

Merrill Lynch 4Q02 and Full Year 2002 Analyst Conference Call

Good morning, and welcome to Merrill Lynch's conference call to review Fourth Quarter and Full Year 2002 operating results. The following live broadcast hosted by Tom Patrick, Executive Vice Chairman, Finance and Administration, and Ahmass Fakahany, Chief Financial Officer, is being recorded and is copyrighted and proprietary to Merrill Lynch. Statements made today may contain forward-looking information about management's expectations, strategic objectives, business prospects, anticipated expense savings and financial results, anticipated results of litigation and regulatory proceedings, and other similar matters. A variety of factors, many of which are beyond our control, affect the operations, performance, business strategy and results of Merrill Lynch and could cause actual results and experiences to differ materially from the expectations and objectives expressed in any statements. These factors include, but are not limited to, the factors described in the company's reports filed with the SEC, which are available at the SEC's website, www.sec.gov. Merrill Lynch undertakes no responsibility to update or revise any forward-looking statements.

An on-line rebroadcast of this conference call will be available today at approximately 1:00 p.m. Eastern Standard Time via Merrill Lynch's Investor Relations website at www.ir.ml.com.

Now...over to Tom.

Good Morning.

I'm here with Ahmass Fakahany, who, as you know, was named Executive Vice President and Chief Financial Officer of Merrill Lynch in December. I will review our full year and fourth quarter results, and then Ahmass, Martin and I will be happy to take your questions.

Today, Merrill Lynch reported full-year 2002 net earnings of \$2.6 billion, or \$2.69 per diluted share. These results include \$143 million of research settlement-related expenses, \$126 million of September 11-related net insurance recoveries, and \$42 million of net restructuring benefits, for a net after-tax increase to earnings of \$25 million. Excluding these items, 2002 net operating earnings were \$2.6 billion, or \$2.67 per diluted share.

Fourth quarter net earnings were \$603 million, or 63 cents per diluted share, including research settlement-related costs of \$65 million, primarily offset by net insurance recoveries and restructuring credits, for a net after-tax reduction to earnings of \$12 million. Operating net earnings for the fourth quarter were \$615 million, or 64 cents per diluted share.

A year ago, conventional wisdom was that there would be a market recovery in the second half of 2002. As it turned out, the 2002 market environment was the most challenging in recent memory. The improvement in our operating earnings during 2002 demonstrates that our revenue diversification, and decisive re-sizing and resource allocation actions, were effective and timely. In each business, we are delivering on our margin improvement and business development objectives, and have made good progress in further diversifying sources of revenue. We are managing with discipline and focus, and have continued investing in a select number of attractive growth opportunities throughout the past year. Our ongoing efforts continue to make the firm more efficient, and we remain confident that we have the built-in operating leverage to substantially increase profitability when market conditions improve.

For the remainder of my remarks, I will focus on full-year and fourth quarter operating results for both the 2002 and 2001 periods, which exclude the impact of September 11-related expenses and recoveries, the research settlement-related expenses, and restructuring-related items.

Full-Year Results

Full-year 2002 net operating earnings were \$2.6 billion, or \$2.67 per diluted share, up 7% from the \$2.4 billion, or \$2.50 per diluted share, reported for 2001. These results reflect Merrill Lynch's third strongest year ever as measured by net operating earnings, amidst a market environment which deteriorated progressively throughout the year. In fact, our 2002 net operating earnings are less than \$100 million below our 1999 net earnings—our second best year ever.

Despite a 15% year-over-year decline in net revenues, to \$18.6 billion, the full-year 2002 operating pre-tax operating margin rose nearly 4 percentage points from 2001, to 20.7%. With the exception of the 21.4% recorded at the peak in 2000, this is the highest pre-tax margin achieved by the firm for any year since 1993.

You may recall that this time last year, I told you that I thought delivering a 20% pre-tax margin on \$20 billion in revenues was reasonable, based on the plans we were executing to scale the firm to the "post bubble" environment. We have exceeded this expectation, and in the process have produced highly competitive margins. This improvement was in part attributable to decisive expense management. Non-interest expenses were reduced by \$3.4 billion, or 19%, from 2001 levels and by \$6.3 billion, or 30% from the peak in 2000.

Full-year 2002 operating non-compensation expenses, excluding goodwill, declined by \$1.4 billion, or 20%, from 2001 levels, with reductions in nearly every category. We have reduced expenses in most quarters during the last two years, with substantial reductions in each of our businesses.

Full-year 2002 compensation expenses were 50.7% of net revenues, in line with our 51% target. Compensation expenses are down by \$1.8 billion from 2001, due in part to the decline in revenues, but more importantly due to the decisive actions we've taken to re-size the firm's capacity. The number of full-time employees declined to 50,900 at year-end. This is down 11% from 57,100 at the end of 2001, and 30% below the peak of 72,600.

Full-year 2002 ROE was 12.0%.

Now... highlights of our fourth quarter results...

Fourth Quarter Results

Fourth quarter net operating earnings of \$615 million were 25% higher than the 2001 fourth quarter, on net revenues that were 12% lower, at \$4.2 billion. Revenues declined in almost all categories as a result of the deterioration in the market environment. Compared with the 2002 third quarter, net operating earnings were 6% higher on net revenues that declined by 4%. The pre-tax operating margin was 21.7%, over six percentage points higher than in the year-ago quarter.

Non-compensation costs were \$427 million, or 25% lower than the 2001 fourth quarter. The year-over-year expense reductions were across virtually all expense categories. Compared with the 2002 third quarter, non-compensation expenses increased by \$37 million, due primarily to an increase in legal expenses.

Compensation expenses were 47.2% of net revenues, compared with 48.2% in the 2001 fourth quarter. Compensation expenses were 13% lower than the year-ago quarter, due primarily to lower incentive compensation accruals and reduced staffing. Throughout 2002, each of our businesses was extremely disciplined in managing total compensation costs.

Now... highlights of the operating performance of each business. Again, all of my comments exclude the items I noted earlier from both the 2002 and 2001 periods. I'll start with Global Markets and Investment Banking:

GMI

The 2002 environment was marked by economic and geopolitical uncertainty, weaker corporate earnings and decreased investor confidence, which led to a significant deterioration in market conditions. Global equity indices posted their third consecutive year of declines, and capital markets origination and M&A activity were severely depressed. These factors were partially offset by strength in fixed income markets.

By leveraging diverse sources of revenue, focusing on expenses and effectively allocating resources throughout 2002, GMI continued to improve its profit margins despite the deteriorating market environment. GMI's 2002 full-year pre-tax operating margin is now among the highest in the industry, underscoring Merrill Lynch's emphasis on operating discipline, appropriate sizing of capacity, and profitable market share.

GMI's results also demonstrate the strength of Merrill Lynch's debt markets business, which had a record year in 2002 for net revenues and profits. They also reflect the firm's scale and other advantages in its equity markets business. Taken together, these factors have been integral to further enhancing Merrill Lynch's competitive positioning and profitability across the market cycle.

GMI's full-year 2002 net revenues were \$8.4 billion, 18% lower than 2001, but the full-year pre-tax operating margin increased nearly one percentage point to 28.2%. Strong expense management enabled GMI to reduce non-interest costs by 19%, or \$1.4 billion, from 2001 levels and achieve \$2.4 billion in pre-tax operating earnings.

GMI's fourth quarter pre-tax operating earnings were \$558 million, 29% higher than the 2001 fourth quarter, on net revenues that were 10% lower than the year-ago quarter, at \$1.8 billion. GMI's fourth quarter pre-tax operating margin was 31.4%, an improvement of nearly ten percentage points over the fourth quarter of 2001, as the 21% year-over-year reduction in non-interest expenses outpaced the decline in net revenues.

The decline in GMI's fourth quarter net revenues compared with the 2001 fourth quarter was driven primarily by reduced equity and investment banking revenues, partially offset by a strong revenue increase in debt markets. Revenue from the trading of interest rate products remained strong, although lower than in the third quarter as the yield curve environment was somewhat less favorable. Trading of credit products was also strong during the quarter. Revenues from cash equity and equity-linked trading were essentially unchanged from the 2002 third quarter while investment banking revenues rose, driven primarily by increased equity origination.

Now...turning to Global Private Client...or GPC...

Global Private Client (GPC)

The challenging market environment throughout 2002 underscored the strength of Merrill Lynch's individual client relationships, as well as the value of the investment advice and high quality service delivered by Merrill Lynch's Financial Advisors. The environment also highlighted the advantages of the scale and breadth of our product offering and Merrill Lynch's commitment to open architecture. We provide our private clients with the most comprehensive approach in the industry to addressing their individual financial needs. These factors, combined with operating discipline and a continued emphasis on increasing fee-based and recurring revenue sources, are important growth drivers and have been integral to the significant improvement in GPC's financial performance during the year.

GPC's 2002 full-year pre-tax operating earnings were \$1.2 billion, up 31% from 2001. Despite an 11% decline in full-year net revenues, to \$8.8 billion, GPC's pre-tax operating margin was 13.7%, up more than four percentage points from 2001, reflecting substantially improved performance globally.

GPC's business in the United States generated a 2002 full-year pre-tax operating margin of 15.9%, up nearly four percentage points from 2001. This increase was due to expense reduction as well as a high percentage of fee-based and recurring revenues, which stabilized overall revenues as transaction volumes fell.

The performance of GPC's business outside the United States improved in 2002 as the refocusing of the private client business in Japan was completed. The recently-announced integration of the GPC businesses inside and outside the United States is a further step towards growth and increased profitability in this business.

GPC's fourth quarter pre-tax operating earnings were \$298 million, 4% lower than the 2001 fourth quarter, and included costs associated with the integration of the U.S. and non-U.S. businesses. Despite an 11% decline in net revenues, to \$2.1 billion, GPC's fourth quarter pre-tax operating margin increased to 14.0%, up from 13.1% in the year-ago quarter. GPC's business in the United States generated a fourth quarter pre-tax operating margin of 17%, up nearly one percentage point from the 2001 fourth quarter.

Now...let me touch on some key operating highlights:

- First ... FA turnover remains at historically low levels among top producers. U.S. Private Client continues to successfully recruit select high-production FAs.
- Next... net flows of assets into annuitized products in the U.S. totaled nearly \$30 billion in 2002, which included assets new to the firm as well as the conversion of existing client assets to fee-based accounts. The continued strength of these flows reflects strong demand for professionally managed account products. We have seen a 23% growth in the number of managed accounts over the past two years, and Merrill Lynch ranks number one in managed account assets, according to *Cerulli Associates*, a financial services research and consulting firm.
- And lastly...revenue diversification, which continues to be an engine of growth and remains a key focus. Today, more than 70% of Private Client's U.S. revenue comes from activities other than selling stocks and bonds on a commission basis. Merrill Lynch is a top 10 jumbo mortgage originator in the United States, with 2002 mortgage originations of \$21 billion. Demand during 2002 was strong for small business services, including lending. Merrill Lynch is also a top 401-K and IRA provider, ranking among the top three based on the most recent *Greenwich* survey. And, earlier this month, we launched a new cash management service called *Beyond Banking⁰*, as part of the comprehensive financial management platform, *Total MerrillSM*.

Net new money into Private Client accounts totaled \$10 billion during the 2002 fourth quarter... the highest for any quarter this year. This was entirely attributable to inflows in the United States. Total assets in Private Client accounts increased 3% during the quarter to \$1.1 trillion, due primarily to market appreciation.

Assets in asset priced accounts totaled \$182 billion, or 16.0% of total Private Client assets at the end of 2002, essentially unchanged from the third quarter of this year.

Now...turning to Merrill Lynch Investment Managers or MLIM...

MLIM

As you know, the market environment in 2002 was extremely difficult for the asset management business. However, MLIM continued to deliver outstanding investment performance, leverage its products across distribution channels and control costs rigorously, which resulted in improved profitability in 2002.

Approximately 70% of MLIM's global assets under management were above benchmark or median for the 1-, 3-, and 5-year periods ending November 2002. MLIM's U.S. retail mutual funds had even stronger performance.

MLIM's full-year 2002 pre-tax operating earnings were \$344 million, a 14% percent increase from 2001. Net revenues were \$1.6 billion, 20% lower than 2001. However, MLIM's pre-tax operating margin rose more than six percentage points from 2001, to 22.2%, as the integration of MLIM's global investment platform and re-alignment of resources reduced expenses and improved productivity.

For the fourth quarter, MLIM posted improved pre-tax operating earnings and margins despite lower revenues. Pre-tax operating earnings were \$73 million, 22% higher than the 2001 fourth quarter, which was negatively impacted by increased litigation expenses. Net revenues were 26% lower than the year-ago period, at \$339 million. MLIM's pre-tax operating margin improved to 21.5%, an increase of more than eight percentage points from the fourth quarter of 2001.

Assets under management totaled \$462 billion at year-end, up slightly from the third quarter of 2002, due primarily to \$5 billion of net inflows, and market-driven appreciation.

To conclude, the 2002 market environment was the most challenging we have seen in decades. We remain cautious in our near-term outlook, and we expect market conditions to remain unsettled for some time. Unless there is a meaningful improvement in the environment from the fourth quarter, it will be difficult to maintain 2002 revenue levels in 2003. Additionally, at this point, given the market environment, we are not optimistic that 2003 first quarter revenues will be above the run rate for the second half of 2002. We re-iterate our view that stabilization in the equity and credit markets in the near term is unlikely, as investor confidence remains low and economic and geopolitical concerns weigh on the markets globally.

We continue to see opportunities to reduce non-compensation expenses in 2003, but we do not expect that these savings will be achieved on a straight-line basis each quarter, nor do we expect that they will be of the same magnitude that we have achieved in the past year. We expect that throughout 2003 we will incur additional costs in such areas as contingency and recovery, and compliance with the Patriot Act. We also anticipate that we will incur some additional costs associated with the integration of our Global Private Client business.

We will continue to manage our capacity relative to the business environment we see. We plan to manage our compensation expenses closely and are targeting a full-year compensation ratio of 50-51% for 2003. Please remember that our first quarter compensation expenses are higher due to seasonal factors and will therefore likely be at or above the high end of this target range.

The strength of our full-year and fourth quarter 2002 results demonstrates that we are sized appropriately and have been nimble enough to respond to changing market opportunities throughout the year. We are making progress as planned on a number of growth initiatives, and we are already seeing benefits from investments we made during 2002. We have substantially improved our financial performance relative to competitors, and we remain well-positioned to generate significant incremental profitability with any improvement in the revenue environment.

Now...Ahmass, Martin and I would be happy to take your questions...