

Schroder

# Global Climate Change Fund

## Monthly Newsletter

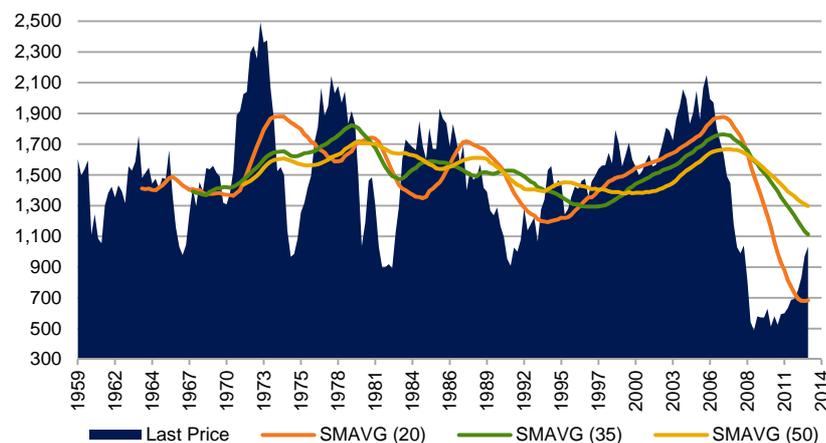
The rebound in the US housing market is providing further impetus for our energy efficiency theme, as we explore below. In other news, we note the complexities of climate science; meanwhile, deep divisions within the EU continue to hamper climate progress.

### Key investment theme: energy efficient housing

Energy efficiency trends continue to develop strongly, with a great example being the US housing market. A variety of new standards and regulations are driving faster adoption of insulation, lighting and low-energy housing to be built into new and existing housing stock. While we recently featured LED stocks as plays in the fund as the technology becomes affordable, we also continue to hold several businesses that have direct exposure to efficient housing trends in the US. These include housing products retailers **Home Depot** and **Lowe's**, insulation and roofing manufacturer **Owens Corning**, and house builder **Meritage Homes**, all of whom have product offerings allowing property owners to invest in reducing the energy consumption of their homes.

As the graph below illustrates, these structural trends are also being supported by a very strong cyclical recovery in new US housing construction, which is unsurprising given it is coming from the lowest level in over 50 years. That suggests the recovery has a long way to run. We will not be in a hurry to sell these stocks unless valuations become extreme as the cycle should help profits to surprise on the upside.

Fig 1: US Housing Starts – last 55 years



Source: Bloomberg, 3 May 2013

So at the risk of being repetitive, energy efficiency investments offer compelling returns (to the consumer and to the investor) and we retain over 40% of the fund holdings in the theme.

### Science and Policy Developments

Two striking studies have been released in the journal Nature Geoscience showing ice melting trends in Antarctica. The first study found that ice melt on the Antarctica Peninsula since AD 1000 has been non linear and largely

### In this month's newsletter

#### Key investment theme: US Housing

- Energy efficiency trends continue to develop strongly, with a great example being the US housing market which is in cyclical recovery.
- We continue to like businesses with both direct and indirect exposure to this theme.

#### Policy developments and climate change news:

- Two striking but contrasting studies have been released showing ice melting trends in Antarctica.
- At a recent summit, Lord Stern declared that technical progress at addressing climate change has come faster than anticipated but the lack of global political will has become the biggest hurdle.

#### Update on key markets

- Carbon price
- Agricultural commodities
- Oil and gas
- Power prices

#### Investment philosophy

While the path to a low-carbon economy is predictable, we do not believe it is well understood, or discounted, by the equity market – representing a significant alpha generation opportunity. A broad investment universe gives us the opportunity to select only the best value-for-growth stock ideas across all sectors, and we believe that a portfolio consistently focused on these stocks will outperform global equities over time.

#### Stock selection strategy and activity

We believe that the structural growth trends created by climate change will remain a powerful underlying driver to performance in global equities, with the hugely compelling returns on energy efficiency investments making this the most powerful theme in the short term.

**The Global Climate Change strategy is a product of the Global and International Equities Team.**



occurred since the mid-twentieth century<sup>1</sup>. The study was based on the analysis of a 360 metre ice core with a record of freezing and melting over the previous millennium. It suggested this accelerated melting was linked to man-made global warming. The other study, however, focused on the analysis of the thinning of the West Antarctica ice sheet and concluded there is a link with the El Niño event in the 1990s which would have caused rapid thinning of glaciers in the West Antarctica region.

There may actually be an explanation for this discrepancy of findings, coming from the different geographical locations of the two studies: the warming and circulation changes in West Antarctica can indeed be linked to changes in the tropical Pacific Ocean, a natural variability. But the record melt in the Peninsula seemed mainly driven by a shift in the strong westerly wind belt that circles Antarctica which would have been influenced by increasing greenhouse concentrations and ozone depletion – confirming the man-made global warming assumption.

### Political will is the biggest obstacle

Influential bodies sent strong messages this month to reiterate the urgency of the climate change battle. As emissions keep rising from emerging market countries despite the global economic slowdown, an IEA report warned on the slow development of low-carbon energy solutions and the double-digit growth of coal-fired generation in the last decade far outpacing growth in non-fossil fuel generation.

At a World Resources Institute (WRI) and International Monetary Fund (IMF) summit, Lord Stern declared technical progress at addressing climate change has come faster than anticipated but the lack of global political will has become the biggest hurdle. Lord Stern, chair of the Grantham Research Institute on Climate Change and the Environment, said he was confident on the progress going forward given US and China commitments. He also supported the publication of *The Carbon Tracker Initiative* which joined effort with the Grantham Institute to publish its second report, *Unburnable Carbon*. This work is raising awareness of the risk of a carbon bubble from overvaluation of oil, coal and gas reserves. The report's assumption is that these reserves should be not be burned if we want to meet our existing internationally agreed carbon limit targets, thus investing more capital in those assets could be seen as a risk.

### Back-tracking on back-loading

The European Union (EU) Parliament voted against the setting aside of a number of carbon emission allowances ("back loading", aimed at postponing auction of some 900m carbon permits) in order to tighten up the market. The measure was rejected by 19 votes sending a negative signal to markets that there is a lack of political support for the carbon price which subsequently collapsed. This vote reflects deep divisions and confronting interests inside the EU. There were fears that raising the carbon price could affect European business competitiveness, whilst some environmentalists oppose emissions trading and favour more rigid measures to control greenhouse gases. The back-loading solution had been pushed as a quick fix to a carbon market depressed by oversupply of credits in the economic crisis, and a first step to the deeper structural reform of the European Trading Scheme (ETS) over the next few years.

So EU carbon policy is now quite a mess, and thus there is a growing likelihood that individual national governments act separately, for example following the UK carbon floor or carbon taxes. Connie Hedegaard, the European Commission's climate commissioner, reaffirmed the EC's commitment to move on the next political steps and ensure the EU has a strong ETS. She also commented on the challenge of passing climate laws in the context of an economic downturn.

The remaining measures the Commission has identified to improve the functioning of the EU ETS include: an increase in the carbon emissions reduction target to 30% by 2020 (from 20%); an early revision of the annual linear reduction factor; an extension of the EU ETS to other sectors; a limit to access to international credits; and discretionary price management mechanisms. Back-loading could come back after an EU environmental committee review, but this will take time - Germany is yet to produce a definitive position on the question and could wait until the German elections in September.

## Investment philosophy

Tackling climate change will have a powerful impact on the global economy. Long-term policy goals to cut greenhouse gas emissions require nothing less than an industrial revolution to engineer a low-carbon economy. Adapting to some climate change that is already inevitable and mitigating further climate change through the transition to a low-carbon economy will, thus, affect all industries over time. As such, we believe that a dynamic and evolving universe across all sectors is the best way to capture the investment opportunity.

The Schroder Climate Change Team has undertaken a fundamental analysis of every major sector of the economy in constructing our investment universe. We have created a comprehensive investment universe, from which to select over 700 stocks from developed and developing markets. This broad investment universe also gives us the opportunity to always focus on great investment ideas, not just the 'sexy' stocks of the day. Only the very best value-for-growth stock ideas make it into the portfolio, and we are not afraid to exclude whole sectors if they become overvalued.

While the path to a low-carbon economy is predictable, we do not believe it is well understood, or discounted, by the equity market. As a result, the fast-changing growth and relative valuation opportunity that climate change presents to investors represents a significant opportunity for alpha generation. We believe that a portfolio consistently focused on these stocks could outperform global equities over time.

<sup>1</sup> "Acceleration of snow melt in an Antarctic Peninsula ice core during the twentieth century", <http://www.nature.com/ngel/journal/v6/n5/abs/ngel1787.html>

## Strategy and outlook

Equities offer good value, both in absolute terms and in particular relative to bonds. With increasing signs that the Eurozone is finally tackling its structural problems, and a US economy gradually recovering from the imbalances of the last decade, there are encouraging signs for the more cyclical areas of the market where the climate change strategy focuses. The US federal fiscal consolidation and the economics and politics of a deeper Eurozone integration remain important risks in 2013, as does the politically volatile Middle East. However, there is a growing resilience to the global economy as the stresses of the financial crisis gradually heal and we believe that each of the above risks can be navigated in a manageable way.

We believe that the structural growth trends created by climate change will remain powerful underlying drivers to performance in global equities, with the hugely compelling returns on energy efficiency investments making this the most powerful theme in the short term. Consequently over 40% of holdings in the portfolio are exposed to this heterogeneous trend, with lighting, materials, housing and industrial efficiency technologies all well represented.

We highlight the following trades in what was a fairly busy April:

In **energy efficiency** we sold our position in **Cree**. We realized our price target very quickly and took profit. We structurally like the LED industry but the company became overvalued and we recycled the money elsewhere. We tactically added to **Owens Corning** – our US insulation company. The shares had underperformed the housing stocks on no real newsflow following a poor quarter. We added on conviction the market was being far too short sighted and subsequently the shares have performed very strongly. We also added to **Schneider Electric**, **EMC** and **Quanta Services** on weakness.

We added a new position in **Brambles** – the Australian environmental logistics group. The company is growing its market share in recyclable pallets which in itself are taking share from traditional throw away pallets and containers. With good upside to fair value and excellent fundamentals we added the stock into our strategy.

We took the decision to sell out of our **Celanese** position. The company has outperformed materially and we felt the risk reward had become challenging. We like the company fundamentally but decided to recycle the money and take our profits.

In **sustainable transport** we took the decision to exit **Guangzhou auto**. The company has struggled more than we expected and we exited the position.

In **environmental resources** we added to positions in **Trimble Navigation** following weak performance that was un-attributable to fundamentals.

In **clean energy** we added to **Drax** given relatively moderate performance and significant upside to fair value.

In **low carbon fossil fuels** we sold our position in **Dominion Resources**. Whilst the management and outlook for the company are both excellent we reached valuation levels that are much harder to justify and have exited hoping for a better price for re-entry.

We also took the difficult decision to sell our **Newcrest Mining** position. Despite the stock being a poor performer we felt it was appropriate to sell the stock given the significant mis-executions from the management team. The management have failed to deliver production volumes near their own targets. We felt the risk reward looked challenging and recycled the money into higher conviction positions.

### Current allocation

Investment theme	% of fund
Energy Efficiency	46
Sustainable Transport	16
Low-Carbon	13
Environmental Resources	13
Clean Energy	7
Other/General	5

Region	% of fund
North America	51
Continental Europe	16
UK	13
Japan	13
Emerging Markets	5
Pacific X Japan	2

Source: Schroders, as at 30 May 2013

# Update on key markets

## Carbon Price



Source: Bloomberg, as at 30 April 2013

Carbon prices remain very weak and have been weakening further this year. With the European Parliament voting down an effort to tighten the market by moving some emission allowances to later in the decade, efforts to support a higher carbon price are in turmoil. We would expect some further European Commission effort to restructure the carbon market later this year, with the consequence of failure being a fragmentation of the system and more national solutions such as the UK carbon price floor being imposed in other European countries.

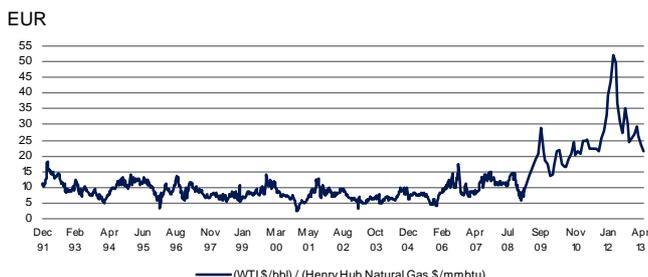
## Agricultural Commodities



Source: Bloomberg, as at 30 April 2013

After the weather disruption and high prices of 2012, we expect big plantings in South and North America this year, and although a long northern winter has delayed planting, early evidence is that planting intentions are very high. This should begin a supply response to help replenish the current low inventories and we would expect some decline in the price of corn this year as a result. Through its disruptive impact on yield, climate change is clearly inflationary for agricultural prices in aggregate, and the fund remains well exposed to the value chain of this sector given the higher investment that will be required to contain prices.

## Oil/Gas



Source: Bloomberg, as at 30 April 2013

Despite some recent mean reversion in the US oil/gas spread, gas remains an extremely cheap source of energy. It is extremely cheap relative to oil and coal, which will incentivise further fuel switching towards gas. In Europe and Asia gas prices are currently trading at more than double US prices, and we expect energy intensive industry to increasingly expand in the US given lower for longer gas prices. For many environmental reasons, new build plans in power generation are skewed in favour of gas over coal or oil. We also expect gas to gain more traction within transportation markets over the next few years, given the excellent relative price and emission-related properties. All in all global gas demand will far outstrip coal and oil, which should support prices over the long run.

## Power Prices



Source: Bloomberg, as at 30 April 2013

With weak developed market economic growth and low US gas prices, we expect power prices to remain weak in the short term but move up steadily over the next 3-5 years, given that at current prices there is little economic incentive for new capacity construction in most generation technologies (notwithstanding strong government support programmes for most renewables). This should then provide greater incentives for new generation to be added, with cleaner generation technology taking the lion's share of that growth. More recent economic malaise and a lowering of commodity prices have lowered forward price expectation along the curve.

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