

# OUTLOOK 2009

## What's Next for the Markets & the Economy

### TRANSCRIPT

#### Volatility, Market Risk, and Safety in Diversification

**Michael O'Keefe:** Hello. I'm Michael O'Keefe, head of Investment Management and Guidance at Merrill Lynch. 2008 may well go down as one of the most tumultuous years in the markets and the economy, and it tested the very investment wisdom and guidance that we have relied upon for so many years.

Many investors reacted to this incredible volatility by getting out of the markets entirely and going into cash. Others froze and did nothing at all. It was the hardest assault on our emotions as investors in a very long time.

It was a year that forced us to confront and come to terms with both risk and our reaction to risk. The reactions we've had are both emotional and natural in a crisis. We shouldn't reject this emotional reaction, but we can try to manage it more effectively as we embark on achieving our financial goals and dreams in the New Year and beyond.

To talk about how we can do that and to discuss the impact of risk and reaction on your portfolios, I'm joined today by Chris Wolfe, chief investment officer for Merrill's Private Banking and Investment Group and Ash Rajan, director, Investment Management and Guidance.

**Michael O'Keefe:** Ash, I'd like to start with you.... summarize the lessons learned in 2008, and what clients specifically should be doing as a result.

**Ash Rajan:** First step for clients is to understand that *this was not personal*. '08 affected everybody—the savvy, the experienced, the inexperienced, the initiated, the uninitiated. So it's not personal. But it was a wakeup call for all of us to go back to the basics. Michael, for years investors prided themselves on rational investing. It worked, because we've made a connection between risk, which is the center of all emotion, and reward. Higher the risk, higher the reward, and vice versa.

But this year, '08, was very different. It was not about reward. It was about loss. Sometimes very deep losses.

**Chris Wolfe:** Well, I think to pick up on something that Ash said, the, the issue that investors faced in 2008 was really about how they dealt with the losses in the markets.

And over normal times, what we'll call, where we don't see extreme events, we'll see portfolios naturally move and naturally rebalance where the reinvestment of income from

bonds or the reinvestment of income from stocks will tend to keep portfolios in line. But this year's movements were extreme.

So we think about this as a great time to go back to the basics about rebalancing and reinvesting, putting it on a regular schedule, whether it's annually, biannually or, in some cases, even quarterly, to go the other way.

The issue for investors is to insure that the portfolio risks, the asset-allocation risks, are in line with their goals and objectives.

## THE VALUE OF DIVERSIFICATION IN A DOWN MARKET

**Michael O'Keeffe:** So talk a little bit more about the idea of the market's volatility, certain markets falling, others maybe rising, and how that ties to volatility and to rebalancing.

**Chris Wolfe:** Well, a lot of clients looked at this year and said: "Diversification—does it work? What's going on? Everything I own went down." And I think the answer to that question, from our perspective, is: diversification *did* work. And let me give you an example.

While diversified portfolios may be down, concentrated portfolios are down further. And I think, as investors know, if you're down 10%, you need 11 to recover that loss. If you're down 50%, say in a concentrated strategy, you need 100% to recover that loss.

So I think the challenge for investors in this environment is to look at the diversification as offering a benefit of mitigating the losses, making their hurdle rate for returns over the next few years lower than if they were concentrated, trying to get growth at any cost, and now with losses they may have, having to look at a big hill of recovery.

## FINDING INCOME STREAMS TO REBUILD YOUR PORTFOLIO

**Michael O'Keeffe:** Take a step back and look at what I'll call the typical 60-40 portfolio, stocks, bonds, that's a high concentration in equities. How should a client think about that?

**Chris Wolfe:** Well, I think the broad message for clients that are more traditionally oriented is we want to be paid to wait. There's a lot of strategies that do that, but this environment is one about rebuilding and about saving, and ultimately, for clients, about having the opportunity to reinvest. And the way that you'll be able to do that if you're a client is to get income from your portfolio, and those income streams will allow you to rebalance, will allow you to reposition portfolios with a minimum of fuss and not having to sell assets at depressed levels.

A lot of strategies do that, particularly on the equity side with equity income, dividend plays-- as well as looking at the fixed income pieces providing that balance of income streams.

## FIXED INCOME SOLUTIONS: TREASURIES, CDS & MUNIS RE-EVALUATED

**Michael O’Keeffe:** Treasuries... whether we’re in a bubble as it relates to the Treasury market. Ash, your view on that?

**Ash Rajan:** You know, the common notion may be just that, Michael. And also, when something is so accessible and appears so riskless, it’s that much less attractive. It’s a common human sensation. But we believe, and research has stressed this very often, that Treasuries are still very buyable.

For one, you do not have the burden as a client, as an individual investor, as institutional investors do, in that you can own a Treasury and own it until maturity and enjoy the coupon, enjoy the income, as well as the threshold of safety.

Just like Treasuries, that a... Treasury-like fixed income... CDs for instance: simple, overly simple, overly accessible, and hence not so attractive in the past, but to be revisited as bastions of safety, relative safety in the fixed-income market.

And municipals on top of that. This is an old favorite of our clients. And this is not new thinking. They’ve all ... they’ve enjoyed municipals because of the tax-advantage status. But the posture to municipals may have to change.

The legacy view of municipals is to own a municipal bond or municipal bonds in your state. So there was a home bias to municipals. But today, it’s about spreading the risk of states, looking at pre-funded municipalities that have the propensity to survive a deep recession.

Professional advantages have demonstrated savvy and demonstrated experience in bundling that and providing that to our clients.

## EQUITY MARKETS AROUND THE GLOBE: AN EMPHASIS ON QUALITY

**Michael O’Keeffe:** Ash, let’s go a little deeper into the equity market ... other dimensions of guidance we offer ... and talk to us, as well, about how we think about global investing.

**Ash Rajan:** Well, three defining rules in equity investing as it relates to today: *quality, quality, quality*. The more investors hear about quality they think of it as predictability, and they always think: “What can predictability do for me? Does it pay me?” This year, going forward, predictability and high quality will pay.

**Michael O’Keeffe:** I’m hearing you more from a domestic perspective, but how do we think about it internationally?

**Ash Rajan:** Very ironically, unlike the previous years--when there was a, sort of a distinct difference between our international views and domestic views--this year they’re on the same page. It’s just virtually the same template of quality that takes on and overlays to the international theater, if you will.

## LOOKING AHEAD TO NEW MARKET REALITIES IN 2009

**Michael O’Keeffe:** Ash and Chris, this has been a terrific discussion, thanks for joining us today.

We will continue to face a very new market reality and it will continue to test our emotions. But you have already taken a proactive step in managing risk and your reactions to it simply by watching this year’s Outlook broadcast and this video on investor behavior.

The next step is to reach out to your Financial Advisor and continue the dialogue about your personal tolerance for risk, goals and expectations and ways to make adjustments to your portfolio that expand its diversification and dial up its quality.... Thank you.

**Opinions expressed are as of January 2009, and are subject to change.**

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