NAFA

National Fullerton Asset Management Limited

Dr. Amjad Waheed, CFA
Chief Executive Officer

Inflation and Your Investments

In the last 10 years, bank deposit rates averaged 3.3% per annum, whereas inflation (CPI) has averaged 8.8% per annum. Thus, bank depositors have been earning a negative rate of return on their investments. This situation worsened in 2008 as inflation (CPI) averaged 21%, whereas the average bank deposit rate averaged 4.6%. The table below shows the impact of inflation on the value of your investment. For example, if an investor is going to earn a 5% per annum return on his/her investment over the next 15 years, and the annual inflation is expected to be 10% per annum during the same period, then the real value of his/her investment will be halved in 15 years. If an investor earns a return of 10% per annum on his/her investment/bank deposit over the next 15 years, and inflation remains 10% per annum during the same period, then the real value of his/her money will remain constant at Rs 100,000 even after 25 years. Thus, what an investor thinks as a risk-free investment is actually not "risk-free" since it carries the risk of inflation eating into the value of his/her investment.

Based on the historical long-term trends, one can predict that inflation is expected to remain around 10% per annum in the future as well. Thus, the minimum objective of an investor should be to earn a return equal to inflation - 10% per annum. Some banks and money market funds, such as NAFA Government Securities Liquid Fund, are presently offering a return of around 10% p.a. with minimal risk. However, as can be seen below in the Table, a return equal to inflation only ensures that the real value of investment remains constant, with no growth. In order to earn a return higher than inflation, an investor is typically required to take some risk by investing in the stock market, real estate or a business. Thus, investing is an art of balancing inflation risk against investment risk. A risk free investment - especially in Pakistan's context - exposes the investor to inflation risk. Investment such as the stock market or real estate, where the expected return is in excess of inflation, exposes the investor to investment risk. The Table below shows that if inflation is around 10% per annum and if an investor can earn a return of say, 15% per annum, the real value (inflation-adjusted) of his/her investment will almost double in 15 years.

The year 2008 was the worst year in the history of the Pakistani stock market, where it dropped by 58%. Investors have become very risk averse since then, especially due to the deteriorating law and order situation in the country. Investors presently prefer to invest in our money market and income funds versus our balanced or equity funds. This is the reason that NAFA Government Securities Liquid Fund, one of the lowest risk funds in the industry (AA+ rating by PACRA), grew to over Rs 1.1 billion in only a couple of weeks following its launch.

We expect the investment climate to improve considerably in the near future following the successful military operation in Swat and recovery in the economic fundamentals. The stock market is trading at very attractive valuations and is expected to show good performance going forward. Therefore, for those investors who wish to earn a higher return than inflation, this is a good opportunity to take some exposure in equities. NAFA Multi Asset and NAFA Islamic Multi Asset Funds are balanced funds with half of their investments in equities (policy weight). They offer the potential to investors to earn a return higher than inflation, while taking only partial exposure in equities.

IMPACT OF INFLATION ON INVESTMENT VALUE

Initial Investment of Rs. 100,000; Expected Inflation: 10% per annum				
	Inflation Adjusted Value based on a return of			
Years Invested	**5% p.a.**	**10% p.a.**	**15% p.a.**	**20% p.a.**
1	95,455	100,000	104,545	109,091
5	79,247	100,000	124,889	154,505
10	62,801	100,000	155,974	238,718
15	49,768	100,000	194,795	368,832
20	39,440	100,000	243,278	569,864
25	31,255	100,000	303,829	880,469