

BAE SYSTEMS 2000 PENSION PLAN STATEMENT OF INVESTMENT PRINCIPLES

1. Introduction

The Board of Directors (the Board) of the BAE Systems 2000 Pension Plan Trustees Limited (the Trustee) has agreed to this Statement of Investment Principles (SIP), required under the Pensions Act 2004. The Board acts for and makes decisions on behalf of the Trustee Company. The SIP is for the BAE Systems 2000 Pension Plan (the Plan).

The Board will review this SIP at the minimum following each actuarial valuation and it is the Board's practice to review the SIP annually and after any significant change in investment policy. Any amendment to the SIP will only come into effect after obtaining and considering written advice from a person whom the Board considers to be suitably qualified and experienced in investment matters and after consulting the sponsoring employer

In the process of preparing the SIP, the Board has:

- Considered written advice from BAE Systems Pension Funds Investment Management Ltd (BAPFIM).
- Considered written advice from Aon Consulting Ltd.
- Consulted with the sponsoring employer, BAE Systems plc.

A copy of the SIP as amended from time to time will be sent to the sponsoring employer and to each of the investment managers employed to manage the assets of the Plan. The Board will seek confirmation of compliance with these principles through regular reports from the investment managers.

The Board provides the opportunity for its members to receive training in investment and other pensions-related issues.

The Board has delegated authority for the consideration of investment issues to an Investment Committee that meets at least quarterly and acts within its own Terms of Reference which are reviewed periodically. The Investment Committee receives additional training on investment issues.

The Investment Committee has appointed three external advisers with wide experience of investment to advise them on investment policy issues and in addition is supported by the investment staff of BAPFIM, BAE Group Pensions and external consultants where appropriate.

Fees to external advisers, consultants and other professional advisers are paid. External consultants and other advisers are paid at an hourly rate with fixed fees being agreed for one off projects. The performance of all advisers is reviewed on a periodic basis.

The Investment Committee has adopted a business plan to ensure the orderly oversight of the investments of the Plan.

2. The Investment Objective

The investment objective of the Plan is to invest the Plan's assets so that taking capital, income and contributions together its assets are sufficient to meet its liabilities and statutory obligations.

3. Classes of Investment

The Board formally considered the suitability of all classes of investments before deciding on the final asset allocation. Although the Board is open to the use of any financial instruments in principle, it does not believe it appropriate to allow its investment managers to use new financial instruments without first seeking its agreement.

The following asset classes are currently considered to be suitable for the Plan:

- Equities, convertible stocks and warrants
- Fixed interest and index linked stocks both government and corporate
- Property
- Cash deposits, currencies, short term bills and notes
- Policies and bonds issued by insurance companies
- Futures and options (for asset allocation changes and hedging only)
- Private equity and infrastructure
- Structured financial assets
- Swap transactions

The great majority of the Plan's assets are liquid and easily realisable. The Board takes the view that the balance between liquid and illiquid investments is appropriate. Illiquid assets defined as private equity and infrastructure (excluding property) should not exceed 11% of non-matching assets (see Table 2) and together with other structured financial products shall not exceed 15% of the non-matching assets.

The Plan may invest in the approved asset classes through collective investments whether quoted or unquoted including limited partnerships.

The Board has entered into a stock lending agreement in order to enhance the income on the assets of the Plan. The Board has sanctioned the use of

derivatives, including Swap transactions, only in order either to reduce risk or to facilitate efficient portfolio management.

4. Expected return on Investments

The long term expected returns on the asset classes modelled in the asset-liability study on which the strategic asset allocation has been based are shown in Table 1. The returns shown are real returns (i.e. after inflation). Over short time periods, the achieved returns may differ markedly from the assumptions. The assumption for long-term inflation is 3.0%pa.

Table 1: Long term real return assumptions (% pa)

Asset Class	Expected Real Return
UK Equity Return	5%
Overseas Equity Return	5%
Government Bond return	1.5%
UK Index Linked return	1.0%
UK Property	4.75%

5. Asset Allocation

In order to set the asset allocation of the Plan, the Board commissioned asset liability modelling from Aon Consulting Ltd and Lehman Brothers using as a starting point the Actuarial Valuation as at 5 April 2007. The models used to establish the asset allocation were proprietary to both consultants and used stochastic modelling techniques to test the behaviour of different asset allocations on the funding of the Plan in many different economic scenarios.

The resulting asset allocation was that which in the opinion of the Board and after hearing advice from Aon Consulting and BAPFIM and the three independent investment advisers, proved the most appropriate mix of risks and return. The asset allocation was set following consultation with the principal employer. In reaching its decisions, the Board also formally considered the financial position of the sponsoring employer and continues to review it periodically.

In considering the future asset allocation of the Plan, the Board with their advisers examined strategies aimed at reducing volatility and locking in solvency margin improvements as they occur. The strategy involves three elements: an equity option overlay, an interest and inflation rate hedges and progressive reductions in risk assets as solvency margins improve. All three strategies are dependent on market levels and therefore the timing of the implementation is not fixed.

The assets in the Plan can be divided into three broad categories:

- Return Seeking Assets. These consist of equities (quoted and unquoted) and property

- Fixed Interest Assets. These assets loosely match the liabilities but are managed actively against a benchmark. They include both fixed income and index linked government and corporate bonds
- Matching Assets: These are assets, both fixed income, index-linked and swaps, which are designed to supplement the Fixed Interest Assets by bringing the overall level of interest rate and inflation hedging closer in performance to that of the liabilities

The programme to reduce investment risk means that over time and at a pace dictated by a combination of market levels and levels of the solvency margin, the balance between return seeking assets, fixed income and matching assets will change.

The Return Seeking and Fixed Interest Assets are managed relative to a benchmark established by the Board (Table 2).

As a result of the decision to establish a de-risking strategy, certain assets will be held in a “Matching Portfolio” and will not be included in the performance benchmark. These will largely be index linked gilts, conventional gilts and swaps and as the portfolio is built up the asset allocation shown in Table 2 will be adjusted. From 1 January 2011, all index linked securities were transferred to the Matching Portfolio.

As at 1 January 2011, the Matching Portfolio formed 10.3% of the assets of the Plan in accounting terms..The Matching Portfolio consists of the following assets.

Table 2: Matching Asset Portfolio

Assets	Plan Assets %	Note
Index Linked Gilts	10.3	
Inflation Swaps*	0.4	} Nominal value £302m
Interest Rate Swaps*	0.1	
Collateral Cash	(0.4)	
Total	10.4	

* In accounting terms only the difference between the nominal and the market value is taken into the accounts. The underlying economic exposure is shown in the Note.

Table 3: Strategic Asset Allocation (ex Matching Assets)

	%	Range (%)	Benchmarks
Quoted Equities	45	+/-5	
UK Equities	22.5	+/-5	FTSE All Share 5% Capped
Overseas Equities:	22.5	+/-5	Weighted Contribution of Asset Categories
North America	7.5	*	S&P Composite / TSE 60
Europe	7.5	*	FTSE All Worlds Developed Europe ex UK
Japan	3.0	*	FTSE All World Developed Japan
Asia	2.3	*	FTSE All World Developed ex Japan
Emerging Markets	2.2	*	MSCI Emerging Market Free
Fixed Interest:	34.6	+/-5	Weighted Contribution of Asset Categories
Government	17.3	5-20	FTSE All Stocks
Corporate	17.3	5-20	IBOXX Sterling Overall Index
Structured Products		0-4	n/a
Property	10.1	+/-2	IPD Pension Funds Index/5%real return over 5 years
Cash	2.5	0-10	7 Day Sterling Index
**Total ex-Unquoted	92.2	89-100	Weighted Contribution of Asset Categories
Unquoted Securities:	7.8	0-11	See below section 5
Private Equity		0-6	-
Infrastructure		0-5	-
Total ex-Matching Assets	100		Weighted Contribution of Asset Categories

* +/-2%; **The Performance Benchmark

- Geographical exposure on overseas regions can be varied by +/- 2% of the total fund
- Up to 5% of the portfolio can be held in overseas bonds
- The asset allocation is rebalanced to the strategic asset allocation quarterly

The investments in Property and Private Equity (including infrastructure) are less liquid than the other Return Seeking Assets and it is recognized that each individual investment may be held for a number of years. Any reduction to Return Seeking Assets under the derisking programme is likely to be achieved by reducing the Quoted Equity exposure at the point of derisking,

with any reduction to the less liquid assets conducted at a suitable time in the lifecycle of the investment. The Board will monitor the proportion of Return Seeking Assets invested in less liquid asset classes and effect an orderly withdrawal from these assets over time if the proportion is excessive or expected to become excessive in the opinion of the Board.

6. Fund Management Arrangements and Performance Objectives

The Board has appointed a number of investment managers to invest the assets of the Plan. BAPFIM has been appointed as lead investment manager with the role of helping the Board in formulating investment policy and in coordinating its execution. The investment managers with the exception of BAPFIM are paid a fee for their services based on a percentage of assets under management. Some fees paid contain a performance element. The Board believes that it is not in the best commercial interest of the Plan to publish details of these fees. BAPFIM is a non-profit making business and its costs are shared between the schemes that it manages, and the charge to the Plan is substantially lower than those of commercial fund management groups.

The Board has considered the issue of transaction and related costs. The Board believes that these are best controlled by ensuring that its investment managers have coherent processes to control costs and that these are reported to the Board on a regular basis in accordance with the IMA/NAPF Disclosure Code. No investment managers are authorised to pay “soft” commissions.

The Board has established performance objectives over and above the benchmark returns gross of fees. It believes that the investment management mandates and performance benchmarks are consistent with the investment objectives of the Plan. These objectives together with the investment managers for the asset class at the time of the agreement of this SIP are shown in Table 3. The objectives have been discussed and agreed with the investment managers in each asset class. Changes to the investment managers will be noted in the Report and Accounts of the Plan.

The Board has arranged for performance to be measured by an external consultant. An annual review of performance is conducted with the consultant and quarterly results are noted and, when necessary, discussed. The performance of the Plan is published annually in the Report and Accounts.

Table 4: Performance Objectives and Investment Managers

Asset Class	3 Year Rolling Return*	Investment Manager	Type of Mandate
Total Fund (ex unquoted securities)	+ 0.8%	BAPFIM	Active
UK Equities	+2.0%	BlackRock	Active
UK/US Equities	+0.5%	BAPFIM	Active
UK Small Companies	+2.0%	Artemis / Axa Framlington	Active
European Equities	+2.0%	Threadneedle/ JPMorgan Asset Management /	Active
Japanese Equities	+2.0%	Nomura Asset Management	Active
Pacific (ex Japan)/Emerging Market Equities	+2.0%	BAPFIM	Active
UK Gilts	+0.75%	BAPFIM	Active
Corporate Bonds	+0.75%	BAPFIM	Active
Property	in excess of 5% real return	LaSalle Investment Management	Active
Active Currency	+3%	Barclays Global Investors	Active
Private Equity/Infrastructure	See below	Various	Active
On an annual basis, the target is to at least equal the benchmark in each asset category and for the Plan as a whole.			
* %p.a. relative to benchmark for asset class in Table 2 and gross of fees.			

The Board has committed to invest 4% of Scheme assets in Private Equity and a further 3% into Infrastructure investments. Both are long term investments and illiquid asset classes and annual performance can be exceptionally volatile in Private Equity. The Board has therefore decided to judge the performance of both over a longer timeframe. In the case of infrastructure, the programme will be judged against an objective of earning a return of 1.5% in excess of equities (net of fees). For Private Equity the Board has established the following benchmarks.

- To outperform the FTSE All World Index by 3% - 5% over ten year rolling periods.
- To outperform a weighted Cambridge Associates' private equity median portfolio benchmark over 10 year rolling periods.

The Board decided that property was most appropriately benchmarked against an absolute return rather than an index return. The benchmark return, which the property manager is expected to exceed, is a 5% real return over a property cycle. For the purposes of measurement of the performance benchmark of the overall fund on an annual basis, it is intended to use the IPD Pension Fund Index.

The Board has appointed an active currency manager.

Given the need to judge the performance of the unquoted investments over a long timeframe and that part of the portfolio is invested in assets used to match liabilities, the Board assesses shorter term performance on a one and three year rolling basis against a performance benchmark excluding these assets.

The Board considers that the performance objectives set for the investment managers are consistent with a relatively low risk profile for the Plan as a whole. The Board has not set its investment managers objectives with reference to tracking errors or defined downside performance limits, as it is not believed that such objectives satisfactorily deal with controlling risk in the investment portfolios. The Board believes that this is best dealt with by regular monitoring of investment risk in order to ensure that the risk being taken by the managers is consistent with the objectives set; by the broad spread of investments between different asset classes and by investment guidelines which restrict for example the concentration of underlying portfolios.

The Board has appointed a custodian bank to ensure the security of its investments.

7. Socially Responsible Investment (SRI)

The Board has requested that investment managers consider social, environmental and ethical issues to the extent that they are relevant in assessing the specific holdings and to the extent that they may have a financial impact on the Plan's assets.

8. Corporate Governance Responsible Ownership

The Board has adopted the Hermes Responsible Ownership Principles as its comprehensive policy on corporate governance issues. The Principles found at http://www.hermes.co.uk/eos_policy_documents.aspx applies to its investments. The Board also subscribes to the Institutional Shareholders' Committee's Statement of Principles on the Responsibilities of Institutional Shareholders and Agents and welcomes the development of these principles into the UK Stewardship Code. It has decided that the most effective way to implement its policies is to appoint Hermes Equity Ownership Services to act on its behalf over all its equity investments in the UK and overseas. Their role will be to vote in accordance with the policy (or exceptionally, as directed by the relevant investment manager or the Board); where appropriate to engage with management to improve shareholder value and to report on their activities. Providing no ongoing engagement activity is compromised, the Board will publish the results of their engagement.

9. Risk Measurement and Management

The Board have identified the following principal sources of risk:

- The risk to the solvency of the Plan from the failure of the principal employer. The Board keep the covenant of the principal employer under regular review.
- The risk that arises to the solvency of the Plan from a mismatch of assets and liabilities. The Board approach this by undertaking asset - liability modelling exercises at least every three years (see section 5 above) and through their plans to increase the Matching portfolio as and when circumstances permit.
- The risk from fund managers significantly underperforming their objectives. This risk is controlled through careful monitoring of the asset managers' performance and through the mandates given to the managers.
- The risk of over concentration of investment risk is controlled through the diversification of assets and managers.
- The risk arising from operations is controlled through a regular programme of internal and external audits. For external fund managers, the Plan cannot have direct control but seeks to protect its assets through its investment management agreements and its use of reputable fund managers. The Board have also safeguarded the assets by the appointment of an external custodian.
- The risk arising from counterparties in investment transactions is controlled through ensuring that all counterparties are regulated and subject to basic financial checks where appropriate; by ensuring that a sufficient number of counterparties are used to diversify risk; and by ensuring that transactions are adequately collateralised where appropriate.

10. Money Purchase Investments

The Plan provides a facility for members to pay AVCs into the Plan to enhance their benefits at retirement. Arrangements have been put in place to offer members a range of funds in which to invest their AVC payments. The Board's objective is to provide a range of funds that will provide a suitable return for members. In keeping with its policy for the Plan assets, the Board's policy is to seek to achieve the objective by allowing members to invest in a suitable mixture of real and monetary assets.