Government of the Punjab

Punjab Pension Fund

Dated: 10 September 2013

MONTHLY REVIEW OF INVESTMENTS
August 2013

FUND SIZE

- A summary of changes in fund size during FY14 is given in the following table:

Rs. millions (rounded to the nearest million)

	1st July - 31st Aug 2013
Beginning fund size (30th June 2013)	17,585
Add: Contribution during the period	-
Less: Transfer to Reserve Pension Fund	-
Add: Gains during the period	337
Less: Expenses during the period	(4)
Ending fund size	**17,918**

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 Jun 2012		30 Jun 2013		31st Aug 2013	
	Amount	%	Amount	%	Amount	%
PIBs	9,480	60.7	9,560	54.3	9,369	52.2
T-Bills	139	1.0	-	-	1,444	8.0
Short term bank deposits	5,349	34.3	5,928	33.7	2,124	11.8
National Saving Schemes	-	-	1,831	10.4	1,861	10.4
Corporate bonds/TFCs	501	3.2	246	1.4	97	0.5
Cash at bank	130	0.8	11	0.1	3,017	16.8
Other assets*	6	0.0	9	0.1	6	0.1
Total Fund Size	**15,605**	**100.0**	**17,585**	**100.0**	**17,918**	**100.0**

*Other assets include prepaid expenses for management of PPF and book value of fixed assets (motor cycles, computers etc.) of PPF.

- Long-term investments consist of PIBs and TFCs whereas short-term investments consist of T-bills, National Saving Schemes and bank deposits.
- PPF keeps switching exposure between T-bills, National Saving Schemes & short-term bank placements in pursuit of higher rates of return.

FUND'S PERFORMANCE

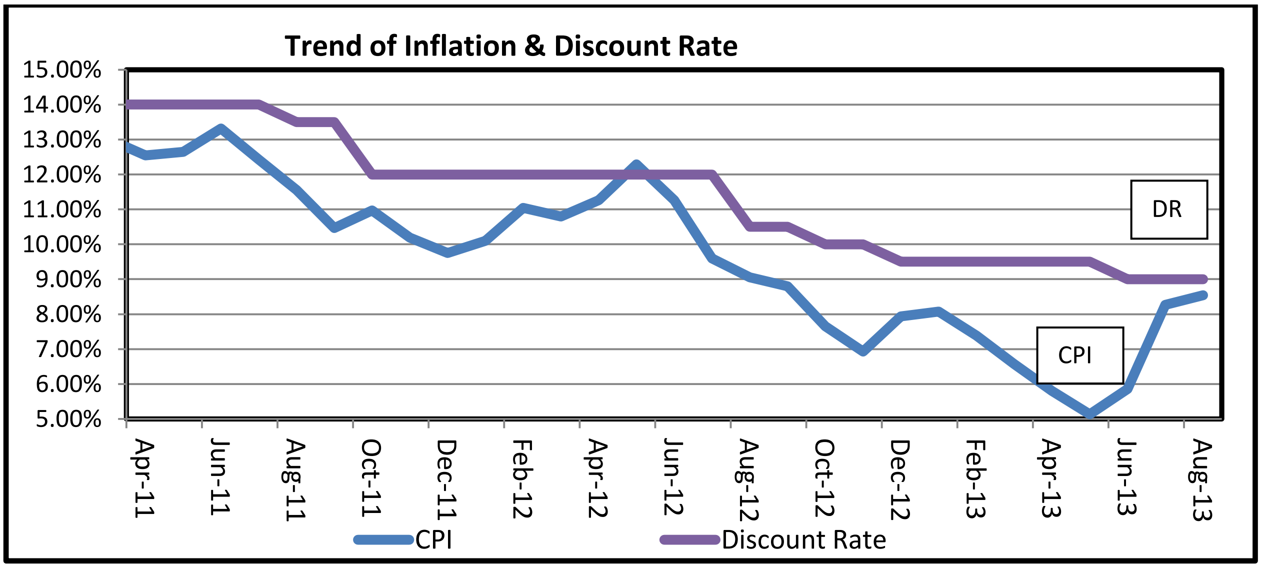
- Time Weighted Return (TWR) earned by PPF is summarized as under:

Period	Annualized Return for the period				Long-term Benchmark
	Gross Return	Net Return*	Year End Discount Rate	CPI Inflation	CPI Inflation + 3%
FY 2008-09	15.21%	15.00%	14.00%	13.14%	16.14%
FY 2009-10	13.79%	13.61%	12.50%	12.69%	15.69%
FY 2010-11	13.48%	13.32%	14.00%	13.13%	16.13%
FY 2011-12	13.96%	13.79%	12.00%	11.26%	14.26%
FY 2012-13	12.85%	12.69%	9.00%	5.85%	8.85%
Jul 2008 – Jun 2013 (CAGR)**	13.85%	13.67%	12.14%	11.17%	14.17%
July-August 2013	11.81%	11.68%			
August 2013	11.82%	11.68%			

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

**CAGR means Compound Annualized Growth Rate

- Inflation rates over the last few years (FY 09 to FY 12) have been much higher than our long-term inflation expectations of 9%-10% p.a. Interest rates have also been higher than our long-term expectations.
- In order to lock-in high yields for a long period of time, the Fund invested a large proportion of its assets in long-term fixed-rate instruments consisting mainly of PIBs.
- In FY 13, CPI Inflation rate has declined sharply and SBP has reduced the policy rate by 3.0% cumulatively (from 12% to 9%).
- The investment strategy followed over the past few years i.e. investment in long-term fixed-rate instruments at attractive yields, is now paying off. Despite lower interest rates, PPF continues to earn an attractive rate of return because of its high yielding portfolio of PIBs.
- Inflation bottomed out in May 2013 at 5.13% and since then it's on a rising trend as indicated by the following graph. The recent cycle of phasing out electricity subsidies and increase in fuel prices is likely to lead further increase in prices in coming months.

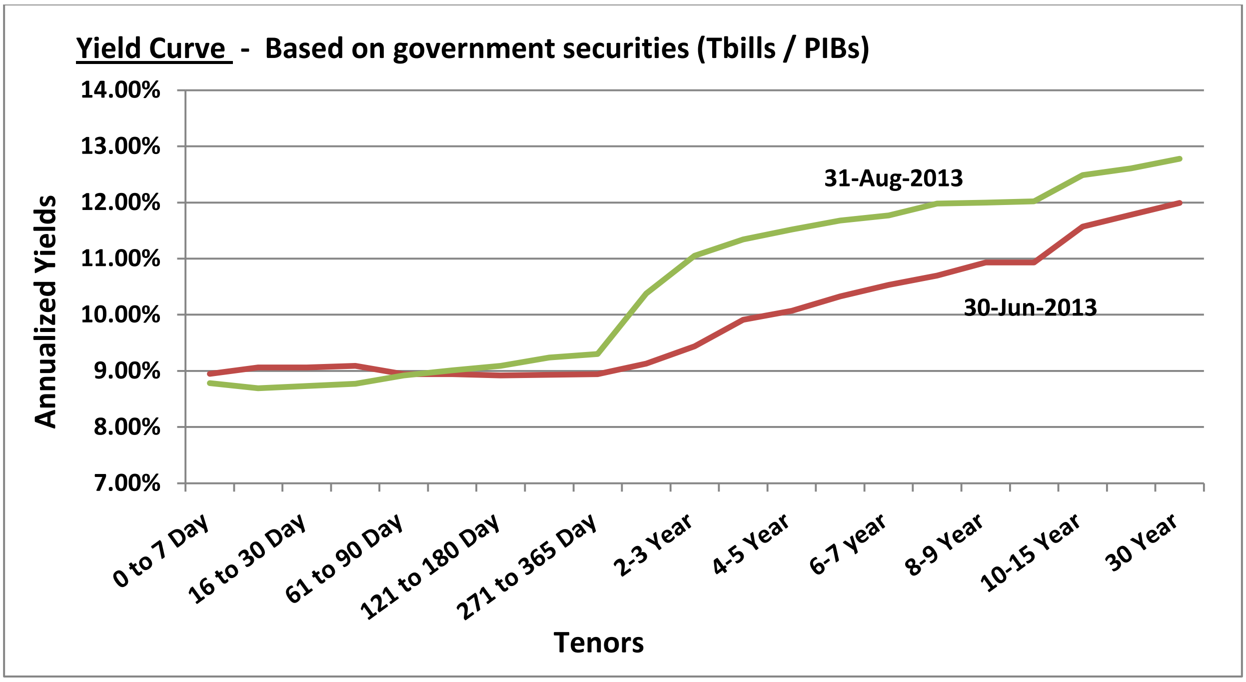


GROWTH IN ASSETS vs. LIABILITIES AND FUNDING RATIO

- We have constructed a liability index on the basis of next 30-year pension-related cash outflows projected by the Actuary of the Fund. The index captures the growth in the present value (computed at market rates of interest) of next 30-year liabilities.
- The following table summarizes the amount & growth of market value of Fund's assets vis-à-vis the amount & growth in present 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%
FY 2010-11	10.81%	-2.88%	13.4	608.9	2.19%
FY 2011-12	16.86%	25.40%	15.6	757.1	2.06%
FY 2012-13	20.46%	38.96%	18.8	1052.1	1.79%
Jul-Aug FY14	-1.52%	-7.30%	18.5	975.5	1.90%
Jul 2008 – Jun 2013 (CAGR)	15.21%	18.83%			

- Since the pension liabilities have very long maturities, their present value is highly sensitive to changes in interest rates.
- The present value of liabilities has a negative correlation with interest rates - it increases sharply when interest rates decrease and vice versa.
- The biggest market risk exposure of 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.
- During the period July-August FY14, long term interest rates reversed with the expectations of resurge in inflation. The long-term interest rates (yield on 10-yr PIBs) crossed 12% which were below 11% at the end of FY13. This has resulted in a decrease of 7.30% in present value of liabilities. Although Market value of Fund's assets also declined by 1.52% during the same period, the decline in present value of liabilities is much higher than decline in market value of assets. This occurred because there is a substantial Duration Gap between the Fund's assets and its liabilities. Duration measures the sensitivity of present value of a series of cash flows to changes in interest rates. Despite investing a large proportion of Fund's assets in long-term fixed-rate bonds which have higher Durations, the overall Duration of Fund's assets is still much lower than the overall Duration of Fund's liabilities.



REVIEW OF IMPORTANT ECONOMIC & FINANCIAL VARIABLES

GDP GROWTH

- GDP growth during FY13 fell to 3.6 percent from 4.4 percent in FY12. Higher growth in industrial sector, as compared with last year, was insufficient to make up for the slowdown in services. Agriculture growth has remained almost unchanged during the year as compared with the last year.
- Analysis of the demand side shows that the Growth in FY13 was primarily driven by private consumption. Strong worker remittances, a vibrant informal economy and higher fiscal spending supported consumption growth during the year. On the other hand investment demand remained sluggish – a trend that has continued over the past several years. It is important to realize that over-dependence on consumption makes growth unsustainable, especially when a country’s investment rate has been falling. During the recent years lower investment-to-GDP can be attributed to security concerns, energy constraints, and excess capacity with the manufacturing sector and lower appetite of commercial banks to lend to private sector. Public investment has also been overshadowed by subsidies.
- On external front, slower global economic growth weighed on Pakistan’s exports and financial inflows.
- For FY14, the government has set a GDP growth rate target of 4.4%.

GDP Growth Rates	FY 10	FY 11	FY 12	FY 13
A) Commodity Producing Sector	**1.8%**	**3.3%**	**3.06%**	**3.42%**
I. Agriculture	**0.2%**	**2.0%**	**3.45%**	**3.35%**
Crops	-4.2%	1.0%	2.9%	3.2%
Important Crops	-3.7%	1.5%	7.4%	2.3%
Other Crops	-7.2%	2.3%	-7.7%	6.7%
Cotton Ginning	7.3%	-8.5%	13.8%	-2.9%
Livestock	3.8%	3.4%	3.95%	3.68%
Fishing	1.4%	-15.2%	3.77%	0.65%
Forestry	-0.1%	4.8%	1.74%	0.13%
II. Industry	**3.4%**	**4.7%**	**2.66%**	**3.49%**
Manufacturing	1.4%	2.5%	2.13%	3.51%
Large Scale	0.4%	1.7%	1.18%	2.83%
Small Scale	6.3%	6.6%	6.52%	6.44%
Mining & Quarrying	2.8%	-4.4%	4.58%	7.58%
Construction	8.3%	-8.6%	3.16%	5.18%
Electricity & Gas Distribution	16.7%	66.4%	2.73%	-3.20%
B) Services Sector	**3.2%**	**3.9%**	**5.34%**	**3.71%**
Wholesale & Retail Trade	1.8%	2.1%	1.66%	2.52%
Transport Storage & Communication	3.0%	2.4%	8.91%	3.44%
Finance & Insurance	-3.3%	-4.2%	1.01%	6.64%
Ownership of Dwelling	4.0%	4.0%	4.00%	3.99%
General Government Services	8.0%	14.1%	11.1%	5.6%
Other Private Services	5.8%	6.6%	6.3%	4.0%
GDP at Factor Cost (A+B)	**2.6%**	**3.7%**	**4.4%**	**3.6%**

EXTERNAL ACCOUNT

- Balance of payments is summarized in the following table:

Billion US $

	July FY13	July FY14	Growth %
Current Account	**(0.43)**	**0.05**	**111**
Trade balance(Goods)	(1.39)	(1.18)	15
Trade balance (Services)	(0.29)	(0.16)	44
Income transfers (net)	(0.18)	(0.22)	(20)
Remittances	1.21	1.40	17
Capital Account	**0.02**	**0.03**	**39**
Financial Account	**0.01**	**0.26**	**5140**
Net Errors & Omissions	**(0.20)**	**(0.63)**	
Overall Balance of Payments	**0.61**	**0.82**	**34**

Source: SBP

- The Current Account posted a surplus of USD 46 million during the first month of FY14. The country posted a current account deficit of USD 427 million during the same period in last year.
- Trade balance for the period improved by 15% attributed to 1% decline in imports and 9% increase in exports.
- Services balance also improved by a massive 44% on the back of 12% increase in exports and 14% decline in imports of services.

- Current transfers continued to provide much needed support on the back of healthy remittances. Remittances were up by 17% during the July FY14 compared with the same period of last year.
- Capital and financial account also showed some encouraging signs with the beginning of FY14 as they posted a surplus of USD 287 million during the first month of FY14 as compared to only USD 23 million surplus in the same period last year.
- The overall Balance of Payments also remained positive USD 820 million.

INFLATION

- A summary of consumer price inflation rates is given in the following table:

	CPI Inflation								
Period	**CPI Overall (%)**			**CPI Food (%)**			**CPI Non-food (%)**		
	YOY	**MOM**	**12mma[1]**	**YOY**	**MOM**	**12mma**	**YOY**	**MOM**	**12mma**
Jun-2013	5.9	0.7	7.4	7.9	1.1	7.1	4.4	0.5	7.5
Jul- 2013	8.3	2.0	7.3	9.2	3.0	7.1	7.6	1.3	7.3
Aug-2013	8.5	1.2	7.2	10.3	2.0	7.3	7.3	0.6	7.2
12 month high	8.8	2.0	10.4	10.3	3.0	9.8	9.7	1.5	10.8
12 month low	5.1	-0.4	7.2	5.3	-1.3	7.1	4.1	-0.4	7.2

[1]12 month moving average Source: FBS, SBP.

- CPI showed another month of high inflation and recorded 1.2% on MOM basis during August 2013; while, on YoY basis CPI settled at 8.5%
- Food inflation was mainly responsible for this higher number both on MoM as well as on YoY basis as it recorded 2% and 10.3% respectively.
- We expect there can be seen some upward pressure in prices as the government has increased electricity and fuel prices recently; their impact is yet to be realized. And there is another phase of passing on electricity prices on consumers as government agreed with IMF.
- The Government has set an inflation target of 8 percent for FY14. However, we expect that inflation may close in the range of 9-10 percent for FY14.
- A summary of measures of core inflation is given in the following table:

	Core Inflation					
Period	**NFNE[1] (%)**			**Trimmed[2] (%)**		
	YOY	**MOM**	**12mma**	**YOY**	**MOM**	**12mma**
Jun-2013	7.8	0.4	9.6	6.8	0.6	9.0
Jul-2013	8.2	1.5	9.3	7.8	1.2	8.8
Aug-2013	8.5	0.6	9.2	7.9	0.6	8.6
12 month high	10.5	1.5	10.8	10.4	1.2	10.9
12 month low	7.8	0.2	9.2	6.7	0.2	8.6

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

- Both measures of core inflation have also showed upward trend in prices on YoY basis in line with CPI.
- The following table summarizes international commodity price inflation rates:

	Inflation Rates (%) as per the indices maintained by IMF								
Period	(Overall) Index of Fuel & Non-fuel Commodities			Commodity Fuel (Energy) Index			Index of Non-fuel Primary Commodities		
	YOY	MOM	12mma	YOY	MOM	12mma	YOY	MOM	12mma
May-2013	-3.2	0.2	-4.6	-4.7	0.4	-4.9	-0.3	-0.2	-3.6
Jun-2013	5.2	-0.1	-3.1	7.0	-0.3	-3.3	2.1	0.4	-2.3
Jul-2013	3.3	2.6	-1.9	6.4	4.2	-1.9	-2.3	-0.3	-1.5
12 month high	5.2	4.4	2.4	7.0	7.9	9.9	4.5	2.2	-1.5
12 month low	-9.1	-3.8	-4.9	-12.0	-4.2	-4.9	-11.4	-3.0	-11.2

Source: IMF

- Despite continued slowdown in economic growth around the world, commodity prices showed a sharp increase of 2.6% on a MoM basis, solely contributed by petroleum prices. The break-up shows that on MoM basis, fuel/energy related commodities recorded a sharp increase of 4.2% whereas non-fuel commodities recorded deflation of 0.3%.
- The inflation figures are based on US dollar (and not Pak rupee) prices of commodities, therefore these figures need to be interpreted carefully. For instance, assuming a 10% depreciation of rupee against dollar, an inflation of 3.3% in dollar terms may actually mean inflation of 13.3% in rupee terms. Further, the impact of currency depreciation on domestic prices is reflected with some time gap.

INTEREST RATES

- A summary of important interest rates is given below:

Period	Yield on 1-yr T-bill (% p.a.)		Yield on 10-yr PIB (% p.a.)		6-month KIBOR (% p.a.)	
	Month end	12mma	Month end	12mma	Month end	12mma
Jun-2013	8.94	9.69	10.93	11.62	9.09	9.82
Jul-2013	9.20	9.47	11.76	11.51	9.08	9.58
Aug-2013	9.30	9.38	12.02	11.54	9.15	9.46
12m high	10.01	11.61	12.10	12.69	10.22	11.69
12m low	8.94	9.38	10.80	11.51	9.08	9.46

Source: SBP, Reuters

- Despite the 50 basis points cut in discount rate in last Monetary Policy, the yield on 10 year PIBs remained firmed at 12.0% which reflects that market is expecting resurgence in inflationary pressure.

- State Bank of Pakistan is going to announce its Monetary Policy Statement on 13th September 2013; we expect no change in policy rate based on followings:
  - Although inflation has reversed in the last two months, but it is still comfortably below the discount rate and there is no immediate pressure to increase the discount rate because of inflation.
  - There were very strong speculations that IMF will push for hike in discount rate and it will be key condition for approval of loan. However, the program has been finally approved and the agreed document has no condition of increase in discount rate.
  - We think that future course of interest rate will be mainly based on inflation and coming months CPI number will be a crucial factor to drive the interest rates direction.

INVESTMENT STRATEGY

- Current portfolio of the Fund is based on the expectorations that inflation and interest rates have bottomed out and no further decline in discount rate is expected. Our expectations of reversal in inflation have also started realizing as CPI reversed since start of FY14. We expect this trend to persist in coming months. The liquid portion of Fund's portfolio will be used to capitalize on any opportunity to lock in securities at higher returns if rates go up; however, in an upward interest rates scenario, the fund may not be able to post a decent real return over inflation.
- If inflation & interest rates remain low, the high yielding PIB portfolio will provide an attractive spread above inflation.
- If inflation and interest rates increase, the Fund will have the opportunity to further build its high-yielding long-term bond portfolio by diverting part of its short-term liquid investments.

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