Dated: 13 August 2012

MONTHLY REVIEW OF INVESTMENTS
July 2012

FUND SIZE

- A summary of changes in fund size during FY13 is given in the following table:

Rs. millions (rounded to the nearest million)

	July-FY13
Beginning fund size (30th June 2012)	15,605
Add: contribution during the period	-
Less: transfer to Reserve Pension Fund	-
Add: gain/(loss) during the period	173
Less: expenses during the period	(2)
Ending fund size	**15,776**

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 2011		**30Jun 2012**		**31Jul 2012**	
	Amount	**%**	**Amount**	**%**	**Amount**	**%**
PIBs	8,942	65.2	9,480	60.7	9,494	60.2
T-Bills	1,254	9.1	139	1.0	798	5.1
Short term bank deposits	3,002	21.9	5,349	34.3	4,958	31.4
Corporate bonds/TFCs	501	3.7	501	3.2	507	3.2
Cash at bank	8	0.1	130	0.8	15	0.1
Other assets*	1	0.0	6	0.0	4	0.0
Total Fund Size	**13,708**	**100.0**	**15,605**	**100.0**	**15,776**	**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%
FY 2011-12	13.96%	13.79%	11.26%	14.26%
Jul 2008 – Jun 2012 (CAGR)**	14.10%	13.92%	12.54%	15.54%
July 2012	13.89%	13.73%		

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

**CAGR means Compound Annualized Growth Rate

- Inflation rates over the last 3-4 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.
- In order to lock-in high yields for a long period of time, the Fund has invested a large proportion of its assets in long-term fixed-rate instruments consisting mainly of PIBs. The Fund's exposure to long-term PIBs stands at 60.2% of Fund size at the end of July 2012.
- During the four year period from Jul 2008 to Jun 2012, PPF earned a compound net rate of return of 13.92% p.a. which is 1.38% p.a. higher than the compound inflation rate of 12.54% p.a. Thus PPF has been able to beat inflation by a respectable margin.

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%
FY 2011-12	16.86%	25.40%	15.6	757.1	2.06%
July 2012	1.60%	2.82%	15.9	778.5	2.04%
Jul 2008 – Jul 2012 (CAGR)	14.07%	14.73%			

- 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 FY12, interest rates declined by more than 1%, which resulted in a sharp increase in present value of liabilities (25.4%). Although Market value of Fund's assets also increased by 16.86% during the same period, but 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
- 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.
- The declining trend in inflation and secondary market yields continued during July FY-13, therefore, the present value of liabilities increased by 2.82% compared with 1.6% increase in market value of assets during the month.

REVIEW OF IMPORTANT ECONOMIC & FINANCIAL VARIABLES

1) GDP GROWTH

- The country achieved GDP growth rate of 3.7% for FY12 which indicates that the economic growth improved over last year's revised growth rate of 3.0%, but still missed the target of 4.2%.
- The economic performance of the country has weakened as a result of both domestic as well as external factors. As far as domestic factors are concerned, the continuing energy sector crises, poor law and order situation, inability of the Government in implementing tax reforms and high government borrowings all remained hurdles in the way of economic growth. On external front there is also a difficult global economic environment which does not help the prospects of domestic economic growth.
- The average GDP growth rate of last four years is 2.87% which is the lowest over a 4-year period during the last 5 decades.
- The economy needs a growth rate of 5-6% p.a. in coming years in order to meet the growing requirements of employment.

2) EXTERNAL ACCOUNT

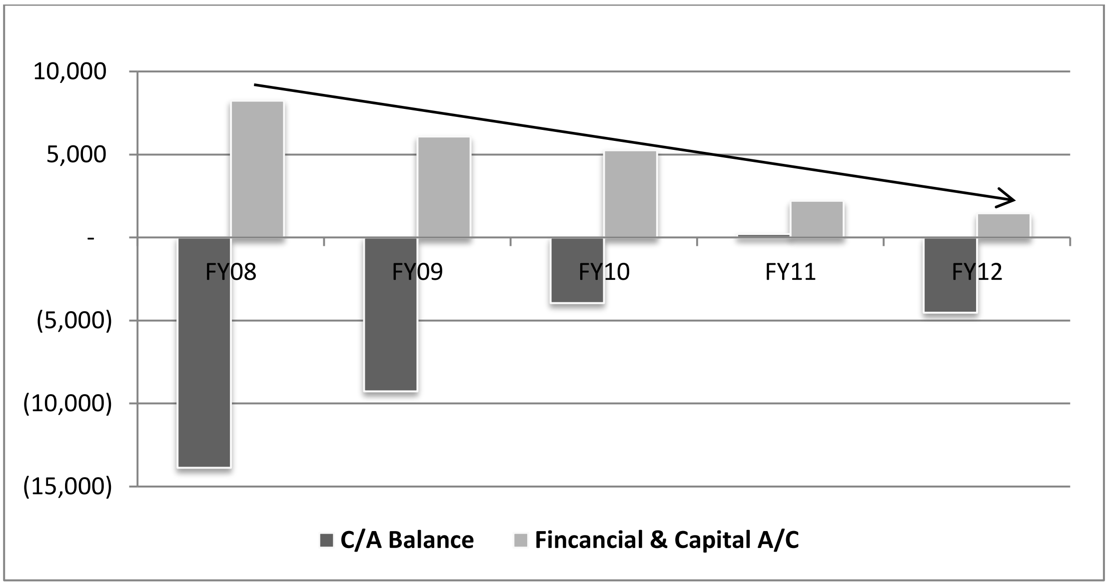
- Balance of payments is summarized in the following table:

Billion US $

	Jul-Jun 11	Jul-Jun 12	Growth* %
Current Account	**0.21**	**(4.52)**	**(2211)**
Trade balance(Goods)	(10.52)	(15.38)	(46)
Trade balance (Services)	(1.94)	(3.01)	(55)
Income transfers (net)	(3.02)	(3.41)	(13)
Remittances	11.20	13.19	18
Capital Account	**0.16**	**0.17**	**6**
Financial Account	**2.10**	**1.35**	**(36)**
Overall Balance of Payments	**2.49**	**(3.28)**	**(232)**

Source: SBP

- During FY12, current account deficit increased sharply and reached at USD 4.52 billion as compared to a surplus of USD214 million during FY11.
- The trade deficit deteriorated the most and reached at USD 15.38 billion as compared to USD 10.52 billion during the same period last year. This was primarily due to a sharp increase in imports (12%) and negative growth in exports (-3%).
- The deficit in services also increased by 55% and reached USD 3.01 billion from last year's USD 1.94 billion, mainly due to the non-realization of Coalition Support Fund (CSF) inflows (During FY11, Govt. received USD 743 million under CSF).
- The current transfers continued to provide much needed support on the back of 18% growth in remittances.
- The graph plotted below shows that the current account deficit of FY12 is not very high when we compare it with past years. The major cause of concern is continually declining Capital & Financial inflows. Both domestic and external factors are responsible for this situation;
  - Pakistan is losing its attraction as a destination for foreign investments as a result of domestic constraints of poor infrastructure, worsening law & order situation and energy shortages. According to Global Competitiveness report FY12, Pakistan stands at 138th position out of 142 countries in terms of competitiveness (the ranking was 92nd in FY08).
  - The International Financial Institutions (IFIs) like World Bank and Asian Development Bank are reluctant to provide loans in the absence of a letter of comfort from the IMF as Pakistan could not implement required reforms under the recent IMF program.
- During FY12, capital & financial account surplus of USD 1.5 billion was insufficient to balance the current account deficit of USD 4.52 billion and the major portion of deficit in current account had to be financed through reserves which resulted in downward pressure on the exchange rate.



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
May-2012	12.3	1.1	11.2	11.3	0.2	11.5	13.0	1.9	10.9
Jun-2012	11.3	0.0	11.0	10.3	-0.2	11.0	12.0	0.2	11.0
Jul-2012	9.6	-0.2	10.8	9.1	1.8	10.4	10.0	-1.7	11.0
12 month high	12.3	1.8	13.7	13.2	2.2	17.9	13.0	1.9	11.0
12 month low	9.6	-0.7	10.8	9.1	-2.2	10.4	9.3	-1.7	10.2

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

- CPI for the month of July 2012 stood at 9.6%, which is not only significantly lower than market expectations but also lowest since Dec 2009. The MoM inflation remained negative 0.25%.
- On YoY basis, CPI inflation remained relatively lower than expectations mainly because of lower food group inflation and even lower growth in Housing & Fuel index with 30% weightage in overall CPI posted a growth of only 5.6%. Agriculture sector growth remained satisfactory and international commodity prices also declined during the year and contributed to lower food inflation.
- However, on MoM basis the situation was reverse as the food inflation remained 1.8% while there was deflation of 1.7% in non-food group. Food group high inflation is mainly due to Ramzan effect while the deflation in non-food group is mainly because of decline in oil prices announced on 1st July 2012 (gas prices for domestic users were slashed by ~50).
- In the Budget of FY13, government has set the inflation target at 9.5% which seems ambitious considering that the economy continues to grapple with multiple challenges including the energy crisis which creates supply side constraints, high government borrowing and spending which creates aggregate demand pressures

and worsening external account situation which puts downward pressure on 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
May-2012	11.2	0.8	10.5	11.7	0.5	11.5
Jun-2012	11.5	0.7	10.6	11.1	0.5	11.5
Jul-2012	11.3	1.0	10.7	10.7	0.7	11.4
12 month high	11.5	1.4	10.7	12.4	1.3	12.7
12 month low	10.1	0.5	9.6	10.4	0.3	11.4

[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

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
Apr-2012	-5.7	-2.4	16.6	-0.7	-3.3	24.8	-14.4	-0.5	3.8
May-2012	-6.7	-6.0	13.1	-2.3	-7.2	21.3	-14.2	-3.4	0.3
Jun-2012	-12.9	-8.1	9.0	-11.9	-11.2	17.0	-14.6	-2.0	-3.4
12 month high	38.2	4.0	30.2	43.6	4.7	32.2	29.5	2.8	32.8
12 month low	-12.9	-8.1	9.0	-11.9	-11.2	17.0	-14.7	-7.4	-3.4

Source: IMF

- In June 2012, the overall Commodity Index and both of its major components i.e. Fuel and Non-Fuel Commodity Indices recorded deflation on a YoY as well as MoM basis.
- This deflationary trend is mainly attributable the faltering of the global economy and weakening global demand for commodities.

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
May-2012	11.96	12.44	13.34	13.09	12.01	12.48
Jun-2012	11.97	12.28	13.31	13.03	12.06	12.33
Jul-2012	11.87	12.11	13.06	12.95	11.99	12.18
12m high	13.33	13.61	13.34	13.98	13.38	13.62
12m low	11.69	12.11	12.04	12.95	11.82	12.18

Source: SBP, Reuters

- SBP slashed the discount rate by 1.5% from 12% to 10.5% during its latest Monetary Policy Decision dated 10 Aug 2012. The reduction in discount rate was much higher than market expectations which ranged from no change to a maximum reduction of 1%. Important points of the Monetary Policy Statement are summarized below:
    - The economy seems stuck on a path of high inflation and low growth mainly because of continuing energy crisis and fiscal imbalances. Provisional estimates of the fiscal deficit from the financing side suggest that the fiscal deficit may have reached 6.4 percent of GDP or Rs1328 billion in FY12. This excludes the debt consolidation of power and food sector arrears of 1.9 percent of GDP.
    - Positive developments include some deceleration in inflation and receipt of much delayed Coalition Support Funds. However, stickiness in both the core inflation measures points towards the persistence of inflation in low double digits. SBP projects average CPI inflation for FY13 to remain in the range of 10 to 11 percent, which is higher than the Government's announced target of 9.5 percent for FY13.
    - In order to enhance the prospects of future productivity and economic growth, there is a need to revive investment in the economy which has declined to very low level of 12.5% of GDP.
    - Trade deficit for FY13 is expected to be similar to the FY12 outcome i.e. around USD 15 billion. However, the recent receipt of $1.12 billion in Coalition Support Funds and the expected receipt of much delayed auction proceeds of 3G licenses could reduce the external current account deficit to $2.5 billion or 1 percent of GDP in FY13.
    - Increase in real rates due to the decline in inflation and the need to revive private sector credit are the major considerations behind SBP's decision to reduce the discount rate by 1.5%.
- We think that high interest rates were the only means of discouraging the Government from excessive borrowing and the recent reduction in rates will only encourage the Government to borrow more. Lower rates may also revive private sector borrowing and investment to some extent but the net effect of higher government and private sector borrowing & spending will be higher aggregate demand. In the wake of supply constraints of the economy imposed by the energy shortfall, higher aggregate demand may translate into higher inflation. If that happens, interest rates may have to be raised once again. We foresee a high probability of such a scenario over the next six months.
- Right now, the preferred strategy of PPF is to keep its liquid funds in short-term fixed income investments until the direction of the economy and its key variables becomes clearer.

INVESTMENT STRATEGY

- During its meeting held in July 2012, the ISC decided to make a small allocation to Equity investments and to set KMI-30 Index as the benchmark for these investments.
- Considering the continuing economic uncertainties, the ISC also decided to increase allocation to short-term fixed income investments.
- The ISC also decided to propose a few amendments to the governing documents for consideration of the Management Committee. The amendments are aimed at expanding the investment options, improving the investment process and providing more flexibility in pursuing investment strategies according to the prevailing economic environment.

(Abdul Rehman Warraich)
Head of Investments
Punjab Pension Fund

(Aquil Raza Khoja)
General Manager
Punjab Pension Fund