# Serco Pension & Life Assurance Scheme

## Statement of Investment Principles – August 2020

### 1. Introduction

The Trustee of the Serco Pension & Life Assurance Scheme (the "Scheme") has drawn up this Statement of Investment Principles (the "Statement") to comply with the requirements of the 1995 Pensions Act (the "Act") and subsequent regulation. The Statement is intended to affirm the investment principles that govern decisions about the Scheme's investments. A separate document detailing the specifics of the Scheme's investment arrangements is available upon request.

In preparing this Statement the Trustee has consulted the Sponsoring Company to ascertain whether there are any material issues of which the Trustee should be aware in agreeing the Scheme's investment arrangements.

### 2. Process For Choosing Investments

The process for choosing investments is as follows:

- Identify appropriate investment objectives
- Agree the level of risk consistent with meeting the objectives set
- Construct a portfolio of investments that is expected to maximise the return (net of all costs) given the targeted level of risk

In considering appropriate investments for the Scheme the Trustee has obtained and considered the written advice of Mercer Limited ("Mercer"), whom the Trustee believes to be suitably qualified to provide such advice. The advice received and arrangements implemented are, in the Trustee's opinion, consistent with the requirements of Section 36 of the Pensions Act 1995 (as amended).

### 3. Investment Objectives

Overall investment policy falls into two parts. The strategic management of the assets is fundamentally the responsibility of the Trustee acting on advice from its investment consultant, Mercer, and is driven by their investment objectives as set out below. The remaining elements of policy are part of the day to day management of the assets which is delegated to professional investment managers.

The Trustee's primary objective is to ensure that the assets of the Scheme are sufficient to meet its obligations to beneficiaries. The ultimate measure of the Scheme's ability to pay members' benefits is the ratio of assets to buyout liabilities (i.e. the buy-out funding level). The Trustee's primary aim can, therefore, be translated into a desire to avoid significant deterioration of the buy-out funding level and take attractive opportunities to complete buy in transactions as market opportunities arise.

The Trustee also recognises the importance of ensuring that the assets of the Scheme are managed in a manner which takes due regard of the interests of the Company, upon whom the responsibility for funding the obligations to beneficiaries ultimately falls. The Trustee agreed the following objectives based on the results of the 5 April 2018 Actuarial

Valuation and future updates, in consultation with the Company, and having considered written advice from Mercer:

- To provide for the Scheme to be fully funded on the technical provisions assumptions, with a view to restoring the funding level being restored to 100% by 2028.

- To provide for the Scheme to be fully funded over the long-term (by 2033) on the lower risk self-sufficiency basis.

- To limit the likelihood of excessive increases in the ongoing deficit over the medium to long term, such that the 1 in 20 downside in 3 years' time, under the self-sufficiency basis, is not expected to be materially more than £65m worse than the expected position.

## 4. Risk Management and Measurement

There are various risks to which any pension scheme is exposed, which the Trustee believes may be financially material to the Scheme over its anticipated lifetime. The Trustee has considered the following risks:

- The risk of deterioration in the Scheme's funding level.

- The risk arising through the mismatch between the Scheme's assets and its liabilities. This risk is largely managed, as the Scheme has a target to hedge 100% of the interest rate and inflation sensitivity of the liabilities as measured on the self-sufficiency basis.

- The risk that the day to day management of the assets will not achieve the rate of investment return expected by the Trustee. The Trustee recognises that the use of active management involves such a risk.

- The risks that may arise from the lack of diversification of risky investments. With the exception of assets that aim to manage the risk from a mismatch of assets and liabilities, the Trustee aims to ensure the asset allocation policy in place results in an adequately diversified portfolio.

- The risk of overseas currencies, in which the Scheme's overseas investments are denominated, depreciating relative to sterling. The investment managers are mandated to ensure that any overseas currency exposure is hedged back to sterling.

- The risk that members of the Scheme live longer than expected and this leads to greater payments being made from the Scheme. This risk is partly managed via the Scheme's buy-in contract with Pension Insurance Corporation ("PIC").

- The risk that overseas risk free rates do not move in tandem with UK gilts, which would cause additional volatility relative to the liabilities of overseas bonds with the buy and maintain credit portfolios. The Trustee has taken the decision to hedge a proportion of this risk.

- The risk associated with Environmental, Social and Governance ("ESG"). The risk that ESG issues, including climate change, may have substantive impacts on the global economy and subsequently investment returns. Further information on the Trustee's policies on managing this risk is set out in section 11.

- Non-financial matters including but not limited to members' views in relation to social and environmental impact and present and future quality of life of the Scheme's beneficiaries, are not explicitly taken into account in the selection, retention and realisation of investments. However, members have a variety of methods by which they can make views known to the Trustee.

The Trustee recognises that although taking additional risk may increase expected returns over a long period, it also increases the risk of a shortfall in returns relative to those required to cover the Scheme's accruing liabilities as well as producing more short-term volatility in the Scheme's funding position. The Trustee has taken advice on the matter and (in light of the objectives noted previously) considered carefully the implications of adopting different levels of risk. The targeted level of risk is defined by the objectives detailed in Section 3.

The documents governing the manager appointments include a number of guidelines which, among other things, are designed to ensure that only suitable investments are held by the Scheme. The managers are prevented from investing in asset classes outside their mandate without the Trustee's prior consent.

The safe custody of the Scheme's assets is delegated to professional custodians (either directly or via the use of pooled vehicles).

Should there be a material change in the Scheme's circumstances, the Trustee will review whether and to what extent the investment arrangements should be altered, in particular whether the current risk profile remains appropriate.

## 5. Portfolio Construction

The Trustee has adopted the following control framework in structuring the Scheme's investments subject to the overriding constraint that at the total Scheme level the expected level of risk is consistent with that detailed in Section 3:

- There is a role for both active and passive management. Passive management will be used:

  - to diversify risk;

  - to invest in markets deemed efficient, where the scope for active management to add value is limited;

  - where the Trustee has difficulty in identifying active managers to add value consistently in a particular market;

  - as a temporary home pending investment with an active manager.

  In particular, the Scheme's LDI portfolio which invests predominantly in UK government bonds and related instruments is passively managed.

- To help diversify manager-specific risk, multiple manager appointments within a single asset class are preferred where practical, particularly when investment in that asset class is actively managed.

- At the total Scheme level and within individual manager appointments, investments should be broadly diversified to ensure there is not a concentration of investment with any one issuer. This restriction does not apply to investment in UK Government debt.

- Illiquid investments may be held as long as the Trustee judges that the lack of liquidity will not prevent the Scheme from achieving the investment objectives set out in Section 3.

- Investment in derivatives is permitted either directly or within pooled funds as long as they contribute to a reduction in risk or facilitate efficient portfolio management.

- Investments may be made in securities that are not traded on regulated markets. Recognising the risks (in particular liquidity and counterparty exposure) such investments will normally only be made with the purpose of reducing the Scheme's mismatch risk relative to its liabilities or to facilitate efficient portfolio management. In any event the Trustee will ensure that the assets of the Scheme are predominantly invested in regulated markets.

- The Scheme shall not invest in securities issued by the Scheme's Sponsoring Employer or affiliated companies (other than any such securities held within a pooled fund in which the Scheme invests).

- No appointed investment manager shall invest in the securities issued by the relevant manager's company or any affiliated companies (other than any such securities held within a pooled fund in which the Scheme invests).

- A bulk-annuity buy-in was transacted in April 2017 with PIC to cover the majority of pensioner liabilities. The premium paid was in the form of a portfolio of gilt edged securities which had a value of £665m as at 31 January 2017. The value of the PIC annuity contract was calculated to be £651m as at 5 April 2020.

## 6. Investment Strategy

The Trustee regularly reviews the Scheme's investment strategy and investment arrangements and will take decisions to invest in asset classes which are expected to deliver appropriate returns consistent with the objectives outlined in Section 3, as and when attractive opportunities arise. The Scheme may also, from time to time, invest opportunistically in equity call options with a view to generating additional returns. The collateral for this will be sourced from the LDI portfolio.

The benchmark allocation of the Scheme's assets between the major asset classes is detailed in the table below.

| | **Strategic allocation %** |
|---|---|
| Private Debt | 15.0 |
| LDI | 45.0 |
| Buy and Maintain Credit | 40.0 |
| **Total** | **100.0** |

The LDI portfolio aims to hedge the interest rate and inflation risks arising from the liabilities (measured on the self-sufficiency basis). The allocations to private debt and buy and maintain credit are expected to be built-up over time, as-and-when opportunities arise. At the time of writing the Scheme completed the funding of the Buy and Maintain Credit mandates and c.8% has been invested (drawn-down) in the two Private Debt mandates.

## 7. Investment Managers and Day to Day Management of the Assets

The Trustee delegates the day-to-day management of the assets to professional investment managers.

The Trustee has determined, based on expert advice, a benchmark mix of asset types and ranges within which each appointed investment manager may operate.

In addition to the benchmark investment strategy, the Trustee has established a Strategic Risk Portfolio as a means of expressing strategic, but off-benchmark, views as deemed appropriate with Mercer's support and advice. The Strategic Risk Portfolio provides an effective mechanism for the Trustee to implement investment decisions efficiently without re-stating the benchmark provided to the investment manager[1]. Permitted instruments include gilts, swaps, swaptions, equity options, foreign exchange contracts and exchange-traded futures.

Details of the appointed managers can be found in a separate document produced by the Trustee entitled "Investment Policy Implementation Document", which is available to members upon request.

### 7.1 Aligning manager appointments with the Scheme's investment strategy

The Trustee is responsible for the selection, appointment, removal and monitoring of the Scheme investment managers. Investment managers are appointed based on their capabilities and, therefore, their perceived likelihood of achieving the expected return and risk characteristics required for the asset class being selected for, in line with the objective set out in Section 3. The Trustee also regularly reviews the continuing suitability of the Scheme's investment managers.

The Trustee looks to its Investment Consultant for their forward looking assessment of a manager's ability to outperform over a full market cycle. This view will typically be based on the Investment Consultant's assessment of the manager's idea generation, portfolio construction, implementation and business management, in relation to the particular investment fund that the scheme invests in. The Investment Consultant's manager research ratings assist with due diligence and questioning managers during presentations to the Trustee and are used in decisions around selection, retention and realisation of manager appointments.

If the investment objective for a particular manager's fund changes, the Trustee will review the fund appointment to ensure it remains appropriate and consistent with the trustees' wider investment objectives.

Some appointments are actively managed and the managers are incentivised through remuneration (via performance related fees) and performance targets (an appointment will be reviewed following periods of sustained underperformance). The Trustee will review the appropriateness of using actively managed funds as part of the wider monitoring of the Scheme's managers.

The majority of the Scheme's investments are made through segregated investment vehicles and the Trustee have specified criteria in the investment manager agreements

[1] Examples of previous trades include inflation swaps to increase the Scheme's inflation hedge ratio, triggers to prompt the purchase of index-linked gilts to further increase the Scheme's inflation and interest rate hedge ratios and swaptions that would cause the Scheme to reduce the interest rate hedge ratio at pre-defined levels, below which the Trustee believes upside potential to enhance the Scheme's financial position outweighs downside risk.

for the asset class manager to be in line with the Trustee's specific investment requirements.

With respect to the LDI portfolio, the manager has been appointed to manage the assets in line with a Scheme-specific benchmark based on the underlying liabilities of the Scheme and a target liability hedge ratio. In relation to the Buy and Maintain Credit mandates, the Trustee has established a duration target, credit quality limits, and various other risk and return criteria.

7.2 Responsible Investing engagement with investment managers

The Trustee will also consider the Investment Consultant's assessment of how each investment manager embeds ESG into its investment process and how the manager's responsible investment philosophy aligns with the trustees' responsible investment policy. This includes the investment managers' policy on voting and engagement. The Trustee will use this assessment in decisions around selection, retention and realisation of manager appointments.

The Trustee monitoring investment managers' engagement activity on a regular basis and their level of integration is documented at least annually, based on the Investment Consultant's assessment of each manager ESG factors.

7.3 Evaluating investment manager performance

The Trustee receives investment manager performance reports from the managers and Mercer on a quarterly basis, which present performance information over 3 month, 1 year, 3 year and since inception periods. The Trustee reviews absolute performance, relative performance against a suitable index used as a benchmark, where relevant, and against the manager's stated performance target (over the relevant time period). The Trustee's focus is primarily on long term performance but short term performance is also reviewed and explored with the manager if necessary.

If a manager is not meeting performance objectives, or their investment objectives for the mandate have changed, the Trustee may ask the manager to review their fees instead of terminating the appointment.

There are active mandates with performance related fees, which have hurdle rate structures in place to avoid the trustees paying additional fees during periods of long term underperformance.

The Trustee meets with all the investment managers at least once a year in normal circumstances and challenges their portfolio construction and responsible investment philosophy.

7.4 Portfolio turnover costs

The Trustee receives MiFID II reporting from their investment managers and Mercer (where applicable) but do not regularly analyse this information.

Portfolio turnover costs are mostly considered as part of manager selection exercises and when a new manager is appointed by comparing portfolio turnover across the same asset class, or relative to the manager's specified portfolio turnover range in the investment guidelines or prospectus. However, for some portfolios (e.g. Buy and Maintain Credit) the Trustees do monitor turnover and will engage with the manager if this is higher than expected.

7.5 Investment manager changes

The Trustee is a long term investor and is not looking to change the investment arrangements on a frequent basis.

For open-ended funds, the Trustee will retain an investment manager unless:

- There is a strategic change to the overall strategy that no longer requires exposure to that asset class or manager;

- The manager appointment has been reviewed and the Trustee is no longer comfortable that the manager can deliver the mandate;

For closed-ended funds (e.g. private markets), the Scheme is invested for the lifetime of the fund. At the time of appointment, the Trustee receives an indication of the expected investment duration of their funds. In order to maintain a strategic allocation to these asset classes, the Trustee may choose to stay with the manager in a new closed ended fund (if available) for that asset class or appoint a different manager.

## 8. Expected Return

The Trustee expects the investment policy set out in Section 6 to generate a long term return over the liability benchmark that is sufficient to meet the objectives outlined in Section 3. From inception of the target investment strategy the long term expected return is expected to be around 1.2% per annum higher than investing solely in UK government bonds. This allows for a prudent estimate of the expected outperformance of any active managers. It is recognised that over the short-term, performance may deviate significantly from the long-term target.

## 9. Additional Assets

The Trustee offers a range of investment vehicles for members to invest Additional Voluntary Contribution's (AVC's). The providers include:

- Aviva
- Utmost Life and Pensions (following the business transfer of Equitable Life to Utmost on 1 January 2020)
- Legal & General
- Prudential

In addition cash balances are held in the Trustee's bank account and the Scheme holds annuities with Canada Life and PIC in respect of insured pensions.

## 10. Realisation of Investments

Although a proportion of the pension payroll is met through the annuities held, the cash inflow to the Scheme is generally lower than the outflow due to the incidence of transfer value payments and retirement lump sums; hence the Scheme is considered "cashflow negative". As such, income generated from the Scheme's mandates (notably private debt and buy and maintain credit) may be used to help meet the cashflow requirements with any additional requirements met from the collateral within the LDI portfolio.

## 11. Responsible Investment and Corporate Governance

The Trustee believes that environmental, social and governance (“ESG”) factors may have a material impact on investment risk and return outcomes, and that good stewardship can create and preserve value for companies and markets as a whole. The Trustee also recognises that long-term sustainability issues, particularly climate change, present risks and opportunities that increasingly may require explicit consideration. The Trustee has taken into account the expected lifetime of the Scheme when considering how to integrate these issues into the investment decision making process.

The Trustee has given the appointed investment managers full discretion when evaluating ESG factors, including climate change considerations, and in exercising voting rights and stewardship obligations attached to the Scheme’s investments in accordance with their own corporate governance policies and current best practice, including UK Corporate Governance Code and UK Stewardship Code.

The Trustee considers how ESG, climate change and stewardship is integrated within investment processes when appointing new managers and monitoring existing managers. These issues are monitored by the Trustee which takes advice from the investment consultant’s assessment of how the fund managers incorporate ESG factors. Monitoring is undertaken on from time-to-time and is documented.

The Trustee has not set any investment restrictions on the appointed investment managers in relation to particular products or activities, but may consider this in future.

Members’ views are not explicitly taken into account in the selection, retention and realisation of investments, but members have a variety of methods by which they can make views known to the Trustee.

## 12. Compliance with this Statement

The Trustee monitors compliance with this Statement and obtains written confirmation from the investment managers that they have given effect to the investment principles in this Statement so far as reasonably practicable and that in exercising any discretion the investment managers have done so in accordance with Section 4 of The Occupational Pension Schemes (Investment) Regulations 2005.

## 13. Review of this Statement

The Trustee will review this Statement in response to any material changes to any aspects of the Scheme, its liabilities, finances and the attitude to risk of the Trustee and the Company which they judge to have a bearing on the stated Investment Policy. As part of the review, the Trustee will take expert investment advice and consult the Company.

Such a review will normally coincide with actuarial valuations of the Scheme which will be carried out at least every 3 years.

Ratified and adopted by the Trustee of the Serco Pension
and Life Assurance Scheme, 2020