

VOLUNTARY PENSION FUNDS SECTOR IN SERBIA

Second Quarter Report 2011

CONTENTS

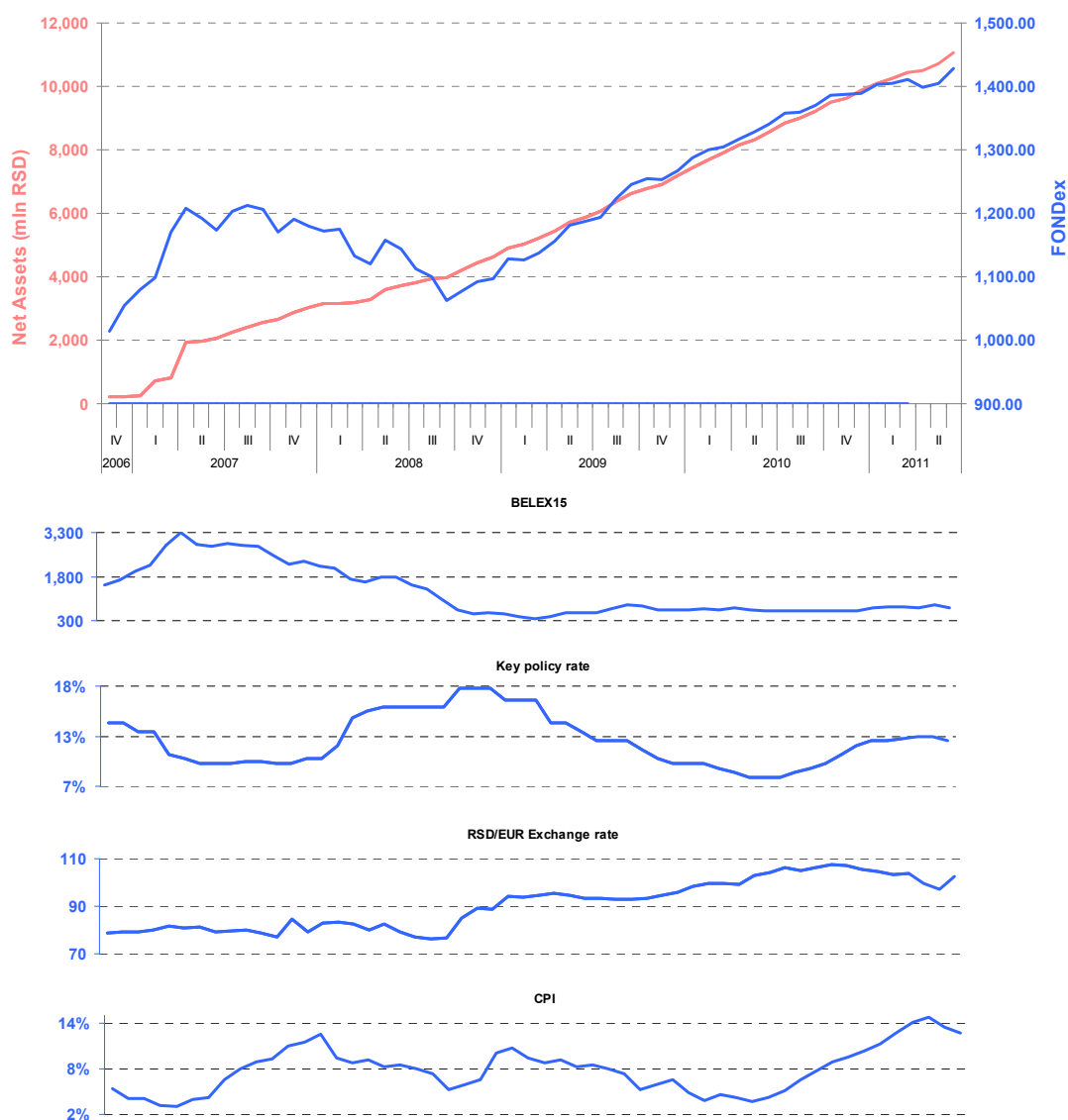
1. INTRODUCTION.....	3
2. MARKET PARTICIPANTS	6
3. VPF OPERATIONS	7
VPF net assets	7
Composition of VPF assets	8
VPF securities trading.....	10
Fees charged by management companies	11
Transaction costs	12
Number and structure of VPF beneficiaries.....	13
Contribution payments, withdrawals and transfers.....	16
Return/risk ratio	18
4. CONCLUSION	22
5. SPOTLIGHT ON.....	23
Amendments to the Law on Voluntary Pension Funds and Pension Schemes	23
VPF investment policy	23

1. INTRODUCTION

For more than four and a half years of their operation, voluntary pension funds (VPFs) have recorded a constant rise in net assets that outstripped RSD 11 bln by end-Q2 2011. Relative to the quarter earlier, net assets grew 6.1%, or 29.2% in the year to date.

Since the start of VPF operation, net assets have been on a continuous rise.

Chart 1: Movements in net assets, FONDex and key indicators since the start of VPF operation



At end-Q2 2011, FONDex¹ reached record 1,428.33 points². The return of FONDex, which represents the weighted average of all funds' return, came at 1.2%³, while the year-to-date return measured 6.5%. The return on T-bills and interest earnings on deposits with banks (which at the same accounted for the largest share in the funds' portfolio) gave the strongest boost to FONDex.

Movements in prices of Belgrade Stock Exchange (BSE) shares, measured by BELEX15⁴, may be divided into several periods. Following a mild fall in April, the index hiked in May, touching its record quarterly high of 825.08 points by end-May. The index plunged anew in June and hit 747.96 points by the quarter-end. Relative to end-Q1 2011, BELEX15 lost 1.8%, though gaining 17.9% year-on-year.

Trading on the BSE totalled around RSD 7.90 bln, which was below the levels recorded in the previous two quarters (RSD 9.25 bln and RSD 9.41 bln), but significantly more than in the earlier quarters of 2010. As in Q1 2011, the greatest share in the volume of trading (c. one fourth) concerned NIS and Nikola Tesla airport shares. Measured by the number of transactions, activity on the BSE contracted relative to Q1 (the number of transactions halved), but was much more intensive than in earlier quarters. The greatest number of transactions (over 98%) related to trading in shares of the above two issuers.

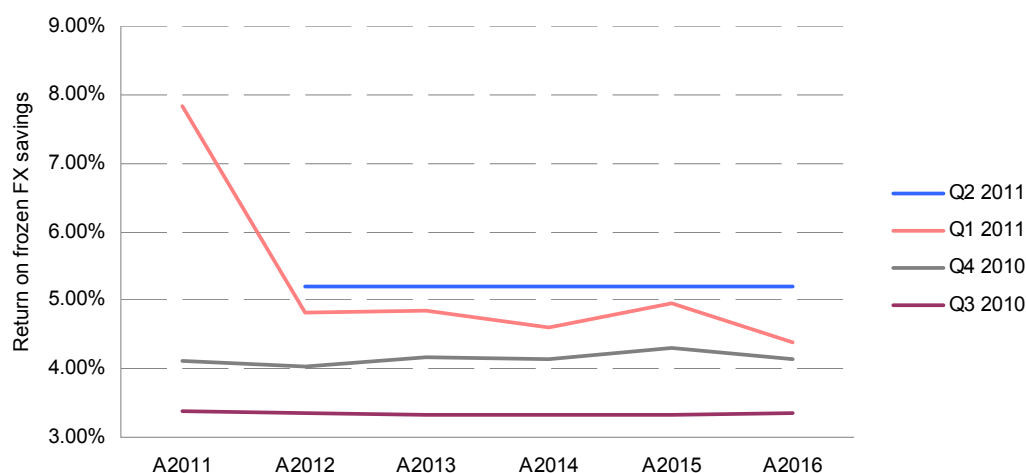
The upward trend in return on frozen FX savings bonds, set in train by end-2010, continued in the quarter under review. Relative to the quarter earlier, returns rose by 23–80 basis points, depending on maturity. The flat-shaped yield curve moved up again, ranging from 5.19% to 5.21%. The A2011-series bonds worth c. EUR 252 mln fell due on 31 May – trading in these bonds came to an end a few days earlier.

¹ FONDex shows movements in investment units of all VPFs in the market.

² The initial FONDex value of 1000 points was recorded on 15 November 2006 when the first VPF began to operate.

³ 4.9% p.a.

⁴ Of total investment in shares, over 90% were shares covered by BELEX15, which means that BELEX15 is a relevant benchmark for shares in the funds' portfolio.

Chart 2: Yield curve for frozen FX savings bonds (end of quarter)

The market of debt government instruments (T-bills and bonds) experienced an increased volume of issues and a reduction in interest rates. The total market value of dinar-denominated issues came at around RSD 100.3 bln vs. RSD 89.1 bln in Q1 2011. Most issued were 1-year (39.3 bln) 18-month (18.4 bln), and 3-month bills (17.3 bln).

Table 1: Return and market value of dinar government debt instruments (by maturity)

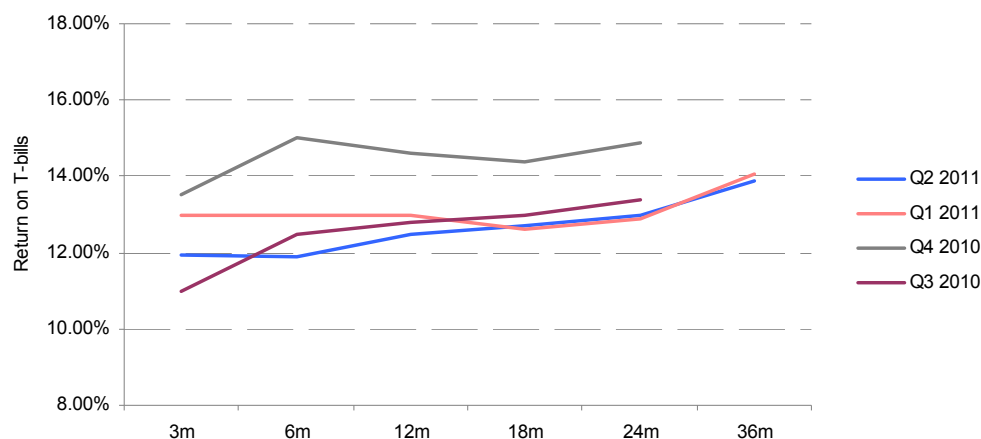
Maturity	Q3 2010		Q4 2010		Q1 2011		Q2 2011	
	Return %	Market value	Return %	Market value (bln)	Return %	Market value (bln)	Return %	Market value (bln)
3m	11.00%	15.6	13.50%	20.9	13.00%	17.3	11.95%	16.7
6m	12.50%*	18.6	15.00%	33.1	13.00%	15.9	11.90%	13.2
12m	12.80%	10.3	14.59%	5.0	13.00%	19.2	12.50%	39.3
18m	13.00%*	2.1	14,39%*	1.1	12,60%*	21.4	12,69%*	18.4
24m	13.40%	2.8	14,90%*	1.2	12.89%	13.3	12,99%*	8.0
36m					14.05%	2.1	13.89%	4.8
Total		49.4		61.3		89.1		100.3

Note: Return at the last auction held in the quarter (asterisk (*)) means that the auction was not held over the last 10 days of the quarter).

Also issued in this period were euro-denominated government debt instruments – 3-year bonds at 5% and 15-year bonds at 5.85%.

Contraction in return on T-bills, initiated in the quarter earlier, continued in Q2, mainly for up to 1-year bills.

Return on 3-m, 6-m and 1-year bills fell by 105, 110 and 50 basis points respectively. The return for other maturities remained flat on earlier quarters.

Chart 3: T-bills yield curve (end-of-quarter)

The dinar's appreciation against the euro, in place since early-year, continued in the first half of the quarter. The dinar, however, weakened again in June. It lost 1.1%⁵ in Q2 or 1.8% in the year to date. Around a third of fund assets (32.2%) were invested in euro-denominated financial instruments, most of which were government debt securities.

The upward trend in inflation, recorded over the previous three quarters, reversed in Q2. Inflation decelerated and even turned negative in some months. Annual CPI growth was 14.7% in April, 13.4% in May and 12.7% in June, while monthly price growth rates settled at 1.1%, 0.4% and -0.3% respectively.

Owing to high inflation, a rise in the key policy rate, initiated in H2 2010, continued in early Q2. Nonetheless, in response to receding inflationary pressures, the NBS cut the key policy rate by the quarter-end, bringing it to 12% at the end of June, down by 25 basis point on end-Q1. As a result, the interest earned by most companies on dinar balances held in custody accounts, was reduced by the same amount (25 basis points).

2. MARKET PARTICIPANTS

The VPF market comprises six companies managing eight VPFs, three custody banks, 61 natural persons engaged in dissemination of information about VPF membership (of 230 of them licensed by the NBS to perform such activities) and four agent banks⁶.

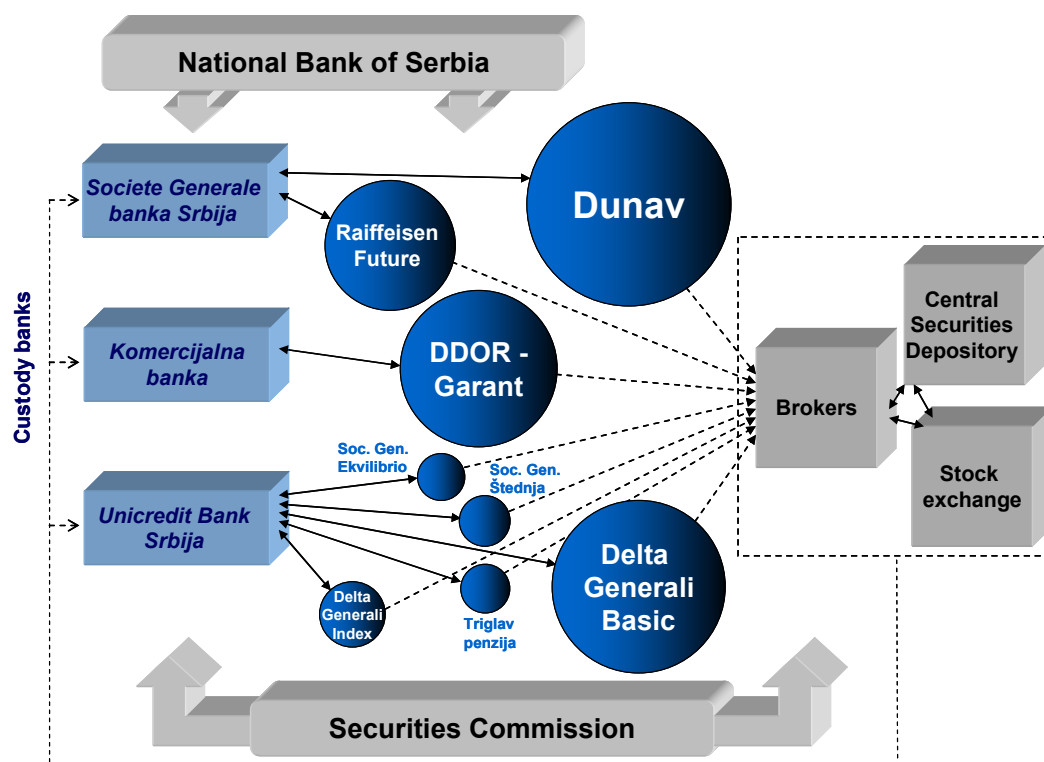
VPF management companies cooperate with 11 brokerage houses in securities trading.

⁵ 4.3% p.a.

⁶ NLB banka a.d. Beograd, Raiffeisen banka a.d. Beograd, Volksbank a.d. Beograd and Société Générale Banka Srbija a.d. Beograd.

At end-Q2 2011, total employment in VPF management companies was 126, down by 1 and 36 q-o-q and y-o-y respectively.

Chart 4: VPF market participants



3. VPF OPERATIONS

VPF net assets

In Q2 2011, net assets rose 6.1% q-o-q or 29.2% y-o-y. In Q2 2011, RSD 636.5 mln were paid to members' individual accounts, which impacted most on net assets growth. In Q2, total contributions, net of contribution fees, came to RSD 621.9 mln, whereas withdrawals amounted to RSD 123.3 mln. Total fees charged by companies were RSD 67.4 mln.

Net assets reached RSD 11 bln and contribution payments RSD 636.5 mln. Concentration in the sector remains high.

Table 2: End-quarter net assets of the VPF sector

2007	2008	2009	2010	2011	
				Q1	Q2
3.05	4.64	7.19	9.86	10.44	11.07

RSD bln

Measured by HHI, market concentration in the sector⁷ was relatively high – 2,866 points at end-Q2. What attests to high market concentration are two funds classified as ‘large’ and two as ‘medium’, making up 97% of the market, while the largest fund accounted for c. 42% of total net assets.

Chart 5: End-quarter concentration in the sector

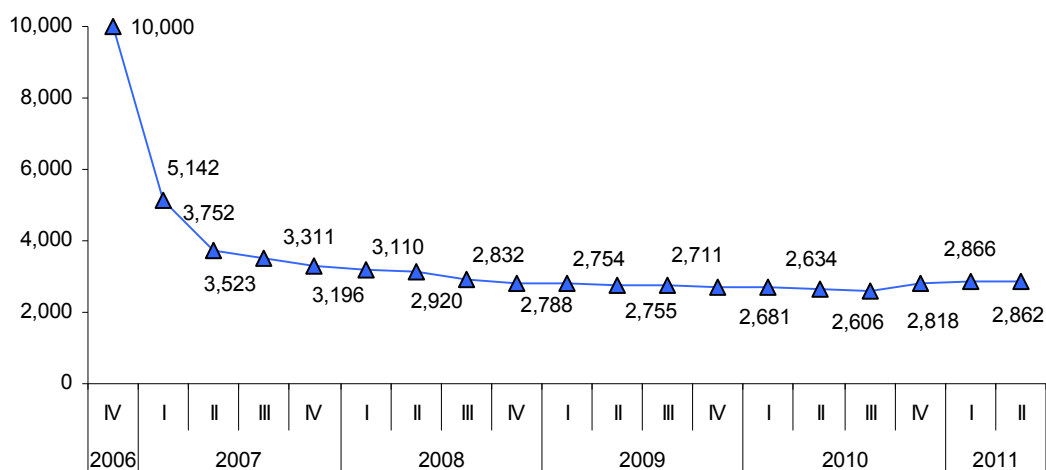


Table 3: Number of funds by groups divided by market share

Share in net assets (%)	2007 Q4	2008 Q4	2009 Q4	2010 Q4	2011	
					Q1	Q2
Large (20 and above)	3	2	2	3	2	2
Medium (5 – 19.99)	-	2	3	1	2	2
Small (0 – 4.99)	4	6	5	4	4	4

Composition of VPF assets

In Q2, government debt securities accounted for the major portion of VPF assets – 67.8%, of which T-bills made up 48.8%, frozen FX savings bonds – 10.3%, long-term government bonds – 8.8%, demand deposits – 19.6%, shares – 5.4%, term deposits – 4.3%, and property – 0.7%.

Most assets were invested in government securities. One third of assets – in foreign currency.

The greatest change in the structure of VPF assets was recorded for long-term government bonds – their share in the portfolio rose 6.6 pp (from 2.2% to 8.8%). The Ministry of Finance began to issue these bonds by mid-Q1 2011. Funds invested most in 3-year dinar coupon bonds (4.7% of assets) with the end-June

⁷ In terms of the share in total net assets.

return to maturity of around 14%, as well as in 3- and 15-year euro bonds (4.1%) with respective 5% and 5.85% return at the quarter-end.

In contrast, the share of T-bills fell 4.8 pp, while the portion of frozen FX savings bonds lost 3.5 pp as A2011-series bonds (2.7%) matured in the quarter under review.

The share of assets denominated in foreign currency – euros, was RSD 3.62 bln or 32.2% of total assets, while dinar-denominated assets accounted for RSD 7.61 bln or 67.8%. Relative to the quarter earlier, the share of FX assets was reduced by over 3 pp as the focus shifted to dinar-denominated assets.

The major part of assets – as much as c. 92.6%, was exposed to the interest rate risk, in response to the rising share of debt instruments in the funds' portfolio. The exposure to price risk fell further from 21.6% to only 17.2% due to a reduced portion of shares and frozen FX savings bonds, while the exposure to currency risk was 32.2%.

Chart 6: End-quarter composition of VPF assets

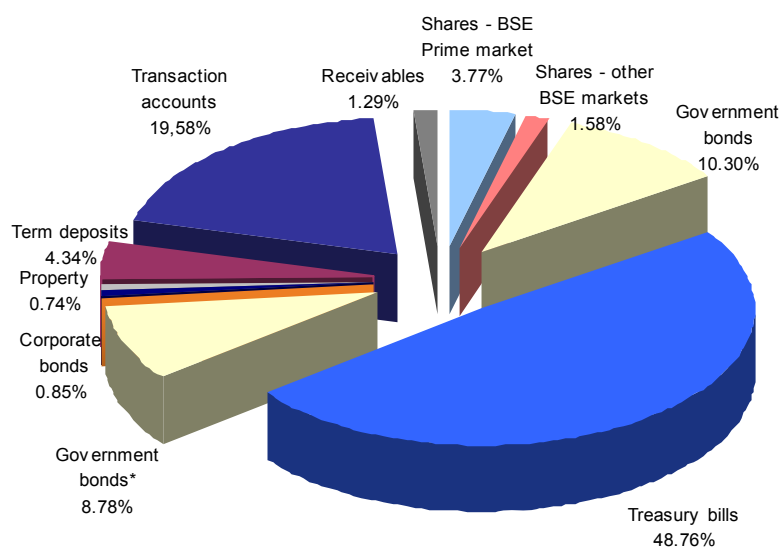


Table 4: Exposure of VPF assets to market risk

	Price risk	Currency risk	Interest risk	2007	2008	2009	2010.	2011	
								Q1	Q2
Shares	✓			22.4%	6.3%	7.2%	11.4%	6.3%	5.4%
Frozen FX savings bonds	✓	✓	✓	37.8%	33.7%	25.2%	18.1%	13.6%	10.3%
T-bills		✓*	✓	0.8%	0.0%	46.6%	46.7%	53.5%	48.8%
Government bonds		✓	✓	-	-	-	-	2.2%	8.8%
Foreign government bonds	✓	✓	✓	-	-	-	0.3%	-	-
Corporate bonds	✓	✓	✓	-	-	-	1.0%	0.9%	0.8%
Property	✓	✓		-	1.7%	1.1%	0.9%	0.8%	0.7%
Balances in dinar accounts			✓	37.7%	57.4%	15.9%	8.0%	9.5%	12.9%
Balances in FX accounts		✓	✓	1%	0.9%	4.0%	13.5%	12.2%	11.0%

* relates to the portion of euro-denominated T-bills.

VPF securities trading

VPF trading volumes of RSD 5.46 bln in Q2, up by 29% on Q1, were record high since the start of VPF operation. T-bills retained their major share in securities purchases (close to 95%) – the maturity to sale ratio changed significantly relative to the quarter earlier, settling at 91% : 9%. The share of VPFs in BSE trading was up to around 5.8%.

Trading volumes were record high. Auctions of government securities had the largest share.

Table 5: VPF securities trading

RSD bln

	2008	2009	2010	2011	
				Q1	Q2
Securities trading	1.51	12.59	14.92	4.22	5.46
Purchases	1.07	8.12	8.12	2.21	2.77
BSE	0.78	0.40	1.29	0.19	0.21
Unregulated market	0.25	0.38	0.30	0.03	-
Auctions of government securities	0.03	7.34	6.53	1.99	2.56
Sales	0.39	0.39	0.76	1.14	0.24
BSE	0.09	0.05	0.56	0.17	0.24
Unregulated market	0.30	0.34	0.20	0.98	-
Maturity	0.05	4.08	6.05	0.86	2.47
Purchase to sale and maturity ratio	2.42	1.82	1.47	1.1	1.1
Share in total BSE trading	1.2%	1.1%	7.6%	4%	5.8

Fees charged by management companies

The Law on Voluntary Pension Funds and Pension Schemes sets maximum fees that may be charged to fund members. Contribution and management fees may not exceed 3% and 2% respectively, while the account transfer fee may be charged only at the level of real transfer costs.

Management fees will be limited to 1.25% after net assets of all funds reach 0.75% of GDP.

The new Law, adopted in early May 2011, envisages different fees charged by management companies – these fees will be applied once net assets of all funds reach 0.75% of GDP. The maximum management fee is set at 1.25%, while the contribution fee is not capped.

Fees are one of the parameters that members should bear in mind when choosing a fund, but should not be observed as an isolated factor. The fee level is contingent on the fund investment strategy and its performance. As a rule, funds actively investing in more complex and riskier instruments are intended for younger persons who pay contributions over a longer horizon. Such funds charge higher fees, but are also expected to post higher return in the long run. On the other hand, a fund investing passively in safe financial instruments should charge lower management fees. Investment policy (scheduled investment by fund members), fees charged by companies, the expected fund return and the risk taken by the fund (and the member) should be accounted for when choosing a fund.

Since the start of operation, companies charged a 2% management fee, while the contribution fee declined and currently stands at 2.22%. The relative shares of these two types of fees changed – at the start of VPF operation, contribution fees

were dominant by contrast to the current 80% of management fees. This was a result of rising net asset value and an enlarged base to which management fees are applied.

Though visible in the first instance, the contribution fee is not the largest cost incurred by a member. It is paid only once, as a front-load fee. The management fee is charged every day on the calculated value of VPF net assets and is contained directly in the investment unit value, meaning that the calculated and published value is deduced by the amount of the management fee.

A further rise in net assets and boosted fund competition may result in gradual lowering of the management fee. One company has envisaged in its schedule of charges a variable amount of fee depending on its performance in the sector and the sum of accumulated funds in individual accounts.

Table 6: Fees from 2007 to 2010 and fees by quarter for 2011

	<i>RSD mln</i>					
	2007	2008	2009	2010	2011	
					Q1	Q2
Contribution fee	43.5	56.9	54.9	59.3	13.0	14.51
Management fee	33.4	72.2	117.2	170.6	49.8	52.86

Transaction costs

Transaction costs are incurred by management companies in securities trading. The new Law envisages that costs arising from the purchase, sale and transfer of securities (Central Securities Depository fees, stock exchange fees, tax charges and costs of the current maintenance of property that fund assets are invested in) are charged against fund assets. Other costs are incurred by the management company – these are mostly brokerage fees.

Brokerage, custody bank and stock exchange fees accounted for the largest share of transaction costs. Transaction costs are directly related to the volume of management company trading and types of instruments being traded. Most costs are incurred in stock trading on the BSE and the lowest costs in T-bills trading.

In response to relatively high trading volumes at the start of operation, particularly trading on the BSE, transaction costs were the highest at the time. The economic crisis induced contraction in the activity of management companies that directed their investment to safer instruments implying lower cost. In 2009, the costs rose again in response to reduced balances in transaction accounts, a shift to government T-bills and a gradual increase in shares trading. At the same time, a rise in net assets pushed up the value of VPF transactions in absolute amount.

Table 7: Transaction costs from 2007 to 2010 and by quarter for 2011

RSD mln

	2007	2008	2009	2010	2011	
					Q1	Q2
Transaction costs	10.00	5.34	7.37	9.74	2.15	2.24
Brokerage fees	4.52	2.22	3.80	4.46	0.86	0.94
Custody bank fees	1.83	1.47	1.98	2.41	0.73	0.62
Stock exchange fees	1.56	0.84	0.38	1.14	0.22	0.36
Central Securities Depository fees	0.99	0.56	1.20	1.45	0.35	0.32
Transfer tax relating to the acquisition of securities	1.10	0.24	-	-	-	-

VPFs generally invest in long-term debt securities, while the portion of shares is relatively low. Such structure impacts on low transaction costs – c. 0.1% relative to net assets.

Number and structure of VPF beneficiaries

At end-Q2 2011, 171,959⁸ of beneficiaries were in the accumulation phase⁹ Total membership contracts¹⁰ stood at 226,761. At the same time, 13 beneficiaries holding 19 membership contracts, who are currently in the withdrawal phase, are receiving scheduled payments. All information from this point onwards, unless specified otherwise, refers to beneficiaries in the accumulation phase.

Q2 saw 4,000 net membership contracts and 3,000 new beneficiaries.

Table 8: Number of contracts and beneficiaries from 2007 to 2010 and by quarter for 2010 and 2011

thousand

	2007	2008	2009	2010	2011	
					Q1	Q2
No. of contracts	158.5	201.6	215.7	220.4	222.7	226.8
No. of beneficiaries	- ¹¹	156.0	165.2	166.8	169.0	172.0
Percentage of active beneficiaries – ¹²	-	41.1%	34.9%	33.6%	31.5%	32.0%

⁸ The number of beneficiaries is the number of members of one or more VPFs. The number is smaller than the number of membership contracts as a significant number of beneficiaries have more than one membership contract in one or several funds.

⁹ VPF membership has two phases – the accumulation phase (when contributions are made) and the withdrawal phase (when funds accumulated are withdrawn).

¹⁰ The number of membership contracts is the sum total of individual membership contracts and the number of members of all pension plans.

¹¹ Data on the number of beneficiaries and the average amount of accumulated funds are available as of June 2008.

¹² The average percentage of active beneficiaries by month in the period it relates to.

In the 2008–2010 period, the strongest growth in the number of new beneficiaries was recorded in 2009 (close to 10,000), while 2010 saw a marginal increase. The upward trend continued in H1 2011 when the number of beneficiaries rose by more than 2,000 in Q1 and 3,000 in Q2.

Average accumulated funds per beneficiary depend on the amount of contributions, the funds' return and the length of the accumulation phase. All three factors impact on the growth in average funds in members' individual accounts. The average amount of accumulated funds of members who have made at least one contribution is RSD 77,395 and is constantly rising.

As the percentage of active members ranges between 30% and 35%, and is broadly unchanged since 2009, we can assume these are beneficiaries contributing to pension funds each month. Average accumulated funds of these beneficiaries total around RSD 130,000.

VPF beneficiaries in Serbia may be domestic and foreign persons. The number of domestic persons holding fund membership contracts is double that held by foreign nationals who, however, hold on average six times more funds in their accounts.

Table 9: Average funds from 2007 to 2010 and by quarter for 2011

	2007	2008	2009	2011	
				Q1	Q2
Average accumulated funds	-	34,594	52,234	73,673	77,395

RSD

At end-Q2 2011, the number of members of two or more VPFs amounted to 30,911 or around 18% of the total.

Table 10: Number of beneficiaries by number of funds in which they are members

Number of funds	Number of beneficiaries
1	141,048
2	21,911
3	8,953
4	39
5	8

Table 11: Number of beneficiaries by membership contract

Number of contracts	Number of beneficiaries
1	129,484
2	31,728
3	9,536
4	885
5	290
6	32
7	3
10	1

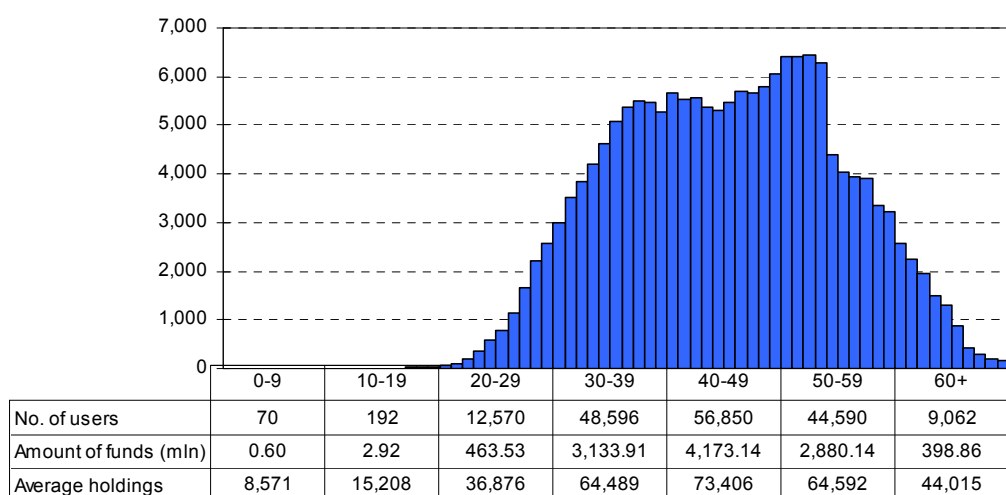
Table 12: Structure of beneficiaries by payment dynamics

Active beneficiaries	Period	Number of beneficiaries	Share (%)
	1 month	54,971	31.97%
	3 months	64,996	37.80%
	6 months	68,143	39.63%
	12 months	85,817	49.91%
	From the start of membership (1)	142,953	83.13%
No funds on accounts (2)		No funds on accounts (2)	16.87%
Total (1+2)		Total (1+2)	

In terms of gender composition, no significant changes were recorded relative to previous years. Men remained dominant (c. 59.7%). The gender ratio is slowly changing – of new members, there were 46.5% men and 53.5% women.

At end-2010, the average age of VPF beneficiaries was close to 44 years, while beneficiaries aged 30–50 accounted for over 61%. Such structure has not changed since the start of VPF operation. Further, the percentage of beneficiaries meeting the age requirement for the withdrawal of funds (53 years under the old Law) was largely similar to earlier years and accounted for approximately 20% of the total.

Chart 7: Distribution of VPF beneficiaries by age



Contribution payments, withdrawals and transfers

Apart from 2007 when most VPFs were set up and when contributions were the lowest, total contributions were stable throughout the years, ranging between RSD 2.2 and 2.4 bln p.a.

In the first half of 2011, contributions into VPFs amounted to RSD 1.2 bln.

In quarterly terms, contributions have been stable over the past year, trending between RSD 550 and 660 bln. Contributions were up RSD 80 mln from Q1 to c. RSD 640 mln in Q2.

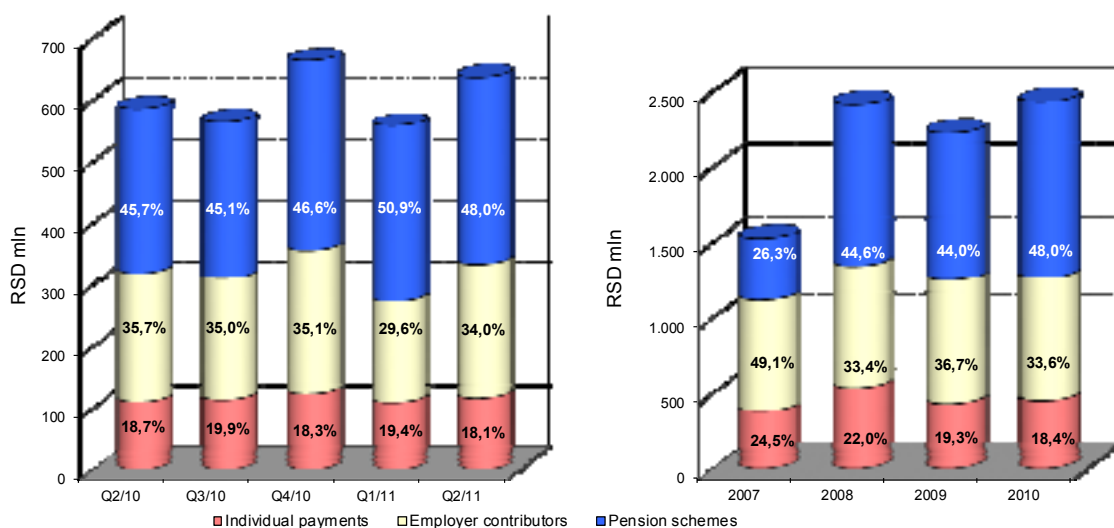
Table 13: Contributions from 2007 to 2010 and by quarter in 2011

	2007	2008	2009	2010	2011	
					Q1	Q2
Total contributions	1.52	2.41	2.22	2.43	0.56	0.64

in RSD bln

Most contributions are made through pension plans that imply the highest saving for the employer in terms of exemption from tax and contribution payment for the paid-in amount, up to the legally stipulated ceiling. Furthermore, pension plan sponsors can negotiate the level of contribution fees for their members, which is another reason for the above contribution method.

Chart 8: Volume and composition of total contributions by year and by quarter in 2011

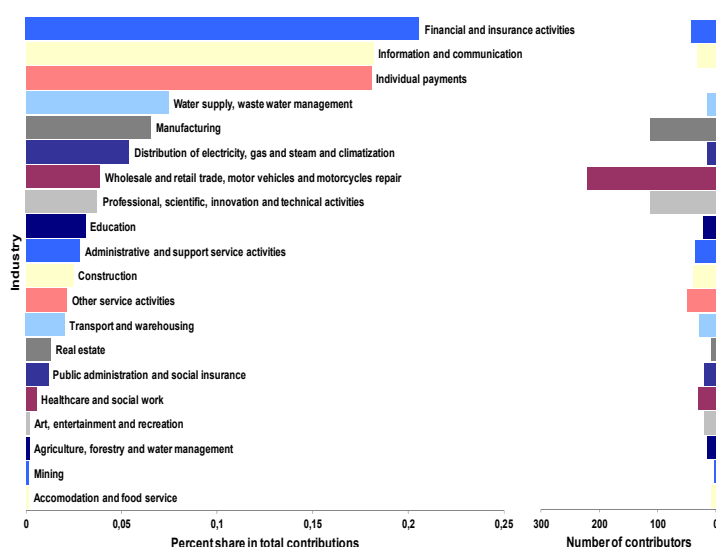


In Q2 2011, of total contributions, individual payments accounted for c. 18%, employer contributions 34% and pension plans c. 48%. This ratio has remained broadly unchanged since 2008.

Five contributors paid over RSD 25 mln each (c. RSD 239 mln together) or 46% of the total. The remaining more than 800 of companies paid less than RSD 25 mln each, or around RSD 283 mln together. The remaining contributions were made by individuals.

Though the Law envisages individual payments, most contributions were made through contributors and pension plans. Employers may contribute on behalf of their employees and thus make saving in the form of tax relief. Ample potential for further growth in the membership base are companies with high staffing levels.

Chart 9: Payment of contributions and number of contributors by activity



Withdrawals are generally lump-sum, which is logical as members entitled to withdrawal are not long-standing fund members and their accumulated sum is therefore relatively small. Future period is likely to see an increase in scheduled and other types of withdrawals, in response to growth in accumulation years and the accumulated sum, particularly after the adoption of the new Law setting the maximum lump-sum amount to be drawn at 30%.

In the first six months of 2011, withdrawals by eligible members amounted to RSD 250 mln.

Table 14: Withdrawals from 2007 to 2010 and by quarter in 2011

	2007	2008	2009	2010	2011	
					Q1	Q2
Total withdrawals	141	384	448	458	125	123

Withdrawals grow by the year as a result of system development – as contributions and net assets increase and Pillar III matures, absolute withdrawals will rise as well. In Q2 2011, contributions exceeded withdrawals by c. RSD 520 mln. However, what is atypical for the nature of VPFs is that withdrawals are made as soon as beneficiaries turn 53 (the minimum retirement age) – even before they meet the requirements for state pension. One of the reasons is a short contribution period and small accumulated funds.

Transfers concern inter-fund transfers. A member may transfer a part or all of his assets from one fund to another, thereby covering only the real transfer costs. The largest transfers were recorded in 2008. Q2 2011 saw average transfers of around 40 mln.

Inter-fund transfers amounted to RSD 140 mln in H1 2011.

Table 15: Inter-fund transfers from 2007 to 2010 and by quarter over the past year

in RSD mln

	2007	2008	2009	2010	2011	
					Q1	Q2
Total transfers	19	235	141	216	98	42

Return/risk ratio

Given a short period of VPF operation, market turbulences (the crisis, plummeting stock, etc) and varying times of the start of VPF operation, the return from the outset of operations is not an adequate basis for comparing fund performances. Furthermore, when comparing returns, the portfolio risk should also be taken into account.

Fund return is the percentage change in the investment unit value over a particular period. It represents the ratio of the investment unit value at the start and end of the period. The VPF return since the start of operation may be classified into three phases. The first phase of decreasing return lasted until September 2008 in response to plummeting BSE stock making up over 20% of the overall portfolio. Responding to market changes, funds rechanneled their investment to safer instruments, which resulted in modified investment structure and lowering of the portion of shares to below 10%. At one moment, over 50% of assets were held in custody bank accounts. Funds directed their assets in T-bills when they were first issued, while at the same time maintaining the portion of frozen FX savings at around 25-30%. Such investment policy enabled VPFs to maintain their assets, while FONDex never fell below 1000 points. The shift in the investment structure ushered in the second phase marked by vigorous growth in return. That was the time of key policy rate hikes that exerted a positive impact on T-bills and deposits, the EUR/RSD exchange rate and consequently euro-indexed instruments. The third phase featured stagnation in return (c. 10% in 2010). Such trends indicate that short-term return volatility is possible, particularly in case of funds investing a major part of their assets in riskier securities. Besides, such funds expect higher return in the long run.

Fund risk implies the investment unit volatility directly linked to the risk of instruments from the fund portfolio and their mutual correlation. It is measured by the standard annualised deviation of daily investment unit return. The higher volatility and divergence from the mean value, the higher the standard deviation as a risk measure. Following the initially higher risk levels over 5% p.a, stemming from greater positions taken in shares, the risk entered a steady downward path reflected in modified investment structure, only to settle at 1–2% a year.

Investment unit volatility was more pronounced in 2007 and 2008 when funds began to operate. The riskiest were investments in equity instruments and BSE shares. As their portion in assets declined, volatility subsided.

Table 16: Return and risks of VPFs and FONDex

Name of VPF; start of business / return from the start of business (p.a.)	For the past year				
	Investment risk				
	2007	2008	2009	2010	Q2 2011
Delta Generali 15.11.2006 / 7.33%	12.08% 7.56%	-9.75% 6.76%	15.20% 2.88%	9.25% 1.45%	6.63% 2.14%
Raiffeisen Future 03.01.2007 / 11.26%		4.90% 2.72%	12.14% 1.08%	8.81% 1.69%	5.49% ¹³ 1.90%
DDOR-Garant 10.01.2007 / 7.42%		-7.07% 4.99%	12.66% 2.21%	9.40% 1.26%	3.14% 3.55%
Dunav 02.04.2007 / 5.08%		-5.83% 6.27%	15.84% 3.72%	9.40% 1.77%	8.88% 1.91%
Delta Generali INDEX (ex Nova penzija) 16.04.2007 / 2.41%		-10.18% 5.99%	13.19% 2.26%	8.55% 0.97%	3.97% 4.26%
Triglav penzija 11.09.2007/6.66%		0.46% 5.24%	11.67% 2.34%	9.16% 1.67%	5.09% 2.20%
Societe Generale Štednja 06.11.2008 / 12.07%			13.76% 1.75%	9.84% 1.33%	5.93% 1.97%
Societe Generale Ekvilibrio 06.11.2008 / 11.16%			12.38% 2.24%	9.12% 1.31%	7.93% 1.51%
FONDex 15.11.2006 / 8.30%		-6.88% 6.29%	15.04% 3.21%	9.57% 1.57%	6.53% 2.06%

Riskier funds are those leaving more room for riskier investments (into shares, etc) with a view to posting higher return in the long run. They are intended for younger members with over a 10-year investment horizon. As such funds can suffer even short-term losses they are not tailored to older members intending to draw their funds within a short term. Members should therefore opt for a fund with no or small percentage of risky instruments with low volatility.

The return/risk ratio¹³ moved in line with changes in its individual components. Since the start of VPF operation, the ratio moved in three phases. The first phase was marked by a moderate decline, triggered by falling return,

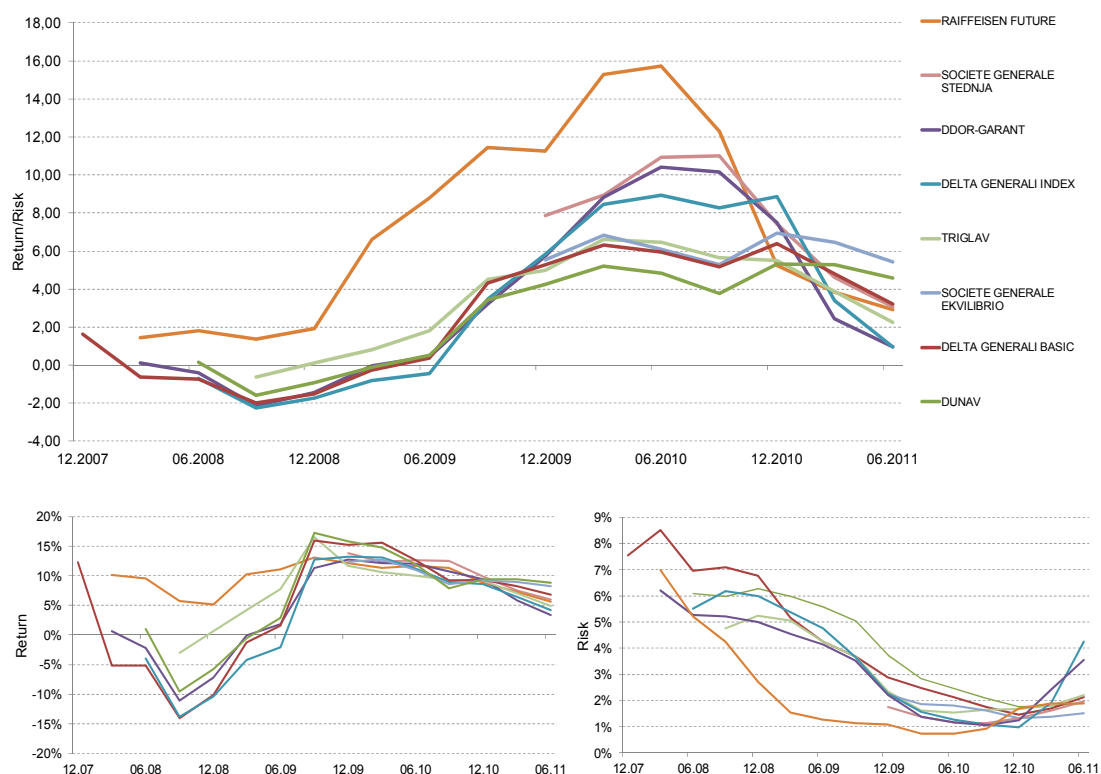
¹³ The return/risk ratio is calculated by dividing the return for a particular period by the value of risk for the same period.

though the decline was mitigated by diminished fund riskiness. It is noteworthy that funds taking less risk posted higher return. Such ratio is however expected in light of negative trends in the financial market. Still, once the market enters calmer waters, the ratio may change as its current levels are unsustainable from a long-term perspective (VPFs being long-term investment vehicles). The second phase was that of vigorous growth in the value and rising return, together with a further decline in risk. The third phase saw stagnation, prompted by the stabilisation of risk and return in 2010.

The return/risk ratio measures the performance of investment and risk management systems. A fund with a higher ratio posts better results. Individual components of the ratio are equally important as two funds may have different component values and the same ratio (higher return and higher risk). The choice between such two funds depends on member's risk tolerance. Assuming the same ratio value, choosing a fund with higher return implies higher risk, i.e. worse performance in times of market turbulences. Management companies prescribe in their policies investment limitations and possible fund riskiness.

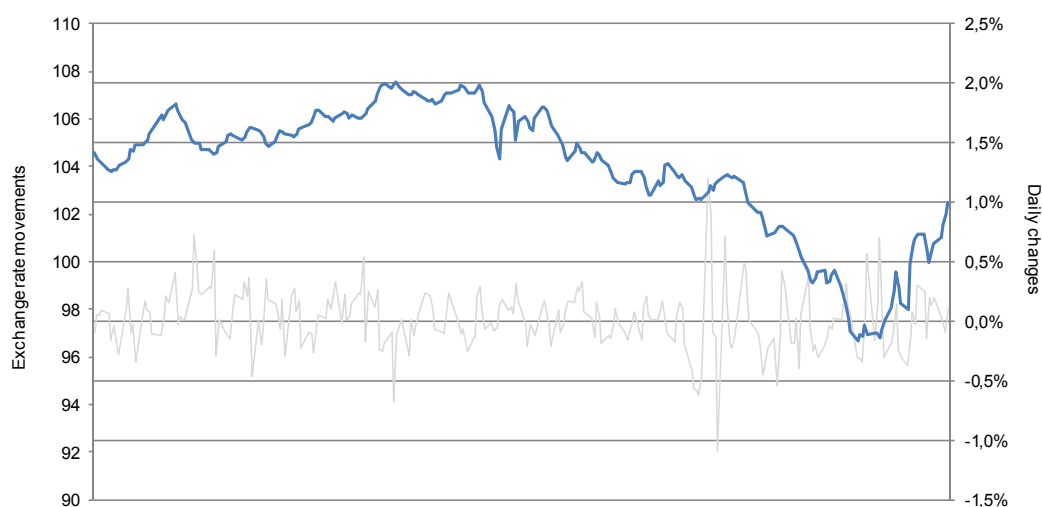
The return/risk ratio has its limitations. First, the period it covers is short and data series are insufficient. Furthermore, given the circumstances of fund operation (the crisis, volatile environment, plummeting stock exchange shares), the results achieved are not adequate for establishing future values. The most conservative funds, i.e. those taking the lowest risk, posted the highest return. Besides, due to poor BSE liquidity and undeveloped secondary T-bill trading, the investment unit volatility may be underestimated.

Chart 10: Risk to return ratio in the VPF market, chronologically



The risk to return ratio narrowed in H1 2011 relative to 2010. Funds' return declined, while investment risk heightened. The strongest contribution to falling return came from factors affecting the prices of euro instruments, movements in the dinar against the euro, and interest rate trends. As the domestic currency strengthened and interest rates surged, the value of euro instruments declined. Funds investing more in foreign currency instruments recorded a heftier fall in the return on investment units. At the same time, the investment risk increased. Growth in the standard deviation of investment units stems from higher volatility of instruments, particularly in case of funds with a greater percentage of foreign currency instruments.

Chart 11: Exchange rate of the dinar and daily changes in the exchange rate for the past year



4. CONCLUSION

In 2010 and early 2011, long-term dinar and FX T-bills were issued, as well as 2026-maturity government coupon bonds. At the same time, shares of two large companies – NIS a.d. Novi Sad and Nikola Tesla Airport were listed on the BSE Prime Market. First municipal bonds are about to be issued as well.

The appearance of new financial instruments, notably long-term, is highly significant for VPFs as it enables more efficient assets and risk management, including greater investment diversification in line with each company's investment plan.

Tax reliefs increase each year in accordance with rising retail prices. At the onset of VPF operation, the relief equalled 10% of average wage or RSD 3,000. The amount set for 2011 is RSD 4,343 – employers are exempt from the household income tax and mandatory social insurance contributions, while natural persons do not have to pay the household income tax provided contributions are made via wage garnishment.

There is ample room for further development of Pillar III in Serbia. As the economy recovers and the standard of living improves, contributions into private pension funds will rise as well. Clear signals about the need to save for old age, sent to citizens by economic policy creators, are likely to bolster the sector development. Further, awareness raising and education about VPFs will certainly enhance citizens' interest in securing additional retirement income. Besides, more weight should be lent to private pensions in the dialogue between employers and employees, enabling employers to display greater social care for their staff.

5. SPOTLIGHT ON...

Amendments to the Law on Voluntary Pension Funds and Pension Schemes

Most notable amendments to the Law on Voluntary Pension Funds and Pension Schemes, adopted in Q2 2011, relate to the following:

- the age for funds withdrawal is set at 58, instead of 53, while early withdrawal is possible only in case of permanent incapacity for work. Lump-sum withdrawals can amount up to 30% of funds accumulated. These changes affect only new members, while those who concluded contracts before the new Law entered into force are subject to earlier restrictions.
- Instead of each day, investment unit values are published in daily press at least once a week, for each day in the previous period. Companies will continue to publish on their websites daily data on investment unit values.
- the amount of contribution and management fees will be changed once total net assets of all VPFs reach 0.75% of GDP – the management fee will be capped at 1.25% p.a, instead of current 2%, while the contribution fee will not be limited (current cap: 3%). Net assets currently account for c. 0.37% of GDP.
- permitted forms of investment are broadened to include short-term debt securities issued or guaranteed by banks headquartered in the Republic and investment units of open-end investment funds. Limitations relating to investment in real estate and deposits are now regulated by secondary legislation.
- members may use assets they accumulated in funds as a guarantee for obligations towards the Republic and banks in respect of first-time apartment purchases, in accordance with the Government's decree.
- costs charged against fund assets are stipulated – those are costs arising from the purchase, sale and transfer of securities (Central Securities Depository fees, market operator fees, tax charges and costs of the current maintenance of property). All other costs are borne by the management company.
- VPF management companies are no longer obliged to compile and audit semi-annual financial statements.
- a company is able to transfer a fund to another company, via a contract, provided it obtains the NBS's previous approval and informs all members.

VPF investment policy

Investment policy is a document defining precise asset management rules and identifying the key factors for investment decision making. Prospective members should therefore read carefully the investment policy document of the fund, particularly the segment relating to the investment target and investment risk. As stipulated by rules of the profession, an investment policy must contain the following elements:

- Fund type and profile,

- Accountability and manner of investment decision making,
- Fund's investment target,
- Degree of fund riskiness,
- Strategic allocation of investment,
- Benchmark and performance measurement,
- Changes and rebalancing.

Investment policy defines the fund in terms of members it is generally intended for, the investment style, investment horizon, etc. It describes the process of investment decision making, manner of changing investment policy, way of informing fund members, and their rights in case of policy amendments. It also contains clearly set objectives of fund asset investment, in absolute or relative amounts relative to benchmark, as well as information based on which such objectives were adopted. Risk tolerance is linked to the investment target and is quantitatively defined for particular types of investment and the overall portfolio. Fund risk may be measured as volatility, tracking risk relative to the benchmark, or as the loss risk. Strategic allocation of funds implies the stipulation of instruments that the fund will invest in, bearing in mind the risk tolerance and the investment target. Allocation sets the targeted, maximum and minimum percentage of assets for investment. The spread between the floor and ceiling for investment in a particular instrument should not be too large – on the basis of the proposed allocation, the fund's strategic orientation should be clear. The spread and maintenance of targeted allocation should be defined in detail in the part relating to rebalancing, while changes in investment policy imply the amendment deadlines and terms. Investment policy should define the benchmark for measuring the fund's performance. The benchmark could be the market index or composite index that must correspond to the set target and the fund's strategic allocation.