

## **Alvis Pension Scheme (the "Scheme")**

### **Statement of Investment Principles (the "Statement")**

#### **1. Scope of Statement**

This Statement has been prepared in accordance with the European Pension Directive 2003/41/EC, the Pensions Act 2004 and the Occupational Pension Schemes (Investment) Regulations 2005

The effective date of this Statement is June 2009. The Trustee's policy is to review this Statement and the Scheme's investment strategy no later than three years after the effective date of this statement and without delay after any significant change in investment policy.

This statement has been prepared with the assistance of Deloitte Total Reward and Benefits (DTRB).

#### **2. Consultations Made**

The Trustee has consulted with the company, BAE Systems plc, prior to finalising this Statement and will take the company's comments into account when they believe it is appropriate to do so.

The Trustee is responsible for the investment strategy of the Alvis Pension Scheme. As required under the Act, the Trustee has consulted a suitably qualified person by obtaining written advice from Deloitte Total Reward and Benefits Limited ("DTRB") on the suitability of the investments in respect of their security, quality, liquidity and profitability, the need for diversification and the principles contained in this Statement. DTRB is authorised and regulated by the Financial Services Authority.

The day-to-day management of the Scheme's assets has been delegated to investment managers that are authorised and regulated by the Financial Services Authority. A copy of this Statement has been provided to the investment managers appointed and is available to the members of the Scheme.

#### **3. Objectives and Policy for Securing Objectives**

The Scheme is a Final Salary Scheme with benefits due to members being linked to their pensionable salary at, and pensionable service to, the date of retirement or earlier date of death or withdrawal. The Scheme's liabilities thus originate from benefits due to active members, deferred members and pensioners. These are not directly dependent on the return achieved on the Scheme's investments.

The Trustee's objectives for setting the investment strategy of the Scheme have been set with regard to the Scheme's Statutory Funding Objectives as set out in the Statement of Funding Principles.

The Trustee's primary objectives are:

- "funding objective" - to ensure that the Scheme is fully funded using assumptions that contain a modest margin for prudence. Where an actuarial valuation reveals a deficit, a recovery plan will be put in place which will take into account the financial covenant of the employer;
- "stability objective" – to have due regard to the likely level and volatility of required contributions when setting the Scheme's investment strategy;
- "security objective" – to try to ensure that the solvency position of the Scheme (as assessed on the prescribed bases) is expected to improve. The Trustee will take into account the strength of employer's covenant when determining the expected improvement in the solvency position of the Scheme and;
- "risk management" – to manage the risks of matching assets against the method used by the Scheme Actuary in funding calculations.

- "Liquidity Objective" – to ensure, that over the shorter-term, the Scheme's income, including contributions and investment income, will meet expenditure, for example on the provision of benefits and administration services except when exceptional payments are needed, such as members taking cash sums at retirement.

#### **4. Choosing Investments**

The Trustee recognises that pension liabilities are essentially bond-like in their characteristics and so bond type assets represent the better "matching asset". As such, a portfolio of appropriate bond type investments is the strategy that will best protect the funding level against changes in the value of the liabilities. However, the concurrent existence of a funding deficit within the Scheme and the support of a sponsor with a strong covenant are considered to justify a departure from a "minimum risk" position by investing in return seeking assets in the interim. It is, though, the intention of the Trustee to increase the allocation to bonds over time, and so reduce the level of investment risk relative to the liabilities, as relative market pricing and funding levels permit.

In addition, the Trustee recognises the "regret risk" associated with not holding return seeking investments over the longer term. Consequently, the Trustee feels that some equities and other return seeking assets are appropriate in an attempt to improve the ongoing and solvency positions and to reduce the reliance on the Company's contributions to fund liabilities. However, both the Trustee and the Company recognise that holding return seeking assets will bring increased volatility of sponsor contribution requirements in anticipation of reduced costs in the long term.

The types of investments held and the balance between them is deemed appropriate given the liability profile of the Scheme, its cashflow requirements, the funding level of the Scheme and the Trustee's objectives.

The assets of the Scheme are invested in the best interests of the members and beneficiaries.

The Trustee exercises its powers of investment in a manner calculated to ensure the security, quality, liquidity and profitability of the portfolio as a whole. In order to avoid an undue concentration of risk a spread of assets is held. The diversification is both within and across the major asset classes.

Assets held to cover the Scheme's technical provisions (the liabilities of the Scheme, established according to UK subsidiary rules enacted to comply with the European Pensions Directive 2003) are invested in a manner appropriate to the nature and duration of the expected future retirement benefits payable under the Scheme.

The assets of the Scheme are invested predominantly in regulated markets (with investments not in regulated markets being kept to a prudent level) and properly diversified to avoid excessive reliance on any particular asset, issuer or group of undertakings so as to avoid accumulations of risk in the portfolio as a whole.

Investment in derivatives is only made in so far as they contribute to the reduction of investment risks or facilitate efficient portfolio management and are managed such as to avoid excessive risk exposure to a single counterparty or other derivative operations, and will not lead to the creation of an overdraft, other than for short term liquidity reasons.

#### **5. The Balance Between Different Kinds of Investments**

The Trustee recognises that the key source of financial risk (in relation to meeting its objectives) arises from asset allocation.

They therefore retain responsibility for setting asset allocation, and take expert advice as required from their professional advisers.

The Trustee reviews its investment strategy every three years, following each formal actuarial valuation of the Scheme (or more frequently should the circumstances of the Scheme change in a material way). This Statement is reviewed at least every three years and at least after each significant change.

A broad range of available asset classes has been considered. This includes consideration of so called "alternative" asset classes (for example property, private equity, and hedge funds). The Trustee has set a Scheme-specific strategic benchmark consistent with the principles set out in this Statement. This can be found in Appendix I.

## **6. Investment Risk Measurement and Management**

The key investment risks are recognised as arising from asset allocation. These are assessed triennially in conjunction with the actuarial valuation of the Scheme, following which the Trustee takes advice on the continued appropriateness of the existing investment strategy.

Risks associated with changes in the employer covenant are assessed by monitoring the Failure Score (as defined for the purposes of calculating the risk-based element of the Pension Protection Fund levy.) Additionally, under conditions of legal confidentiality, the Trustee has ongoing dialogue with the company over relevant issues. The Trustee monitors the risks arising through the selection or appointment of fund managers on a quarterly basis.

The Trustee acknowledges that investment returns achieved substantially outside the expected deviation (positive or negative) may be an indication that the investment manager is taking a higher level of risk than indicated.

Day-to-day management of the assets in implementing the scheme specific strategic benchmark is delegated to professional investment managers who are all regulated by the Financial Services Authority (FSA). The investment managers have full discretion to buy and sell investments on behalf of the Scheme, subject to the constraints of their mandates. The mandates are set out in Appendix I. Each manages investments for the Scheme to a specific mandate, which includes performance objectives, risk parameters, and timescales over which their performance will be measured.

## **7. Custody**

For assets managed on a segregated basis for the Scheme, day-to-day control of custody arrangements is delegated to the custodians. The Trustee receives a copy of the investment managers' reports, custodians' and auditors reports of their respective procedures, prepared in accordance with FRAG21/94 issued by the Institute of Chartered Accountants are sent directly to the auditors and accounts team where applicable. The Trustee has signed agreements with the custodians.

Additionally, there are investments in pooled funds that give the Trustee a right to the cash value of the units rather than to the underlying assets. In this case the managers of the pooled fund are responsible for the appointment and monitoring of the custodian of the relevant fund's assets.

## **8. Expected Returns on Assets**

Over the long-term the Trustee's expect the assets to outperform the liabilities (as calculated by a proxy of gilt based investment) by 2.8% pa, accepting significant differences from the long-term target each year.

## **9. Social, Environmental or Ethical Considerations**

The Trustee has delegated responsibility for the selection, retention and realisation of investments to the investment manager(s) (within certain guidelines and restrictions for segregated assets).

The Trustee's policy is to leave social, environmental or ethical issues to the discretion of the investment managers.

The Trustee has reviewed and has accepted the managers' policy on this issue and will monitor this policy from time to time. The Trustee believes it has appointed managers who take a responsible attitude to social, environmental and ethical considerations.

The Trustee's policy is to invest part of the Scheme's assets on a passive basis. The Trustee does not consider it appropriate for a passive investment manager to take account of social, environmental or ethical considerations in the selection, retention and realisation of investments. However, it is the Trustee's policy to give discretion to the passive investment manager to pursue a policy of engagement with companies. The extent to which social, environmental or ethical considerations are taken into account in this engagement policy is left to the discretion of the passive investment manager.

### 10. Activism, and the Exercise of the Rights Attaching to Investments

The Trustee has given their investment managers discretion in this area. The managers of the segregated assets have been instructed to always exercise the rights and notify the Trustee if they do not vote with the management recommendation.

### 11. Compliance with this statement.

The managers prepare quarterly reports that are considered by the Trustee. These reports contain:

- reports of all transactions and a cash reconciliation;
- a review of recent performance and performance relative to the target, together with the manager's expectations for the future;
- explanation of any new investment categories that the investment manager wishes to invest in, together with his proposals and;
- any proposed change of the fund director or fund manager that might in the investment manager's opinion affect the suitability of the investment manager to manage the Scheme's assets.

The custodian will supply an annual statement that all dividends and interest payments due to the fund have been collected and all transactions settled in a timely manner. Exceptions will be highlighted.

### 12. Additional Voluntary Contribution ("AVC") Arrangements

Some members obtain further benefits by paying AVCs to the Scheme. The liabilities in respect of these AVCs are equal to the value of the investments bought by the contributions. The AVC providers are Prudential (the only one accepting future contributions) Nationwide and Equitable Life (both small residual holdings.) From time to time the Trustee reviews the choice of AVC investments available to members to ensure that they remain appropriate.

..... Nigel Tinsley Pensions Director	 ..... Signature	<u>24/5/10</u> ..... Date
..... Anthony Parsons Trustee Director	 ..... Signature	<u>31/5/10</u> ..... Date

## Alvis Pension Scheme

### Appendix I to Statement of Investment Principles

The preceding Statement relates to the Trustee's long-term principles of the Scheme. This Appendix sets out the Trustee's current investment strategy and should be read in conjunction with the Trustee's Statement of Investment Principles (the "attached Statement").

The Trustee's investment strategy has been established in order to maximise the likelihood of achieving the primary objectives set out in the attached Statement. The details are laid out below:-

#### Scheme Specific Benchmark

Asset Class	Proportion of assets
<b>Return Seeking Assets</b>	
UK Equities	22.5%
Overseas Equities	22.5%
Alternatives (Diversified Growth)	15.0%
<b>Liability Matching Portfolio</b>	
Fixed Income Corporate Bonds	40.0%

The Trustee decided on the investment strategy in August 2009 and is in the process of implementing.

The Trustee is yet to fund an alternatives manager and the assets are temporarily being held in cash and equity.

#### Summary of Investment Arrangements

The following describes the mandates given to the fund managers within each asset class.

#### Investment Mandates

Manager	Brief	Proportion of fund
JP Morgan Asset Management	To invest in a broadly diversified portfolio of UK equities	10-30%
Baillie Gifford	To invest in a broadly diversified portfolio of global equities	10-30%
Legal & General	To invest in and track stocks in UK and overseas equity markets.	Up to 15%
F&C Asset Management	To invest both directly and through	30-50%

	a managed fund in a broadly diversified portfolio of bonds	
Alternatives manager	To invest in a range of alternative investment strategies	10-20%

The Trustee sold assets in the F&C property fund in 2008. The Trustee is considering reinvesting the proceeds in an alternative investment managers to invest in a broader range of alternative investments.

#### Re- balancing arrangements.

The proportions of the fund within each brief will be reviewed at least every 3 years or more regularly if required. The Trustee receives reporting from their Investment Consultant on a quarterly basis which includes recommendations for any changes to be made.

#### Fee Structure for Advisers

The Trustee's investment advisers are paid for regular advice received on a fixed fee basis. For other significant areas of advice (e.g. one off special jobs, or large jobs, such as asset and liability modelling), the Trustee will endeavour to agree a project budget or will operate on the basis of the time spent by the advisor.

These arrangements recognise the bespoke nature of the advice given and that no investment decisions have been delegated to the adviser.

#### Alvis Pension Scheme.

#### Appendix II to Statement of Investment Principles

#### Compliance with Myners Principles

Myners Principle	Current Scheme Position
<b>1. Effective Decision Making</b>	
<i>'Decisions should be taken only by persons or organisations with the skills, information and resources necessary to take them effectively. Where trustees elect to take investment decisions, they must have sufficient expertise and appropriate training to be able to evaluate critically any advice they take.'</i>	The Trustee Directors ensure compliance with this principle by taking responsibility for setting the overall investment strategy and manager structure to ensure that this correctly reflects the circumstances of the Scheme. In doing so, the Trustee Directors draw on advice from their professional advisers and investment managers. Trustee Directors receive ongoing training from their investment advisers on issues as and when required.
<i>'Trustees should ensure they have sufficient in-house staff to support them in their investment responsibilities.'</i>	

<p><i>'Trustees should generally be paid, unless there are specific reasons to the contrary.'</i></p> <p><i>'It is good practice for trustee boards to have an investment sub-committee to provide the appropriate focus.'</i></p> <p><i>'Trustees should assess whether they have the right set of skills, both individually and collectively, and the right structures and processes to carry out their role effectively.'</i></p> <p><i>'Trustees should draw up a forward-looking business plan.'</i></p>	<p>The Trustee Directors employed by the company are not paid additionally for their duties but are given sufficient time to undertake their duties.</p> <p>Due to the small number of Trustee Directors a sub committee is not considered appropriate.</p> <p>The Trustee Directors receive ongoing training.</p> <p>A business plan has been drawn up.</p>
<p><b>2. Clear Objectives</b></p>	
<p><i>'Trustees should set out an overall investment objective for the fund that:</i></p> <p><i>Represents their best judgement of what is necessary to meet the fund's liabilities given their understanding of the contributions likely to be received from the employer</i></p> <p><i>Takes account of their attitude to risk, specifically their willingness to accept underperformance due to market conditions</i></p> <p><i>Objectives for the overall fund should not be expressed in terms which have no relationship to the fund's liabilities, such as performance relative to other pension funds, or to a market index.'</i></p>	<p>As part of their ongoing regular review the Trustee Directors set an overall investment objective that reflects both the Scheme's liabilities and its attitude to risk. This objective is set out in the Scheme's Statement of Investment Principles.</p>
<p><b>3. Focus on Asset Allocation</b></p>	
<p><i>'Strategic asset allocation decisions should receive a level of attention (and, where relevant, advisory or management fees) that fully reflect the contribution they can make towards achieving the fund's</i></p>	<p>The Trustee Directors formally considered the investment strategy in conjunction with the Asset Liability study.</p>

<p><i>investment objective.'</i></p> <p><i>'Decision-makers should consider a full range of investment opportunities, not excluding from consideration any major asset class, including private equity.'</i></p> <p><i>'Asset allocation should reflect the fund's own characteristics, not the average allocation of other funds.'</i></p>	<p>The Trustee Directors consider a full range of available asset classes. This includes consideration of so called "alternative" asset classes (for example property, private equity and hedge funds.)</p> <p>A Scheme-specific asset allocation benchmark is in place, which reflects the Scheme's characteristics.</p>
<p><b>4. Expert Advice</b></p>	
<p><i>'Contracts for actuarial services and investment advice should be opened to separate competition. The fund should be prepared to pay sufficient fees for each service to attract a broad range of all kinds of potential providers.'</i></p>	<p>They have been separately tendered</p>
<p><b>5. Explicit Mandates</b></p>	
<p><i>'Trustees should agree with their investment manager(s) an appropriate explicit written mandate between the trustees and the manager(s) on:</i></p> <p><i>an objective, benchmark(s) and risk parameters that taken together with all the other mandates are coherent with the fund's aggregate objective and risk tolerances.'</i></p>	<p>For segregated assets, Investment Management Agreements (IMAs) set out explicit objectives and benchmarks and timescales for measurement and evaluation.</p> <p>For pooled assets, these items are set out in the relevant fund's prospectus. The Trustee will judge the relevant performance according to their criteria, discussed with the managers, if the legal language of the prospectus does not agree exactly with those criteria. In such cases, advice will have been taken from the</p>

<p><i>'the manager's approach in attempting to achieve the objective; and'</i></p> <p><i>clear timescale(s) of measurement and evaluation, such that the mandate will not be terminated before the expiry of the evaluation timescale for underperformance alone.</i></p> <p><i>The mandate and trust deed and rules should not exclude the use of any set of financial instruments without clear justification in light of the specific circumstances of the fund.</i></p> <p><i>Trustees, or those whom they have delegated the task, should have a full understanding of the transaction-related costs they incur, including commissions.</i></p> <p><i>They should understand all the options open to them in respect of these costs, and should have an active strategy – whether through financial incentives or otherwise – for ensuring that these costs are properly controlled without jeopardising the fund's other objectives.</i></p> <p><i>Pension funds should not permit "soft" commissions to be paid without good reason.</i></p>	<p>Investment Consultants.</p> <p>For assets held in life assurance "notional funds" these matters are in the policy documents and side letters.</p> <p>Risk is controlled implicitly through the outperformance target and explicitly by way of internal constraining controls set by the managers. The Trustee Directors consider risk on both a strategic (asset allocation) basis and as part of the manager review process.</p> <p>The Investment Manager's process and sources of added value are reviewed as part of a rolling programme of manager interviews and regular reports provided by the Scheme's investment managers.</p> <p>Powers of Investment in the Trust Deed are broad.</p> <p>Trustee Directors control transaction related costs and prevent unnecessary commissions by measuring performance against benchmarks net of all costs. Managers judged on this basis do not pay unnecessary commissions, as these would result in underperformance, for which they could be terminated.</p> <p>Soft commissions are not used by any of the directly appointed investment managers.</p>
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<p><b>6. Activism</b></p>	
<p><i>'The mandate and trust deed should incorporate the principle of the US Department of Labor Interpretative Bulletin on activism.</i></p> <p><i>Trustees should ensure that managers have an explicit strategy, elucidating the circumstances in which they will intervene in a company; the approach they will use in doing so; and how they measure the effectiveness of this strategy.'</i></p>	<p>Voting is presently delegated to the Scheme's investment managers who have a clearly defined active engagement policy.</p>
<p><b>7. Appropriate Benchmarks</b></p>	
<p><i>'Trustees should:</i></p> <p><i>explicitly consider, in conjunction with their investment manager(s), whether the index benchmarks they have selected are appropriate; in particular, whether the construction of the index creates incentives to follow sub-optimal investment strategies;'</i></p> <p><i>in setting limits on divergence from an index, ensure that they reflect the approximations involved in index construction and selection;</i></p> <p><i>'consider explicitly for each asset class invested, whether active or passive management would be more appropriate; and where they believe active management has the potential to achieve higher returns, set both targets and risk controls that reflect this.'</i></p>	<p>Managers have been set specific benchmarks and objectives for each investment class and market related to the liabilities of the Scheme.</p> <p>Specific divergence limits are not set but are implied in the manager's performance targets and are monitored accordingly.</p> <p>A mixture of active and passive management has been adopted appropriate to each asset class.</p>
<p><b>8. Performance Measurement</b></p>	
<p><i>'Trustees should arrange for measurement of the performance of the fund and make formal assessment of their own procedures and decisions as Trustees.'</i></p>	<p>The Scheme's investment advisers provide independent manager monitoring.</p> <p>No decision-making is delegated to advisers.</p>

<p><i>'Trustees should also arrange for a formal assessment of performance and decision-making delegated to advisers and managers.'</i></p>	<p>The Trustee Directors receive professional advice and monitors their decisions by evaluating the success as to whether or not the objectives of the Scheme have been met.</p>
<p><b>9. Transparency</b></p>	
<p><i>'A strengthened Statement of Investment Principles (SIP) should set out: who is taking which decisions and why this structure has been selected; the fund's investment objective; the fund's planned asset allocation strategy, including projected investment returns on each asset class, and how the strategy has been arrived at; the mandates given to all advisers and managers; and the nature of fee structures in place for all advisers and managers, and why this set of structures has been selected.'</i></p>	<p>A strengthened Statement of Investment Principles has been put in place, which also reflects the requirements of the European Pensions Directive, the UK Pensions Act 2004 and the Investment regulations 2005.</p>
<p><b>10. Regular Reporting</b></p>	
<p><i>'Trustees should publish their SIP and the results of their monitoring of advisers and managers. They should send key information from these annually to members of the fund, including an explanation of why the fund has chosen to depart from any of these principles.'</i></p>	<p>These matters are published to members.</p>