

Schroder ISF\*

# Global Climate Change Equity

## Monthly Newsletter

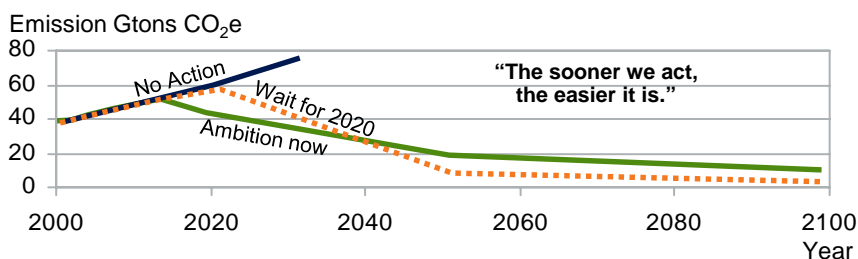
Issued in January 2012

The big event of December was the Durban-based UN Climate Summit. As we stated in our November newsletter we weren't expecting any significant progress on an international, legally binding climate change agreement; and sadly we, as with most observers, were proved correct.

### What were the outcomes of the Durban meeting?

The main outcome was the "**Durban Platform for Enhanced Action**". This is an agreement by all the world's countries to have in place a legally binding treaty by 2015 which will enter into force in 2020. At this stage it is unclear what the binding targets will be, but most would expect that it will be carbon intensity improvement targets (i.e. carbon emissions per unit of GDP) for the world's poorest countries and absolute emission reduction targets for the major emitters. Though there are still major obstacles, essentially the "plan" is a recognition that no country wanted to be seen as a cause of failure in the UN process.

**Fig 1: Total Greenhouse Gas Emissions**



Source: <http://climateinteractive.wordpress.com>

There was acceptance that in the interim action needs to be taken to address the "**ambition gap**" and see if there are tools available to encourage countries to improve their existing voluntary commitments set at the 2011 Copenhagen summit. This is because it is widely acknowledged that existing national commitments do not deliver sufficient emissions reductions to put us on the critical 2°C path. There is also growing concern about the flexibility written into the Copenhagen pledges. For example:

- The US committed to a 17% cut in emissions on 2005 levels by 2020, but it currently won't state what its 2005 emissions are
- Brazil committed to a 36% reduction from business-as-usual, but earlier in 2011 it raised its BAU emissions forecast giving it an extra 18% of emissions
- And in the EU, the excess emissions permits that its Eastern European members hold from the first Kyoto period could, if allowed to be used, enable the EU to increase emissions at the same rate it is now.

There was agreement for a second commitment period to the **Kyoto Protocol**, which would start on 1 January 2013, after the current commitment period expires. It is unclear at this stage what the commitments are during this second period (though they are likely to be the pledges made at Copenhagen), and it is likely to only cover countries representing 15% of global emissions (the EU, Norway, Switzerland, Australia and New Zealand). However, it is a positive that the Kyoto Protocol survived and by having a legally binding treaty still in existence it helps to smooth the passage for the global treaty agreed in the Durban Platform.

### What does this mean?

The act of delaying any international agreement for a decade will significantly increase the efforts needed to reduce emissions. If emission reductions to limit us to a 2°C warming path are delayed until 2020 then this means that we would need to reduce carbon emissions at an (impossible, in our humble view) 9% per annum rate, versus an (only highly improbable) 3.7% per annum rate if one was to begin now.

Whether either reduction rate is achievable is a moot point, as figures published by the Global Carbon Project showed that global CO<sub>2</sub> emissions had increased by 3% during 2011, which is on the back of a 6% increase in 2010; this all during a period of weak economic activity. This decade-long delay in action is more than likely to commit us to a

### In this month's newsletter

#### Policy developments and climate change news:

- Our low expectations for the Durban-based UN Climate Summit were sadly proved correct.
- The act of delaying an international agreement for a decade will significantly increase the necessary pace of eventual emission reductions.

#### Key investment themes: From mitigation to adaptation

- With progress on global emission reductions falling so short of levels necessary to avoid dangerous climate change, equity investors need to deepen their understanding of its implications for the corporate sector.
- it is already absolutely clear that natural catastrophes represent a growing threat to economies, businesses, and in particular insurers.

#### 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

Our exposure to the energy efficiency theme has risen to over 40% of the fund. The current portfolio has significant upside to fair value, and we believe it will perform very strongly once the equity markets get back to focussing on company fundamentals.

#### 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

3°C warming path, and underlines the continued disconnect between science and political action.

Even if a globally legally binding agreement is achieved by 2015 there is no guarantee that countries will sign up to it (Russia, Japan, the US and Canada all pulled out of the Kyoto Protocol). One has only to recall that the Bali climate negotiations in 2007 ended with an agreement to halt warming at 2°C and the “Durban platform” merely underlines the fact that the past four years of international negotiations have achieved nothing in meeting this goal. Perhaps one benefit of a 2015 target is that this will tie in nicely with the presidential electoral cycle in the US, and with the 13<sup>th</sup> Five Year Plan in China, and provide a greater chance of getting both these major emitters to sign up to a new global agreement.

There also continues to be emissions reduction activities going on at the regional, national and state level:

- China has reinforced its commitment to a national Emissions Trading Scheme (ETS) being implemented by 2015
- The state of Rio de Janeiro aims to establish Brazil's first ETS by 2013
- The EU Court of Justice has ruled that (as of 1 January 2012) all airlines flying to, or from, the EU's 27 states will be taxed on their emissions
- 2012 should also see the introduction of carbon taxes in Japan and South Africa.

**To summarise, the lack of co-ordinated action means that there will be costlier, steeper emissions reduction required in the future. These actions will also be more questionable in their effectiveness compared to pre-emptive action. While there is still a continuing UN climate process, the chances of avoiding a 50% chance of dangerous climate change under the mainstream IPCC scenarios are vanishing rapidly.**

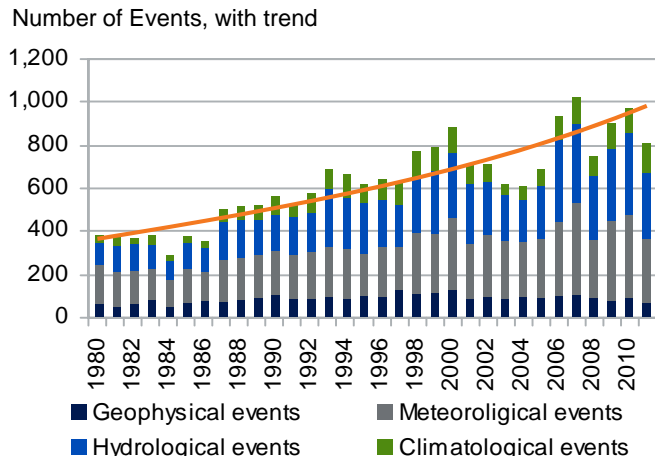
On the basis that competitive financial interests can deliver where politicians fail, our focus therefore remains on those low-carbon and energy efficiency technologies that are becoming increasingly competitive with incumbent fossil fuel technologies.

## Key Investment Themes: From mitigation to adaptation

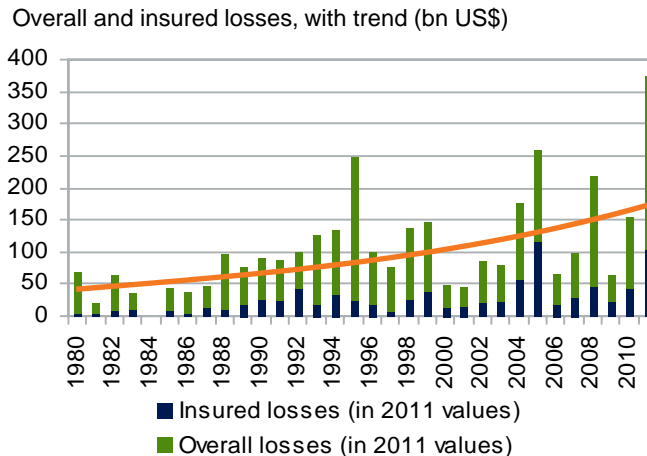
With progress on global emission reductions falling so woefully short of levels probably necessary to avoid dangerous climate change, equity investors need to significantly deepen their understanding of its implications for the corporate sector. We expect planning for adaptation to climate change to be a growing theme in the next 1-2 years.

As the reinsurance industry data below demonstrate, it is already absolutely clear that natural catastrophes (driven by meteorological, hydrological and climatological events) represent a growing threat to economies, businesses and, in particular, insurers.

**Fig 1: Natural Catastrophes Worldwide, 1980 - 2011**



**Fig 2: Natural Catastrophes Worldwide, 1980 – 2011**



Source: Munich RE, 2012. **Geophysical events** (Earthquake, tsunami, volcanic eruption). **Meteorological events** (Storm). **Hydrological events** (Flood, mass movement). **Climatological events** (Extreme temperature, drought, forest fire)

With significant disruption to global supply chains, the devastating tsunami in Japan and floods in Thailand in 2011 highlighted how interconnected the global economy has become. This interconnectedness brings new risks for companies to manage, and the aforementioned events have already led many management teams to reassess their supply chain organisation.

We believe that the preparedness and resilience of individual businesses will become an increasingly important component of profitable success and equity valuation in the future. For instance companies may incur higher costs to build in such resilience, or run the risk of lost business and permanent competitive weakening as a result of “unexpected” business disruptions. Resilience is hard to value in a financial model, yet it clearly has value. Positioning a global portfolio in those companies with the best understanding of the implications of climate change on their business will become more synonymous with a “quality” bias.

In terms of the insurance industry, such clear trends represent both opportunity and threat. Following the higher losses, the reinsurance industry will see better pricing power to incorporate higher loss assumptions. It should also lead to new product revenue streams as innovation increases in the industry, and competitive advantage for those businesses able to invest in proprietary catastrophe risk assessment modelling.

With climate change mitigation looking less likely by the year, we expect to hear much more from national governments and multinational companies on adaptation strategies and investments in the years ahead.

## 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.

With growing pressure on government finances, we are very focussed on 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 fund, and exposure to clean energy where subsidies are still required, is at an all-time low for our portfolios.

We have utmost conviction that long-term performance is not generated by selling good quality companies that are investing intelligently in projects with good IRRs (provided those returns are not dependant on excessive economic assumptions). Calculated as the average of our individual holding fair values, the current portfolio has significant upside to fair value, and we believe it will perform very strongly once the equity markets readjust to the realities of higher sovereign risk and gets back to focussing on company fundamentals.

We made the following significant changes in December:

In **clean energy** we took the decision to exit our position in **Wacker Chemie** as it became evident that German solar installations were going to disappoint meaningfully. Whilst a relatively recent position we had to materially revise the outlook as it looked like Germany was beginning to suffer the effects of a significant freezing of credit in certain markets such as solar. We continue to believe in the consolidation of the industry but with the market taking another leg down we took the decision to step aside when we revisited our numbers.

**Energy efficiency** continues to be our biggest weighting by theme going into 2012. We started a position in **Texas Instruments** given an attractive valuation, a potential bottoming of the semis cycle and strong exposure to energy efficiency themes. We also added back **Polycom**, as the earlier optimism that had caused the stock to reach fair value and for us to sell it last month receded, and we managed to re-enter the stock at a good price. With the ever high oil price, companies are making tele-conferencing one of the key enterprise spend areas and **Polycom** is the pure play beneficiary of this trend. We sold our remaining position in **Nine Dragons Paper**. The stock has recovered meaningfully over the last few weeks and we took the opportunity to exit following a poor management meeting and significant concern over the future health of the balance sheet given management plans.

We also sold out of **Philips**. With the stock having performed better we decided that the risk reward wasn't sufficient versus our opportunity set during the re-structuring they are undertaking. With significant execution risk and a history of disappointment we re-allocated the funds.

In **low carbon fossil** fuels we sold our position in **Quicksilver Resources**. This has been a poor performer but recent concerns over management and balance sheet strength convince us that the risk reward is not favourable, particularly with a poor commodity price backdrop in the US for natural gas.

### Current allocation

Investment theme	% of fund
Energy Efficiency	46
Low-Carbon	16
Sustainable Transport	15
Environmental Resources	12
Clean Energy	4
Other/General	7

Region	% of fund
North America	44
UK	15
Continental Europe	14
Japan	11
Emerging Markets	11
Pacific X Japan	1

Source: Schroders, as at 31 December 2011

## Update on key markets

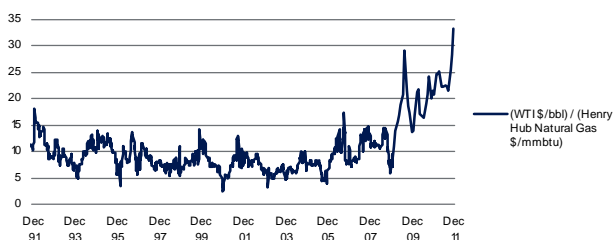
### Carbon Price



Source: Bloomberg

Carbon prices have weakened considerably in recent weeks. There have been several reasons for this which include a rapidly weakening economic outlook in Europe, a liquidity problem in European banking and also the market has been digesting 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. It is important to remember that 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.

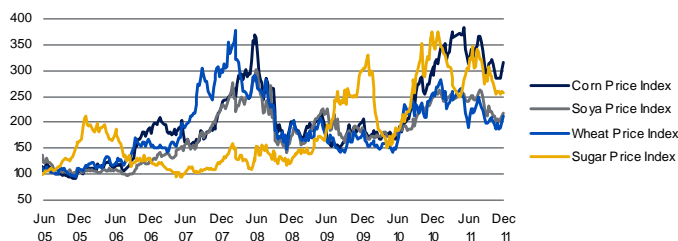
### Oil/Gas



Source: Bloomberg

US gas remains very weak and 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 at more than 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.

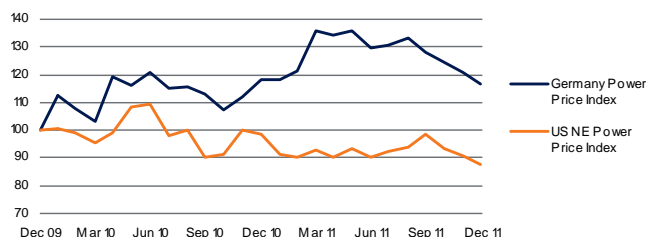
### Agricultural Commodities



Source: Bloomberg

Tight global inventories in many key crops leaves the agricultural system vulnerable to further disruption. This may result in price spikes and increased volatility but generally we expect prices to continue to follow their longer term upward trend. Recent moves have been a reversal towards that trend, from temporarily higher levels. Climate change is clearly inflationary for agricultural prices in aggregate, and the fund remains exposed to the value chain of this sector given the higher investment that will be required to contain prices. The more recent market volatility has also impacted by reduced speculative demand.

### Power Prices



Source: Bloomberg

We expect power prices to complete a stabilisation 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 (not withstanding strong government support programs 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 has lowered forward price expectation along the curve in the last quarter.

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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