

BTPS 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 Hermes Investment Management Limited (HIML) and consultation with the Principal Company of BTPS, British Telecommunications plc (BT). No amendment to this Statement will be made without written advice from a suitably qualified person and in consultation with BT.

Investment Managers

At 31 December 2007 the assets of the Scheme were managed by a total of seven investment managers with three managers each managing over 10% of Scheme assets.

Manager	Mandate	£m	%
Hermes Investment Management Ltd	Global securities	17,762	44.8
Legal & General Investment Management	Global equities	14,156	35.7
Hermes Real Estate Investment Management Ltd	Global property	5,794	14.6
A further four managers	Various	1,962	4.9
Total		39,674	100

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 match its liabilities. The asset allocation strategy and the Scheme's liabilities are reviewed regularly.

At 31 December 2007 the target strategic allocation and projected 10-year real investment return for each asset class was as follows:

Asset class	Allocation %	Return % pa
UK Equities	21.0	4.5
Overseas Equities	28.0	4.9
UK Fixed Interest	14.5	2.0
Overseas Fixed Interest	1.0	2.2
UK Index Linked Bonds	8.5	1.1
Overseas Index Linked Bonds	1.0	1.5
UK Property	11.0	3.3
Overseas Property	2.0	3.3
Alternative Assets:		
Commodities	3.0	1.8
Hedge Funds	5.0	3.7
Infrastructure	1.0	5.0
Private Equity	4.0	4.5
	100.0	

The Trustee has approved an additional 2% allocation to alternatives to be funded from UK equities in due course.

50% of the exposure to foreign currencies embedded in the overseas equities and overseas property allocations is hedged back into sterling to remove some of the currency risk. Hermes continually assesses current market conditions and trends and has defined latitude to implement tactical adjustments around the strategic asset allocation target.

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 the equity investments of the Scheme might, over the short to medium-term, influence the volatility of the funding level of the Scheme, and hence may influence the volatility of the employer balancing contribution rate. 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 and currently considered formally on a monthly basis.

As part of achieving the Scheme's objective, the Trustee has set a demanding target for the total investment return over three years (from capital appreciation and investment income) on the assets of the Scheme. Currently, this target is that the Scheme return exceeds a benchmark return that would theoretically be available if the Scheme assets had been invested according to the strategic asset mix (see the Distribution of Investments section), and the returns in each asset class had been the average return for the 50 largest UK pension funds, as calculated by the WM Company. This return objective is being reviewed by the Trustee in 2008.

Investment Strategy

The Scheme's investments are highly diversified by asset class, geographical area, sector and industry. Part of each asset class and geographical diversification is invested in smaller, more volatile and less marketable assets, but the total of such assets is limited by the Trustee. Hermes is the Scheme's principal investment manager. However, the Trustee has appointed other investment managers to manage some portfolios.

Investments are made on the expectation that greater long-term returns will be achieved through a prudent but generally high exposure to real assets. Tactical realisations of individual investments are made by the appropriate investment managers.

During 2007, the Scheme's exposure to equities has been reduced through a continuing de-risking strategy. This hedges the downside risks associated with the Scheme's equity exposure, from approximately 50% to close to 40% of the Scheme's assets.

The investment managers are permitted to use derivative contracts for efficient portfolio management as in some cases they have advantages including lower overall costs and greater liquidity. Derivative contracts are financial instruments

(futures, options, swaps & forwards) that derive their value from another reference asset class.

Socially Responsible Investment

The BTPS is a founder member and provides the current chairman of the board of the United Nations Principles for Responsible Investment, which acts as a framework for investors to take environmental, social and governance issues fully into account.

When appointing managers of segregated portfolios on behalf of the Scheme, the appointee is instructed, when selecting investments for the Scheme, to be prepared to account for the following:

- that companies are run in the long term interests of shareholders and that this requires them to effectively manage relationships with employees, suppliers and customers;
- that companies behave ethically and to have regard for the environment and society as a whole;

The letters of appointment request that the manager uses its best endeavours to exercise the ownership rights associated with shares.

Hermes, the Scheme's principal investment manager, has issued Statements on Corporate Governance both in the UK and internationally, which are published on its website www.hermes.co.uk.

Performance Measurement

The Trustee receives quarterly reports on investment performance from the WM Company. As well as giving the BTPS returns by market and geographical sectors, the results in these sectors are compared with the returns on specific benchmarks set for the BTPS, and with the returns in these sectors of other pension funds. The Trustee also monitors regularly the performance of all the individual portfolios managed by Hermes and the external managers.

The BTPS assets are invested in 42 separate portfolio mandates, including 17 index tracking and 25 active portfolios. Only 24 of the active portfolios have three years or more historical performance and 18 of these portfolios have beaten their three-year performance benchmark over the period to 31 December 2007. The Trustee will pay particular attention to the remaining 6 that had not beaten the benchmark and will take the steps necessary to ensure performance improves.

Mandates for Advisers and Managers

All investment advisers and managers have agreed in writing with the BTPS Trustee the services to be provided and, where appropriate, the performance target and how it will be measured.

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

Advisers 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.

Taking Decisions

The BTPS Trustee is responsible for the stewardship of the assets of the Scheme. All the Trustee Directors are therefore involved in decisions on the target for the distribution of assets between different classes. In making these decisions the Trustee is assisted by their advisers and by modelling studies of the future long-term asset and liability ratios of BTPS using various different economic scenarios and distributions of investments. 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 some delegated authority for tactical asset allocation. It also oversees the appointment and removal of investment managers.


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Chairman of the BTPS Trustee

14 May 2008
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Date