BAA Pension Scheme

Statement of Investment Principles – December 2015

1. INTRODUCTION

1.1 This Statement of Investment Principles (the "Statement") has been prepared by BAA Pension Trust Company Limited (the "Trustee") in its capacity as trustee of the BAA Pension Scheme (the "Scheme"). The Statement sets out the principles governing the Trustee's decisions about the investment of the Scheme's assets. The Trustee refers to this Statement when making investment decisions, to ensure that they are consistent with the principles set out in it.

1.2 The Statement is designed to meet the requirements of the Pensions Acts 1995 and 2004 as well as the Occupational Pension Schemes (Investment) Regulations 2005 and subsequent legislation (collectively referred to as the 'Pensions Acts').

1.3 The Scheme's investment arrangements, based on the principles set out in this Statement, are detailed in the Investment Policy Implementation Document ("IPID") which should be read in conjunction with this Statement.

1.4 The Trustee has obtained written professional advice from the Scheme's Investment Advisor in preparing this Statement and the accompanying IPID. The Trustee believes that the Investment Advisor meets the requirements of the Pensions Acts. In matters where the investment policy may affect the Scheme's funding policy, input has also been obtained from the Scheme Actuary. The Trustee will obtain similar advice whenever it reviews this Statement.

1.5 The Trustee's investment powers are set out within the Scheme's Trust Deed & Rules, subject to applicable legislation. If necessary, the Trustee will take appropriate legal advice regarding the interpretation of these. The Trustee notes that, according to the law, the Trustee has ultimate power and responsibility for the Scheme's investment arrangements.

1.6 The Trustee seeks to maintain a good working relationship with LHR Airports Ltd (the "Principal Employer") and will discuss any proposed changes to the Statement with the Principal Employer. However, the Trustee's fiduciary obligations to Scheme members will take precedence over the Principal Employer's wishes, should these ever conflict.

1.7 The Trustee believes that its investment policies and their implementation are in keeping with best practice, including the principles underlying the Myners Code of Best Practice for pension fund investment published in 2001, and subsequently updated.

1.8 The Trustee does not expect to revise this Statement frequently because the Statement covers broad principles. 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 Principal Employer that it judges to have a bearing on the Statement. This review will occur no less frequently than triennially. Any such review will again be based on written expert advice and will be in consultation with the Principal Employer.

2. SCHEME GOVERNANCE

2.1 The Trustee is responsible for the investment of the Scheme's assets but is permitted to delegate execution of these responsibilities. When determining which responsibilities to delegate, the Trustee has taken into account whether it has the appropriate training and is able to secure the necessary expert advice in order to take an informed decision. The Trustee's ability to execute the decision effectively is also taken into account.

2.2 The parties to whom specified duties and responsibilities have been delegated to on an ongoing basis are set out below. The Trustee may appoint additional parties from time to time to take on particular duties and responsibilities as detailed at the time of appointment.

2.3 The Trustee will undertake all elements of its duties and responsibilities conscientiously, diligently, with integrity and to the highest standards, acting in the best interests of the Scheme's beneficiaries. These duties and responsibilities, which are specified in detail in the Trustees' Job Description, may be summarised as:

(a) To act in accordance with the Trust Deed and Rules of the Scheme, within the framework of the law.

(b) To act prudently and honestly and with utmost good faith.

(c) To act in the best interests of the beneficiaries and strike a balance between the interest of different classes of beneficiary.

(d) To ensure the appropriate levels of knowledge, competence and capability are achieved.

(e) To take advice on technical matters and any other matters which they do not otherwise fully understand.

(f) To invest the funds and to arrange and manage such investments in the best interest of the beneficiaries.

Within this framework the Trustee acknowledges that responsibilities are divided into three categories, duties, powers and discretionary powers.

1) Duties are specific tasks which the Trustee must ensure are carried out, including those specified by statute.

2) Powers are rights which the Trust Deed and Rules give the Trustee.
3) Discretionary powers are those which permit the Trustee to make choices.

In order to achieve these aims the Trustee will ensure that the right set of skills is available, both collectively and from each individual director and that the right structures and processes are in place to ensure the Trustee's role is carried out effectively.

2.4 The Trustee has established the Investment Committee ("IC"). The Trustee has delegated responsibility for overseeing and monitoring the Scheme's investments to the IC:

Items to be monitored;

- The Scheme's funding level, on a quarterly basis.
- The investment managers, at least annually and more often on an exceptions basis (in the event of negative organisational developments, poor performance etc.).
- The Scheme's asset allocation and rebalancing.
- Any ad-hoc projects, such as manager selection exercises.
- Triennial investment strategy reviews.

2.5 An Investment Advisor has also been appointed by the Trustee. The Investment Advisor's role is to:

- Propose a process for implementing the Scheme's investment strategy.
- Monitor the incumbent Investment Managers and recommend changes as appropriate. Assist in the selection of new Investment Managers where relevant.
- Co-ordinate the implementation of investment management arrangements.
- Advise as to the implications of significant legislative, financial and economic changes.
- Review this Statement and recommend changes as required.
- Provide such advice as requested by the Trustee and IC.

The details of the Investment Advisor's appointment, including the scope of its remit and its fees are set out in a contract entered into between the Trustee and the Investment Advisor.

2.6 The Trustee has chosen to delegate day-to-day management of the Scheme's investments to the Investment Managers, in accordance with the Pensions Acts. The terms of each Investment Manager's appointment are contained in the Investment Management Agreement issued by the Investment Manager to the Trustee. The duties and the responsibilities of the Investment Managers are as follows:

- Operate within the conditions set down by the Investment Management Agreement.
- Select individual investments with regard to their suitability and diversification.
- Supply the Trustee with sufficient information each quarter to allow the review of activity and performance.

Details of the Scheme's strategic framework, within which the Investment Managers operate, are specified in the IPID. A listing of the Scheme's current Investment Managers (including a description of their mandates, and benchmarks) is also set out in the IPID.

2.7 The Custodian is responsible for the safekeeping of the Scheme's assets and performs the associated administrative duties (e.g. trade settlement, dividend collection, corporate actions, tax reclamation and proxy voting). The Custodian's duties and responsibilities are:

- Hold the Scheme's assets in safekeeping and conduct all related administration functions.
- Settle all investment trades as instructed by the Investment Managers.

The details of the Custodian's appointment, including service levels and fee details, are set out in a contract entered into between the Trustee and the Custodian.

2.8 The responsibility for selecting and monitoring the custodians of the investments managed within collective investment vehicles does not reside with the Trustee. The Trustee is satisfied with the arrangements in place.

2.9 The Scheme Actuary performs a valuation of the Scheme at least every three years, in accordance with regulatory requirements. The main purpose of the actuarial valuation is to assess the extent to which the Scheme's assets cover the accrued liabilities and agree the Recovery Plan.

3. INVESTMENT OBJECTIVE

3.1 The Trustee aims to invest the assets of the Scheme prudently to ensure that the benefits promised to members are provided as and when they fall due.

3.2 In setting the current investment strategy, the Trustee initially considered the lowest risk combination of assets in relation to the Scheme's estimated liabilities. The estimated liabilities are a series of projected cash flows calculated on assumptions contained in the valuation basis. In principle, the matching assets would be a combination of highly rated Government bonds that provided the same cash flows. However, it is unlikely that such a combination exists to provide a precise match. Further, certain characteristics of the liabilities cannot be matched in practice.

3.3 The combination of assets selected is intended to achieve a higher return than the lowest risk strategy while maintaining a prudent approach to meeting the Scheme's liabilities.

3.4 The overall objective of the Scheme is to reach an ongoing funding level of 100%, based on the Technical Provisions basis.

4. RISK, RETURN AND INVESTMENTS CONSIDERED

4.1 The Trustee recognises that it is not necessarily possible, or even desirable, to select investments that exactly match the Scheme's estimated liabilities. Given the ongoing commitment of the Principal Employer to the Scheme, the Trustee believes that a degree of investment risk can be taken on, in the expectation of generating excess returns relative to the lowest risk strategy, since it is also acceptable to the Principal Employer.

4.2 In deciding to take investment risk relative to the liabilities, the Trustee has carefully considered the following possible consequences:

- The assets might not achieve the excess return relative to the liabilities anticipated over the longer term. This would result in deterioration in the Scheme's financial position and consequently higher contributions than currently expected from the Principal Employer.
- The relative value of the assets and liabilities will be more volatile over the short term than if investment risk had not been taken. This will increase the likelihood of there being a shortfall of assets relative to the liabilities in the event of discontinuance of the Scheme. This consequence is particularly serious if it coincides with the Principal Employer being unable to make good the shortfall.
- This volatility in the relative value of assets and liabilities may also increase the short-term volatility of the Principal Employer's contribution rate set at successive actuarial valuations, depending on the approach to funding adopted.

4.3 The Trustee has taken advice on these issues. It has also held related discussions with the Principal Employer.

4.4 The Trustee's willingness to take investment risk is dependent on the continuing financial strength of the Principal Employer and its willingness to contribute appropriately to the Scheme. The financial strength and perceived commitment of the Principal Employer to the Scheme is monitored and the Trustee may reduce investment risk relative to the liabilities should either of these deteriorate.

4.5 The degree of investment risk the Trustee is willing to take also depends on the financial position of the Scheme. The Trustee will monitor the financial position of the Scheme and its liability profile, with a view to altering the investment objective, risk tolerance and/or return target should there be a significant change in either.

4.6 There are many different combinations of assets and investment management approaches that could be adopted in targeting a particular level of investment risk and/or expected return. The Trustee's objective is to identify those combinations that it believes are likely to maximise the return (net of all costs) for the level of risk taken.

4.7 The Trustee believes that diversification limits the impact of any single risk. However, the diversification of risk across multiple sources is constrained by the Trustee's ability to implement and effectively monitor the range of investments being considered.

4.8 The asset categories set out below are among those that have been considered in setting the Scheme's investment strategy. The Trustee has noted the risks that investing in these asset categories introduces relative to the liabilities. Deciding to invest in assets other than the matching assets is a source of *strategic risk*, of which the risks below are components:

4.8.1 UK Government bonds – although UK Government bonds are the lowest risk asset relative to the Scheme's liabilities, they are not risk free. *Interest rate risk* exists if the cash flow profile of the UK Government bonds held differs from that of the projected liabilities. *Inflation risk* exists if the assets and projected liabilities have different linkages to inflation.

4.8.2 Non-Government Sterling bonds – in addition to interest rate risk and inflation risk, investing in non-Government bonds introduces *credit risk*. Credit risk reflects the possibility that the payments due under the bond might not be made by the borrower.

4.8.3 Non-Sterling bonds – in addition to the risks listed above, investing in non-Sterling bonds adds *currency risk*. The Scheme's liabilities are denominated in Sterling but investing in non-Sterling assets means that the assets are not, unless the currency risk is hedged. Consequently, changes in exchange rates may impact the relative value of the assets and liabilities. Non-Sterling bonds may be issued by governments and non-governmental borrowers.

All interest bearing assets, including high yield bonds and emerging markets debt as well as cash, share the risk characteristics detailed above to varying degrees.

4.8.4 Equities – equities, whether public or private, represent an ownership stake in a company. The value of this stake is determined by the buyer and seller of the stake and there is no certain value to this investment (unlike the payments contracted under a bond, subject to credit and currency risk). A periodic payment, in the form of a dividend, might be made to an equity holder although the timing and amount of this is uncertain. The uncertainty of the return from equities relative to the liabilities is captured in the form of the *equity mismatch risk*. The equity mismatch risk may be broken down into the credit risk of the

underlying company, and the *volatility risk* associated with the stability of the price of the equity as well as currency risk for equities denominated in currencies other than Sterling among other risks.

4.8.5 Property – the return generated by an investment in property can be broken down into income and capital. The income component is subject to interest rate risk and inflation risk relative to the liabilities. There is also uncertainty as to the long-term level of the income. The capital value of the property is determined by the buyer and seller of the property and is not certain. The risks and uncertainty, including currency risk in the case of properties outside the UK, are captured within *property mismatch risk*. It should be noted that property is a relatively heterogeneous asset category, with sub-categories potentially exhibiting very different behavioural characteristics and attaching risk exposures.

4.8.6 Macro-orientated strategies – investments related to macro-economic factors, including interest rates, currencies and commodities. These strategies are often dependent on active management, as well as broader economic policies and factors.

4.8.7 Multi-strategy – investments which combine a range of different credit, equity and macro-orientated ideas. Multi-strategy portfolios typically hedge wider market risks and often use many different investment ideas at once, so that the overall return is not overly dependent upon any one strategy.

4.9 Active management introduces *active risk* into the combination of assets held.

4.9.1 Active management within an asset category is defined as holding a combination of securities that differs from the asset class benchmark.

4.9.2 Active management across asset categories arises when the combination of asset categories held differs from that of the benchmark.

4.9.3 Skill-based investment strategies (e.g. market-neutral and arbitrage strategies) are usually largely made up of active risk.

4.9.4 Manager selection risk arises due to the possibility of selecting an active manager that underperforms its benchmark net of management and transaction fees.

4.10 The risks associated with investing in derivatives are largely the same as those of investing in the underlying asset categories.

4.10.1 *Leverage* may be an additional risk introduced if the economic exposure arising from investing in a derivative is greater than the capital committed to the investment.

4.10.2 *Administrative risk* may also be present depending on the terms of the contract governing the derivative.

4.11 *Regulatory risk* arises from investing in a market environment where the regulatory regime may change. This may be compounded by *political risk* in those environments subject to unstable regimes.

4.12 *Liquidity risk* refers to the ease with which assets are marketable and realisable. This risk applies to all the asset categories listed above, albeit to varying degrees.

4.13 The Trustee acknowledges that it is not possible to monitor all the risks listed above at all times. However, it seeks to take on those risks it expects to be rewarded for over time, in the form of excess returns, in a diversified manner. The resulting combination of assets and investment management approaches has been selected to be consistent with the investment objective, risk tolerance and return considerations detailed above and is monitored periodically to ensure this remains the case.

5. STRATEGIC MANAGEMENT

5.1 The Scheme-specific Strategic Asset Allocation, a high-level asset distribution for the Scheme's investments, has been determined to reflect the strategic risk that the Trustee has decided to take. The detail of the Benchmark and the associated investment management structure is set out in the IPID.

5.2 The combination of assets underlying the Strategic Asset Allocation has been selected based on assumptions as to the future behaviour of the individual asset categories relative to the Scheme's liabilities. Observed behaviour and future behaviour from the point of observation will likely differ from the assumptions used in the decision making process. Consequently, the Trustee monitors the progression of the Scheme's financial position, given the investment objective set above, to assess whether the realised outcome is proving consistent with the level of risk expected. The Trustee reviewed the Scheme's investment objectives and Strategic Asset Allocation in 2014, in conjunction with the actuarial valuation.. The changes introduced subsequently are reflected in the IPID. The Trustee acknowledges that the actual allocation may deviate from the one outlined in the IPID.

5.3 Each of the asset categories held is expected to make a specified contribution to the overall return profile of the Scheme, as per the assumption of future behaviour. Regular reporting, on a frequency as specified in the IPID, serves as a check as to whether the expectation is being realised. The return may be broken down between the strategic return, arising from investing in the specified asset category, and the active return, arising from the actions of the Investment Managers. Selection, risk management and monitoring related to the Investment Managers are discussed in the next Section.

6. MANAGING THE INVESTMENT MANAGERS

6.1 Day-to-day management of the assets is delegated to the Investment Managers, in accordance with the relevant Investment Management Agreements and attaching guidelines.

6.2 The IC and Trustee have taken advice from the Investment Advisor in selecting and retaining the Investment Managers. Each Investment Manager has been chosen for its perceived expertise in managing the specified brief according to the guidelines set by the Trustee or its delegates as captured in the Investment Management Agreement.

6.3 Each brief has an explicit outperformance target relative to its stated benchmark. Risk management parameters are also included in some of the briefs. The timescale of performance measurement and assessment is specified too.

6.4 The Trustee accepts that it is not possible to specify investment restrictions where assets are managed via pooled funds. Nevertheless, notwithstanding how the assets are managed, the Trustee takes appropriate legal and investment advice regarding the suitability of the relevant investment vehicles.

6.5 Performance of each Investment Manager is measured independently by the Performance Measurer. Performance is measured monthly and aggregated to facilitate comparison over longer periods. Performance is also aggregated across Investment Managers in order to calculate Scheme returns.

6.6 The Trustee retains the Investment Advisor to provide further help with monitoring the Investment Managers. The Investment Advisor provides quantitative analysis of the Investment Managers' portfolios as well as qualitative advice related to the factors likely to affect the Investment Managers' performance in future.

7. SOCIALLY RESPONSIBLE INVESTMENT

The Trustee's policy is that its Investment Managers should take account of social, environmental and ethical considerations in the selection, retention and realisation of investments to the extent material to the value of the investments, and where to do so would not prejudice the best long-term financial interests of the Scheme, more generally.

8. CORPORATE GOVERNANCE

The Trustee wishes to encourage best practice in terms of activism. It therefore encourages its managers investing in equities to discharge their responsibilities in respect of investee companies in accordance with the Statement drawn up by the Institutional Shareholders' Committee.

9. CASHFLOW MANAGEMENT AND REBALANCING

9.1 A working cash balance is held for imminent payment of benefits and expenses. Under normal circumstances it is not the Trustee's intention to hold a significant cash balance.

9.2 In general, the Scheme's Investment Managers have discretion in the timing of realisations of investments and in considerations relating to the liquidity of those investments. The Trustee will notify the Investment Managers of any amounts that need to be realised from their portfolios for the payment of benefits or expenses, and the timing of such realisations.

9.3 The Trustee recognises that there is a risk in holding assets that cannot be easily realised should the need arise. Thus, the majority of the assets held are realisable at short notice through either the sale of units in pooled funds, or the sale of assets as part of the segregated mandate.

10. COMPLIANCE WITH THIS STATEMENT

10.1 The Trustee will review compliance with this Statement periodically, and normally annually. Each Investment Manager will periodically be requested to provide written confirmation that they have complied with the terms of their agreement with the Trustee and all applicable statutory and regulatory requirements.

10.2 The Trustee undertakes to advise the Investment Managers promptly and in writing of any material change to this Statement.

10.3 A copy of this Statement has been provided to the Principal Employer, Investment Advisor, Investment Managers, Performance Measurer, Custodian and Scheme Actuary.

Signed on behalf of BAA Pension Trust Company Limited (the Trustee of the BAA Pension Scheme).

Signed: _____ Date: _____

Name: _____

Signed: _____ Date: _____

Name: _____