

Launching the ML Carbon Leaders Europe Index

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The ML Carbon Leaders Europe index offers exposure to low carbon footprint stocks with favourable valuation characteristics. The index is constructed on a sector neutral basis in order to take into account the different sector characteristics of carbon footprints.

Combining carbon footprint with low trailing PE

The quantification of carbon can be taken as a proxy for environmental quality. A company that cares about its environmental impact, usually a peripheral consideration, indicates a company that has a higher overall business quality. This should demonstrate higher share price returns. In addition, a strategy of picking low trailing PE stocks outperforms its benchmark in all stages of the economic cycle, according to work by quantitative strategist Khuram Chaudhry.

Carbon disclosure requirement

Climate change issues have been at the forefront of media through 2007. Companies are facing increasing requirements for carbon disclosure, from investors, policy makers and consumers. With the quantification of carbon, investors can evaluate possible implications on valuation, and thus take a view on the company's environmental risk exposure. Media coverage will keep the topic current, with the newsflow catalyst of discussions on a post 2012 framework for reduction in December in Bali.

Catalysts include regulatory drivers

Carbon calculation is important because Europe has signed up to reduction targets under the Kyoto protocol. Some companies are already regulated by the emissions trading scheme and thus have an obligation to report carbon data, but others realise that understanding the sources of carbon, and implementing reduction measures, can be a cost saving tool.

Investors lower their own carbon footprint

The ML Carbon Leaders Europe index has a carbon footprint of 79.4 compared with the DJ Stoxx 600 which is 409.6. The index offers investors the opportunity to lower their carbon footprint without taking size or sector bias versus the benchmark, the DJ Stoxx 600. The index is published on Bloomberg under tickers MLEICO2E (EUR) and MLEICO2D (US\$), for the price return, and MLEICO2R (EUR) and MLEICO2T (US\$) for the total return, on a daily basis.



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Carbon data provided by Trucost



For information on Trucost see page 7

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Refer to important disclosures on page 10 to 11. Analyst Certification on page 9.

8 reasons to invest in Carbon Leaders

Quality - delivery of shareholder value

Carbon leadership indicates a higher overall quality of management. If a company cares about its environmental impact, usually a peripheral consideration, it cares about the overall strategy of the business - and more importantly delivering shareholder value.

Carbon is quantifiable, valuation driver

The increasing requirement for carbon disclosure, driven by regulatory requirement and investors, provides a quantifiable earnings driver. If carbon costs are internalised, either by taxation or the cost of carbon offsetting, there will be a valuation impact. Best in class companies are likely to retain a higher value.

Better cost control

Best in class footprint companies are more likely to have better cost control. Carbon footprint measurement provides a normalised benchmark within sub sectors. Thus differences in footprint could come from efficiency of energy use or logistics suggesting a more optimal cost base among the footprint leaders.

Environmental reputational risk higher

The reputational risk from negative environmental impacts of sectors and companies is higher today, because of increased media coverage. Consequently share price moves following negative media coverage could be more severe going forward. Backing the leaders mitigates this risk for investors.

Wider reduction measures implemented

Countries are not on track to make regulatory (Kyoto) or voluntary reduction targets. To get to the targets wider emission reduction measures will need to be implemented across a broader range of companies. Investing in the leaders lowers the risk of being exposed to a negative earnings impact from regulatory measures.

Climate change to remain in media

Climate change issues will remain in the media. In December the conference of the parties in Bali will discuss a global post 2012 framework, and provide an indicator of the severity of the measures required.

Invoking behavioural change, low cost solution

Backing carbon leaders can invoke behavioural changes in companies towards increasing efficiencies, in energy use, and supply chain factors for example. This is the lowest cost solution for reducing emissions.

Reduces investor carbon footprint

Reduces investor carbon footprint. The carbon footprint of the ML Carbon Leaders Europe index is 79 tonnes compared 410 for the DJ Stoxx 600.¹

A broader discussion on these points is set out in 'Carbon Leaders; Quality win-win stocks', August 2007.

EU has stated mission to get to low carbon economy...

Political Commitment to get to a Low Carbon Economy

The EU has been particularly vocal on climate change issues through 2007. In February, the EU need to cut greenhouse gas emissions to 20% below 1990 levels by 2020. If other developed nations also need to cuts the EU would reduce emissions by 30%. These are tough commitments in our view, and are unlikely to be achieved without more intervention than is currently in place. In addition in June the EU published a green paper on 'Adaptation to climate change in Europe' – options for EU action' which stated;

- 'A swift transition to a global low carbon economy is the central pillar of the EU's integrated climate change and energy policy'.

¹ The carbon footprint of the Carbon Leaders Europe index and the DJ Stoxx 600 index is calculated by total emissions divided by total emissions.

...to get there wider measures than currently in place needed

Our previous analysis (Carbon Leaders; Quality win-win stocks; August 2007) showed that even the European Environment agency notes that meeting targets cannot be taken for granted. The EU emissions trading scheme only targets 45% of country emissions on average. Only two countries, Sweden and the UK, are on track to meet their targets under the burden sharing agreement. In our view this points towards the implementation of broader measures, of which the economic tools are taxes or quotas – both having the potential to impact a broader range of companies.

ML Carbon Leaders Europe Index

The ML Carbon Leaders Europe index, the first of its kind, is an index based primarily on company carbon footprints. We believe that concerns over the implications of climate change and the need for governments to reach carbon reduction targets means that companies that are leaders in their carbon footprint will generate superior returns.

The objective of the ML Carbon Leaders Europe Index is to provide exposure to stocks that are the most efficient in the sector in terms of carbon footprint. In our analysis, we have used the ICB supersector classification of the DJ Stoxx 600 index. In addition, these stocks are covered (Buy or Neutral) by Merrill Lynch, and have a low trailing PE. A committee of analysts oversees the maintenance of the index and ensures the rules continue to be relevant. The carbon data is provided by Trucost.

Base sample DJ Stoxx 600

Selection of constituents

The composition of the index is reviewed twice a year, on the first trading day of December and June. The index review is carried out by a committee of analysts, the ML Carbon Leaders Europe Index Committee. The new composition is implemented on the 10th trading day after the review. The committee identifies stocks which fit the methodology below, following relevant analysis of updated Trucost carbon data and stock valuation.

Take stocks with carbon data availability, with an ML rating of 'neutral' or 'buy'

Our initial stock selection universe is the DJ Stoxx 600 Europe index. We take the stocks where there is availability of Trucost data (currently c580 stocks) and select the stocks that are 'Buy' or 'Neutral' rated by ML research analysts.

Companies ranked by carbon footprint.....

From this sample, we rank the companies by their carbon footprint, based on most recently available data, (typically 2005 and 2006). Carbon footprint is the amount of carbon that is emitted to produce \$1m of revenue. This provides a normalised benchmark for stocks within the same supersector. Where the carbon footprint is the same for the top companies, the company with the lowest tonnage of CO₂ emission is selected.

...and PE

In addition we rank companies by their trailing 12 month PE ratio. A strategy of picking low trailing PE stocks has been proven profitable during all stages of the economic cycle. ML quantitative analyst Khuram Chaudhry uses a value cycle framework to determine optimum strategies during different stages of the economic cycle. Please see 'European Quant Panorama – 28th September 2007' for further details. His work shows that the best value indicator during all phases of the economic cycle is the low trailing P/E, as shown in table 1 below.

Table 1: Monthly Excess Price Returns from various Value Strategies at different phases of the economic cycle (% vs. MSCI Europe)

	Phase 1 – ‘Boom’	Phase 2 – ‘Slow-down’	Phase 3 – ‘Recession’	Phase 4 – ‘Recovery’	Average of 4 Cycles
All Value Strategies	0.49	0.37	0.38	1.85	0.64
Low Trailing P/E	0.8	0.8	0.99	1.85	1.11
ML Turbo Dividend	0.74	0.24	2.25	-0.06	0.79
High Dividend Yield	0.29	0.4	0.45	1.89	0.76
Low Forecast PEG	0.54	1.36	0.89	0.04	0.71
Low Forecast P/E	0.74	0.16	1.29	0.6	0.7
Low Price to Book	1.12	-0.38	0.3	1.57	0.65
Low Trailing PEG	0.75	0.96	0.14	0.74	0.65
Low Price to Cash	0.77	0.49	-0.61	1.4	0.51
Low Price/Sales	0.78	-0.18	-0.5	0.52	0.16

Source: Merrill Lynch European Quantitative Strategy – MSCI, IBES. Back-testing period Jan 1992 to Mar 2007

Based on the Carbon footprint and the P/E ranking, we calculate a combined score for each of the stocks. We put a weight of 2/3 on the Carbon footprint ranking and 1/3 on P/E ranking to calculate the combined score. The stocks are ranked within the ICB supersectors based on the combined score. We select the highest ranking (1 = high) stocks within each sector. The number of stocks we select reflects the market cap weighting of the sector in the overall index. There are 60 stocks in the final index, representing the top ten percent of low carbon and low PE stocks from their combined rankings. We equally weight all stocks in the index.

Table 2: DJ Stoxx Sector distribution

Supersector name	Weight	Number of Stocks in DJ Stoxx 600	Number of stocks in ML Carbon Index Europe
Oil & Gas	8.67%	27	5
Chemicals	3.04%	21	2
Basic Resources	4.60%	24	3
Construction & Materials	2.63%	29	2
Industrial Goods & Services	7.82%	90	5
Automobiles & Parts	2.84%	14	2
Food & Beverage	5.53%	28	3
Personal & Household Goods	3.90%	28	2
Health Care	7.14%	29	4
Retail	3.19%	25	2
Media	2.44%	35	1
Travel & Leisure	1.53%	27	1
Telecommunications	6.38%	20	4
Utilities	6.72%	33	4
Banks	19.96%	64	12
Insurance	6.90%	34	4
Financial Services	2.94%	49	2
Technology	3.78%	23	2
	100.00%	600	60

Source: ML Equity Derivatives Strategy

In addition to the above function, the ML Carbon Leaders Europe index committee will have the following responsibilities:

- Ensure the rules of the index remain relevant following any structural changes in the carbon measurement and related theme.
- Decide on extending the implementation of changes to the index from one trading session to any period up to five trading sessions. This will be done in the event that a material increase in the liquidity/capacity of the index is required in order to minimise market impact. Any such decision will be announced in advance.

- Moreover, the committee will also exercise discretion on the treatment of non-standard corporate events (e.g. take-overs of constituents by non-constituents, spin-offs, etc) and any relevant re-weighting or capping.

Stocks in the ML Carbon Leaders Europe Index

We obtain the current composition of the index by applying the above methodology. The table below shows the constituent list of the ML Carbon Leaders Europe Index as of close of business on 27-Sep-07.

The free float market cap of the index is EUR 758Bn, which represents 10.45% of the Stoxx 600 index in terms of market cap. The current stocks in the Carbon index have a market cap of at least EUR 1Bn with 3month average daily turnover of at least EUR 8Mn. The index has a dividend yield of 3.1% on a trailing 12-month basis, including specials, while we forecast a future yield of 3.4% pa excluding special dividends. Moreover, according to our projections, the index has a beta of 1.09 with respect to the Stoxx 600 with a tracking error of 3.7% and correlation of 0.97. The 12-month volatility of the index based on daily data is 16.0%.

Table 3: ML Carbon Leaders Europe Constituents

Ticker	Name	Supersector	Trailing P/E	Carbon Footprint	Final Rank	FF Mkt Cap (EUR Bn)	Turnover (EUR Mn)	Dividend Yield
BMW GY	BMW	Automobiles & Parts	10.7	67.1	1	14.78	178.3	1.6%
RNO FP	Renault	Automobiles & Parts	8.9	80.3	2	20.30	192.2	3.0%
HBOS LN	Hbos	Banks	8.7	14.5	1	48.93	29,539.9	5.5%
SHBA SS	Svenska Handelsbanken	Banks	9.6	21.9	2	10.62	793.8	4.1%
CSGN VX	Credit Suisse Group	Banks	10.2	19.3	3	48.27	836.3	2.9%
GLE FP	Societe Generale	Banks	9.6	22.9	4	56.03	473.8	4.4%
KN FP	Natixis	Banks	8.5	27.0	5	5.85	50.2	5.6%
KBC BB	Kbc Groep	Banks	13.3	18.8	6	15.60	80.3	3.4%
BB/ LN	Bradford & Bingley	Banks	7.6	27.7	7	2.78	4,484.1	7.6%
LLOY LN	Lloyds Tsb Group	Banks	10.7	24.7	8	43.79	22,463.0	7.2%
DANSKE DC	Danske Bank	Banks	9.7	27.3	9	13.08	622.5	3.7%
DEXB BB	Dexia	Banks	11.5	27.4	10	11.94	77.1	3.8%
ACA FP	Credit Agricole	Banks	8.2	27.9	11	20.32	173.5	4.2%
ETE GA	National Bank Of Greece	Banks	18.9	26.6	12	21.26	59.5	2.2%
OUT1V FH	Outokumpu	Basic Resources	7.6	424.3	1	2.81	43.0	4.3%
KAZ LN	Kazakhmys	Basic Resources	9.9	687.6	2	4.67	4,096.7	1.6%
VED LN	Vedanta Resources	Basic Resources	12.7	673.8	3	3.91	5,793.2	1.0%
LXS GY	Lanxess	Chemicals	14.1	261.6	1	2.83	33.3	0.7%
JMAT LN	Johnson Matthey	Chemicals	20.6	217.6	2	5.26	4,035.8	2.2%
FER SM	Grupo Ferrovial	Construction	17.9	88.9	1	3.48	72.0	1.7%
SYV SM	Sacyr Vallehermoso	Construction	12.2	137.4	2	2.83	23.7	2.5%
III LN	3i Group	Financial Services	3.9	18.1	1	5.53	6,260.2	2.1%
PFG LN	Provident Financial	Financial Services	8.4	25.6	2	1.67	2,208.3	8.6%
SCTN LN	Scottish & Newcastle	Food & Beverage	17.5	188.2	1	7.46	6,243.2	4.0%
DGE LN	Diageo	Food & Beverage	19.6	180.4	2	40.22	16,352.2	3.4%
RI FP	Pernod-Ricard	Food & Beverage	19.5	202.0	3	12.87	65.7	1.7%
EF FP	Essilor International	Health Care	27.6	79.0	1	9.22	38.5	1.2%
SYST VX	Synthes	Health Care	24.8	82.3	2	4.17	45.7	0.6%
GN DC	Gn Store Nord	Health Care	31.4	59.1	3	1.50	106.8	0.0%
RHK GY	Rhoen-Klinikum	Health Care	22.1	83.5	4	1.98	8.2	1.1%
HAS LN	Hays	Ind Goods & Serv	13.2	10.5	1	2.57	2,020.4	4.2%
RAND NA	Randstad	Ind Goods & Serv	11.8	10.7	2	2.43	44.5	3.3%
ADEN VX	Adecco Sa-	Ind Goods & Serv	12.6	10.5	3	5.14	132.2	1.8%
VDOR NA	Vedior Nv-Cva	Ind Goods & Serv	14.2	10.7	4	2.67	34.3	2.0%
TPK LN	Travis Perkins Plc	Ind Goods & Serv	12.1	53.5	5	2.62	2,156.6	2.9%
HNR1 GY	Hannover Re	Insurance	8.1	9.9	1	2.12	26.1	4.5%

Table 3: ML Carbon Leaders Europe Constituents

Ticker	Name	Supersector	Trailing P/E	Carbon Footprint	Final Rank	FF Mkt Cap (EUR Bn)	Turnover (EUR Mn)	Dividend Yield
AGN NA	Aegon	Insurance	8.2	10.0	2	19.52	154.4	4.6%
AV/ LN	Aviva	Insurance	8.0	10.6	3	27.23	11,538.4	4.7%
MUV2 GY	Muenchener Re	Insurance	8.7	10.0	4	28.97	270.3	3.4%
TL5 SM	Gestevisión Telecinco	Media	14.8	32.9	1	1.70	23.1	6.9%
GA FP	Cie Generale De Geophysique	Oil & Gas	23.7	55.5	1	6.13	51.3	0.0%
SPM IM	Saipem	Oil & Gas	39.6	275.6	2	7.47	104.7	1.0%
TEC FP	Technip	Oil & Gas	33.9	310.4	3	6.69	56.5	1.7%
STL NO	Statoil	Oil & Gas	9.8	650.7	4	14.80	2,784.0	2.2%
AKVER NO	Aker Kvaerner	Oil & Gas	37.4	468.7	5	3.61	268.7	1.2%
BRBY LN	Burberry Group	Pers & HH Goods	24.1	78.9	1	4.00	2,807.2	1.8%
BWY LN	Bellway	Pers & HH Goods	7.3	150.3	2	1.69	1,596.9	4.0%
KGF LN	Kingfisher	Retail	14.7	61.9	1	6.04	5,817.8	6.7%
CO FP	Casino	Retail	16.3	68.2	2	3.55	26.9	2.9%
MSY LN	Misys	Technology	15.0	36.2	1	1.57	1,640.4	3.8%
SAP GY	Sap	Technology	27.0	30.6	2	36.99	370.6	1.1%
PTC PL	Portugal Telecom Sgps	Telecommunications	12.7	34.0	1	8.47	34.3	4.8%
TEL NO	Telenor	Telecommunications	11.4	35.7	2	10.60	873.1	0.0%
TEF SM	Telefonica	Telecommunications	20.2	33.2	3	81.79	945.7	2.0%
TKA AV	Telekom Austria	Telecommunications	15.4	34.8	4	6.12	29.3	4.1%
WMH LN	William Hill	Travel & Leisure	14.0	130.5	1	3.24	1,973.0	3.9%
KEL LN	Kelda Group	Utilities	13.7	405.8	1	3.39	3,269.5	5.4%
SVT LN	Severn Trent	Utilities	17.0	550.8	2	4.72	4,107.1	4.9%
REC NO	Renewable Energy Corp	Utilities	237.4	86.1	3	4.80	556.6	0.0%
SWV GY	Solarworld	Utilities	34.3	122.3	4	3.35	40.3	0.2%

Source: ML Equity Derivatives, Trucost, Factset

Carbon Methodology & Interpretation

Carbon Data has been supplied by Trucost

All carbon data has been supplied by Trucost, a UK based environmental measurement company. Data is based on environmental disclosures from companies, and from estimates based on an input-output analysis, using sector analysis. The most recent data for the complete sample of companies in the DJ Stoxx 600 is 2005, and company carbon data is based on publicly available sources like the carbon disclosure project and annual reports, and estimated data based on public disclosure of sector breakdown within companies.²

Carbon Footprint

The carbon footprint is the amount of carbon generated in the production of \$1m of revenue, i.e. a company with a carbon footprint of 50 produces 50 tonnes of CO₂e³ for every \$1m of revenues. All carbon footprint data is measured on a tonnes of carbon equivalent basis.

Direct and Indirect emissions

In short, carbon can be measured on a direct and indirect basis. Direct emissions are those that occur as an integral part of the day to day operations of the business. These emissions will of course be more significant to some sectors than to others. Indirect emissions for a company are measured as emissions from the course of producing or using a good or services, and are usually supply chain related. We compare companies by looking at total (direct plus indirect) emissions.

For some sectors there is little or no difference between footprints, and in some cases a company may rank the strongest in the sub-sector for direct, but the worst for indirect carbon footprint. There may also be few stocks in the sub-sector.

² Source data (carbon disclosure project, company accounts or estimates can be provided for companies on request)

³ TCO₂e is the commonly used term to measure the 6 greenhouse gases in their 'carbon dioxide equivalent', since the greenhouse gases have different global warming potentials

About Trucost*

- Trucost is an environmental research company, which helps companies and investors understand the environmental impacts of business activities in quantitative and financial terms.
- Trucost provides data, analysis and advice for institutional investors, corporations and government.
- Trucost has standardised comparable data on over 4,000 companies globally.
- Trucost's comprehensive coverage and sophisticated proprietary modelling processes ensure that all companies in an index are included, not just those that disclose environmental information.
- Further information on Trucost is available from www.trucost.com
- Trucost has the support of an International Advisory Panel of nine leading academics in the fields of economics and the environment, who lend their considerable expertise to the specialist research staff.

Methodology

Trucost has the world's largest database of Greenhouse Gas disclosures with up to 8 years of historic data. However there are many companies that do not disclose their carbon impacts. To calculate the Carbon Footprint of companies considered for the Carbon Leaders fund, Trucost reviews company Annual Reports and Accounts, environmental/ sustainability reports, public disclosures and corporate websites. Where there is no public disclosure, Trucost employs its environmental profiling system. Trucost's proprietary Input-Output model makes it possible to calculate levels of environmental emissions and resource use resulting from the activities of any company.

*Source: Trucost

Risks

If the carbon information provided by Trucost becomes unavailable Merrill Lynch will use its best endeavours to appoint an equivalent third party information provider.

Table 4: Companies Mentioned Table

ML ticker	Company	Currency	Price
TGOPF	3i	GBP	996.5
AHEXF	Adecco	CHF	69.35
AEGOF	Aegon	EUR	13.45
AKKVF	Aker Kvaerner	NOK	170.75
AIVAF	Aviva plc	GBP	733.5
BLWYF	Bellway	GBP	1032
BAMXF	BMW	EUR	46.35
BDBYF	Bradford	GBP	310
BBRYF	Burberry	GBP	646
CGUIF	Casino Guichard	EUR	73.49
CGPVF	CGG-Veritas	EUR	223.73
CRARF	Credit Agricole	EUR	27.25
CSGKF	CS Group	CHF	76.8
DNSKF	Danske Bank	DKK	212
DXBGF	Dexia	EUR	21.38
DGEAF	Diageo	GBP	1081
ESLOF	Essilor	EUR	44.22

Table 4: Companies Mentioned Table

ML ticker	Company	Currency	Price
GRFRF	Ferrovial	EUR	59.5
GGNDF	GN Store Nord	DKK	53.5
HVRRF	Hannover Re	EUR	35.23
HAYPF	Hays	GBP	133.75
HBOOF	HBOS	GBP	916
JMPLF	Johnson Matthey	GBP	1667
KZMYF	Kazakhmys	GBP	1455
KBCSF	KBC Group	EUR	96.17
KLDGF	Kelda Group	GBP	859.5
KGFFH	Kingfisher	GBP	180.3
LNXSF	Lanxess	EUR	33.37
LLDTF	Lloyds TSB Group	GBP	542.5
MUSJF	Misys	GBP	218
MURGF	Munich Re	EUR	132.8
NBGIF	Natl Bank Greece	EUR	44.74
NTXFF	NXBP	EUR	15.37
OUTKF	Outokumpu	EUR	25.83
PDRDF	Pernod Ricard	EUR	150.36
PTGXF	Portugal Telecom	EUR	9.86
FPLPF	Provident Fincl	GBP	899.5
RANJF	Randstad	EUR	37.92
RNSDF	Renault	EUR	101.77
RNWEF	Renewable Energy	NOK	258
RHKJF	Rhoen-Klinikum	EUR	22.73
SYRVF	Sacyr	EUR	24.28
SAPMF	Saipem	EUR	29.68
SAPGF	SAP A.G.	EUR	40.63
SNCWF	Scottish & Newc.	GBP	615
XSVRF	Severn Trent	GBP	1408
SCGLF	SocGen	EUR	120.16
SRWRF	Solarworld AG	EUR	40.11
SLDKF	Statoil	NOK	182
SVNLF	Svenska Hbank	SEK	200.5
XYSTF	SYNTHES	CHF	131
TNHPF	Technip	EUR	62.6
GETVF	Telecinco	EUR	18.72
TEFOF	Telefonica	EUR	19.56
TKMAF	Telekom Austria	EUR	18.31
TELNF	Telenor	NOK	106.25
TVPKF	Travis Perkins	GBP	1578
VDNRF	Vedanta	GBP	2057
VEDRF	Vedior N.V.	EUR	15.38
WIMHF	William Hill	GBP	642

Source: ML Equity Research

Analyst Certification

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