

Appendix Seven

Statement of Investment Principles

Introduction

This Statement of Investment Principles has been agreed by the Trustee of the BT Pension Scheme (BTPS) to comply with Section 35 of the Pensions Act 1995. It has been prepared following written advice from BT Pensions Scheme Management Limited (BTPSM) and consultation with the Principal Employer of BTPS, British Telecommunications plc (BT). BTPSM is authorised and regulated by the Financial Services Authority. No amendment to this Statement will be made without written advice from a suitably qualified person and in consultation with BT.

Investment Objective and Funding Requirements

The main investment objective is to ensure that over the long-term, and after allowing for all future income, the Scheme will always have enough money to meet the cost of the payments to be made.

The investment of the assets of the Scheme should be consistent with funding a defined level of benefits within an acceptable level of risk, while trying to minimise the cash cost to BT over the long term, having regard to the funding requirements of the Pensions Act 2004 and an acceptable level of risk of significant cash injections being required from BT. The Trustee acknowledges that, in particular, the level of investment in risky assets might, over the short to medium-term, influence the volatility of the funding level of the Scheme, and hence may influence the size of the contributions from the employer. The Trustee takes independent advice on the quality of the covenant of BT and thus its ability to meet its obligations. The estimated relative values of the Scheme's assets and liabilities are regularly monitored.

As part of achieving the Scheme's objective, the Trustee periodically sets a target for the total real investment return (from both capital appreciation and investment income) on the assets of the Scheme. Currently, this target is a real return of 3.5% per annum.

Risk

Given the ongoing commitment of BT to the Scheme, a degree of investment risk can be taken in the expectation of generating higher returns. This risk is constrained by diversifying across different classes of investment and a range of investment managers. In setting the appropriate level of investment risk the Trustee considers a range of factors, including the impact and probability of a significant fall in the value of the assets of the Scheme, the financial strength or covenant of BT and the financial strength of the Scheme. Investment risk is monitored by BTPSM on an ongoing basis and reviewed by the Trustee each month. The Trustee has in place a plan for reducing risk in the Scheme as the proportion of pensioner members increases.

The Trustee's policy is to have separate management and custody of assets, which minimises the risk of a misuse of Scheme assets. Custody arrangements are reviewed regularly to ensure that the custodians continue to have appropriate control and checking procedures in place.

The Trustee authorises the use of derivatives by BTPSM, some of the Scheme's investment managers and certain subsidiary undertakings. BTPSM uses derivatives to manage the Scheme's risk profile which includes their use to rebalance the Scheme's asset allocation regularly to keep within guidelines agreed by the Trustee and for making tactical adjustments.

Taking Decisions

The Trustee is responsible for the stewardship of the assets of the Scheme. All the Trustee Directors are therefore involved in

decisions on the strategic target for the distribution of assets between different classes. In making these decisions the Trustee is assisted by BTPSM and other advisers. Training is undertaken where appropriate so that all Trustee Directors have the necessary expertise to take the decisions required of them and to evaluate critically the advice received. The Trustee has an Investment Committee, which has delegated authority for tactical asset allocation. It also oversees the appointment and removal of investment managers and the performance of BTPSM.

Distribution of Investments

Targets set for the strategic allocation of assets between different classes of investment reflect the Trustee's views on the appropriate balance to be struck between returns and risk, and on the extent to which the Scheme's assets should be distributed so as to meet its liabilities. Investments are made on the expectation that greater long-term returns will be achieved through a prudent exposure to real assets, including equities and property. The Scheme's investments are highly diversified by asset class, geographical area, sector and industry.

The majority of the Scheme's assets are readily marketable and the Scheme will benefit from substantial contributions over the next 17 years. However, part of the Scheme is invested in less liquid, but potentially higher returning, assets. The total of such assets is limited by the Trustee and it is not anticipated that there will be any material need to realise these investments in the foreseeable future in order to meet benefit payments.

At 31 December 2009 the target strategic allocation and projected long-term real (i.e. excess of retail price inflation) investment return for each asset class is shown in the table below:

	Target Allocation %	Expected Real Return %
Equities	33	5.1
Fixed interest	20	2.4
Inflation-linked	15	1.0
Property	12	3.8
Alternatives	20	3.2
	100	

Alternatives include Commodities, Infrastructure, Hedge Funds and Private Equity investments. A portion of the exposure to foreign currencies embedded in the overseas assets is hedged back into Sterling to remove some of the currency risk.

The Trustee advised by BTPSM continually assesses current market conditions and trends and has defined latitude to implement tactical adjustments around the strategic asset allocation targets for both assets and currencies under authority delegated from the Trustee Investment Committee.

Mandates for Advisers and Managers

Hermes is the Scheme's principal investment manager. However, the Trustee has appointed other investment managers to manage a significant portion of the Scheme's assets. All investment advisers and managers have agreed in writing with BTPSM, on behalf of the Trustee, the services to be provided and, where appropriate, the performance target and how it will be measured.

The fees paid to investment managers for these active mandates may comprise a base fee plus an additional fee calculated as a proportion of the amount by which the manager exceeds a performance target. Linking fees to performance in this way is felt

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to encourage outperformance, whilst ensuring fees do not vary purely due to changes in underlying market values.

Advisers, other than BTPSM, are normally paid a fixed fee for a specific role, as here a performance-related fee is most unlikely to improve the quality of the advice and will probably result in an overall increase in the total fee paid.

At 31 December 2009 the assets of the Scheme were managed by a wide range of investment managers with three managers each managing over 10% of Scheme assets.

Manager (mandate)	£ million	%
Hermes* (global securities and property)	18,043	52.9
Legal & General Investment Management Ltd (global equities)	7,905	23.2
M&G Investment Management Ltd. (corporate bonds)	3,999	11.7
Other managers	4,165	12.2
Total	34,112	100.0

* Includes Hermes Investment Management Limited, Hermes Real Estate Investment Limited, Hermes Focus Asset Management Limited, Hermes Focus Asset Management Europe Limited, Hermes GPE LLP, Hermes BPK Partners LLP.

Performance Measurement

The Trustee receives monthly reports on investment performance from BTPSM and from other advisors coordinated by BTPSM. This includes an update on Scheme performance and funding, Scheme level risks, a breakdown of assets by asset type, Scheme level cash flows and a review of the performance of the individual portfolios managed by Hermes and other investment managers.

Any managers demonstrating consistent or extreme under performance or where there are other significant concerns will be subject to a detailed review, undertaken by BTPSM on behalf of the Trustee.

Sustainable Investment

As a founder member of the United Nations Principles for Responsible Investment (UN PRI), BTPS uses this framework to ensure that environmental, social and governance issues are taken fully into account in its investments.

When reviewing existing or appointing new investment managers on behalf of the BTPS, managers are encouraged to consider long term sustainable ownership where possible. We endeavour to use all available methods to exercise our ownership rights by voting and engaging where possible either directly or via an appointed overlay service.

We believe that good corporate governance is of paramount importance and we expect best practice as a minimum in this area from all our managers.

We also utilise Sustainability as an investment theme for the Scheme as opportunities arise.