For professional investors and advisers only

Schroder ISF*
Global Climate Change Equity
Monthly Newsletter

January 2010

Disarray at Copenhagen

The UN agreement-making process on climate change broke down at Copenhagen, and the situation for investments in climate change mitigation can be summed up as ‘little changed’.

For now, individual countries and regions will continue with their own individual, low-emission economic transition plans, but without the cohesive framework that a global agreement could have provided.

In the last 12 months, no major country has weakened their commitment to creating a low carbon economy, and, indeed, many have been strengthened. However, when it came to hammering out a global deal, the complexity of nearly 200 individual corners to fight ultimately proved too difficult to overcome.

A disappointing outcome

The conference produced a last-minute, cobbled-together compromise agreement.

The main positive was the drawing in of China and the US to a goal of keeping global temperature increases to below 2ºC. Basically, the world’s major economies have agreed that temperatures rises should ideally be kept below 2ºC, and other countries have ‘noted’ this.

This positive is offset by the lack of any real detail or certainty over emission reductions, with individual countries left to submit their own action plans later. A Chinese negotiator has already described the accord as being like a ‘voluntary agreement’, which is unlikely to inspire confidence among the private sector when making long-term investment decisions.

So, what conclusions can be drawn?

Firstly, the UN process of reaching consensus is clearly under severe pressure now, and has, perhaps, been fatally undermined by December’s chaotic negotiating process. After such blatant spoiling tactics and bilateral frictions, distrust amongst world leaders will probably have risen, proving negative for decision-making on all kinds of other important global issues.

When leaders like Angela Merkel – who would normally be heralding a deal – say ‘we have done one step, we have hoped for several more’, you know that there is little behind this voluntary international agreement. That said, it will be important to see how participants interpret the agreement over the next few months.

By 31 January 2010, the signatories have to submit emission reduction plans that they will voluntarily make. These plans will give an indication of intent and commitment, but are likely to be close to the already public positions on the matter.

Thus, we are left with a situation little changed from before Copenhagen – that of a patchwork of individual national emission reduction plans and a lack of trust on the issue between nations.

Governments will remain wary of the free rider problem, fearing that if they go too far in reducing emissions unilaterally their domestic businesses will be put at a competitive disadvantage.

As we have written previously, this raises the spectre of environmental protectionism going forward.

What does this mean for stocks?

Irrespective of the Copenhagen ‘fudge’, the national action plans already on the table will drive meaningful investment in low carbon technologies for the foreseeable future.

Europe, China, India, Korea, Australia, Brazil, Japan and the US all have major renewable energy investment plans. The electric car industry, which is clearly the long-term solution to emissions from the transport sector, is also developing rapidly.

We expect a continuation of strong investment growth in these areas, which, along with energy efficiency, represent our core investment themes.

The investment outlook here is unchanged, and we expect 2010 to be a relatively good year for clean energy stocks.

In this month’s newsletter

Schroders

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

Carbon loses out

The big loser from Copenhagen has been the carbon markets, with no clear agreement for a continuation of the scheme beyond 2012.

Without a clear framework for extending the international carbon markets, companies too focused on carbon credits or carbon prices will face serious challenges. We are, therefore, avoiding direct exposure to carbon markets within the fund.

Furthermore, the lack of clarity on carbon pricing will make regulation all the more important to achieve stated industrial policy, with UK new nuclear power a perfect example.

The private sector will simply not take the risk of investing $5-10 billion to build a new nuclear power station in the UK without greater guarantees over power, prices or regulated returns – and, with even less certainty on carbon prices now, governments will have to introduce other policy mechanisms to achieve their goals.

Adapting to the inevitable?

The bottom line is that Copenhagen will probably have more impact on international diplomacy than short-run investments in low carbon technologies, where the growth outlook remains strong for the time being.

However, an increasing number of participants will probably conclude that successful mitigation of climate change is becoming much less likely.

More thought will, therefore, be given to protecting societies from the consequences of climate change, and regions such as the EU, which are committed to climate change mitigation, will have to begin accepting that more investment needs to be focused on adapting to the more inevitable and disruptive climate change ahead.

Plans are already in place to drive growth in low carbon technologies for the next three to five years, so this matters little in the short term.

For now, we will be avoiding carbon market-oriented stocks where uncertainty is greatest, and stick to more basic and affordable low carbon technologies such as energy efficient materials and fuel efficient engines, along with wind and nuclear power generation.

Climate Science

A December report by 100 leading European marine scientists highlighted the increased rate of ocean acidification as a direct result of higher carbon dioxide (CO_2) levels in the atmosphere. The aggregation of a multitude of individual research projects notes that increased acidification will disrupt oceanic ecosystems and food chains, having profound implications for food supply and the other ecosystem services that oceans provide.

Separately, the Arctic Monitoring and Assessment Programme (reporting to the governments of eight arctic countries) reported that melt water discharge from the Greenland ice sheet has increased by 30% over the last decade. This rate of discharge is already considerably above that which is factored into existing IPCC projections, and thus represents further evidence that change is tracking towards the more severe scenarios.

Key Themes – Copenhagen in detail

Since 2007, most world governments have been working on developing a global agreement on climate change, via the UN, that could become a successor to the Kyoto protocol when it expires in 2012. Completion of the new treaty was targeted for the Copenhagen summit in December 2009.

However, it became clear in the run up to Copenhagen that there were some very big challenges to overcome. The following sections briefly cover these challenges and the level of resolution achieved:

1. Achieving a legally binding commitment on global and country emissions reductions

Outcome: A small group of countries (the US, China, India, Brazil and South Africa), drafted the 'Copenhagen Accord'. This is a political agreement, with no legally binding mechanisms. Other conference participants agreed to 'take note' of the Accord, rather than adopt it.

This leaves many questions unanswered, including whether the climate change process still remains within the United Nations (given the accord was developed outside of this process) and whether there will be any visibility on timing for a legally binding agreement. All eyes now turn to see who submits 2020 targets under the accord by the end of January 2010, and what these will be. However, the UN process continues, with the next major conference and attempt at a full agreement scheduled for Mexico in late 2010.

2. International Agreement to limit long-term warming to 2°C or less by 2100

Outcome: The Copenhagen Accord recognised the scientific view that, to prevent dangerous climate change, average global warming should be limited to 2°C (though there is no requirement on world governments to hold warming to this level). However, the final paragraph of the accord includes a reference to implementation, including a '…consideration of strengthening the long-term goal… including in relation to temperature rises of 1.5°C'. This reference, and the fact that 2°C warming is acknowledged as dangerous, implies that governments will work towards limiting atmospheric GHG concentrations to 450ppm or less.

The accord also notes that 'deep cuts in global emissions are required according to science' and that 'a low-emission development strategy is indispensable to sustainable development'. It should not be underestimated as a positive to have the US, China and India all sign up to this statement, as it underpins the direction of industrial policy towards low carbon technologies in the next decade.

3. Promises by developed nations to limit their emissions in both the medium term (2020) and long term (2050) and promises by developing nations to slow their emissions growth (either relative to business as usual [BAU] or to intensity/unit of GDP)

Outcome: One of the major surprises of the accord was the exclusion of long-term reduction targets (2050) as this had appeared to be the least controversial aspect of the negotiations. There is currently no clarity on what the exact 2020 targets will be and this will not be known until sometime after January 31st 2010, once participating countries have submitted their proposed targets (though there will still be lengthy negotiations after this process). It is likely that the respective national targets announced ahead of Copenhagen will remain in place, but there are some areas where this may not be the case.

Japan's 25% reduction target was contingent on an international agreement being achieved; the US' targets are still to be approved by Congress and we are unlikely to see the EU increasing its target from 20% to 30% as it had offered as this was conditional on other countries' commitments. These targets are not expected to be sufficient to limit warming to 2°C.

There is also no reference to a peak emission year, though the wording says '…we should cooperate in achieving the peaking of global and national emissions as soon as possible…'

There is no reference to a 2050 global reduction target and, whilst this is a concern, many governments have already included the achievement of their mid-term targets into national legislation, with mandates for energy efficiency, renewable energy and sustainable transport already issued to help them achieve these targets.

Finally, the loss of momentum in a global agreement that Copenhagen represents may hamper the passage of emissions 'cap-and-trade' schemes in the US and Australian legislature. The lack of legally binding mid and long-term targets also does not provide the clarity that businesses that have assets with long lives (e.g. power stations) need when making future investment decisions.

4. Developing countries hoping for compensation for damage caused by climate change (and how to adapt to it), as well as for low-carbon technology transfer and development from the developed world

Outcome: Agreement was reached for a collective fast-start funding for the period of 2010-2012 of US$30 billion (pledges currently amount to US$25.2 billion) and for a 'goal of mobilising US$100 billion a year by 2020 to address the needs of developing countries'. On the surface, this goes some way to meeting the concerns of developing countries; however, there remains no clarity over where the funding will come from and whether it is in addition to the aid financing that many developing countries already receive. Funding is also likely to be contingent on countries signing up to the accord. Furthermore, the accord made reference to technology transfer through a 'Technology Mechanism', but there was little clarity on the issue beyond this statement.

5. Tropical countries with large forests are pushing for a scheme whereby nations that protect their forests are financially rewarded

Outcome: The accord recognises 'the crucial role of reducing emission from deforestation and forest degradation, and the need to enhance removals of greenhouse gas emission by forests'. It also recognises the need to establish a mechanism to enable the mobilisation of financial resources from developed countries to help achieve this.

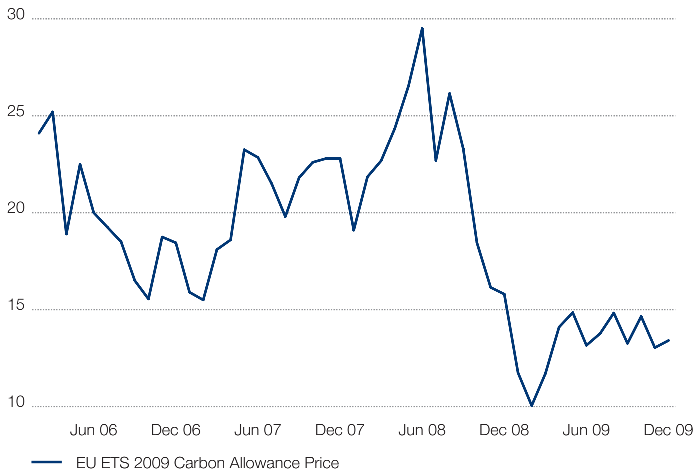
A Copenhagen Green Climate Fund will be established to help finance, amongst other things, reduced deforestation and reforestation activities. The details of how this will be implemented still need to emerge, and could have important long-term impacts on the value of various forestry-related businesses.

6. Agreement on limiting emission from aviation and shipping

Outcome: There was no agreement to regulate these sectors. This will mean that the EU will push ahead with including aviation in the EU Emissions Trading Scheme (ETS) by 2012 and is likely to advance legislation for the inclusion of shipping as well. There are likely to be legal challenges to this from non-EU carriers. Whilst it is likely initial reduction permits will be grandfathered out (i.e. given out for free) to the industry, emission allowances decline over time, having negative implications for an already beleaguered aviation sector.

Update on key markets

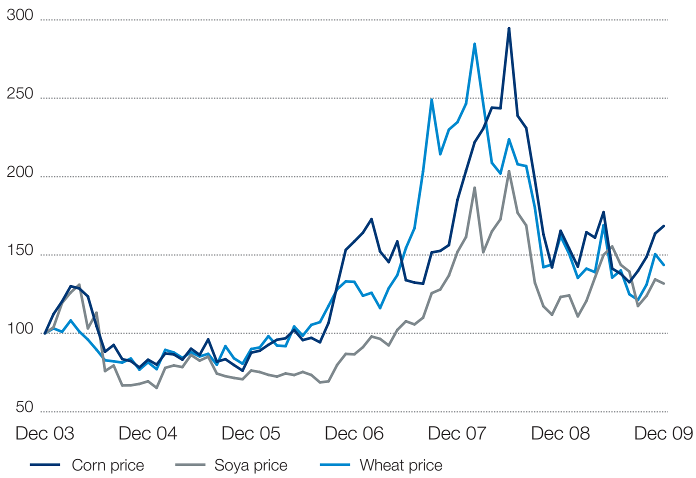
Carbon Price



Source: Bloomberg.

Lower economic output and, therefore, demand for power, led to softer carbon markets in Europe in 2009. This was compounded in December by a chaotic Copenhagen climate change conference which provided little clarity for the future of carbon markets beyond 2012. Nevertheless, at the very least the EU Emission Trading Scheme will continue through 2020, even if international carbon credits lose some support. We would not expect a strong recovery in carbon prices in 2010, and continue to avoid stocks directly exposed to the carbon markets in favour of more basic technologies such as renewable energy, and energy efficiency.

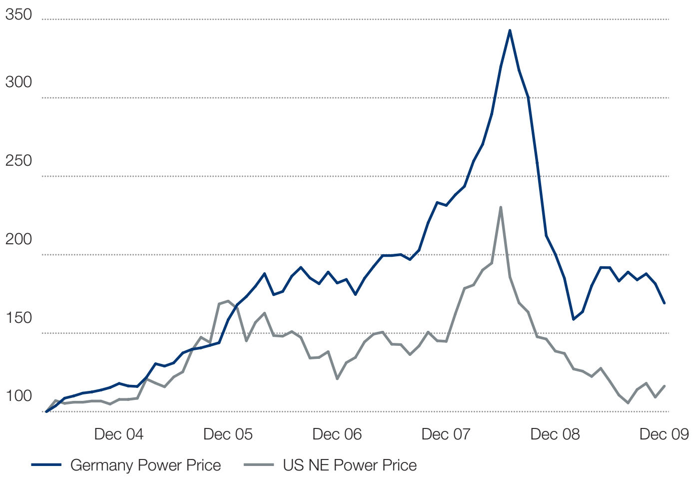
Agricultural Commodities



Source: Bloomberg.

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. Most grain and oilseeds have rebounded into year end. 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 has broken out to new highs as Indian production is not expected to sufficiently rebound in 2010. Higher prices are driving better profitability for Brazilian sugar and ethanol companies such as Cosan, which is held in the portfolio.

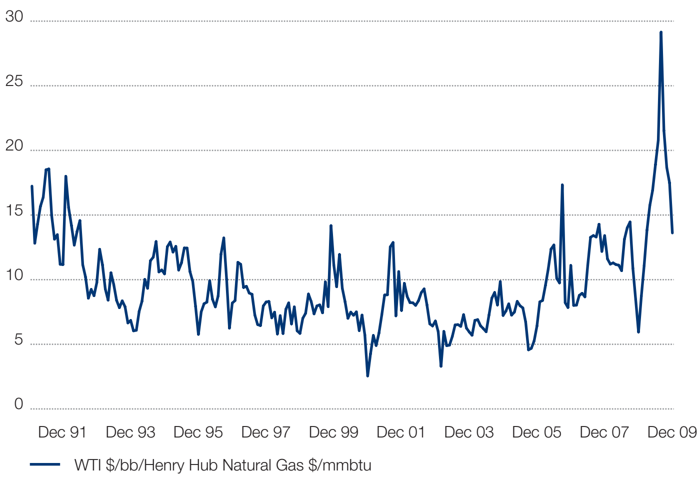
Power Prices



Source: Bloomberg.

US power prices have finally stabilised, while European power prices have stalled in the face of persistently weak industrial demand and an oversupply of gas in the region. 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 many stimulus plans and low carbon growth strategies around the world to support renewables capacity growth.

Oil/Gas



Source: Bloomberg.

Despite a significant recent winter rally, 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 over the next few years, setting the stage for good medium-term performance in the gas price and related companies.

Performance in December

Market review

Equity markets had another good month in December, with all major US and European indices reaching new yearly highs and ending the month in positive territory.

Investors around the world were encouraged by good economic news from the US, with stronger-than-expected employment data boosting confidence about the recovery.

The positive sentiment was tempered at times, however, with concerns about default in Dubai unsettling investors as the month began, and worries about sovereign risk associated with Greece and Spain dampening the mood later in the month.

Considerations about how continued de-leveraging could hinder the recovery also weighed on investors' minds, but did not prove sufficient to prevent the upward progress of global equities.

In sector terms, information technology, consumer discretionary, materials, utilities and industrials all outperformed (within MSCI World). Financials fell, however, with sentiment weakening following significant returns and after several capital raisings in the US and Europe.

The big climate change story was the Copenhagen summit; yet two years of negotiations were concluded with little more than a last-minute, non-binding agreement.

However, while little progress was made on a global agreement, the build-up to the summit has catalysed all major economies to implement low carbon investment strategies, which we expect to drive good growth in climate change investments over the next two to three years.

Fund performance

The fund outperformed the MSCI World Index during December, benefiting from positive stock selection across a range of sectors.

Our industrial holdings were the strongest contributors during the month, with **Spirax-Sarco Engineering**, battery producer **A123 Systems** and car parts maker **JTEKT Corp** all performing well. We believe the latter will benefit from long-term structural growth in electric power steering systems, which improve fuel efficiency and where JTEKT has a 45% global market share.

Stock selection was also markedly positive in information technology (led by video conferencing supplier **Polycom**), energy (notably **Niko Resources** and **Quicksilver Resources**) and the consumer discretionary sector, where **Honda Motor Company** and **Lowe's Companies**, among others, outperformed.

Honda remains attractive given its leading position in fuel efficient engine technology, whilst home improvement retailer Lowe's has been focusing on reducing fuel consumption across the supply chain and provides a wide range of energy efficient products for residential housing and construction markets.

Elsewhere in the portfolio, there were strong returns from titanium materials firm **RTI International Metals** and ethanol producer **Cosan**, and good returns from utilities **Centrica** and **PG&E Corp**.

Wind turbine manufacturer **Gamesa** was the main detractor. The stock has suffered recently following the resignation of the firm's chairman, but these changes have not affected our view on the growth prospects of the company.

Stock selection strategy and activity

This month we again increased our exposure to several companies with strong growth prospects in the clean energy space, while taking profits in a range of holdings as they approached our estimates of fair value.

Despite the disappointing Copenhagen conference, we expect 2010 to be a recovery year for many companies involved in clean energy and low carbon technologies. Customer orders for many companies involved in renewable energy deployment appear to have bottomed in mid-2009, setting up this year for good order growth. We are positioning the fund accordingly, with increased exposure to these areas of our investment universe.

Within Clean Energy, we added to three firms involved in renewable energy from wind.

Suppliers **Gamesa** and **Hansen Transmissions** are high conviction holdings for a recovery in wind installations in the second half of 2010, and we took the opportunity to top up both positions after share price weakness. Wind farm developer **Infigen** is set to benefit from Australia's new 2020 renewable energy targets, which look likely to support high returns on new investment in wind generation.

We also added to our holding in **First Solar**, as very strong demand for solar panels was seen during the fourth quarter in Germany – the key market for this firm. This trend is expected to continue into the first half of 2010.

In the Environmental Resources space, we added to our holding in **China Forestry**, after investing through the IPO last month. The business will be supported by China's range of policies and incentives aimed at developing a larger domestic forestry industry. We also took profits in irrigation equipment manufacturer **Lindsay Corp** after strong performance, and added to food retailer Kroger. We believe **Kroger** offers considerable upside as rising agricultural prices bring an end to food deflation in the US during 2010.

Amongst Energy Efficiency stocks, we trimmed our holdings in engineering firm **Spirax-Sarco** and also in LED device manufacturer **Cree**. **Denway Motors** (Sustainable Transport) had performed well after M&A rumours and we also reduced the holding.

Current allocation

Investment theme	% of fund
Clean energy	23
Energy efficiency	21
Environmental resources	17
Low-carbon fossil fuels	15
Sustainable transport	13
Other	7

Region	% of fund
North America	42
Europe ex UK	19
UK	12
Japan	10
Pacific ex Japan	8
Emerging markets	5

Source: Schroders, as at 31 December 2009