NBP Fullerton Asset Management Ltd.
A Subsidiary of National Bank of Pakistan

Managing Investment Risks

Dr. Amjad Waheed, CFA
Chief Executive Officer

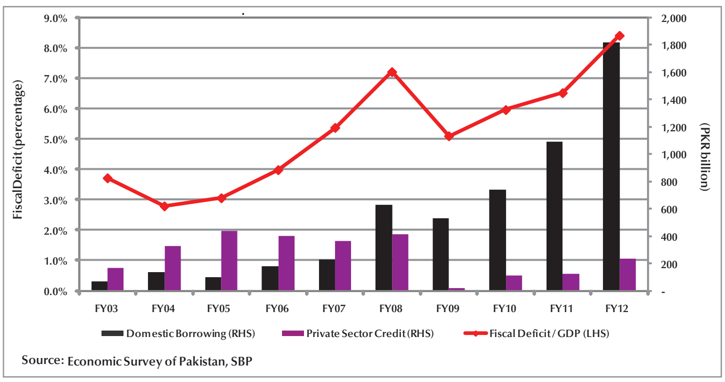
The economics risks facing Pakistan are on the rise emanating from unprecedented Government borrowing and depleting foreign exchange reserves. Government domestic borrowing has risen from Rs 230 billion in FY 2007 to Rs 1,815 billion in FY 2012 (see chart-1). Consequently, borrowing by the more productive private sector has declined from Rs 366 billion in FY 2007 to Rs 235 billion in FY 2012. Failure to improve the tax to GDP ratio and rationalization of government expenditures resulting in excessive government borrowing has serious implications for the economic and investment climate of the country.

Large foreign currency payments to IMF and others are due during this Fiscal year. Foreign exchange reserves have already depleted to US$ 10 billion from around US$ 15 billion in June 2011. Domestic debt servicing can be managed in the short run by further domestic borrowing, however, the same is not possible to make foreign debt payments. Consequently, further deterioration of the foreign exchange reserves is expected in the second half of this fiscal year. This may lead to increased risk of rupee devaluation and sovereign default, which has serious implications for the investment climate of the country. Being an election year, we do not expect from the present government to finalize a new package with IMF that can help stave off the existing foreign debt servicing burden. IMF has indicated that it will not be willing to finalize a package with an interim government as the new elected government may not take ownership of this package. Based on the above, inflation and interest rates are expected to rise significantly in the second half of this Fiscal Year.

Fixed Income investments include bank deposits, Treasury bills, Pakistan Investment Bonds, Fixed Income mutual funds, and National Savings Schemes. An investor is exposed to interest rate risks if he purchases fixed rate instrument of say 5-year maturity with return of 10% per annum and subsequently interest rates rise to 30% per annum. In this case, the investor is stuck with a lower profit rate. This can be described with an example where an investor of Defence Savings Certificate is told that on an investment of Rs 100 today, the Government will pay him or her Rs 297 after 10 years. The Government will pay the committed amount at the end of 10 years. However, if inflation rises considerably during this 10-year period, the investor will not be able to purchase even a cup of tea for the Rs 297 that he or she will receive at that time. Investors are advised to keep their fixed rate investments short-term, generally maturing within the next six months to mitigate inflation and interest rate risks. Money market mutual funds are feasible in this scenario as the average maturity of their investments cannot exceed 90 days as per the SECP Regulations. If investors are investing in TFCs / Sukuks, then floating rate instruments are preferable to fixed rate as the rate on these instruments are linked to the market interest rates (KIBOR) that generally reset every 6 months.

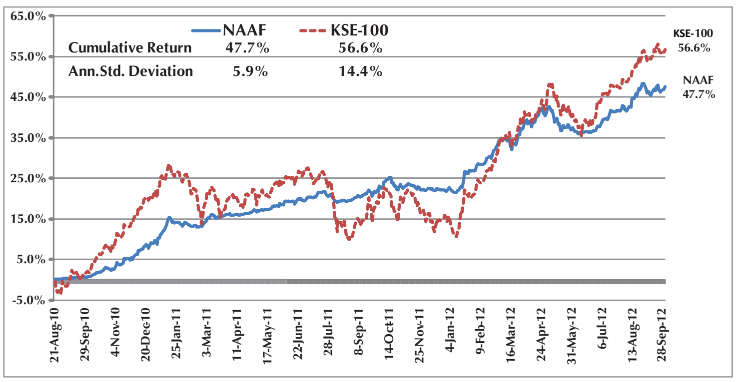
Equities are a good hedge against inflation in the long-term, as businesses generally increase the price of their products and services in line with inflation. Accordingly, their earnings also increase, which is reflected in their rising stock prices. However, in the short-run, equities respond negatively to rise in inflation and interest rates. Therefore, it is better to invest in equities via asset allocation funds where the fund manager has the flexibility to completely exit from equities if he or she expects a substantial rise in interest rates and inflation. NAFA Asset Allocation Fund is an example where the return on the Fund over the last two years is 48%, which is competitive compared with the stock market return of 57% during the same period. However, the risk (volatility) of the Fund at 6% is less than half than that of the stock market (14%) (see chart-2). Thus, the Fund has offered investors a good return with a low risk by a combination of superior stock selection and better market timing.

Chart -1: Private Sector & Government Borrowing Vs. Fiscal Deficit



Source: Economic Survey of Pakistan, SBP

Chart-2: Relative Performance of NAFA Asset Allocation Fund (NAAF)



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