Government of the Punjab

Punjab Pension Fund

Dated: 08 February 2011

MONTHLY REVIEW OF INVESTMENTS

January 2012

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-Jan 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	1,101
Less: expenses during the period	(12)
Ending fund size	**14,797**

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 January 2011	
	Amount	%	Amount	%	Amount	%
PIBs	5,737	47.4	8,942	65.2	8,940	60.4
T-Bills	3,145	26.0	1,254	9.1	133	0.9
Short term bank deposits	3,015	24.9	3,002	21.9	5,193	35.1
Corporate bonds/TFCs	176	1.5	501	3.7	508	3.4
Cash at bank	21	0.2	8	0.1	20	0.1
Other assets*	3	0.0	1	0.0	3	0.0
Total Fund Size	**12,097**	**100.0**	**13,708**	**100.0**	**14,797**	**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

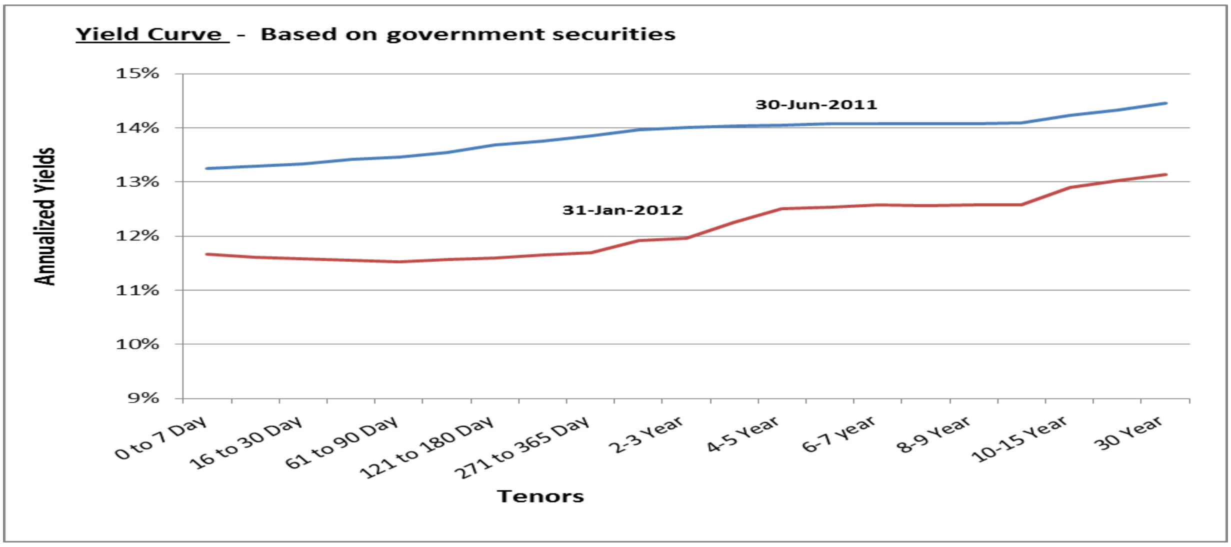
- Time Weighted Return (TWR) earned by PPF is summarized as under:

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 - January 2012	14.01%	13.85%		
January 2012	14.10%	13.92%		

*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 60.4% of Fund size at the end of January 2011.
- During the first seven months of the current financial year, inflation and 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 (more than 60% of the fund size) and timely placement of a sizeable amount in TDRs (~35% of the fund size) at attractive rates. The following chart shows the downward shift in yield curve since Jun 2011:



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 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%
Jul-Jan 2011	10.30%	27.14%	15.1	767.7	1.97%
Jul 2008 – Jan 2012 (CAGR)	13.79%	16.49%			

- 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-Jan FY 12, interest rates have declined by more than 1.0% which has resulted in a sharp increase (~27%) in present value of liabilities. Market value of Fund's assets also increased significantly (by 10.30%) during this period. However, 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 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 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 lower due to a variety of factors including continuing energy shortages, poor law & order situation, high government borrowing and crowding out of the private sector.
- The economic performance has weakened as a result of unresolved chronic nature structural problems (especially in energy and infrastructure), two major floods, and difficulties in implementing key policy reforms. Also a more challenging global economic environment added worries to limit prospectus of economic growth.

- IMF has projected Pakistan's GDP growth at 3.4% for FY12, and has also concluded that Pakistan's near and medium-term prospects are challenging as growth is likely to remain slow in the wake of high inflation & vulnerable external account position.

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 improvement. 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).
- A worrying aspect of the 1Q-FY12 data is how deficit was financed. Financing depended entirely on domestic sources as foreign flows dried up. In fact there was a net retirement on external side.
- IMF, in its recent outlook report on Pakistan, has forecasted that fiscal deficit is likely to reach 7% of GDP; much higher than government's revised target of 4.7% of GDP .
- The SBP, in its recent quarterly report on the economy, highlighted a few points of concern regarding the fiscal target for FY12:
    1) the strong growth in tax revenue during 1Q-FY12 was largely due to import related sales tax on high prices of imported oil and fertilizer, which is likely to be offset by subsidies on both in coming periods;

2) heavy dependence (Rs. 150 billion) on receipt of payments from Coalition Support Fund and sale proceeds of 3G licenses;
3) The expected surplus of Rs. 125 billion in the provincial balances which also seems unlikely as the actual provincial surplus was merely Rs. 11.6 billion during 1Q-FY12.

3) EXTERNAL ACCOUNT

- Balance of payments is summarized in the following table:

Billion US $

	Jul-Dec 11	Jul-Dec 12	Growth* %
Current Account	**0.01**	**(2.2)**	**-**
Trade balance(Goods)	(5.8)	(7.6)	32
Trade balance (Services)	(0.3)	(1.3)	274
Income transfers (net)	(1.5)	(1.6)	7
Remittances	5.3	6.3	20
Capital Account	**0.1**	**0.1**	**37**
Financial Account	**1.0**	**0.1**	**(90)**
Overall Balance of Payments	**1.0**	**(1.8)**	**(284)**

Source: SBP

- During the 1H-FY12, current account deficit stood at USD 2.2 billion as compared to USD 8 million surplus during the same period of last year. Despite 20% rise in remittances, the current account deficit increased mainly due to substantial increase in deficit on trade of goods as well as services). Surge in import bill of petroleum and fertilizer & slower growth in exports due to lower cotton prices were the major factors adversely impacting external trade.
- Unlike the past, when the deficit in current account used to be financed by surpluses in capital & financial account; during 1H-FY12, capital & financial account recorded only a modest surplus of USD 167 million and most of deficit in current account had to be financed through reserves which resulted in downward pressure on the exchange rate.
- Because of above reasons, overall balance of payments posted a deficit of USD 1.8 billion during 1H-FY12 against a surplus of USD 975 million for same period last year.

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**
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
Jan-2012	10.1	1.5	11.6	9.2	1.5	13.5	10.7	1.6	10.3

12 month high	13.3	1.5	13.7	17.9	2.9	18.2	11.6	1.6	10.7
12 month low	9.7	-0.7	11.6	9.2	-2.2	13.5	9.3	0.1	10.2

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

- The YoY CPI inflation for the month of January 2012 was recorded at a moderate level of 10.1% but the MoM CPI inflation stood at a 12 month high of 1.5%. The MoM rise in inflation is mainly contributed by food inflation (1.56% MoM having weight of 34.8%) and housing and energy (2.27% MoM having weight of 29.4%).
- As far as remaining part of FY12 is concerned, SBP has projected that annual CPI inflation will remain close to the target of 12% for the year.
- Due to a slowdown in the global economy, especially the developed world, commodity prices have softened considerably which offers a reason to expect lower inflation in coming months. However domestic CPI may not get full benefit of international falling prices as government's recently announced higher support price of wheat and exchange rate depreciation due to increasing external account pressure may also add to inflationary pressures .

- 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**
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
Jan-2012	10.3	1.1	10.0	10.4	0.8	11.6
12 month high	10.6	1.4	10.0	12.4	1.1	12.8
12 month low	9.6	0.4	8.8	10.4	0.3	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 showing extreme changes in price
Source: SBP

- YOY NFNE inflation is slightly higher than the overall CPI inflation .
- Year-on-year inflation as per the Trimmed Mean (which is the most reliable and stable measure of inflation) stood at 10.4% which is the lowest during the last 12 months and suggests that lowering of inflationary pressures is broad based.
- The MoM increase in both core inflation measures has increased compared with the past few months therefore the future trends in these measures need to be watched carefully.

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
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
Dec-2011	5.7	-0.9	27.5	17.4	-0.5	31.8	-12.2	-1.7	21.0
12 month high	38.2	5.0	30.2	43.6	9.4	32.2	46.2	4.8	32.8
12 month low	5.7	-5.0	24.5	17.4	-5.8	20.7	-12.2	-7.4	21.0

Source: IMF

- On YoY basis, international commodity prices record the lowest inflation over the last 12 months.
- The major reason behind recent slowdown in international commodity prices lies in slowdown of the global economy.
- The energy prices are solely responsible for YoY inflation otherwise there is a deflation in non-fuel index.

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
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
Jan-2012	11.69	13.04	12.58	13.38	11.82	13.06
12m high	13.90	13.61	14.20	13.98	13.81	13.62
12m low	11.69	12.93	12.04	13.38	11.82	13.00

Source: SBP, Reuters

- In the latest Monetary Policy Statement (MPS) announced on 30 Nov 2011, the SBP identified the following weak spots in the economy which could delay a further reduction in discount rate:
  1) Large fiscal deficit and domestic borrowing by the Government;
  2) Weak Balance of Payments position due to widening Current Account Deficit, poor foreign inflows, debt repayments starting in second half of current financial year etc. with adverse implications for foreign exchange reserves and exchange rate;
  3) High month-on-month inflation (averaging 1.3%) during first four months of FY12 and inflationary implications of increase in support price of wheat;

- All of the above challenges continue to persist.
  1) The Fiscal situation is very challenging and IMF has forecasted that the fiscal deficit for FY12 is likely to be in the range of 7% of GDP.
  2) The External Account pressures have already started to translate into exchange rate depreciation.

3) The inflation numbers have shown improvement. All the measures of YOY inflation (including headline CPI and both the measures of core inflation) are currently in the range of 10%-10.5% which is well below the discount rate of 12%. International commodity prices have also softened. Despite these improvements, the future outlook of inflation is uncertain considering the demand-supply gap in the economy i.e. supply constraints in the economy (due to energy shortages and weak External Account position) combined with high fiscal deficits/spending by the Government which pushes up aggregate demand.

- IMF has forecasted a rise in inflation and has recommended that discount rate should be raised to fight inflation.
- SBP is now faced with a dilemma whether to lower the discount rate on the basis of lower current inflation or to take a forward looking view of things and keep rates on hold until the uncertainties relating to fiscal situation, external account and inflation come under control.

INVESTMENT STRATEGY

- In its meeting held during December 2011, the Management Committee discussed inclusion of Derivatives among the permissible investments laid down in Punjab Pension Fund Rules 2007. The Management Committee directed that, in the next meeting, a draft Investment Policy related to Derivatives should be presented along with recommendations regarding derivative transactions that may be suitable for PPF.
- 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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