

Schroder ISF\*

# Global Climate Change Equity

## Monthly Newsletter

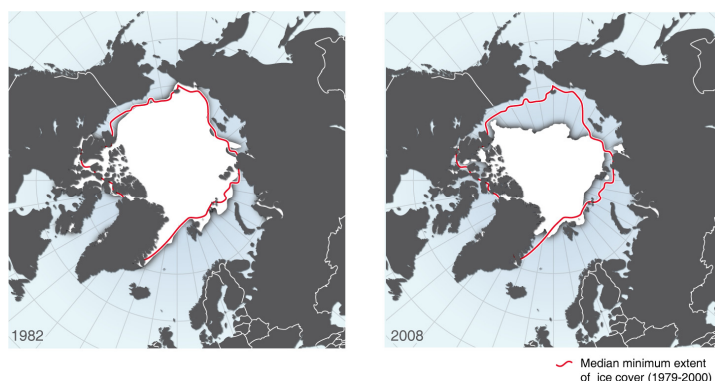
May 2011

Over the last couple of months there have been several reports on the warming of the world's oceans. Winter Arctic ice mass was equal to its smallest on record this year (since 1979). However, the group of scientists who predicted that the Arctic summer ice would all be gone by 2013 have revised their calculations, saying they expect this to occur by the end of this decade.

### Climate change impacts marine food webs

The ice disappearance is an obvious concern as a harbinger of the changing climate, but it also has other far reaching effects. Less ice means less ice algae growing on its underside, meaning less krill (which feeds on the algae). Krill forms the basis of the marine food web and its decline will have an impact throughout the marine food chain.

Chart 1: Arctic sea ice minimum extent in September 1982 and 2008



Source: UNEP/GRID-Arendal, Arctic sea ice minimum extent in September 1982 and 2008, UNEP/GRID-Arendal Maps and Graphics Library, <http://maps.grida.no/go/graphic/arctic-sea-ice-minimum-extent-in-september-1982-and-2008>

### China improves carbon efficiency, but it's the West's consumption where efficiency needs to be realised

China reported on its 11th five year plan (2006-2010) in which it had set itself targets to reduce energy use per unit of GDP by 20% and to increase the use of non-fossil energy to 10% of its energy mix. Emissions intensity actually fell by 19%; during the same period India reduced its emissions intensity by 14%, the EU by 5% and the US by 4%. However, China was starting from a much higher level of inefficiency and still uses almost three times as much energy per unit of GDP as the EU or the US.

For the first time in the new five year plan, China has now set an emissions reduction target of 17% per unit of GDP. The vigour with which the Chinese government pursues these targets will determine when emissions will peak, with US researchers predicting that this could occur in 2030 as demand for buildings, appliances and industry will have reached saturation point by then.

With China emitting 25% of the world's CO<sub>2</sub> its ability to curtail CO<sub>2</sub> emissions as soon as possible is essential if the world is to avoid dangerous climate change. However, the onus should not all be on China. As a recent Norwegian study illustrated, many developed countries have been able to meet their CO<sub>2</sub> reduction commitments through increased production outsourcing to countries such as China and India. If one were to factor out China's export related emissions then its carbon footprint would be well behind the United States. The report put forward the proposal that country emissions should be calculated from the consumption side rather than the production side.

### In this month's newsletter

#### Policy developments and climate change news:

- Over the last couple of months there have been several reports on the warming of the world's oceans.
- China emits 25% of the world's CO<sub>2</sub> but we shouldn't ignore the impact from Western imports.
- The EU continues the drive for further carbon reductions.

#### Key investment themes: Energy Efficiency

- If China is to achieve its energy efficiency and emission targets, new technologies will have to be deployed.
- NVC is the leading domestic lighting brand in China.

#### 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

## EU continues the drive for further carbon reductions

The EU has been suggesting that it may exceed its 2020 target of a 20% reduction in carbon emissions levels on 1990 figures. It may consider increasing this target to 25% and would consider holding back emissions permits to meet this target, much to the concern of high carbon emitting business. The EU has underlined its intentions for improving the carbon efficiency of its industry by outlining its plans to allocate only a proportion of free emission allowances to industry up to 2020.

High carbon companies will receive free allowances up to a benchmark based on the average performance of the most efficient 10% of installations in a sector for 2007-2008, but will have to purchase the majority of their emission permits for the 2013-2020 period. This will benefit companies operating carbon efficient business models as well as those companies that can provide more efficient production technologies. In addition, EU regulators have proposed to introduce an emissions levy on industries that are outside of the emissions trading scheme, impacting households, road transport and agriculture.

## UK introduces a domestic carbon price floor

The UK has made what is perhaps one of the boldest political commitments of late, setting a rising carbon tax from 2013, to

be paid should the carbon cost on the EU Emissions Trading Scheme be lower. The carbon price 'floor' will rise from £16 per tonne in 2013 towards a target price of £30 per tonne in 2020, representing close to 10% annual increases.

## Maritime emissions could be included in EU Emissions Trading Scheme

The EU has also announced that it is planning to consider tools to reduce maritime greenhouse gas emissions, either through the EU ETS or levies and taxes, as the International Maritime Organisation has failed to develop a plan despite a decade of negotiations.

## Water scarcity, an increasing political concern

Finally, with much attention being focussed on the Middle East at the moment, the UN Security Council has raised the prospect of water resource scarcity in the region being the cause of future conflict.

It is not just the Middle East where water scarcity is a cause for concern. The US Interior Secretary has said "alarm bells" were sounding across the US political spectrum about the western US's diminishing water supplies and that there was an urgent need for planning to deal with the issue.

# Key Investment Themes: Energy Efficiency - NVC Lighting

If China is to achieve its energy efficiency and emission targets, new technologies will have to be deployed across all energy consuming products. Globally, both Compact Fluorescent (CFL) and LED light sources are rapidly expected to take share from older technologies, and this shift is no different in China, as the charts below show.

Chart 2: Global demand for energy-saving products

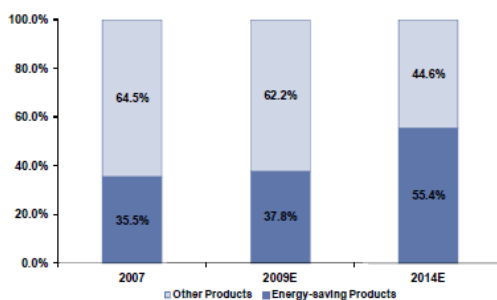
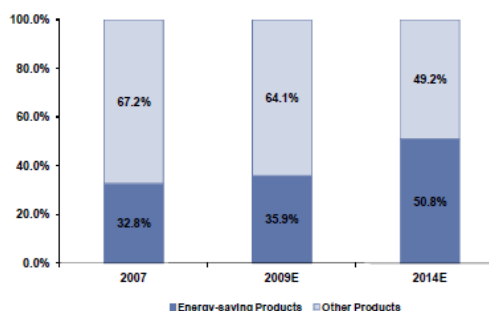


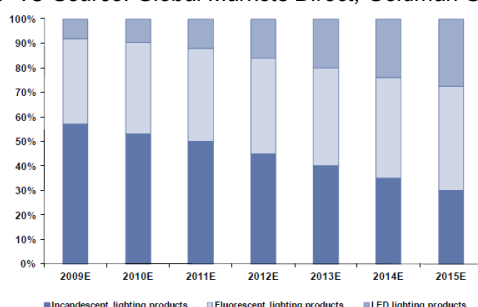
Chart 3: Chinese demand for energy-saving products



Source: Freedonia Custom Research; Goldman Sachs

We have recently added NVC Lighting back to the portfolio, after a period of consolidation in the shares. NVC is the leading domestic lighting brand in China, competing head-to-head with Philips and Osram. Its products service both residential and commercial buildings, through branded distribution outlets across China. It also has a rapidly growing export business into the UK and other developed countries. With a higher share of energy-saving products than most of its domestic competitors, we expect NVC to easily outgrow its peers and take market share, and benefit from government incentives to stimulate the shift to CFL and LED technology.

Chart 4: Global market share trend of different lighting products, 2009-15 Source: Global Markets Direct; Goldman Sachs



The combination of a growing market and market share gains should drive over 20% earnings growth for the next 3-5 years. This growth comes for a multiple of 13.5x our estimate of 2012 earnings, leaving plenty of scope for appreciation in the shares over the next 1-2 years.

## 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. 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.

In **Clean Energy** we took the decision to sell out of our position in **Cameco**, the Canadian uranium miner. There is too much uncertainty in future uranium demand to justify the valuation. We did trim our position in **EDF Energies Nouvelles** following a bid from its parent company. We also trimmed our position in **Roth & Rau** given strength.

We added to **Quicksilver Resources**, one of our **Low Carbon Fossil Fuels** holdings on unjustified weakness.

In **Environmental Resources** we decided to trim **Guangdong Investment** on concern the management has lost strategic focus and that the latest round of contracting for their core asset may disappoint. The valuation was not discounting that possibility and so we trimmed the stock and continue to do so on strength. We also took the opportunity to sell out of **Danaher** which has been very strong over the last six months and was looking expensive on valuation.

**Energy Efficiency** continues to be our biggest weighting by theme and we added another two new names in April. We bought a position in **NVC Lighting** as highlighted above.

Our second add was a position in **On Semiconductor** which has a leading energy saving "Green Point" technology for their power semiconductors. The stock looks attractive on valuation and had been oversold on its Japanese exposure.

We continued to add to **Samsung**, the world leader in Organic LED technology.

In **Sustainable transport** we had taken the decision to exit **Landi Renzo** on strength relating to US political news-flow around natural gas at the very end of March and we continued to sell into April. The valuation flattered Landi's prospects in the US market and we exited the position. We also trimmed **Giant Manufacturing**, taking profit.

### Current allocation

Investment theme	% of fund
Energy Efficiency	35
Sustainable Transport	17
Low-Carbon	17
Environmental Resources	15
Clean Energy	9
Other/General	7

Region	% of fund
North America	35
Continental Europe	23
United Kingdom	15
Japan	12
Emerging Markets	12
Pacific X Japan	2

Source: Schroders, as at 29 April 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.

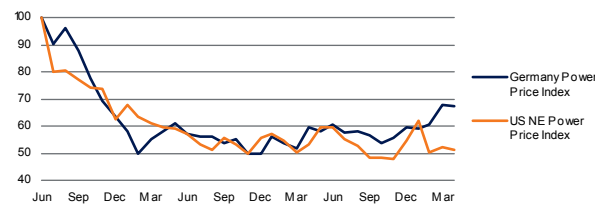
### Oil/Gas



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 (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.

**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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