National Fullerton
Asset Management Limited

Investment Outlook

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Prospects of Income Mutual Fund Industry

The mutual fund industry went through a crisis in the second half of 2008 due to fall in the value of equities and TFCs followed by a redemption run. This was a result of macro-economic situation where there was severe liquidity shortage stemming from a fall in foreign exchange reserves, loss of investor confidence, rising inflation and interest rates, etc. The income fund industry in Pakistan is about 5 years old, and this was its first major crises. Many AMCs, including NAFA, paid back redemptions in time. However, there were some that delayed payments to their investors due to their holding of illiquid assets.

Following the crises, the Mutual Fund Association of Pakistan and SECP have worked hard to try to improve controls and procedures, so that the industry is better prepared in the future. One important and critical step in this regard has been using the most recent trading prices of TFCs in calculating the daily Net Asset Value (NAV)/ unit price of funds. This means that the NAV is realistic and investors investing or redeeming their investments are getting a fair treatment. Prior to this, quotes of TFCs from brokerage houses were used to calculate the NAV of funds, which at times did not properly reflect the market value of these TFCs. The new system has introduced some volatility in NAVs as TFC prices may vary from one day to another. However, income fund investors have also got used to this low volatility and are no more redeeming in panic. On the contrary, fresh investments are growing in the income funds.

Another major step that SECP has taken is the introduction of categories of mutual funds, which also include risk guidelines in terms of maturity, liquidity and credit quality of the instruments in which the funds can invest. Now there is a clear distinction between the Income and Money Market schemes. The Table below summarizes the key characteristics of Income and Money Market Schemes. New funds launched have to follow these guidelines from the first day whereas existing funds have up to March 5, 2010 to comply with these guidelines. Funds launched under money market schemes, such as NAFA Government Securities Liquid Fund, can invest primarily in short-term Treasury Bills (AAA rated) and banks with rating of AA and above. These funds are not allowed to invest in TFCs, CFS or spread transactions. The average maturity of assets of these funds shall not exceed 90 days. Thus, the maturity, liquidity or credit quality risk in these funds is very low.

Term Finance Certificates (TFCs) dropped by about 20% in value during the liquidity crunch in the 4th Quarter of 2008. They have risen by about 10% in value since then, but are still trading about 10% below their par value. Thus, they offer very attractive yields and upside potential at these price levels. We are therefore presently holding on to our TFC portfolio in NAFA Cash and Income Funds. Once the TFC prices come close to their par value, we will considerably reduce our TFC portfolio and increase our investment in bank deposits. NAFA has got an approval from its Board that NAFA Cash and Income Funds will not invest in any security with a credit rating below AA-.

To summarize, investors in mutual funds lost confidence in income funds following the crises that the industry experienced in the 2nd half of 2008. However, SECP and the industry have taken substantial steps to improve risk controls and procedures and the industry is much better equipped to handle any crisis in the future.

COMPARISON OF MONEY MARKET AND INCOME FUNDS REGULATIONS

	INCOME SCHEME	MONEY MARKET SCHEME
Investment Avenues	Government Securities, TFCs, bank deposits, money market instruments, reverse repo, CFS, and spread transactions. (no equity exposure)	Government securities, bank deposits, money market instruments, and reverse repos against government securities. (no equity exposure)
Weighted Average time to Maturity of Assets	• Weighted average time to maturity of net assets shall not exceed 4 years (except Gov. Securities). • No restriction regarding time to maturity or duration of any single asset in the portfolio. At least 25% of the net asset shall be invested in cash and near cash instruments.	• Weighted Average time to maturity of net assets shall not exceed 90 days. • Time to maturity of any asset shall not exceed six months.
Credit Rating	• Rating of any security/ bank/ DFI/ NBFC shall not be lower than investment grade (BBB-).	• Rating of any security / bank shall not be lower than AA. • Rating of any NBFC shall not be lower than AAA.