kept changing during the year. PPF also kept 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%
FY 2010-11	13.48%	13.32%	13.13%	16.13%
Jul 2008 - Jun 2011 (CAGR)**	14.16%	13.97%	12.99%	15.99%

*Net Return means the return after deducting expenses incurred on management of PPF
**CAGR means Compound Annualized Growth Rate

- Despite high inflation (13.13%) for the 12 month period ending on June 2011, PPF managed to earn a net rate of return (13.32%) that was higher than inflation.

- Over the 3-year period since establishment of PPF, the average annual rate of return of PPF has been 13.97% which is approximately 1% more than the average annual inflation rate of 12.99%.

- Inflation rates over the last 2-3 years have been much higher than the long-term inflation expectations of 9%-10% p.a. Current interest rates are also higher than the long-term expectations. 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

- As per the last Actuarial Assessment Report, the present value of pension liabilities of the Government of the Punjab stood at Rs. 688 billion as on 30 June 2010.

- The actual assets of PPF stood at Rs. 13.7 billion as on 30 Jun 2011.

- If PPF were envisaged as a fully funded pension plan, the value of its assets would match the value of the total pension liability of the Government of the Punjab, and the funding ratio (the ratio of its assets to its liabilities) would equal one (or 100%). This would mean that for the accrued pension liabilities, the Government of the Punjab would not have to earmark any budgetary resources because these would be met by PPF from the return on its assets.

- Currently the Government of the Punjab does not have an explicit target for the Funding Ratio. The desired Funding Ratio can be inferred from the projected injections of funds in PPF by the government as stated in the Medium Term Budgetary Framework 2009-12 announced by Government of the Punjab. If the injections of funds were to stay on course and there were no withdrawals then at the current average rate of return on PPF funds, the projected funding ratio in 2016 would be 2.3%. Thereafter, this ratio is expected to stay in the range of 2%-2.5%.

- Assuming that the pension liability of the Government of the Punjab as on 30 June 2011 is the same as that on 30 June 2010, this translates into a Funding Ratio of 2% i.e. actual assets of Rs. 13.7 billion against required liabilities of Rs. 688 billion.

- When interest rates go down the rate of return on assets can also goes down and the pension plan needs a larger amount of assets to pay the pension liabilities promised to the employees. Thus a decline in interest rates can lower the Funding Ratio of a pension plan further.

- In order to properly manage a pension plan, two things are important.
    - Firstly, the Funding Ratio of the pension plan should be high so that sufficient assets vis-à-vis the liabilities are available. A Funding Ratio of 100% is ideal.
        - Currently, the Funding Ratio of the pension plan is in the range of 2% which means that the current level of assets is sufficient to meet only 2% of accrued pension liabilities of the Government of the Punjab. This Funding Ratio is clearly quite low and the government may consider increasing this ratio. To make PPF fully funded would need an asset base of about Rs 700 billion as on June 30, 2011. To achieve this magnitude of asset base would require a

long-term and sustainable plan of gradual injection of funds into the pension plan.

- Secondly, the Fund should preferably make long-term fixed-rate investments whose maturity is as close as possible to the maturity of pension liabilities. With fixed-rate investments the rate of return on the assets of the Fund will be less vulnerable to the fluctuations in the market rate of interest.
  - Considering the importance of long-term fixed-rate investments, PPF has invested 65% of its assets in long-term fixed-rate bonds and remains ready to invest further as opportunities to invest long-term at attractive fixed rates arise.

INFLATION

- A summary of a few important measures of inflation during FY 2010-11 is given below:

	YOY Inflation (%)				
	CPI			NFNE[1]	Trimmed[2]
	overall	Food	non-food		
June 2011	13.1	15.7	11.0	10.4	12.0
12mma[3]	13.9	18.0	10.5	9.7	13.0
12m high	15.7	21.2	12.0	10.4	13.6
12m low	12.3	12.8	8.9	9.2	11.6

[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 (10% items showing highest increases in price & 10% items showing lowest increases or negative changes in price)

[3]Twelve month moving average

Source: SBP

- CPI consists 40% of food items and 60% of non-food items. During FY 2010-11, CPI inflation was driven primarily by higher food prices. During the later part of the financial year, food prices began to revert back to normal as the shortages created in the aftermath of floods began to correct. YOY CPI inflation touched a high of 15.7% in Sep 2010 when YOY food inflation also touched a high of 21.2%. YOY non-food inflation remained in a range of 8.9% to 12% during the year.

- YOY non-food-non-energy measure of core inflation ranged between 9.2% and 10.4% during FY 2010-11 showing that the inflationary pressures during the were concentrated mainly in food and energy items.

- YOY trimmed-mean measure of core inflation ranged between 11.6% and 13.6% during FY 2010-11 showing that within the food & energy items, the inflationary pressures were quite broad based.

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INTEREST RATES

- A summary of important interest rates for FY 2010-11 is given below:

	Yields (% p.a.)		
	1-yr T-bill	10-yr PIB	6-m KIBOR
June 2011	13.85	14.09	13.78
12mma	13.44	13.79	13.46
12m high	13.85	14.25	13.83
12m low	12.42	12.95	12.42

Source: SBP, Reuters

- Interest rates increased during the first half of the financial year as SBP increased the discount rate thrice (a cumulative increase of 1.5% from 12.5% at end June 2010 to 14% by end Nov 2010) on the back of high inflation and high domestic borrowing by the Government.

- During the second half of the financial year, inflation eased off from its highs but SBP maintained the discount rate at 14% due to concerns regarding the macroeconomic implications of continued high borrowing and spending by the Government.

OUTLOOK FOR FY 2011-12

GDP Growth:

- For FY 2011-12, the Government has set a GDP growth target of 4.2%.

- Future growth outlook will be shaped by policy responses to several key domestic challenges including energy shortages (which are restricting output growth) and high fiscal deficit & government borrowing (which crowds out the private sector) and inflationary pressures (which affect the purchasing power of consumers and also the costs of doing business).

- Agriculture sector is likely to perform better in FY12 because of low base due to floods related damages during last year, more fertile post-flood land, a shift toward more productive and disease resistant BT cotton and higher expected water availability compared with last year. However, rising fertilizer prices pose a downside risk (if farmers use less fertilizer because of high prices, the productivity of the crops may be adversely affected).

- Industrial sector faces multiple challenges including shortage of electricity and gas, law & order situation, competition for auto manufacturers from imported cars as the government has increased the age limit for used cars from 3 to 5 years.

Fiscal Balance:

- The Government has set a budget deficit target of 4% for FY 2011-12. The Government also plans to reduce the Revenue Deficit to zero in FY 2011-12. This will require a significant increase in tax collection along with a rationalization of expenditures especially subsidies.

- High growth in revenues will not be easy to achieve considering that the economy is growing at a rate that is below its potential.

- Lowering the subsidies will also be a challenge because such adjustments usually result in higher inflation.

External Account:

- After remaining in deficit for six consecutive years, Pakistan's Current Account posted a surplus of US$ 0.5 billion in FY 2010-11 on the back of strong growth in exports (29%) and a healthy increase in worker's remittances (26%) during the year.

- SBP has projected a Current Account Deficit of 0.8% of GDP in FY 2011-12. Even after assuming a healthy growth in foreign remittances, SBP expects a modest Current Account Deficit in FY 2011-12 due to the following reasons:
  - Higher cotton prices, which played a major role in last year's stellar performance, are on a declining trend in the international markets. This will adversely affect the export figures in future.
  - Slowdown in the global economy, especially in the developed world, may also impact exports.

Inflation:

- Government has set the inflation target at 12% for FY 2011-12. SBP expects that CPI inflation will be in the range of 11-12% during FY 2011-12.

- The expectations of lower inflation compared with the past year are based on the following reasons:
  - During the past year, CPI inflation was driven primarily by higher food prices. Food items have a 40% weight in the overall CPI. Food inflation is expected to be lower during FY 2011-12 because of high base effect and improved supply situation as the shortages created in the aftermath of last year's floods have largely corrected.
  - International commodity prices are also softening (although YOY inflation is still high, MOM inflation was -5% in May and -1.5% in June 2011 as per the Commodity Index maintained by IMF) and this trend is expected to continue in the near future because of the economic slowdown across the globe and particularly in the developed world.

Interest rates:

- SBP has already lowered the discount rate by 0.5% from 14% to 13.5% during its Monetary Policy decision dated 30 July 2011.

- SBP cited a gradual buildup of foreign exchange reserves, containment of Government borrowings from SBP, expectations of contained Current Account Deficit (0.8% of GDP) and contained inflation (in the range of 11% to 12%) and the need to revive private sector credit and investment as the major reasons behind its decision to lower the discount rate.

- Further lowering of discount rate can be expected during FY 2011-12 as long as the key macroeconomic variables i.e. Government borrowing for SBP, Current Account balance and Inflation follow the trend projected by SBP.

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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 is expected to 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.

AUDITORS

Government of the Punjab appointed M/S KPMG Taseer Hadi & Co., Chartered Accountants, as auditors of the Fund. The auditors have completed the audit for the year ended 30 June 2011 and have submitted their 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.

Place: Lahore
Dated: 13 January 2012

Chairman

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