

THE GREAT GLOBAL SHIFT

Seeking Growth in a G-Zero World

An approach to investing in a global economy where it's every nation for itself



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For the past three summers, world events have put investors' nerves to the test. Ongoing worries about the debt crisis in Europe and political strife on three continents have shaken confidence and roiled markets. A number of investors continue to simply react to the latest isolated economic report or news headline. We at Merrill Lynch think it's essential to reveal the larger patterns in the global economy—pointing out to you both the risks and the opportunities they create.

Last fall, Lisa Shalett, chief investment officer of Merrill Lynch Global Wealth Management, teamed up with Eurasia Group president Ian Bremmer to describe the great rebalancing of economic power currently taking place. This Whitepaper, *Seeking Growth in a G-Zero World*, is a powerful follow-up to their initial insight, one that focuses on the countries, sectors and companies that they believe are best positioned to adapt to new global rules and realities. Along the way, Shalett and Bremmer offer a number of forward-thinking solutions.

To help you turn these solutions into tangible actions, you can rely on your advisor, who can make available an array of resources designed to address virtually any financial need you might have. Among these resources are insights like the ones contained in this Whitepaper, delivered with a truly global perspective. That, along with your advisor's personal advice, which is rooted in a deep understanding of your personal goals, can help you gain an increasingly important advantage in the current investment climate.

Once you've read this Whitepaper, I hope that you use it as the basis for a thoughtful conversation with your advisor about making intelligent, suitable investments at a time when certainty is in short supply. As global events unfold, we'll continue to bring some of the world's most able financial minds to bear on your goals and needs. It's the kind of guidance your advisor is uniquely equipped to offer. Over nearly a century, we have made it our business to care deeply about the people we serve, and to respond to challenges resolutely and creatively. That will not change.

Dan Cummings
HEAD OF INTERNATIONAL WEALTH MANAGEMENT

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SEEKING GROWTH IN A G-ZERO WORLD

An approach to investing in a global economy
where it's every nation for itself

BY IAN BREMMER & LISA SHALETT



Ian Bremmer is the president of Eurasia Group, a leading consultancy on geopolitical risk, and is widely regarded as one of the most influential thinkers on global trends.



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Long-standing Canadian tradition dictates that new foreign affairs ministers make their first official visit abroad to Washington. However, weeks after John Baird's appointment as Canadian foreign minister in 2011, he broke with the past and flew to Beijing.

It would be easy to interpret this as evidence of American decline and Chinese ascent. But the realities are more complex than that. Baird's decision can actually be seen as reflecting a new way that countries like Canada are responding to a rapidly transforming world—and the latest stage in the dominant investing theme of the last 30 years.

Though the message sent by Baird's visit to Beijing was largely symbolic—Canada's trade with the United States dwarfs what it does with China, and this isn't likely to change—his choice of itinerary clearly resulted from a clear comprehension of his country's economic position. Long reliant upon its superpower neighbor, Canada is now seeking to diversify its portfolio of geopolitical partnerships. It does not want to remain as vulnerable as it has been to the economic cycles of one economy.

As part of its strategy, the Canadian government has stated that it hopes to double trade with China by 2015. Already the province of British Columbia is exporting more to Asia than to anywhere else. Meanwhile, the Ottawa government has approved the export of natural gas from new liquefaction facilities on the B.C. coast. If the United States continues to balk at the idea of constructing the Keystone pipeline to distribute oil from the Alberta tar sands to U.S. markets, Canada has now laid the groundwork to turn toward the East and offer more of its energy to China and other Asian markets.

Leaders understand that to put all of one's eggs in one basket is just too dangerous.

Any nation would, in theory, want a diverse set of allies, both economic and strategic. Yet, in practice, it has never been as necessary as it is now. In our post-economic crisis world, the familiar system of Western-led globalization has evolved into something more fractious and complex, and many countries are beginning to realize that they need to hedge their bets by forging a stronger and more diverse set of partners. Increasingly, the countries that can adapt to the pace of geopolitical and macroeconomic change are the ones more likely to emerge as the winners.

Governments around the world—both developed and emerging—are responding to these new conditions. Take, for instance, Mongolia's "third neighbor" doctrine, which aims to fortify relations with the United States and other nations as a counterbalance to the country's deep ties (and historical subservience) to Russia and China. Or consider the ambitious Trans-Pacific Partnership, linking nine countries around the Pacific Rim, including the United States, but pointedly excluding the most dominant economic player in the region, China. The cliché has become an international reality: As leaders look to the coming years and decades, they understand that to put all of one's eggs in one basket is just too dangerous. As for investors, successfully navigating this next chapter in globalization—managing its risks as well as taking advantage of the opportunities—will require an updating of the old investing playbook.

A NEW CHAPTER BEGINS

Over the last 30 years, no phenomenon has had more of an impact on geopolitics, the world economy and financial markets than globalization. In the aftermath of World War II, the United States used its capital and energy to build a system reflecting the values and priorities of the West. The Bretton Woods accord, the IMF, the World Bank, the United Nations, NATO and eventually the G-7 provided the institutional base for a global economic architecture. In it, multinational corporations operated with few restrictions, emerging nations provided cheap labor and manufactured goods for the developed world, developed nations provided markets and capital for emerging ones, and governments had limited roles as economic actors on the global stage.

Globalization triggered an explosion in cross-border trade and innovation. It opened markets and drove phenomenal economic growth. It helped tame inflation, transform societies away from poverty and disease, and break down historic ideological barriers. It also produced new resource challenges for the earth and the environment. But most important for investors, it has for three decades underpinned enormous wealth creation. During this period, investing was straightforward, if not always simple. Devising a winning strategy was largely a matter of aligning one's portfolio with the companies, sectors and countries most able to take advantage of globalization.

We are by no means seeing globalization's death throes. It has, however, reached an inflection point. Ever since the financial crisis, asset classes and markets around the world have moved in unison like never before, up and down, risk on and risk off.¹

¹ BofA Merrill Lynch Global Research, Global Quant Panorama, "Approaching Extremes," May 22, 2012.



History has shown that correlations such as these are almost always higher during periods of instability and economic stress. But globalization has created a world where markets and financial exchanges are more tightly linked than ever before. Capital flees to safety at the first sign of trouble; capital gorges on growth whenever a fragment of hopeful news appears. In short, the tight-knit world that globalization has created has also heightened risks. As countries find ways to both mitigate these risks and exploit them, the next chapter of globalization is starting to unfold.

CNBC's Ron Insana moderates a roundtable with the authors and BofA Merrill Lynch Global Research's Michael Hartnett.

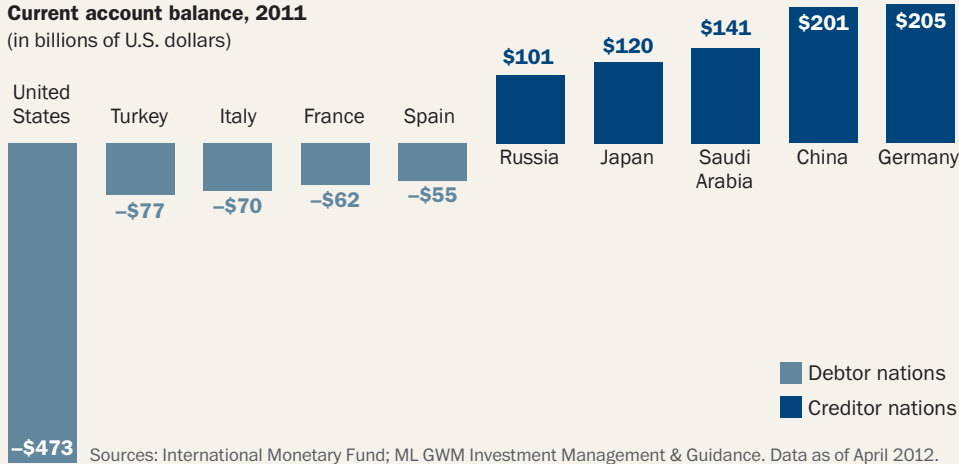
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A series of chronic imbalances, laid bare by the financial crisis, has also contributed to the tumult of our present moment. There is, for instance, the imbalance between debtor nations and creditor nations.² Countries dominated by aging populations vs. those dominated by youthful ones.³ The hollowing out of the middle class in some countries vs. rising middle classes in others.⁴ As the countries hurt by these imbalances become ever more preoccupied with solving their domestic problems, they will be forced to withdraw from the world stage even further than they already have. This in turn will create a global power vacuum where once the West reigned supreme.

The BRICs don't form a cohesive bloc. China has said again and again that it needs to focus on its own problems, not the world's. The G-20 is too large and unwieldy to come

CHRONIC IMBALANCES: A nation's current account balance—or its net flow of transactions with other countries—is one key factor, along with its total amount of debt owed, that can push a country to the debtor's side of the ledger. Look for the widening divide between creditor and debtor nations to continue to slow developed-world growth and fuel volatility.

Current account balance, 2011
(in billions of U.S. dollars)



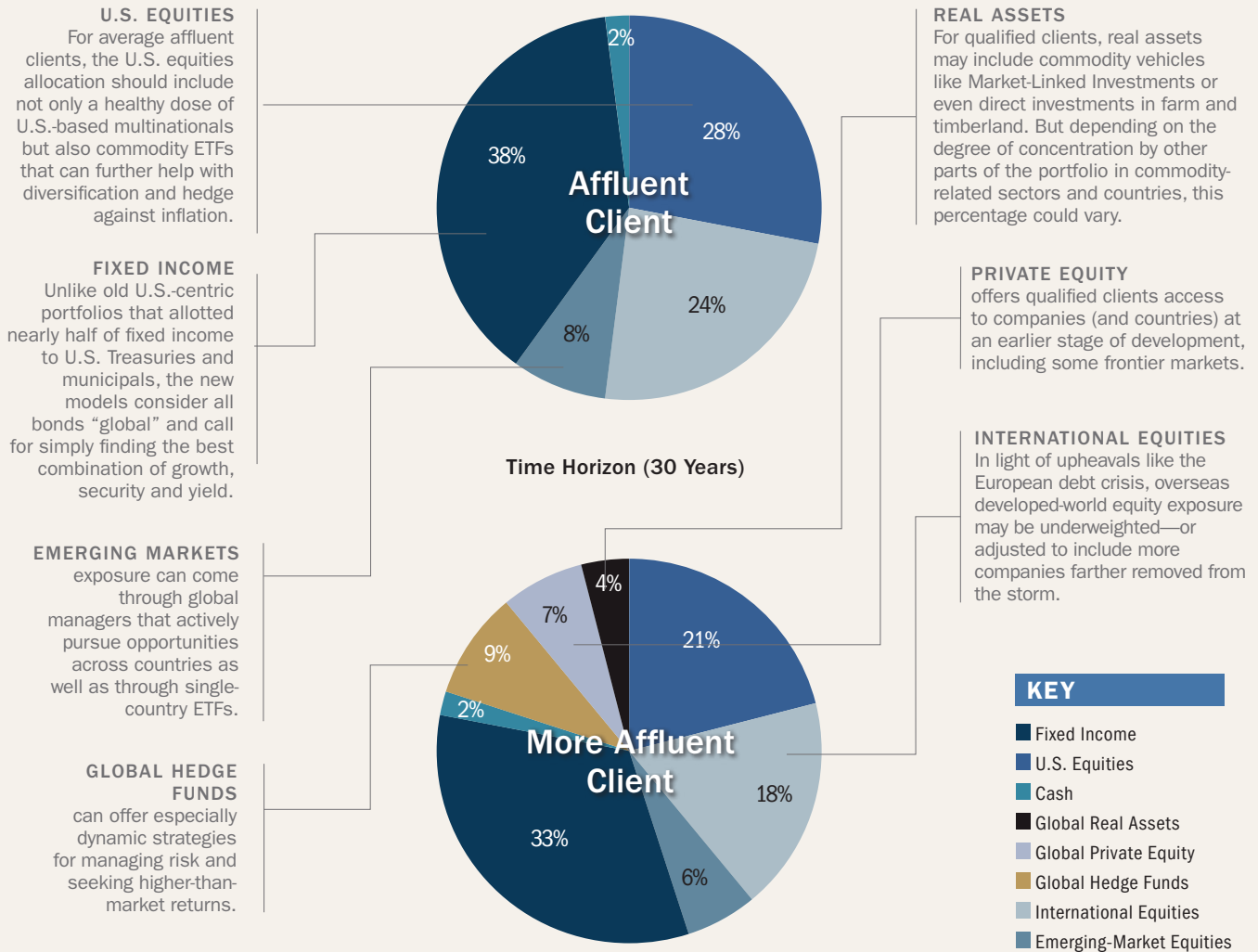
² Public debt as a percentage of GDP was 78% among developed markets on average in 2009, compared with just 33% for emerging markets, according to BofA Merrill Lynch Global Research, "The Case for Emerging Markets," Feb. 2012.

³ The developing world accounted for almost 90% of the estimated 140 million births per year as of 2011, according to the Population Reference Bureau's World Population Data Sheet 2011.

⁴ One explanation for recent political unrest in many emerging markets—not just in Arab Spring countries, but in China and India too—is the increasing discontent in those countries of an expanding and newly vocal middle class, according to *The Economist*, "The New Middle Classes Rise Up," Sept. 3, 2011.

THE GLOBAL SHIFT PORTFOLIO

The Merrill Lynch model portfolios highlighted in the first Great Global Shift Whitepaper published last fall were built to withstand the upheavals of today's volatile global marketplace. Here we show how, by taking a dynamic approach to these recommended allocations, you and your advisor can continue to adapt to the world's shifting risks and opportunities.⁵



For more information on these portfolio models, see the back page.

to any accord. The G-7 is largely preoccupied with its own fiscal challenges. We now live in a G-Zero world.

Already this dynamic has produced dramatic examples of geopolitical volatility, including recent world emergencies that have driven home just how much the old system of global leadership is weakened. It took months for the international community to even seriously consider intervening militarily in Syria's gruesome civil war. A similar attitude prevails toward longer-term problems facing the world—such as climate change, where strong political leadership would be required to spearhead a

coordinated global plan—and international financial crises. One need only look at how countries have responded to the current debt crisis in Europe. The coordinated shock and awe that global central banks employed in response to the 2008 financial crisis has been conspicuous in its absence. Instead countries from China to Brazil, from Australia to Britain, are all pursuing individual policy responses uniquely focused on their specific country-based objectives.

With the dearth of global leadership, power is accruing to regional players, each of which exerts its own gravitational pull. Indeed, every issue the world faces now requires negotiation, which spurs greater uncertainty and amplifies risk. Increasingly, it's every nation for itself.

THE ECONOMICS OF THE GREAT GLOBAL SHIFT

Today's fractious state of affairs is being driven not just by geopolitics but also by economics. The global economy, after all, continues to grow ever more diverse. Thirty years ago, the share of global GDP accounted for by emerging markets was just 31%. That figure is projected to grow to 48% in 2012, indicative of the speed at which emerging markets are expanding relative to developed economies.⁶ In 2012 nearly 80% of the year-over-year growth in global GDP is expected to come from emerging markets, up from 66% last year.⁷

Meanwhile, the business cycles of many developing nations have, in one important sense, become less correlated to the cycles of the United States and the West. In the years since the financial crisis, the largest emerging economies, such as China and Brazil, have gone through two complete monetary cycles—easing in 2008 amid the global recession followed by tightening as growth heated up in 2010–2011, with easing resuming again in 2011–2012. During the same period, the developed world, led by the United States, largely remained stuck in the ultra-low-interest-rate doldrums. As recently as the 1990s, governments in these emerging-market countries could never have carried out fiscal and monetary policies that might enable them to buck the cycles of the industrialized nations. They didn't have the strong balance sheets or international credibility needed to pull it off. But their subsequent rise on the world stage has given them flexibility—to ease and tighten, to spend on stimulus or raise and lower taxes—so that their economies are no longer fettered to the developed world.⁸

⁵The "affluent client" model portfolio at left is based on the Global RIC Tier 0 Moderate Strategic Allocation, and the "more affluent client" is based on the Global RIC Tier 2 Moderate Strategic Allocation. The latter includes alternative investments, which are defined as hedge funds, private equity and real assets. Additionally, up to 20% of the Global RIC Tier 2 Moderate Strategic portfolio might be illiquid for three to five years. We define liquidity as the percentage of assets, by invested value, within a portfolio that can be reasonably expected to be liquidated within a given time duration under typical market conditions. Most alternative investment products are sold on a private placement basis, and eligible clients must typically be Qualified Purchasers (\$5 million net investments).

⁶IMF World Economic Outlook Database, April 2012. The percentage of GDP figure is on a purchasing-power-parity basis, which seeks to reflect the true purchasing power of money in any country by adjusting for foreign exchange rates, with the U.S. dollar as the reference currency.

⁷BofA Merrill Lynch Global Research, "The Case for Emerging Markets," Feb. 2012.

⁸BofA Merrill Lynch Global Research, "G20 Emerging Market Year Ahead," Dec. 1, 2011



Current examples of well-positioned countries include developed markets like Canada and Australia, emerging ones like Indonesia and Brazil, and even frontier markets like Ghana.

THE PIVOT STATES

Some countries are in a stronger position than others to take advantage of this G-Zero world and the next chapter of globalization. To be sure, large global and regional powers such as the United States, China and Russia will remain advantaged. For all the hand-wringing about imminent American decline and the enormous fiscal challenges ahead, the United States is still the world's innovation capital and its universally recognized safe haven. It shouldn't be surprising that U.S. equities have outperformed those of most other regions of the world—including the major emerging-market indexes—since stocks hit rock bottom in 2009.⁹ China, despite a recent slowdown and increasing fears of a hard landing, has been able to withstand Europe's crisis and recession by increasing exports to the United States and other non-euro regions.¹⁰ And Russia, despite its own major domestic political problems, has its vast natural-resource riches and an array of trading partners.¹¹

For the smaller countries around the world, the ability to avoid capture by these regional and global powers will largely determine their fortunes. The current successful ones, like Canada, are cultivating the ability to “pivot” between multiple trading partners while leaving themselves at the mercy of none. This flexibility improves their growth potential and provides them with heightened resilience to the pitches and rolls of the G-Zero world.

Just as the big regional and global powers do, these successful smaller countries cut across all stages of economic development—including developed states such as Canada, Australia and Singapore; emerging economies like Indonesia, Turkey, Brazil and South Africa; even frontier markets like Kenya and Ghana.

Their advantages don't immunize these countries from severe global downturns. Ultimately, that's not possible for any economy. Still, such nations as Singapore, Canada and Australia did weather the financial crisis and global recession better than much of the rest of the developed world. In fact, Australia's economy has effectively decoupled from the West; though Aussie GDP slowed considerably directly after the financial crisis, it hasn't suffered a recession since the 1990s, a period during which the United States has gone through two.¹²

In addition to the ability to pivot, such countries tend to have other built-in advantages. In Canada the biggest equity investors are domestic institutions that adhere to long-term, buy-and-hold philosophies—one reason its financial markets are less susceptible to risk off. Australia is where Asia goes to buy the iron ore and copper used to build the infrastructure that its emerging middle classes increasingly demand. What's

Ian Bremmer deconstructs the “G-Zero.”

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⁹ As of early June 2012, the S&P 500 had gained more than 90% since the March 2009 bottom. By comparison, the German DAX gained 70%, and the MSCI Emerging Markets Index 87%, according to data from Bloomberg.

¹⁰ April 2012 trade surplus report, China's General Administration of Customs, english.customs.gov.cn.

¹¹ In 2011, Russia surpassed Saudi Arabia as the world's largest oil producer; the country's overall exports are relatively evenly distributed between Europe and the United States, China and Turkey, according to the *CIA World Factbook*.

¹² BofA Merrill Lynch Global Research, “Australia Macro Outlook,” Jan. 20, 2012.

CAN THE DOLLAR SURVIVE THE G-ZERO?

A new world calls into question the U.S. dollar as the world reserve currency. Or does it?

One signature development of globalization has been the entrenchment of the U.S. dollar as the dominant world reserve currency. For more than 70 years, central banks and international bodies like the International Monetary Fund have used dollars to settle cross-border debts, and countries and companies have used dollars to invoice a large percentage of their trade. The euro, yen and pound sterling are also used as reserve currencies, but to nowhere near the same degree as the U.S. dollar. This gives the United States extraordinary flexibility in managing its fiscal affairs. Because it gets to pay off its debts with its own currency, the U.S. could possibly reduce the value of its outstanding balances by simply printing more—something its creditors, particularly China, have grumbled about with increasing regularity. Which raises the question: In a G-Zero world, where countries

become less reliant on a single power, is the dollar's long run as the world's dominant currency nearing its end?

In a word: No. History moves slowly when it comes to such changeovers. The last time it occurred—when the world moved to the dollar from the British pound around World War II—sterling had been the chief paper in most government vaults for more than 50 years after the U.S. had surpassed the U.K. as the world's largest economy. Much of the inertia has to do with how enmeshed a reserve currency becomes in the fabric of international finance.

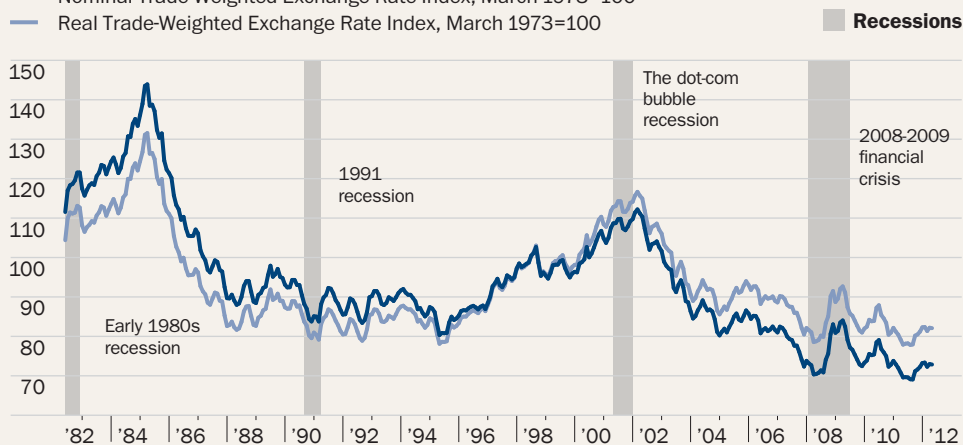
This isn't to say countries haven't begun laying the groundwork for change. In late May, China and Japan inked an accord to open direct trading between yen and renminbi, potentially a first step toward getting more renminbi into circulation. Other countries have been using small portions of their cash stores to acquire gold, hedging against a shake-up in world reserve currencies. Still, says John Shin, senior FX research analyst with BofA Merrill Lynch Global Research, it will be many years before the dollar is at serious risk of losing its top standing.

The United States is still the world's innovation capital and its universally recognized safe haven.

ALL EYES ON THE DOLLAR: Whether you take into account inflation (real trade-weighted, below) or you don't factor in inflation, the U.S. dollar has weakened for much of the past 10 years against the world's other leading currencies. Recently, however, the buck has been perking up.

U.S. dollar index against other major currencies

— Nominal Trade-Weighted Exchange Rate Index, March 1973=100
 — Real Trade-Weighted Exchange Rate Index, March 1973=100



Sources: FactSet; ML GWM Investment Management & Guidance. Data as of April 2012.

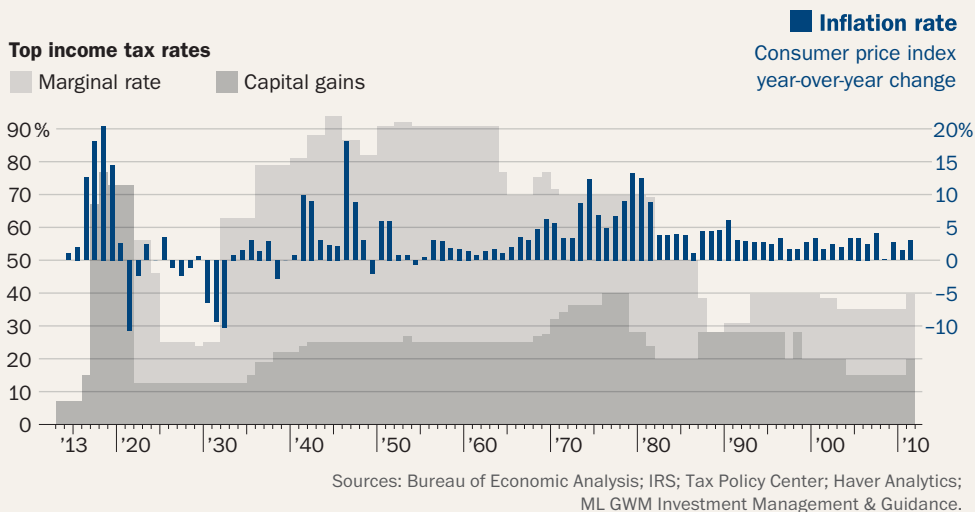
Indonesia's middle class has expanded by a factor of 30 since 2004 and is now bigger than India's.

more, most pivot states have strong balance sheets; in general, the winners going forward will more likely fall on the creditor side of the ledger than on the debtor. Many also possess a growing middle class.

Indonesia is a textbook example. It has the classic pivot-state characteristic of well-balanced trade ties (which are distributed fairly evenly among China, the United States, Japan and Singapore). But it also has an exploding middle class, which has expanded by a factor of 30 since 2004 and now exceeds 50 million people. That's bigger than the middle class of India.¹³ In the end, this and other factors—including a highly skilled workforce, an expanding manufacturing base, and relative openness to foreign investment—should help keep Indonesia's economy¹⁴ on an even keel and protect it in the event that a black-swan-like event, such as a sharp deterioration of U.S.–China relations, destabilizes the region.

Other countries won't be so well positioned, and the divergence is likely to widen between a new set of haves and have-nots. Mexico and Taiwan are two examples of countries whose strategic advantages are compromised by an inability to pivot away from a single dominant neighbor. Although Mexico's GDP has grown at an average rate of 4.6% over the past two years, 75% of its exports go to the United States.¹⁵ The country's second largest source of foreign currency—some \$21 billion a year—is remit-

TWO THIRDS OF THE "TRIPLE THREAT": As noted below, taxes and inflation in the U.S. haven't been this low for this long since the 1930s. Given that these patterns almost have to change, investors may want to start now to do more to plan for that eventuality.



¹³ "Missing BRIC in the Wall," *The Economist*, July 21, 2011; BofA Merrill Lynch Global Research.

¹⁴ Indonesian GDP grew faster in 2011 (up 6.5% year-over-year) than at any time since 1996, though the pace is projected to slow to 6% in 2012, according to BofA Merrill Lynch Global Research, "Indonesia Macro Watch," Feb. 6, 2012.

¹⁵ *CIA World Factbook*.

HOW ETFs CAN HELP

Tap into emerging-market opportunity while reducing part of the “triple threat.”

The sharp rise in popularity of exchange-traded funds over the past several years has been a net positive for globally minded investors looking to tightly control their bottom line. The funds—which are managed to match the performance of some benchmark measure, such as a foreign stock exchange, the spot prices of commodities or a basket of stocks in the same sector—tend to charge lower fees and be more tax-efficient than more actively managed vehicles like mutual funds. This and the fact that there are now ETFs tracking hundreds of local equities indexes around the world make them a particularly cost-effective vehicle

for gaining exposure to the most advantaged regions of the world. When investing through ETFs, it will fall on you and your advisor to choose the right mix of broad country benchmark indexes designed to give you the best combination of resilience and growth, and to rebalance as conditions require. In other instances, you may have a more specific view about sectors within a country or across related markets. In those cases, you may decide on a higher-load mutual fund that specializes in finding the most successful Brazilian agricultural companies or the multinational tech firms that are best positioned to sell to the Brazilian, Indonesian and African consumer markets. The point is to be more conscious of using the right vehicle for the right purposes.

tances from Mexicans working abroad, mostly north of the border.¹⁶ The largest source of foreign currency is oil sold to the United States. Taiwan, despite an economy growing at a 5% clip and a sturdy middle class, sends 42% of its exports across the Straits of Taiwan to China.¹⁷ Even more nettlesome, Chinese authorities have for many years offered powerful Taiwanese businessmen tax breaks and other financial inducements to increase their China trade, and in the process have created a de facto pro-Beijing lobbying force inside the Taiwan elite. Should China experience the hard landing that many economists fear, or should the United States slip into recession, Taiwan and Mexico will be among the economies hardest hit.

As the global economy realigns, some of the winners and losers will be even more surprising. While South Africa and other sub-Saharan countries don't draw as much attention as emerging markets in other regions, they boast a combined 840 million people¹⁸ who are rapidly urbanizing and becoming consumers. Many of the countries have prized sources of oil, diamonds, copper and coal, as well as enormous stretches of arable land that many Asian and Middle Eastern countries covet. Of course, viewing Africa in a favorable investment light challenges many of our preconceptions about geopolitical reality. But such notions are holdovers from an earlier period, when a different paradigm ruled. Investing in Africa may not seem like an obvious way to add stability to a portfolio, but by taking a fresh look at such markets, investors will be less likely to surrender potential opportunities that offer not only growth, but also protection against the risks posed by a G-Zero world.

A SMARTER DIVERSIFICATION

As the global economy reorders itself, investors can find that a strategy based on yesterday's assumptions and circumstances no longer fits today. But what takes its place? A

¹⁶ U.S. Department of State, Country Background Notes, Nov. 16, 2011.

¹⁷ *CIA World Factbook*. Taiwan's economic growth prospects depend on China's; a 1% slowdown in Chinese GDP, for example, will contract Taiwan's GDP by 0.6%, according to BofA Merrill Lynch Global Research, “Taiwan Macro Watch,” May 30, 2012.

¹⁸ Population Reference Bureau, World Population Data Sheet 2011.



good first step is to actually think like a pivot state—emulate its flexibility and diversity. By building a diverse range of international relationships, pivot states may be better positioned to seek growth while fortifying their defenses against volatile times. Investors can do the same, and that starts with embracing a more dynamic approach to asset allocation.

While the classic tenets of strategic asset allocation (maintaining a 60/40 ratio of equities/bonds and cash for a moderate-risk profile, for example) remain the cornerstone of investment advice for investors with 20- to 30-year time horizons, investors can take advantage of shorter-term shifts in market volatility and correlations by “overweighting” and “underweighting” certain asset classes—that is, temporarily assigning more or less of the portfolio to them. Similarly, investors in a G-Zero world should look more closely at their asset and sub-asset classes. A broad “emerging markets” investment may, in fact, contain a wide array of various country exposures, some of which are well positioned to succeed in the G-Zero era and some that are not. Focusing on the more promising investments may require nontraditional, more actively managed funds. Investors may also need to make use of specific exchange-traded funds that capture the performance of stock indexes in the countries that combine stability and growth.

In the first installment of *The Great Global Shift: New World, New Rules* (www.ml.com/newworld), we highlighted a handful of basic principles that can help investors put these ideas into practice. Here are some other guidelines to keep in mind when investing in the new world order.

Extending Global Horizons Even Further

Given the murky outlook for growth in the United States and other developed nations, investors should consider an even more diversified portfolio by increasing their direct exposure to international stocks and bonds. This may include targeted exposure to some countries that combine growth and stability in the same investment. For example, a portfolio’s overseas fixed-income allocation might be expanded to include Australian sovereign bonds or the corporate bonds of a Singapore bank. An emerging-market allocation might include a larger helping of Indonesian and Brazilian ETFs.

Another way to gain exposure to regional or country-specific trends is to focus on particular investment themes—such as the emerging-market consumer theme.¹⁹ It remains relevant and continues to evolve, including not just automobiles and technology but also pharmaceuticals and services such as health care and education. One potentially promising theme is centered around sustainable energy technologies, water scarcity and agricultural productivity. Even within a portfolio’s U.S. equities allocation, an investor could do well by following the U.S. manufacturing renaissance theme, or America’s coming energy independence.²⁰

¹⁹ Real consumption growth in emerging markets has averaged 7% per year since 2007, 10 times that of the United States over the same period, according to BofA Merrill Lynch Global Research, “Why to Invest in DM Stocks to Play the EM Consumer,” May 23, 2012.

²⁰ BofA Merrill Lynch Global Research, “U.S. Manufacturing Renaissance,” March 27, 2012.



THE NEW NORMAL: The Merrill Lynch Option Volatility Index (MOVE) and the Chicago Board Options Exchange Volatility Index (VIX) confirm what most investors already know: Markets continue to lurch from one crisis to the next.



Sources: Bloomberg; ML GWM Investment Management & Guidance. Data as of May 16, 2012.

In a portfolio's fixed-income allocation, an investor might include Australian sovereign bonds or the corporate bonds of a Singapore bank.

Focusing on Companies Even More Than Countries

Gaining exposure to national economies that combine growth and resilience is a vital strategy, particularly over the long haul. But in the immediate term, investors may also want to consider emphasizing multinational corporations that themselves have business exposure to a range of overseas markets. Whether based in the United States or in other developed nations, companies with a global footprint have an increased ability to withstand economic downturns. This kind of diversity serves as a natural hedge in an uncertain world, just as it does for successful pivot states. Investors should especially seek out multinationals with substantial presence in emerging markets—a sweet spot of the EM consumer theme.²¹ Best-of-breed companies, especially those with world-class brands, healthy balance sheets, differentiating technologies and reliable dividend yields, should be high on any list. And the search shouldn't be limited just to equities. There was a time when most of the triple-A-rated bonds in the world were sovereign bonds. More and more, however, the highest-rated new debt issuances are coming from corporations.

Investing Toward Specific Goals

Investors may have an easier time making changes to their investment strategy if they can evaluate investment success in a way that's more in line with new realities. No longer is it enough to measure performance in terms of relative return, comparing one's portfolio to the S&P 500. Rather, it may make a great deal more sense to set clear financial goals, and then seek the investment strategy for each goal that will help meet it. Investment performance is a critical measure of a portfolio, but it's not the only one. Other important criteria include concrete cash and income goals as well as specific time horizons, risk tolerances and levels of priority for each objective.²²

Merrill Lynch's behavioral economist takes on home-country biases.

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²¹ BofA Merrill Lynch Global Research, "Why to Invest in DM Stocks to Play the EM Consumer," May 23, 2012.

²² Merrill Lynch Global Wealth Management, "Introduction to Goals-Based Wealth Management," Summer 2011.

Instead of rebalancing their portfolios once a year, investors may want to consider doing it as many as two or three times a year, or even quarterly.

Investors should ask themselves how much income they anticipate needing from the portfolio in the first five to 10 years of retirement, then the next five to 10, and so forth. Do they hope to buy a vacation home any time over the next several years? What education needs for children and grandchildren are on the horizon? What sort of legacy goals do they have? Many hedge fund managers and other institutions have long thought about investing in more granular terms such as these. A pension fund manager has precise income goals and payout dates to hit regardless of how the markets perform. That's why institutional managers are generally less likely to track their progress against benchmarks or conventional wisdom and are more focused on thinking about the actual dollar amounts they want to earn, along with the investments or assets that give them the best chance of meeting their targets.

There is also a psychological benefit to a goals-based approach to investing: By structuring a portfolio that is designed to help meet their income and liquidity needs in almost any scenario, investors can more easily muster the discipline needed to stick with the overall investment plan.

Rebalancing More Frequently

Showing self-restraint and stick-to-itiveness doesn't always mean following an overly conservative buy-and-hold philosophy. In fact, in a world of increasing volatility, being a disciplined investor requires more active and frequent engagement with markets. It requires putting volatility to work in your portfolio—not just by investing against the grain but also by having the courage to buy when markets are down and to take profits when they're riding high. Instead of rebalancing their portfolios once a year, investors may want to consider working with their financial advisor to rebalance as many as two or three times a year, or even quarterly.

Hedging Your Currency Risk

As investors increase their international exposures, it becomes more important for them to understand how currency fluctuations can affect returns. For many years, U.S.-based global investors didn't need to concern themselves much with currency risk, because the U.S. dollar was mired in a more than decade-long period of weakness against the world's other leading currencies. But recently the dollar has begun to reverse that slide, and if the trend continues it has the potential to undercut or even wipe out profits from overseas assets denominated in foreign currencies.

Over the longer term, beyond the next five years, if the United States tries to print its way out of its fiscal hole (see "Can the Dollar Survive the G-Zero?," page 9), this pattern could morph yet again;²³ however, in the meantime, globally oriented investors may want to consider hedging their currency risk. In most cases, global-allocation funds have hedging strategies in place, though it's worth asking your financial advisor to confirm just what those strategies are. Other investors with more complex, customized global portfolios with direct ownership of assets in foreign currencies may require a more sophisticated hedging strategy involving the purchase of options or futures designed to pay out if the dollar keeps strengthening.

Lisa Shalett explains the "triple threat."

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²³ BofA Merrill Lynch Global Research, Liquid Insight, "Reserve Currency Determinants," May 6, 2012.

Being Aware of Taxes, Inflation and Fees

Just as U.S.-based investors must be vigilant about currency fluctuations, so too must they keep a sharp eye on three other factors that are increasingly likely to curtail returns, especially at a time of heightened global risk and volatility. They are taxes, inflation and fees. Because all three are interrelated, and because they all affect an investor's bottom line, some active managers call this rule of thumb "triple-threat awareness."

First, higher taxes are almost certainly in the cards, given the U.S. government's attempts to balance its budget and prevent a looming fiscal crisis. Tax-efficient vehicles like municipal bonds can help soften the blow. Second, though inflation has remained at bay and is projected to be benign over the medium term, the expected eventual speeding up of the U.S. economy will arguably lead to an uptick in inflation sometime within the next three to four years. To diminish its potential impact, investors may want to seek out shorter-term sources of yield, such as higher-yield corporate bonds, or mix in more dividend-paying stocks, and start increasing exposure to risk assets like commodities that correlate favorably with inflation. Third, investors can offset both inflation and higher taxes by being more mindful of the fees they pay, which largely depends on which ETFs, actively managed funds and other investment vehicles are used to carry out a particular strategy.²⁴ (See "How ETFs Can Help," page 11.)

PUTTING IT ALL TOGETHER

A portfolio is a dynamic entity, so when you increase your level of diversification you will want to look at your investments in a more detailed way. For instance, if you increase your exposure to an economy like Australia, with its mega coal mines and vast reserves of iron ore, you may well need to tweak your commodity allocation, to reduce your portfolio's potential vulnerability to fluctuations in natural-resource prices.

The world economy and the way markets interact have become undeniably more complex. As the forces of globalization evolve, the degree of complexity will only increase. There's a reason so much money remains on the sidelines and that gold prices have achieved such heights. Investors are expressing their recognition that the world has changed in some fundamental way. What they want to understand is what all this change means for them as investors.

Strategically adding exposure to pivot states and multinationals, aligning goals with allocations, and limiting the potential fallout from currency swings, inflation, taxes and fees—all these may seem like adding complexity to investing. But at bottom, the ideas are meant to produce clarity. Applying strategies that acknowledge the geopolitical realities of the world today—and where your portfolio fits into it—is simply a method for helping you and your advisor sort the wheat from the chaff. And the point of investing in today's global economy is, in the end, just as straightforward: to identify ways to fortify your holdings against a riskier planet and increase your chances of meeting your goals. 🌐



²⁴ Merrill Lynch Wealth Management, *CIO Reports*, "Cherry Picking the Dips and Fighting the 'Triple Threat,'" May 10, 2012.

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Investing in securities involves risks, and there is always the potential of losing money when you invest in securities.

Consider the asset allocation suggested on page 6 in reference to your own individual risk tolerance, time horizon, objectives and liquidity needs. Certain investments may not be appropriate given your specific circumstances and investment plan. Certain security types, like hedged strategies and private equity investments, are subject to eligibility and suitability criteria. Your Financial Advisor can help you to customize your portfolio in light of your specific circumstances.

The investments discussed have varying degrees of risk. Some of the risks involved with equities include the possibility that the value of the stocks may fluctuate in response to events specific to the companies or markets, as well as economic, political or social events in the U.S. or abroad. Bonds are subject to interest rate, inflation and credit risks. Investments in high-yield bonds may be subject to greater market fluctuations and risk of loss of income and principal than securities in higher rated categories. Investments in foreign securities involve special risks, including foreign currency risk and the possibility of substantial volatility due to adverse political, economic or other developments. These risks are magnified for investments made in emerging markets. Investments in a certain industry or sector may pose additional risk due to lack of diversification and sector concentration. Investments in real estate securities can be subject to fluctuations in the value of the underlying properties, the effect of economic conditions on real estate values, changes in interest rates, and risk related to renting properties, such as rental defaults. Market-Linked Investments have varying payout characteristics, risks and reward; investors need to understand the characteristics of each specific investment, as well as those of the linked asset. There are special risks associated with an investment in commodities, including market price fluctuations, regulatory changes, interest rate changes, credit risk, economic changes and the impact of adverse political or financial factors.

Diversification, asset allocation and rebalancing do not assure a profit or protect against loss in declining markets. Rebalancing may pose a tax event.

Past performance is no guarantee of future results.

Alternative Investments are speculative and subject to a high degree of risk. Although risk management policies and procedures can be effective in reducing or mitigating the effects of certain risks, no risk management policy can completely eliminate the possibility of sudden and severe losses, illiquidity and the occurrence of other material adverse effects. In addition to certain general risks, each product will be subject to its own specific risks, including strategy and market risk.

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