Investment Beliefs Vodafone Group Pension Scheme

1. The sponsor's covenant strength in combination with the Master Agreement allows the Trustee to take equity and other risk which the Trustee believes to be rewarded, but in order to manage short term risk a certain amount of diversification is prudent.

2. Managing downside risk and achieving attractive net returns is essential, but both come with an unavoidable amount of complexity, this complexity must be managed through a strong governance structure.

3. Passive investing is appropriate for some but not all asset classes.

4. As a relatively long-term investor, the Trustee can exploit an illiquidity premium, but liquidity needs will change over time and must be managed with robust modelling and stress testing.

5. The Trustee's Responsible Investment policy highlights that Environmental, Social and Governance (ESG) factors can have an impact on financial performance, and it is therefore part of Trustee's fiduciary duty to incorporate these factors into investment decisions. The Trustee believes that this helps to reduce investment risk, and in some cases enhances long-term investment returns.

6. The additional governance burden associated with tactical decision making is not sufficiently rewarded, but when opportunities in markets arise to expedite strategic changes the Trustee will consider them.

7. Alignment of interest between Trustee, sponsor and other stakeholders improves the prospect of achieving the Trustee's objectives.

Appendix – elaboration on investment beliefs

1. **The sponsor's covenant strength in combination with the Master Agreement allows the Trustee to take equity and other risk which the Trustee believes to be rewarded, but in order to manage short term risk a certain amount of diversification is prudent.**

   - The Trustee relies on sponsor's strength to be able to keep Scheme's finances in a healthy position - even if substantial return portfolio losses were to occur.
   - As a result, and in-line with the Master Agreement, the Scheme is able to take more risk and therefore can run a larger growth portfolio and higher target return than it would have without a strong sponsor.
   - Consequently, the size of the hedging portfolio can be smaller and less interest rate and inflation rate hedging is necessary until the scheme's funding position improves and de-risking in-line with the Master Agreement occurs.
   - Even so, there are circumstances where the timing of a cash call on the sponsor following a substantial market downturn could be inconvenient.
   - Some degree of diversification within the growth portfolio is therefore prudent, to dampen the correlation between the Scheme's finances and those of the sponsor.

2. **Managing downside risk and achieving attractive net returns is essential, but both come with an unavoidable amount of complexity, which must be managed through a strong governance structure.**

   - As the Scheme matures, downside risk management becomes increasingly important. Why?
      i. Payments to pensioners increase relative to the sponsor's contributions. This increases the importance of achieving positive investment returns and – even more importantly - avoiding negative returns.
      ii. The impact of a period of bad investment returns will be less easily compensated for by subsequent good investment returns if the portfolio is gradually liquidated to pay out pensions. This is because divesting the portfolio effectively locks in returns and hence reduces the opportunity to recover from a period of bad returns.

- Managing downside risk and achieving positive returns *every single year* thus becomes more and more important for the Scheme over time.
- This requires superior risk management skills and risk modelling ability.
- It also requires sourcing and management of attractive investment opportunities, *which are necessarily more complex* than 'just' running an equity portfolio.
- This in turn requires the Trustee to have a strong governance structure so that the Trustee can provide effective oversight over investment and risk management decisions that are delegated to professionals. To ensure this the Trustee it is required to have the skills to ask the right questions and fully understand the answers.

3. **Passive investing is appropriate for some but not all asset classes. Specifically, any illiquid investments and credit related investments where benchmark exposure would lead to over exposure to large borrowers will be actively managed; any developed markets equities where investment skill is unlikely to consistently translate into outperformance will be passively managed; other asset classes to be judged against these principles.**

- There is no right and wrong in the passive versus active debate.
- Note that most investment managers and consultants have a vested interest in talking up the importance of active management.
- Overall, then actively managed investments cannot outperform the market. This means that for every investment that has outperformed the market, there is likely to be another that has not.
- *After fees* and costs are taken into account, *the vast majority of active investors lose money* relative to the benchmark. This supports the argument for <u>passive</u> investing.
- The *counter argument* is that if all schemes just invest in the benchmark, there will be a tremendous opportunity to outperform the benchmark by analysing companies' performance and predicting which ones will be winners and which losers before company results (and potential defaults) determine this.
- Consequently, there is <u>no generic right answer</u> to the active/passive question.
- The development of smart benchmarks, credit screened indices and factor investing goes some way to find acceptable middle ground.

- For many investments, particularly where specific skillsets are required to source and manage these, *there are no good benchmarks.* Active investing is thus the only option for these.
  Examples are infrastructure, re-insurance, student housing and royalty payments.

4. **As a relatively long-term investor, the Trustee can exploit an illiquidity premium, but liquidity needs will change over time and must be managed carefully with robust modelling and stress testing.**

- Most investors have short term horizons
  For example.
  i. Private equity investors will liquidate their investments after 5 to 7 years,
  ii. Insurers and investment managers have quarterly and annual performance targets
  iii. Retail investors are often even shorter term focused).
- Pension funds, in particular those whose schemes are open to new accrual, are in a unique position of being able to invest for the *very long term* – 20, 30 years or even longer. They can exploit that position by buying assets that shorter-term investors cannot or will not touch and that are hence relatively cheaper (i.e. These long term assets can have a greater yield.).
- However, as time progresses and the funding ratio improves, *cashflow needs do change* (*M*ore pensioners may need to be paid, there may be fewer actives contributing to the scheme.) and insurance buy-ins may be contemplated.
- That means the *investment horizon* will *shorten*.Very long-term investments are then no longer attractive.
- Even if existing investments do not need to be liquidated from a cashflow perspective, as other more liquid investments are being sold first, the portfolio can become skewed to illiquid investments. As long as these generate cashflow this is not necessarily a problem, but the Trustee will need to consider proper cashflow modelling for the scheme.
- *The Trustee* will also need to run regular stress tests to ensure there are no unforeseen circumstances that may cause a liquidity squeeze and hence forced selling. (Which will then be at unattractive prices.)

5. The Trustee's Responsible Investment policy highlights that Environmental, Social and Governance (ESG) factors can have an impact on financial performance, and it is therefore part of Trustee's fiduciary duty to incorporate these factors into investment decisions. The Trustee believes that this helps to reduce investment risk, and in some cases enhances long-term investment returns.

  - ESG has become an important element in pension fund investing, to the extent that *regulators* (domestic and international) are starting to take an interest in pension funds' ESG strategies.
  - This is obvious from a risk perspective – bad practices at corporates can result in reputational damage for investors in those businesses.
  - *B*ad practices can also damage the business prospects of those corporates and hence the investment returns.
  - *Members* are also becoming *more demanding* and want to understand what their pension fund does in terms of investing in *(for example)* climate change, child labour and funding dictatorial *or* abusive regimes.
- To respond to these demands - or better still to anticipate them - the Trustee has developed a Responsible Investment Policy that can be shared with stakeholders.
- In addition to the overarching belief on Responsible Investment, beliefs in specific areas of RI are highlighted below:
  - The Trustee's primary responsibility is to act in the best financial interest of the Members of the Scheme. The Trustee believes that incorporating financially material ESG factors into investment decision making is therefore complementary to their primary responsibility as doing so helps to reduce investment risk and, in some cases, enhances long-term investment returns.
  - The Trustee believes it should be aware of and informed on the RI values of the Sponsor when setting the Scheme's own approach to RI
  - The Trustee believes that engagement is an effective way of implementing positive change and is an important part of protecting value for VGPS's Members – The Trustee believe that when companies are governed properly, they are more likely to be sustainable in the long-term.

6. The additional governance burden associated with tactical decision making is not sufficiently rewarded, but when opportunities in markets arise to expedite strategic changes the Trustee will consider them.

- Tactical decision making – buying low priced assets and selling high priced ones - makes good business sense.
- However, in order to know what is low and what is high, *expert analysis* is required.
- VGPS is efficiently managed via a small executive team assisted by outsourced investment advice and management.
- The executive team does *not have the skillset, time or modelling capability* to support any tactical decision making.
- The Trustee and committees don't have these resources either and therefore would be *unable to provide oversight* over any tactical decision making.
- Tactical decision making is therefore <u>best left to the experts</u>: investment managers who will regularly take tactical decisions within the scope of their mandate.
- However, regular <u>rebalancing</u> of the portfolio is considered a sensible mechanistic way that goes some way towards the same principle of buying low priced assets and selling high priced ones.
- Rebalancing works by *regularly – and mechanistically* - selling assets that have risen in price and buying assets that have fallen in price.
- Disinvesting from overweight allocations (relative to the Strategic Asset Allocation) on a monthly basis also has a similar effect.

7. **Alignment of interest between Trustee, sponsor and other stakeholders improves the prospect of achieving the Trustee's objectives.**

- The Trustee maintains a constructive and open dialogue with the sponsor, and regularly invites the sponsor to present at Trustee Board meetings and consults with the sponsor on investment strategy.
- Alignment of interest – and more generally a spirit of transparency and good communication – between sponsor and Trustee proves its value particularly in times of market stress.
- This is because market stress often puts the relationship between sponsor and Trustee under pressure and can result in a breakdown of trust.
- Proper alignment of interest, and a mutual understanding of what the Trustee and sponsor are trying to achieve, lowers the risk of unproductive questioning and unnecessary reporting.
- Parties can thus concentrate on taking decisions that position for success rather than having to spend a lot of effort in explaining failure.