Schroder International Selection Fund*

Global Climate Change Equity

Monthly Newsletter

Issued in September 2009

In this month's newsletter

Copenhagen – *A game of chicken, anyone?*

Pre-Copenhagen negotiations so far look like an international game of 'chicken', with hard bargaining going on to ensure relative national advantage within the overall goal of 50% global cuts. The current sticking point is the 2020 target for industrialised nations' emission cuts. (As we reported last month, the 2050 goal has now been agreed.) Most developed nations have called for a 16-24% reduction by 2020 relative to 1990 levels, but the US is refusing to commit to this. There are now 15 days of official negotiations before Copenhagen kicks off, with further talks scheduled in Bangkok in late September and Barcelona in November. We remain of the view that a deal will get done, but it will be last minute and with plenty of diplomatic noise in the meantime.

Progress at a national level continues

The Australian Renewable Energy Target (RET) legislation was passed on August 20, with a target of 20% of energy to come from renewable sources by 2020. This will mean mandatory targets for increased renewable energy production to 9,500GWh (2010) and to 45,000GWh (2020). The RET legislation is supportive of solar PV home installations and wind farms, but does not specifically support other renewables such as geothermal. The RET legislation was also decoupled from the Australian Carbon Pollution Reduction Scheme (carbon cap-and-trade mechanism), which was voted down on August 13, and is expected to be reviewed before returning to the Senate in November. This legislation is expected to enhance the returns on new wind power generation in Australia, which is the clear focus of **Infigen Energy,** a holding in the fund.

On August 31, the Democratic Party of Japan (DPJ) won a landslide election victory, ending the 50-year reign of the Liberal Democratic Party (LDP). The DPJ's environmental platform was much stronger than the LDP and included many supportive policies for the clean energy sector. These included the introduction of a domestic emissions trading market and carbon caps, mandates to reduce greenhouse gas emissions by 25% below 1990 levels by 2020 or by 30% below 2005 levels by 2020. The manifesto also proposed the introduction of feed-in tariffs for all types of renewable energy, and subsidies for green vehicles and energy saving appliances, boosting research and development. With 40% share of the Japanese solar PV market, fund holding **Sharp** should be one of the main beneficiaries of these new policies.

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The aerospace industry searches for options

The International Air Transport Association (IATA) has set a goal of achieving carbon neutral growth in aviation GHG emissions by 2020. IATA believes that fuel efficiency would need to be improved by 1.5% a year and, in addition to this, the industry will need to use biofuel blends. To this end, the industry has been experimenting with algae plants as leading alternatives to fossil fuels. Whilst most alternative fuel testing has been on jatropha and camelina plants to date, Agal oil shows more promise, as it does not conflict with land requirements for food crops. The tiny plants are capable of producing 60% of body weight as oil and the resulting fuel is of high quality, equal to or better than current jet fuel requirements.

The challenge is how to supply more than 60 billion gallons of jet fuel burned every year by the world's aircraft, so the real obstacle is cost, scaling up and feedstock. The first fuels are expected to be 50:50 blends or less. Aerospace biofuels are still very early stage, and we feel more confident investing in aerospace efficiency (i.e. titanium and carbon fibre materials) or technology to reduce the need for air travel (i.e. high quality video conferencing equipment).

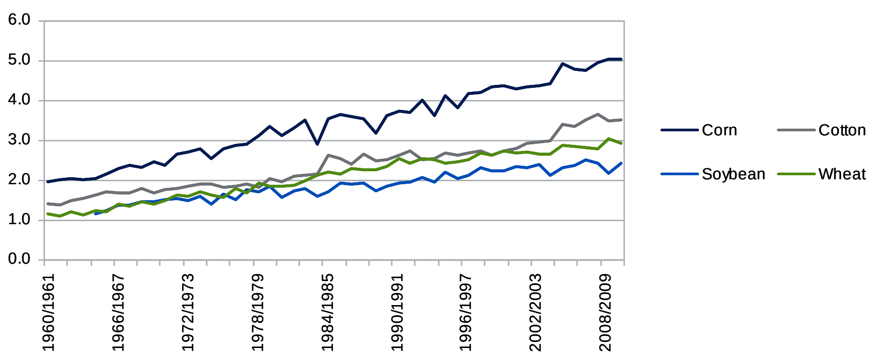
Key Investment Themes : The Global Dry

Demand for greater agricultural productivity is placing ever greater stress on land and water resources. Pressure from population growth and urbanisation, growth in biofuels, a shift to more western diets, particularly in emerging markets, and increased variability in the weather are all driving demand for an increase in global crop acreage and yield.

The UN is concerned that up to 25% of global production might be lost by 2050 due to climate change, land degradation and loss, water scarcity and species infestation. Of these, water scarcity, exacerbated by climate change patterns, presents the greatest concern. Some of the largest exporting countries for cereal crops have been suffering and continue to suffer from some of the severest droughts recorded. Globally, there have been severe droughts in Argentina since 2008; Australia since 2004, areas in the Black Sea (Russia and Ukraine) in 2009, failure of the 2009 Indian monsoon, and moderate drought in Iraq, China and Mexico this year.

Yet, agriculture is also part of the reason for water scarcity concerns. Since 1960, global food production levels have risen dramatically, mainly through yield improvements but also some acreage growth. Corn has seen an increase in yield since 1965 from 2t/ha to 5t/ha, cotton from around 1.5t/ha to 3.5t/ha, and wheat from just over 1t/ha to nearly 3t/ha. These yields have been achieved partly through extensive irrigation, but also through hybridisation, increased fertiliser use and mechanisation.

Global average yield increases for major cereal crops (1960-2008)



Source: USDA Foreign Agricultural Service

In order to continue to improve yield, and feed a population expected to grow by another 1.5 billion over the next 40 years, the UN believes a major investment in irrigation systems is required amounting to billions of dollars, especially in emerging markets and in Asia.

According to Intergovernmental Panel on Climate Change (IPCC), about 18% of the world's cropland receives supplementary water through irrigation, but this supplies a far larger proportion of global production due to enhanced productivity. Much of this irrigated land is in Asia where existing irrigation systems are often 50-70 years old and millions of smallholders have invested in pumps that extract water from shallow aquifers leading to falling water tables. Countries such as India and China urgently need to repair and modernise irrigation systems.

Genetic Modification (GM) is a technological extension of hybridisation and offers promise for soybean, corn and cotton (but not significantly for wheat yet), as well as vegetables longer term.

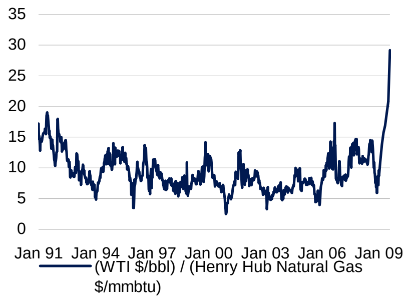
At the moment, GM is thought to only account for around 10% of total land use for these primary crops, grown mainly in the US, Argentina, Brazil and India. Although GM seeds are more expensive, their increased tolerance to herbicides, insecticides and drought (particularly if sold as a combination), should help to meet global food demand in the future. The first GM seeds with increased drought resistance are expected to be available in 2011/12.

The fund invests in companies focussed on achieving improved but sustainable agricultural production. Thus we have invested in the most efficient technology for irrigation, the latest advances in hybridisation (i.e. genetically modified organisms, with a hopeful eye on the promised drought-resistant plants) and agricultural equipment.

This year, we have been building exposure to irrigation equipment supplies, where we see strong growth in the years ahead, with **Lindsay Corp** of the US**,** and **Jain Irrigation** of India being two recent additions.

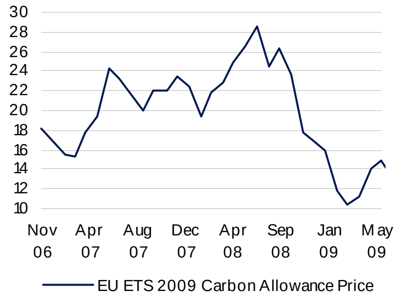
Update on key markers

Oil/Gas



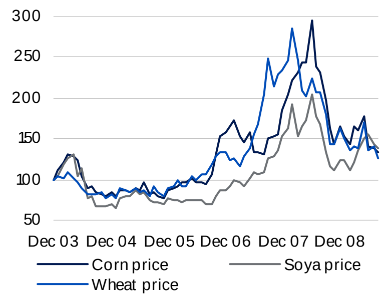
US natural gas prices remain extremely cheap relative to oil and coal. The competitiveness of natural gas relative to oil and coal will further increase as carbon regulation and pricing is introduced in the US market over the next few years, setting the stage for good medium-term performance in the gas price. However, with very weak industrial demand, short term the gas market is oversupplied and a strong recovery is unlikely before winter 2009. Most gas stocks remain hedged at higher prices for 2009, leaving this short-term price weakness manageable for now.

Carbon Price



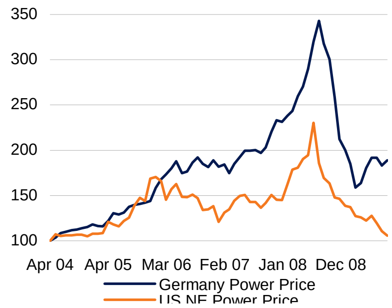
Lower economic output, and therefore demand for power, led to a softer carbon market in Europe at the start of the year. Shortages of issued emission permits versus projected demand in 2009 are now lower, and can be met by lower-cost CDM credits (UN certified emission reduction projects in developing countries). However, there will still be shortfalls in permits above the CDM quota as we approach the end of phase II (2011-2012), which along with a rebound in economic activity is now driving a rising carbon price. This bodes well for low-carbon energy generators, a key theme within the fund.

Agricultural Commodities



Most grain and oilseeds have remained weak over the summer. The overall trend is one of consolidation in grain prices, with some soft commodities such as sugar exhibiting better fundamentals following lower production in India. Sugar is making new highs weekly, driving better profitability for Brazilian sugar and ethanol companies such as **Cosan**, which is held in the portfolio.

Power Prices



US power prices continue to decline, while European power prices have rallied following sharp declines from the highs of 2008 driven by recession-related demand destruction.

As the economic incentive that high power prices provided for renewable energy deployment recedes, the development of policy support around the world is increasingly important. That continues apace, with money now flowing from the Obama stimulus plans to support US renewables capacity growth.

Source for all four charts: Bloomberg, as at 31 August 2009

Performance in August

Market review

Global equity markets rose again in August, led by improvements in western economies. Favourable economic news from the US included better-than-expected home sales, payroll numbers, growth in exports (industrial supplies and capital good shipments) and firmer durable goods orders. Industrial orders were also better than expected in Europe, with a 3.1% month-on-month rise. There was a bigger surprise in the UK, when the Bank of England extended its asset purchase programme by £50 billion, just a month after signalling an end of quantitative easing.

Overall, the pattern is of consistently more positive economic data, with markets further supported by cautious central banks that are determined not to remove liquidity and monetary easing too early.

Equity markets in Greater China, however, fell sharply following recent strong performance, as investors began to question the sustainability of growth, especially given reports that the government is looking to remove 'froth' in the economy by curbing bank lending and overcapacity in industries such as steel and cement.

There was also strong growth in India's economy in the second quarter, but there are also fears about the potential impact of the country's drought, as the monsoon season is yielding less rain this year than normal.

Financials produced the best returns in the MSCI World Index. The industrials and utilities sectors also performed well. The weakest sectors were energy, consumer staples and materials.

Fund performance

The portfolio underperformed the MSCI World index, primarily because of our lack of exposure to banks, which were among the best performers in the index (but where climate change does not make a significant impact on the investment cases hence our zero weighting).

We are also hurt by profit taking in some of the positions that have performed very well recently. This included **Guangdong Investment** (utilities) and, in the auto space of the consumer discretionary sector, **BorgWarner** and **Denway Motors**. China-related stocks generally fell in the month, as investors grew more concerned that tighter bank lending would lead to slower demand and slower growth.

Niko Resources also detracted. Earnings from the Canada-based E&P firm were lower than market expectations. First gas production from its offshore India wells started in April, and the ramp-up programme appears to be solidly on schedule.

On the positive side, performance was stronger in consumer staples, led by our holding in Brazil's **Cosan**. Quarterly earnings were better than expected, due to its sugar business reporting higher sales volumes and prices.

There were also good returns from **Sekisui Chemical**, **Central Japan Railway**, **Bouygues**, **Lindsay**, **Saft Groupe** and **Gunns**. France-based Bouygues reported a very strong set of results, with margins better than predicted in construction and telecommunications. The company also raised its revenue forecasts.

In the US, the government handed out $600 million in grants to companies working with the three big American car manufacturers to develop batteries for hybrid and electric cars. Saft is working with Ford and was one of the companies to benefit, with its' electric car JV being the largest recipient of grants to any component supplier in the program.

Stock selection strategy and activity

With the market rally continuing into August, albeit slightly more muted, a number of our stocks are pushing close to our estimates of fair value. We, therefore, have been aggressive in taking profits in these stocks, while at the same time adding to attractively valued growth stocks, which have been overlooked by the market through the recent rally.

We view the financial crisis induced slowdown in 2009 as a great buying opportunity year for alternative energy companies with a true competitive advantage, and, therefore, have continued to increase the portfolio exposure to these types of stocks as we go through the year.

In the Clean Energy theme, we initiated a position in **First Solar**. First Solar is well-positioned to take advantage of growing opportunities in the US, which should be one of the fastest growth solar markets, and crucially is the lowest cost producer in the world, which will help the company weather pricing pressures in the industry.

We took some profits in **Dongfang Electric** after the stock's strong outperformance, as investors digest the huge growth in nuclear and wind energy planned in China. Dongfang has the largest order book among the major power equipment companies in both wind turbines and nuclear generation.

Much of the key portfolio activity in the month was concentrated in the Environmental Resources area. We initiated a position in **Danaher**, a diversified industrial group with a strong and increasing focus on environmental technologies, in particular products designed to improve water quality.

We added to **Syngenta** and **Makhteshim-Agan Industries**, both of which manufacture crop protection chemicals.

This continues our moves over the last few months to increase net exposure to agriculture. However, we sold out of **Potash**, where the investment case weakened as pricing in the industry came under pressure.

We exited desalination equipment maker **Energy Resources** after a profit warning and news of further delays to key projects.

We also took profits in **Cosan**, which refines sugar and ethanol in Brazil, after strong performance on the back of the soaring price of sugar.

Overall, we expect market volatility to continue, given plenty of opportunity for stock picking within the climate change theme that itself has important catalysts ahead.

Current allocation

Investment theme	% of fund	Region	% of fund
Clean energy	25	North America	42
Energy efficiency	21	Europe ex UK	28
Environmental resources	16	UK	10
Sustainable transport	15	Pacific ex Japan	8
Low-carbon fossil fuels	14	Japan	8
Other	9	Emerging markets	4

Source: Schroders, as at 31 August 2009