

# **BAE SYSTEMS PENSION SCHEME STATEMENT OF INVESTMENT PRINCIPLES**

## **1. Introduction**

The Board of Directors (the Board) of BAE Systems Pension Funds Trustees Limited (the Trustee) has agreed to this Statement of Investment Principles (SIP), required under the Pensions Act 1995. The Board acts for and makes decisions on behalf of the Trustee Company. The SIP is for the BAE Systems Pension Scheme (the Scheme).

The Board must review this SIP at least every three years and will normally do so in conjunction with actuarial valuations. Further, this SIP will be reviewed without delay after any significant change in investment policy. This statement will only be amended 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 employers.

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 employers, represented by BAE Systems plc.

A copy of the SIP as amended from time to time will be sent to BAE SYSTEMS Plc and to each of the investment managers employed to manage the assets of the Scheme. The Board will seek confirmation of compliance with these principles through regular reports from the 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 Sub-committee which operates within its own Terms of Reference which are reviewed from time to time.

The bulk of the Scheme's assets are invested via the BAE SYSTEMS Common Investment Fund (CIF) and members of the Investment Sub Committee are also Directors of the CIF trustee. The CIF follows investment policies consistent with the Scheme's. The CIF board has appointed four external advisors with wide experience of investment to advise them on investment issues and in addition are supported by the investment staff of BAPFIM and external consultants where appropriate.

Fees are paid to external advisers, consultants and professional advisers. 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 Sub-Committee has adopted a business plan to ensure the orderly oversight of the investments of the Scheme and formally considers its effectiveness as a committee on an annual basis.

## **2. The Investment Objective**

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

## **3. Classes of Investment**

The Board has 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, they do not believe it appropriate to allow the investment managers to use new financial instruments without first seeking their agreement.

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

- 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 purposes only)
- Private equity and infrastructure
- Structured financial assets
- Swap transactions

The great majority of the Scheme's assets are liquid and easily realizable. The Board takes the view that the balance between liquid and illiquid investments is appropriate, and that illiquid assets defined as unquoted investments (excluding property) and structured products shall not exceed 15% of the Scheme's assets.

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

The Trustee has entered into a stock lending agreement which is currently suspended. It has also put in place a commission re-capture programme.

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 investments 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 assumptions. The long-term assumption for inflation is 2.5%pa.

**Table 1: Long Term Real Return Assumptions**

<b>Asset Class</b>	<b>Expected Real Return %</b>
UK Index linked	1.2%
Government bond	1.8%
UK Corporate bond	2.4%
UK Equity	5.5%
Overseas equity	5.5%
UK property	3.75%

#### **5. Strategic Asset Allocation**

In order to set the asset allocation of the Scheme, the Board commissioned an Asset Liability Study from Aon Consulting Ltd using as a starting point the Actuarial Valuation as at 5 April 2008. The model used to establish the asset allocation was proprietary to Aon Consulting Ltd and used stochastic modelling techniques to test the behaviour of different asset allocations on the funding of the Scheme 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 four independent investment advisers, proved the most appropriate mix of risks and return. The asset allocation was set following consultation with BAE Systems plc. In reaching its decisions, the Board also formally considered the financial position of the sponsoring employers and continues to review it periodically.

In considering the future asset allocation of the Scheme, the Trustee Board with its advisers examined strategies aimed at reducing volatility and locking in solvency margin improvements as they occur. The Trustee has agreed a strategy that involves two elements: an interest rate hedge and progressive reductions in risk assets as solvency margins improve. Both strategies are dependent on market levels and therefore the timing of the implementation is not fixed. They may be supplemented with the use of other risk reduction strategies such as equity hedging strategies on an opportunistic basis.

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 interest and swaps, which are designed to be a reasonably close match for the liabilities of the Scheme.

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 Interest and Matching Assets will change.

The Return Seeking and Fixed Interest Assets are managed relative to a strategic asset allocation established by the Trustees. This is shown below (Table 2). In May 2010, the Scheme invested in a higher performance equity fund managed by BAPFIM (the BIF Fund).

As a result of the decision to establish a de-risking strategy, certain assets will be held in a "Matching Portfolio" as acquired under the programme to reduce volatility and are not included in the performance benchmark. These will largely be index linked gilts, conventional gilts or swaps. The percentage of total assets in the Matching Portfolio will be shown in the Report and Accounts. From 1 January 2011, all index linked securities will be transferred to the Matching Portfolio.

**Table 2: Strategic Asset Allocation (ex Matching Assets)**

	<b>%</b>	<b>Range (%)</b>	<b>Benchmarks</b>
<b>Quoted Equities</b>	<b>57.5</b>	<b>+/-5</b>	
UK Equities	33.5	<b>+/-5</b>	FTSE All Share Index 5% Capped
Overseas Equities	23	<b>+/-5</b>	FTSE All World Index
BIF	1	<b>+/-1</b>	Equally Weighted UK/Europe/US Index
<b>Fixed Interest</b>	<b>24</b>	<b>+/-5</b>	Weighted Contribution of Asset Categories
Government	12	<b>5-14</b>	FTSE All Stocks
Corporate Bonds	12	<b>+/-3</b>	IBOXX Sterling Overall Index
<b>Property</b>	<b>10.5</b>	<b>+/-5</b>	IPD Index/5% Real Return over 5 years
<b>Cash</b>	<b>0</b>	<b>0-10</b>	
<b>Total ex-Unquoted</b>	<b>92.0</b>	<b>91-100</b>	Weighted Contribution of Asset Categories
<b>Unquoted Securities</b>	<b>8.5</b>	<b>0-15</b>	See Below: Section 6
Private Equity*	5.5	<b>0-9</b>	
Infrastructure	3	<b>0-6</b>	
<b>Total</b>	<b>100</b>		Weighted Contribution of Asset Categories

\* Private Equity target is 6% when fully committed.

<b>Overseas Equities</b>	<b>Benchmarks</b>
North America*	S&P Composite / TSE 60
Europe*	FTSE Developed All World Europe ex UK net of tax
Japan*	FTSE Developed All World Japan
Asia ex Japan*	FTSE All World Pacific ex Japan
Emerging Markets*	MSCI Emerging Market Free

Weighted according to FT All World Index \* +/-2% v Index Weighting

The strategic asset allocation is rebalanced quarterly.

- 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

## **6. Fund Management Arrangements and Performance Objectives**

The Board has appointed a number of investment managers to invest the assets of the Scheme. 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 believe that it is not in the best commercial interest of the scheme to publish details of these fees. BAPFIM charges its costs to the schemes which it manages on a pro rata basis. Its charge to the Scheme is substantially lower than equivalent commercial fund management groups.

The Board has considered the issue of transaction and related costs. They believe that these are best controlled by ensuring that their investment

managers have coherent processes to control costs and that these are reported to them on a regular basis in accordance with the IMA Disclosure Code. No investment managers are authorised to pay “soft” commissions. The Board may utilise commission recapture agreements.

The Board has established performance objectives over and above the benchmark returns. It believes that the investment management mandates and performance benchmarks are consistent with the investment objectives of the Scheme. 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. Future changes to the investment managers will not necessarily require a revised SIP but will be noted in the Scheme’s Report and Accounts.

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 Scheme is published annually in the Report and Accounts.

**Table 3: Performance Objectives and Investment Managers**

Asset class	3 Year rolling return % pa*	Investment manager	Type of mandate
Total fund (ex private equity and infrastructure)	+ 0.5%	BAPFIM	Active
UK/US/European Equities	+0.5%	BAPFIM	Active
BIF	+2.0%	BAPFIM	Active
UK Small Companies	+2.0%	Axa Framlington / Artemis	Active
Japanese Equities	+2.0%	Nomura Asset Management	Active
Asia (ex Japan) Equities	+2.0%	Prudential Portfolio Managers Asia	Active
UK Gilts	+0.75%	BAPFIM	Active
Corporate Bonds	+0.75%	BAPFIM	Active
Property	In excess of 5% real return	LaSalle Investment Management/ OLIM	Active
Currency Overlay	+3%	BGI	Active
Private Equity / Infrastructure	See below	BAPFIM / Funds	Active
On an annual basis, the target is to at least equal the benchmark in each asset category and for the scheme as a whole. * target relative to benchmark			

The Board has committed to invest 6% of the Scheme 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%pa over ten year rolling periods.
- To outperform a weighted Cambridge Associates private equity median portfolio benchmark over 7 – 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 managers are expected to exceed, is a 5% pa 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 Index.

The Board has agreed to invest in mandates with an absolute return objective. They have awarded an active currency mandate with an allocation of £250m.

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 Trustees assess 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 Scheme as a whole. They have not set their 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 this is best dealt with by the 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 not adopted formal policies on SRI. The Trustees have requested the investment managers to evaluate social, environmental and ethical issues in the same way as financial or other factors to the extent that they are relevant in assessing specific holdings and may have a financial impact on the Scheme's assets.

## **8. Responsible Ownership**

The Board and the CIF trustee have adopted the Hermes Responsible Ownership Principles as their comprehensive policy on corporate governance issues which applies to its investments. ([http://www.hermes.co.uk/eos\\_policy\\_documents.aspx](http://www.hermes.co.uk/eos_policy_documents.aspx)), They also subscribe to the Institutional Shareholders' Committee's Statement of Principles on the Responsibilities of Institutional Shareholder and Agents and welcome the development of these principles into the UK Stewardship Code. They have decided that the most effective way to implement their policies is to appoint an agent to act on their behalf over all their equity investments in the UK and overseas. The agent's role will be to vote in accordance with the Scheme's policy (or exceptionally, as may be directed by the relevant investment manager or the CIF trustee) and 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 and a summary of their voting activity.

## **9. Risk Measurement and Management**

The Trustee has identified the following principal sources of risk:

- The risk to the solvency of the Scheme from the failure of the sponsoring employers. The Trustee keeps the covenant of the employers under regular review.
- The risk that arises to the solvency of the Scheme from a mismatch of assets and liabilities. The Trustee approaches this by undertaking asset -liability modelling exercises on a regular basis (see section 2 above) and through their plans to progressively 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 described above.
- The risk arising from operations is controlled through a regular programme of internal and external audits. For external fund managers, the Scheme cannot have direct control but seeks to protect its assets through its investment management agreements and its use of reputable fund managers. The Trustee has 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 Investment**

The Scheme provides a facility for members to pay AVCs into the Scheme to enhance their benefits at retirement. Members of the Scheme's 100 Plus section have retirement accounts that also provide money-purchase benefits. Arrangements have been put in place to offer members a range of funds in which to invest their AVC and other money-purchase funds. The Board's objective is to provide a range of investment options that give access to real and monetary assets and allow suitable combinations of risk and expected return for members wishing to pursue different objectives that are typically appropriate for money-purchase benefits.

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