

Schroder ISF*

Global Climate Change Equity

Monthly Newsletter

September 2011

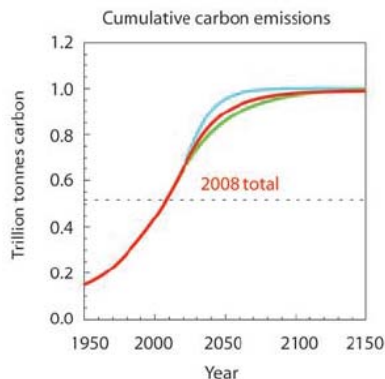
The Cancun Agreement that came out of the COP16 meeting in 2010 reiterated a global ambition to limit global warming to 2°C above pre-industrial levels and to consider limiting warming. It did not, though, impose any binding requirements on nations on achieving this through greenhouse gas (GHG) emissions cuts. So what does it mean to limit global warming to 2°C?

Science and policy developments:

Thinking differently - constraints on cumulative carbon emissions

What does it mean to limit global warming to 2°C? In 2007 the Intergovernmental Panel on Climate Change (IPCC) estimated that by limiting atmospheric concentrations of carbon dioxide (CO₂) to 450ppm there would be a 50/50 chance of avoiding this dangerous level of global warming. At the time, the IPCC estimated that, based on climate-carbon cycle feedbacks, this would require cumulative emissions of CO₂ being limited to 1800 Gt CO₂. Research from the University of Oxford and the Potsdam Institute for Climate Impact Research, published in Nature in 2009, revised this figure to one of limiting emissions to 1tn tonnes of carbon between 1750 and 2050. It pointed out that by 2008 we had already released half of this figure and that it would only take 40 years to release the second half. Furthermore, the longer we leave it to take action, the higher the costs will be as GHG emissions reduction rates will have to be that much greater.

Figure 1: Cumulative carbon emissions



Source: Nature Reports, Climate Change, Volume 3, May 2009

Having a total cumulative figure of the allowable GHG emissions to avoid dangerous climate change provides a very useful benchmark on which to base further analysis. This is what an initiative called "Carbon Tracker" has done. This initiative has taken the research published in Nature to show that from 2000 to 2050 we can only emit 886Gt (114Gt short of a trillion tonnes) and that during the first 10 years of the twenty-first century we had already emitted 1/5 of this figure. This means that for the next 40 years we can only afford to emit 565Gt to avoid a fifty-fifty chance of dangerous climate change.

Carbon content of proven fossil fuel reserves

Carbon Tracker then assessed the amount of carbon that is contained within the proven reserves of coal, oil and gas. This came to a figure of 2795Gt CO₂ (65% from coal, 22% from oil and 13% from gas). Given that we only have 565Gt of cumulative emissions left to burn, this implies that only 1/5 of proven fossil fuel reserves can be burnt between 2011-2050 (as shown in figure 2) and that under the International Energy Agency's energy demand forecasts we would reach this limit within 16 years.

In this month's newsletter

Policy developments and climate change news:

- We look at what it means to limit global warming to 2°C.
- An initiative called "Carbon Tracker" has developed a total cumulative figure of the allowable greenhouse gas emissions to avoid dangerous climate change.
- If we burn all fossil fuels currently in energy company reserves, dangerous long-term climate change (over two degrees warming) becomes a reality society needs to plan for.
- If we are to avoid dangerous climate change, the market is mispricing the asset base of most fossil fuel energy stocks.

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

The eurozone crisis will lead to slower global growth, and the policy maker response has been disappointing.

Those climate change investments that deliver clear returns on investment are being prioritised.

The portfolio is focussed on sustainable growth companies that are not reliant on government subsidies, with the energy efficiency theme at 43% of the fund.

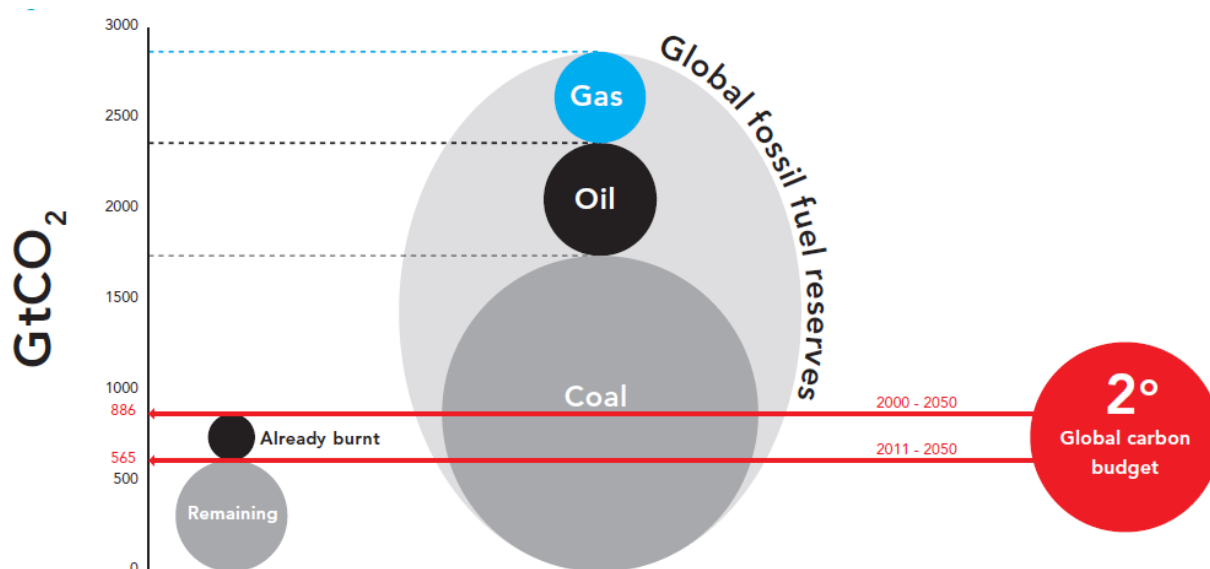
The Global Climate Change strategy is a product of the Global and International Equities Team.

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



Schroders

Fig 2: Comparison of the global 2°C carbon budget with the carbon embedded within proven fossil fuel reserves

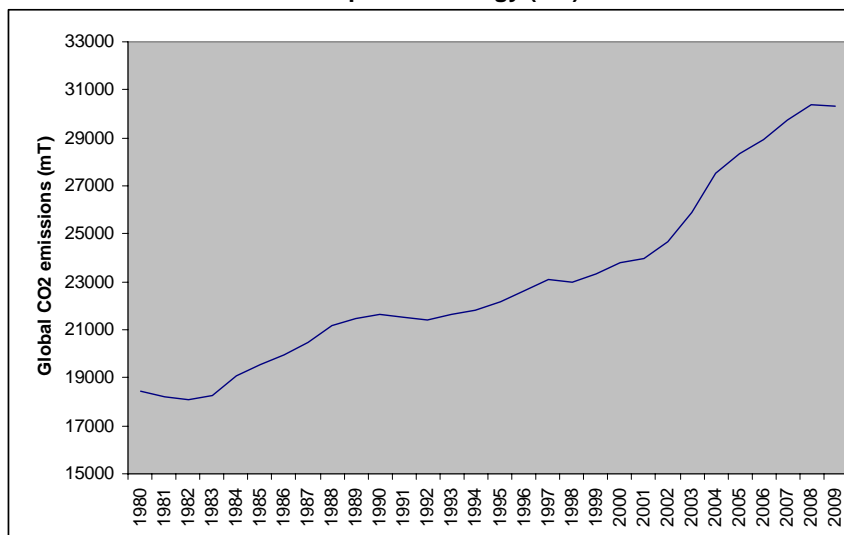


Source: Carbon Tracker Initiative, “Unburnable Carbon – Are the world’s financial markets carrying a carbon bubble?”, 2011

Figure 2 represents the global fossil fuel reserves of both listed and national companies, but if we were to look at figures for the leading listed oil and gas companies (not coal) than this indicates that during 2010 they were expected to invest some \$798bn in CAPEX (Global Data: Global Oil and Gas Capital Expenditure Outlook – 2010) which, if we are to avoid dangerous climate change, would become stranded assets within 16 years. It is important to note that the report takes a conservative view of potential reserves by quoting P1, or 90% probability of economic extraction, and so the problem is likely even greater.

These figures make for sobering reading. The majority of governments recognise the need to limit global warming to 2°C, yet, as Fig 3 demonstrates, we are still failing to curtail the rate of CO₂ emissions even with a global recession.

Fig 3: Total global CO₂ emissions from the consumption of energy (mT)



Source: US Energy Information Administration, International Energy Statistics, downloaded 24/08/2011

Something has to give

The inescapable conclusion is that if we burn all fossil fuels currently in energy company reserves, dangerous long-term climate change (over 2 degrees warming) becomes a reality society needs to plan for. On the other hand, if we are to have a good chance of avoiding dangerous climate change, the market is mispricing the asset base of most fossil fuel energy stocks. Is it any surprise that there are huge vested interests on both side of the debate?

Given these constraints, in reality we continue to believe that natural gas is the necessary bridge to the new energy balance, and we will see very strong volume growth for global gas consumption as utilisation of gas reserves are prioritised over others in future.

We think the fundamentals for gas are turning and we invest a significant proportion of the strategy to take advantage of this thematic. Our positions in **BG**, **China Suntien**, **Beijing Enterprises**, **Niko Resources**, **Progress Energy**, **QEP Resources** and **Quicksilver Resources** are a few examples of stocks we own that are beneficiaries of this theme.

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 will outperform global equities over time.

Strategy and outlook

The sovereign debt crisis in Europe is clearly putting downward pressure on the global economic growth outlook. More than ever, the underlying economic momentum and the remaining monetary policy firepower of emerging economies will be a key advantage in the next 12 months and we believe these economies will continue to deliver good growth.

The latest wave of extreme risk aversion has been non-discriminatory, with index futures activity pressuring shares regardless of their particular economic sensitivities and valuations. We have reacted to it as we normally do in such circumstances: we continue to assess our holdings and universe, review fair market value and valuation, and, lastly, check our growth expectations with a 12 month and three to five year time frame in mind.

With the growing pressure on government finances, we are more focussed than ever on those climate change investments that have a clear positive return on investment, and thus do not require government subsidy. As a result, our exposure to the energy efficiency theme has risen to over 40% of the funds, and clean energy where subsidies are still required, has never been a lower exposure in our portfolios.

In Clean Energy we bought a new position in **Wacker Chemie**. The company has more than 50% of its earnings from the production of the highest quality poly-silicon which is a critical input for the manufacture of solar cells. While the cell-making industry suffers significant overcapacity, the contract poly-silicon price has held up very well and we believe a stronger second half should clear any doubts about inventory and end demand. Wacker has a strong balance sheet and significant cost advantages to the rest of the industry and represents a tentative first step back into the solar market for the strategy. The company has sold out of its poly-silicon production until 2016. We also added to our position in **Calpine** on weakness.

In Environmental Resources we took the opportunity to add to **AGCO** as the stock has been weak due to greater macro uncertainty during this period of market consolidation. It had significant upside to our fair value and agricultural commodity prices have been resoundingly robust giving us greater confidence. We funded this by trimming our **United Utilities** and **China Resources Enterprise** positions which have been strong relative outperformers.

Energy Efficiency continues to be our biggest weighting by theme. We switched out of our position in **Siemens** and bought a new position in **Schneider Electric** as we had more upside to our fair value. We added to our position in **On Semiconductor** which had declined significantly during the current market rout. We also added to our positions in **Hexagon** and **Ameresco** on significant pullbacks. We trimmed **Bridgestone** and **Fanuc** to partially fund the additions as they had been very strong performers.

In Sustainable Transport we took the decision to increase our position in **Borgwarner** at what we consider attractive levels, funded with a trim of **Norfolk Southern** which had held up very well and looked comparatively expensive.

Current allocation

Investment theme	% of fund
Energy Efficiency	43
Low Carbon	18
Sustainable Transport	15
Environmental Resources	13
Clean Energy	4
Other/General	7

Region	% of fund
North America	44
Continental Europe	18
United Kingdom	14
Emerging Markets	11
Japan	11
Pacific X Japan	2

Source: Schroders, as at 31 August 2011

Update on key markets

Carbon Price



Source: Bloomberg

Carbon prices have weakened considerably in recent weeks, as the market has digested higher energy efficiency targets in Germany, which, if achieved, would reduce demand for permits in the 2012-2020 phase three of the emission trading scheme. However, the EU sees carbon prices as a key tool for achieving investment in emission reduction technologies, and we would expect any prolonged weakness in carbon prices to produce further tightening in emissions quotas over time.

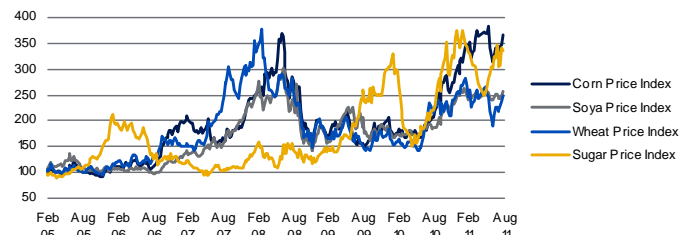
Oil/Gas



Source: Bloomberg

US gas, which looks to have found a floor, remains extremely cheap relative to oil and coal, which will incentivise further fuel switching towards gas. In Europe and Asia gas prices are already moving higher, currently trading close to double US prices, and leading to higher revenues across the gas value chain. 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.

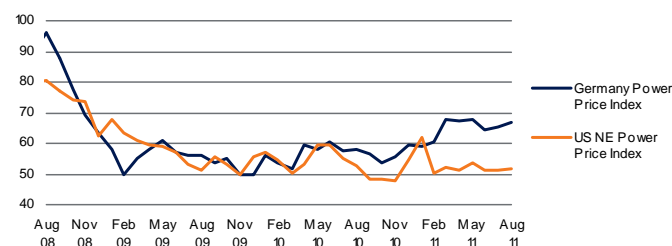
Agricultural Commodities



Source: Bloomberg

Tight global inventories in many key crops leaves the agricultural system vulnerable to further disruption and we expect prices to remain at high levels throughout 2011. Recent trends have shown some weakness, particularly wheat where Russian supply is recovering after the devastating drought and fire of 2010. 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.

Power Prices



Source: Bloomberg

We expect power prices to complete a bottoming process over the next few months and 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.

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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