

Schroder ISF*

Global Climate Change Equity

Monthly Newsletter

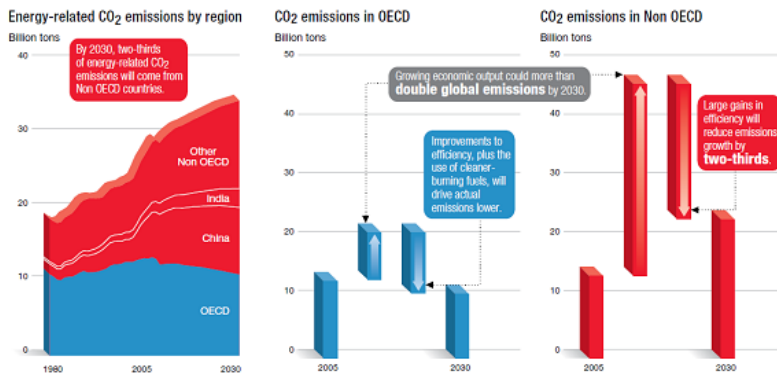
March 2011

Over the last two months, BP and Exxon have published their energy outlook reports looking at future energy demands and carbon emissions to 2030. Both reports conclude that, by 2030, emissions will increase by 25-27% from current levels.

Oil companies agree on failure of emissions reduction policies

The reports also conclude that current climate change policies are failing to set the global economy on a path to limit atmospheric concentrations at 450ppm. This is the approximate level at which mainstream climate science states we cannot exceed in order to avoid dangerous levels of climate change.

Chart 1: Expected global carbon dioxide emissions over time



Source: http://www.exxonmobil.com/corporate/files/news_pub_eo_2010.pdf

While the message about efforts to decrease greenhouse gas emissions is becoming a bit repetitive, there has been new research coming out of the science community which is more interesting.

The Missing link?

Two separate studies both indicate that the increase in atmospheric emissions is a direct cause for more extreme weather. A study by Oxford University ran two computer programmes. One modelled the effects of higher atmospheric greenhouse gas (GHG) concentrations on weather and compared them with observed weather events and the other ran weather impacts if GHG concentrations remained at pre-industrial levels. The exercise found that, because of the higher emissions there was a doubling of the probability of the 2000 flooding event happening in the UK.

The other study, run by the University of Victoria, Canada, confirmed that the increase in extreme rain, snow and hail (as predicted by climate models) is real and could not be explained by natural variability. The models, while only two studies, do raise interesting outcomes. One is that if we are now able to demonstrate the causation between emissions and extreme events, then this potentially opens the door to legal actions. The other is that we would now be able to determine which natural disasters can be linked to climate change and this would therefore help focus adaptation funds and government responses.

This research will need to be replicated, but its conclusions on weather impacts may be very visible today. For example, in 2010 the Amazon rainforest experienced its second extreme drought in a decade (the drought of 2005 was previously said be a

In this month's newsletter

Policy developments and climate change news:

- Latest reports conclude that by 2030, emissions will have increased by 25-27% from current levels.
- They also conclude that current climate change policies are failing to limit atmospheric concentrations to safe levels.
- Two separate studies indicate that the increase in atmospheric emissions is a direct cause for more extreme weather.

Key investment themes: OLEDs

- Organic Light Emitting Diodes look like the future of display technology.
- OLED energy efficiency is driven from the lower watts required to emit light.
- OLEDs promise significantly better picture quality, lower energy consumption and previously impossible forms.

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

- With strong liquidity across the world, low interest rates and low bond yields, we believe that attractively valued equities have a strong outlook in 2011.
- The fastest progress in clean energy and energy efficiency is coming in Asia and South America
- We remain focused on companies with strong balance sheets, sustainable competitive advantage, good management teams and visible growth

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

*Schroder International Selection Fund is referred to as Schroder ISF throughout this document.



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one-in-a-100 year event). These droughts may have severe implications for the carbon cycle as it is estimated that trees died in their low billions, and that as they decompose they will turn the Amazon from a carbon sink to a carbon source. Some scientists worry that the combined effects of these droughts may mean this tipping point has already been reached. Nevertheless, the arguments to implement international policy to protect forests and restore degraded lands now seem even more pressing.

Energy Efficiency: Organic Light Emitting Diodes

While it might seem somewhat strange to be focusing on consumer goods, our new purchase of Duksan Hi Metal in Korea is the perfect reason to discuss a major trend in consumer goods.

OLED energy efficiency is driven from the lower watts required to emit light (industry term: watts/lumen) compared to current Liquid Crystal (LCD) TVs and, as we explore below, the growth should be significant.

For manufacturers, the OLED decision centres on whether the increased costs of using an emissive material can be more than offset by the reduction in other component costs and any pricing premium they can apply to the end consumer. Initial studies and estimates suggest this will indeed be the case hence a supply side push seems probable and is evidenced by Sony, Samsung and LG's recent actions.

Consumers are also likely to show strong interest. OLEDs promise significantly better picture quality (true blacks, faster response rate, wider viewing angle), **lower energy consumption (-50%)** and previously impossible form factors including transparent screens, those which can be bent, twisted or even rolled up and put away. To put this into context, a December 2010 UK retail electricity annualised cost for one 52 inch television would be up to £182 and that is for just one television so the saving potential is clear. Unlike LCD screens, OLEDs don't need to be backlit and hence, they're thinner, use fewer parts in manufacturing, and can reduce power consumption significantly.

Chart 2: Transparent OLED screens



Source: Google

Duksan Hi-metal is an electronic materials company and its fastest growing segment produces and markets active-matrix organic light-emitting diodes (AMOLEDs). These are used as materials for organic light emitting diodes (OLEDs). Duksan is a key and only current supplier to the OLED industry leader Samsung who have a JV (with Samsung SDI) in Samsung Mobile Display – currently the world leader in OLED production with **90% market share**. Samsung believe they will have a commercially viable 40" OLED TV out in 2012.

OLEDs look like the future of display technology. The innovative possibilities in addition to the ability to improve existing displays for both consumer and supplier mean they are simply too attractive to ignore. Manufacturing issues are holding back mass supply and adoption today but with the world's biggest and brightest firms committed to solving these problems, their ascendancy seems fairly assured. We think the stock is attractively valued and is growing at a significant pace with consensus estimates looking for in excess of 50% revenue growth for 2011 and 2012.

Investment philosophy

Tackling climate change will have a powerful impact on the global economy. Long-term policy goals to cut greenhouse gas emissions requires 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 will outperform global equities over time.

Strategy and outlook

With strong liquidity across the world, low interest rates and low bond yields, we believe that attractively valued equities have a strong outlook in 2011. While we expect equity markets to be volatile, we believe that many balance sheets are repaired, corporate profitability is high and the outlook for growth is robust. We continue to believe that growth in developed economies will be more muted in contrast with robust and more sustainable growth in many developing economies. Much of the fastest progress on low-carbon investments is coming in Asia and South America, and we are finding increased opportunities in these markets. The risks are ever present and we will continue to see the euro crisis play out in 2011 with the likelihood of sovereign debt re-structuring. We are also mindful of the fiscal consolidation that the US will have to embark upon but expect rates to remain low and for inflation to remain manageable.

We continue to focus on companies with strong balance sheets, sustainable competitive advantage, good management teams and visible growth.

In **energy efficiency** we added a new position **Hexagon**, a Swedish computer-aided design and Engineering Equipment Company. We also added **Arm Holdings** as they are beneficiaries as producers of computer processor designs that are less energy consuming.

We added **Fanuc**, a manufacturer of factory automation systems and energy efficient equipment with strong growth in Asia. Given the shift to LED lighting and specifically organic LED backlighting in televisions, we bought a position in **Duksan Hi Metal** in Korea as featured above.

To fund these attractively valued purchases we took the decision to sell **Quanta services** and **Schnitzer Steel** where strong performance had meant the stocks were at or above fair value and valuations looked stretched.

Within **environmental resources** we initiated a position in **China Resources Enterprise** the owner of Chinese food retail outlets that benefits from increasing agriculture prices. We also added **United Utilities** in the UK, with the benefit of being a water distributor with inflation-adjusted returns. We sold **Monsanto** and **Adecoagro** as they hit our target prices.

Our holdings in **clean energy** went down slightly as we sold **PG&E** on a relatively full valuation. We also sold **Paladin Energy** as the stock had performed significantly on the back of stronger Uranium prices and we felt the risk / reward was skewed to the downside.

Dresser-Rand was sold as it performed extremely well and looked overvalued in **Low carbon Fossil Fuel**. We took the opportunity to add to **Niko Resources** as the stock over-corrected to results that did not impact the longer-term outlook. We also trimmed **BG Group** on strong performance.

Within **Sustainable transport** we added to **Norfolk Southern**, **Giant Manufacturing** and **LG Chemical** on compelling outlooks and attractive valuations.

Current allocation

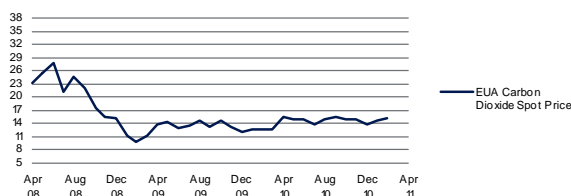
Investment theme	% of fund
Energy efficiency	28
Sustainable transport	19
Environmental Resources	17
Low carbon	17
Clean energy	11
Other/general	8

Region	% of fund
North America	35
Europe ex UK	23
UK	14
Japan	13
Emerging markets	9
Pacific ex Japan	3

Source: Schroders, as at 28 February 2011

Update on key markets

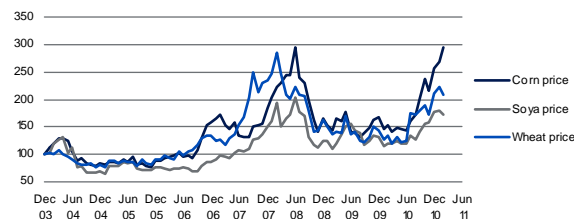
Carbon Price



Source: Bloomberg

A rebound in industrial power demand through 2010 has recently buoyed carbon prices in Europe. Combined with hawkish noises from the EU on the potential for more stringent emission reduction targets (i.e. possibility of 30% by 2020 rather than 20%), carbon prices appear to have established a new range 12-16 euro trading range.

Agricultural Commodities



Source: Bloomberg

Unfavourable weather conditions in many important agricultural regions continue to drive key grain prices to new highs. Tight global inventories in many key crops leaves the system vulnerable to further disruption, and we expect prices to remain at high levels throughout 2011. Climate change is clearly inflationary for agricultural prices in aggregate, and the fund remains heavily exposed to the value chain of this sector given the higher investment that will be required to contain prices

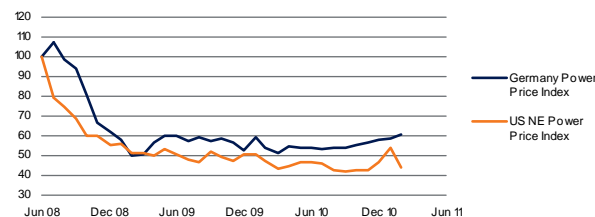
Oil/Gas



Source: Bloomberg

US gas remains extremely cheap relative to oil and coal, which will incentivise further fuel switching towards gas in 2010. In Europe and Asia, gas prices are already closing the gap to oil, leading to higher revenues across the gas value chain. For environmental reasons, new build plans in power generation are skewed in favour of gas over coal or oil. In addition, at current US prices marginal producers are curtailing investment, setting the stage for good medium term performance in the gas price and related companies. We also expect gas to gain traction within transportation markets over the next few years, given the excellent relative price and emission related properties.

Power Prices



Source: Bloomberg

Signs of an improvement in power demand are coming steadily coming through in the US and Europe, driven by a strong rebound in industrial activity. We expect power prices to complete a bottoming process over the next few months and move up strongly over the next 3-5 years, given that at current prices there is little economic incentive for new capacity construction in most generation technologies (not withstanding strong government support programs for most renewables).

The views and opinions contained herein are those of Simon Webber, Matthew Franklin and Giles Money, fund managers of Schroder ISF Global Climate Change Equity, and may not necessarily represent views expressed or reflected in other Schroders communications, strategies or funds.

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