

Lisa Shalett and the Chief Investment Officer Team • MAY 10, 2012

IN SUMMARY

- We believe that the right strategy today is not to embrace the “risk-on”/“risk-off” behavior of recent years, nor to stay on the sidelines in the perceived safety of cash. Rather, we are recommending that investors “cherry pick the dips” by focusing on opportunistic stock selection for the intermediate term.
- Investors need to begin to contemplate the future “triple threat” to portfolios—a combination of a simultaneous rise in taxes, inflation and interest rates. Against this backdrop, the favored investments of fixed income and cash that have played such a powerful role in portfolios over the past five years, are unlikely to be as effective as stocks, commodities and real assets. “The Great Rotation” harkens.
- The destabilizing political outcomes from recent Eurozone elections hold a silver lining. Ultimately we think these populist forces will drive a more moderate, pro-growth approach to the crisis that supports ECB rate cuts, a lower euro, improved periphery competitiveness and some debt diluting inflation.

Cherry Picking the Dips and Fighting the “Triple Threat”

- **Sometimes we all need a little perspective. Disappointing employment data in the U.S. and anti-austerity electoral outcomes in Greece and France have investors once again questioning their risk positioning. Given the volatility of the past several years, this is natural. We agree that the current complex environment demands vigilance as there are few clear signals for a self-sustaining growth recovery. However, we believe that the right strategy today is not to embrace the “risk-on”/“risk-off” behavior of recent years, nor to stay on the sidelines in the perceived safety of cash. Rather, anchored to a very constructive relative view on equities for the intermediate term, we are recommending that investors with an eye to the future begin focusing opportunistically on stock selection geared to battle what we call the “Triple Threat.”**

What is the “triple threat?” Well, for the past several decades—and especially the last 10 years—capital markets, especially in the U.S., have been characterized by huge positive tailwinds from historically low and secularly falling interest rates, low to moderate inflation and historically low taxes. These are factors that have disproportionately benefited fixed income investments. Recent experience of solid returns, eerily low volatility, unprecedented government intervention and huge positive inflows have spoiled bond investors—making them largely immune to the gathering storm clouds. Like “the boy who cried wolf,” cautions about coming bond market volatility have routinely been swamped by low growth, deflation fears and central bank intervention so as to fall on deaf ears. Similarly, benefits to the U.S. Treasury market driven by problems outside the country—like safe haven flows fleeing the Eurozone debt crisis—have diluted the market pricing of America’s increasingly fragile fiscal reality. **While we have no crystal ball on timing how the “triple threat” will unfold, we believe that the U.S. dealing with the “fiscal cliff” at least in part by 2013, the Eurozone moving toward a growth balanced crisis workout plan that will allow some inflation, and the recovery of China will combine to unleash its forces. Ultimately, the withdrawal of Federal Reserve (Fed) stimulus will play a critical role.**

Under this scenario, stock returns meaningfully trump bond returns, ushering in what Bank of America Merrill Lynch (BoFA ML) global equity strategist, Michael Hartnett has called the “Great Rotation.” Battling the “triple threat” will require

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investors to build portfolios leveraged to companies with pricing power (brands and proprietary technology), commodities, and real assets (real estate, real estate investment trusts and gold). Under this scenario, cash is toxic as it rapidly loses its purchasing power, especially in the beginning as negative real returns expand as long as the Fed is “behind the curve” in pricing the shift in sentiment. **We don’t think we are there yet, but we want to start preparing by building our shopping lists of longer duration assets (primarily stocks) with attractive valuations.**

- **However, in the current short-term environment, we want to “cherry pick the dips,” rather than “buying them” or “selling them.” This is important and a subtle shift from the purely macro-driven risk-on/risk-off positioning executed by many market participants in response to systemic and macro forces that have dominated the post-crisis markets.** Although we believe that we are far from out of the woods with regards to “the role of macro” in shaping the backdrop—we do think that the transition back to a market that discriminates on company fundamentals has begun. This is a glacial sentiment shift that reflects the age of the 12-year bear market in equities, the extraordinarily high levels of cash on the sidelines and reasonable valuations for the best global companies. In essence, we think the expiration date of “kicking the can down the road” is approaching and we want a disciplined strategy for navigating the transition. Specifically, as Hartnett noted in this month’s Research Investment Committee Report, *The 3-2-1% Rules*, as long as the U.S. is experiencing gross domestic product (GDP) growth in the 2% range (such as the 2.2% estimated for the first quarter) and policy stimulus in the form of another quantitative easing (“QE3”) is possible, fear still reigns and thus bond yields remain low.

Consequently, in the interim and through year-end 2012, we are positioning for a narrowing equity rally that grinds upward. As BofA ML U.S. equity strategist Savita Subramanian noted this week, the S&P 500 target is roughly 1,450 by year end. The implication is that for a core subset of equities, we think that risk/return is asymmetric and that short-term upside is just meaningfully higher than downside—especially compared to other investments. We believe this scenario will reward those companies that possess the rare and still reasonably valued attributes of growth, quality and income. These companies, with pristine balance sheets, high cash balances and sustainably high profit margins are exploiting their brands, proprietary technology and global footprints. They will likely reward investors with above-average dividend growth and constructive shareholder friendly cash-flow deployment. We are finding

the best opportunities in U.S. large cap multi-nationals and among Emerging Market local best-of-breed companies.

For our strategic asset allocations, we are neutral global equities, as we want to remain strongly underweight in the Eurozone. In global fixed income, we have remained overweight to our strategic asset allocation, as we see a near-term opportunity to potentially exploit three key dimensions of the environment: 1) continued aggressive central bank liquidity accommodation, 2) historically strong corporate balance sheets, and thus low default probabilities; and 3) low issuance volumes. In U.S. Treasuries and other “safe haven” sovereigns that we believe are overvalued, we have preferred global investment-grade corporates, high yields, high-quality essential revenue municipals and Emerging Market debt. As we have noted, we expect credit and spread-oriented securities to meaningfully outperform history this cycle. Emblematic of the transformation of the fixed income asset class this cycle is the fact that in 2009 more than 50% of the sovereign bond issuance was AAA rated. Today that volume is 10% and likely to fall even more. Conversely, within the S&P 500 alone, there are 36 issues with credit default swap (CDS) spreads below the U.S. Treasury. That said, we recognize that the “triple threat” awaits and on the margin we prefer not only credit risk to duration and rate risk, but increasingly we prefer to gain our income exposure through equities.

One way investors can gain active exposure to this pending “great rotation” between stocks and bonds is by considering a global flexible asset allocation fund in their portfolio. We would source this allocation from our fixed income sleeves today. Among alternatives, we continue to prefer gold, oil and timber among commodities; and non-directional approaches among hedged strategies—relative value, market neutral, arbitrage and global macro. Current private equity vintages should also continue to benefit, exploiting the low costs of financing and reasonable asset valuations.

- **We have long believed that the Eurozone debt crisis is both a political and an economic affair. As such, we have been focused on the electoral dynamics of austerity and their implications, not only for Eurozone growth but for the stability of the policymaking apparatus itself. From this perspective, we were not at all surprised by this weekend’s events where Nicolas Sarkozy lost the French presidency to the socialist Francois Hollande and Greek elections produced a fragmented collection of fringe parties with limited room for ruling coalition building. We believe the implication of these events, when combined with the recent collapse of the government in the Netherlands,**

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is actually positive for nearer term Eurozone growth, supportive of a more dovish European Central Bank (ECB), but highly challenging for Germany and the direction of European Commission (EC)/European Monetary Union (EMU).

Early market reactions have been reasonably muted, and in our minds rightly so. The political turmoil that was evidenced in these elections has the potential to be destabilizing. However, those forces are somewhat offset by the likelihood that the single-minded German grip on austerity posturing and the iron-fisted inflation fighting of the ECB are going to be forced to moderate by the economic reality of recession and the political reality of an increasingly weary citizenry. Such a scenario creates a more balanced intermediate-term outlook for growth and thus risk-based assets. Under this scenario, rates drop a bit, the euro weakens, which helps improve export competitiveness, and inflation rises, diluting the debt burden. That said, although volatility has not surged, we caution investors about minimizing the importance of European elections and the populist positions that underpin them, as many pundits have tried to do. Their arguments have focused on two themes: 1) the view that Greece no longer really matters and 2) that Hollande is too much of a pragmatist to truly execute on his campaign promises to push for pro-growth EC policies and renegotiation of the fiscal compact. We disagree with both propositions and therefore will remain hypervigilant about developments.

While it is true that the managed default in March massively reduced external systemic exposure to Greek sovereign debt, a failure of Greece to deliver on agreed reforms because of a failure of government consensus would mean that negotiated aid payments would be withheld—causing even more pain for Greeks and their likely exit from the euro. Although markets may be discounting this eventuality, the potential for unintended consequences around consumer confidence and bank runs that bleed across borders cannot be ruled out.

Second, on Hollande, many, including the political consulting firm, the Eurasia Group have suggested that German Chancellor Angela Merkel and Hollande will quickly reconcile their differences exposed during the campaign and resume with a Franco-German leadership bloc that holds fast to austerity. While we have no particular insight into the potential for the fiscal compact to be renegotiated, we believe in the “power of the people” and that at the very least, the pro-growth balance of Hollande will have to get its hearing. When it does, the increasingly isolated position of Germany will demand compromise. European history is too powerful in that regard and the EMU is still a fragile work in process.

- **As we have noted repeatedly over the past weeks, the risks associated with the upcoming January 2013 “fiscal drag” do not appear to rate highly on the list of investor concerns—at least not yet. While they may be out of sight at the minute—taking a backseat to concerns about global growth and the burgeoning U.S. presidential campaign rhetoric, these risks are not going to go away magically and our assessment is that in almost any scenario—some taxes are going up in 2013.**

As we noted in last week’s CIO View, *Muddle Through—Really?*, neither current economic forecasts for GDP nor company earnings forecasts for 2013 appear to reflect the full potential of 3.5-4.5% drag on GDP growth, which at current levels would spell outright recession. In fact, most market forecasters have suggested yet another round of “can kicking” where former U.S. President George W. Bush era tax cuts get extended into 2014. While that is certainly plausible and recent history supports this potential outcome from our lawmakers, as BofA ML co-head of global economics Ethan Harris has explained, a “policy of uncertainty” can only be promulgated for so long before it meaningfully suppresses confidence and growth—a scenario he is forecasting will mute GDP growth in the second half of 2012, potentially keeping it under 2%. In addition, while it is clear that Washington has agreed to leave the “fiscal cliff” debates until after the election in November and the lame duck session of Congress, he reminds us that neither the debt ceiling nor the ratings agents may allow us the gift of delay. **To contextualize the urgency here and the potential comparisons to the premature fiscal tightening of Herbert Hoover in 1929, Harris has pointed out that his estimate of a 4.6% GDP headwind would easily exceed the modern history record of tightening of 3.1% of GDP in 1969 by 50%. Even if some legislative relief arrives and the fiscal cliff is only 2%, he has illustrated that this would still be the second-largest annual austerity program in the past 50 years.**

But how would we likely achieve even a reduction in the austerity program from 4.6% to 2%? It almost certainly involves tax increases even if the Bush tax cuts remain intact. Specifically, we would likely see the expiration of the payroll tax cut increasing government coffers by \$120 billion and the suspension of extended unemployment benefits for a savings of \$40 billion. And then there will be the debate about the Alternative Minimum Tax (AMT) patch, which today shelters 30 million Americans from additional taxes. The Republicans have vowed to protect it, but at what cost? If the Patient Protection and Affordable Care Act is upheld by the Supreme Court, it spells another 2-3% increase from many taxpayers. The

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Simpson-Bowles budget plan illustrated that solving our fiscal crisis without both revenue gains and spending cuts is almost mathematically impossible. With ratings agents and the buyers of our bonds watching for fiscal responsibility, even a total Republican sweep of the executive office and both houses of Congress is unlikely to forestall an increase in everyone's 2013 tax bill.

- **One important offset to the disappointing employment report for the U.S. consumer is the current dynamics in the energy markets.** Global crude oil prices peaked eight weeks ago, and West Texas Intermediate (WTI) has broken decidedly below \$100 per barrel. U.S. crude oil inventories hit a 21-year high, as booming shale oil production is overwhelming storage and transportation infrastructure around Cushing, Okla. (the main Gulf of Mexico terminal in the U.S.) just as we are approaching peak summer driving season. With the oil price break, gasoline pump prices have retreated about 5% from a \$3.94/gallon national average to \$3.78. Some market commentators have suggested that the pullback in prices is related to unwinding of speculative positions.

However, our view is that fundamentals have played a factor, including the moderating growth in the U.S., the strengthening U.S. dollar and an intensifying recession in Europe coupled with a cooling in geopolitical tensions between Iran and Israel. Further buffering the cooling in oil prices are the still very attractive pricing dynamics in natural gas that serve as an anchor to the entire energy complex. While there are indications that record-low natural gas prices are finding a foundational bottom, as production is starting to decline and end of April storage injections were a record low, most analysts believe that prices can not sustain an upward move for at least a year. Taking production offline has so far remained sticky, as shut-in wells and rapid productivity gains from new fracking technologies have given drillers more patience than usual. But gas rig counts continue to decline and there are increasing reports production is being shifted from dry gas to wet gas. But natural gas price increases will also be dependent on demand and that will mean an actual acceleration in the pace of coal displacement if the market is to find equilibrium.

PORTFOLIO THEMES ON THE HORIZON

- **New World, New Rules: Massive structural imbalances drive sustained higher volatility in capital markets**
- **Emerging Bond Volatility and the "Great Rotation" Back to Stocks**
- **America's Manufacturing Renaissance and Coming Energy Independence**
- **Building Protection for the "Triple Threat"**
 - Rising Taxes
 - Rising Rates
 - Rising Inflation

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When considering your portfolio in light of our current guidance, consider the tactical positioning around asset allocation suggested below 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.

ASSET CLASS	BENCHMARK STRATEGIC ASSET ALLOCATION FROM RIC*	TACTICAL POSITIONING RELATIVE TO STRATEGIC ASSET ALLOCATION	OPPORTUNITIES AND RISKS
Cash	2%	UNDERWEIGHT	Current returns are negative on a real basis even in a low inflation backdrop; we want to get paid to wait and the perceived safety of cash may be overstated in an age of financial repression
Global Equities	45%	NEUTRAL	Valuations are constructive and corporate fundamentals, especially of global best-of-breed franchises, are excellent. We are looking for opportunities to upgrade by mid-year as reflationary policies take hold
U.S. Large Cap	21%	OVERWEIGHT	Focus on themes of growth, yield and quality with a focus on dividend growers; best-of-breed players with pricing power and dominant franchises; prefer tech, energy and healthcare. Avoid consumer discretionary. Regional banks are an emerging opportunity
U.S. Mid & Small Cap		UNDERWEIGHT	Stocks have run far, fast. Slow domestic growth should keep these stocks range bound and some profit taking may be warranted as lending/hiring is still constrained
International Developed	18%	UNDERWEIGHT	Japanese quantitative easing will help yen and exporters, UK is cheap and reflating, Olympics may be catalyst; Eurozone still highly uncertain and will struggle with austerity and deleveraging driven recession risks, extreme valuations and liquidity actions of the ECB suggest short positioning should be covered but European banks still very much at risk; Canada and Australia commodity linked preferred
Emerging Markets	6%	OVERWEIGHT	Prefer LatAm and Asia as they reflate; Eastern Europe should be avoided on Eurozone debt contagion; Expect rate cuts in 2H
Global Fixed Income	33%	OVERWEIGHT	Low growth and low inflation create constructive backdrop for total return
U.S. Treasuries	N/A	UNDERWEIGHT	Negative real returns and Fed intervention have created highly overvalued and unattractive conditions. Although policy is unlikely to change anytime soon, we prefer risk/return elsewhere. For those who need exposure, we prefer intermediate duration
U.S. Municipals		OVERWEIGHT	Valuations relative to Treasuries remain highly attractive and tax-exempt status will not be threatened anytime soon. Prefer essential service revenue bonds and high quality, actively selected credits. 10-20 year durations is the sweet spot
U.S. Investment Grade		NEUTRAL	Some opportunities remain here, especially slightly down the quality curve given very low default rates and strong balance sheets. U.S. Bank bonds may have more room to rally
U.S. High Yield & Collateralized		OVERWEIGHT	Spreads remain attractive and default rates will likely remain low—valuations will overshoot this cycle on quality of balance sheets
Non-U.S. Corporates		OVERWEIGHT	Corporates are "new Sovereigns." We continue to want to be cautious on Eurozone debt despite the improving liquidity environment as we expect rate volatility to remain above average and indices have high weight to European banks which still need to re-capitalize.
Non-U.S. Sovereigns		NEUTRAL	We like the space especially through active manager exposure. Solid themes should be leveraged to the commodity complex and recovering Asia like Canada, Australia and New Zealand. Yield differentials still slightly attractive
Emerging Market Debt		OVERWEIGHT	Strong fundamentals and good growth differentials create good opportunities for USD denominated. Among local denominated quality, yield and currency advantages are solid for total return investors.
Alternatives**		OVERWEIGHT	
Commodities/Currencies	Included in Real Assets	OVERWEIGHT	Prefer oil, gold and select agriculturals
Hedged Strategies	9%	NEUTRAL	Prefer low volatility and non-directional strategies to provide portfolio diversification. Market neutral, relative value, distressed credit and select global macro preferred
Real Assets	4%	NEUTRAL	Prefer REITs; TIPS fully valued after excellent run
Private Equity	7%	OVERWEIGHT	Current vintages should benefit from low valuations and low costs of capital. Prefer infrastructure, energy and healthcare related

*Moderate Global Allocation Tier 2 Liquidity

**Alternative Investments are available only to pre-qualified clients.

Source: Merrill Lynch Investment Management & Guidance, April 2012.

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We continue to believe that the dynamics of very slow global growth, debt-driven deflationary pressures and deleveraging will favor global fixed income and select commodities over stocks in the intermediate term. That said, as 2012 unwinds we believe large underweights to equities will not be warranted. For those investors who have largely been sitting on the sidelines in cash, we would source rebalancing funds from cash and U.S. Treasuries to achieve neutral equity weightings. For those already fully invested, we increasingly see the value of establishing some bar-belled exposures with increased equity risk (rotating a bit to higher volatility allocations through Emerging Markets, high-yield bonds and select cyclicals, especially those that are energy related) being balanced by solid income-generating allocations. Active stock selection is likely to matter in 2012, with our framework favoring those who can drive earnings growth through pricing power and secular strength. With dynamic asset allocation remaining critical, we continue to see global multi-asset or flexible mandates as an effective way to navigate the crosscurrents in 2012.

With a keen eye on capital preservation, we are focused on proactive risk management. Our approach has three prongs:

- **First**, we encourage investors to diversify risk through a more global and multi-segmented approach to asset allocation. For equities, this means eliminating excessive home-country bias and including exposure to Emerging Markets. In fixed income, while we have continued to favor high-quality municipals, we think investors should consider exposure to a mix of corporate high-grade and high-yield bonds as well as non-U.S. sovereign and corporate debt. Broadening asset class exposure may also be appropriate for some investors who might consider including real assets, gold and low volatility/absolute return-oriented alternatives in their portfolios.
- **Second**, we think that overall portfolio risk can be reduced by exploiting today's scarcity themes of Growth, Quality and Yield. Where market volatility has caused portfolios to drift from long-term asset allocations, rebalancing opportunities exist to add to these themes. Large, multinational dividend growers, many of which gain market share in the secular growth story of the Emerging Market consumer, are opportunities.
- **Finally**, we see opportunities to be more tactical as we actively manage risk. Higher volatility creates more risk but also more opportunities. Utilizing a flexible multi-asset manager for a portion of your equity sleeve can help raise the odds that absolute return goals are met.

12 PORTFOLIO ACTION IDEAS FOR 2012

The guidance below, and how it is implemented, should be considered only in light of your individual investment plan—including your risk tolerance, time horizon, objectives and liquidity needs. You should discuss these with your Financial Advisor.

1. Maximize yield and broaden exposure to high corporate free cash flows in your equity sleeve by adding **dividend-paying and dividend-growing stocks as well as stocks with a history of strong buybacks**. Barbell between pure defensives and cyclical exposure.
2. Increase **Emerging Markets equity and fixed income exposure to at least 10% of your portfolio**.
3. **Diversify fixed income** sleeve to include high yield, global sovereign and Emerging Market debt; reduce U.S. Treasuries; continue to use high-quality municipals.
4. **Utilize flexible multi-asset class managers** for some of your risk budget (fund this from your equity allocation).
5. **Assess tax-efficiency portfolios** in equities using ETFs rather than mutual funds where the case for active management is weak. Fixed income sleeves should optimize after-tax returns through the use of both municipals and taxables as opportunities are available along the curve.
6. **Include exposure to commodities**, such as oil and gold.
7. **Consider adding private equity** as a long-term play on low valuations and the growth of new technologies in healthcare, software/social networking and energy.
8. **Manage downside risk** by including non-directional hedged strategies (relative value, market neutral, global macro and select market-linked investments).
9. **Reduce TIPS exposure for now; inflation at bay and fully valued**.
10. **Maximize real purchasing power and security of cash positions** through diversification/optimization between FDIC-insured deposits, money market funds and ultra-short duration funds.
11. **Manage the risk of a stronger U.S. dollar** by hedging international exposures.
12. **Rebalance more frequently to exploit volatility** (at least quarterly or after substantial equity market moves).

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DID YOU KNOW?

A recent analysis of 2010 census data revealed that America's population diversity is actually "bubbling up from the bottom" of the age structure and has not yet made it to the senior cohorts. Specifically, the census data illustrated that nearly 50% of the nation's infants are the children of minority parents with 25% Hispanic. By contrast, the over 85-year-old cohort in America is 85% white.

Source: The Milken Institute Review, Second Quarter 2012

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