
BAE Systems Pension Scheme

BAE Systems Section

Statement of Investment Principles for Defined Benefit assets (and certain legacy AVCs)

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Section 1 – Introduction

- 1.1 This Statement of Investment Principles (“SIP”) has been prepared by BAE Systems Pension Funds Trustees Limited (the “Trustee”), the Trustee of the BAE Systems Pension Scheme BAE Systems Section (“the Section”) in accordance with the Pensions Act 1995 (as amended) and the Occupational Pension Schemes (Investment) Regulations 2005 (as amended).
- 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 (and certain legacy AVCs) under the Section 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 Section’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 The Trustee’s investment responsibilities are governed by the Section’s Rules and this SIP takes full account of its provisions. 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 best practice and in any event with the law (including the Pensions Act 1995 and the Occupational Pension Schemes (Investment) Regulations 2005).
- 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 should any of the investment principles or policies change.

Section 2 – Governance

- 2.1 The Trustee has responsibility for strategic decision making on investment matters, including the oversight and management of responsible investment ('RI') and the risks and opportunities related to climate change.
- 2.2 The Trustee has agreed that all strategic policy decisions on investments will be taken by the Trustee Board after in-depth consideration by the Funding & Investment Committee ("FIC") and following receipt of appropriate advice.
- 2.3 The Trustee reviews the appropriateness of the Section'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.
- 2.4 The Trustee has delegated authority for the consideration of investment issues, including but not limited to the integration of climate change and ESG considerations, to the FIC, which operates within its 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 considers its effectiveness as a committee on an annual basis.
- 2.5 The Trustee has appointed Goldman Sachs Asset Management International ("GSAM") to be its Outsourced Chief Investment Officer. ("OCIO")
- 2.6 Day-to-day investment decisions have been delegated to GSAM and a number of external investment managers, managed through GSAM, 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.
- 2.7 Each of the investment managers' fees are related to the value 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.
- 2.8 The Custodian, an institution acting as guardian of the Section'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.
- 2.9 An actuarial valuation of the Section 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 Section. 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 Trustee has adopted a Cash Flow Matching investment strategy. The aim of this strategy is to ensure sufficient asset cash flows to meet liability cash flow requirements in reasonably foreseeable circumstances.
- 3.2 The portion of total assets invested in such a way will increase over time as more members retire and become pensioners. The remainder of the assets are invested in order to generate higher expected returns, to allow the purchase of further cash flow matching assets at the appropriate future time.
- 3.3 The Trustee and its advisors use Asset Liability Modelling ("ALM") and consider expected returns to assist in setting investment policy. The expected returns are designed to allow the purchase of sufficient amounts of cash flow matching assets to meet all liabilities as they fall due.
- 3.4 The Section provides predominantly defined benefits. It currently provides some money purchase benefits funded by additional voluntary contributions (AVCs). The defined benefits section is closed to new entrants.

Section 4 - Strategy

4.1 The Trustee is required to set the overall investment strategy and has chosen to adopt a Cash Flow Matching Framework to match the Section's liability cashflows.

4.2 The key components of the investment strategy within the Cash Flow Matching Framework are as follows:

- **A Current Pensioner Portfolio ("CPP").** This is a portfolio of cash flow generative assets (such as Matching Plus assets¹, corporate bonds, physical gilts and other assets that are expected to provide a predictable stream of cashflows). The intention is that the asset cash flows generated by this portfolio will broadly match the expected liability cash flow profile of the Current Pensioners², and thus be used to pay benefits as they fall due. For this portfolio, the Trustee has defined a target split of future asset purchases. It has set a number of limits on the split of existing assets within CPP, but intentionally kept these limits quite broad.

The logic for doing this is that the cash flow matching assets are generally intended to be held to maturity and match specific streams of liability cash flows once optimised. It is thus not desirable to set limits that require material ongoing rebalancing within the portfolio. Rather, adjustments to the weightings of assets within the CPP will occur as updated current pensioner liability forecasts become available and additional assets are added to the CPP.

The CPP is the principal source of current pensioner payments and will be optimised to align asset cash flows (including income and principal repayments) with pension payments as far as practicable. Ongoing management of the CPP will involve the delivery of income whilst minimising credit default risk.

CPP portfolio	Actual Asset breakdown as at 31 December 2023	Target breakdown for <u>new purchases</u>		
		Up to 2027	2028-2041	2042 onwards
Matching Plus	33%	Min 0%, max 60%	Linear interpolation between 2027 and 2042 purchases	Min 0%, max 20%
Investment Grade Credit	49%	Min 20%, max 80%		Min 20%, max 40%
Gilts	18%	Min 20%, max 80%		Min 40%, max 80%

¹The Matching Plus assets contain property, infrastructure debt, private debt, and other secure income assets.

² For pensioners as at March 2021, the target is to match all future expected cash flows. For members who become pensioners at a subsequent date, only cash flows which fall within the next 15 years will be targeted by the CPP portfolio. Thus, in each future year, the CPP will be increased so as to match (i) the first 15 years of cashflows relating to members retiring that year and (ii) any pensioner cash flows that previously fell outside the 15-year window but now fall within it. The logic for this approach is that longer dated cash flow matching assets are limited to a small number of issuers and so can be more expensive and more difficult to source in sufficient quantities.

- **The "Excess" Current Pensioner Portfolio ("Excess CPP").** This is a portfolio of cash flow generative assets (such as Matching Plus assets*, corporate bonds, physical gilts and other assets that are expected to provide a predictable stream of cashflows), derivatives (such as swaps and synthetic gilts) and cash.

The Excess CPP does not have a fixed split between different kinds of investments as the portfolio exists to

support the Section’s de-risking ahead of plan provided the opportunity exists to do so. The Excess CPP also exists to support the hedging of the inflation and interest rate sensitivities of the future pensioner liabilities. The assets held within the Excess CPP are predominantly nominal and index-linked gilts, investment grade corporate bonds, and derivative instruments. The intention is that the asset cash flows generated by this portfolio will broadly match the expected liability cash flow profile of future pensioners and will be reallocated to the CPP as members reach retirement age.

The Scheme Actuary will carry out calculations once per quarter and report the indicative target amount of cash and gilts in the Excess CPP portfolio to GSAM that should be held as part of the Excess CPP (for risk buffer purposes). The Target Risk Buffer is broadly 10% cash, 10% gilts, and 80% FPP assets. GSAM will use reasonable endeavours to maintain a level of cash and gilts broadly aligned with this indicative amount.

Should the amount be below the indicative target at a quarterly check, GSAM will notify the FIC via the Trustee team.

- **A Future Pensioner Portfolio (“FPP”).** This is a portfolio of growth assets, and the aim is to provide a higher level of returns than the CPP. Over time, as non-pensioner members retire, assets in this portfolio will be sold and replaced with CPP assets to match these new pensioner cash flows. Should market conditions be favourable, FPP assets may also be sold to supplement the Excess CPP.

The target allocations within the FPP are applied to all assets within these portfolios (i.e. current holdings as well as new purchases). The targets remain constant until 2038 and then taper down in a linear fashion to a lower-risk portfolio (invested in line with the CPP at that point) in 2042.

Target for FPP*	Up to 2037	2038-2042	In 2042
Listed Equity	10%	Linear interpolation between 2037 and 2042 strategies	-
Private Equity	25%		-
Alternatives	42%		-
Property	7%		-
Infrastructure Equity	16%		-

**Due to the illiquid nature of the FPP assets, the asset allocation of the portfolio will change over time. GSAM’s ability to rebalance to this target is therefore limited in practice and the Trustee accepts that material deviations may occur and may persist for some time.*

- **A Target Buffer (“TRB”).** This portfolio is part of the funding target for the Section. The TRB is designed to act as a buffer for prudence and is largely invested in line with the FPP subject to an amount of cash and gilt holdings as calculated by the Scheme Actuary each quarter and provided to GSAM quarterly in line with Scheme Actuary calculations. The TRB is broadly 10% cash, 10% gilts, and 80% FPP assets. GSAM will use reasonable endeavours to maintain a level of cash and gilts approximately aligned with this indicative amount.

In practice, for operational reasons and to avoid unnecessary transfer of assets between portfolios, the minimum cash and gilts in the TRB sit within the Excess CPP, whilst the TRB in excess of this sits within the FPP. Therefore, the TRB assets are contained in the Excess CPP and the FPP. The notional allocation of TRB assets is for strategic purposes and does not affect the day-to-day management of assets.

- 4.3 At a high level, c.2% of total assets are expected to be sold from the FPP each year, in order to fund purchases in the CPP to match new pensioner payments. GSAM's Investment Guidelines govern these movements.
- 4.4 The expected return of an investment will be monitored regularly and will be directly related to the Section's investment objective. It is the Trustee's policy that the investment strategy and asset allocation of the Section will be structured so as to ensure that the expected long-term return on the investment portfolio is consistent with achieving the overall objectives as set out in Section 3 above.
- 4.5 The Trustee's policy is that there will be sufficient investments in liquid or readily realisable assets to meet cashflow requirements in foreseeable circumstances so that the realisation of assets will not disrupt the Section's overall investments, where possible. The Trustee will ensure sufficient cash is available to meet benefits and other payment obligations.

Section 5 - Risk

- 5.1 The Trustee regards risk as any factor that may render the Section unable to meet its obligation to pay benefits as they fall due and/or its ongoing statutory funding obligations.
- 5.2 The Trustee may use derivatives if they contribute to a reduction of risks or facilitate efficient portfolio management. The Trustee consults with its advisors when assessing the strategic use of derivatives to manage the Section’s risk profile.
- 5.3 The Trustee has identified its key risks, examples of which are set out in the table below along with a description of the control and / or mitigation in place. Please note that the Trustee also maintains a detailed risk register.

Risk	Control and Mitigation
Investment Risks	<p>FPP Returns: The risk that there are insufficient funds to purchase the required amount of future CPP assets, driven by the FPP return being lower than assumed by the Scheme Actuary.</p> <p>This risk is primarily addressed by:</p> <ul style="list-style-type: none"> - Reducing the size of the FPP (and thus reliance on FPP returns) over time. This occurs as members retire and also opportunistically (into Excess CPP) if market conditions and the funding position allow. - 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, illiquidity risk, currency risk, counterparty risk, active management risk. - Utilising investment tools and strategies which aim to deliver returns in a risk-controlled manner, including the use of liability hedging techniques and other derivative instruments. - Maintaining a minimum target Risk Buffer. - Underwriting material underperformance with Company contingencies. - Regularly monitoring investment performance using a range of risk and return metrics and taking appropriate action. - Regularly monitoring ongoing appropriateness of all investment managers and taking appropriate action. <p>Future CPP purchases: The risk that the cost of future CPP purchases is higher than assumed by the Scheme Actuary (equivalently, that the yield is lower), meaning not all cash flows can be matched in future.</p> <p>This risk is primarily addressed by:</p> <ul style="list-style-type: none"> - Facility to allow pre-purchasing of assets into the Excess CPP if market conditions and funding conditions allow, subject to agreement between the Company and Trustee. - Hedging a portion of the economic risk associated with future purchases - Spreading future purchases over time. - Ensuring flexibility in the range of assets that can be bought.

	<ul style="list-style-type: none"> - Setting risk tolerances around the target quantum and target asset split of future purchases to provide sufficient flexibility to the investment manager to take advantage of market opportunities. <p>Credit default risk in CPP assets: The risk that asset cashflows are lower than expected due to issuer defaults.</p> <p>This risk is primarily addressed by:</p> <ul style="list-style-type: none"> - Having credit quality limits within the portfolio. - Ensuring GSAM has in place a policy for assessing the credit risk of assets which do not have a credit rating readily available in the market.
Demographic risk	<p>The risk that longevity improves, and other demographic factors change increasing the costs of the Section benefits.</p> <p>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 - Hedging a portion of longevity risk via a longevity swap - Making an allowance for longevity improvements (above “best estimate”) in the calculation of the required risk buffer.
Liquidity risk	<p>The risk of the Section 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"> - Adopting a cashflow matching strategy for pension payments - Monitoring the level of transfer value and other benefit activity and consider this as it impacts the levels of cash required. - Maintaining a minimum proportion of Excess CPP in cash and gilt assets.
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 CPP, 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 Section assets either with intent or due to a lack of knowledge.</p> <p>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 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 Section.

	<ul style="list-style-type: none"> - Having internal controls 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.
<p>Sponsor risk</p>	<p>The risk of the Principal Employer being unable to make the necessary level of contributions in the future.</p> <p>This risk is primarily addressed by:</p> <ul style="list-style-type: none"> - Regular advice provided by the covenant advisor. The Section uses a specialist covenant advisor 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. The Trustee also considers the covenant alongside wider funding and investment strategy. - Prohibiting GSAM from investing in any "employer-related investments" (as defined in Section 40 of the Pensions Act and the 2005 Regulations) in respect of BAE Systems plc to the extent that such investments are prohibited by Section 40 of the Pensions Act and the 2005 Regulations. In addition, GSAM is prohibited from buying or subscribing for any shares in BAE Systems plc or any employer participating in the BAE Systems Section (other than for the purposes of implementing an index tracking policy in relation to all or part of the fund) or investing in any debt instrument issued by such an entity.
<p>Environmental, Social and Governance ("ESG") risk</p>	<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 ("ESG") 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 6.</p>

Section 6 – ESG 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 considered in the selection, retention and realisation of investments.
- 6.2 The Trustee has integrated climate-related risks and opportunities within the Section’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”).
- 6.3 The Trustee has a long-term investment time horizon of over 10 years. The Trustee recognises that financially material factors, including ESG factors (such as climate risks and opportunities) need to be assessed in the context of the long-term nature of the Section’s investments and is relevant at different stages of the investment process.
- 6.4 GSAM and any 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.
- 6.5 The Trustee has delegated responsibility for the management of the Section’s assets, both public and private, to GSAM. In selecting new investment managers for the Section, 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 The Section’s strategic benchmark has been determined using a range of factors including 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 the Section’s strategic benchmark. However, they are considered within the Section’s wider risk management framework.
- 6.7 The Trustee has not imposed any restrictions or exclusions in 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.

Stewardship, Voting and Engagement

- 6.8 The Trustee recognises that stewardship encompasses the exercise of voting rights and engagement with investee companies (directly or via investment managers) in relation to various matters relevant to the long-term performance of an investment, including their performance, strategy, capital structure, conflicts of interest management, and monitoring of compliance with agreed policies. It has examined the issues in relation to corporate governance and on the exercise of voting rights and recognises that good corporate governance creates the framework within which a company should be managed.
- 6.9 The ultimate purpose of the Trustee’s duty of stewardship is to preserve and enhance the long-term investor value and to reduce the risks underlying these investments. The Trustee’s belief is that actively engaging on financially material factors, which include ESG issues, contributes to identifying both investment opportunities and risks.
- 6.10 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:** Human rights
- **Governance:** Business ethics

- 6.11 GSAM supports the Trustee with managing Stewardship and Voting policies in relation to the equity holdings, where applicable. The exercise of voting rights are therefore delegated to GSAM 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 GSAM's stated policy, endorsed by the Trustee, and to engage with companies to ensure that companies follow the adopted policies.
- 6.12 The Trustee has outlined their policy surrounding voting, which is included in the Section's Stewardship Policy. Whereas voting responsibilities are outsourced to GSAM, the Trustee recognises that it has a fiduciary and regulatory responsibility to retain agency in the process. Manager oversight is the key mechanism for this, and the Trustee therefore holds GSAM accountable not only for voting activity as a whole, but also how it has voted on significant votes. The Trustee has also defined what it believes to be a significant vote, which is a vote that meets the following criteria:
- Votes relating to one of its key stewardship themes;
 - Votes relating to a company that has high climate risk exposure;
 - Votes relating to a company to which the Section has a large £ exposure; and
 - Votes identified due to potential controversy, driven by the size and public significance of a company, the nature of the resolution, and the weight of shareholder vote against management recommendation.
- 6.13 The Trustee has designed engagement and escalation policies, respectively, which are outlined in detail in the BAE Systems Pension Scheme's Stewardship Policy, which will be reviewed and updated as and when appropriate.
- 6.14 The Trustee delegates engagement activities with issuers of debt and private market investments to GSAM where appropriate and 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.
- 6.15 Leading direct engagement with issuers is a minimum stewardship expectation of the Trustee. The Trustee expects its managers to use 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. 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.
- 6.16 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 expects GSAM and other investment 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 our key themes;
 - Embedding and maintaining an inclusive and supportive corporate culture;
 - Managing conflicts of interest;
 - Provision of tailored reporting on stewardship activities.
- 6.18 It is the responsibility of the FIC to lead engagements with investment managers.

6.19 Currently, the Trustee is a signatory of the following industry organisations:

- Paris Aligned Investment Initiative ('PAII')
- The Institutional Investors Group on Climate Change ('IIGCC')

Monitoring

6.20 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.

6.21 Climate change related factors may also create investment opportunities that may be considered. Outside of investment risks, the Trustee believes there are other considerations associated with climate risk management integration that they should be aware of and manage, for example the impact of climate on the mortality assumptions for the Section.

6.22 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 Section 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. GSAM remains well informed on Section policies and decisions on climate-related factors, which helps ensure that their implementation of the Section's investment strategy is aligned with these.

6.23 The Trustee meets with GSAM on a periodic basis. The Trustee will also, from time to time, meet with external individual asset managers that GSAM utilises to manage specific asset pools. In conjunction with GSAM, the Trustee agrees an agenda for discussion, which, where appropriate, may include ESG issues. 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 return from the portfolio.

Climate Scenario Analysis and Climate Metrics

6.24 To aid the Trustee's assessment of the resilience of the Section against climate-related risks, climate scenario analysis will be performed in relation to the Section's assets, liabilities, and covenant by the Trustee's advisors and GSAM. This analysis will be performed triennially; interim updates may be performed, for example if there are material changes to the Section'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 Section's climate risk metrics, calculated by GSAM.

6.25 The FIC, on behalf of the Trustee, are also monitoring relevant climate metrics as set out under DWP's adoption of the recommendations of the TCFD (the results of which are disclosed in the Section's annual TCFD report). As part of this ongoing monitoring the FIC will consider what targets are appropriate in relation to these metrics. GSAM will consider, on behalf of the Trustee, 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 7 – Arrangements with investment managers

- 7.1 The Trustee has appointed GSAM to implement the Section's investment strategy. The terms under which GSAM operate are set out in the investment management agreement (the "IMA"). The Trustee, using 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.
- 7.2 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 Section's investment performance in the medium to long-term. GSAM is incentivised to do this through the targets and objectives that are set for GSAM.
- 7.3 GSAM manages assets directly on behalf of the Trustee as well as having the delegated authority to appoint, monitor and changes the Trustee's external asset managers.
- 7.4 GSAM has processes in place to review external managers on behalf of the Trustee, including performance reviews, manager oversight meetings and operational due diligence reviews. These reviews incorporate benchmarking of performance and fees, with some managers on performance-related 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 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.
- 7.5 The Trustee is working with GSAM to understand portfolio turnover and its associated costs, including for external managers. It is also working with GSAM to understand the total expense ratio.
- 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. The arrangements with GSAM contain provisions which enable termination on a period of notice.

Section 8 – Additional Voluntary Contributions

- 8.1 The Section also provides a facility for members to pay Additional Voluntary Contributions (“AVCs”) to enhance their pensions at retirement. The vast majority of Scheme members now have their AVCs invested under a DC Master Trust established by the Company (the Mercer Master Trust – MMT). The only AVCs which remain in the Scheme are insured with profits funds and direct investments under the Scheme. No new investments are available, but members can pay into their existing arrangements.
- 8.2 The Trustee therefore considers that its primary duty is to both efficiently manage and communicate with members, as appropriate, regarding the legacy AVC arrangements for which it is responsible. The Trustee also notes that MMT AVC members are able to transfer an amount back to the Scheme in order that this value can be used towards a tax-free cash entitlement under the Scheme. The maximum amount that can be transferred from MMT is the maximum tax-free cash lump sum amount on an individual member basis.
- 8.3 The legacy AVC arrangements are reviewed periodically to ensure that the investment profile of the funds remain consistent with the objectives of the Trustee and the needs of the members.