

BAE Systems Executive Pension Scheme

Statement of Investment Principles

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Section 1 - Introduction

- 1.1 This Statement of Investment Principles ("SIP") has been prepared by BAE Systems Executive Pension Scheme Trustees Limited (the "Trustee") as the trustee of the BAE Systems Executive Pension Scheme ("Scheme") in accordance with the Pensions Act 1995 (as amended) and the Occupational Pension Schemes (Investment) Regulations 2005 (as amended) (the "Investment Regulations").
- 1.2 This Statement of Investment Principles sets out the Trustee's policies for investment of assets held for the purpose of providing defined benefits, as required by section 35 of the Pensions Act 1995.
- 1.3 In preparing this SIP the Trustee has consulted BAE Systems plc (the "Principal Employer") and obtained written investment advice. 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 it reviews this SIP. The Trustee has also obtained legal advice for this review.
- 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. The SIP will be reviewed in consultation with the Principal Employer.
- 1.5 In addition to the statutory requirements imposed by the Pensions Act 1995 and the Occupational Pension Scheme (Investment) Regulations 2005, the Trustee's investment responsibilities are set out in the Scheme's Rules dated 12 December 2012 (the "Rules"). This SIP takes full account of the provisions of the Rules. A copy of the 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 the law (including the Pensions Act 1995 and the Occupational Pension Scheme (Investment) Regulations 2005) and best practice.
- 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 after any significant change in investment principles or policies.

Section 2 – Governance

- 2.1 The Trustee will invest the Scheme's assets in the best interests of members and beneficiaries.
- 2.2 The Trustee has responsibility for strategic decision making on investment matters. The Trustee has agreed that all strategic policy decisions on investments will be taken by the Trustee Board following receipt of appropriate advice.
- 2.3 The Trustee has appointed Goldman Sachs Asset Management International ("GSAM") to be its Outsourced Chief Investment Officer ("OCIO").
- 2.4 Day-to-day investment decisions have been delegated to GSAM and a number of external investment managers in accordance with guidelines agreed with the Trustee. The investment managers are authorised and regulated by the Financial Conduct Authority, or an equivalent regulatory authority, and are responsible for the management of the underlying investments. The arrangements require GSAM (and any external investment manager to whom investment discretion is delegated) to have regard to the requirements contained in Regulation 4 of the Occupational Pension Schemes (Investment) Regulations 2005, the requirements of the SIP (where applicable) and section 36 of the Pensions Act 1995 when selecting investments.
- 2.5 Each of the investment managers' fees, are related to the amount of assets managed within their portfolio 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, an institution acting as guardian of the Scheme's assets, is responsible for the safekeeping of these assets – with the exception of holdings in collective vehicles, for which appointment of the Custodian is the responsibility of the Investment Manager, and illiquid assets (such as limited partnerships), private placements, certain loans derivative contracts etc.
- 2.7 An actuarial valuation of the Scheme is performed at least every three years, in accordance with statutory 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 objective of the Scheme is to hold sufficient and appropriate assets to meet the Scheme's liabilities as and when they fall due.
- 3.2 The Scheme provides predominantly defined benefits, but it also provides money purchase benefits. The Scheme is closed to new entrants and, from 1 July 2022, also closed to accrual of all further benefits.
- 3.3 Over time the Scheme's membership and liabilities will 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 one of the aims of which is to maximise 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 and its advisors uses Asset Liability Modelling ("ALM") and considers expected returns to assist in setting investment policy.

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 manage the Scheme’s investments.
- 4.2 Under this approach the assets in the Scheme have been 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 high total returns to improve the overall performance of the Scheme’s assets. These assets will be exposed to equity risk, credit risk and risks associated with investing in alternative assets. It is not expected that new allocations will be made to the Growth portfolio.

Growth Asset Allocation Ranges	Lower Limit	Upper Limit
Listed Equity	0%	5%
Private Equity	0%	100%
Alternatives	0%	5%
Property	0%	20%
Leverage *	0%	5%

*Note the above allocations are notional exposure limits and leverage reflects the balancing item such that the total allocation is 100% of total assets.

- 4.2.2 **Matching Plus assets:** These assets are expected to provide long-term stable cash flows in order to meet benefit payments as they fall due. They are likely to be held to maturity and may have a range of credit ratings or no formal ratings, but are on average, across the portfolio, at least BB+ rated. They are expected to generate higher returns than Matching assets.

Matching Plus Asset Allocation Ranges	Lower Limit	Upper Limit
Private Placements	0%	25%
Private Debt	0%	25%
Property	0%	30%
Infrastructure	0%	50%
Other	0%	20%

- 4.2.3 **Matching assets:** The main characteristic for this category is secure return in order to meet benefit payments as they fall due. These assets, on average, will be of investment grade or above and will, on average, have higher credit quality than Matching Plus with minimal default probability. These assets are expected to have a reasonable amount of liquidity, taking account of the specific needs of the Scheme.

Matching Asset Allocation Ranges	Lower Limit	Upper Limit
Investment Grade Credit	35%	65%
Gilts and Cash	35%	65%

4.3 Allocation of assets

The Trustee agreed a journey plan to reduce investment in Growth assets and increase investment in Matching and Matching Plus as the Scheme matures. The Scheme reached its target allocation of 65% Matching, 25% Matching Plus and 10% in Growth in July 2019. The Scheme is now targeting holding 80% in Matching and 20% in Matching Plus by 2032.

4.4 Realisation of assets

The Trustee's policy is that, where practicable, there will be sufficient investments in liquid or readily realisable assets to meet cash flow requirements in foreseeable circumstances so that the realisation of assets will not disrupt the Scheme's overall investments. The Trustee, together with GSAM and the Scheme administrators, have a cash flow management policy in place and will also hold a balance of cash to help meet unanticipated benefit and other payment obligations.

4.5 Investment objectives

The Trustee, in conjunction with BAE Systems plc ("the Company") have discussed and agreed an implementation framework for the investment strategy agreed as part of the 2020 actuarial valuations. The Current Growth Assets will fall over time through the natural run off of the private equity and alternatives portfolios, with no further allocations expected.

Overall investment objective: To invest the assets so that taking capital, income, and contributions together the Scheme's assets are sufficient to meet its liabilities and statutory funding obligations.

Investment parameters	Growth assets	Matching Plus assets	Matching assets
Expected returns (p.a.)	Weighted average of underlying benchmarks	(50% FTSE Actuaries UK Conventional Gilts All Stocks Index / 50% FTSE Actuaries UK Index-Linked Gilts All Stocks Index) + 2%	Liability hedging benchmark + 0.5%
Target allocation	10%	25%	65%
Target allocation limits	+5% / -10%	+ 10% / -10%	+5% / -10%
Currency Hedge Target	Unhedged	100%	100%
Average Credit Quality	N/A	Minimum BB+	A

4.6 The Trustee has delegated day to day management of the Scheme's assets to the OCIO, GSAM, and to external professional investment managers who are authorised and regulated by the Financial Conduct Authority or an equivalent Regulator.

4.7 The Trustee reviews the appropriateness of the Scheme's investment strategy on an ongoing basis. This review includes consideration of the performance of all strategies across listed and unquoted assets against any guidelines or benchmarks set. The Trustee must also consult the Principal Employer before amending the investment strategy.

Section 5 - Risk

- 5.1 The Trustee regards risk as any factor that may render the Scheme unable to meet its obligation to pay benefits as they fall due and/or its ongoing statutory funding obligations.
- 5.2 The Trustee has identified examples of its key risks which are set out in the below table along with a description of the control and/or mitigation in place. The Trustee also maintains a detailed risk register.

Risk	Control and Mitigation
Investment Risk	<p>The risk that the Scheme assets fail to deliver the returns expected. This risk is primarily addressed by:</p> <ul style="list-style-type: none"> - Adopting an investment strategy where the strategic asset allocation evolves in line with the Scheme's liabilities such that the cash flows from the assets provide a greater match for the expected benefit payments as the Scheme matures. - Setting risk tolerances around the strategic asset allocation to provide sufficient flexibility to the investment manager/(s). - Ensuring the investment managers have in place appropriate policies setting out how they manage asset risks including concentration risk, default risk, liquidity risk, currency risk, counterparty risk, active management risk. - Utilising investment tools and strategies which aim to deliver returns in a risk-controlled manner, this includes the use of liability hedging techniques. - Ensuring GSAM has in place a policy for assessing the credit rating of assets which do not have a credit rating readily available in the market and a policy for allocating assets between the three asset categories. - Regularly monitoring investment performance using a range of risk and return metrics and taking appropriate action. - Regularly monitoring ongoing appropriateness of investment managers and taking appropriate action. - Derivatives can only be used for efficient portfolio management or risk management and not for speculative purposes.
Demographic risk	<p>The risk that longevity improves and other demographic factors change increasing the costs of the Scheme benefits. This risk is primarily addressed by:</p> <ul style="list-style-type: none"> - Keeping informed about tools aimed specifically at managing these risks. - Keeping mortality and other demographic assumptions under review and considering and revising them as appropriate explicitly at each formal valuation
Liquidity risk	<p>The risk of the Scheme not having sufficient liquid assets to allow it to meet benefit payments as they fall due.</p> <p>This risk is addressed through:</p> <ul style="list-style-type: none"> - Restrictions on additional allocations to Unlisted Assets to serve to improve liquidity over time. - The Trustee also monitor the level of transfer value and other benefit activity and considers this as it impacts the levels of cash required.

Collateral risk	<p>The risk of not having sufficient collateral to maintain the target level of hedging.</p> <p>This risk is addressed through</p> <ul style="list-style-type: none"> - Maintaining a minimum level of collateral in the LDI portfolio, which is monitored daily by GSAM. - Having in place a liquidity waterfall of liquid assets that could be used to raise additional collateral if needed.
Operational risk	<p>The risk of mismanagement of Scheme assets either with intent or due to a lack of knowledge. This risk is primarily addressed by:</p> <ul style="list-style-type: none"> - Using global custodians for the physical custody of assets who are not also the managers of assets. - Taking professional advice and considering the appointment of specialist transition managers to help manage the transition risk. - Regular scrutiny of providers and audit of the operations they conduct for the Scheme. - Internal controls are in place to mitigate against failures due to operational risks. The Trustee is insured against losses resulting from third party errors to the extent that the Trustee is unable to obtain full redress from the third party.
Sponsor risk	<p>The risk of the Principal Employer being unable to make the necessary level of contributions in future. The Trustee uses a specialist covenant adviser to carry out regular reviews of the Principal Employer. The Principal Employer reports on its financial results to the Trustee Board 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> <p>This risk is primarily addressed by:</p> <ul style="list-style-type: none"> - Regular advice provided by the covenant advisor - Consideration of covenant alongside wider funding and investment strategy - A restriction on employer related investments. <p>Investment in employer related investments of BAE Systems plc is limited to a maximum of 5% of the market value of assets at any given time as required by section 40 of the PA95 and the Investment Regulations. In addition, the Scheme Rules prevent the Trustee from buying shares in BAE Systems plc except for the purpose of implementing an index-tracking policy in relation to all or part of the fund.</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:</p> <ul style="list-style-type: none"> - Ensuring that Environmental (including exposure to climate change risks), Social and Governance factors are incorporated into the investment analysis and decision-making process. - The Trustee's approach to the consideration of ESG risks and climate risk is set out in Section 6.
Interest Rate and Inflation risk	<p>The risk that the Scheme's funding level is volatile due to the Scheme's liabilities being sensitive to movements in inflation and interest rates. The liabilities are sensitive to movements in inflation because the benefits payable to members increase in line with inflation (up to a capped level). The liabilities are sensitive to movements in interest rates because as the Scheme matures the aim is to increase investment in assets which are closely linked to interest rates. These risks are primarily addressed by:</p> <ul style="list-style-type: none"> - The Trustee aims to be 100% hedged on a gilts +0% discount basis (with a +/-5% tolerance) against interest rate movements and inflation

	<p>movements as measured using the liability hedging benchmark assumptions agreed as part of the statutory triennial actuarial valuation.</p> <ul style="list-style-type: none">- Being 100% hedged means that the Scheme's assets move broadly in line with the Scheme's liabilities in relation to the relevant risk. This information is monitored by GSAM on behalf of the Trustee and reported at least quarterly.
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Section 6 – Socially Responsible Investment and Corporate Governance

- 6.1 Within the context of its overall objective, the Trustee considers the extent to which Environmental (including climate change), Social and Governance (ESG) factors should be taken into account in the selection, retention and realisation of investments.
- 6.2 The Trustee has a long-term investment time horizon of over 10 years, over which climate risks and opportunities should be considered.

Consideration of financially material factors in investment arrangements

- 6.3 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, GSAM and external Investment Managers are expected to 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

- 6.4 The Scheme's 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 in how climate-change will materialise, the Trustee has not made explicit allowance for these risks in setting the Scheme's strategic benchmark. However, they are considered alongside the Scheme's wider risk management framework.

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

- 6.5 The Trustee has delegated responsibility for the management of the Scheme assets to GSAM. In selecting new investment managers for the Scheme, GSAM, on the Trustee's behalf, considers 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.
- 6.6 For Private Markets and unquoted assets, as part of the selection process, GSAM, on behalf of the Trustee, ask the fund manager relationships to confirm adherence to the UK Bribery Act. Background checks on key principals are carried out utilising a specialist third party provider.

Consideration of non-financial factors in investment arrangements

- 6.7 The Trustee has not imposed any restrictions or exclusions in the investment arrangements based on non-financial factors including member views. This includes non-financially material ESG factors and member views. 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

- 6.8 The Trustee believes the climate change risk is a financial risk to the Scheme which could affect the investments in the portfolio to some degree. Whilst the Trustee will not fundamentally alter their investment strategy as a result, due to the nature of the Scheme and the current strategic asset allocation, they will include and consider climate risk metrics alongside the wider risk-management framework, and decision-making process, of the Scheme. This includes investing time and resources to measure the carbon footprint of the portfolio.

Over time, investment opportunities are likely to be created by climate change related factors and these

should be taken advantage of where possible, and when aligned with the Trustee’s duties to the Scheme. Outside of investment risks, the Trustee believes there are other considerations associated with climate integration that they should be aware of and manage. Investment decisions should also be guided by wider ESG considerations beyond climate change risks, to the extent that they are financially material.

6.9 The Trustee believes that alignment of Scheme’s and Sponsor’s climate change objectives is important. The Trustee will therefore seek to align with the Sponsor’s climate change objectives wherever it is deemed appropriate.

6.10 The Trustee believes that the short-, medium-, and long-term time horizons over which climate risks and opportunities should be considered are as follows:

Short Term	Five years from now
Medium Term	Fifteen years from now
Long Term	Twenty-five years from now

Stewardship, Voting and Engagement

6.11 The Trustee recognises that stewardship encompasses the exercise of voting rights, consideration of an investee company’s capital structure, engagement by and with investment managers and consideration of how they manage actual and potential conflicts of interest in relation to their engagement, and the monitoring of compliance with agreed policies. It has examined the issues in relation to corporate governance and on the exercise of voting rights. It recognises that good corporate governance creates the framework within which a company should be managed. The ultimate purpose of the Trustee’s duty of stewardship is to maximise the benefits accruing to the Scheme’s members and the Trustee understands that by actively engaging with financially material factors, which include ESG issues, contributes to identifying both investment opportunities and risks.

6.12 The Trustee understands that in order to best channel its stewardship efforts it should focus on a selection of key themes. The Trustee has therefore chosen to identify one key stewardship theme from each category within ESG. These are:

- **Environmental:** Climate change
- **Social:** Societal risks
- **Governance:** Business ethics

6.13 The Trustee has also designed engagement and escalation policies, respectively, which are outlined in detailed in the Scheme’s Stewardship Policy.

6.14 In relation to engagement activities, which are delegated to GSAM, the Trustee expects managers to engage with issuers to maintain or enhance the long-term value of its investments and thus limit negative externalities on the planet and society. The Trustee recognises that there is no ‘one-size-fits-all’ stewardship approach and instead encourages its managers to prioritise stewardship opportunities and apply the most suitable/influential engagement strategies based on their in-depth knowledge of a given asset class, sector, geography and/or specific company or other asset. Leading direct engagement with issuers is a minimum stewardship expectation of the Trustee. The Trustee expects its managers to use include letter writing, phone calls, participation and attendance at annual and other shareholder meetings, and focused engagement dialogues with both management teams and non-executive directors to achieve this. The Trustee monitors at what level GSAM engages to ensure that they are able to access the right engagement counterparts and influence company behaviour where appropriate. The Trustee challenges GSAM when it feels their engagements are not sufficiently focused on decision-makers such as management or board-level executives.

6.15 The Scheme’s Stewardship Policy will be reviewed and updated as and when appropriate.

6.16 Where possible, the Trustee will use its influence to encourage responsible long-term behaviour through its own activities and its asset managers’ compliance with its RI policy and the Stewardship Code

principles. The Trustee generally prefers engagement over divestment as a way of instigating change.

6.17 The Trustee delegates engagement activities with issuers of debt, private markets managers, property managers and infrastructure managers to GSAM.

6.18 It is the responsibility of the Trustee to lead engagements with investment managers. The Trustee therefore expects GSAM and any future managers if relevant to demonstrate standards that can be summarised as:

- Effective processes for and delivery of stewardship activity, alignment with leading standards, and evidence of positive engagement outcomes related to the Trustee's key themes;
- Embedding and maintaining an inclusive and supportive corporate culture;
- Managing conflicts of interest;
- Provision of tailored reporting on stewardship activities.

Monitoring

6.19 GSAM, on behalf of the Trustee, consider ESG (including climate change risks) when monitoring investments and carrying out its regular reviews and meetings with external managers.

6.20 The Trustee meets with GSAM on a periodic basis. In conjunction with GSAM, the Trustee agrees an agenda for discussion, which, where appropriate, may include ESG issues including stewardship. Where considered appropriate, GSAM is challenged directly by the Trustee and their advisers on the impact of any significant issues that may affect the prospects for risk and return in the portfolio.

Section 7 – Arrangements with investment managers

GSAM implements the Scheme's investment strategy within the terms of an investment management agreement (the "IMA"). The targets and objectives for GSAM are set to align with the Trustee's investment policies and these details are set out in the Investment Guidelines, a schedule to the IMA. The Trustee, utilising detailed quarterly control panels, regularly monitors and reviews the effectiveness of GSAM against these objectives, ensuring that GSAM is incentivised to comply with the Investment Guidelines and the Trustee's objectives.

GSAM manages investments directly on behalf of the Trustee as well as having the delegated authority to appoint, monitor and change the Trustee's external investment managers.

- 7.1 The Trustee expects GSAM to make decisions based on assessments about medium to long-term financial performance of an issuer of debt or equity and to engage with issuers of debt or equity in order to improve their, and thereby the Scheme's performance in the medium to long-term. (And is incentivised to do so through the targets and objectives that are set for GSAM).
- 7.2 The Trustee has processes in place to review and monitor the services, performance and fees of GSAM regularly. The Trustee reviews the performance of GSAM, the investment strategy overall and individual mandate investment performance.
- 7.3 GSAM appoints and has processes in place to review external managers on behalf of the Trustee, including performance reviews, manager oversight meetings and operational due diligence reviews. The method and time horizon for evaluating and remunerating external managers is determined by policies set by GSAM, rather than the Trustee. The performance of the externally managed mandates are measured over longer time periods
- 7.4 GSAM reviews external managers, including benchmarking of performance and fees. On appointment or commitment to a new fund, GSAM reviews the governance structures of external managers and assesses whether their fees and expenses are in line with industry peers and also seeks assurances from the external managers of its private market fund investments, that the remuneration of key personnel is appropriately structured and aligned to incentivise investment performance over the long term.

The Trustee notes that a number of the mandates that GSAM oversees are legacy mandates not selected or designed by GSAM. GSAM will monitor these mandates and periodically review their continued appropriateness for the Scheme.

- 7.5 The Trustee does not have a set definition of portfolio turnover costs or targeted turnover levels as it prefers to assess performance after all trading costs have been taken into account. However, the Trustee is developing processes to review the investment holding turnover costs incurred by GSAM and its external managers via reporting provided to the Trustee on an annual basis.
- 7.6 GSAM do not set a minimum tenure for external managers to demonstrate their ability to deliver to expectations but will keep performance under regular review. GSAM, on behalf of the Trustees, can remove a manager at any point in time, having given the required notice as agreed in the IMA between the parties, if believed appropriate to do so, or for example if there is a wider strategic change. Some external managers are appointed to manage private market investments, which often have a fixed term duration, agreed at the outset of the investment.