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Investment Options via Mutual Funds

In Pakistan, five key investible asset classes for which reliable long-term data is available are bank deposits, T-bills, PIBs, National Savings Schemes (NSS as represented by the SSC) and Equities. One can also calculate long-term returns under Capital Protected Strategy (CPS), a globally recognized synthetic investment product, wherein investment is initially made in low risk avenues and exposure in equities is gradually increased with the changing performance of equities and low risk assets (T-bills, Bank deposit). The objective of the CPS strategy is to gain a reasonable upside through the stock market along with protection of initial amount. Following is the performance of these key asset classes over the last 14-years from January 2001 to December 2014: (See Charts below)

The historical analysis of these asset classes supports the basic notion that there is a positive relation between risk and return. As expected, equities have the highest volatility or risk and bank deposits and T-bills the lowest. Analysis shows that for investors with the long-term investment horizon and high appetite for risk, equities offer the highest return. Capital Protected Strategy offered the best risk-adjusted return as measured by the Sharpe Ratio (excess return per unit of risk) during the last14-year period. More specifically, CPS delivered an attractive nominal return of about 14.5% per annum at a relatively low risk level (standard deviation of 7.8%). The inflation during the 14-year period has averaged around 8% p.a.

Investing directly in the above mentioned investment avenues (except bank deposit and NSS) involves activities that are not only cumbersome and time consuming but also call for active management and professional expertise. Also, investing in these asset classes entails varying degrees of investment risks such as liquidity, interest rate, credit and market risks. Mutual fund investment is an alternative option that makes investing in these asset classes simple along with other advantages such as liquidity & easy withdrawal, tax benefits, professional management, diversification, regulatory protection and oversight of the Trustee. Mutual funds also offer the option to invest in a shariah-compliant manner.

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Initially, categories of funds were not clearly defined and so the differentiation between funds in terms of risk and return was vague. The authorized investments and investment limits were not clearly specified. However,following the 2008 crisis in the mutual fund industry different categories of Collective Investment Schemes (CIS) were defined namely money market, income, asset allocation, balanced, capital-protected, and equities. These schemes cater to the varying risk return level and financial goals of the investors. As a result of categorization of schemes, risk guidelines and disclosures are now clearly defined, and investors are better aware of the risk/return characteristics of these categories of funds.

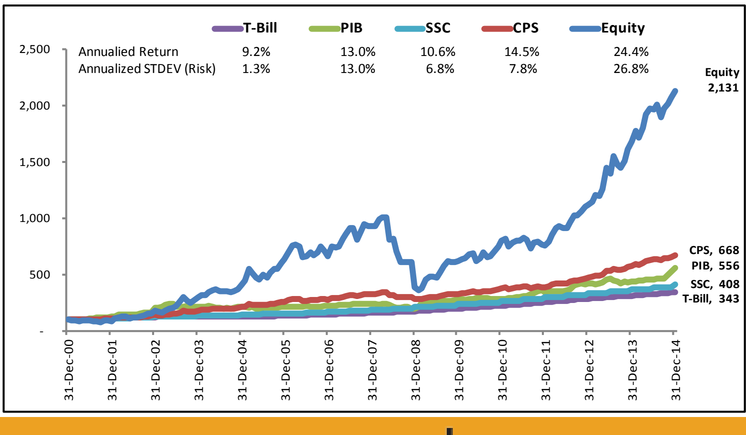
Money market funds are the safest of mutual funds as these are allowed to invest only in T-bills and AA & above rated banks and commercial paper with average maturity of the Fund not exceeding 90 days. Thus investment in money market funds offers stability of return and exceptionally low level of risk. Balanced funds and asset allocation funds offer an opportunity to invest in multiple asset classes such as T-bills, corporate bonds, and equities. The objectives of these funds are to provide a combination of regular income from investment in money market and fixed income securities, and capital growth though investment in equities. Equity / stock funds invest primarily in the stock market with the objective to provide capital growth. Retirement saving schemes commonly known as Voluntary Pension Schemes (VPS) offer the investor an opportunity for individualized asset allocation according to his or her risk / return parameters and investment time horizon, along with attractive tax benefits.

To effectively manage investment risks, asset management companies have a robust risk management framework with dedicated risk management resources to monitor, identify, measure and control the risks involved in the investment management activities including operational and investment risks. An added protection is that all the assets of the mutual funds are in the hands of the trustee, which in most cases in Pakistan is the Central Depository Company (CDC). The trustee oversees all investment activities carried out by the investment management company on behalf of the unit holders of the funds.

Prior to making any investment directly or through mutual funds investors should determine the suitability of the investment avenue based on their liquidity needs, investment horizon, risk appetite, etc. For instance, only those investors should invest in equity funds, who have a relatively longer investment time horizon. If someone needs to marry his daughter the next year, he should not put his money in a stock fund. This is because next year the stock market may be down, and the investor will have to experience a loss on liquidating his investment. However, over a longer time period stock market tends to bounce back after a decline, and provides investors better returns than bank deposits, NSS and inflation.

Overall, the performance track record of Asset Management Companies (AMCs) is good as reflected by their superior performance versus the benchmark. NAFA's funds have exceptional performance track record with most of funds comprehensively out-performing their respective benchmarks. For instance, during the last 5-year period ending February 2015, our flagship NAFA Stock Fund has delivered a cumulative return of 316% (33% p.a.) versus 248% (28% p.a.) return by the stock market, translating into an out-performance of 68% (5% p.a.). This out-performance is net of management fee and all other expenses.

Future Value of Rs. 100 at the end of 14 years – Nominal Term



Future Value of Rs. 100 at the end of 14 years – Real Term