

Investment Policy Implementation Document

Introduction

The Statement of Investment Principles (“SIP”) of the QinetiQ Pension Scheme (“the Scheme”) sets out the guiding principles upon which the Scheme’s investments are based. The purpose of this Investment Policy Implementation Document (“IPID”) is to provide details of the specific investments in place alongside other information relevant to the management of the investments.

Investment Beliefs

The investment beliefs set out in this document provide a set of overriding principles by which the Trustee makes investment decisions. The beliefs adopted by the Trustee are high level, but their interpretation has a meaningful impact on the way the Scheme’s investment strategy will be devised and implemented.

Investment objectives

The Trustee believes its overarching objective is to secure the promised benefits to members, not to generate surpluses at the end of the life of the Scheme.

Strategy Development

The Trustee recognises the need to take risks when the Scheme has a funding gap and is prepared to adopt a prudent investment strategy which is expected to produce a return in excess of the expected growth in liabilities.

The Trustee believes that as the Scheme moves closer to its long-term objective date, continuing to transition the Scheme’s assets to an investment strategy that matches the cashflows to be paid is in the members’ long-term interests.

Risk budgeting and taking advantage of opportunities

The Trustee believes it should only take as much risk as required to achieve its overarching objective to secure the promised benefits to members.

However, the Trustee also believes that markets are dynamic, and valuations can become distorted over the short to medium term. While the Trustee does not believe in making short-term tactical allocations, it may wish to take opportunities to re-risk the Scheme’s assets in exceptional cases if market valuations become sufficiently attractive. However, any re-risking will be done on the basis that it will allow the Scheme to reduce risk over the long-term (i.e., taking more immediate risk to take less future risk).

The Trustee recognises the timing of any reversal in market valuations is unknown, and that a sufficiently long-time horizon would be needed to capture the benefits.

Rewarded and unrewarded risks

The Trustee believes some risks are rewarded and some are not.

The Trustee believes that investing in certain asset classes usually offers an adequate risk premium as a reward to justify the risk. These risk premiums include, but are not limited to, equity, credit, complexity, and illiquidity. However just because these risks may be rewarded, it does not oblige the Trustee to seek exposure to them.

On the other hand, the Trustee believes that some risks are not rewarded and will seek to remove these risks where it is practical and cost effective to do so. These unrewarded risks are interest rate risk, inflation risk and longevity risk. The Trustee has entered into multiple bulk annuity insurance contracts in respect of a proportion of pensioner liabilities to help manage and reduce funding risks.

Interest rate risk and inflation risk

The Trustee has concluded that the impact of interest rate and inflation movements on the Scheme's liabilities and funding position is considered unrewarded because the Scheme is not expected to receive any long-term benefit from being exposed to interest rate and inflation sensitivity. Taking into account the collateral sufficiency requirements and liquidity implications, the Trustee has decided to target a hedge ratio of 80% of the interest and inflation rate risks embedded in the Scheme's liabilities.

The Trustee acknowledges the approximations used when constructing the liability benchmark and the additional funding level volatility that can materialise if the Scheme's interest rate and inflation hedge ratio exceeds the funding level on the equivalent basis. Given the approximations used when designing the LDI benchmark, the Trustee has implemented the following monitoring framework:

- **Ongoing basis** – The Investment Consultant monitors changes in inflation expectations and will proactively flag any meaningful movements to the Trustee.
- **Quarterly basis** – The Trustee monitors the drift in the LDI benchmark due to changes in market conditions (i.e. inflation expectations) and assesses the necessity to accelerate the timing of the annual benchmark refresh based on information provided in the quarterly LDI monitoring report. The report includes a notification trigger to enable the Trustee to determine whether an additional liability benchmark refresh should be carried out.
- **Annual basis** – A liability benchmark refresh is carried out with an updated split of fixed and real cashflows shared with the LDI manager to achieve a more accurate hedging portfolio. This annual refresh reflects changes in market conditions and changes in the implied proportion of liabilities that are inflation linked. Scaling factors are applied to the cashflows to approximately allow for transfers out since the last benchmark refresh.
- **Triennial basis** – Following the actuarial valuation, the Scheme Actuary provides updated liability cashflows to the Investment Consultant which captures updated membership data, latest demographic assumptions and amendments to RPI-CPI wedge assumption. This information is then converted into a stream of fixed and real cashflows which is then used to design a new liability benchmark.

Longevity risk

The Trustee has determined that Scheme members living longer than anticipated represents an unrewarded risk. The Trustee seeks to hedge out this risk where the Scheme can afford to do so. The Trustee acknowledges the collateral implications of purchasing an annuity contract or implementing a longevity swap. Therefore, the Trustee assesses the most efficient use of capital taking into consideration various competing objectives.

Currency hedging

The Trustee believes that currency hedging is implemented for risk management rather than return generation purposes. The Scheme obtains its currency hedging via foreign exchange forwards and therefore there are collateral implications for holding these derivatives. Taking into consideration the risk reduction benefits of hedging overseas currency, the collateral implications of holding foreign exchange forwards and the high levels of volatility in foreign exchange markets means that the Trustee targets a currency hedge target of 50%.

Assessing risks

When assessing investment risks the Trustee believes that both quantitative and qualitative factors should be considered in any decision making.

Responsible Investment (RI)

The Trustee believes that Responsible Investment issues can have a material impact on the long-term performance of its investments. Environmental, Social and Governance (“ESG”) factors, including climate change risk, present risks, and opportunities.

The Trustee believes that their investment managers are best placed to act on ESG matters and should integrate ESG considerations into their investment processes. The Trustee requests investment managers to provide engagement case studies on priority ESG themes. The Trustee believes that companies that are well governed in relation to ESG factors will be stronger and as a result deliver better risk-adjusted returns and outcomes in the longer term.

The Trustee has decided to align itself with the Sponsor’s 2030 net zero commitment. The Trustee will engage with the Scheme’s investment managers to gather the relevant data to achieve this objective, which includes improving data coverage and data transparency.

The Trustee’s policies in relation to RI (encompassing sustainability and stewardship) are set out in the Statement of Investment Principles (SIP). The Trustee has also produced a Taskforce on Climate-related Financial Disclosures (“TCFD”) In line with the requirements.

Diversification

The Trustee believes that diversification reduces the overall volatility of the Scheme’s asset returns. This includes diversification across asset classes, markets, and investment styles.

Active vs. passive

The Trustee believes that active management is best used where there is no acceptable passive option or there is convincing evidence that active management can add value.

Costs matter

Investment costs, of which manager fees comprise a significant part, reduce the value of the Scheme’s assets. Sufficient emphasis should be placed on implementation costs when considering whether to evolve the investment strategy. In any implementation, the risks and costs of change should be carefully considered and managed as part of the decision-making process.

Understanding

The Trustee will not invest in anything it does not understand. In the absence of evidence to the contrary, the Trustee believes that a simple solution is preferable to a more complicated solution.

Governance

The Trustee’s governance budget (time and money) should be focussed on investment decisions that will have the greatest positive effect on long-term objectives. The Trustee believes that there is a minimum allocation required to justify the monitoring and governance associated with that allocation. This minimum will vary by asset class and manager, but each investment needs to bring sufficient value to the Scheme to justify the holding.

The Trustee’s policies in relation to stewardship including voting and engagement are set out in the SIP.

Strategic Benchmark

Having considered advice from the investment advisers, Hymans Robertson LLP, and having due regard for the objectives, the liabilities of the Scheme, the risks to the Scheme, and the covenant of the employer, the Trustee has decided upon the following strategic target asset allocation:

Asset Class	Target Allocation %
Total Growth	12.0
Global equities (structured)	12.0
Private equity	- ^[1]
Total Income	23.0
Loans & high yield bonds	17.0
Synthetic credit	6.0
Total Protection	83.0
LDI	41.2
Asset-backed fund	1.8
Annuity Policy	40.0 ^[2]
Offsetting cash	-18.0^[3]
Total Scheme	100.0

^[1] The target allocation reflects the fact that the private equity mandates are in run off.

^[2] The Annuity Policy target allocation is not an explicit target.

^[3] Offsetting cash is the sum of the two synthetic allocations to equity and credit which is supported by the LDI portfolio

Protection assets are defined as annuities, conventional and index-linked gilts and related securities, derivatives, cash, interest rate and inflation swaps and high quality “cash plus” funds. Liability driven investments (“LDI”) will consist of these defensive assets. The asset-backed fund can be thought of as index-linked due to the inflation-linked nature of the income stream. The Trustee holds multiple bulk annuity policies with insurers. Under the policies, the insurers make monthly payments to the Scheme and carry the risk of longevity for a subset of the pensioners, as well as the investment risks for this proportion of the Scheme’s assets.

Income assets include synthetic credit and higher yielding alternative credit. Their aim is to distribute regular income in order to meet benefit payments, manage capital risks and match redemptions to cashflows. An opportunistic trigger framework for adding and removing synthetic credit has been implemented with the manager based on historic spread levels. The synthetic credit allocation provides credit sensitivity for the Scheme which is aligned with the Scheme’s long-term ambition to hold physical credit instruments given these assets can provide a hedge to insurer pricing. The Trustee intends to introduce an allocation to physical credit once sufficient distributions from the illiquid income mandates have been received and the collateral sufficiency position is in a comfortable place.

Growth assets include global and private equities. The global equity exposure is obtained synthetically through a total return swap contract. Downside protection has been integrated into the Scheme’s global equity exposure via the use of an equity option overlay. The structured equity solution shapes the returns delivered from equity markets and tailors the equity exposure to achieve the required risk-return profile. The increased certainty over investment outcomes and risk reduction benefits associated with structured equity will be reviewed periodically to

determine whether this approach is consistent with the Trustee's beliefs and long-term objective. The private equity allocation is now in run-off with distributions exceeding capital commitments.

The actual asset allocation will vary relative to this benchmark due to movements in markets.

Collateral Framework

The Trustee has designed a collateral waterfall framework to ensure the desired interest rate and inflation hedging exposure can be achieved in a capital efficient manner whilst maintaining a high levels of collateral resilience.

The assets within the collateral pool are split into Tier 1 and Tier 2 assets. Tier 1 assets are defined as liquid collateral designed to support an interest rate rise move of at least 5%. Tier 2 assets are defined as back-up collateral that would be required to support an interest rate rise of greater than 5%. Back-up collateral assets can include corporate bonds with an explicit UK guarantee, or which have the benefit of an indemnity from the UK government and holdings in several pooled funds which invest in high quality asset backed securities and credit.

The primary objective of the Tier 2 assets in the collateral pool is to support the LDI arrangement and act as the first port of call to meet any collateral calls that might materialise under a rate rising environment. Therefore, assets held in the Tier 2 portfolio need to provide high levels of liquidity and incur minimum trading costs under normal market conditions. The Tier 2 framework has been designed with the following principles:

1. Operational considerations – the framework provides clear decision-making process.
2. Defensive focus – the underlying assets should focus on capital preservation
3. Simplicity – the framework should be straightforward to enable decisions to be clearly communicated.

The Trustee has implemented a framework which requires the Tier 1 portfolio to hold sufficient assets to support a 500bps rate rise movement before exhaustion. The LDI manager is required to notify the Trustee and Investment Consultant if the collateral headroom in the Tier 1 portfolio cannot support a 400bps rate rise movement before exhaustion. There are further notification triggers if the collateral headroom level falls beneath 350bps and 300bps.

The Trustee has agreed a framework for deploying capital into Tier 2 assets. The agreed framework is as follows:

- Collateral headroom between 500bps and 600bps before exhaustion = Invest in Liquid ABS
- Collateral headroom between 600bps and 700bps before exhaustion = Invest in High Grade ABS
- Collateral headroom between 700bps and 800bps before exhaustion = Invest in Global ABS
- Collateral headroom above 800bps before exhaustion = Explore standalone physical credit allocation

All the collateral headroom figures are after the allowance for convexity and agreed stresses. As the Scheme holds synthetic exposure, which is supported by the LDI collateral pool, the following stresses have been agreed:

- **Foreign currency stress** = 10% of the notional foreign exchange forward exposure
- **Structured equity stress** = 15% of the notional exposure of the equity total return swaps
- **Synthetic credit stress** = 3.5% of the notional exposure of the credit default swaps

Investment manager structure

The current investment managers, along with their target allocation are shown below.

Asset Class	Investment Manager Objective	Target Allocation
Global Equities (structured)	<p>Insight Investment Management (“Insight”) To replicate the return of the underlying index of the derivative instruments.</p> <p>Equity option overlay looks to shape the returns offered by equity markets with a focus on providing downside protection should there be an equity market correction.</p>	12.0%
Private Equity	<p>Adams Street Partners LLC To outperform the MSCI World index over rolling 10-year periods</p>	-
Private loans	<p>HPS Investment Partners LLC (“HPS”) To achieve target return of 7% per annum with a 6% cash yield</p>	6.0%
Private loans	<p>Partners Group To achieve target return of SONIA + 4-6% per annum with a 5% cash yield</p>	4.0%
	<p>Ares Management Limited (“Ares”) To achieve target return of 6-8% per annum with a 5% cash yield</p>	
Corporate bonds	<p>M&G PLC (“M&G”) To achieve return target of 5-6.75% per annum</p>	3.5%
Corporate bonds	<p>DRC Capital LLP (“DRC”) To achieve return target of 6-7% per annum</p>	3.5%
Synthetic Credit	<p>Insight Investment Management (“Insight”) To replicate the return of the underlying index of the derivative instruments</p>	6.0%
LDI	<p>Insight Investment Management (“Insight”) Tier 1 assets – To hedge interest rate and inflation exposure</p>	41.2%

Asset Class	Investment Manager Objective	Target Allocation
	Tier 2 assets – To support LDI arrangement and meet any collateral calls that might materialise	
Asset Backed funding	To produce a stream of annual payments of £2.5m linked to CPI for 20 years from March 2012	1.8%
Annuity Policies	<p>Scottish Widows and Legal and General Assurance Society Limited</p> <p>To make monthly payments to the Scheme and carry the risk of longevity for a subset of the pensioners.</p>	40.0%

Custody

The Trustee has appointed Northern Trust as global custodian for all its assets managed on a segregated basis, including the synthetic global equity, synthetic credit and LDI mandates managed by Insight. Northern Trust also keeps a record of the units the Scheme holds in pooled funds.

Credit Facility

To support the Scheme's objective of increasing the interest rate and inflation target hedge ratios in line with the funding position, whilst ensuring that there is enough collateral to support the collateral framework defined above, the Trustee has entered into a temporary credit facility to improve the short-term liquidity position of the investment strategy. The facility will be repaid using the distributions from the Scheme's illiquid mandates over the next few years.

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