Government of the Punjab

Punjab Pension Fund

Dated: 06 January 2011

MONTHLY REVIEW OF INVESTMENTS

December 2011

FUND SIZE

- A summary of changes in fund size during FY12 is given in the following table:

Rs. millions (rounded to the nearest million)

	Jul-Dec FY12
Beginning fund size (30th June 2011)	13,708
Add: contribution during the period	-
Less: transfer to Reserve Pension Fund	-
Add: gain/(loss) during the period	936
Less: expenses during the period	(10)
Ending fund size	**14,634**

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 2010		**30 June 2011**		**31 December 2011**	
	Amount	**%**	**Amount**	**%**	**Amount**	**%**
PIBs	5,737	47.4	8,942	65.2	8,882	61.4
T-Bills	3,145	26.0	1,254	9.1	-	-
Short term bank deposits	3,015	24.9	3,002	21.9	5,138	35.1
Corporate bonds/TFCs	176	1.5	501	3.7	501	3.4
Cash at bank	21	0.2	8	0.1	14	0.1
Other assets*	3	0.0	1	0.0	(1)	0.0
Total Fund Size	**12,097**	**100.0**	**13,708**	**100.0**	**14,634**	**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 and bank deposits.
- PPF keeps switching exposure between T-bills & short-term bank placements in pursuit of higher rates of return.

FUND'S PERFORMANCE

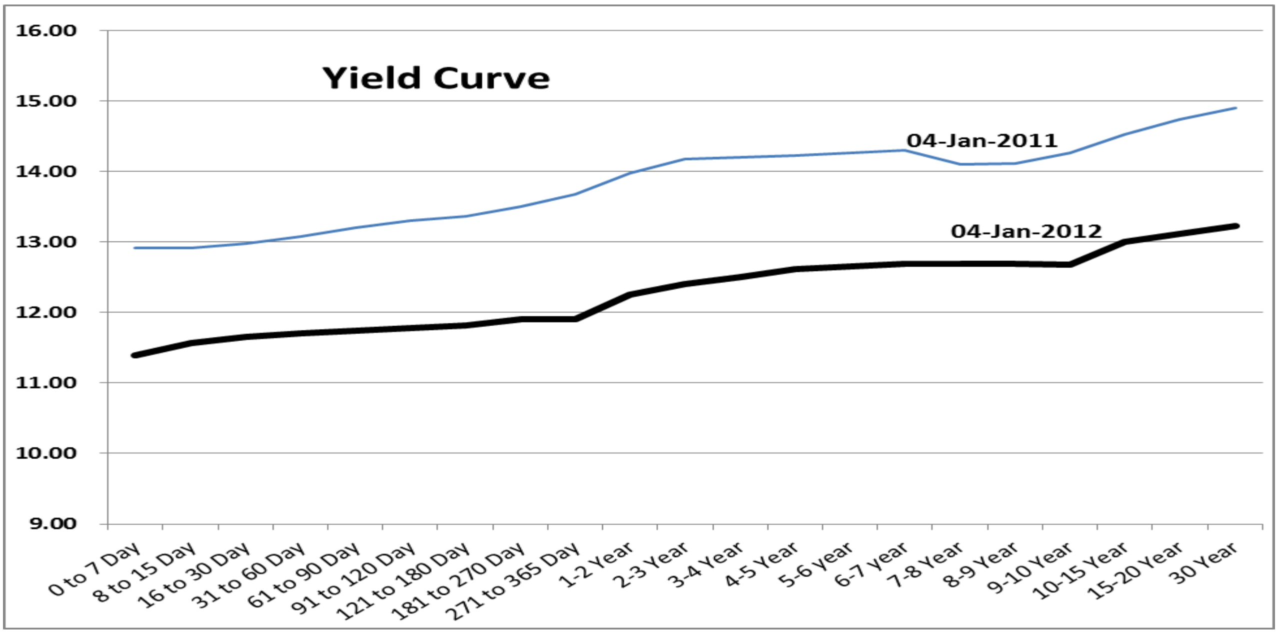
- Time Weighted Return (TWR) earned by PPF is summarized as under:

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%
July - December 2011	14.00%	13.83%		
December 2011	14.02%	13.84%		

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

**CAGR means Compound Annualized Growth Rate

- Inflation rates over the last 3 years 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.
- The Fund gradually increased its investment in long-term fixed-rate instruments consisting mainly of PIBs. The Fund's investment in long-term PIBs stands at 61.4% of Fund size at the end of December 2011.
- During the first half of the current financial year, inflation as well as interest rates have declined considerably. Despite that, PPF is set to earn a stable rate of return in the range of 13.75%-14% during the current financial year due to its large PIB portfolio (61% of fund size) and the timely placement of a sizeable amount in TDRs (35% of fund size) at attractive rates. The following chart shows the downward shift in yield curve during last one year period:



LHS: Interest Rates in (%)

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 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 Fund's assets vis-à-vis the amount & growth in 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%
Jul-Dec 2011	7.82%	22.02%	14.8	736.8	2.01%
Jul 2008 – Dec 2011 (CAGR)	13.44%	15.56%			

- 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 Jul-Dec FY 12, interest rates have declined by more than 1.0% which has resulted in a sharp increase (around 22%) in present value of liabilities. Market value of Fund's assets also increased significantly (by 7.82%) during this period. Growth in market value of assets fell well short of the growth in present value of liabilities because a substantial Duration Gap still remains between the Fund's assets and its liabilities. Duration measure 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 much lower than the overall Duration of Fund's liabilities.

REVIEW OF IMPORTANT ECONOMIC & FINANCIAL VARIABLES

1) GDP GROWTH

- For FY12, the Government has set a GDP growth target of 4.2%. However, there is a high probability that actual growth will be much lower due to a variety of factors including continuing energy shortages, high government borrowing, crowding out of the private sector and high inflation.
- Pakistan and IMF recently concluded a series of meetings held in UAE in which IMF has estimated that Pakistan's economy may grow at a rate of 3.5% for FY12.

2) FISCAL MANAGEMENT

- A summary of revenues and expenditures during 1Q FY12 and their comparison with the same period of the previous financial year is shown in the following table:

	Jul - Sep						
	Amount (Rs. bn)		As % of total exp.		As % of GDP		Growth (%)
	FY 11	FY 12	FY 11	FY 12	FY 11	FY 12	FY 12
(1)Total revenue	**400**	**534**	**59.2**	**67.5**	**2.3**	**2.5**	**33.4**
(1a) Tax	317	409	46.9	51.7	1.9	1.9	28.9
(1b) Non-tax	83	125	12.3	15.8	0.5	0.6	50.4
(2) Total expenditure	**676**	**791**	**100.0**	**100.0**	**4.0**	**3.8**	**16.9**
(2a) Current	567	657	83.8	83.0	3.3	3.1	15.9
Debt Service	162	177	23.9	22.4	1.0	0.9	9.3
Defence	93	107	13.8	13.6	0.5	0.5	15.1
(2b) Development	59	89	8.8	11.2	0.3	0.4	49.7
Budget surplus / (deficit)	**(276)**	**(257)**	**(40.8)**	**(32.5)**	**(1.6)**	**(1.2)**	**(6.9)**
Financing							
External	57	(4)	8.4	(0.6)	0.3	0.0	(107.7)
Domestic	219	262	32.4	33.1	1.3	1.2	19.3

Source: Ministry of Finance

- As per the latest fiscal numbers released by ministry of finance, total deficit of Pakistan during first quarter FY12 showed improvement as it went down to 1.2% of GDP from last year's 1.6% of GDP.
- A 33% increase in total revenues (backed by increase in both tax and non-tax) and a relatively contained expenditure growth of 16.9% helped to achieve this better performance. During the same period last year, total revenue growth was -6.3% therefore, the healthy rise in revenues in 1Q FY12 is also due to low base of last year (tax collection were hampered due to floods last year).
- In relative terms, the performance can't be declared satisfactory as tax-to-GDP remained same at 1.9% and also, the Government annual target of fiscal deficit for FY12 i.e. 4% of GDP, still does not seem achievable.
- A worrying aspect of the 1Q-FY12 data is how deficit was financed. Financing depended entirely on domestic sources as foreign flows dried completely. In fact there was a net retirement on external side.
- IMF, in its recent outlook report on Pakistan, has forecasted a fiscal deficit of 5.3% of GDP for FY12 which is well above the government's target of 4%.

3) EXTERNAL ACCOUNT

- Balance of payments is summarized in the following table:

Billion US $

	Jul-Oct 11	Jul-Oct 12	Growth* %
Current Account	**(0.5)**	**(1.6)**	**187**
Trade balance(Goods)	(3.8)	(5.3)	40
Trade balance (Services)	(0.9)	(0.9)	1
Income transfers (net)	(0.8)	(0.9)	5
Remittances	3.5	4.3	23
Capital Account	**0.0**	**0.0**	**-**
Financial Account	**0.7**	**(0.1)**	**(117)**
Errors and Omissions	**(0.0)**	**0.3**	**(1056)**
Overall Balance of Payments	**0.15**	**(1.4)**	**(1036)**

Source: SBP

- During the first four months of FY 12, current account deficit stood at USD 1.6 billion which is 187% higher on YoY basis compared to same period of last year and also breached the government's full year estimate of current account deficit of USD 1.4 billion. The current account deficit is mainly due to 40% increase in trade deficit (on the back of 23.2% growth in imports and 14.3% growth in exports) while on the other side current transfers increased by only 11% (mainly due to 23% rise in remittances).
- During Jul-Oct FY-12, financial account posted a deficit of USD 117 million against a surplus of USD 689 million during the same four months of FY-11. A decline of 23% in FDI, net outflow of portfolio investment and negative net debt disbursements were the contributing factors.
- Because of above, overall balance of payments posted a deficit of USD 1.4 billion during Jul-Oct FY-12 against a surplus of USD 149 million for same period last year.
- IMF has forecasted a current account deficit of 1.7% of GDP for FY12 which translates into a deficit in the range of $ 3.5 billion for FY12.
- Some of the key reasons for higher deficit in FY12 include the following:
    - Pakistan's trade deficit is structural in nature due to low value addition and narrow manufacturing base. However, last year this deficit was lower due to cyclical reasons such as record high cotton prices.
    - Higher oil prices and rising oil imports (because electricity generation is increasingly oil dependent) also play an important role.
- A bigger concern is the weakness in the financial account which reflects the country's limited ability to attract foreign inflows. This may have an adverse effect on the exchange rate considering that debt repayments to IMF are also starting in second half of FY12. If the current trends intensify, the possibility of the country entering into another IMF program cannot be ruled out.

4) 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
Oct-2011	11.0	1.4	12.8	11.7	1.6	16.2	10.4	1.3	10.4
Nov-2011	10.2	0.3	12.4	10.0	0.1	15.3	10.3	0.4	10.4
Dec-2011	9.7	-0.7	11.9	9.5	-2.2	14.4	9.9	0.4	10.2
12 month high	13.9	1.4	13.7	20.2	2.9	18.2	11.6	1.5	10.7
12 month low	9.7	-0.7	11.9	9.5	-2.2	14.4	9.3	0.1	10.2

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

- After a long double digit inflationary period, the YoY CPI inflation for the month of Dec 2011 has been recorded at 9.7% which is the lowest inflation number during the last 24 months. The MoM deflation of 0.7%, mainly due to falling food prices (-2.2% MoM) especially those of perishable items (-12.02% MoM), remained the one of the major contributory factor. Another main reason behind this lower YoY CPI inflation number is high base effect (prices had increased sharply during the first half of last year because of unprecedented floods).
- During the second half of FY-12 inflation is expected to remain relatively high but the lower inflation during the 1H-FY12 will help full year CPI to stay within the annual target of 12% set by government.
- Due to prolong of recessionary phase among the developed world, commodity prices have softened considerably which would also be a reason to expect lower inflation in coming months. However domestic CPI may not get full benefit of international falling prices as governments recently announced higher support price of wheat and increasing external account pressure may also add to inflationary pressures due to depreciation of exchange rate.

- 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
Oct-2011	10.5	1.4	9.9	11.7	1.0	12.1
Nov-2011	10.4	0.6	10.0	11.5	0.5	11.9
Dec-2011	10.2	0.5	10.0	10.6	0.3	11.7
12 month high	10.6	1.4	10.0	12.4	1.1	12.8
12 month low	9.6	0.4	8.6	10.6	0.3	11.3

[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
Source: SBP

- YOY NFNE inflation also on declining trend but remained relatively stable on YoY basis. On MoM basis, a rise of 0.5% clearly reflects that sharp decline in CPI is mainly due to falling prices of food item.
- Year-on-year inflation as per the Trimmed Mean (which is the most reliable and stable measure of inflation) also came down significantly and stood at 10.6% during Dec FY-12 which suggests that inflationary declining is quite widespread and the lower YOY CPI inflation number is broad based.
- The following table summarizes international commodity price inflation rates:

Period	Inflation Rates (%) as per the indices maintained by IMF								
	(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
Sep-2011	25.4	-0.8	30.2	33.7	0.4	30.0	13.0	-2.8	31.1
Oct-2011	14.8	-2.9	29.7	25.1	-0.3	31.1	-0.7	-7.4	28.2
Nov-2011	13.1	1.8	29.2	25.5	4.2	32.2	-5.7	-2.5	25.0
12 month high	38.2	6.1	30.2	43.6	9.4	32.2	46.2	5.6	32.8
12 month low	13.1	-5.0	24.5	20.9	-5.8	20.7	-5.7	-7.4	25.0

Source: IMF

- After recording negative MoM inflation for last couple of months, International commodity prices index increased by 1.8% on MoM and 13.1% on YoY basis which is also the lowest YOY inflation recorded over the last 12 months.
- The major reason behind recent slowdown in international commodity prices lies in deteriorating outlook for the global economy.
- Analysis of the trends in domestic prices and international commodity prices suggests that domestic inflation is being driven by domestic factors (such as supply side problems e.g. energy shortages etc. and excessive deficit spending by the Government) rather than international prices.

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
Oct-2011	11.78	13.49	12.04	13.77	11.91	13.51
Nov-2011	11.78	13.36	12.14	13.62	11.82	13.36
Dec-2011	12.07	13.22	13.01	13.52	12.02	13.23
12m high	13.90	13.61	14.22	13.98	13.83	13.62
12m low	11.78	12.81	12.04	13.29	11.82	12.89

Source: SBP, Reuters

- In the latest Monetary Policy Statement (MPS) announced on 30 Nov 2011, the SBP maintained the discount rate at 12%. The SBP gave the following key reasons in support of its decision:
    - Worsening fiscal situation and widening current account deficit calls for caution especially when IMF program had ended and foreign inflows have dried up. Also debt repayments are due in 2H FY-12. Balance of Payments is also under pressure and foreign exchange reserves have declined by USD 1.4 billion.
    - MoM inflation is a cause of concern as it has posted increase of 1.3% on average during first four months of FY12. Although inflation target of 12% for FY-12 is achievable but there are doubts regarding achievement of single digit inflation target in FY-13. Higher prices announced for wheat crop in FY12 are also likely to add to inflationary pressures.
- Although, MoM inflationary pressure has eased off significantly but the fiscal and external account situation is still a cause of concern. We think that SBP may continue it cautious stance and do not expect further monetary easing in coming MPS which is going to be announced by the end of January 2012.

INVESTMENT STRATEGY

- The ISC is convinced that, subject to proper justifications and limits, Derivatives can help in improving the investment and risk management strategy of the Fund. The ISC has recommended to the Management Committee to request the Government of Punjab to amend Punjab Pension Fund Rules 2007 and include Derivatives as permissible investments.
- The decision regarding allocation to equity investments will be debated further in the next meeting of ISC before it is taken to Management Committee for approval.
- PPF has not been able to get an attractive offer from any AA rated commercial bank for long-term bank deposits. The issue of reallocation of long-term bank deposits to other investment avenues will also be debated in the next ISC meeting on the basis of written communication made with commercial banks in this regard.

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