

## **Merrill Lynch Second-Quarter 2008 Earnings Call**

Good afternoon and welcome to Merrill Lynch's conference call to review our second quarter and first half 2008 results. The following live broadcast is copyrighted to Merrill Lynch. Statements made today may contain forward-looking information. While this information reflects management's current expectations or beliefs, you should not place undue reliance on such statements as our future results may be affected by a variety of factors that we cannot control.

You should read the forward-looking disclaimer in our quarterly earnings release as it contains additional important disclosures on this topic. You should also consult our reports filed with the SEC for any additional information including risk factors specific to our business and the information on calculation of non-GAAP financial measures that is posted on our Investor Relations website, [www.ir.ml.com](http://www.ir.ml.com), where an online rebroadcast of this conference call will be available later today at approximately 7:00 p.m. Eastern time.

And with that I'll turn the call over to John Thain, Merrill Lynch's Chairman and Chief Executive Officer.

### **John Thain:**

Thank you, Sara, good afternoon, everyone. Thank you all for being on the call.

I would like to make a few opening comments and then I'll turn the call over to Nelson to go through the details. This was obviously a difficult and disappointing quarter for us in terms of bottom line. The losses that were generated were almost exclusively from our existing mortgage and mortgage-related positions, and from our exposures to the monolines. Those positions continued to deteriorate in value over the course of the quarter, particularly because our quarter ended in June, and the last two weeks of June were particularly a difficult time. I would like to emphasize a couple of points.

First, our core franchise, the efforts of our 60,000+ people, remains very strong. Excluding marks and credit valuation reserves and fair-value adjustments, our core franchise generated \$7.5 billion of revenues for this quarter -- and that's in a difficult market environment. On a pre-tax basis, that would be just under \$2 billion of pre-tax income in the quarter. So we

are very confident with our business strategy and the earnings power of our core franchise.

If you just get in to a little bit of the detail, and Nelson will do this more, on the Global Markets and Investment Banking side, investment banking had over \$1 billion of revenues in the quarter. We were the # 2 merger advisor for the first half of the year in EMEA, and # 3 in terms of global debt and equity fees. Our trading businesses also had a number of important positive areas. We had record revenues in both our Rates and our Currencies business for the first half.

Our commodities business was up 57% year-over-year. And we had record revenues in our prime brokerage business. The international component of our business continued to grow. We were up 13% overall versus the first quarter, and our EMEA business was up 30%. And the pipeline in investment banking continues to hold in. Year-over-year the pipeline is down only 7% versus the second quarter of 2007.

So the banking, and sales and trading businesses were doing well, and the wealth management business, also in a difficult environment continued to do well. \$3.4 billion of revenues, down slightly from the first quarter, 22% pre-tax margin, a continued increase in our annuitized products -- about \$8 billion in annuitized products -- which brings the total annuitized products to about 70%, and we had a small reduction -- \$5 billion in net new assets -- and the second quarter, because of tax payments, tends to be a slightly more difficult quarter for us.

The second point I want to make is that we have a record level of liquidity. \$92 billion in our liquidity pool, almost all cash and cash equivalents, almost all in our parent company. Just to give you an idea of \$92 billion, that's up from \$82 billion at the end of the first quarter, up from \$79 billion at the end of the year. That \$92 billion, if you compare it to our commercial paper outstanding, we have \$8 billion in commercial paper outstanding... if you compare \$92 billion to our free-credit balances, we have \$14 billion of prime broker free-credit balances. So we are extremely liquid.

The third point I want to make is we have been reducing our risky assets. We have been reducing our balance sheet, and we have been de-risking our positions. We will this quarter report risk-weighted assets. Our risk-weighted assets will be down 27% for this quarter. That's about a \$130

billion reduction. Adjusted assets, which is less of a good measure of our risk profile, but still a measure people look at, our adjusted assets will be down 14%.

And in some of the more focused on areas, like leveraged loans, our leveraged loans were down 47% quarter-over-quarter. They are now at a level of \$7.5 billion. They are actually down even more than that percentage wise for the full year, but quarter-over-quarter down 75% to \$7.5 billion. Excluding our bank's portfolio, so in our trading books, our Alt-A position is down 50% to \$1.5 billion. Our sub-prime position is down 30% to \$1.0 billion, and our commercial real estate position is down 15% to \$17.5 billion. And just to give you an idea of that decline in our commercial real estate portfolio, we did that with no P&L impact. So those were all done where we carried that inventory.

So, strength of the core franchise, very liquid, and reducing risky assets with shrinking our balance sheet. Next point I want to make is that in spite of this loss for the quarter, we likely have in our last two quarters more than replaced the capital that we have lost. So at the end of the second quarter, we replaced capital that we lost... at the end of the first quarter, we replaced the capital that we lost... at the end of the year we more than replaced the capital that we lost.

In this quarter, as we have talked about in each of the quarters, we analyzed what our different options were, and we raised capital in the way we thought was the most effective, and most advantageous to our shareholders. So we have concluded the sale of our 20% stake in Bloomberg -- that transaction which of course was in the papers today, but we both signed and closed that transaction today. So that transaction is done.

We sold our 20% interest in Bloomberg for \$4.425 billion. We also entered into our letter of intent to sell a controlling stake in FDS. FDS is a subsidiary that performs administrative-type functions for mutual funds, things like sub-accounting and transfer agency-type of functions.

We are expecting that the total enterprise will be valued in excess of \$3.5 billion, and we will sell a controlling interest in that. Just to give you an idea of what that means in terms of our capital ratios... On a pro forma basis, taking into account the loss for the quarter and pro forma for these

two transactions, we will have a Tier 1 ratio -- Tier 1 equity to risk-weighted assets of around 9.5%, and we will have a total equity to risk-weighted assets of around 15%. And just to benchmark that, the Fed's guideline for total capital to risk-weighted assets to be deemed well capitalized is 10%. So we are at 15 versus that 10. And 9.5% on a Tier 1 basis.

The other comment in terms of capital raising, we have decided that we would not sell any of our BlackRock stake. BlackRock as we have always talked about is strategic to us. We in fact in the discussions of BlackRock have broadened and lengthened our distribution agreement with them, and we continue to agree that that is a very good and important partnership for us, and is working well with us. Based upon the most recent stock price performance, our stake in BlackRock is worth approximately \$13 billion.

Last point I'll make and before I'll turn it over to Nelson is, we told you at the end of the first quarter that we were going to focus on expenses, and that we were going to reduce our headcount by 10% of our non-financial advisor headcount, that is about 4,000 people. We delivered on that promise. We have actually reduced our headcount by 4,200 people. We told you at the time we expected annualized run rate savings of about \$800 million. The actual annualized run rate savings will be \$925 million. We also told you that we expected to save about \$600 million in 2008. That number will actually be about \$730 million. So we are trying to be good about delivering on what we promised.

So overall, in spite of the difficult market, difficult quarter, obviously disappointing results, our core franchise continues to deliver. We are very liquid. We have reduced our risky assets on our balance sheet, and will continue to do that. We have continued to replace any capital losses with new capital and actually made our capital ratios better, and we will continue to focus on expenses. With that, I'll turn it over the Nelson.

**Nelson Chai:**

Thanks, John.

Let me take a moment to review our major segments.

In **Global Markets and Investment Banking**, second quarter net revenues of negative \$5.3 billion were down substantially from prior periods and GMI's pre-tax loss for the quarter was \$8.2 billion.

However, as we have detailed in Attachment VIII of our press release, excluding write-downs and fair value gains on our debt, GMI adjusted revenues, were \$4.3 billion during the quarter, which represents an 11% increase over first quarter of 2008.

In our FICC businesses, strong performance in our core businesses -- Rates & Currencies, Credit Trading and Commodities -- were more than offset by losses and credit valuation adjustments.

If you turn to Attachment VI in our release, I will walk you through each of our major exposures starting with ABS CDOs and related monoline exposures – which accounts for the majority of our write-downs, as John mentioned, both this quarter and over the last twelve months.

As you can see on the top of Attachment VI, on the super senior ABS CDO front, at quarter-end our net exposure was approximately \$4.2 billion, which was comprised of a \$20 billion long position and a \$16 billion short position. Our net CDO position reflects a \$3.5 billion write-down, partially offset by an increase in net exposure due to certain hedges deemed ineffective.

Given the market environment, we remain prudent in our valuation approach. We are taking into consideration incremental remittance and other data which was negative during the quarter. As a result, we increased our average cumulative loss assumptions for this portfolio across most underlying collateral types in the second quarter.

As a result of these losses in our underlying super senior ABS CDO positions, the corresponding value of our related hedges increased during the quarter.

As I mentioned, our total U.S. super senior ABS CDO short position was \$16 billion in the second quarter. Of this amount, \$9.6 billion were with the monolines and \$6.0 billion were with other financial counterparties such as insurance companies and hedge funds.

For the ABS CDO hedges we have with the monolines, our credit valuation adjustment was negative \$1.4 billion during the quarter which was driven largely by the market observables for the monolines to which we have exposure. On average, we have written down the value of these hedges to approximately \$0.30 on the \$1 at quarter-end.\

In addition, we have hedges in place with the monolines on asset classes away from CDOs, primarily CMBS and corporate CLOs. While the market value declines on these positions we are hedging have been modest, the negative credit valuation adjustment on the related hedges with monoline counterparties was \$1.5 billion. Our remaining carrying value on these hedges is \$3.6 billion.

As I turn to residential mortgages, which are detailed on Exhibit Seven, the vast majority of our exposure is from U.S. prime mortgages that we have primarily originated from our high net worth First Republic and GWM clients. On average, these clients have FICO scores in excess of 750, loan-to-values less than 60%, and virtually zero default history.

As John mentioned earlier, away from these U.S. prime mortgages, our other residential exposures were down in aggregate by 25%, with reductions of:

- 29% in Sub-prime;
- 51% in Alt-A; and
- 15% outside of the U.S.

In aggregate, the majority of our exposure reduction was driven by asset sales of approximately \$2 billion during the quarter.

Within both commercial real estate and leveraged finance, we remain comfortable with the quality of both of these portfolios but have substantially reduced our net exposures to these asset classes consistent with our overall strategy to reduce risk.

In leveraged finance, we reduced our exposure by approximately \$7 billion in the quarter through sales that were completed at levels on average consistent with our marks at the time of the execution. In commercial real estate, excluding First Republic Bank, we reduced our exposures to about

\$15 billion, down 17% from the first quarter, primarily due to sales of whole loan/conduit exposures in the U.S. and EMEA and again, we did sell without taking marks.

Finally, within our U.S. Bank investment securities portfolio, we recognized net pre-tax write-downs of \$1.7 billion through the income statement during the second quarter of 2008, as the impairment we had previously recorded through other comprehensive income or OCI, was deemed to be other than temporary. At quarter-end, our portfolio was \$18 billion, a reduction of approximately \$2 billion from the first quarter, of which more than \$850 million was from sales and paydowns.

Turning to **Equity Markets**, second quarter net revenues of \$1.7 billion, excluding the fair value gains on our debt was up 45% versus the first quarter of 2008. This strong operating performance was driven by record financing and services revenues, which reported double-digit sequential and year-on-year revenue growth as our businesses benefited from increased flows resulting from the European dividend season during the second quarter. Also driving Equity Markets performance, was a rebound in our proprietary trading book which suffered losses during the first quarter but and was up materially from the prior-year period.

Partially offsetting these sequential gains were declines in Equity-Linked and our private equity business. Private equity revenues were negative \$184 million for the quarter, primarily due to continued price declines on our publicly traded investments, which we marked-to-market.

**Investment Banking** revenues were up nearly 30% sequentially driven by EMEA which generated record revenues in the first half of the year, most notably bookrunning the \$24 billion rights issue for RBS, the largest equity issuance globally ever. Additionally, particular strength came from emerging markets such as Russia where our first half revenues were more than 4x those we generated in all of 2007. While industry-wide deal volumes have declined, Merrill Lynch has maintained its strong global position in the second quarter. As John mentioned, we were #3 in global debt and equity fees and recently named Best Global M&A House for 2008 by *Eurromoney*. We continue to engage in active strategic dialogue with clients, advising on industry-leading transactions, such as the \$13 billion Rusal / Norilsk deal – the largest ever M&A transaction in Russia and the recently announced \$18bn acquisition of Rohm & Haas by Dow Chemical.

Turning to **GWM** --

GWM continued to deliver solid performance with quarterly revenues of \$3.4 billion, down 7% from the first quarter as performance was impacted by continued market depreciation and persistent market volatility. However, pre-tax earnings of \$738 million, were up 3%, and GWM's margin increased from 20% to 22% in the second quarter, despite our continued investment in growth initiatives.

Notable highlights for the quarter include:

- \$8 billion in net new annuitized inflows
- Client assets of more than \$1.6 trillion
- Success in retaining our industry leading team of financial advisors and net positive recruiting in our top two quintiles
- Double-digit revenue and pre-tax growth from First Republic
- International FA growth of 11% year-over-year, excluding Japan
- Record quarterly revenues in Latin America

**GPC** net revenues for the second quarter were \$3.2 billion, down slightly from the first quarter, despite the market volatility, reflecting the stability of the client franchise and the significant proportion of recurring revenues.

The sequential decline was also impacted by the first quarter gains from the VISA IPO.

During the quarter, net inflows of client assets into annuitized-revenue products was \$8 billion. However, net new money was negative \$5 billion. This represents our first quarter of negative net new money since the second quarter of 2003, and reflects seasonal client income tax payments and the merger-related departure of a significant institutional retirement client.

We continue to invest in our market-leading platforms and increase our FA population, which increased by 30 professionals during the quarter. We also continue to realize success in our recruiting efforts, particularly in our top two quintiles where we added almost 140 FAs on a net basis.

In **GIM**, net revenues were \$193 million for the quarter, reflecting a 35% decline from the first quarter. Weakness in GIM, accounted for almost half of the overall revenue decline in GWM versus the first quarter and was the result of lower revenues from our equity investments in alternative investment management companies.

As I turn to expenses, John mentioned our focus on expenses. For the second quarter our operating expenses, excluding the restructuring charge, were 11% lower than the first quarter of this year and 16% lower than the second quarter of last year. This sequential expense reduction was driven by our previously announced reduction in workforce as well as the absence of expenses related to the accelerated vesting of certain restricted stock that took place in the first quarter.

Non-comp costs excluding the restructuring charge did increase 8% year-over-year primarily due to growth in technology and occupancy expenses attributable to the First Republic acquisition which happened in early 2007 and infrastructure build-out in Europe which occurred in the back half of 2007. We remain focused on managing the firm's expenses to be better in line with the business activity.

As John mentioned earlier, we exceeded our targeted headcount reductions and estimate the associated pre-tax cost savings will be approximately \$730 million in 2008 and approximately \$925 million on an annualized run-rate basis. This quarter we are recording a pre-tax restructuring charge of approximately \$445 million.

Our effective tax rate for the quarter was 42.9%, a modest increase from last quarter, reflecting changes in the geographic mix of our earnings.

During the quarter, we issued \$2.7 billion of perpetual non-cumulative preferred stock. At quarter-end and adjusting for our convertible preferred securities on an if-converted basis, total equity capital was \$39.5 billion and our adjusted book value per share was \$24.94.

As John mentioned earlier, through the completed sale of our Bloomberg stake and our expected sale of a controlling interest in FDS, we are continuing to further bolster the firm's capital base. Pro forma for these

sales, we expect our adjusted book value per share to be in-line with first quarter levels.

Finally, we continue to reduce our balance sheet across all key measures. We expect total assets to be down 7% versus the first quarter and below a trillion dollars, we expect adjusted-assets to be down 14% versus the first quarter resulting in adjusted-assets leverage ratio to decline from 16.1x in the first quarter to 14.5x in the second quarter. As John mentioned, our risk weighted assets are expected to decline 27% in Q2. And we project our level 3 assets to decrease approximately 20% for the quarter to approximately 6% of our total asset base. Let me be clear, we remain focused on continuing to reduce our balance sheet and risk weighted assets in the coming quarters.

And with that, we will open it up to questions. Thank you.