**Southern Water Pension Scheme**

**Statement of Investment Principles (the "Statement") – June 2023 (replaces September 2020)**

## 1. Introduction

This Statement has been prepared by Dalriada Trustees Limited (the "Trustee") as the trustee of the Southern Water Pension Scheme (the "Scheme"). It sets out the principles that govern the decisions about the investment of the Scheme's assets. The Trustee will refer to this Statement when making investment decisions to ensure that they are consistent with these principles.

The Scheme's investment arrangements, based on the principles set out in this Statement, are detailed in the Investment Policy Implementation Document ("IPID") which is available on request. The IPID will be reviewed promptly in response to any changes to the manager structure or investment strategy.

In preparing this Statement, the Trustee has obtained written advice from the Scheme's Investment Consultant (Willis Towers Watson).

The Trustee's investment powers are set out within the Scheme's governing documents and relevant legislation.

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

The Trustee believes that its investment policies are in keeping with the Pensions Act 1995 and subsequent legislation.

The Trustee does not expect to revise this Statement frequently because it covers broad principles. However, it will be reviewed at least once every three years and without delay after any relevant, material changes to the Scheme or relevant regulation.

## 2. Roles and Responsibilities

The Trustee is accountable for the investment of the Scheme's assets. This includes setting investment objectives, establishing risk and return targets, setting the Scheme's strategic benchmark, investment manager structure and monitoring performance. In addition the Trustee has appointed a firm of professional consultants (the "Investment Consultant") to provide relevant advice. The Trustee also takes advice from the Scheme Actuary and other professional advisors where appropriate.

The Investment Managers are responsible for the day-to-day management of the Scheme's assets in accordance with the guidelines agreed with the Trustee. The Investment Managers have discretion to buy, sell or retain individual securities in accordance with these guidelines. The Investment Managers report to the Trustee regularly regarding performance. In addition, the Investment Consultant provides monitoring of the Scheme's Investment Managers and the Scheme's assets in aggregate.

The Custodians are responsible for the safekeeping of the Scheme's assets, whether appointed directly by the Trustee (in the case of segregated accounts) or by the Investment Managers (in the case of holdings in collective vehicles) and for performing the associated administrative duties (e.g. trade settlement, dividend collection, corporate actions, tax reclamation and proxy voting).

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 an appropriate funding strategy for the Scheme. In addition, the Scheme Actuary provides quarterly funding updates, monitoring the movement of assets and liabilities over the period.

The Investment Consultant and Scheme Actuary's fees are determined in line with agreed hourly rates, although specific fees may be agreed for particular projects. Investment Managers are paid an ad valorem fee, in line with normal market practice, based on the value of assets that they manage for a given scope of services which includes consideration of long-term factors and engagement. Some of the managers may be pad incentive fees based on the performance achieved. In addition to management fees, investment managers may charge custodian fees and other third party expenses.

The Trustee reviews the costs incurred in managing the Scheme's assets annually, which includes the costs associated with portfolio turnover. In assessing the appropriateness of the portfolio turnover costs at an individual manager level, the Trustee will have regard to the actual portfolio turnover and how this compares with the expected turnover range for that mandate.

Further details of the fee structures are provided in the IPID.

## 3. Investment Objectives

The Trustee considered a number of possible objectives in order to set an appropriate investment strategy for the Scheme before agreeing on the following:

- Over the long-term, to restore the Scheme's ongoing funding position against technical provisions ("TP"), as set out in the Statement of Funding Principles, by relying on a balance between contributions and investment returns to achieve this goal.

- To achieve the above with due regard to risk.

## 4. Risk and Return Targets

The Trustee recognises that, with the development of modern financial instruments, it could be possible to select investments that are similar to the estimated liability cash flows. However, in order to meet the long-term funding objective within a level of contributions that the Employer has indicated it is willing and able to make, the Trustee has agreed to take some investment risk relative to the liabilities. This taking of investment risk seeks to target a greater return than the matching assets would provide while maintaining a prudent approach to meeting the Scheme's liabilities. The Trustee consider these points to be financially material considerations that are relevant to the likely time horizon of the Scheme's investments.

Before deciding to take investment risk relative to the liabilities, the Trustee considered carefully the following possible issues:

- Over the short-term, the inclusion of investment risk will mean that the relative value of the assets and liabilities will be more volatile 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 a discontinuance of the Scheme. This consequence is particularly serious if it coincides with the Employer being unable to make good the shortfall.

- The increased volatility in the relative value of assets and liabilities from taking investment risk may also increase the short-term volatility of the Employer's required contribution rate.

- The ability of the Employer to take investment risk is dependent on the continuing financial strength of the Employer and its ability and willingness to contribute appropriately to the Scheme.

Having regard to the above issues, the Trustee has adopted investment arrangements that it believes offer an acceptable trade-off between risk and return. The investment strategy makes use of three key types of investments:

1. A range of instruments that provide a match to changes in liability values
2. An allocation to return-seeking assets, which may include equities, corporate bonds, property, private equity, infrastructure, emerging market debt and hedge funds
3. Both actively and passively managed portfolios.

Following a review of the Scheme's investment strategy, the Trustee has agreed to target a constant return relative to liabilities before transitioning to a low risk portfolio once full funding on the TP basis has been reached. The Trustee intends also to review the degree of liability "hedging" provided by the Scheme's matching assets and may increase the level of hedging independent of the target allocation to growth and matching assets.

The Trustee's policy is periodically to review the nature of the financial risks within the Scheme and to take action to mitigate those risks deemed unlikely to contribute to outperformance of the assets (relative to the liabilities), where it considers it practical and desirable to do so.

## 5. Policy on Risk

There are various risks to which any pension scheme is exposed, which the Trustee believes may be financially material to the Scheme. The Trustee's policy on risk management over the Scheme's anticipated lifetime is set out below.

The Trustee has chosen to employ active management in some of the asset classes managed. It has selected Investment Managers whom it believes have the skill and judgement to add value net of fees. Active management gives rise to *active risk*, which arises due to the potential for selecting an active manager that underperforms its benchmark net of management and transaction fees. Though the use of active management increases risk, the Trustee believes this is outweighed by the potential gains from successful asset management. In those asset classes where the Trustee believes that the risk of using active management is unlikely to be rewarded, index tracking management is used.

In order to manage the active risk, the Trustee monitors the Investment Managers performance on a quarterly basis and compares the investment returns with the appropriate performance objectives to ensure continuing acceptable performance.

Across all of the Scheme's investments, the Trustee is aware of the potential for regulatory and political risks. *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.

The Trustee is also aware of *concentration risk* which arises, for example, when a high proportion of the Scheme's assets are invested in securities, whether debt or equity, of the same or related issuers. The overall investment arrangements are intended to provide an appropriate spread of assets by type and spread of individual securities within each asset class.

The Trustee regularly reviews the Scheme's *solvency risk* and *mismatching risk* by monitoring the level of strategic risk against the liabilities. Solvency levels are monitored through ongoing triennial actuarial valuations.

The Trustee acknowledges that it is not possible to monitor all the risks listed above at all times. However, it has sought to take on those risks which it expects to be rewarded for over time, in the form of excess returns, in a diversified manner.

In addition, the Trustee is required to provide narrative disclosures in the Trustee Annual Report and Accounts on the credit and market risks arising from its investment arrangements. These risks are defined as follows:

- *Credit risk*: this is the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation. This is managed through the diversification of the Scheme's credit exposures and the use of a skilled investment manager to select credit investments.

- *Market risk*: this is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices. Market risk comprises three types of risk: currency risk, interest rate risk and other price risk, each of which is further detailed as follows:

  - *Currency risk*: this is the risk that the fair value or future cash flows of a financial asset will fluctuate because of changes in foreign exchange rates. This is mitigated through investing a significant proportion of the Scheme's assets in sterling denominated investments.

  - *Interest rate risk*: this is the risk that the fair value or future cash flows of a financial asset will fluctuate because of changes in market interest rates. This is managed through holding a portfolio of matching assets (comprising physical bonds and derivatives) to seek to broadly match movements in the Scheme's liabilities.

- *Inflation risk*: this is the risk that the fair value or future cash flows of a financial asset will fluctuate because of changes in inflation rate. This is managed through holding a portfolio of matching inflation-linked assets intended to provide a broad match to changes in the Scheme's liabilities caused by movements in inflation.

- *Other price risk*: this is the risk that the fair value or future cash flows of a financial asset will fluctuate because of changes in market prices (other than those arising from interest rate risk or currency risk), whether those changes are caused by factors specific to the individual financial instrument or its issuer, or factors affecting all similar financial instruments traded in the market. This is managed by holding a diversified portfolio of return-seeking assets.

- *Derivatives risks*: these are the risks that arise from using leveraged derivatives instruments within the Scheme. The key risks arising from the use of derivatives are as follows:

  - *Counterparty risk*: this is the risk that a financial institution which is a counterparty to a transaction fails to deliver its side of the agreement. This is managed through the daily collateralisation of derivatives contracts.

  - *Basis risk:* the risk that the returns from backing assets used to meet the payable leg of a derivative contract do not match exactly the payment to be made. This is managed through the investment policy adopted by the Trustee and the skill of the Scheme's investment managers.

  - *Legal and operational risk:* the successful operation of derivatives depends on the various legal documents governing the derivative contracts and the correct completion of operational tasks. This is managed through the professional advice taken by the Trustee and the skill of the Scheme's investment managers.

  - *Liquidity risk:* the risk that changes to market conditions could lead to the Fund needing to post additional collateral at short notice in order to maintain the Fund's liability hedging arrangements. This risk is managed through the investment strategy adopted by the Trustee and the guidelines provided to the Scheme's investment managers.

Considerations specific to Environmental, Social and Governance ("ESG") issues are addressed in Section 10.

## 6. Strategic benchmark

The Trustee has previously agreed a journey plan under which the Scheme will target a constant return above liabilities in order to reach full funding on the TP basis. The target allocation may change over time as the Scheme progresses.

Following completion of the 2022 valuation the Scheme's investment strategy is currently under review and the strategic asset allocation will reflect the trade-off between risk and return which the Trustee considers appropriate.

The Trustee has established a high-level investment manager structure, for dividing the assets amongst different types of managers. The current overall investment manager structure is set out in detail in the IPID.

## 7. Investment managers

The Scheme uses many different managers and mandates to implement its investment policies. The Trustee ensures that, in aggregate, its portfolio is consistent with the policies set out in this Statement. The Trustee will also ensure that the investment objectives and guidelines of any particular pooled vehicle are consistent with its policies, where relevant to the mandate in question. Where segregated mandates are used, the Trustee will use its discretion, where appropriate, to set explicit guidelines within the Investment Management Agreement to ensure consistency with the Trustee's policies, where relevant to the mandate.

To maintain alignment with the SIP, investment managers are provided with the most recent version of the Scheme's Statement of Investment Principles upon updates and are required to confirm that the management of assets is consistent with those policies.

As part of its engagement policy, the Trustee monitors the Scheme's investment managers on at least an annual basis in order to assess the sustainable investment, stewardship (including voting) and ESG characteristics and managers' engagement activities. Should the Trustee's monitoring process reveal that a manager's portfolio is not aligned with the Trustee's policies, 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 may be replaced.

Day-to-day management of the assets is delegated to professional Investment Managers who are all regulated by the Financial Conduct Authority (the "FCA") or the relevant regulatory authority.

The Investment Managers have full discretion to buy and sell investments on behalf of the Scheme, subject to agreed constraints. They have been selected for their expertise in different specialisations and each manages investments for the Scheme to a specific mandate, which includes performance objectives, risk parameters, and timescales over which their performance will be measured. The IPID gives details of each Investment Manager's mandate as set out in their respective investment management agreements.

The Trustee's main objectives when considering the selection of Investment Managers are as follows:

(1) For active management, to select a combination of investment products that together (though not necessarily individually) would generate the maximum, net of fees, added value over the benchmark, given the Scheme's tolerance for risk;

(2) To employ highly-rated Investment Managers, according to the Investment Consultant's research, wherever possible (subject to objective 1);

(3) To minimise potential transition costs by retaining the incumbent managers where possible (subject to (1) and (2) above), but allowing for the fact that the cost of making a change can easily be outweighed by superior future performance.

The Trustee regularly assesses the continuing suitability of the Scheme's Investment Managers. The Investment Consultant provides help in monitoring the Investment Managers, both in the form of written reports and attendance at meetings.

The Trustee will review the appointment of any Investment Manager for any reason it considers appropriate. The Trustee appoints its investment managers with an expectation of a long-term partnership, which encourages active ownership of the Scheme's assets.

The Trustee expects the investment managers to invest with a medium to long time horizon, and to use their engagement activity where possible to drive improved performance over these periods.
When assessing a manager's performance, the focus is on longer-term outcomes, and the Trustee would not expect to terminate a manager's appointment based purely on 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.

## 8. Investment Restrictions

Formal investment management arrangements have been drawn up between the respective Investment Managers and the Trustee, or are set out in the governing documents of pooled investments, within which strict guidelines and investment restrictions for the manager are specified.

## 9. Selection, Retention and Realisation of investments

Within individual mandates, the investment managers have discretion in the timing of the selection, retention and realisation of investments and in considerations relating to the liquidity of those investments, subject to the relevant appointment documentation and pooled fund governing documents. The majority of the Scheme's assets are held in liquid investments. The Trustee's policy is to select, retain and realise assets consistent with maintaining the overall investment strategy. The Trustee receives regular advice from the Scheme's investment consultant to guide decisions on which mandates should be targeted in order to meet ongoing requirements to sell assets to meet benefit outgo net of all contributions received.

## 10. Responsible Investment and Corporate Governance

The Trustee believes that good stewardship and environmental, social and governance ("ESG") issues may have a financially 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. Given the Trustee's investment objectives, the potential longer term impact of these issues are relevant to the Scheme.

The Trustee has given the appointed investment managers full discretion when evaluating ESG issues, including climate change considerations, and exercising voting rights and stewardship obligations attached to the Scheme's investments.

Similarly, the Scheme's voting rights are exercised by its investment managers in accordance with their own corporate governance policies, and taking account of current best practice including the UK Corporate Governance Code and the UK Stewardship Code. However, the Trustee recognises that it remains responsible for the votes cast on its behalf by the Scheme's investment managers.

In accordance with the PLSA's Voting and Engagement Guidelines, the Trustee has agreed on two priorities for stewardship, which are communicated to the investment managers.

These are climate change and sustainability, and corporate governance.

There is an expectation that the Scheme's investment advisor will keep the Trustee informed on ESG issues.

The Trustee considers how ESG, climate change and stewardship is integrated within investment processes in appointing new managers. The Trustee also monitors its existing managers' ESG practices as part of the Scheme's quarterly monitoring reports, and discusses ESG considerations as part of ongoing reviews.

Non-financial matters (as defined in the Regulations) are not taken into account when determining the Scheme's investment policy. Member views are not actively sought but the Trustee regularly updates members via newsletters and by making a copy of the Statement of Investment Principles available on request.

As part of its engagement policy, the Trustee monitors the Scheme's investment managers on at least an annual basis in order to assess other relevant matters including capital structure of investee companies and the associated management of actual and potential conflicts, other stakeholders and the ESG impact of underlying holdings.

## 11. Additional Voluntary Contribution Assets ("AVCs")

The Trustee has full discretion as to the vehicles made available for members' AVCs. Only investment vehicles that are considered suitable for AVC investment are considered by the Trustee having taken appropriate advice. Nevertheless, members are expected to take independent financial advice when choosing an AVC vehicle.

It is closed to new contributions.

Dalriada Trustees Limited as Trustee of the Southern Water Pension Scheme