

Schroder ISF\*

# Global Climate Change Equity

## Monthly Newsletter

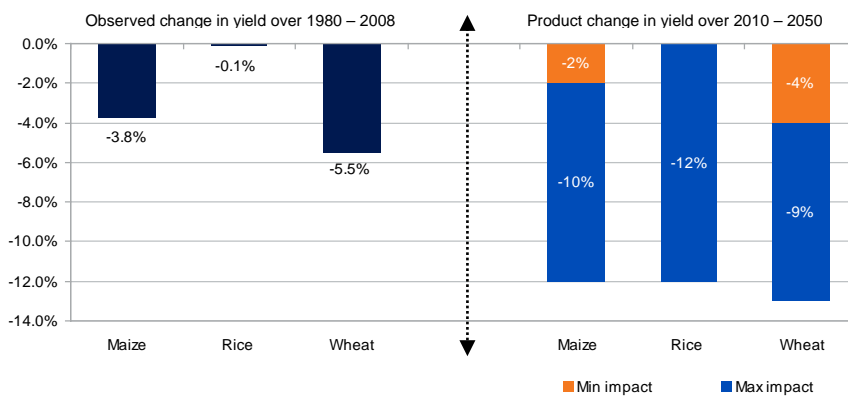
June 2011

This June, Oxfam will release a report highlighting concerns that the price of food staples will double over the next twenty years. Meanwhile, a study entitled “Climate Trends and Global Crop Production since 1980” has shown that the effect of rising temperatures has caused a drop in crop yields over this period.

### A growing need for adaptation in agricultural production

While yields have increased since 1980 due to improvements in agricultural practices and plant breeding, the effects of warming have exerted a drag on these improvements. Effectively, a 1°C temperature increase above optimum, lowers grain yield by 10%. According to the authors, agricultural commodity yields could decrease by a further 12% by 2050 (see chart 1 below).

Chart 1: Grain yields have already declined up to 5.5% due to climate change; yields are projected to decline even further in coming decades



Source: Labell et al, 2011 and Nelson et al, International food Policy Research Institute

The study highlights the need to begin looking at tools for agriculture to adapt to a warmer world. Potential solutions could be in genetically engineering more heat-tolerant plant species, or seeing areas of agricultural production moving further north. Climate change is one of several factors currently impacting the price of food; these include population growth, increased meat consumption and potential competition with biofuels. This year there are already concerns over the impact of droughts in parts of Europe and the United States on wheat yields and, in a trend that seems set to continue from last year, we have already seen rioting (in this case in the Maldives) in part due to rising food prices.

### Continued fall out from Fukushima

The repercussions from the Japan tsunami for various nations' nuclear strategy continue to be felt. Japan has announced that it will be re-thinking its plans to boost the share of nuclear capacity from 30% to 50% by 2030, with a greater role for renewables. At present, the full implications of this statement are unclear. As we highlighted in our note on Japan last year, there is little suitable land or off-shore capacity for large-scale wind development, meaning that the likely beneficiaries would be increased investment in energy efficiency and in solar. In order to fill the gap that would be left through suspending Japan's nuclear new-build, HSBC estimates that there would need to be an additional renewable capacity of between 1.75-3.5GW per annum between 2011 and 2030 (two to three times the current 2011 renewable forecast for Japan), while Germany has announced its intentions to phase out nuclear power by 2022. With 25% of Germany's electricity currently being produced by nuclear this implies a significant change to the current electricity system, as the gap

### In this month's newsletter

#### Policy developments and climate change news:

- An imminent report by Oxfam will show the cost of food staples doubling in 20 years
- We need to look at tools to enable agriculture to adapt to a warmer world
- repercussions from the Japan tsunami for various nations' nuclear strategy continue to be felt

#### Key investment themes: Energy Efficiency

- Factory automation and energy efficiency are growing at 30% p.a. in China
- China's biggest challenge is to use less power per unit of GDP

#### 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.
- We will continue to see the euro crisis play out in 2011 with the likelihood of sovereign debt re-structuring.
- We are 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.

**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

in supply would be made up, in part, by off-shore wind farms in the North Sea to replace the nuclear power stations in the south. This will require investment in the transmission and distribution grid. Analysts have also estimated that electricity use could be cut by 10% over the next decade through more efficient machinery and buildings.

The most significant planned increase in nuclear power was from China with an estimated 45% of global new capacity additions in 2010. They have already completed a review of existing plants and are finishing the process of reviewing planned plants. We expect the results within 3 months but expect there to be minimal disruption to the plans. Nuclear power has been regarded as a strong contributor to delivering a low-carbon economy and we continue to believe that this will remain so. At the margin sentiment has improved for renewables but we continue to favour energy efficiency, grid infrastructure and most importantly Gas.

## Key Investment Themes: Energy Efficiency

Having spent two weeks in Asia, including visits to Beijing, Chengdu, Chongqing, Singapore and Hong Kong, the big themes are all centred on energy, inflation and the new 5 year economic plan in China. With factory automation and energy efficiency growing an estimated 20-30% p.a. in China, we discuss the sector and opportunities as well as our holdings.

### Energy Efficiency is currently around 35% of the fund's investments

Key drivers for this theme at the moment are strong wage inflation in China, input costs increasing with raw material inflation, and power prices to commercial and industrial customers increasing. There are also more blackouts as electricity demand exceeds supply. We explore the charts below:

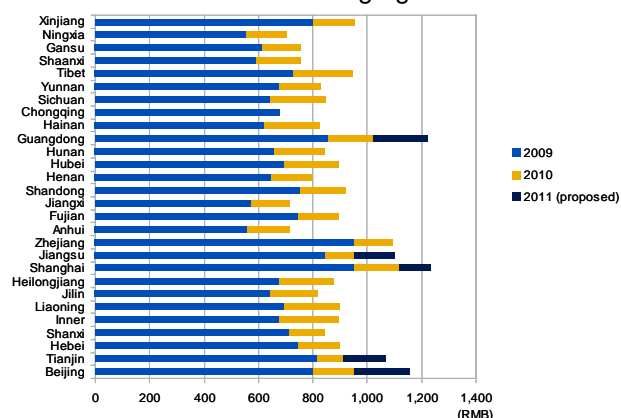
Chart 2: Spot coal prices in China



Source: CEIC, CLSA Asia-Pacific Markets

Coal prices continue to increase and this pushes up the electricity cost to industry, given that over 75% of electricity is coal derived from China.

Chart 3: Provincial minimum wage growth

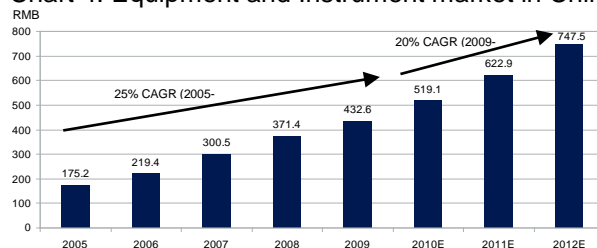


Source: CLSA Asia-Pacific Markets

As shown above, wage growth of 20% in the minimum wage category this year, has a meaningful affect on the margins of many of the labour intensive industries that reside in China unless they can offset the labour cost and mitigate their energy usage. Labour productivity has been the main solution in maintaining margins despite strong cost of goods sold inflation.

The equipment market has been a key enabler of this and is forecast to continue to grow significantly as in Chart 4.

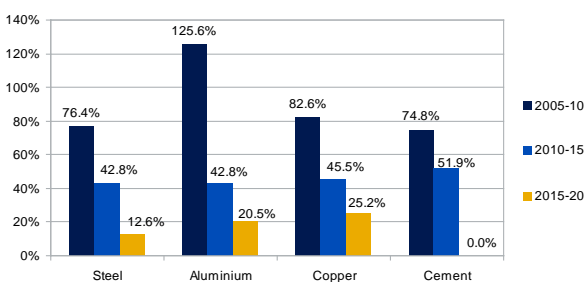
Chart 4: Equipment and Instrument market in China



Source: Company data, China Instruments and Meters Association

A lot of the solutions that are offered in this diverse industry are products that are key components or systems in driving efficiency. This will be in the power generation and many other general industrial sectors. The fund has significant exposure to factory automation which helps automate processes and maximises the efficiency of the facility. Examples include **Fanuc**, **Siemens**, **Hexagon**, **Honeywell**, **THK**, **Yaskawa Electric** and **China High Precision Automation**. Our position in China High Precision Automation has a particular exposure to pollution/water and also to power production which is China's biggest emitter of GHGs. China's emissions in 2009 were 7.5bn tonnes from energy-related industry. We believe China High Precision Automation has significant opportunity to capture share away from the tier 1 foreign vendors over time and will grow faster than the broader market.

Chart 5: Production growth of energy intensive metals and cement sectors in China



Source: CLSA Asia-Pacific Markets

The biggest challenge in China is to use less power per unit of GDP and this is the explicit aim of the government and the focus of the 5 year plan. By 2020, China has committed to reduce its carbon dioxide emissions per unit of GDP by 40 to 45% from 2005 levels and use non-fossil fuels for about 15% of its energy. In addition, mandatory carbon and energy intensity reduction targets are set at the national and provincial levels.

The scale of investment and emission reduction will bring massive opportunities across a variety of industries, and each of our five themes is effectively included in this 5-year plan. We will continue to focus on companies with strong balance sheets, sustainable competitive advantage, good management teams and visible growth that benefit from climate change and the 5-year plan in this space.

## 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. Whilst 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. 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. With increased focus on leading indicators moving lower and Chinese tightening we maintain that these are manageable decelerations.

We used the relative strength in Clean Energy stocks to continue to sell down our holdings. Whilst the companies we trimmed are under offer - one is trading at an immaterial discount in the case of EDF Energies Nouvelles and one at premium in the case of Roth & Rau - we continue to use them to fund our new ideas.

We participated in the IPO of Solazyme which is a technology company that has developed a number of strains of microalgae that are highly efficient at converting sugars into oils. The company is very well positioned as a second generation biofuels company. The algae can be fed on sugars derived from corn starch, sugar cane or cellulosic materials. We think the valuation looks attractive and the company has a solid technological advantage.

In Environmental Resources we took the opportunity to top up Trimble Navigation as the stock has been weak during this period of market consolidation.

Energy Efficiency continues to be our biggest weighting by theme and we added two new names in May. We bought back a position in Quanta Services which is the leading US electrical contractor. The company benefits from the significant investment cycle in US electrical infrastructure spending and has reached a level where it looked attractive again.

We also initiated a new position in Zumtobel, a leading European designer and manufacturer of luminaries and ballasts used in professional lighting. The company has the second largest market share in Europe and has strong technological proficiency in LED lighting solutions for Commercial and Industrial applications. We think the shares look attractively valued and have a brighter outlook than the market is giving them credit for. We partially funded these with a trim of Hexagon, Polycorn and Rexam given strong performance.

In Sustainable Transport we took the decision to trim our position in RTI International following substantially improved performance on little news-flow.

### Current allocation

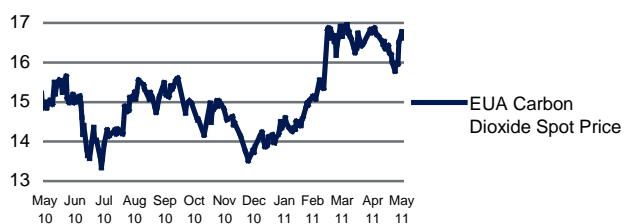
Investment theme	% of fund
Energy Efficiency	36
Low-Carbon	18
Sustainable Transport	17
Environmental Resources	14
Clean Energy	7
Other/General	8

Region	% of fund
North America	37
Continental Europe	23
United Kingdom	14
Japan	13
Emerging Markets	12
Pacific X Japan	2

Source: Schroders, as at 31 May 2011

## Update on key markets

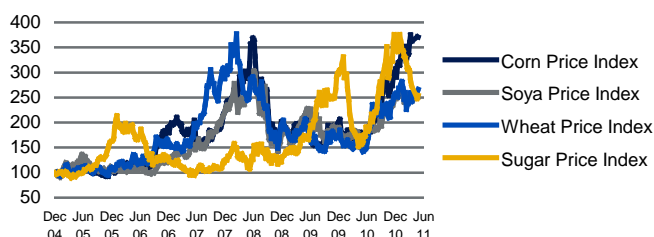
### Carbon Price



Source: Bloomberg

A rebound in industrial power demand, coupled with the removal of 7,000MW of low emission nuclear capacity in Germany, has significantly tightened European carbon markets. 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 have broken out above the previous 12-16 euro per tonne trading range, and should consolidate at these levels.

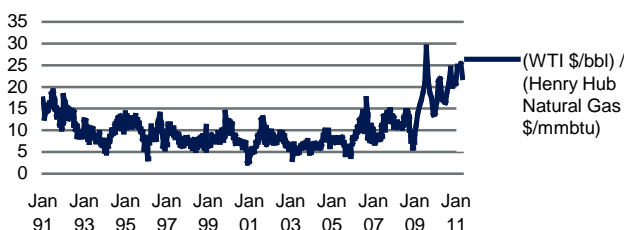
### Agricultural Commodities



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. Competition for planting between different crops has been intense this season, which illustrates how many agricultural commodities remain in tight supply. 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.

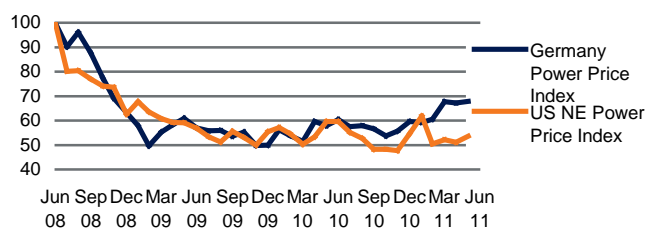
### Oil/Gas



Source: Bloomberg

US gas remains extremely cheap relative to oil and coal, which will incentivise further fuel switching towards gas. In 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.

### Power Prices



Source: Bloomberg

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 (notwithstanding 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.

**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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