

# *Royal Ordnance Pension Scheme*

## Statement of Investment Principles

27 June 2024

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## *Section 1 – Introduction*

- 1.1 This Statement of Investment Principles (“SIP”) has been prepared by the Royal Ordnance (Crown Service) Pension Scheme Trustees Limited (the “Trustee”) of the Royal Ordnance Pension Scheme (the “Scheme”) in accordance with the Pensions Act 1995 (as amended) and the Occupational Pension Schemes (Investment) Regulations 2005.
- 1.2 The Scheme’s investment arrangements, based on the principles set out in this SIP, are detailed in the Investment Policy Implementation Document (“IPID”).
- 1.3 In preparing this SIP the Trustee has consulted BAE Systems plc (the “Principal Employer”) and obtained written investment advice from the Scheme’s Investment Adviser. Where matters described in this SIP may affect the Scheme’s funding policy, input has also been obtained from the Scheme Actuary. The Trustee will obtain similar advice whenever they review this SIP.
- 1.4 The Trustee will seek to maintain a good relationship with the Principal Employer and will discuss any proposed changes to this SIP with the Principal Employer.
- 1.5 The Trustee investment responsibilities are governed by the Scheme’s Trust Deed and Rules and this SIP takes full account of its provisions. A copy of the Trust Deed and Rules is available for inspection by members, upon request.
- 1.6 The Trustee strives to ensure that the investment policies and their implementation are in keeping with best practice, including the Myners principles first published in 2001 and revised in 2008.
- 1.7 The Trustee does not expect to revise this SIP frequently as it covers broad principles, however it will be reviewed at least every three years and without delay, if there are relevant, material changes to the Scheme and/or Principal Employer.
- 1.8 The IPID will be reviewed at least every year, and without delay, if there are relevant, material changes to the Scheme and/or Principal Employer.
- 1.9 Both the SIP and the IPID need to be reconfirmed on an annual basis with the Principal Employer.

## *Section 2 - Governance*

- 2.1 The Trustee has ultimate responsibility for decision making on investment matters. The Trustee has agreed that all strategic policy decisions on investments will be taken by the Trustee after in depth consideration by the Funding and Investment Committee (“FIC”) and following receipt of advice from the Investment Adviser.
- 2.2 The Investment Adviser is appointed by, and acts on behalf of, the Trustee. Their performance and continued ability to provide appropriate advice to the Trustee is reviewed annually.
- 2.3 The Trustee has delegated authority for the consideration of investment issues to a FIC which operates within Terms of Reference which are reviewed from time to time by the Trustee. The Trustee believes the FIC has appropriate experience and receives appropriate training in order to make informed decisions. The FIC formally considers its effectiveness as a committee on an annual basis.
- 2.4 Day to day investment decisions have been delegated to a number of Investment Managers in accordance with guidelines agreed with the Trustee. The Investment Managers are authorised and regulated by the Financial Conduct Authority, and are responsible for the management of the underlying investments. The Trustee has entered into signed Investment Management Agreements with the Investment Managers, the terms of which are consistent with the principles in the SIP.
- 2.5 Each of the Investment Managers’ fees are related to the amount of assets managed within their portfolio (an ad valorem fee) and in certain cases, the amount of performance generated relative to a benchmark. Minimum fees may also apply in some cases.
- 2.6 The Custodian is responsible for the safekeeping of the Scheme’s assets. For the Scheme’s segregated assets, the Trustee has appointed Northern Trust to act as custodian. Where the Scheme invests in collective vehicles, the appointment of the custodian is the responsibility of the Investment Manager.
- 2.7 An actuarial valuation of the Scheme is performed at least every three years, in accordance with regulatory requirements. The main purpose of the actuarial valuation is to assess the extent to which the assets cover the accrued liabilities and agree an appropriate funding strategy for the Scheme. Full details of the current funding strategy and contributions payable can be found in the Statement of Funding Principles and Schedule of Contributions respectively.

## ***Section 3 - Objectives***

- 3.1 The main objective of the Scheme is to hold sufficient and appropriate assets to meet the Scheme's liabilities and statutory obligations as and when they fall due.
- 3.2 The Scheme provides predominantly defined benefits, but it also provides certain money purchase benefits related to members; additional voluntary contributions ("AVCs"). The defined benefits section is closed to new entrants and only existing active members are accruing further benefits.
- 3.3 Over time the Scheme's membership and liabilities are projected to mature with the average period to payment of the liabilities decreasing and the requirement for investment income to pay ongoing pensions becoming an increasing priority.
- 3.4 The Trustee has therefore adopted a maturity driven approach to investments aimed at maximising the probability that pension payments will be met in full and on time. This approach aims to achieve a return on the assets which, taken in conjunction with contributions, is sufficient over time to meet the Scheme's liabilities.
- 3.5 The Trustee uses Asset Liability Modelling ("ALM") to assist in setting investment policy. ALM is undertaken at each valuation. Further details around the investment policy can be found in the IPID.

## *Section 4 - Strategy*

- 4.1 The Trustee is required to set the overall investment strategy and has chosen to adopt a maturity driven approach to managing the Scheme's investments.
- 4.2 Under this approach the assets in the Scheme can be divided into three broad categories – Matching, Matching Plus, and Growth.
  - 4.2.1 **Growth assets:** The primary objective of assets in this category is to achieve higher total returns to improve the overall performance of the Scheme's assets and help to reduce any deficit, should one exist. These assets will be exposed to equity risk, credit risk (through sub-investment grade issues) and more esoteric risks through alternative type assets.
  - 4.2.2 **Matching Plus assets:** These assets are expected to provide long term cashflows as well as manage the economic growth risk associated with some of the liabilities. They are likely to be held to maturity and may have lower credit ratings or no formal ratings, but are investment grade equivalent. They are expected to generate higher returns than Matching assets (see 4.2.3) and are likely to command an illiquidity premium.
  - 4.2.3 **Matching assets:** The main characteristic for this category is secure return and cashflow. These assets are investment grade and, on average, have higher credit quality than Matching Plus with minimal default probability. The assets within the Matching portfolio are, on the whole, expected to be liquid.
- 4.3 Further details of these categories including allocation limits, permissible assets and other key metrics are set out in the IPID.
- 4.4 The day-to-day management of the Scheme's assets is delegated to one or more Investment Managers as set out in the IPID.
- 4.5 The Trustee reviews the appropriateness of the Scheme's investment strategy on an ongoing basis. This review includes consideration of the continued competence of the Investment Managers with respect to performance within any guidelines set. The Trustee must also consult the Principal Employer before amending the investment strategy.

## ***Section 5 – Manager Engagement Policy***

- 5.1 The Trustee, following receipt of advice from the Investment Adviser, has appointed each of its Investment Managers to deliver a specific benchmark or performance target, which overall will align to deliver the broader Scheme investment strategy. The Trustee and their Investment Adviser ensure that all manager engagements have clearly defined benchmarks, objectives and management parameters.
- 5.2 Where appropriate, and where commercial considerations permit, the terms of the mandate and the basis on which the manager is engaged will be defined specifically for the Scheme. Where such tailoring is not directly achievable, the Trustee will invest in pooled funds where the objectives of the fund and the policies of the Investment Manager will be evaluated by the Trustee to ensure that they are appropriate for the needs of the Scheme. The Trustee will take advice in determining the appropriateness of each manager and mandate for the Scheme. By investing in this manner, the Trustee is confident that the managers appointed will make decisions which are commensurate with the period over which the Trustee expects to be invested in each mandate.
- 5.3 Remuneration for each mandate is determined at the inception of each mandate based on commercial considerations and typically set on an ad valorem basis. Where appropriate to the nature of the mandate, the term of the mandate and the role the mandate plays within the investment strategy, the Trustee may agree to a fee structure where the manager is incentivised to deliver outperformance relative to an agreed benchmark, typically in conjunction with a lower ad valorem fee. The Trustee periodically reviews the fees paid to all of its managers against industry standards.
- 5.4 The Trustee reviews the nature of the Scheme's investments on a regular basis, with particular reference to suitability and diversification. The Trustee seeks and considers written advice from a suitably qualified person when determining the appropriateness of each manager and mandate for the Scheme, particularly in relation to diversification, risk, expected return and liquidity. If, at any time, investment in a type of security or product not previously known to the Trustee is proposed, appropriate advice is sought and considered to ensure its suitability.
- 5.5 The Trustee recognises the long-term nature of its liability profile and appoints its managers to invest in such a way that generates long term sustainable returns. The Trustee will carry out necessary due diligence on the underlying investment decision making process, to ensure the manager makes investment decisions over an appropriate time horizon aligned with the Scheme objective.
- 5.6 The duration of each mandate is determined by the Trustee at the inception of each mandate. For open-ended investments, the Trustee generally engages managers on an ongoing basis with no pre-determined term of appointment. For such mandates, the Trustee expects the minimum duration of the appointment will be three years, this being the period over which performance of the mandate can be appropriately evaluated although all mandates are subject to ongoing review against various financial and non-financial metrics in addition to their continued appropriateness within the investment strategy. For close-ended investments, the Trustee expects the term of the appointment to be the lifetime of the investment.
- 5.7 The Trustee reviews the performance of each of its managers and mandates on a regular basis against a series of metrics, including financial performance against the benchmark and objectives of the mandate. Material deviation from performance or risk targets is likely to result in the mandate being formally reviewed. The Trustee draws input from their Investment Adviser to support any such review of and engagement with its Investment Managers. Where necessary, the Trustee will highlight any areas of concern identified during such reviews to the manager as part of its engagement process.
- 5.8 The Trustee has expectations of the level of turnover within each mandate which is determined at the inception of the mandate, based on the Trustee's knowledge of the manager, investment process and the

nature of the portfolio. Whilst the Trustee expects performance to be delivered net of costs, including the costs of trading within the portfolio, the Trustee expects managers to report on at least an annual basis on the underlying assets held within the portfolio and details of any transactions over the period. The Trustee will challenge its managers if there is a sudden change in portfolio turnover or if the level of turnover seems excessive. The Trustee will request turnover costs incurred by the asset manager over the Scheme reporting year.

## Section 6 - Risk

- 6.1 The Trustee regards risk as any factor that may render the Scheme unable to meet its obligations to pay benefits as they fall due and satisfy its funding objectives.
- 6.2 The Trustee has identified examples of risks that have the potential to cause the funding level to deteriorate. These are summarised at a high level in the below table, with more granular detail and controls recorded in the Scheme's risk register.

| Risk  | Further details  |
|---|--|
| Investment Risk                                 | <p>The risk that the Scheme assets fail to deliver the returns expected.</p> <p>The Trustee monitor a number of more granular investment risks through ongoing reporting and the risk register, including:</p> <ul style="list-style-type: none"> <li>i) investment manager risk (e.g. performance relative to benchmarks, acting outside of remit)</li> <li>ii) investment implementation and operational risks (e.g. hedging not implemented efficiently, act in good faith on incorrect data)</li> <li>iii) risks specific to the LDI portfolio and the use of leverage (e.g. collateral adequacy, counterparty and roll risk)</li> </ul> |
| Demographic risk                                | <p>The risk that longevity improves and other demographic factors change increasing the costs of the Scheme benefits.</p>  |
| Liquidity risk                                  | <p>The risk of the Scheme not having sufficient liquid assets to allow it to meet its benefit payments as they fall due and/or top up its LDI portfolio to ensure sufficient levels of collateral. This risk is addressed through having a cashflow management policy and a collateral waterfall structure.</p>  |
| Sponsor risk                                    | <p>The risk of the Principal Employer being unwilling or unable to make the necessary level of contributions in future. The Scheme uses a specialist covenant adviser to carry out regular reviews of the Principal Employer.</p> <p>The Principal Employer reports on its financial results to the Trustee twice a year. The Trustee monitors key metrics in relation to the strength of the covenant of the Principal Employer every quarter and takes appropriate action in response to any adverse developments.</p>   |
| Environmental, Social and Governance (ESG) risk | <p>The risk that ESG factors can have a significant effect on the long-term performance of the assets held. This risk is primarily addressed by ensuring that Environmental (including exposure to climate change risks), Social and Governance factors are incorporated into the investment analysis and decision making process.</p> <p>The Trustee's approach to the consideration of ESG risks and climate risk is set out in Section 7.</p>   |

- 6.3 Since 31 December 2016 the Trustee has provided narrative disclosures in the Scheme's Annual Report and Accounts on its view of the credit and market (currency, interest rate and other price related) risks arising from the investment arrangements of the Scheme.
- 6.4 The Trustee does not expect managers to take excess short term risk and will regularly monitor the manager's performance against the benchmarks and objectives set on a short, medium and long terms basis.

## ***Section 7 – Environmental, Social and Governance Considerations***

- 7.1 The Trustee’s objective is to ensure the Scheme holds sufficient and appropriate assets to meet its obligation to pay benefits as they fall due and meet its statutory funding obligations. Within the context of this objective the Trustee considers the extent to which Environmental (including climate change), Social and Governance factors should be taken into account in the selection, retention and realisation of investments.
- 7.2 The Trustee has integrated climate-related risks and opportunities within the Scheme’s risk management process. These include ensuring compliance with the Occupational Pension Schemes (Climate Change Governance and Reporting) Regulations 2021 based upon disclosures in line with the current recommendations of the Task Force on Climate-related Financial Disclosures (“TCFD”).

### **Consideration of financially material factors in investment arrangements**

- 7.3 The Trustee recognises that the consideration of financially material factors, including ESG factors, needs to be assessed in the context of the long-term nature of the Scheme’s investments and is relevant at different stages of the investment process. Furthermore, the Trustee expects that their responsible investment adviser and Investment Managers take account of all the relevant financially material factors, including the potential impact of ESG factors, in the implementation of the investment mandate and in the selection, retention and realisation of investments.

#### *Strategic Considerations*

- 7.4 The strategic benchmark has been determined using appropriate long-term economic and financial assumptions from which expected risk/return profiles for different asset classes have been derived.

Given the inherent uncertainty, the Trustee has not made explicit allowance for the risks of climate change in setting their strategic benchmark.

#### *Selecting Investment Managers and selection of direct investments with regard to ESG factors*

- 7.5 The Trustee has delegated responsibility for the management of the Scheme assets to several Investment Managers. In selecting new Investment Managers for the Scheme, the Trustee and their Investment Adviser consider potential managers’ approaches to responsible investment and the extent to which managers integrate ESG issues in the investment process as a factor in their decision making.

### **Consideration of non-financial factors in investment arrangements**

- 7.6 The Trustee has not imposed any restrictions or exclusions to the investment arrangements based on non-financial factors. Furthermore, the Trustee does not otherwise take into account non-financial factors in the selection, retention and realisation of investments.

### **Monitoring climate-related risks and opportunities**

- 7.7 The Trustee believes that it is their responsibility to know more about climate risks.
- 7.8 As noted above, the Trustee believes that climate change risk is likely to be a financial risk affecting the Scheme’s investments to some degree, and that the Scheme should therefore integrate climate risk metrics into its wider risk management framework as well as its decision-making process, with investment opportunities likely to be created by climate change related factors that may be considered where possible.

Outside of investment risks, the Trustee believes there are other considerations associated with climate integration that they should be aware of and manage.

- 7.9 The Trustee aspires to invest in a way that is aligned with the goals of the Paris Agreement (limiting global temperature rises to well below 2°C above pre-industrial levels by 2050) to the extent that is feasible, possible and in the financial interests of the Scheme to do so. The Trustee will also look to consider climate-related risks beyond the minimum regulatory requirements where this is consistent with its fiduciary duty and financial objectives.
- 7.10 The Trustee has a long-term investment time horizon of over 10 years, over which climate risks and opportunities should be considered.

### **Stewardship, Voting and Engagement**

- 7.11 The Trustee recognises that stewardship encompasses the exercise of voting rights, engagement by and with Investment Managers and the monitoring of compliance with agreed policies. It also recognises that good corporate governance creates the framework within which a Company should be managed. The Trustee delegates direct voting and engagement activities to its Investment Managers to exercise in line with their policies in these areas. The Trustee takes into account these policies in selecting managers and also in monitoring them over time.
- 7.12 The Trustee separately considers any conflicts of interest arising in the management of the Scheme and its investments and has ensured that each manager has an appropriate conflicts of interest policy in place. Managers are expected to disclose any potential or actual conflict of interest to the Trustee.
- 7.13 The exercise of voting rights is therefore delegated to the Scheme's Investment Managers with the objective of preserving and enhancing long term shareholder value (including having regard to ESG factors). Their role is to vote in accordance with their stated policies, endorsed by the Trustee, and to engage with companies to ensure that companies follow the adopted policies. Under DWP Guidance, it is the Trustee's responsibility to define the significance of votes placed on its behalf and to be transparent with stakeholders and beneficiaries regarding outcomes. Significant votes have been defined as votes which meet one or more of the following criteria:
- Votes relating to one of the Trustee's key stewardship themes; and
  - Votes relating to an issuer to which the Scheme has a large £ exposure;
- 7.14 The Trustee believes that Stewardship through voting, monitoring and engagement is an effective method for instigating change and believe that engagement with companies is a more effective tool for instigating change compared to divestment. The Trustee will encourage their investment managers to work collaboratively with other asset owners, investment managers and relevant industry stakeholders where this is consistent with the Trustee's fiduciary duty and financial objective, on the basis that working together is likely to lead to more effective engagement.
- 7.15 The Trustee will aim to ensure that their asset managers engage with underlying companies to improve their management of climate risks where appropriate. The Trustee understands that in order to aid these efforts and to best channel its stewardship activities, it should focus on a key stewardship theme. The Trustee has therefore chosen to identify "Climate Change" as its key stewardship theme. This will be communicated to the Scheme's Investment Managers in due course.
- 7.16 Where initial engagement has made little progress, the Trustee expects its Investment Managers to escalate engagement accordingly. Escalation can include voting against management, proposing shareholder resolutions and ultimately divestment. Should there still be little progress made after escalation, the Trustee expects its Investment Managers to consider disinvestment as a final course of action. To be truly effective as an escalation tool, divestment must be accompanied by communication with the company of the reasons for the investment decision and, on occasions, of what might lead to that

decision being reversed. The Trustee requests engagement case studies from Investment Managers to support its monitoring and oversight.

### **Monitoring**

- 7.17 The Trustee's Investment Adviser considers ESG (including climate change risks) when monitoring investments and carrying out its regular reviews and meetings with external managers.
- 7.18 The Trustee meet with the Investment Managers on a periodic basis. In conjunction with the Investment Managers, the Trustee agree an agenda for discussion, which, where appropriate, may include ESG issues. Where considered appropriate, the Investment Managers are challenged directly by the Trustee and their advisers on the impact of any significant issues that may affect the prospects for return from the portfolio.
- 7.19 Whilst the Trustee has overall responsibility for all investment decisions of the Scheme, certain responsibilities regarding climate policy and strategy are delegated to the Scheme's Funding and Investment Committee ("FIC"). This includes overseeing the implementation of the 'Environmental, Social and Governance Considerations' policy (referenced as Section 7 in this document), including the assessment of climate-related risks and opportunities. FIC meetings take place quarterly, after which the FIC reports any meaningful items to the Trustee for consideration or sign-off

### **Climate Scenario Analysis and Climate Metrics**

- 7.20 To aid the Trustee's assessment of the resilience of the Scheme against climate-related risks, climate scenario analysis will be performed in relation to the Scheme's assets, liabilities, and covenant by the Trustee's advisors. This analysis will be performed triennially; interim updates may be performed, for example if there are material changes to the Scheme's strategy or if there are significant changes to the methodology and industry practice relating to the analysis. To this end, the Trustee will consider annually whether a refresh of the analysis is required. The Trustee also receives annual reporting on the Scheme's climate risk metrics from its investment advisor.
- 7.21 The FIC, on behalf of the Trustee, are also working to agree and begin monitoring relevant climate metrics as set out under DWP's adoption of the recommendations of the TCFD (the results of which will be disclosed in the Scheme's annual TCFD report). As part of this ongoing monitoring the FIC will consider what targets are appropriate in relation to these metrics. The Trustee will consider the impact on these metrics when making investment decisions. The metrics will be calculated in each Scheme year, and the performance against the selected target will be measured and reviewed in each Scheme year.

## ***Section 8 – Additional Voluntary Contributions***

- 8.1 The Scheme also provides a facility for members to pay Additional Voluntary Contributions (AVCs) to enhance their pensions at retirement. The majority of AVC payers were transferred to a Master Trust arrangement in 2023. The remaining AVC payers in the Scheme are invested in with profits funds which will run off until the members retire.
- 8.2 The with profits funds will be reviewed annually by means of a Stewardship report provided by the insurer.