The rapid rise of China and other emerging nations has ushered in sweeping changes being felt from the bauxite mines of Asia to the gas pump on Main Street to the expensive office space in São Paulo.
that is likely to be the dominant trend for the next century.

Yet today, while most of us must admit the apparent logic of going global, emotions intervene. The science of investor psychology confirms what most observers of financial history already know: Investing and clear thinking don’t always go hand in hand. If they did, panic would never grip markets and euphoria wouldn’t cause investors to disregard fundamentals. But it’s not just emotion that keeps us from making the most of fresh opportunities in a changing world. Traditional modes of thinking—indeed, some of the most basic orthodoxies of our investing logic—now require serious reconsideration. According to Meir Statman, an economist and expert in behavioral studies, even in times of chronic uncertainty, especially compared with U.S. Treasuries.

The Age of Managing Risks
The first step in going global is to recognize our emotional inclinations and reflexive choices. Are government bonds really the best choice when debt is rising and interest rates are plummeting? Is buying and holding a handful of traditional investments really a prudent course when risks and opportunities move restlessly around the globe? The global economy has made volatility structurally higher—meaning that instead of thinking of turmoil as a temporary situation to be endured before the return of a calmer “normal,” we have to adjust to the reality that the world is more turbulent, and that it will almost certainly stay that way.

During a time of change, portfolios must adapt to meet new challenges and opportunities (see figure 2). Risk management is something investors and their financial advisors have to incorporate into each investment decision, giving it at least as much thought as efforts to maximize returns.

Managing risks in this environment requires an approach that once might have seemed better suited to market speculators: an approach more dynamic than old-style investing, more tactical, more flexible and quicker to respond. It’s not enough, for instance, to diversify along traditional lines: risky growth stocks on the one hand and stable dividend-paying blue chips on the other. It means knowing how to diversify between countries and regions: between Southeast Asian chip manufacturers and South American miners. It means seeking out mutual funds that have broader mandates with an ability to hedge positions or to range across borders and asset classes. It means taking a look at alternative assets in general, including commodities and, for qualified investors, hedge funds and private equity to determine whether they’re appropriate for your portfolio.

Traditional asset classes, too, must be seen through a more global, dynamic prism. Diversification matters more than ever, but it no longer can be achieved by dutifully filling neatly defined slots with 60-percent stocks, 30-percent bonds, and 10-percent cash and then holding on for dear life. Are those stocks positioned to capture global growth, to help protect against currency fluctuations, to provide yield potential? Are you prepared to change direction as new opportunities arise?

A New Approach to Stocks
The truisms we’ve embraced for generations about these familiar securities no longer apply. Stocks, in one way of
At a glance, “fixed income” doesn’t seem to change much. But in the “before” model, it’s almost entirely allocated to U.S. bonds, with 14% of all assets dedicated to Treasuries and municipals—and just 1.75% to bonds from overseas.

In the “after” models, no distinction is made between U.S. and foreign bonds—they’re all classified as “global.”

Though there’s no specific allocation to “commodities” for average affluent clients, exposure still comes through ETFs listed on U.S. stock exchanges.

Through global managers, even the most mainstream clients can access companies based in South America, Asia and Eastern Europe.

For qualified clients, “real assets” could include the standard commodity vehicles plus direct investments in farm and timberland.

Private equity lets qualified clients invest in companies (and countries) at an earlier stage in their development.

Hedge funds offer especially dynamic strategies for managing risk and seeking higher-than-market returns.

In the “after” models, exposure also grows to include foreign companies based in developed nations like Canada and Japan.

Operations cut across regions and countries, they can offer investors exposure to global growth. Consider that in 2010 40 percent of profits for the companies in the S&P 500 came from overseas, according to BofA Merrill Lynch Global Research.

Still—nice as it would be—you can’t own the world just by owning multinationals. These stocks are part of the answer, but the move toward national insularity means that, over time, foreign countries are likely to tilt their regulatory environments toward domestic companies. So at some point, protecting yourself from a world of risks and gaining the full advantages of its opportunities should have you consider actually investing in those companies directly.

But how? Individual investors aren’t likely to leap into the Nigerian stock exchange or parse the intricacies of investing in Indonesia or jump at investing in a toll road project in China. What they can do, however, with the help of their financial advisors, is locate the money managers that invest in emerging-market tech companies, or select a money manager that takes long and short positions on the vicissitudes of the Asian business cycle. Of course, the success of active management depends on making wise decisions, so due diligence is key (see sidebar, “Know Your Managers”).

There are other ways to tap into specific, otherwise hard-to-reach global investments. Market-linked investments, for example, are debt instruments with returns that can be linked to the performance of any of a wide range of assets, including the stock-exchange indexes of developing countries—Brazil, say, or China, or Russia.

Looking at Bonds in the Context of Currencies

To paraphrase Hunter S. Thompson, when the going gets weird, the opportu-

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**FIGURE 2: THE GLOBAL PORTFOLIO MAKEOVER**

**BEFORE**

At a glance, “fixed income” doesn’t seem to change much. But in the “before” model, it’s almost entirely allocated to U.S. bonds, with 14% of all assets dedicated to Treasuries and municipals—and just 1.75% to bonds from overseas.

**AFTER**

In the “after” models, no distinction is made between U.S. and foreign bonds—they’re all classified as “global.”

Though there’s no specific allocation to “commodities” for average affluent clients, exposure still comes through ETFs listed on U.S. stock exchanges.

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In the “after” models, exposure also grows to include foreign companies based in developed nations like Canada and Japan.

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Note: All of the sample allocations are based on Merrill Lynch’s model portfolios. The “before” scenario is based on the U.S. RIC Tier 0 Moderate Strategic Allocation; and in the “after” scenarios, the “affluent client” is based on the Global RIC Tier 0 Moderate Strategic Allocation, while the “more affluent client” is based on the Global RIC Tier 2 Moderate Strategic Allocation. The “more affluent client” portfolio includes alternative investments, which are defined as hedge funds, private equity, and real assets. Additionally, up to 20 percent of the Global RIC Tier 2 Moderate Strategic portfolio might be illiquid for three to five years. We define liquidity as the percentage of assets, by invested value, within a portfolio that can be reasonably expected to be liquidated within a given time duration under typical market conditions. Most alternative investment products are sold on a private placement basis, and eligible clients typically must be qualified purchasers ($5 million net investments). The U.S. equity allocation in the “after” portfolio is an approximation of the North American allocation identified in the RIC Global Strategic Model.
to an unprecedented 1.72 percent in the yield on 10-year Treasuries dipped worth noting, for example, that even as bonds in other parts of the world. It’s yielding municipals, corporates, and with appropriate allocations to higher-riskier bonds here at home, or they can adopt a bond strategy as diversified as any approach to other asset classes, with appropriate allocations to higher-yielding municipals, corporates, and bonds in other parts of the world. It’s worth noting, for example, that even as the yield on 10-year Treasuries dipped to an unprecedented 1.72 percent in September, the yield on comparable tax-free municipal bonds was tracking at 2.11 percent, with prices holding steady as state governments got a jump on their federal counterparts in bringing fiscal problems under control. The spread between U.S. and Chinese bonds is similarly striking. Over the past 10 years, Chinese government and corporate bonds as a group have posted total annualized returns (the combined returns from price appreciation and interest coupons) of 8.9 percent, compared with 5.7 percent for U.S. bonds.

In light of this disparity, the leap into foreign bonds should feel less strange. But any decision to do so requires an investor to make yet another cognitive jog—and start thinking about currencies. That’s because foreign bonds bring exchange rates directly into play.

This is not as true in the case of Chinese bonds (although they could have other issues) because China’s currency is unlikely to lose ground to the dollar. But suppose you purchase a French bond with an attractive yield. If the euro drops while you own the bond—certainly a possibility, given the eurozone’s debt problems—the extra income from that higher yield could be wiped out when you convert back to dollars. Some foreign countries and companies offer bonds transacted only in dollars, which can help mitigate currency risk. However, that approach limits the range of choices, as well as the possibility of gains if currency moves in your favor.

So what do you do? Here again, investors should set aside conventional thinking and embrace the shift—for instance, buying the bonds of emerging-market governments and companies in places like Malaysia or Indonesia or Peru. The logic is fairly simple. As capital continues flooding into those countries, their currencies will likely gradually keep appreciating as their central banks take advantage of the inflows to lift the purchasing power of their citizens.

As with the new world order in equities, a smart, global approach to fixed-income investment comes down to working with your financial advisor to find the right bond funds led by managers experienced in foreign markets, whether they’re watching emerging markets anywhere in the world or dedicated to a specific region—like those new models of fiscal health, the Pacific Rim and South America.

Know Your Managers

When it comes to managing a global investment fund, few things matter more than proven experience.

As the geo-shifts accelerate and overseas investments seem to promise better returns, many fund managers, accustomed to working within narrow asset classes and styles (U.S. large-cap, corporate fixed income, etc.), are recasting themselves as “global” fund managers. While they may be extremely competent managers, not all have the access and true expertise necessary to tap opportunities in unfamiliar markets. Here are some criteria to consider when trying to separate the best global managers from the pack:

Are they tested in good times and bad? Going back to the technology crash that began in 2000, a decade of extraordinary volatility has yielded a large population of managers seasoned in all phases of the business cycle. Long track records have made it easier to discern the lucky from the good, and to see which managers have performed during the toughest times. As every investor knows, “past returns are not indicative of future results,” but past returns can be indicative of the disciplines and controls that a fund has in place.

Are they truly global? When a fund manager who has made a name in U.S. small-cap stocks starts a multi-asset fund with exposure to emerging markets, there’s no guarantee the transition will go smoothly. Just as the global economy favors large, multinational stocks, it also favors fund managers with proven global reach. For example, typically only the largest, most experienced global funds hold a qualified foreign institutional investors (QFII) status, crucial for gaining access to Chinese investment markets.*

What do they spend on research? In the same way an innovative manufacturer keeps improving its products through research and development, leading global funds maintain staffs dedicated to tracking events as they unfold and finding opportunities others may miss. The resources a fund commits to in-depth, local, and original research into the areas in which it invests can tell you a lot about whether it is truly generating original, exciting ideas or simply following popular trends.

* Defined by the China Securities Regulatory Commission, a qualified foreign institutional investor (QFII) is an approved overseas fund management institution, insurance company, securities company, or other asset management institution that invests in China’s securities market.
Commodities for a Shrinking Planet

For all of its complexities, the new age of global risk at some level boils down to the tensions among four children forced to share three dolls. As world population rises by a staggering 200,000 per day, emerging middle classes demand a steadily higher standard of living and a greater share of finite resources. To meet demand, according to one estimate, farms worldwide will have to produce more food during the next half century than during the previous 10,000 years. Add energy, industrial metals, and building materials to the mix, along with the intense pressure being placed on gold prices by central banks that have started buying up gold as an alternative to dollars and euros, and it becomes clear why every macro-economic and sociological trend points to a similar conclusion: Many investors likely could benefit from increasing their focus on commodities.

Commodities do pose risks, and they don’t produce interest income or dividends. But they do provide an important source of diversification. Like stocks, commodities are cyclical and influenced by global growth; and because they are

Even More Targeted Solutions for Qualified Investors

Volatile times demand creativity. For affluent investors, that may mean looking for alternatives.

There are plenty of ways for today’s globally minded investors to gain access to international markets. The U.S. stock market trades shares of multinationals as well as foreign companies, and overseas government and corporate bonds are making their way into growing numbers of portfolios. But for investors defined as “qualified” because of higher levels of investable assets and other factors, there are additional, even more sophisticated vehicles for targeting growth, dialing up diversification, and seeking protections against volatility. These investments are not suitable for everyone, and clients need to have the appropriate investment objectives, time horizons, liquidity needs, and risk tolerance, but the potential benefits may be worth it.

Private Equity

In many emerging markets, particularly the frontier markets in Africa and Southeast Asia that may represent some of today’s biggest growth opportunities, public securities exchanges are rudimentary at best. So to gain access to these growth stories, affluent investors may need to look at funds that trade not in stocks or bonds but that actually buy and sell whole companies.

The private-equity market has changed considerably since the pre-credit-crisis days of highly leveraged, exorbitantly priced buyouts. In addition to going more global, the deals getting done now tend to be smaller, with a greater emphasis on cash and less on borrowing. While the formula may make for fewer splashy headlines, it’s a climate that actually favors affluent individual investors.

Many private-equity companies also have been enticing investors by distributing regular interest or dividend payments. Because private equity requires investors to commit capital for extended periods, getting some income while you wait can ease those illiquidity concerns.

Global Hedge Funds

In a volatile global economy, policy makers and government agencies in Washington, Brussels, or Beijing can jolt international markets with a single speech or regulation. To keep pace, affluent investors may need to rely more on global hedge funds, which can have the flexibility to offset risks and exploit opportunities as they arise. Global macro funds, for example, base their investment models on forecasts and analyses of international politics and policies, relations among countries, interest rates, and other factors. Event-driven funds, meanwhile, seek to take advantage of temporary market inefficiencies caused by political developments, natural disasters, or other events that may affect companies’ operations.

Ultra-structured Solutions

At a time of rapidly shifting global risks and opportunities, growth with safety is a priority for many investors. Ultra-structured solutions, an exclusive subset of market-linked investments, give qualified investors the ability to customize exposure to a wide variety of global themes across the risk asset classes, all while building in protective features more characteristic of bonds. An ultra-structured note might be designed, for example, to track the performance of the Turkish lira, protecting against the first 10 percent of any losses if the currency ends up weakening over the next several years. Or a note might allow an investor to benefit from the widening spreads between U.S. and Asian bonds while buffering against the first 30 percent of losses if those spreads start to narrow.

Ultra-structured notes do carry credit risk—the company issuing them could default. Still, they provide another way of diversifying a complex portfolio and reducing the impact of a volatile investment world while taking advantage of its distinct growth potential.
The New Rules of Global Investing

Global shifts have overturned some of our most basic orthodoxies of investment thinking. Here are new rules that investors can use to position themselves for protection and growth:

**Going global.** As nations turn more inward to deal with domestic challenges, investors may need to become that much more international in their search for growth, yield, quality, and effective ways to manage risk.

**Taking a more dynamic approach.** Although “buy-and-hold” isn’t exactly obsolete, investors may need to consider more dynamic, tactical, and flexible approaches to reducing risk and maximizing returns. These may include actively managed funds as well as alternatives such as market-linked investments that explicitly manage downside market exposure.

**Getting yield from multinational stocks.** Look for corporate dividends to become a more important source of yield as U.S. multinationals deploy the cash on their fast-improving balance sheets to lure investors in volatile markets.

**Seeking the safety of emerging-market bonds.** With U.S. Treasury yields at historic lows, global fixed income becomes more attractive, especially in markets that pair higher interest rates with currencies likely to be buoyed by influxes of foreign capital. (A stronger local currency makes for stronger real returns when bonds are converted back to dollars.) Experienced global fixed-income managers can help source the right combinations of currency strength and yield.

**Buying direct exposure to overseas equities.** While U.S.-based multinationals give some access to emerging-market growth, it’s prudent to have assets that provide more direct exposure to some of the world’s fastest-growing economies (e.g., China, Turkey, Malaysia, even Nigeria). Experienced global fund managers, again, are especially critical here, along with market-linked investments that can be tied to stock indexes or baskets of stocks in less-established markets.

**Reducing risk with commodities.** One of the world’s most volatile asset classes also can be one of its best diversifiers. Although owning commodities poses its own risks, it can reduce overall portfolio risk by providing a hedge against scarcities in vital natural resources that can drive up production costs and hurt corporate earnings and consumer spending.

subject to such vagaries as weather, disease, embargoes, and tariffs, they’re potentially even more volatile. But whereas equity prices reflect a forward-looking view of company earnings, commodities prices depend more on immediate demand and scarcities. In August 2011, for example, when fears about U.S. and European government debt drove world stocks into wild swings, the price of oil moved much less because global demand for energy held firm.¹

Because most commodities actually are raw materials, they also provide possibly the best natural counterpart to the rising cost of materials on world markets than it is to higher wages or other consequences of a faster-growing U.S. economy. In a real sense, owning commodities can offer a hedge not just for your investment portfolio but also against higher consumer prices, be they of groceries or gasoline.

**Seeking Flexibility and Growth**

For at least 40 years, growth has been the investor’s watchword. Success meant crafting a portfolio of what appeared to be stable, mostly U.S.-based stocks and bonds that would grow predictably—not in a straight line but with relatively brief interruptions that would be more than counterbalanced by long stretches of economic expansion. The fundamental strength and resilience of the U.S. economy was the unquestioned foundation on which investors could always build.

Now we need to balance that view of the world—and that style of investing. More shocks are doubtlessly coming: climate change, inflation in world food prices, and continued movement out of the dollar into gold and other currencies. And there will be other, unexpected crises—natural disasters such as the Japanese earthquake and tsunami as well as man-made upheavals such as the Arab spring—that further roil the global landscape. As humans, we will, as always, adapt and re-engineer. As investors, we must be prepared for risk, even in the unlikeliest places. As we saw during the financial crisis, even money market funds are not entirely safe when an outlier event like a freeze in the financial markets occurs (and, given their exposure to the very short-term debt of European banks, there is at least a possibility that money market funds could be impacted again). So, we must focus on sustainability, resilience, the
Japan has presented challenges to investors over the past two decades, but time and again it has been able to rely on its citizens to help pull itself out of crisis.

ability to deal with the unforeseen, and also the wherewithal to capitalize on often fleeting opportunities.

Flexibility gives nations the capacity for extraordinary strength and resilience. Japan has presented challenges to investors over the past two decades, but time and again it has been able to rely on its citizens to help pull itself out of crisis. Most recently, in September 2011, the Japanese government announced plans to spend $248 billion on disaster relief funded in part through higher taxes and disaster bonds. The country is banking on its citizens’ personal savings as a way out of a crisis that could have crippled another nation.

As for the United States, for all the challenges it faces and the noise it sometimes creates, it remains one of the most flexible, stable, and sought-after economies on the planet. With just 4.6 percent of the global population, the United States accounts for as much output in a year as the next three largest economies—Japan, China, and Germany—combined. Judging by reports in the popular media, you would think that the United States makes nothing and consumes everything. In truth, the United States is still a global manufacturing powerhouse, the world’s second-largest, having ceded the top spot to China only in 2008. The list goes on and on: When combining goods and services, the United States remains the world’s top exporter, a fact masked by headline trade-deficit figures. According to just about any consumer survey, the planet’s most recognizable brands are largely American. The United States has the world’s favorite economy for foreign investors, the largest market for information technology spending, and the largest and highest-quality university system in the world. All of which is to emphasize the obvious resilience of the United States that has brought the nation back resoundingly from crisis after crisis in the past.

As much as the United States and other traditional players in the global economy admire the growth of newcomers, the winners among the emerging nations will be those that learn from the developed countries and find ways to move beyond pure growth and adopt the flexibility to survive inevitable shocks of their own.

Much the same can be said of investors facing a world they never foresaw. The winners are likely to be those who maintain the flexibility, both in mind and in portfolio, to see and respond to the world as it has become.

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Endnotes
1 According to Standard & Poor’s data, cash dividends per share on the S&P 500 were $22.73 as of September 26, 2011, compared with $16.27 as of September 26, 2000.
2 The active manager will deviate from various benchmark weights to produce a return that exceeds the passive return with minimal risk.
3 U.S. Department of the Treasury. Data as of September 22, 2011.
4 Bloomberg, BVAL Muni Benchmark 10-Year. Data as of September 22, 2011.
5 Chinese bond market returns are based on the S&P/CITIC Composite Bond Index, and U.S. returns are based on Barclays U.S. Aggregate Bond Index. All indexes in U.S. dollars. Data as of September 30, 2011.
8 According to BofA Merrill Lynch Global Commodities Research, the price of Brent crude declined 2 percent in August 2011.
11 Ibid.
14 “The World We Live In” (see note 11); Quacquarelli Symonds World University Rankings.
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