

# Statement of Investment Principles for the NAAFI Pension Fund

August 2024

## 1. Introduction

This Statement of Investment Principles (“SIP”) sets out the policy of the Trustees of the NAAFI Pension Fund (“the Trustees”) on various matters governing decisions about the investments of the NAAFI Pension Fund (“the Fund”), a Defined Benefit (“DB”) scheme. This SIP replaces the previous SIP dated February 2023.

The SIP is designed to meet the requirements of Section 35 (as amended) of the Pensions Act 1995 (“the Act”), the Occupational Pension Schemes (Investment) Regulations 2005 (as amended) and the Pension Regulator’s guidance for defined benefit pension schemes (March 2017).

This SIP has been prepared after obtaining and considering written professional advice from LCP, the Fund’s investment adviser, whom the Trustees believe to be suitably qualified and experienced to provide such advice. The advice considers the suitability of investments including the need for diversification given the circumstances of the Fund and the principles contained in this SIP. The Trustees have consulted with the relevant employer in producing this SIP.

The Trustees will review this SIP from time to time and, with the help of their advisers, will amend it as appropriate. These reviews will take place as soon as practicable after any significant change in investment policy and at least once every three years.

- **Appendix 1** sets out details of the Fund’s investment governance structure, including the key responsibilities of the Trustees, investment advisers and investment managers. It also contains a description of the basis of remuneration of the investment adviser and the investment managers.
- **Appendix 2** sets out the Trustees’ policy towards risk appetite, capacity, measurement and management.
- **Appendix 3** sets out the Fund’s investment manager arrangements.

## 2. Investment objectives

The primary objective is to ensure that the Fund should be able to meet benefit payments as they fall due. In addition to this primary objective, the Trustees have additional objectives. These are as follows:

- to operate an investment strategy that provides sound long-term growth, whilst managing and maintaining investment risk at an appropriate level. What the Trustees determine to be an appropriate level of risk is set out in Appendix 2.
- that the Fund should be fully funded on a technical provisions basis (ie the asset value should be at least that of its liabilities on this basis) with a secondary objective of being fully funded on a “gilts flat” basis in the longer term. Progress against both objectives is

reviewed on a regular basis. The Trustees are aware that there are various measures of funding, and have given due weight to those considered most relevant to the Fund.

### 3. Investment strategy

The Trustees, with the help of their advisers and in consultation with the employer, formally reviewed the investment strategy in 2024, considering the objectives described in Section 2 above. The Trustees expect to undertake a formal review of the strategy at least once every three years, but in practice they continually evaluate the appropriateness of the strategy and potential new investment opportunities, which may lead to change.

The Fund's investment strategy is designed as a "run-off" investment strategy with a relatively low level of risk. As at 30 June 2024, the Fund's asset class split was as follows:

Asset class	Asset allocation
Long lease property	6%
Corporate bonds	58%
Liability driven investments ("LDI") and Liquidity	36%
Total	100%

The Trustees aim to hedge around 100% of the Fund's exposure to interest rate and inflation risk on a Technical Provisions basis.

There is no formal rebalancing policy. The Trustees monitor the asset allocation on a regular basis and consider, with the help of their advisers, whether it is appropriate to rebalance the assets taking into account factors such as market conditions and anticipated future cashflows.

### 4. Considerations in setting the investment arrangements

When deciding how to invest the Fund's assets, the Trustees consider several risks, including, but not limited to, those set out in Appendix 2. Some of these risks are more quantifiable than others, but the Trustees have tried to allow for the relative importance and magnitude of each risk.

The Trustees considered a wide range of asset classes for investment, taking account of the expected returns and key individual risks associated with those asset classes as well as how these risks can be mitigated where appropriate. The key assumptions for expected returns above gilts (as at 30 June 2024) are as follows:

- 2.2% pa for long lease property;
- 0.9% pa for corporate bonds; and
- -0.3% pa for passive gilt-based Liability Driven Investments (LDI).

In setting the strategy the Trustees considered:

- the Fund's investment objectives, including the target return required to meet the Trustees' investment objectives;

- the Fund's cash flow requirements in order to meet future benefit payments;
- the interests of members and other beneficiaries;
- the circumstances of the Fund, including the profile of the benefit cash flows (and the ability to meet these in the near to medium term), the funding level, and the strength of the employer covenant;
- the guarantee provided by the Ministry of Defence;
- the risks, rewards and suitability of a number of possible asset classes and investment strategies and whether the return expected for taking any given investment risk is considered sufficient given the risk being taken;
- the need for appropriate diversification between different asset classes to ensure that both the Fund's overall level of investment risk and the balance of individual asset risks are appropriate;
- the Trustees' investment beliefs about how investment markets work, and which factors are most likely to impact investment outcomes; and
- other factors that the Trustee believes to be financially material over time horizons relevant to the funding of benefits, including environmental, social and governance ("ESG") factors and the risks and opportunities relating to climate change.

The Trustees' key investment beliefs, which influenced the setting of the investment arrangements are:

- asset allocation is the primary driver of long-term returns;
- risk-taking is necessary to achieve return, but not all risks are rewarded;
- risks that do not have an expected reward should generally be avoided, hedged or diversified;
- investment markets are not always efficient and there may be opportunities for good active managers to add value;
- environmental, social and governance ("ESG") factors are likely to be one area of market inefficiency and so managers may be able to improve risk-adjusted returns by taking account of ESG factors;
- climate change is a financially material systemic issue that presents risks and opportunities for the Fund over the short, medium and long term;
- voting and engagement are important and can create long term value which is in the best interest of Fund members and therefore we (with the help of our advisers) encourage managers to improve their voting and engagement practices;
- costs have a significant impact on long-term performance and therefore obtaining value for money from the investments is important;
- aligning the Fund's assets with net zero greenhouse gas emissions by 2050 where practicable is expected to help reduce the risks to the Fund from climate change;
- to be effective, a net zero program needs to be consistent with climate science, with both short-term and long-term targets and a focus on real world impacts; and

- collaborative investor action can help address systemic risks such as climate risk.

## 5. Implementation of the investment arrangements

Before making investment decisions, the Trustees obtain and consider proper written advice from their investment adviser on the question of whether the investment is satisfactory, having regard to the need for suitable and appropriately diversified investments.

Details of the investment managers are set out in Appendix 3.

The Trustees and investment managers to whom discretion has been delegated exercise their powers to giving effect to the principles in this Statement of Investment Principles, so far as is reasonably practicable.

The Trustees have limited influence over managers' investment practices because all the Fund's assets are held in pooled funds, but they encourage their managers to improve their practices where appropriate.

The Trustees' view is that the fees paid to the investment managers, and the possibility of their mandate being terminated, ensure they are incentivised to provide a high quality service that meets the stated objectives, guidelines and restrictions of the fund. However, in practice managers cannot fully align their strategy and decisions to the (potentially conflicting) policies of all their pooled fund investors in relation to strategy, long-term performance of debt/equity issuers, engagement and portfolio turnover.

The Trustees seek to ensure that the managers' investment approaches are consistent with their policies before any new appointment, and to monitor and to consider terminating any existing arrangements that appear to be investing contrary to those policies. The Trustees expect investment managers, where appropriate, to make decisions based on assessments of the longer term financial and non-financial performance of debt/equity issuers, and to engage with issuers to improve their performance. They assess this when selecting and monitoring managers.

The Trustees evaluate investment manager performance by considering performance over both shorter and longer-term periods as available. Generally, the Trustees would be unlikely to terminate a mandate on short-term performance grounds alone.

The Trustees' policy is to evaluate each of their investment managers by reference to the manager's individual performance as well as the role it plays in helping the Fund meet its overall long-term objectives, taking account of risk, the need for diversification and liquidity. Each manager's remuneration, and the value for money it provides, is assessed in light of these considerations.

The Trustees recognise that portfolio turnover and associated transaction costs are a necessary part of investment management and that the impact of portfolio turnover costs is reflected in performance figures provided by the investment managers. The Trustees expect their investment consultant to incorporate portfolio turnover and resulting transaction costs as appropriate in its advice on the Fund's investment mandates.

## **6. Realisation of investments**

The investment managers have discretion over the timing of realisation of investments of the Fund within the portfolios that they manage, and in considerations relating to the liquidity of investments.

The Trustees, on the administrators' recommendation, decide on the amount of cash required for benefit payments and other outgoings and inform the investment managers of any liquidity requirements. The Trustees' preference is for investments that are readily realisable but recognise that achieving a well-diversified portfolio may mean holding some investments that are less liquid (eg property). The Trustees receive income from some of the portfolios.

## **7. Financially material considerations and non-financial matters**

We consider how ESG considerations (including but not limited to climate change) should be addressed in the selection, retention, and realisation of investments, given the time horizon of the Fund and its members.

We influence the Fund's approach to ESG and other financially material factors through our investment strategy and manager selection decisions. The Trustees expect their investment managers, where appropriate, to have taken account of financially material considerations (including climate change and other ESG factors) as part of their investment analysis and decision-making process, within the parameters of the mandates they are set. We seek to appoint managers that have the skills and processes to do this, and periodically review how the managers are taking account of these issues in practice.

We encourage our managers to improve their ESG practices, although acknowledge that we have limited influence over managers' investment practices where assets are held in pooled funds.

Our ambition is to align our assets with net zero greenhouse gas emissions by 2050. To do this, we seek to select managers and invest in funds with credible net zero targets, where appropriate. We note that unlike an explicit net zero target, a net zero ambition is not a formal commitment and does not fall under any external reporting frameworks.

The Trustees' objective is that the financial interests of the Fund's members is their first priority when choosing investments. The Trustees will take members' preferences into account if they consider it appropriate to do so.

Non-financial matters may be taken into account if the Trustees have good reason to think that the members would share the concern; and that the decision does not involve a risk of significant detriment to members' financial interests.

## **8. Voting and engagement**

We recognise our responsibilities as owners of capital, and believe that good stewardship practices, including monitoring and engaging with investee companies, and exercising voting rights attaching to investments, protect and enhance the long-term value of investments.

The Trustees' policy is to delegate to the investment managers the exercise of rights attaching to investments, including voting rights and engagement with investee companies. The Trustees expect the investment managers to use their discretion to maximise financial returns for members and others over the long term.

We monitor managers' activities in relation to ESG factors and engagement on a regular basis, seeking to understand how they are implementing their stewardship policies in practice to check that their stewardship is effective and aligned with our expectations.

The Trustees seek to appoint managers that have strong stewardship policies and processes, reflecting where relevant the recommendations of the UK Stewardship Code issued by the Financial Reporting Council, and from time to time the Trustees review how these are implemented in practice.

We have selected a stewardship priority theme to provide a focus for our monitoring of investment managers' engagement activities. We will review the chosen theme(s) regularly and update if appropriate. Our current stewardship priority theme is corporate transparency.

We chose this priority because it is a market-wide area of risk that is financially material for the investments and can be addressed by good stewardship. Therefore we believe it is in our members' best interests that our managers adopt strong practices in this area.

We will write to our investment managers periodically to notify them of our stewardship priority (or priorities) and remind them of our expectations of them in relation to ESG factors (including climate change) and engagement. If our monitoring identifies areas of concern, we will engage with the relevant manager to encourage improvements.

**Approved by the Trustees of the NAAFI Pension Fund on 30 August 2024**

## *Investment governance, responsibilities, decision-making and fees*

The Trustees have decided on the following division of responsibilities and decision-making for the Fund. This division is based upon the Trustees' understanding of the various legal requirements placed upon them, and their view that the division of responsibility allows for efficient operation and governance of the Fund overall. The Trustees' investment powers are set out within the Fund's governing documentation.

### **1. Trustees**

In broad terms, the Trustees are responsible in respect of investment matters for:

- developing a mutual understanding of investment and risk issues with the employer;
- setting the investment strategy, in consultation with the employer;
- formulating a policy in relation to financially material considerations, such as those relating to ESG considerations (including but not limited to climate change);
- setting the policy for rebalancing between asset classes;
- setting a policy on the exercise of rights (including voting rights) and undertaking engagement activities in respect of the investments;
- putting effective governance arrangements in place and documenting these arrangements in a suitable form;
- appointing, monitoring, reviewing and dismissing investment managers, investment advisers, actuary and other service providers;
- monitoring the exercise of the investment powers that they have delegated to the investment managers and monitoring compliance with Section 36 of the Act;
- communicating with members as appropriate on investment matters;
- reviewing the investment policy as part of any review of the investment strategy;
- reviewing the content of this SIP from time to time and modifying it if deemed appropriate; and
- consulting with the employer when reviewing the SIP.

### **2. Investment managers**

In broad terms, the investment managers are responsible for:

- managing the portfolios of assets according to their stated objectives, and within the guidelines and restrictions set out in their respective investment manager agreements and/or other relevant governing documentation;
- taking account of financially material considerations (including net zero alignment and other ESG considerations) as appropriate when managing the portfolios of assets;

- exercising rights (including voting rights) attaching to investments and undertaking engagement activities in respect of investments;
- providing the Trustees with regular information concerning the management and performance of their respective portfolios, including information on voting (where applicable) and engagement undertaken and progress on net zero alignment over time; and
- having regard to the provisions of Section 36 of the Act insofar as it is necessary to do so.

The custodians of the portfolios (whether there is a direct relationship between the custodian and the Trustees or not) are responsible for safe keeping of the assets and facilitating all transactions within the portfolios.

### 3. Investment adviser

In broad terms, the investment adviser is responsible, in respect of investment matters, as requested by the Trustees, for:

- advising on how material changes within the Fund's benefits, membership, and funding position may affect the manner in which the assets should be invested and the asset allocation policy;
- advising on the selection, and review, of the investment managers, incorporating its assessment of the nature and effectiveness of the managers' approaches to financially material considerations (including climate change and other ESG considerations);
- participating with the Trustees in reviews of this SIP; and
- supporting the Trustee in achieving the Fund's net zero ambition, including through manager selection, monitoring, and engagement.

### 4. Fee structures

The Trustees recognise that the provision of investment management and advisory services to the Fund results in a range of charges to be met, directly or indirectly, by deduction from the Fund's assets.

The Trustees have agreed Terms of Business with the Fund's actuarial and investment advisers, under which work undertaken is charged for by an agreed fixed fee or on a "time-cost" basis.

The investment managers receive fees calculated by reference to the market value of assets under management or the value of liabilities hedged. The fee rates are believed to be consistent with the managers' general terms for institutional clients and are considered by the Trustees to be reasonable when compared with those of other similar providers. See also Section 5 of the SIP.

The fee structure used in each case has been selected with regard to existing custom and practice, and the Trustees' view as to the most appropriate arrangements for the Fund.

However, the Trustees will consider revising any given structure if and when it is considered appropriate to do so.

## **5. Performance assessment**

The Trustees are satisfied, taking into account the external expertise available, that there are sufficient resources to support their investment responsibilities. The Trustees believe that they have sufficient expertise and appropriate training to carry out their role effectively.

It is the Trustees' policy to assess the performance of the Fund's investments, investment providers and professional advisers from time to time. See Section 5 of the SIP. The Trustees will also periodically assess the effectiveness of their decision-making and investment governance processes and will decide how this may then be reported to members.

## **6. Working with the Fund's employer**

When reviewing matters regarding the Fund's investment arrangements, such as the SIP, the Trustees seek to give due consideration to the employer's perspective. While the requirement to consult does not mean that the Trustees need to reach agreement with the employer, the Trustees believe that better outcomes will generally be achieved if the Trustees and employer work together collaboratively.

### 1. Risk appetite and risk capacity

Risk appetite is a measure of how much risk the Trustees' are willing to bear within the Fund in order to meet their investment objectives. Taking more risk is expected to mean that those objectives can be achieved more quickly, but it also means that there is a greater likelihood that the objectives are missed, in the absence of remedial action. Risk capacity is a measure of the extent to which the Trustees can tolerate deviation from their long term objectives before attainment of those objectives is seriously impaired. The Trustees' aim is to strike the right balance between risk appetite and risk capacity.

When assessing the risk appetite and risk capacity, the Trustees considered a range of qualitative and quantitative factors, including:

- the strength of the employer's covenant and how this may change in the near/medium future;
- the security offered by the guarantee from the Ministry of Defence;
- the desire to run a low risk of seeking any further employer contributions;
- the Fund's shorter-term and long-term funding targets, noting that the Trustees have a long time horizon for gradually achieving an even stronger funding position;
- the Fund's liability profile, its interest rate and inflation sensitivities, and the extent to which these are hedged;
- the Fund's cash flow and target return requirements; and
- the level of expected return and expected level of risk, now and as the strategy evolves.

When deciding on the current investment strategy, the Trustees believed the level of risk to be appropriate given the Trustees' and employer's risk appetite and capacity, given the Fund's objectives.

### 2. Approach to managing and monitoring investment risks

The Trustees consider that there are several different types of investment risk that are important to manage and monitor. These include, but are not limited to:

#### 2.1. Risk of inadequate returns

A key objective of the Trustees is that, over the long-term, the Fund should generate its target return so that it has adequate assets to meet its liabilities as they fall due.

The Trustees therefore invest the assets of the Fund to produce a sufficient long-term return in excess of the liabilities. There is also a risk that the performance of the Fund's assets and liabilities diverges in certain financial and economic conditions in the short term. This risk has been considered in setting the investment strategy and is monitored by the Trustees on a regular basis.

**2.2. Credit risk**

This is the risk that a borrower will cause a financial loss for the other party by failing to meet required payments for a contractual obligation.

The Fund is subject to credit risk because it invests in bonds via pooled funds. The Trustees manage its exposure to credit risk by investing in pooled funds that have a diversified exposure to different credit issuers.

**2.3. Currency risk**

Whilst the majority of the currency exposure of the Fund's assets is to Sterling, the Fund is subject to currency risk because some of the Fund's investments are held in overseas markets. The Trustees hedge the overseas currency exposure back to Sterling as far as possible, to minimise the currency risk within the investments.

**2.4. Interest rate and inflation risk**

The Fund's assets are subject to interest rate and inflation risk because some of the Fund's assets are held in bonds via pooled funds. However, the interest rate and inflation exposure of the Fund's assets hedges part of the corresponding risks associated with the Fund's liabilities.

The Trustees consider interest rate and inflation risks to be generally unrewarded investment risks. As a result, the Trustees aim to hedge around 100% of the Fund's exposure to interest rate and inflation risk on a Technical Provisions basis. The hedging is implemented using a Liability Driven Investment (LDI) portfolio comprising a range of government bonds and derivative instruments, as well as a corporate bond portfolio. The net effect of the Trustees' approach to interest and inflation risk will be to reduce the volatility of the funding level, and so the Trustees believe that it is appropriate to manage exposures to these risks in this manner and to review them on a regular basis.

**2.5. Illiquidity/marketability risk**

This is the risk that the Fund is unable to realise assets to meet benefit cash flows as they fall due, or that the Fund will become a forced seller of assets in order to meet cashflows (including benefit payments and collateral calls). The Trustees are aware of the Fund's cash flow requirements and believe that this risk is managed by maintaining an appropriate degree of liquidity across the Fund's investments and by investing in income-generating assets, where appropriate.

**2.6. Risk from lack of diversification**

This is the risk that failure of a particular investment, or the general poor performance of a given investment type, could materially adversely affect the Fund's assets. The Trustees believe that the Fund's assets are adequately diversified between different asset classes and within each asset class. This was a key consideration when determining the Fund's investment arrangements and is monitored by the Trustees on a regular basis.

**2.7. Investment manager risk**

This is the risk that an investment manager fails to meet its investment objectives. Prior to appointing an investment manager, the Trustees receive written advice from a suitably qualified individual and will typically undertake an investment manager selection exercise. The Trustees monitor the investment managers on a regular basis to ensure they remain appropriate for their selected mandates.

**2.8. Counterparty risk**

This is the risk that one party to a contract (such as a derivative instrument) causes a financial loss to the other party by failing to discharge a contractual obligation. This risk applies in particular for those contracts that are traded directly between parties, rather than traded on a central exchange.

In particular, a range of derivative and gilt repo contracts are deployed within the LDI portfolio, to match efficiently a portion of the Fund's liabilities. Counterparty risk is managed within the LDI funds through careful initial selection and ongoing monitoring of trading counterparties, counterparty diversification and a robust process of daily collateralisation of each contract, to ensure that counterparty risk is limited, as far as possible, to one day's market movements.

**2.9. Collateral adequacy risk**

The Fund is invested in LDI arrangements to provide protection ("hedging") against adverse changes in interest rates and inflation expectations. The LDI manager may from time to time call for additional cash to be paid to the LDI portfolio in order to support a given level of leverage. Collateral adequacy risk is the risk that the Trustees when requested to do so will not be able to post additional cash to the LDI funds within the required timeframe. A potential consequence of this risk is that the Fund's interest rate and inflation hedging could be reduced and that the Fund's funding level could suffer subsequently as a result.

In order to manage this risk, the Trustees regularly monitor the amount by which gilt yields would need to rise before the LDI manager would require additional collateral, to ensure this is maintained at a prudent level. The Trustees also ensure that the Fund has a sufficient allocation to highly liquid assets which can be readily realised should additional collateral be needed.

**2.10. ESG and climate-related risks**

ESG factors are sources of risk, which could be financially material over both the short and longer term. These include risks relating to unsustainable or socially harmful business practices, and unsound corporate governance. We seek to appoint investment managers who will manage these risks appropriately and monitor how these risks are being managed in practice.

Climate change is a source of risk, which could be financially material over both the short and longer term. This risk relates to the transition to a low carbon economy,

and the physical risks associated with climate change (eg extreme weather). We seek to appoint investment managers who will manage this risk appropriately, and we monitor how this risk is being managed in practice.

We encourage our managers (where practical) to set credible net zero targets for the funds in which we invest and to align our investments with net zero greenhouse gas emissions by 2050 to help drive real world emissions reduction and reduce systemic risks relating to climate change. We periodically monitor and engage with our managers on their progress towards net zero alignment.

#### 2.11. Other non-investment risks

The Trustees recognise that there are other, non-investment, risks faced by the Fund, and takes these into consideration as far as practical in setting the Fund's investment arrangements as part of their assessment of the other aspects of the Fund's Integrated Risk Management framework.

Examples include:

- longevity risk (the risk that members live, on average, longer than expected); and
- sponsor covenant risk (the risk that, for whatever reason, the sponsoring employer is unable to support the Fund as anticipated). The Trustees note that the security offered by the guarantee from the Ministry of Defence helps to mitigate this risk.

Together, the investment and non-investment risks give rise generally to funding risk. This is the risk that the Fund's funding position falls below what is considered an appropriate level. The Trustees regularly review progress towards the Fund's funding target, both in the longer-term as well as against short-term milestones, comparing the actual versus the expected funding level.

By understanding, considering and monitoring the key risks that contribute to funding risk, the Trustees believe that they have appropriately addressed and are positioned to manage this general risk.

Details of the investment managers, their objectives and investment guidelines are set out below.

#### **1. M&G – Long Lease Property**

The Fund invests in long lease property through a pooled fund called the M&G Secured Property Income Fund. The objective of this fund is to outperform RPI index by 3% pa (after fees).

#### **2. L&G – Corporate Bonds**

The Fund invests in climate-aware buy & maintain corporate bonds through a bespoke pooled fund with L&G. The objective of this fund is to seek to capture the return received as a result of taking credit risk and liquidity risk through investing in a globally diversified portfolio of bonds, whilst avoiding investments in securities which L&G believes likely to default or experience a significant deterioration in credit quality. The portfolio is 'climate-aware' ie it seeks to have lower greenhouse gas emissions than a comparative index. L&G implemented an upfront reduction in greenhouse gas emissions of over 25% initially. On an ongoing basis, L&G will seek to reduce the greenhouse gas emissions of the portfolio year-on-year, if possible. The fund targets a return of 1% pa above gilts (after fees).

#### **3. Columbia Threadneedle – Liability Driven Investments (LDI)**

The Fund invests in LDI through a bespoke pooled fund with Columbia Threadneedle. The objective of the bespoke pooled fund is to fully hedge the Fund's Technical Provisions liabilities against changing-long term interest rates and inflation expectations. It aims to do this by investing in a range of UK government bonds and derivative instruments, which are expected to broadly mirror movements in the Fund's liabilities caused by movements in long-term interest rates and inflation expectations. This reduces the volatility in the funding position (ie the difference between the Fund's assets and liabilities).

#### **4. Additional Voluntary Contributions (AVCs)**

The Trustees hold some assets invested separately from the main investments, to secure additional benefits on a money purchase basis for those members who elected to pay AVCs.

The Fund's AVC providers are Prudential Assurance Co Ltd and L&G.

Members can no longer make additional AVC payments into the respective funds.