Rolls-Royce UK Pension Fund

Statement of Investment Principles – September 2017

1. Introduction

The Rolls-Royce UK Pension Fund (“the Fund”) exists in its present form following the merger of various former Rolls-Royce pension schemes (“the Former Schemes”):

i) Rolls-Royce Pension Fund

ii) Rolls-Royce Group Pension Scheme

iii) Rolls-Royce Ancillary Benefits Plan

iv) Rolls-Royce Engine Controls Systems Pension Scheme

The Trustee of the Rolls-Royce UK Pension Fund (“the Trustee”) has drawn up this Statement of Investment Principles (“the Statement”) to comply with the requirements of the Pensions Act 1995 (“the Act”) and subsequent legislation. The Pensions Act 1995 requires the Trustee to document the investment principles governing decisions about investments for the purposes of the Fund. These include the Trustee’s policy on choosing investments, the kinds of investments to be held, the balance between different kinds of investments, risk, the expected return on investments, the realisation of investments, and such other matters as may be prescribed by legislation. The Trustee has consulted a suitably qualified person by obtaining written advice from Mercer, the Trustee’s appointed Investment Consultant. The Trustee, in preparing this Statement, has also consulted the Company, Rolls-Royce plc.

Overall investment policy falls into two parts: the Trustee is responsible for the strategic management of the assets; and the Trustee delegates the implementation of its agreed investment strategy to the Trustee’s Investment Executive, comprising individuals who are specialists within the Company and the Trustee’s appointed advisers and whom the Trustee believes possess the required experience, using professional investment managers for the day-to-day management of the assets.

This Statement is consistent with the Trustee’s investment powers, which are set out within the Fund’s Trust Deed & Rules and are subject to applicable legislation. If necessary, the Trustee will take appropriate legal advice regarding the interpretation of these. The Trustee acknowledges that, according to the law, it has ultimate power and responsibility for the Fund’s investment arrangements.

The Trustee believes that the investment policy and its implementation are in keeping with best practice, including the principles underlying the Myners Code of Best Practice for pension fund investments first published in 2001 and updated in 2008.

The Trustee refers to this Statement when making investment decisions to ensure that the decisions are consistent with the principles set out within. In addition, the Trustee will review this Statement in response to any material changes with respect to the Fund which it judges to have a bearing on this Statement. The Trustee will also review this Statement at least once every three years and without delay following any significant change in investment policy. Before any review or revision, the Trustee will obtain and consider written advice from an appropriate investment expert and will consult with the Company. Whilst it is normally expected that there will be general agreement, the Trustee's fiduciary obligation to Fund members will take precedence over the Company's wishes, should these ever conflict.

This Statement sets out the general principles underlying the investment policy.

2. Investment Objectives and Restrictions

2.1 Investment Objective

The Trustee's overriding objective is to meet the Fund's liabilities as and when they fall due. In pursuit of this objective, the Trustee seeks to invest the Fund's assets at an appropriate level of risk relative to the Fund's liabilities.

In seeking to achieve the primary objective, the Trustee follows a low-risk investment strategy in pursuit of excess return relative to the Fund's liabilities by investing a proportion of assets in:

i) a Liability-Driven Investment ("LDI") portfolio, expected to match or "hedge" closely the interest rate and inflation risk profile of the Fund's liabilities;

ii) a Credit portfolio, expected to generate excess returns relative to the Fund's liabilities primarily by harvesting credit spreads above yields on "pure" hedging assets. The Credit portfolio may contribute to the LDI or liability-hedging strategy through investment in fixed interest assets, but may also hold floating rate or non-matching assets; and

iii) a Return-Seeking Asset ("RSA") portfolio, expected to generate excess returns relative to the Fund's liabilities through investment in other non-matching assets such as equities.

Under the terms of an agreement with the Company, the Fund will grant contingent increases to certain benefit tranches should certain parameters be met in respect of the funding position of the Fund and the investment strategy. From an investment perspective, the requirement for the granting of contingent increase is that the Trustee considers, having taken advice, that the Fund is invested prudently. The Trustee has adopted a strategy to invest the assets of the Fund in this way.

3. Strategic Asset Allocation

In order to achieve its investment objectives the Trustee has adopted the following broad strategic asset allocation ranges for the Fund. The Fund may deviate from this allocation due to market movements or due to strategic decisions and there is no requirement to rebalance back to these ranges. In addition, the asset allocation may be refined to take advantage of market opportunities.

	Typical ranges %	
Asset Class	Exposure	Allocation
LDI portfolio	46.0 – 86.0	46.0 – 66.0
Credit portfolio	33.0 - 43.0	33.0 – 43.0
RSA portfolio	3.5 – 8.5	0 – 8.5
Leverage	*Less than 25%*	-
Total	100%	100%

A modest degree of leverage is used within the investment strategy in order to maintain the interest rate and inflation hedge ratios within the rebalancing ranges below whilst also maintaining the asset class exposures within the typical ranges above. Leverage is expected be used within the LDI portfolio or to provide leveraged exposure to equity markets.

The table below sets out the typical liability hedge rebalancing ranges for interest rates and inflation. The hedge ratios are monitored by the Trustee on a regular basis and rebalancing may be undertaken if the ranges are breached, although there is no requirement for the hedge ratios to be automatically rebalanced back within these ranges.

	Rebalancing ranges (%)
Interest rate hedge ratio *	90 – 100
Inflation hedge ratio *	85 – 100

*Measured on a gilts flat basis.

4. Expected Return and Risk

The Trustee expects to generate a return on total assets, over the long term, of circa gilts+ 0.7% to gilts + 0.9% p.a. (net of investment management expenses). It is recognised that over the short term, performance may deviate significantly from the long term target.

The Trustee regularly monitors the level of investment risk and aims to keep this to a prudent level.

5. **Risk Management and Measurement**

The primary risk upon which the Trustee focuses is that arising through a mismatch between the Fund's assets and its liabilities.

The Trustee recognises that modern financial instruments make it possible to select assets with interest and inflation rate sensitivities that are similar to those of the estimated liability cash flows; a strategy known as liability-driven investment ("LDI"). The majority of the Fund's assets have been invested in this way. In addition, derivatives are used to hedge some of the Fund's longevity risks.

However, in order to meet the Fund's long-term objectives while controlling the level of contributions required from the Company, the Trustee has agreed to take a modest amount of investment risk relative to the liabilities. This is done in order to target a greater return than the LDI Portfolio would provide, whilst maintaining a prudent approach to meeting the Fund's liabilities.

In arriving at its chosen investment strategy and the production of this Statement, the Trustee has considered (amongst others) the following risks:

Risk	**Description and mitigations**
Market risk	Fluctuation in market prices and/or future cashflows of financial instruments. The Trustee adopts only a limited allocation to return seeking assets such as equities, and holdings are diversified by geography and sector. Currency risk is also monitored and, where appropriate, hedged.
Interest rate and inflation risk	Changes in market implied interest rates and inflation can affect the value of the Fund's assets and liabilities. The Trustee pays close attention to matching the interest rate and inflation exposures of its liabilities with those of its assets, maintaining high hedge ratios. A majority of assets are allocated to liability-matching asset classes.
Credit risk	Direct credit risk arising from pooled investment vehicles is mitigated by the underlying assets of the pooled arrangements being ring-fenced from the pooled managers. Credit risk arising from direct debt holdings such as corporate bonds is mitigated by diversification limits specified in the investment management guidelines, by requiring investment to be predominantly in investment grade rated or equivalent quality instruments, as well as the skill of the managers in instrument selection.
Counterparty risk	The risk of default by the counterparty to a derivative or similar transaction. The Trustee has set limits diversifying exposure across different counterparties and monitors the total exposure to counterparties across all holdings against aggregate risk limits. Derivative positions are predominantly collateralised daily to mitigate counterparty risk.
Investment manager risk	The risk inherent in the day-to-day running of the asset portfolio by investment managers, including underperformance of portfolios against the objectives set. The Trustee selects its managers carefully and, where appropriate, diversifies across a number of managers.

Concentration risk	The failure of any one of the Fund's investments could jeopardise the Trustee's ability to meet its objectives if it constituted a significant proposition of the assets. The Trustee aims to ensure that the Fund is not unduly exposed to asset class, market or manager specific risk. There is some concentration of the Fund's assets in holdings of government bonds held by the LDI investment manager. The Trustee is of the view that these assets are the best available matching assets for the Fund's liabilities, and this risk reduction more than offsets the concentration risk.
Cash flow and liquidity risk	Cash flow and liquidity risk relates to the realisation of investments in order to meet the benefit payments. The Trustee and its advisors manage the Fund's cash flow requirements over the short-term in order to minimise the possibility that this occurs. The Trustee mitigates liquidity risk by ensuring investment in illiquid assets is kept at an appropriate level, and a prudent approach is taken to maintaining suitable levels of collateral to support derivative programmes.
Custody risk	The Trustee has appointed a leading custodian bank which is independent of the investment managers to act as global custodian to the assets. The Trustee has satisfied itself that the financial security, procedures and controls available justify this as a prudent, efficient and cost effective procedure. Pooled funds will have their own custody arrangements and the global custodian's function in this regard is therefore limited to the safekeeping of any relevant unit certificates, the custodian designated by the pooled fund manager retaining the remaining responsibilities in respect of the underlying securities and cash of the pooled funds.
Leverage risk	The Trustee has considered the risks from the use of leverage, such as a potential need to raise additional collateral and roll risks, and has implemented controls to reduce these risks, including limiting the overall degree of leverage.

6. Rebalancing and Cashflow Policy

There is no formal rebalancing mechanism among the LDI, Credit and RSA portfolios, although some rebalancing does take place within those portfolios.

The Trustee monitors the degree of leverage within the LDI portfolio and may rebalance the asset allocation if it deems that it is appropriate to do so in the context of the leverage of the LDI portfolio. The Trustee may also make decisions about the realisation of assets based on the liquidity of an asset or class, its performance, and the extent to which investments must be in readily realisable form to meet the Fund's outgoing liabilities.

7. Day-to-Day Management of the Assets

7.1 Main Assets

The Trustee delegates the day-to-day management of the assets, including the realisation of assets, to a number of professional investment managers. The Trustee has taken advice from the Investment Consultant that the managers have the appropriate skill and experience for managing the Fund's investments and that they are carrying out their work competently.

The Trustee regularly reviews the continuing suitability of the Fund's investments, including the appointed managers, both of which may be adjusted from time to time. However, any such adjustments would be carried out with the aim of ensuring an overall level of risk that is consistent with the Fund's investment objective.

Appointment and Monitoring of Investment Managers

The documents governing the manager appointments include a number of guidelines which, among other things, are designed to ensure that only suitable investments are made by the Fund. The managers are prevented from investing in asset classes outside their mandate without the Trustee's prior consent. The Trustee restricts managers from investing in employer-related investments where possible, though limited employer-related investments may occur through pooled funds where specific exclusions are not possible.

Arrangements are in place to monitor the Fund's investments to help the Trustee check that nothing has occurred that would bring into question the continuing suitability of the current investments. To facilitate this, the Trustee's Investment Executive meets regularly with the Fund's investment managers and receives regular reports from all of the investment managers and the Investment Consultant. The Trustee also employs an independent performance measurer who reports on a quarterly basis.

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

8. Responsible Investment and Corporate Governance

The Trustee believes that good stewardship is important. The Trustee has considered how environmental, ethical, social and corporate governance ("ESG") issues should be taken into account in the investment process. The Trustee considers that it should in all circumstances act in the best interests of the beneficiaries within the Rules of the Fund. The Trustee has considered the guidance provided by the Law Commission, which states that trustees may take account of risks to a company's long-term sustainability, such as ESG risks, if they are, or may be, financially material. In light of this guidance, the Trustee's policy is that the investment managers should take account of ESG issues where they are believed to be (or are potentially) financially material.

The Trustee has delegated to the investment managers authority for exercising the voting rights attached to the Fund's investments. The Trustee supports the UK Stewardship Code ("the Code"). The terms of reference for the Fund's listed equity investment managers reflect their agreement to adhere to the Code. The Investment

Consultant has undertaken an independent assessment of these managers with regards to their compliance with the Code, which will be undertaken on an annual basis.

In addition to this annual assessment, the Trustee will conduct regular monitoring of stewardship activity on these issues.

9. Compliance with this Statement

The Trustee will monitor compliance with this Statement regularly, and in any event will review this Statement at least once every three years or sooner if there is any significant change in investment strategy. The Statement will also be reviewed in response to any material changes to any aspects of the Fund and its liabilities, finances and attitude to risk of the Trustee and Company which they judge to have a bearing on the stated investment policy. Any such review will be based on written expert investment advice and will be in consultation with the Company.

Agreed by the Trustee of the Rolls-Royce UK Pension Fund at a meeting on 19 September 2017