Government of the Punjab
Punjab Pension Fund

Dated: 12 November 2010

MONTHLY REVIEW OF INVESTMENTS

October 2010

FUND SIZE

- A summary of changes in fund size during the current financial year is given in the following table:

Rs. millions (rounded to the nearest million)

	Jul-Oct 2010
Beginning fund size	12,097
Add: contribution during the period	-
Less: transfer to Reserve Pension Fund	-
Add: gain/(loss) during the period	509
Less: expenses during the period	6
Ending fund size	**12,600**

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 Sep 2010**		**31 Oct 2010**	
	Amount	**%**	**Amount**	**%**	**Amount**	**%**
PIBs	5,737	47.4	5,570	44.7	5,671	45.0
T-Bills	3,145	26.0	4,503	36.1	5,506	43.7
Short term bank deposits	3,015	24.9	-	-	1,004	8.0
Corporate bonds/TFCs	176	1.5	300	2.4	326	2.6
Cash at bank	21	0.2	2,092	16.8	89	0.7
Other assets*	3	0.0	5	0.0	4	0.0
Total Fund Size	**12,097**	**100.0**	**12,470**	**100.0**	**12,600**	**100.0**

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

- Long-term investments consist of PIBs and TFCs whereas short-term investments consist of T-bills and bank deposits.
- PPF has been 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%
Jul-Oct 2010	13.02%	12.86%		
Oct 2010	13.14%	13.00%		

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

- Inflation rates over the last 2-3 years have been much higher than our long-term inflation expectations of 9%-10% p.a. Current interest rates are also higher than our long-term expectations. We consider this an opportunity to invest in long-term fixed rate instruments. 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.

REVIEW OF IMPORTANT ECONOMIC & FINANCIAL VARIABLES

GDP GROWTH

- For FY 2010-11, the government had originally set a GDP growth target of 4.5%. However, recent estimates by SBP project GDP growth in the range of 2.5%-3%.
- Reasons for the slowdown of the economy include:
  - Damage to crops, livestock, infrastructure, industry and economic activity in general, caused by floods;
  - Intensification of inflationary pressures due to
    - food shortages caused by floods
    - rising prices of petroleum products
    - rise in electricity tariffs
  - slowdown in borrowing and investment by the private sector due to a combination of slow economy, rising costs and high interest rates.

FISCAL MANAGEMENT

- A summary of revenues and expenditures during FY 10 and their comparison with the same period of the previous financial year is shown in the following table:

	Jul - Jun						
	Amount (Rs. bn)		As % of total exp.		As % of GDP		Growth (%)
	FY 09	FY 10	FY 09	FY 10	FY 09	FY 10	FY 10
(1)Total revenue	**1,851**	**2,078**	**73**	**69**	**14.1**	**14.2**	**12.3**
(1a) Tax	1,205	1,473	48	49	9.2	10.0	22.3
Direct Tax	440	529	17	18	3.4	3.6	20.1
Indirect Tax	764	944	30	31	5.8	6.4	23.5
(1b) Non-tax	646	605	26	20	4.9	4.1	(6.3)
Dividend	59	53	2	2	0.4	0.4	(9.8)
SBP Profit	161	233	6	8	1.2	1.6	44.6
(2) Total expenditure	**2,531**	**3,007**	**100**	**100**	**19.3**	**20.5**	**18.8**
(2a) Current	2,042	2,386	81	79	15.6	16.3	16.9
Domestic Debt Service	559	578	22	19	4.3	3.9	3.5
Foreign Debt Service	79	64	3	2	0.6	0.4	(19.1)
Defence	330	375	13	13	2.5	2.6	13.7
(2b) Development	449	613	18	20	3.4	4.2	36.7
Budget surplus / (deficit)	**(680)**	**(929)**	**(27)**	**(31)**	**(5.2)**	**(6.3)**	**36.5**
Financing	680	929	27	31	5.2	6.3	36.5
External	150	189	6	6	1.1	1.3	26.2
Domestic	531	740	21	25	4.1	5.0	39.5
Non-bank	224	436	9	15	1.7	3.0	94.6
Bank	306	305	12	10	2.3	2.1	(0.3)
Privatization	1	0	0	0	0	0	-100
Full Year GDP	**13,095**	**14,668**					
Revenue balance (1-2a)	**(191)**	**(308)**	**(8)**	**(10)**	**(1.5)**	**(2.1)**	**61.3**

Source: Ministry of Finance

- The deficit in Revenue Balance reached Rs. 308 bn or 2.1% of GDP in FY 10.
- The high borrowing needs of the government are a major reason behind high interest rates in the market despite a weak economic situation.
- The government had initially set a budget deficit target of 4% for FY 11. As per SBP's analysis, the budget deficit target has shot up to 5.2% of GDP after the announcement of provincial budgets and even that will be difficult to meet considering the enormity of prevailing fiscal imbalances.

DEBT

Domestic Debt:

- The domestic debt profile of Pakistan is summarized in the following table:

Domestic Debt	Amount (Rs. bn)		As % of Total Dom. Debt		As % of GDP		Growth (%)
	Aug-09	Aug-10	Aug-09	Aug-10	Aug-09	Aug-10	FY 11
A) Permanent	682	787	16.8	16.2	5.2	5.4	15.3
PIBs	441	500	10.9	10.3	3.4	3.4	13.5
Prize Bonds	203	240	5.0	4.9	1.5	1.6	18.4
B) Floating	2,038	2,593	50.3	53.3	15.1	16.7	27.2
C) Unfunded	1,321	1,480	32.6	30.4	10.0	10.0	12.0
DSCs	234	226	5.8	4.6	1.8	1.5	(3.6)
SSCs	318	357	7.8	7.3	2.4	2.4	12.3
BSCs	320	377	7.9	7.7	2.4	2.5	17.7
D) FC Instruments	8	3	0.2	0.1	0.1	0.0	(62.2)
Total Domestic Debt	**4,050**	**4,863**	**100.0**	**100.0**	**30.4**	**32.1**	**20.1**
GDP	**13,095**	**14,668**					

Source: SBP

External Debt:

- The external debt profile of Pakistan is summarized in the following table:

External Debt	Amount (USD bn)		Amount (Rs. bn)		As % of GDP		Growth[1] (%)
	Jun-09	Jun-10	Jun-09	Jun-10	Jun-09	Jun-10	Jul-Jun FY 10
A) Public	42.4	44.0	3,470	3,773	26.5	25.7	8.7
Medium & long term	41.8	42.2	3,421	3,610	26.1	24.6	5.5
Short term	0.7	0.8	57	69	0.4	0.5	19.7
IMF (Fed. Govt.)	0	1.1	-	94	-	0.6	-
B) Publicly guaranteed	0.2	0.2	16	17	0.1	0.1	4.8
C) IMF (Central Bank)	5.1	8.1	417	695	3.2	4.7	66.4
D) Scheduled banks	0	0.2	-	17	-	0.1	-
E) Private (non-guaranteed)	3.2	3.0	262	257	2.0	1.8	(1.8)
Total External Debt	**51.1**	**54.5**	**4,183**	**4,674**	**31.9**	**31.8**	**11.7**
Exchange Rate (Rs./USD)	**81.85**	**85.76**					
GDP			**13,095**	**14,668**			

[1]Growth in rupee value
Source: SBP

EXTERNAL ACCOUNT

- Balance of payments during the current financial year has been compared with the balance of payment in the same period of last financial year in the following table:

Billion US $

	Jul-Sep 10	Jul-Sep 11
Current Account	(0.6)	(0.5)
Capital Account	0.0	0.0
Financial Account	2.7	0.6
Errors and Omissions	(0.4)	(0.0)
Overall Balance of Payments	**1.8**	**0.1**

Source: SBP

CURRENT ACCOUNT

- Composition of Current Account during the current financial year and its comparison with the same period of the last financial year is shown in the following table:

Billion US $

	Jul-Sep 10	Jul-Sep 11
Current Account (1+2+3)	**(0.6)**	**(0.5)**
(1) Balance of trade in Goods & Services	**(3.5)**	**(3.7)**
Goods: Exports f.o.b	4.6	5.2
Goods: Imports f.o.b	7.4	8.2
Balance of trade in goods	(2.8)	(3.0)
Services: Credit (exports)	0.8	1.0
Services: Debit (imports)	1.6	1.7
Balance of trade in services	(0.7)	(0.7)
(2) Balance of Income Transfers	**(0.7)**	**(0.6)**
Income: Credit (inflows)	0.1	0.2
Income: Debit (outflows)	0.8	0.8
Interest Payments	0.3	0.3
Profit & Dividend	0.1	0.1
(3) Balance of Current Transfers	**3.6**	**3.8**
Current Transfers: Credit (inflows)	3.7	3.8
Workers' Remittances	2.3	2.6
FCA Residents	0.2	0.1
Current Transfers :Debit (outflows)	0.0	0.0

Source: SBP

- According to SBP, real appreciation in the exchange rate during FY 10 and the resulting trend in the terms of trade suggest a potential widening of trade deficit in FY 11.
- SBP projects the Current Account Deficit to rise in FY 11 to $6.9 bn or 3.7% of GDP on the back of higher growth in imports (projected at 12%) compared with exports (projected at 7%).
- Actual figures show that that Current Account Deficit during Jul-Sep FY 11 has been slightly lower than the same period of last year.

FINANCIAL ACCOUNT

- Composition of the Financial Account during the current financial year and its comparison with the same period of last financial year is shown in the following table:

Billion US $

	Jul-Sep 10	Jul-Sep 11
Financial Account (1+2+3)	**2.7**	**0.6**
(1) Direct Investment	0.5	0.4
(2) Portfolio Investment	0.2	0.1
(2a) Equity	0.8	0.5
(2b) Debt	2.0	0.1
(3) Other Investment	2.0	0.2
Equity based flows (1+2a)	0.8	0.5
Debt based flows (2b+3)	2.0	0.1

Source: SBP

- The sustainability of Current Account Deficit depends on the country's ability to finance it by generating a Financial Account Surplus (preferably through equity rather than debt creating inflows).
- Given the projected rising path of external current account deficit for FY 11, improvement in financial inflows is critical to avoid a fall in country's foreign exchange reserves and pressure on exchange rate.
- During the first two months of the current financial year, the Financial Account is showing a surplus of $ 0.6 bn against $ 2.7 bn during the same period of last financial year. This clearly points towards the difficult times ahead.

INFLATION

CONSUMER PRICES

- 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 2010	12.7	0.6	11.7	14.5	0.7	12.5	11.2	0.6	11.1
July 2010	12.3	1.2	11.8	12.8	1.5	12.6	12.0	1.0	11.1
Aug 2010	13.2	2.5	12.0	15.6	5.1	13.1	11.2	0.3	11.2
Sep 2010	15.7	2.7	12.49	21.2	5.3	14.0	11.0	0.3	11.2
12 month min.	8.9	-0.5	11.7	7.5	-1.7	11.9	10.0	0.1	11.1
12 month max.	15.7	2.7	16.2	21.2	5.3	18.1	12.2	2.8	16.4

[1]12 month moving average

Source: SBP

- A breakdown of CPI inflation into its various components is shown in the following table:

Index	**Weightage % in CPI**	**Sep 2010 - Inflation (%)**		
		YOY	**MOM**	**12mma**
CPI	100	15.7	2.7	12.5
CPI food	40.34	21.2	5.3	14.0
Non-perishable food items	35.20	16.0	3.6	13.1
Perishable food items	5.14	53.9	13.7	20.2
CPI non-food	59.66	11.0	0.3	11.2
Apparel, textile & footwear	6.10	10.1	0.6	7.3
House rent	23.43	7.6	0.3	11.6
Fuel & lighting	7.29	20.8	0.2	16.1
Household, furniture & equipment etc.	3.29	8.7	0.6	6.5
Transport & communication	7.32	15.6	(0.1)	11.7
Recreation & entertainment	0.83	14.4	0.0	8.7
Education	3.45	6.5	0.0	10.6
Cleaning, laundry & personal appearance	5.88	10.0	0.7	10.2
Medicare	2.07	12.5	1.2	8.1

Source: SBP

- It is evident that inflationary pressures are almost entirely attributable to the food segment. The non-food segment does not exhibit high inflation.
- On a month-on-month basis, food inflation contributed 93% and non-food inflation contributed 7% to the overall consumer price inflation.
- Major factors behind food inflation include:
    - Production losses of crops due to floods;
    - Supply disruptions resulting from damage to infrastructure caused by floods;
    - Inefficient market structure (hoarding);
    - Higher transportation costs;
    - Higher international prices.

CORE INFLATION

- 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 2010	10.4	0.7	11.0	11.7	0.7	11.6
Jul 2010	10.3	0.5	10.7	12.0	0.7	11.4
Aug 2010	9.8	0.4	10.5	12.5	0.7	11.2
Sep 2010	9.4	0.4	10.3	12.8	0.9	11.5
12 month min.	9.4	0.4	10.3	10.4	0.4	11.2
12 month max.	11.9	1.7	16.6	12.8	1.3	17.6

[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

- NFNE inflation has been declining over the past few months which indicates that inflationary pressures are concentrated in food & energy items.
- Trimmed mean inflation, on the other hand, has been rising over the past few months which shows that within the food & energy categories, inflationary pressures are quite broad based.

WHOLESALE PRICES

- A summary of inflation rates based on WPI (Wholesale Price Index) is given below:

	WPI Inflation								
Period	**WPI Overall (%)**			**WPI Food (%)**			**WPI Non-food (%)**		
	YOY	**MOM**	**12mma**	**YOY**	**MOM**	**12mma**	**YOY**	**MOM**	**12mma**
Jun 2010	17.6	-0.6	12.9	14.5	1.2	11.9	20.1	-2.0	13.2
Jul 2010	18.7	1.7	14.4	14.3	1.9	12.4	22.5	1.5	15.7
Aug 2010	19.2	2.6	16.0	16.4	4.2	13.1	21.6	1.4	18.2
Sep 2010	21.5	2.1	17.7	21.1	4.5	14.2	21.8	0.2	20.6
12 month min.	0.7	-0.6	7.3	5.8	-0.7	11.4	-4.6	-2.0	2.5
12 month max.	22.0	4.2	17.7	21.1	4.5	17.1	27.7	5.5	20.6

Source: SBP

- A breakdown of WPI inflation into its various components is shown in the following table:

Index	**Weightage % in WPI**	**Sep 2010 - Inflation (%)**		
		YOY	**MOM**	**12mma**
WPI	100	21.5	2.1	17.7
WPI food	42.1	21.1	4.5	14.2
WPI non-food	57.9	21.8	0.2	20.6
Raw materials	8.0	58.3	2.5	41.1
Fuel, lighting & lubricants	19.3	13.3	-1.5	22.5
Manufactures	25.9	21.5	1.3	15.6
Building materials	4.7	10.6	0.2	0.6

Source: SBP

- YOY inflation is very high in both food and non-food segments of wholesale prices.
- MOM inflation captures the recent trend in wholesale prices. It shows that, over the past few months, inflationary pressures have been stronger in the food segment.
- Major factors driving WPI non-food inflation include:
    - Higher prices of cotton & sugarcane due to crop damages during recent floods;
    - Higher international prices of cotton, sugar, metals and edible oil;
    - Rise in electricity tariffs for industrial and agriculture consumers;
    - High cotton product prices.

INTERNATIONAL COMMODITY PRICES

- 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
Jun 2010	9.9	-1.8	13.6	9.6	-0.9	16.7	10.3	-3.2	10.8
Jul 2010	16.4	1.5	18.7	17.4	0.3	22.4	14.9	3.7	14.3
Aug 2010	12.3	3.3	22.5	8.7	0.9	26.5	18.3	7.4	17.3
Sep 2010	17.6	1.3	26.4	14.1	0.4	30.6	23.5	2.7	20.5
12 month high	48.3	5.7	26.4	60.0	8.0	30.6	31.3	7.4	20.5
12 month low	-28.5	-7.5	-36.2	-34.9	-8.8	-42.1	-14.6	-5.1	-24.3

Source: IMF

- A breakdown of the Commodity index into its various components is given below:

Index	Weightage (%) in Commodity Index	Sep 2010 Inflation (%)		
		YOY	MOM	12mma
Fuel & Non-fuel Commodities	**100**	**17.6**	**1.3**	**26.4**
Fuel Commodities (Energy)	**63.1**	**14.1**	**0.4**	**30.6**
Petroleum	53.6	11.6	0.4	40.7
Natural Gas	6.9	6.3	-2.0	25.0
Coal	2.6	40.3	5.9	25.2
Non-Fuel Commodities	**36.9**	**23.5**	**2.7**	**20.5**
Industrial inputs	18.4	31.1	3.6	35.2
Agricultural Raw Mat.	7.7	27.7	3.4	28.2
Metals	10.7	32.9	3.7	39.6
Edibles	18.5	16.8	1.8	9.7
Food	16.7	18.1	2.2	8.5
Beverages	1.8	7.9	-1.1	19.9

Source: IMF

- Analysis of MOM inflation numbers shows that, over the past few months, fuel commodities have exhibited modest inflation whereas non-fuel commodities have exhibited strong inflationary pressures.
- Important factors driving international commodity price inflation include:
  - Weakening of dollar;
  - Concerns regarding supply of agricultural commodities;
  - Strong demand for metals from emerging economies (especially China).

INTEREST RATES

- A summary of interest rates for the last few months 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
Jul 2010	12.42	12.28	12.95	12.61	12.42	12.45
Aug 2010	12.75	12.32	13.19	12.68	12.87	12.47
Sep 2010	12.97	12.36	13.75	12.79	13.27	12.52
Oct 2010	13.17	12.41	13.83	12.88	13.23	12.56
12m high	13.17	12.64	13.83	12.99	13.27	13.25
12m low	11.95	12.21	12.40	12.42	12.23	12.41

Source: SBP, Reuters

- A summary of the total stock of money supply (M2) and the changes in it during the current financial year is given in the following table:

Rs. billions

			Change (1 Jul – 22 Oct 2010)	
		End Jun 2010	Absolute	%
	Broad Money (M 2)	5,777	59	1.0
	LIABILITY SIDE (A+B)			
A	Currency in circulation	1,295	150	11.9
B	Demand & Time deposits	4,482	(91)	(2.0)
	ASSET SIDE (C+D)			
C	Net Foreign Assets (NFA) of banking system	545	46	8.4
D	Net Domestic Assets (NDA) of banking system (a+b+c)	5,232	13	0.2
a	Net Govt. Sector borrowings	2,441	181	7.4
b	Credit to Non Govt Sectors	3,389	(54)	(1.6)
c	Other items (net)	(598)	(113)	(18.9)

Source: SBP

- In its recently issued report on Pakistan's Economy (Annual report FY 2009-10), SBP has emphasized that high inflation is attributable to both cost-push and demand-pull factors.
  - supply shortages of food items and adjustments to electricity and petroleum prices are creating cost-push inflation;
  - high government borrowing and spending is creating demand-pull inflation.

- However, in our opinion, the following factors show that the economy is suffering primarily from supply-driven and/or cost-push inflation:
    - break-up of inflation numbers shows high food & energy inflation and low NFNE (non-food non-energy) inflation. Shortage of food items and adjustments in energy prices are the major reasons behind inflationary pressures;
    - negative private sector borrowing (net retirement of Rs. 54 bn) from the banking sector during the current financial year;
    - slow growth in money supply (1.2% during Jul-Oct of the current financial year);
    - slow GDP growth.
- We do not think that the economy needs further increase in interest rates. The rates are already sufficiently high to discourage the interest-rate-sensitive borrowing and spending. This is illustrated by the net retirement of Rs. 54 bn by the private sector to the banking system during the current financial year. The major adjustment that is needed is the lowering of government borrowing and spending which is a matter of fiscal reform and monetary tightening is unlikely to achieve that objective.
- Nevertheless, we expect that SBP will increase the discount rate by 1% in its next monetary policy decision which is due at the end of November 2010. Our expectation is based on the following reasons:
    - SBP is of the view that demand-pull inflation exists in the economy;
    - Food and energy price inflation usually has second round effects in which non-food non-energy prices increase because cost of living as well as cost of doing business has increased. In the absence of monetary tightening, inflationary expectations may strengthen and the second round effects may become more likely.

INVESTMENT STRATEGY

- Average inflation (CAGR) over the 19 year period from Jul 1991 to Jun 2010 has been 8.8% p.a. Our long-term inflation expectation for the future is in the range of 9-10% p.a. We think that a fixed rate of return of 12.5% p.a. or above on our investments is consistent with our long-term return objective of ‘inflation + 3%’.
- We think that the current inflation rate is too high and will gradually revert to its long-term average. Since above-average inflation has led to above-average interest rates also, our strategy is to invest at fixed rates of return for longer periods.
- Considering the attractive yields on a few highly rated TFCs, the ISC may consider increasing the allocation to corporate bonds/TFCs which currently stands a maximum of 5% of Fund size.

- 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 ISC will consider entering into fixed-for-floating Interest Rate Swaps so that PPF can convert its floating-rate investments into fixed-rate investments.
- The ISC is yet to make a decision on our recommendation to allocate 10% of Fund size to equity investments. This will also be discussed in the next ISC meeting.
- 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. The matter will be discussed in the next ISC meeting. The ISC may consider revising the asset allocation and reallocating this portion to other avenues such as corporate bonds/TFCs, T-bills, Short-term TDRs, PIBs, Saving Schemes or Stocks etc.

(Abdul Rehman Warraich)
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