Standard Life
Investments

Socially Responsible Investing

4th Quarter 2009

Global Outlook Q4

STANDARD LIFE INVESTMENTS

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Socially Responsible Investing

Climate change

The Copenhagen summit is viewed as a ‘make-or-break’ opportunity to act on climate change before it becomes too late and too costly to avoid catastrophic consequences.

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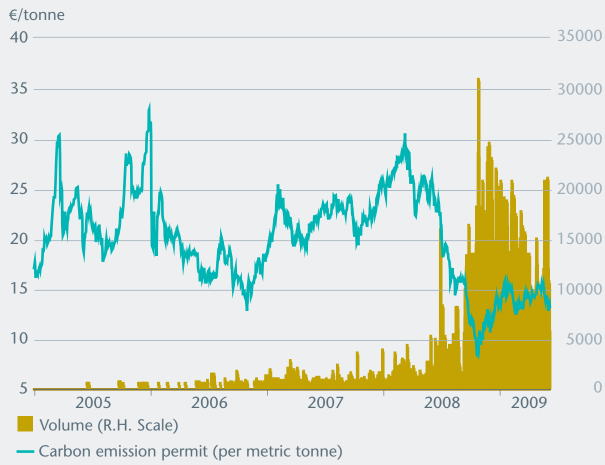
Chart 1
Volume grows, prices languish



Source: Bloomberg

In December 2009, world leaders will meet at a United Nations summit in Copenhagen to discuss a global agreement on climate change. With a ‘climate change aware’ world watching, they will seek a replacement to the 1997 Kyoto Protocol, which is due to expire in 2012. The protocol committed signatory developed countries to reduce greenhouse gas (GHG) emissions. There is a clear recognition that, if unaddressed, climate change will cause severe economic impacts that will threaten global prosperity.

Reductions yes, but to what level?

The initial international effort to address climate change resulted in the 1992 United Nations Framework Convention on Climate Change (UNFCCC). This aimed to achieve the stabilisation of GHG concentrations that would prevent dangerous anthropogenic interference with the climate system. The Kyoto Protocol followed, specifying that industrialised countries would cut GHGs by an average of 5% against 1990 levels over the five-year period from 2008 to 2012. In practice, total GHG emissions from countries committing to these targets have been flat, though the individual countries have demonstrated varying levels of performance. At the same time, GHG emissions from developing countries, who were not Kyoto signatories, have risen dramatically in line with the economic growth they have experienced. This means that international efforts thus far have not reduced the size of the problem.

The Intergovernmental Panel on Climate Change (IPCC), whose role is to assess scientific research on the causes and impacts of climate change, concluded in its 2007 Fourth Assessment Report that global emissions must limit the global average temperature rise to less than 2^{o}C. The IPCC suggests that achieving this goal would require emission reductions of 25-40% by 2020 and 80-95% by 2050. These estimates are regarded as conservative; some scientific observers have suggested that climate change is occurring at a faster rate than the IPCC findings, so deeper emissions cuts are necessary.

The overall level of emissions cuts agreed at Copenhagen will therefore be a key decision. Agreeing to severe reductions will be difficult, but if the level is unlikely to achieve meaningful reductions the agreement will be perceived as ineffective and may fail to gain acceptance and credibility.

Developed versus developing country commitments

Developed countries are the source of most past and current GHG emissions and are viewed as having the lion’s share of the responsibility for addressing climate change. In developing countries, there has been resistance to agreeing to limit the increase in per capita emission levels that will inevitably accompany economic development. However, recent Chinese statements have been more supportive. A major issue to be resolved at Copenhagen is the extent to which developing countries will contribute to global emissions reductions. They are most likely to be affected by the physical impact of climate change. The UNFCCC estimated that the costs of adapting to climate change by developing countries will range from $49 billion to $171 billion per year by 2030. The financing of these costs is a major issue to be considered in Copenhagen.

Market aspects

A further issue to consider in Copenhagen is how financial markets can augment government regulations. For example, the European market for trading carbon emissions was established in April 2005. Chart 1 shows how, despite the hiatus in 2007 when the trading regime moved from phase 1 to phase 2, volumes have increased to the extent that the market is clearly functioning. However, prices for the most part have been well below the levels at which they will deter GHG production.

Corporate stance

Corporate engagement in GHG reduction varies widely. Firms such as General Electric, BP, Siemens and Rio Tinto have called for further regulations, a global carbon market and restrictions on logging in tropical forests. Meanwhile, some US industry groups warn of large-scale job losses and electricity price increases of 50% by 2030 if the US adopts cap-and-trade legislation. However, the International Air Transport Association (IATA), whose members’ actions were not included in the Kyoto Protocol, despite accounting for around 3% GHG production, is taking a pro-active stance. It proposes to halve emissions from 2005 levels. In Europe, where carriers are set to join the EU emissions trading system in 2012, caps on CO_2 are set to be decided this autumn, after which passengers will likely face fare increases. A strong political signal at Copenhagen could make climate change a significant investment theme both for companies and investors to include in their analysis.

Oct 09

House View

This page sets out our House View as it applies to a UK based balanced fund. Details of how the House View applies to other UK-based funds and funds based in other parts of the world can be obtained from your Standard Life Investments representative.

	Positive	Negative	Our View
US Equities	• The recession is ending in response to major policy measures, such as fiscal packages and quantitative easing • Valuations are attractive, especially as more companies return to profitability	• Squeeze on corporate margins is forcing major cuts in employment and investment • Continued uncertainty about extent of downturn in the housing sector	Market supported by favourable long-term valuations and easier monetary and fiscal policy despite credit concerns STAY HEAVY
European Ex-UK Equities	• Management responding to pressures on margins through cost cutting and more M&A activity • Parts of the region did not experience as large a credit boom as other countries	• Exports remain under pressure due to euro appreciation and sharp slowdown in global trade • Continued concerns about efficacy of policy response in Europe	The region remains vulnerable to the strength of the euro currency impacting on company margins STAY LIGHT
UK Equities	• More aggressive monetary and fiscal support than in many other countries • Valuations such as dividend yields provide underpinning for the market	• Oil and resource companies vulnerable to sharp falls in commodity prices • Concerns remain about extent of consumer and housing bad debts as unemployment rises	Despite concerns about the valuation of a number of cyclical sectors, the market is supported by favourable valuations STAY HEAVY
Japanese Equities	• Japan's financial sector is in a stronger position than in some other countries • Increasing dividends plus share buybacks are helpful for investors	• Companies facing much weaker export demand from the US and Europe • Domestic data suggests economy is suffering a severe recession	Growing concerns about the impact of deflation on profit margins while the policy response is more limited than elsewhere STAY VERY LIGHT
Pacific Basin Ex-Japan Equities	• Infrastructure spending remains a primary driver of many economies • Some governments have taken strong action to support domestic activity	• Earnings at risk from the length of the slowdown in OECD demand • Concerns growing about eventual policy tightening in China to cap inflation risks	Long term valuations remain a concern but governments are taking strong action to support domestic activity STAY LIGHT
Global Emerging Market Equities	• Strong commodity demand is supporting some economies • Current account surpluses protect some countries from credit concerns	• Certain economies still require significant support from international bodies • Some central banks are becoming concerned about inflation risks	Some economies are supported by strong China trade links but others remain vulnerable to capital constraints STAY LIGHT
International Bonds			
US	• Quantitative easing by the US authorities should cap Treasury yields	• Vulnerable to increased supply as the fiscal position deteriorates rapidly	STAY HEAVY within international bonds as Treasuries benefit from quantitative easing
Euro-zone	• Slow response by the monetary authorities to the financial and economic crisis	• Extent of likely debt issuance from easier fiscal policy	STAY HEAVY within international bonds on expectations of further ECB quantitative easing
Japan	• Return of deflation and the lack of policy levers to stimulate economic growth	• Valuations starting to look stretched	MOVED TO VERY LIGHT within international bonds on a comparison of international bond yields
UK Bonds			Within UK bonds:
Gilts	• Interest rates are close to zero, anchoring short-dated gilt yields while the authorities are continuing quantitative easing to affect longer dated yields • Defensive characteristics increasingly recognised	• Continued concerns about the extent of the rise in the public sector deficit • Uncertainty about an exit strategy from quantitative easing is worrying some investors	Stay Heavy in conventional gilts Stay Neutral in index-linked debt
Corporate	• Strong retail and institutional investor demand for extra yield	• Downturn in corporate cash flows will lead to higher corporate bond defaults	Stay Very Heavy corporate bonds Corporate bond valuations remain attractive although individual issues require careful examination
Property			
UK	• Property income yields relative to gilt yields have risen to highs last seen in the 1930s. Evidence of price improvement in 'prime' assets as newly raised capital is invested.	• Rental values are falling in line with a weak economic recovery, especially continuing pressures on the retail sector	We favour well located properties with tenants of good financial strength, plus a sector bias towards core London markets, where future supply is limited, and dominant retail locations MOVED TO NEUTRAL
Global	• Lack of overbuilding in this cycle should support growth in rents as economies emerge from recession. • Infrastructure investment underpins opportunities in emerging markets.	• Credit conditions remain very mixed with commercial bank holdings of property overhanging some markets	We prefer selective high yielding logistics markets in Asia & Central Europe, and office locations with low future supply such as Paris and Sydney.
Cash	• Cash is an attractive alternative when corporate earnings and dividends are under pressure	• Cash yields close to zero are encouraging more investors to seek higher-yielding assets	Official interest rates in major economies are expected to remain low well into 2010 STAY VERY LIGHT

The terms, Very Heavy, Heavy, Light, Very Light and Neutral express Standard Life Investments' view of a balanced portfolio against a given benchmark.

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