Statement of Investment Principles – Gallaher "M" Pension Scheme

Introduction

This Statement of Investment Principles (SIP) has been prepared by the Trustee of the Gallaher "M" Pension Scheme ("the Scheme") to comply with the requirements of the Pensions Act 1995, as amended, and the Occupational Pension Schemes (Investment) Regulations 2005.

Effective Date

This SIP is effective from 1 August 2020.

1. Strategy

Investment Objectives

The Trustee's strategic objectives are:

- To target over the long term a return on the investments which aims to maintain the ongoing funding level of the Scheme (with a comfortable margin above the self-sufficiency basis).
- To seek to preserve the security of member's benefits having regard to the risks associated with the target levels of return.

The Trustee recognises that depending on the current level of funding the Scheme requires a strategy to be implemented which is intended to produce a return either in line with or above that assumed by the Actuary in the March 2017 valuation. In determining its objectives the Trustee is mindful of the Company's ability and willingness to pay contributions.

The Trustee also believes that environmental, social and corporate governance (ESG) factors (including climate change) can impact investment risk and return.

Allocation of Assets

The Trustee has divided the assets of the Scheme into two portfolios.

The **Risk Reducing Portfolio** is designed to invest in assets which can be expected to match the interest rate and inflation sensitivity of a proportion of the expected liability cashflows of the full membership. The Risk Reducing Portfolio is mainly invested in bonds.

The **Return Seeking Portfolio** is invested with a longer term horizon to generate the returns required to maintain or improve the Scheme's funding level.

This Portfolio is principally invested in equities. There are various Units available for investment (within a Common Investment Structure) to allow the pooling of assets with the Gallaher "A" Scheme to provide economies of scale.

The current strategic weighting to the Risk Reducing Portfolio is 92.5% of total Scheme assets. The strategic weighting to the Return Seeking Portfolio is 7.5%. The size of the two portfolios will vary due to market movements and will be kept under review by the Trustee.

Risks

The Scheme is exposed to a number of different risks. These include risks relating to:

- Funding – insufficient assets to cover 100% of the accrued liabilities
- Mismatching – a difference in the sensitivity of asset and liability values to financial and demographic factors
- Cash flows – a shortfall of liquid assets to pay benefits
- Investment managers – a failure to meet target returns
- Diversification – inadequate spread of investments
- Covenant – the possibility of failure of the Scheme's sponsor
- Operations risk – fraud, poor advice or negligence.
- Credit risk - possibility of failing to fully meet obligations to investors
- Market risk – This comprises currency risk, interest rate risk and other price risk.
  - Currency risk: value of an asset will fluctuate due to changes in foreign exchange rates.
  - Interest rate risk: value or future cash flows of an asset will fluctuate because of changes in market interest rates.
  - Other price risk - value or future cash flows of an asset will fluctuate because of changes in market prices other than those arising from interest rate risk or currency risk

The Trustee mitigates these risks by careful structuring of its funding and investment management arrangements and by contracts with the fund managers. It also closely monitors these risks and receives formal quarterly reports on funding, cash flows, investment managers (including performance) and diversification. Mismatching is reviewed as part of the triennial actuarial valuation process and at least annually as part the LDI portfolio monitoring process. Operational risk is reduced as far as possible by due diligence on the appointment and review of managers and advisers, and by contracts of engagement.

The Trustee measures and manages investment specific risks such as credit risk and market risk of the Scheme on a regular basis. In the case of market risk the Trustee makes the distinction between risks that arise from interest rate exposure, currency exposure and other price risk. All investments are subject to idiosyncratic price risks that arise from factors peculiar to that asset class or individual investment in addition to credit risk, currency risk and interest rate risk.

Before investing in any asset class, or entrusting the Scheme's assets to the management of a particular manager, the Trustee takes advice from its investment consultant. The decision as to whether to invest in a particular security is delegated to the investment managers within specified investment restrictions.

The purpose of accepting these risks is to ensure that, when considered as a whole, the assets of the Scheme generate required expected future returns.

These risks are managed by ensuring that the Scheme is well diversified both across asset classes and within each asset class. In addition the Trustee takes advice from its investment consultant as to the continuing suitability of the asset classes and managers in which it invests.

The Trustee receives regular reports from fund managers and the investment consultant setting out the nature and extent of the risks in the Scheme's assets.

2. Implementation

Risk Reducing Portfolio

This Portfolio is currently invested in conventional gilts, index linked gilts and corporate bonds, and is managed in a mix of segregated account and pooled funds by Insight Investment. The portfolio contains a Buy and Maintain corporate bond mandate, a legacy supranational bond portfolio and a Liability Driven Investment ("LDI") portfolio (made up of gilts and index-linked gilts) designed to replicate the liability profile of the Scheme. Specifically, LDI is designed to reduce the volatility of the Scheme's funding level, by protecting against interest rate and inflation risks. Insight manages the LDI portfolio with reference to the Scheme's cashflow benchmark and also takes into account the hedging characteristics of the corporate bonds.

Return Seeking Portfolio

This Portfolio is invested in the Common Investment Fund (CIF) which consists of two Units (Global Equity and Hedge Funds) all actively managed. The percentage allocations for the managers stated below are the strategic weights but will vary over time depending on market conditions

Global Equity Unit:

Walter Scott actively manages a portfolio of global equities, comprising 50% of the total return seeking assets, which is aiming to deliver strong positive absolute returns over the long term.

Baillie Gifford actively manages a portfolio of global equities which accounts for 50% of the total return seeking assets. The investment objective is to outperform the MSCI All Country World Index by 2% to 3% per annum (before fees) over rolling five year periods.

Hedge Fund Unit (legacy):

Cardano manages a fund of hedge funds which accounts for about 2% of the total return seeking assets. The Trustee issued a redemption request for the Scheme's investment in Q2 2018 and is expected to be fully redeemed by 2021. Redemption proceeds are monitored and used to manage the Scheme's cashflow requirements where appropriate.

Choosing investments

Individual investment managers have discretion in the timing of the purchase and sale of investments and in considerations relating to the liquidity of those investments. The Trustee may sell assets to fund the Scheme's benefit outgoings and other expenditure.

3. General

Additional Voluntary Contributions (AVCs)

AVCs are invested in assurance policies with the Equitable Life Assurance Society and Zurich Assurance Limited and LGIM (from 1 October 2020), depending on the choices made by contributors.

Environmental, Social and Governance Considerations

In setting the Scheme's investment strategy, the Trustee's primary concern is to act in the financial interests of the Scheme and its beneficiaries, seeking the best return that is consistent with a prudent and appropriate level of risk.

The Trustee believes that environmental, social and corporate governance (ESG) factors (including climate change) can impact investment risk and return. The Trustee considers this risk and takes advice from the investment adviser when setting the Scheme's asset allocation, when selecting managers and when monitoring their performance.

The Trustee regularly monitors how managers integrate ESG into their processes, aided by the provision of reports and updates from its managers and the investment adviser.

Stewardship – Voting and Engagement

The Trustee recognises the importance of its role as a steward of capital and the need to ensure the highest standards of governance and promotion of corporate responsibility in the underlying companies and assets in which the Scheme invests, as this ultimately creates long-term financial value for the Scheme and its beneficiaries.

As part of its delegated responsibilities, the Trustee expects the Scheme's investment managers to**:**

- Engage with investee companies (both debt and equity) with the aim of protecting and enhancing the value of assets; and
- Exercise the Trustee's voting rights in relation to the Scheme's assets
- Take into account social, environmental or governance considerations in the selection, retention and realisation of investments.

The Trustee regularly reviews the suitability of the Scheme's asset managers and takes advice from its investment consultant on possible changes. This advice includes consideration of broader stewardship matters and the exercise of voting rights and engagement by the appointed managers. If an incumbent manager is found to be falling short of the standards the Trustee expects, the Trustee will engage with the manager to understand the approach and seek a more sustainable position, and may ultimately replace the manager.

The Trustee reviews the stewardship activities of its asset managers annually, covering both engagement and voting actions.

Members' Views and Non-Financial Factors

In setting and implementing the Scheme's investment strategy the Trustee does not explicitly take into account the views of Scheme members and beneficiaries in relation to ethical considerations, social and environmental impact, or present and future quality of life matters (defined as "non-financial factors"[1]).

Corporate Governance

The Trustee supports the Institutional Shareholders Committee Code on the Responsibilities of Institutional Investors and expects its investment managers to act in accordance with the Code. The Scheme's investment managers should exercise the voting and other rights attached to investments in the interests of the beneficiaries.

Arrangements with asset managers

The Trustee evaluates the investment managers' performance against the specific mandate that was agreed. The Trustee will also periodically review the suitability of the Scheme's mandates in the context of the Scheme's wider investment strategy, including considering whether the balance between different kinds of investments remains appropriate, the expected return on the investments and the risks to which the Scheme is exposed.

The Trustee appoints investment managers with an expectation of a long-term partnership. When assessing a manager's performance, the focus is on longer-term outcomes so appointments would not usually be terminated as a result of poor short-term performance. However, a manager's appointment could be terminated within a shorter timeframe due to other factors such as a significant change in business structure or the investment team.

There is no set duration for arrangements with asset managers and their performance and continued appointment is reviewed quarterly.

The Trustee takes ESG factors into consideration, where appropriate, in the selection of investments, for example agreeing at a strategic level how to incorporate these factors into the asset allocation and considering managers' ESG approach when appointing new managers. Before investing, the Trustee will seek to understand the manager's approach to sustainable investment (including engagement). When investing in a pooled investment vehicle, the Trustee will ensure the investment objectives and guidelines of the vehicle are consistent with its own objectives. This process ensures manager incentives are aligned with the Trustee's goals.

Should the Trustee monitoring process reveal that a manager's portfolio is not sufficiently aligned with the Trustee policies (including ESG), the Trustee will engage with the manager further to encourage alignment. If, following engagement, it is the view of the Trustee that the degree of alignment remains unsatisfactory, the manager appointment will be terminated.

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[1] The Pension Protection Fund (Pensionable Service) and Occupational Pension Schemes (Investment and Disclosure) (Amendment and Modification) Regulations 2018

Cost Monitoring

Understanding costs:

The Trustee is aware of the importance of monitoring its asset managers' total costs and the impact these costs can have on the overall value of the Scheme's assets. The Trustee recognises that in addition to annual management charges, there are a number of other costs incurred by its asset managers that can increase the overall cost incurred within the investment portfolio.

The Trustee intends to collect annual cost transparency reports covering all of its investments in line with the appropriate Cost Transparency Initiative (“CTI”) template for each asset class. This allows the Trustee to understand exactly what costs are incurred across the investment portfolio.

Evaluation of performance and remuneration:

The Trustee assesses the performance of its investment managers quarterly and the remuneration of its investment managers at least annually. Investment Managers are paid fees for their services based on the value of the Scheme’s assets under management. This is in line with normal market practice and the level of these fees is reviewed against competitive market levels with input from the investment consultant.

Portfolio turnover costs:

The Trustee monitors portfolio turnover costs (defined as the costs incurred as a result of the buying and selling of investments) with input from the investment consultant and through the MIFID II compliant cost reporting received from managers.

The Trustee accepts that some transaction costs need to be incurred to drive investment returns. The level of these costs varies across asset classes and by manager style within an asset class. For this reason there is no overall target for portfolio turnover and this is reviewed on a case by case basis depending on market circumstances and manager strategy.

Custody & Accounting

Northern Trust has been appointed as the Scheme's Custodian. The Custodian provides safekeeping for the Scheme's assets, collects income, deals with corporate actions and provides performance measurement and certain accounting services. Some assets, e.g. assurance policies, are directly held by the Trustee.

Investment Adviser

Aon has been appointed as Investment Adviser. It has the knowledge and experience required under the Pensions Act 1995.

Review of SIP

This SIP will be reviewed at least every three years or immediately following a change of investment policy. Written advice on any changes will be taken from the Investment Adviser, and the Sponsoring Company, Gallaher Limited (part of the JTI group of companies) will also be consulted.
