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Merrill Lynch Second Quarter 2007 Earnings Conference Call Transcript

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning and welcome to the Merrill Lynch second quarter 2007 financial results conference call. All lines have been placed on mute to prevent any background noise. After the speakers' remarks there will be a question-and-answer session. [Operator Instructions] I would now like to turn the conference over to Jonathan Blum, head of Investor Relations. Please go ahead.

Jonathan Blum, Investor Relations

Good morning and welcome to Merrill Lynch's conference call to review second quarter and first half 2007 results. The following live broadcast by Jeff Edwards, Chief Financial Officer, is copyrighted to Merrill Lynch.

Statements made today may contain forward-looking information about management's expectations, strategic objectives, growth opportunities, business prospects, investment banking pipeline, acquisition synergies, anticipated expense levels and financial results, and other similar matters. Such forward-looking statements are not statements of historical fact and represent only Merrill Lynch's current beliefs regarding future performance, which is inherently uncertain. Investors are cautioned not to place undue reliance on such statements, which speak only to the date on which they are made and may be impacted by a variety of factors Merrill Lynch cannot control.

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Unless otherwise indicated, comments will exclude the impact of the one-time compensation expenses related to adopted FAS 123R in the first half 2006 from comparisons to that period, as well as the one-time net gain from the closing of the combination of Merrill Lynch Investment Managers, or MLIM, with BlackRock in the third quarter of last year from the determination of quarterly records. Full GAAP financials, which include the one-time compensation expenses, are available in the attachments to the Merrill Lynch earnings release, as are schedules reconciling those data to the numbers that will be discussed.

And now I will turn the call over to Jeff.

Jeffrey N. Edwards, Chief Financial Officer

Thank you, Jonathan, and good morning to all of you on the call. Today Merrill Lynch again reported a very strong operating quarter.

Total net revenues for the second quarter of 2007 were \$9.7 billion, up 19% from the second quarter of last year and just 1% below the record first quarter. More reflective of our ongoing businesses, year-on-year growth excluding results from MLIM in 2006 and BlackRock in 2007 was even stronger, up more than 27%. This outstanding revenue performance was broad-based, with significant year-over-year increases in all major business lines and regions, and is a testament to the successful execution of our diversification and growth strategies. The critical importance of these efforts was evident in the quarter as we were able to deliver these strong overall results despite lower revenues from our private equity business, which contributed significantly less than in

recent quarters, and in spite of persistently challenging conditions in the U.S. subprime mortgage market.

We also demonstrated good operating leverage as the second quarter pre-tax profit margin of 31.1% was up 2.4 points from last year's quarter. Earnings per diluted share of \$2.24 were up 37% from the year-ago period, and net earnings of \$2.1 billion were up 31% as our active share repurchase program continues to enable our EPS to grow faster than net earnings. Both diluted EPS and net earnings were effectively in line with record first-quarter levels, each down less than 1%.

Return on average common equity was 22.4%, up 3.8 percentage points from the 2006 second quarter. Book value per common share was \$43.55 at the end of the quarter, up 17% from the 2006 second quarter and 3% sequentially. All in all a very strong quarter reflecting continued momentum and confidence in all of our businesses.

Our quarterly results capped an exceptional first half of 2007 that set a number of records. Highlights include record revenues of \$19.6 billion, up 21% from 2006; record pre-tax earnings of \$6.1 billion, which increased 30%, resulting in a pre-tax margin of 31.2%, up 2.1 points; record net earnings of \$4.3 billion, up 31%; record diluted EPS of \$4.50, up 37%; and an ROE of 22.8%, nearly 4 points higher than last year's first half.

International growth was again critical to our success. Non-U.S. revenues comprised 42% of Merrill Lynch's total net revenues for the second quarter, the highest percentage ever. Here are a few of our non-U.S. highlights for the period. Non-U.S. revenues grew at four times the rate of U.S. revenues over the 2006 second quarter. Revenues from India grew strongly, more than doubling the previous quarterly record. We continued to make significant progress in the Middle East, including obtaining a full banking license in Saudi Arabia, joining the Dubai Mercantile Exchange, and being the first-ever international institution to lead a sale on the Kuwaiti stock exchange. We led the first-ever international tranche of a Korean domestic IPO. In Europe, we ranked number one in completed M&A, and we advised on four of the top five deals announced during the quarter. And most importantly, we generated record quarterly net revenues in both EMEA and the Pacific Rim, the two largest non-U.S. regions.

We believe the theme of non-U.S. growth outpacing U.S. growth will remain intact. We continue to invest in our platforms around the world and remain well-positioned to fully capitalize on this trend. It is no coincidence that under our new management structure, the global heads of two of the three major business lines within Global Markets and Investment Banking are based in London: Osman Semerci, as Head of Global Fixed Income Currencies and Commodities, or FICC, and Andrea Orcel as Head of Global Origination.

Now for some more specifics on our performance in the second quarter, beginning by segment.

Global Markets & Investment Banking, or GMI, again generated very strong results as our investments in all three core business lines continue to produce robust and diversified year-on-year growth. GMI's second-quarter net revenues of \$6.2 billion were 36% higher than the second quarter of last year and down just 5% from the record first quarter. For the first time, non-U.S. revenues represented more than 60% of GMI's total net revenues for the period. Pre-tax earnings for the quarter were \$2.1 billion, up 43% from the prior-year period and down 10% sequentially. The pre-tax margin of 34% was up 1.9 percentage points over last year and 1.8 points lower than the first quarter, as investments continued across the business.

Looking at GMI's second-quarter net revenues by major business line: FICC net revenues were the second-best ever at \$2.6 billion, up 55% from the second quarter of 2006 and only 7% lower than the record first quarter. For the first six months, FICC generated record revenues of \$5.4 billion, up 45% from last year. Compared with the second quarter of 2006, the increase in revenues was

driven primarily by increases from trading both credit and interest rate products, the latter of which set a record for the second consecutive quarter. Revenues from commodities were also up substantially. The depth and strength of these increases more than offset a decline from mortgages.

The sequential decline in FICC revenues was driven primarily by credit, commercial real estate, and currencies, which had all set revenue records in the first quarter, as well as commodities. Partially offsetting these declines was a substantial increase from structured finance and investments, which primarily reflects a better performance from our U.S. subprime mortgage activities and to a lesser extent the continued growth in global rates.

While we have seen some positive signals, such as improving first-payment default levels for First Franklin, the environment for U.S. subprime mortgages and related CDOs has yet to fully stabilize. Risk management, hedging, and cost controls in this business are especially critical during such periods of difficulty, and ours have proven to be effective in mitigating the impact on our results. Importantly, we have increasingly diversified our FICC business within and across asset classes and regions, creating many different drivers of growth. Our strong 55% revenue increase in the quarter reflects the breadth of both very active client flows and attractive markets for proprietary risk-taking.

Some additional highlights for FICC in the second quarter include record revenue in EMEA and the Pacific Rim for the second consecutive quarter; continued strength in distressed and structured credit trading; continued innovation in the CDO space, including the development of unique new CDO products involving foreign exchange and hybrid long/short structures; and in commodities, continued diversification of the platform, with the first meaningful revenues from trading coal and our first major structured transaction in metals.

Turning to equity markets, where the second quarter net revenues of \$2.1 billion were up 15% compared with the year-ago quarter and down 10% from the first quarter. Notably, excluding private equity revenues, equity markets revenues actually increased 4% over the strong first quarter and nearly 75% year-on-year.

First-half net revenues for equity markets reached a record \$4.5 billion, up 31% for the prior-year period. We have always said that by its nature the private equity business produces lumpy revenues, and that was evident this quarter, as our larger, publicly traded holdings did not generate as much revenue. Second quarter net revenues from private equity were \$125 million, down from the record of \$705 million in the prior-year period and \$445 million in the first quarter.

Apart from the private equity, significant revenue increases from the equity-linked and financing and services business lines, both of which set new quarterly records, as well as cash trading and strategic risk, all drove the strong growth relative to last year's second quarter. Compared to the first quarter, both financing and services and equity-linked generated strong revenue growth while revenues from strategic risk, which set a record in the prior period, were lower.

Equity markets highlights from the very strong second quarter include: Financing and services, which set a new quarterly record that exceeded the prior record by more than 50% on the strength of yield enhancement activity in Europe, an area where we have made focused investments. Equity-linked trading, where the record revenue performance was driven by emerging markets as well as structured and index products. Cash trading, where our continued progress in electronic and algorithmic trading enables us to increase market share on most global exchanges, including New York, London, and Tokyo. In private equity, we announced important new investments in Nuveen and Veda Advantage, and we continue to see attractive opportunities on a global basis.

To further broaden this business model, we also added senior professionals with significant experience in key industry subsectors, including financial services and media and

telecommunications. And we generated outstanding growth in both the Pacific Rim and EMEA. In each of those regions, cash and equity-linked revenues now exceed those in the U.S.

In Investment Banking, we generated record revenues for the third consecutive quarter, with \$1.4 billion in total, up 41% year-on-year and 5% sequentially. Revenues for the first six months increased 44% over the 2006 period to a record \$2.8 billion. This exceptional performance reflects increasing breadth of our banking franchise and our commitment to developing strong client relationships globally.

Originating nontraditional revenues from our investment banking clients is also a key element of our strategy. This quarter our underwriting businesses stood out. Equity origination set a new revenue record at \$547 million, up 74% from the 2006 second quarter and 51% from the 2007 first quarter, including one significant and creative transaction where we utilized our balance sheet and risk management capabilities to raise capital for a key client. Debt origination revenues were also strong at \$479 million dollars, up 19% from last year, but down 19% from the record first quarter.

Advisory revenues were \$397 million, up 34% from the year-ago period and down less than 1% from the strong first quarter. Importantly, we ranked second in announced and third in completed M&A globally for the quarter.

On a regional basis while investment banking revenues were strong globally, EMEA and the Pacific Rim stood out, both setting new revenue records.

The increasing strength of our franchises is evident in many transactions, but one in particular stands out this quarter, illustrating how we are utilizing both our brains and our brawn to deliver smart solutions for our clients. In Europe we are acting as exclusive adviser and lead financier to consortium of clients in their efforts to acquire ABN AMRO in the largest financial services transaction in history.

Our pipeline ended the second quarter higher than the first and substantially higher than at this time last year, with particular strength in advisory and leveraged finance mandates. Our dialogue with clients remains active in all regions, and we are confident in our ability to execute on this record backlog.

To round out the discussion of GMI, some overall year-to-date numbers that underscore the strong growth trends across the business. First-half net revenues were a record \$12.7 billion, up 39% from the first half of 2006, driving record pre-tax earnings of \$4.4 billion, up an even stronger 46%. As I noted, each major business line achieved record net revenues, demonstrating the progress we've made in building out our franchise and positioning it for future growth.

Turning to Global Wealth Management, or GWM, which generated record revenues, pre-tax earnings, and profit margin in the second quarter, driven by strong results in both Global Private Client, or GPC, and Global Investment Management, or GIM. Aggregate GWM net revenues of \$3.6 billion were up 18% year-on-year and 6% sequentially. Pre-tax profits exceeded \$1 billion for the first time and were up 39% and 20% respectively. The pre-tax margin reached a new high of 27.9%, driven by the revenue growth and operating leverage. GPC revenues for the quarter were \$3.3 billion, the second highest total the business has ever generated. Revenues were up 13% compared to the second quarter of last year and 5% from the first quarter of this year. For the first half, GPC net revenues increased 12% to \$6.5 billion, reaching a new record level that surpasses the old record set during 2000.

Compared to both prior quarters, record fee-based revenues, driven primarily by asset-based fees, combined with higher transaction and origination revenues to drive the overall increase. Year-on-year, net interest also increased substantially.

Highlights for the quarter within GPC include success in recruiting and training and then retaining high-quality FAs, as we net-added 270 during the quarter. Notably, we had net positive recruiting against all our major competitors, and we had the lowest turnover among our top two quintiles of FAs on record. Continued momentum with ultra-high network clients, a segment which continues to grow faster than GPC as a whole. In the Pacific Rim we are rolling out a new ultra-high network business model, focused on what we call Private Investment Banking. This effort brings GPC and GMI together to seamlessly deliver a full array of both wealth management and institutional products and services.

Turning back to the U.S., we've launched our new Unified Managed Account Platform, which has already attracted new high-quality asset managers and is even more appealing to our clients. And finally, we look forward to the consummation of the First Republic transaction and enacting our plans to accelerate the growth from this unique private banking platform. We continue to make progress towards the necessary regulatory and shareholder approvals, and we expect that the deal will close during this third quarter.

Moving on to GIM. Record net revenues of \$305 million were up 119% compared to the second quarter of 2006 and 17% higher than in the first quarter of 2007. First-half GIM net revenues were also a record at \$566 million, up 133%. Relative to the 2006 second quarter, growth was driven by the inclusion of our share of BlackRock's results in the current period but not in the prior-year period as well as growth revenue from our investments in other alternative asset management companies and a pickup in revenue from our alternative investment distribution platform. Sequentially, the growth reflects increased revenues from our investments in both alternative asset management companies and BlackRock, which is scheduled to report its earnings tomorrow morning.

Two important transactions that we announced this quarter position us for future growth in this segment. At the end of the quarter, we closed on investments in GSO Capital Partners, an alternative asset manager focused on the leveraged finance markets, and Sterling Stamos, a fund manager.

Returning to GWM as a whole, second quarter asset flows into private client accounts were solid, despite a quarter that is typically the slowest of the year due to client tax payments. Net inflows into products that generate annuitized revenues were \$12 billion for the quarter and \$28 billion for the first half, while total net new money into the firm was \$9 billion and \$24 billion respectively. Period end client assets again set a new record at \$1.7 trillion, up 14% from a year ago. For the first half of 2007, GWM's results also achieved new highs. Net revenues were a record \$7 billion, up 17% from 2006, and pre-tax earnings a record \$1.9 billion, up 35%. The pre-tax margin improved by 3.6 points to 26.4%, driven by the impact of the BlackRock investment and good operating leverage across the business.

That concludes my discussion of the segments. Now I'll return to the income statement for the firm as a whole, beginning with expenses.

I'll start with compensation. The ratio of compensation expenses to net revenues for the second quarter was 48.9%, down a little from the first quarter and bringing the year-to-date comp ratio to 49.3%. This is about 10 basis points lower than the first half of 2006, reflecting continued operating discipline and the strong revenue environment, even as we continue to hire talented people and drive our growth initiatives forward. As always, the progression towards the full-year ratio will depend on the environment, our business mix, the pace of recruiting and hiring, and competitive compensation trends.

Moving on to non-compensation costs, which were \$1.9 billion for the quarter. Most line items increased only modestly from the first quarter, despite continued investments in the business. The ratio of non-compensation expenses to net revenues in the second quarter was 20%, down 2.6

percentage points from the second quarter of 2006 and up 1 point from the record low set in the first quarter of 2007. On a year-to-date basis, this ratio was 19.5%, down 2 points from last year, as we remained focused on controlling non-comp expenses in order to drive operating leverage.

Now the effective tax rate, which for the second quarter was 29.2%, down 1.1 points from the first quarter rate as we recognized a small discrete net benefit relating to settlements and changes in estimates for prior years. For the first half, our effective tax rate was 28.8%. At this point we continue to expect that rate to increase modestly in the second half, subject of course to the usual factors: business mix, changes in tax laws, and settlements.

Lastly, capital management. As I noted earlier, our second quarter ROE of 22.4% was up 3.8 points from last year and down less than a point from the first quarter. At the same time, book value per share of \$43.55 was up 3% sequentially and a full 17% year-on-year. As management team, we remain intensely focused on driving improvements in both these important performance measures.

Our stock buyback program remained active even though we had to withdraw from the market late in the quarter as required with respect to the First Republic acquisition. For the quarter we repurchased 19.8 million shares for \$1.8 billion. As we enter the second half of the year, let me remind you that we will need to continue to stay out of the market for certain periods prior to the closing of First Republic. Repurchases have had a material effect on our share count. Average diluted shares for the quarter were 923 million, down 5% from this time last year, while period end shares are down 4%. Obviously the full benefits of this reduced share count should become evident in future quarters as an accelerator of growth, in both EPS and book value per share. Importantly, though, even as we have returned a tremendous amount of capital to shareholders, we have continued to invest in expanding our businesses as we find attractive opportunities to deploy capital and drive organic growth.

This concludes my formal review of our results. Again, we are very pleased with the strength and diversity of our performance. Before I open it up to questions, let me make a few comments on our outlook. Most importantly we believe the long-term drivers of secular growth remain solidly in play, and thus we remain fully committed to implementing our strategy to further grow our global franchise. We recognize of course that we are heading into a quarter which is typically the least active of the year from a seasonal perspective. The limited periods of time and in any given market or subsector, environment and our related performance may be uneven. But now we are more able than ever to successfully navigate challenging markets with more revenue pistons firing in more places globally, driving growth and underscoring depth and breadth of the Merrill Lynch franchise, its talented professionals, and its earning power.

Now I'll be happy to take your questions.

QUESTION AND ANSWER SECTION

Operator: Certainly, sir. [Operator Instructions] Our first question comes from the line of Glenn Schorr of UBS. Glenn?

<Q – Glenn Schorr>: Thanks very much. If you guys could help maybe – I mean, first of all let me caveat it with everything is so strong on revenue growth side, we have to pick apart some of the risk issues that people are concentrating on, so forgive me. But can you talk about, maybe start with what your non-investment-grade loan commitments are this quarter versus last quarter? Usually you have to wait for the Q, but it's so topical now I figured I'd ask, and then just the process on how you have it marked, how much has been put back or delayed. How you're comfortable with your hedging position and what you've seen in terms of the readjustments as that market kind of looks for price discovery?

<A – Jeffrey Edwards>: Okay, I'm going to take that as a broad question, Glenn, around the prime CDO market, is that -?

<Q – Glenn Schorr>: Well, I want to talk about the leverage lending side.

<A – Jeffrey Edwards>: – or were you thinking of something else?

<Q – Glenn Schorr>: I'm thinking leverage lending first, just as you've seen some of the private equity commitments delayed as the market tries to digest the supply coming in and kind of come to a common ground. You and others have either participated in some bridges or had a lot of lending commitments, and I think there's lots of questions that I get around how big is it and how much risk is there, really. So if you could towards talk anything toward your position on how you're hedging and how you're thinking going forward, that would be awesome.

<A – Jeffrey Edwards>: Okay, got you. So, broadly speaking about the leverage finance market I'd make the following points. Certainly our – as I mentioned in the call – our backlog is up, and we're very happy with that. We certainly have confidence in our ability to execute that going forward. The market over the course of the last month has seen some selectivity on the part of investors, particularly around structure and pricing. And I think that is both long-term healthy for the market, and I would describe it as just a correction in the market as we've seen in this market from time to time.

Importantly, what we're not seeing is a deterioration in the fundamental credits, and we're not seeing a decline in the liquidity that's coming into the market. We're simply seeing a selectivity, and I think we'll be able to work our way through that market. I think through that adjustment, I think the overall market will. And already I think the feedback loop is as you would expect, and as new transactions get structured, it reflects that adjustment. I would also say that well-structured, well-priced credits continue to effectively be executed in the market. We've priced a number of transactions recently and continue to believe that the undertones of that market remain strong.

<Q – Glenn Schorr>: So I have to wait for the Q for the actual commitment size. But I'm reading into your comments that you are pretty comfortable with your positions, how it's hedged, and don't expect material financial burden going forward on the adjustments we've seen in the markets.

<A – Jeffrey Edwards>: Yeah, I mean, what I would say is I think this is – and this is an important point to make – it is a reflection of what I think is more broadly important, which is we have very effective risk management. We look at these credits on an individual basis and as we underwrite them we obviously undertake extensive due diligence, but we, too, are selective in what we underwrite. I think we have been very effective thus far in that process, and we remain comfortable. It is not to say that there is not going to be some indigestion in the market broadly and clearly that

will impact us to some extent, but overall we think this is a market that is just going through a correction and we're very happy to have a substantial backlog to execute here.

<Q – Glenn Schorr>: That's cool. That's good enough color. Can we switch to the other one that you brought up, in terms of both subprime and CDO exposure? You are one of the largest – or the largest – underwriter of CDOs, and maybe try to give some color around myth versus reality in how people should think about a) what's on your books in terms of residuals and exposure, and b) maybe even comment on related to some of the Bear hedge funds what collateral you have taken on your books or have not. And just overall comfort there, as well.

<A – Jeffrey Edwards>: Okay. Well, look, again I want to make two points. The first is that this is another example where I think proactive, aggressive risk management has put us in exceptionally good position. Obviously the market has gone through a period of flux. We think that remains the case. But aggressive risk management I think has certainly helped transform our risk profile since the end of the year. We've seen significant reductions in our exposure to lower-rated segments of the market. Our warehouse lines are down materially, our whole-loan inventory is down materially. As was the case in the last quarter, we will see a modest increase in our residual position, but it will be small relative to our overall retained interest piece. And I think the majority of our exposure continues to be now in the highest credit segment of the market.

Sorry, the second point I want to make before I leave the question is this is obviously an area that has received a lot of attention and that receives a lot of attention as we work to risk-manage it. But it is only a part of our business, our broader business. It's a part of our structured finance and investment business, which has many other pistons around the world, other asset classes. And in turn, structured finance is only a part of our broader FICC business, which is obviously only a part of GMI and a part of the firm. I think the importance of diversification came through yet again this quarter in these results.

<Q – Glenn Schorr>: Maybe just a last thing, yes or no – obviously, yes – but point of clarification, therefore anything you're financing in your repo business or through your prime brokerage business or on your own books, you've, to the best of your knowledge at the end of quarter is marked to an effective market even if it is a mark to model type of security?

<A – Jeffrey Edwards>: Yeah, that's right. I mean, obviously we have a very robust process around marking these assets, and we're confident in how they were marked, how they'll mark.

<Q – Glenn Schorr>: Cool. All right. Thank you.

<A – Jeffrey Edwards>: Thanks, Glenn.

Operator: Our next question comes from the line of William Tanona of Goldman Sachs.

<Q – William Tanona>: Hi.

<A – Jeffrey Edwards>: Morning, Bill.

<Q – William Tanona>: Just a question, if you look at the net interest profit in GMI, it doesn't look like it really existed this quarter, and you saw a sharp sequential decline in the overall firm's net interest profit and in the corresponding jump in the principal transactions. I know probably some of that has to do with the seasonality around dividend recapture, but can you just give us a little bit more color as to what went on in the GMI segment on the net interest profit side?

<A – Jeffrey Edwards>: Absolutely. And I think you made a key point. We've said for some time and will reiterate here that you should look at net interest and PTs together. On that basis the

combined net interest in PT line for the firm overall is up 2% from the first quarter, 77% from the second quarter.

Two things that are going on there that I'd like to point out. One, as we increase our risk-taking capabilities and increase our focus on trading, you will see and you have seen a general migration in our revenue lines from net interest to PTs. This quarter, that tends to be highlighted by some of the activity around dividend and yield enhancement season in Europe. And as I highlighted on the prepared remarks, that was a strong performer for us this quarter, and the nature of that business is such that you see the revenues show up in PTs, the expenses show up in interest expense, and so it can exacerbate that effect.

<Q – William Tanona>: Great. That's helpful. And then can you give us just a little bit more details in terms of when you can be in the market and when you can't be in the market in terms of repurchasing your shares around your First Republic transaction?

<A – Jeffrey Edwards>: We'll still be out for a period of time here at the beginning of the quarter. And the way you look at averaging for the diluted share count calculation, obviously that will have more of an impact than if we were out later in the quarter which was the case at the end of the second quarter. But we can't predict exactly when that will be, but overall we would expect that we'll be able to be active for most of the quarter, but not all of it.

<Q – William Tanona>: Okay. Thanks.

<A – Jeffrey Edwards>: Thank you.

Operator: Our next question comes from the line of Mike Mayo of Deutsche Bank.

<Q – Mike Mayo>: Good morning.

<A – Jeffrey Edwards>: Hi, Mike.

<Q – Mike Mayo>: Can you give more color on the link quarter non-U.S. growth? It looked like it had a pretty good jump, and also in terms of backlogs, can you give more color by category and also U.S. vs. non-U.S.?

<A – Jeffrey Edwards>: Sure, Mike. As you heard in the comments, the results were extremely strong on a link basis in both the Pac Rim and EMEA across a broad range of our GMI businesses in particular. And it reflects both the investments that we're making in each of those regions to drive growth, as well as strong market conditions there.

In terms of backlogs, from a product perspective I think I highlighted M&A and leveraged finance in particular, and from a regional perspective I would say there is more breadth to that, with particular strength, I would say, in the non-Americas regions again, EMEA particularly strong, parts of the Pac Rim particularly strong. But the U.S. growth was decent here as well. So I would say overall regionally balanced.

<Q – Mike Mayo>: And if I'm doing my math correctly here, it looks like you didn't have any revenue growth – if you slice it U.S. vs. non-U.S. – you didn't have growth in revenues in the U.S. It all kind of stemmed from outside the U.S. Any – that is not different than most of the others, but any color on that?

<A – Jeffrey Edwards>: Yeah, I would say we certainly experienced growth in the U.S. compared to the second quarter of last year. So I would dispute your observation.

<Q – Mike Mayo>: No, that's not – link quarter is how I was looking; I was just wondering if there is anything -

<A – Jeffrey Edwards>: Oh, sorry. Yeah, link quarter we were obviously down overall. But on a year-on-year basis we saw good growth in the U.S., despite some of the challenges in the markets that are more specifically U.S., I would say. This is just part though of a long-term growth pattern that we've seen and we expect to continue. I mean, to give you some sense, in GMI as recently as 2005, EMEA was only about half the size of the U.S., and today it's almost 85% the size of the U.S. And the Pac Rim was less than a third two years ago, and today in the second quarter, it was more than half. So the growth trends here internationally are something that we've seen for some time. We expect them to remain in place, and I think the results reflect that we're well-positioned to capture more than our share of that growth.

<Q – Mike Mayo>: And back to the other topic. Can you remind us what percent of your earnings are related to mortgage or subprime mortgage, and if you could include in that CDOs and warehouse lines or anything else?

<A – Jeffrey Edwards>: Well, just to remind everybody, we made the comment in the first quarter that over the previous five quarters, all of that activity as broadly as we could define it, represented less than 2%. As I said, the business overall was down compared to last year, it was up compared to the first quarter. I don't think there's anything that would change that comment that I made in the first quarter.

<Q – Mike Mayo>: Then lastly, a tougher question perhaps, how much of your capital is at risk or how much in total assets do you have that's somehow related to that same category?

<A – Jeffrey Edwards>: Well, we obviously have a robust economic capital model that we employ to address risk around all of our different assets. From an overall asset standpoint, again the point I would make there is that there's been, we think, an important transformation of the components of that asset base where the exposure that we retain is in the higher-rated tranches of the exposure, and what we've done is reduce exposure in some of the broader or lower-rated categories.

<Q – Mike Mayo>: Okay. Do you have an overall number, though, for how much capital you have at risk related to subprime mortgage, CDOs, warehouse lines?

<A – Jeffrey Edwards>: We don't disclose our capital allocations against any specific or even broader group.

<Q – Mike Mayo>: All right. Thank you.

<A – Jeffrey Edwards>: Thanks, Mike.

Operator: Our next question comes from the line of Richard Bove with Punk, Ziegel.

<Q – Richard Bove>: I was wondering if you could go further into this Bear Stearns transaction? I don't know if the press reports are anywhere near correct. But they are suggesting that you loaned 800 million to this fund that Bear Stearns put together and that at the present time most of the collateral was still held by Merrill Lynch and that most of the assets in that fund are not worth 10 cents on the dollar. So just wondering, number one, why would Merrill Lynch lend 800 million dollars, if that number is at all correct, to a fund which had not been in existence for a year, and secondly, whether the valuations stated in the press are anywhere near correct and if they are how you're valuing the collateral that you now hold in that fund?

<A – Jeffrey Edwards>: Well, let me start by saying that we don't normally comment on client matters which are not material. But there obviously has been a fair amount of media attention here,

so let me just say that we think our net exposure in the situation is both limited and well under control. We obviously have acted in ways that we think are prudent in managing our risk. I think it's again a demonstration of our proactivity here, at this point we remain in active dialogue with Bear Stearns Asset Management. But I think our exposure here is limited. It's contained, and it's appropriately marked.

<Q – Richard Bove>: But can you explain why Merrill Lynch would lend as much as \$800 million to any fund which is less than a year old and which has no track record?

<A – Jeffrey Edwards>: Well, we look at all of our hedge fund clients on a individual basis. Obviously providing financing to hedge funds is what the financing and services business is all about. When we undertake to make such loans, we do so in ways that we believe are structured prudently from a credit perspective, and we expect to resolve this in a reasonable way and a reasonable amount of time.

<Q – Richard Bove>: And I guess finally, just overall in the broad high-yield market, it appears that yields on high-yield bonds have gone up by 55 basis points in the last five to six weeks, which – and the ABX index, which I guess has a lot of relevance or no relevance depending on how you use it, has dropped about 40% over the year. What has that done to the valuation of the overall assets of Merrill Lynch?

<A – Jeffrey Edwards>: Well, let me take the two pieces. The high yield, the price action in high yields markets that you described is, as I said in response to an earlier question, I think part of a normal correction that you would see in this market. The activity that you highlighted in the ABX is something that certainly has been a focus of the broader market since it began to demonstrate volatility earlier this year in the first quarter. At any point in time we've got assets and hedges in place that are directly affected by all of these items. And in the course of a quarter we seek to mark all of those things, and again, it highlights I think the importance of having effective risk management, which we believe thus far we've demonstrated has been very effective.

<Q – Richard Bove>: But does the change in the value of the high-yield market or the cost of operating in a high-yield market of the cost of hedging and of what apparently is higher margin requirements now from the banks, does that change the ability to handle the backlog that now have? Does it reduce the number of deals that will be brought to market, or do people find that the change in economics is not impacting their ability to do these deals?

<A – Jeffrey Edwards>: Well again, I distinguish between the two markets. I would say the leveraged finance market you are seeing a correction, you are seeing selectivity, you are seeing selectivity around pricing. I think that will work its way into transactions as this risk works its way into distribution. But the fundamental credits remain attractive and remain performing. I would say in the subprime market you have got more of a credit dislocation that's working its way through. At the same time you see responses in, say, the CDO market as new classes come about – I mentioned a couple of them in my earnings call – as investors look for diversification plays there. But that market remains more in flux and is likely to remain so for a period of time.

<Q – Richard Bove>: Thank you very much.

<A – Jeffrey Edwards>: Thank you.

Operator: Our next question comes from the line of Prashant Bhatia [Citigroup Smith Barney].

<Q – Prashant Bhatia>: Just in terms of capital management, can you talk a bit about the relationship between the growth that we're seeing on the borrowing side? I think up about 90 billion over the past year and the equity up about 6. Is that kind of the similar incremental leverage we should look for going forward?

<A – Jeffrey Edwards>: Well, as we've looked to grow, we've obviously looked to do so in a way that puts appropriate permanent and long-term capital in place. Markets have been strong from an issuing perspective. We've used those markets to put in place a strong capital structure, build our liquidity, and it is all part of putting in place a capital management structure that allows us to further drive our return on equity, which we think we've done effectively.

Clearly I would not expect to grow long-term debt faster than equity at that rate forever, but our overall capital structure reflects our evaluation of the economic capital that we need to have in place to support the activities that we have. As you point out, we have grown our equity and expect to continue to do so. We've used hybrid structures, as well, to add a further layer in place in a cost-effective way. And all of that's come together to allow us to grow the business and drive return on equity.

<Q – Prashant Bhatia>: Okay. Also, you've clearly got a far more diversified business than you've ever had before. We can see that in the revenue performance. Can you talk a little bit, as the risk appetite maybe for institutions that were chasing yield goes out of the market, where you are seeing some of the offsets on the positive side in some of the businesses where you are benefiting from that trend?

<A – Jeffrey Edwards>: Yeah, I think in general there's more diversification not just to the business but to the risk-taking as well. And you see that in many of the drivers in our other businesses. So looking at FICC for example, comparing ourselves to where we were at this time last year, I described good results in a number of business lines, which were driven both by active client activity as well as proprietary risk-taking opportunities.

Rates was a highlight, set a new record again, the commodities business was very strong. We were up year-on-year in our credit trading businesses. The equity businesses broadly were all up outside of private equity year-on-year with strong results in financing and services in particular, equity-linked in particular, but cash also on a year-on-year basis. And a lot of that activity, as I highlighted, was outside of the U.S. as well, where it was particularly strong results. So there's many different areas where we're seeing increases in risk taking, increases in client activity, all of which serve to offset weakness in any one area.

<Q – Prashant Bhatia>: Okay. And then on the private equity side, you mentioned that being down. Obviously that's a lumpy business and probably points to how strong your equities quarter was compared to last quarter. But can you give us an idea of just the pace of investments on the private equity side, maybe directionally, the capital being allocated to the business and how it compares to last year, and that sort of thing?

<A – Jeffrey Edwards>: Yeah, it's certainly up overall from last year. I mean, last year it was about this time that we announced the HCA transaction, which closed at the end of last year. I mentioned a couple of other transactions this quarter that we've announced that we intend to close later in the year, Nuveen and Veda Advantage. Earlier this year at the end of the first quarter I also announced some acquisitions and investments at that time.

So we continue to see opportunities to broaden out that business. We added a couple of very senior professionals to that business with specific industry expertise in areas where we believe there will be more opportunity for growth. So that business, while the revenues will be as illustrated this quarter, lumpy, continues to organically build itself and position itself for further growth.

<Q – Prashant Bhatia>: Okay. Just one final question on the brokerage side of the business. You're up I think about 270 this quarter, 600 for the year. Can you give us an idea for the mix there of trainees vs. experienced, and then looking ahead with the A.G. Edwards acquisition, is that an opportunity to pick up or recruit more experienced hires, and how do you think about that?

<A – Jeffrey Edwards>: Well, a couple of points to make here. One, discipline is extremely important here. There are competitors out there with very aggressive packages. We're being very disciplined in how we respond to that, and the most important point here is that we believe we've built the best platform for our financial advisers and their clients. And increasingly financial advisers understand the benefit that that platform has, both for themselves and for their clients.

So as I mentioned, we had very strong recruiting against every major competitor. We do continue to invest in our training program; we believe we can create the best quality FAs in the business. And focusing on retention is also very critical. And retention rates were up very strongly. We had the lowest turnover, that we have on record at least, this past quarter. All of that I think is a testament to the investments that we've made in technology, in training, in products that allow us to compete effectively for top-quality FAs.

<Q – Prashant Bhatia>: Great. Thanks, Jeff, that's helpful.

<A – Jeffrey Edwards>: Thank you.

Operator: Our next question comes from the line of Meredith Whitney with CIBC World Markets.

<Q – Meredith Whitney>: Good morning, Jeff.

<A – Jeffrey Edwards>: Hi, Meredith.

<Q – Meredith Whitney>: I need a little extra help on the values you are ascribing to the mortgage piece and the CDO piece, and I appreciate your comments earlier that you are comfortable with how you are valuing them. But for an outsider who doesn't have the benefit of what you see, can you give a little more of a qualitative overview in terms of what methods you are using to value these securities, how the methods have changed, at what point have you decided the market deserves a revaluation of these securities? Did you revalue and write down these securities during the second quarter? Any extra color you can give that would help me and a bunch of others would be appreciated.

<A – Jeffrey Edwards>: Okay. Well, of course we are constantly revaluing these assets and related hedges on a constant basis. So in some cases they get marked down. In some cases they get marked up. Offsets sometimes move in other directions. So the broad answer to your question is yes, we absolutely marked all of that, all of those assets and related hedges during the quarter. In general when there's an active, observable market we have mark to market. When there are related markets that we can use to interpolate, we also can mark effectively to market. There are some parts, such as the residuals, which are more on a mark to model basis based on inputs that we can observe, such as cumulative default curves, for example. And then there are loans that we also make judgments on using a lower cost to market. So that is broad explanation as to how we look at those assets.

<Q – Meredith Whitney>: So for example, just to get a little more help around this, would the Moody's and S&P downgrade affect your evaluations at all?

<A – Jeffrey Edwards>: Everything will affect our valuations and the related hedges, and we'll constantly be updating for all the new input that comes into the market.

<Q – Meredith Whitney>: Okay, just one last follow-up in terms of the severity of these marks. Would you qualify the second quarter severity to be greater than the first quarter?

<A – Jeffrey Edwards>: Well, overall as I pointed out, the business performed better in the second quarter than it did in the first quarter. Still did not perform as well as it did in the second quarter last year, and I think that appropriately gives you benchmarks.

<Q – Meredith Whitney>: Okay. But the indexes are down dramatically from the first quarter this year and second quarter last year, so that – really speaking about valuations.

<A – Jeffrey Edwards>: All of which reflected in those results.

<Q – Meredith Whitney>: Okay. Thanks.

Operator: Our next question comes from the line of Doug Sipkin with Wachovia.

<Q – Douglas Sipkin>: Hi, good morning. Just two questions here. First, on your appetite for buybacks. I mean, obviously you have been very aggressive, maybe 16, 17 billion worth of buybacks over like a 2 1/2-year period, and you indicated that you have ample room to buy back once all the related lock-out periods for First Republic are over. I mean, has your appetite changed at all, stronger or weaker, now that you guys have put a lot of dollars toward also acquisitions and things of that magnitude? So I'm just looking for some color on how the balance, if at all, will shift from inorganic to capital deployment.

<A – Jeffrey Edwards>: We had a new authorization from our Board of Directors during the quarter, which we've only scratched the surface on, really. I think we're some 500 million or so into our new buyback. So we intend to have buybacks, continue to be an important part of our capital management activities. Of course it is only one part. Dividends have also played an important role, and we've increased dividends, as you know, each of the last three years. But the most important point is that we look to deploy capital, and we've found attractive ways to deploy capital organically and will continue to look for those, as well. So net-net I would say we'll continue to balance all of those things over the foreseeable future.

<Q – Douglas Sipkin>: Great. And then, I'm surprised how strong the fixed income trading was in this quarter. You indicated that rates were very strong. I mean, did that get stronger month on month as the interest rates started to spike maybe in the late May-June period. Were you saying June is probably the strongest month for rates?

<A – Jeffrey Edwards>: Well, I would say broadly for our fixed income business – without getting too specific on individual areas within fixed income – I would say it is fair to say that June was the strongest month.

<Q – Douglas Sipkin>: Great. Thanks a lot.

Operator: Ladies and gentlemen, I do apologize. We with have reached the allotted time for questions and answers. I will turn the call back over to Jonathan Blum for some final remarks. Jonathan?

Jonathan Blum, Investor Relations

Thank you. This concludes our investor relations and earnings call. If you have further questions, please call Investor Relations at 212-449-7119. Fixed income investors should call 866-607-1234. Thanks for joining us today. We appreciate your interest in Merrill Lynch.

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