Telefónica UK Pension Plan

Statement of Investment Principles

Introduction

Under the Pensions Act 1995 (as updated by the Pensions Act 2004), the Telefónica UK Pension Trustee ("the Trustee") is required to prepare a statement of the principles governing investment decisions. This document contains that statement and describes the investment principles pursued by the Trustee of the Telefónica UK Pension Plan ("the Plan").

This Statement of Investment Principles ("the SIP") covers both the Defined Benefit and the Defined Contribution sections of the Plan. Details of the implementation of the Plan's investment principles along with the Trustee's governance policy, are set out in a separate document, the Investment Implementation Document ("IID").

The Trustee has consulted the principal sponsoring employer, Telefónica UK Limited ("the Sponsor"), on the principles set out in this statement and will consult the Sponsor on any changes to it. However, the ultimate power and responsibility for deciding investment policy lies solely with the Trustee.

Before drafting this statement, the Trustee has obtained and considered written advice from the Plan's Investment Advisor (KPMG LLP) and also considered advice from the Plan Actuary (Lane Clark & Peacock LLP), the Legal Advisor (Sacker & Partners LLP) and the Covenant Advisor (Penfida Limited).

Investment mandates

While the Trustee retains strategic management of the Plan's assets, a number of professional Investment Managers have been appointed for day-to-day management of the assets, as detailed in the Plan's Investment Implementation Document.

All of the Investment Managers are authorised and regulated by the Financial Conduct Authority under the Financial Services and Markets Act 2000 as amended by the Financial Services Act 2012 and/or by the US Securities and Exchange Commission.

The Trustee has ensured that all advisors and third party service providers are suitably qualified and experienced and that suitable liability and compensation clauses are included in all contracts for professional services received.

Sponsor-Related Investments

Regarding Sponsor-related investments as defined in the Pensions Act 1995 and the Occupational Pension Schemes (Investment) Regulations 2005, other than to the extent that pooled funds are invested in securities issued by Telefónica S.A. (or any other related group company), the Plan's Investment Managers are not permitted to invest in such securities without the Trustee's prior consent. The Investment Managers should have regard to publically available information about potential changes in the ownership of Telefónica S.A. (or any other related group company) and avoid investing in a way which could cause the Plan, should any such change in ownership occur, to be invested in Sponsor-related investments.

Where the Plan invests in pooled vehicles that may hold sponsor-related investments the total exposure to sponsor-related investments is not expected to exceed 5% of the Plan's value. The Trustee monitors its Sponsor-related investments on an annual basis (as at 30 September).

Financially material considerations

The Trustee has considered all financially material considerations over the appropriate time horizon of the investments. This includes how those considerations are taken into account in the selection, retention and realisation of investments. The Trustee has also considered how to exercise the rights (including voting rights) attaching to the investments, and how to undertake engagement activities in respect of the investments (i.e. stewardship).

The Trustee has decided that there are no non-financial matters which fund managers need to be instructed to take into account in the selection, retention and realisation of investments.

Details of how risks and financially material considerations have been addressed and managed by the Trustee are outlined in more detail in the respective DB and DC sections of this document

All decisions about the day-to-day management of the assets, including the above considerations, have been delegated to the investment managers via a written agreement. The Trustee Board and Governance Committee takes investment managers' policies in the above respects into account when selecting and monitoring managers. The investment managers are expected to exercise their powers of investment with a view to giving effect to the principles contained within this statement, so far as reasonably practicable.

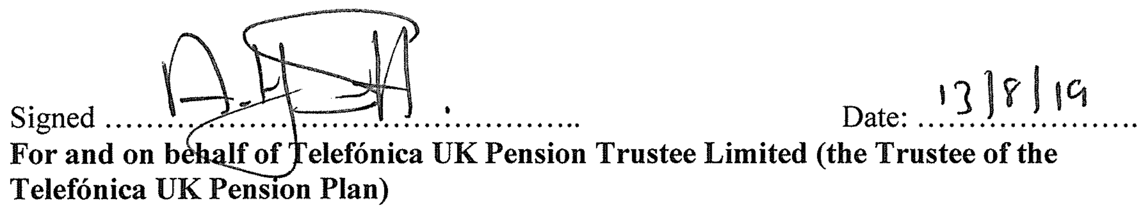
The Trustee has also considered specifically how Environmental, Social and Governance ("ESG") risks are managed in the Plan. As part of this review, the Trustee has agreed on an ESG policy which details how ESG risks are viewed by the Trustee and how these risks are managed in the Plan. The Trustee believes that taking an active approach to include ESG factors in investment decisions reduces overall risks whilst generating sustainable returns. The ESG policy is included within the Appendix of the Investment Implementation Document.

Direct investments

Direct investments, as distinguished by the Pensions Act 1995, are products purchased without delegation to an Investment Manager through a written contract. When selecting and reviewing any direct investments, it is the Trustee's policy to obtain appropriate written advice from their Investment Advisors.

Compliance

This Statement has been prepared in compliance with the Pensions Act 1995, the Pensions Act 2004, and the Occupational Pension Schemes (Investment) Regulations 2005. Before preparing or subsequently revising this SIP, the Trustee consulted the Sponsor and took appropriate written advice. The Statement is reviewed at least every three years, and without delay after any significant change to relevant aspects of the Plan (e.g. Sponsor covenant, attitude to risk etc).



Signed .... Date: 13/8/19 ....

For and on behalf of Telefónica UK Pension Trustee Limited (the Trustee of the Telefónica UK Pension Plan)

Defined Benefit ("DB") Section

Investment objectives

The Plan is closed to new entrants and future benefit accrual so the overall objective is to provide pension and lump sum benefits for the current members (and their dependants) on a defined benefit basis.

The Trustee's investment objective is to achieve the Statutory Funding Objective, which targets full funding on the Technical Provisions basis. The method adopted for the 2017 valuation is to reach and maintain a funding position such that all members' benefits can be met with very little investment risk and/or reliance on the Sponsor's covenant, termed "self-sufficient", by 30 September 2029. The assumptions allow for the Plan's investments to be substantially derisked with effect from that date. The Technical Provisions will be reviewed to be consistent with the Sponsor's covenant and the Trustee's risk tolerance.

The Trustee reviews an estimate of the Plan's funding position (on various bases) at least quarterly to assess the position and whether the investment policy remains appropriate to the Plan's circumstances.

Integrated risk management

The Trustee applies an integrated approach to risk management, as per the Pension Regulators guidance (December 2015), including an ongoing review of the risks associated with the:

- Sponsor's covenant
- Investment strategy
- Plan funding

The Trustee's management of the risks identified does not eliminate them. Rather the management endeavours to balance them to achieve the Plan's objectives. To do this the Trustee receives advice from the Covenant Advisor, Investment Advisor and Plan Actuary, and holds discussions with the Sponsor.

For the purposes of this SIP the investment risks have been set out below, but it is important to note that the Trustee considers them alongside and in the context of the Plan's other risks. For example no more risk will be taken than can be supported by the Sponsor's covenant and the Trustee's risk appetite.

- **Asset and liability mismatch risk:** The relative value of the assets and liabilities will be more volatile over the short term than if investment risk had not been taken;
- **Market risk:** The assets might not achieve the excess return relative to the liabilities anticipated over the short or longer term;
- **Liquidity risk:** The assets may not be liquidated to meet liabilities (e.g. benefit payments, collateral requirements etc) as quickly or cost effectively as anticipated;
- **Concentration risk:** The assets could be more volatile than anticipated due to an idiosyncratic event (e.g. a corporate default);
- **Operational risk:** The risk of fraud, poor advice or acts of negligence;
- **Investment manager risk:** An investment manager may not achieve their objectives;

- **Political risk:** The legislative and tax environment could change from the environment in which the investment strategy was designed; and
- **Investment cost risk:** The cost of suitable advice or day-to-day management of the assets exceeds the anticipated cost.
- **Environmental, Social and Governance risk:** Management of the Plan's assets with regard to Environmental, Social and Governance factors, including but not limited to climate change which can impact the performance of the Plan's investments.

Investment strategy

The Trustee has opted to follow a "spread-value investing" approach, which is designed to help close the deficit with a relatively high degree of certainty, alongside any other funding. It is expected that this approach will exhibit much less volatility than an equity-based investment strategy. The Trustee considers this a long-term strategy that is expected to remain in place until the Plan achieves its objective of becoming self-sufficient – i.e. this approach is strategic in nature, rather than opportunistic / tactical.

Spread-value investing involves taking advantage of the legal protections (such as seniority in the case of liquidation) and contractual obligations (such as fixed temporal constraints regarding contractual lifetime and payments) of credit assets, which the Trustee believes are well suited to meeting the Plan's objectives with greater certainty than a strategy which utilises subordinate non-contractual income assets (e.g. equities). Credit assets have a:

- Defined term to maturity and pay-out profile - equities, for example, don't have either;
- Zero probability of delivering more than their yield to maturity if held to term – the Plan does not need the *unlimited* upside of equities to achieve its objectives;
- Very high probability of delivering returns very close to their yield to maturity – equities cannot offer this predictability; and
- Very low probability of delivering equity like downside – this downside is likely to require additional funding for the Plan to achieve its objectives.

Importantly, unlike the uncertain future returns from equities (accepting the returns may be above or below expectations), the spread available on bond assets is observable and provides a platform for a more robust *engineering* approach to the investment strategy. Admittedly, prudently allowing for losses from credit events introduces some subjectivity but not on the same scale as that associated with expected equity returns.

The Trustee has selected the following diversified mix of credit assets:

Asset	Exposure (% of total assets)	Net spread[1] (above LIBOR)
Investment grade corporate bonds	20.0%	1.3%
Liquid credit	15.0%	2.3%
Semi-liquid credit	10.0%	3.5%
Private market credit (illiquid)	25.0%	3.7%
Credit Default Swaps (CDS) overlay	30.0%	1.3%
Liability Driven Investing (LDI) overlay[2]	n/a	n/a
Collateral for CDS and LDI	30.0%	0.0%

Total		130.0%	2.3%

Note: [1] Estimated spread as at 31 December 2016, net of expected default losses and investment management costs.
[2] With a target hedge ratio (IE01 and PV01) of the funded economic liabilities. This is 65% as at 31 December 2016 but will change over time.

The net spreads assume the underlying credit assets are held to maturity and the assets may exhibit considerable mark-to-market volatility in the period until maturity. As a long-term investor the Trustee expects to hold the majority of credit assets to maturity and so any short term mark-to-market volatility is tolerated. Instead, the Trustee focuses on the risk of permanent losses that may arise from credit events (e.g. defaults). This risk is managed by diversifying across many issuers and employing active credit analysis for the majority of the assets, which is completed by professional Investment Managers.

Liability Driven Investing (LDI) is used to manage the re-investment and inflation risk of the credit assets – most credit assets have much shorter maturities than the Plan's liabilities and so must be re-invested when they mature. This significantly reduces the asset and liability mismatch risk.

The private market credit and the semi-liquid credit assets have been selected as the Trustee believes they offer an illiquidity and/or a complexity return premium which more than compensates for the loss of liquidity. However, the Trustee has limited the allocation to such assets to manage the potential liquidity risk.

Defined Contribution ("DC") Section

Investment objective

The Trustee's objective is to make suitable investment arrangements available to members to provide a retirement fund from which members can buy a pension, take a cash lump sum and/or transfer to another arrangement to drawdown income. They have taken into account their understanding of members' circumstances, in particular members' attitudes to risk and term to crystallising their pension savings.

There are three lifestyle strategies offered by the Plan which gradually de-risk over time and a range of investment options for members who want to create a bespoke portfolio. If a member does not want to select an investment option themselves their investments will be directed into a default arrangement.

The Trustee also holds a closed policy with Equitable Life in respect of the Additional Voluntary Contributions (AVCs) of a small number of DB members who transferred from the BT arrangements.

Risk

The Trustee recognises specific investment risks that can be managed through the choice of investment options provided to members. The different risks will have different levels of importance for members at different stages in their membership and the Trustee has considered this when deciding on the default option and the range of funds to be made available. The Trustee's policy in respect of risk measurement methods and risk management processes is set out below:

- **Expectations:** Risk of not meeting the reasonable expectations of members, bearing in mind members' contributions and fund choices;
- **Loss aversion:** Risk of loss to a member's pension savings from period to period and the subsequent impact on their behaviour;
- **Diverse membership:** Risk of the default fund being unsuitable for the requirements of some members;
- **Inflation:** Risk that the growth in members' pension savings does not keep pace with inflation over the long term;
- **Capital risk:** Risk that short term falls in fund values impact on members' pension savings;
- **Annuity conversion risk:** Risk that poor investment performance impacts on the level of annuity that a member can purchase at retirement;
- **Liquidity risk:** Risk that members' pension savings may not be liquidated in line with reasonable expectations;
- **Fund manager risk:** The risk a fund manager may not achieve their objectives;
- **Operational risk**: The risk of fraud, poor advice or acts of negligence;
- **Political risk:** The legislative and tax environment could change from the environment in which the investment strategy was designed; and
- **Cost risk:** The costs of administering and investing the assets exceeds the anticipated cost.

- **Environmental, Social and Governance risk:** Management of the Plan's assets with regard to Environmental, Social and Governance factors, including but not limited to climate change which can impact the performance of the Plan's investments.

Due to the complex and interrelated nature of these risks, the Trustee considers these risks in a qualitative and a quantitative manner.

- The Trustee's policy is to regularly qualitatively review the range of funds offered and the suitability of the default arrangements; and
- The Trustee also measures risk in terms of the performance of the assets compared to the respective benchmarks on a quarterly basis (including the drawdowns in daily performance).

Default arrangements

New members are auto-enrolled into the Plan so a default investment option is required in the event that members do not specify a preferred investment choice themselves. The aims and objectives of the core default option are:

- to offer investment funds to members that will provide an opportunity to generate growth above the rate of inflation in the accumulation phase;

- to reduce risk as the member approaches their chosen retirement age;

- to ensure the asset allocation at retirement is appropriately aligned so as to be broadly suitable regardless of the type(s) of benefit a member chooses to take. This reflects the Trustee's belief that, as members retire in the future the majority are more likely to take advantage of the full range of benefit options available to them, for example, income drawdown, annuity, a cash lump sum or a combination of these.

The Trustee's policies in respect of the investments in the default option are:

- The Trustee expects the long-term return of the growth phase of the core default option (i.e. the diversified growth assets) to exceed price inflation and general salary growth. The Trustee believes it is important to manage the magnitude of drawdowns (peak to trough losses) in this phase as behavioural studies have shown members to be 'loss adverse'. This means they are prone to react to drawdowns more negatively than the equivalent gains. In some cases members may actually cease contributions. A *diversified* growth approach has been selected due to its ability to manage drawdowns.

- As a member approaches their pension savings crystallisation point the default arrangement transfers a portion of member's savings into a bond fund and a cash fund, whilst retaining a portion in the diversified growth fund. This mix of assets is designed to reduce risk whilst still offering the expectation of real rates of growth over the long term, and is considered to be an appropriate mix regardless of the type(s) of benefit a member chooses at retirement.

The default option is intended to ensure that assets are invested in the best interests of members and beneficiaries because it has been designed for those least likely to engage with investment decision making, based on demographic analysis carried out by investment advisors in

collaboration with the Company. It provides a balance of investment risk and return which is managed through an automated "lifestyling" arrangement, so that members who do not choose to actively manage their own investments are not unduly exposed to inflation risk, annuity conversion risk or capital risk at the most inappropriate times in their lives.

A number of other funds are classified as default arrangements for some members following historic mapping processes where members' funds have been transferred without them expressing a choice. The Trustee's expectations in relation to these investments are:

- Diversified growth fund – as described for the core default option above
- Equity funds – to exceed price inflation and general salary growth
- Corporate bond fund - to perform broadly in-line with annuity prices although returns are expected to be lower than for equities over the long term
- Index-linked bond fund - returns are linked to the rate of Retail Price Inflation (RPI) but are expected to be lower than equities and corporate bonds over the long term
- Cash fund – to provide protection against changes in short-term capital values

Other Lifestyle arrangements

The three alternative lifestyle strategies also invest in diversified growth assets in the growth stage. From that point:

- One then transitions into a bond fund and a cash fund. The bond fund is expected to broadly match the real prices of annuities, giving some protection in the amount of secured income for members who purchase an annuity, whilst the cash fund provides protection against changes in short-term capital values. This Lifestyle strategy is also classified as a default arrangement for some members.

- One then transitions into cash with the aim of preparing members to take their entire pension savings as a cash lump sum.

- The other transitions only a quarter into cash leaving the remainder in diversified growth assets in expectation that this will be transferred to a draw-down arrangement.

Policy on kinds of investments: balance and expected return

The Trustee's policy on the kinds of investments to be held, the balance between the different kinds of investments and the expected return on them is set for each fund that is offered to members on the basis of the overall objective for that fund that is chosen in line with the criteria set out above.

Realisation of investments

The investment managers have discretion over the timing of realisation of underlying investments within the funds that they manage and the liquidity of the underlying assets is considered when the Trustee decides which funds to offer to members. The Trustee chooses funds that offer frequent dealing to enable members to access their benefits and change their investment selections.