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Markets Have You Down ... and Up?

Go-Anywhere Team Finds Value Amid Volatility

Point of View With the Global Allocation Team

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Dennis Stattman, CFA, Managing Director and portfolio manager, is head of the Global Allocation team within BlackRock's Portfolio Management Group (PMG) and a member of the BlackRock PMG Executive Committee, Leadership Committee and Central Strategy Group. Mr. Stattman's service with the firm dates back to 1989, including his years with Merrill Lynch Investment Managers (MLIM), which merged with BlackRock in 2006. He has been a manager of the BlackRock Global Allocation Fund since its inception in 1989. Prior to joining MLIM, Mr. Stattman served as the Director of Research for Meridian Management Company, and as Pension Investment Officer for the World Bank, supervising the management of US equities in the bank's retirement plan.

Dan Chamby, CFA, Managing Director and portfolio manager, is a member of the Global Allocation team within BlackRock's Portfolio Management Group. Mr. Chamby's service with the firm dates back to 1993, including his years with MLIM. Mr. Chamby joined MLIM in 1993 as a research analyst for the fund and was named Associate Portfolio Manager in 2003 and Portfolio Manager 2011. Prior to joining MLIM, Mr. Chamby worked for Fujitsu Ltd. in its Tokyo headquarters as a research analyst. He began his investment career at Mellon Bank in 1982 as an Asia/Pacific Credit Analyst, and later managed the international money market desk.

Aldo Roldan, PhD, Managing Director and portfolio manager, is a member of the Global Allocation team within BlackRock's Portfolio Management Group. Mr. Roldan's service with the firm dates back to 1998, including his years with MLIM, where he was a portfolio manager for various global fixed income portfolios as well as Head of Emerging Market Debt. Mr. Roldan joined the BlackRock Global Allocation Fund team as an Associate Portfolio Manager in 2006 and was named Portfolio Manager in 2011. Prior to joining MLIM, he was a Senior Vice President at Santander Investments, and earlier was a global economic analyst at JPMorgan Chase. Mr. Roldan began his investment career at Chase Econometrics, where he founded and managed the emerging markets research group.

Sharp market gyrations have investors uncertain as to where to focus their attention. The BlackRock Global Allocation team has the flexibility to invest in any asset class, anywhere, and even amid today's heightened volatility, is finding no shortage of opportunities.

- Despite a slowdown in the developed world, emerging markets are bolstering the global economy.
- Price matters, and equities are attractively valued today relative to developed market government fixed income and cash.
- Investors may have to weather some short-term volatility for the long-term opportunity to own good-quality stocks at generation-low valuations.
- A globally diversified, multi-asset, professionally managed portfolio can be an important cornerstone of an investor's financial plan.

You can invest anywhere in the world without restriction. Let's start with the region most in the headlines today – Europe.

What started as a financial crisis centered on sovereign debt markets has infected the banking system and has now started to expose a political crisis of tremendous importance and, ultimately, tremendous consequence for the global economy. Unfortunately, the daily headlines fail to capture the true complexity of the situation. There is really no such thing as "Europe," meaning there is no central European government. You have an amalgamation of states of democratically-elected officials who have to answer to their own local constituencies, and so there is a bit of a dilemma. Authorities in the European Union recognize that there's a need to keep the union together while also addressing this crisis. This is something that will take time. So, it would be a mistake to misinterpret the amount of time required to effect the necessary change or to view the lack of short-term resolution as ineptitude on the part of EU policymakers.

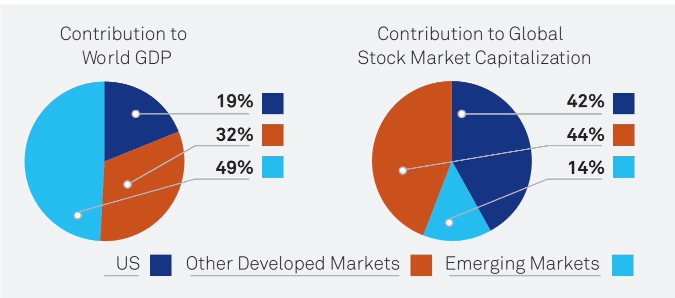
But while Europe is a big short-term worry, we shouldn't lose sight of the fact that there's a boom going on in the world's developing economies – in China, India and Brazil, for example. In fact, the policymakers in China and India face a completely different problem. They're confronted with economies that are overheating, with rising consumer prices and with wages that are growing at a double-digit rate.

Can the relative strength of the emerging markets offset weakness in the developed world?

We believe investors are concerned about both the very obvious slowing in the developed economies, as well as some slowing in the developing economies. But there is still a great deal of growth in China, in India, and in a number of other emerging economies, and we need to keep in mind that there are vast unmet needs in these economies. A new cohort of hundreds of millions of consumers in these regions is just getting a taste of a better life, and they are not going to give up their ambitions. They are going to be buying the basics of middle-class life for decades to come, and this should continue to support the growth of these economies.

Some will make the point that China is slowing. Our sense, however, is that China is slowing from very rapid growth to rapid growth. Now, we should be very clear that this is not by accident, but a result of Chinese government policies to slow the economy. The government is trying to both influence the over-building of housing in some cities and also deal with rising consumer prices and rising wage rates via more restrictive monetary policy. However, as the Chinese economy slows, there is great scope for those policies to change and, if need be, to become more stimulative. Overall, emerging economies do not face the same structural challenges that exist in the developed world. The pie charts below illustrate the contribution of different regions of the world to global gross domestic product (GDP) versus how their stock markets are represented in terms of market capitalization. The emerging economies contribute far more to global GDP (nearly 50%) than is represented by their stock markets (14%). We believe these percentages will converge over the long-term, meaning there's ample scope for growth in emerging stock markets.

Emerging Markets: Large GDP Contribution, But Under-Represented on World Equity Stage



Source: International Monetary Fund (IMF), World Economic Outlook Database, MSCI World. Data as of December 31, 2010.

What about the US economy?

When it comes to the US economy, there is a great deal of uncertainty at this point. What is very clear to us, however, is that the so-called economic recovery that we've had since the last recession is unsatisfactory in terms of the economy's ability to create jobs, its ability to generate tax revenue for governments, and its ability to give businesses and consumers the confidence to go out and spend. So, the bad news is we don't have the strength that we would normally like to see from a recovery. We certainly don't have the jobs that we would like. The good news is that we don't have a boom to come crashing down from. What we have is a period of unsatisfactory growth, but it is not so slow or so difficult that companies can't find a way to make money. In fact, US companies are making record profits.

Are we entering a new recession in the US?

We won't know for sure until after two quarters of negative growth. However, we do need to be prepared for a prolonged period of slow growth. As investors, we have to be prepared to take advantage of the opportunities that arise from volatility and to avoid the pitfalls of an economy that is much slower than we've become accustomed to over the past several decades.

Investors also need to remember that stock markets and economies are often two different things. US companies have exhibited incredible resilience amid the economic downturn, and their stocks represent tremendous value. Japan is another example. We like Japanese companies, but that doesn't necessarily suggest we are bullish on Japan as an economy. Japan is home to many best-in-class operators of businesses that make goods that people and industries around the world generally want. Japan has been thrown on the dust heap of investment mindset and we think that dismisses some very real opportunity.

How does an investor prepare for the possibility of prolonged slow growth?

This cycle is different than past cycles, in our view. Compared to almost any point in time throughout the history of the Global Allocation Fund, we have lower stock valuations. Many high-quality, global companies are trading with dividend yields well above what can be realized in fixed income. As a result, investors do not have the ability to use fixed income for both defense and offense, as they were able to do at times in the 1990s. At this point, fixed income is primarily a short-term defensive instrument. It will not satisfy an investor's return needs over an extended period of time. So, we believe investors may have to accept a bit more short-term volatility for the long-term opportunity to own good-quality stocks at very low valuations and, thereby, expose themselves to the upside that we believe is going to be evident one, two and three years down the road.

Still, daily market swings have many steering clear of stocks. Is it wise to wait out the volatility or should investors be looking at equities now?

Investors absolutely should be looking closely at equities. We're experiencing some of the lowest stock prices in decades. Many measures of value recently are at attractive levels – dividend yields, price/earnings (P/E) ratios, price-to-cash flow. (See table below.) This is not the time for investors to shun stocks, especially when cash equivalents yield zero and fixed income yields are among the lowest many of us have ever seen in our lives. As professional investors who are immersed in the markets around the world every day, we're starting to find a lot of very interesting stocks to buy in various markets and sectors. Certain stocks, particularly when compared to the fixed income markets, in some cases are almost a screaming buy.

Equity Valuations Attractive by Many Measures

	Price/EPS (2012)	Projected EPS Growth (%)	Dividend Yield (%)
US	10.2x	11.6	2.3
Europe	7.5x	7.1	5.5
Japan	11.7x	14.1	2.4
China	9.1x	19.9	2.1
India	12.0x	15.5	1.6
Brazil	8.0x	12.8	4.5
Russia	5.0x	-2.6	2.5

Source: Bloomberg, as of September 30, 2011. Indices used are as follows: US – S&P 500 Index; Europe – Eurostoxx 50 Index; Japan – Topix Index; China – Shanghai Stock Exchange Composite Index; India – BSE Index Sensex 30 Index; Brazil – Bovespa Index; Russia – MICEX Index.

What sectors and markets are you looking to add to right now?

One example is Europe. The selloff there as a result of the financial crisis has been fierce, and we've found some particularly interesting stocks amid the rubble. The German stock index, the DAX, is a good representation of what's going on in Europe. There are companies within the index that have already had their earnings estimates slashed substantially, and yet, we're still seeing the market as a whole trading at a forward P/E of roughly 8x. We're finding best-in-class stocks, for example, that are trading sometimes at 5x or 6x earnings. These represent remarkable value, in our view.

We find that many commodities also represent opportunity, particularly in those cases where the emerging markets are the marginal consumer. Those countries are not slowing in the same way as the developed world, and they are becoming a larger part of commodity consumption. So, for example, oil prices may come down now because of declining consumption and inventory build-up in the United States. However, the rest of the world continues to grow. Today, India and China are consuming at levels that are far below other nations. As these developing economies continue to grow at faster rates, it is likely the demand for natural resources such as oil, coal and natural gas will continue to go higher.

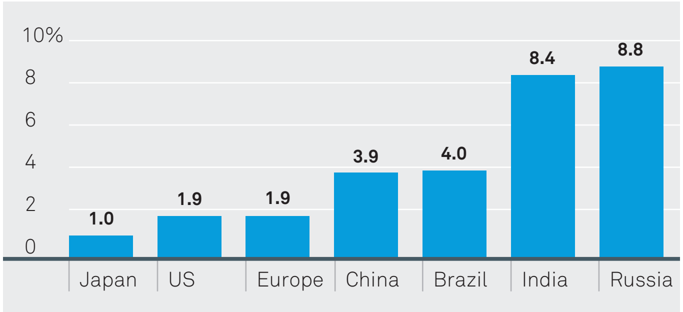
So, the temporary weaknesses in some of these commodity markets are creating excellent buying opportunities for the longer-term, meaning two or three years out.

Where are the opportunities in fixed income today?

The short answer is that the opportunities are fewer than we would like. That said, we do see opportunities in select areas of emerging market debt. We see growth in emerging economies, good balance sheets and, in many cases, declining debt to GDP ratios. These are all attributes we like to see in a bond issuer. In addition, some currencies appear poised to appreciate versus the US dollar. In the US interest rate environment, however, we see far fewer opportunities.

Yields at Record Lows, Value Lacking in US Bonds

Global 10-Year Bond Yields



Source: Bloomberg, as of September 30, 2011

You have the ability to invest freely across asset classes, regions, sectors and market caps. How do you narrow down such a vast universe?

It's a daunting challenge, but it's also a great luxury because very few investment managers have the flexibility that we do to go wherever the opportunities are. Unlike most asset allocation funds, we're not only top-down (making decisions based on which asset classes, sectors and geographies look attractive), we're also, importantly and differently from most, bottom-up. This means we're looking for individual securities that can outperform their markets. Our team is constantly looking for those individual securities that can validate the top-down view and give us greater conviction that we have the right investment view of the world.

Tell us about your team.

We built up the BlackRock Global Allocation team very carefully over time and we would venture to say there is not another team like it anywhere in the industry. In addition to three portfolio managers, we have 13 senior analysts who have a deep background and a great deal of experience looking for individual securities that we believe represent superior investments for our clients. We also have research associates supporting them, gathering data and doing analysis. We have a support group that helps us structure our transactions, another group that helps us with our information and a team that specializes in communicating with our clients.

The way we tend to hire people for our team is also very important. We look for people who are engaged, who have tremendous intellectual curiosity and who have a certain intrepidness. In other words, people join our team with vast knowledge in their areas of expertise, but they have to be willing to work outside their comfort zones, to consider opportunities across the asset class spectrum and to connect points that are seemingly very far apart to arrive at some of the most compelling investment opportunities. Oftentimes, the greatest investments lurk between the seams of two apparently disparate ideas. It's in those intersections where we often find the opportunities that the broader marketplace does not. This, we believe, is our opportunity to realize profits for our shareholders.

What role does risk management play in your investment process?

Risk is the other side of the return coin, and we seek to balance the two. We're always trying to achieve above-market return with controlled risk. The way we manage risk is multi-dimensional. We apply risk management techniques from the broader BlackRock organization — our in-house, industry-leading quantitative risk group. The second means for managing risk is via broad diversification. It's about the different asset classes, which respond differently to different movements in the market, but it goes deeper. We have 600–700 distinct names in the portfolio.

To what do you attribute your success?

First is flexibility. Not only is our mandate flexible, but the team is flexible, experienced and willing to take their knowledge and apply it anywhere in the investment universe. We foster constant dialogue that involves sharing ideas and questioning one other, and this very often uncovers really interesting ideas.

The second thing that is very important to us is price. Price matters; we never want to overpay. So having a very high consciousness of price and being very aware of how the environment is shifting is advantageous.

Third is conviction. Volatility can make an investor do irrational things. The panic roused by market gyrations can cause an investor to sell something that may otherwise be an excellent investment. We're very disciplined and we realize that you sometimes have to sustain some of the pain of an investment to reap its rewards. We buy when we see value and when we are confident in the factors supporting a particular investment: Is it the right country, the right sector, the right management and the right point in the company's capital structure? When the answers are "yes," we then have the conviction to maintain an investment through volatility and, ultimately, realize the value that we hypothesized was there. As investors, we are careful to separate our emotional from rational behavior.

The bottom line: We're blessed with flexibility, we maintain diversification and we're very value-oriented. Price matters.

Any final advice for investors?

No one, including us, knows exactly what the stock market is going to do tomorrow, next week or in the next three months. However, we do have a good grasp on how things are priced today and what you get for a dollar of a stock. What you get right now is pretty good in the stock market and not so good in the bond market. When prices are low, when things are on sale, you can buy more of them with the same amount of money. Price matters, and today, price favors the equity investor.

Further information
www.blackrock.com.au

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