

# CORE Comments

ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

April 19, 2010

## Goldman Sachs and Banking Reform

The egregious aspect of Goldman's actions, as alleged in the complaint by the SEC, is its deliberate actions to mislead one set of its clients (the buyers of its ABACUS synthetic collateralized debt obligation (the "CDO")) so as to serve the interests of another client (the Paulson hedge fund). The complaint lays out the process in clear detail: at certain stages in the creation and marketing of the CDO, third parties raised questions about Paulson's role. According to the complaint, Goldman let it be understood that Paulson was investing in the mortgage-backed securities associated with the CDO. In fact, however, Paulson was choosing the particular securities to be included in the CDO, so as to be able to 'short' the CDO, that is, to take investment positions that would benefit it if and when the securities fell in price. If the allegations of the complaint are true--and they probably are well-supported by evidence Goldman and others have turned over to the SEC--the CDO could not have been successfully sold to investors (who ultimately lost about \$1 billion invested in the CDO) unless Goldman had misled those involved with the fund about Paulson's role. For its part, Paulson fund paid Goldman \$15 million and was paid about \$1 billion for its short position against the CDO. The complaint, not terribly long, may be found at <http://www.sec.gov/litigation/complaints/2010/comp21489.pdf>. Goldman denies the allegations.

*The principal of the Paulson hedge fund identified in the SEC complaint is John Paulson (no relation to the former Treasury Secretary), who correctly analyzed the weakness in subprime mortgage market. He approached Goldman about creating a CDO associated with securities he deemed to be more highly rated than warranted. Paulson's fund was one of the biggest winners 2008 as the mortgage market collapsed.*

Conflicts of interest necessarily arise in financial institutions of Goldman's size, which represent a very diverse set of clients with very differing investment objectives and which have their own proprietary investment positions. But Goldman's conduct in misleading its clients, as alleged in the complaint, cannot possibly be excused as an innocent mistake. If the SEC's allegations prove to be true, how can institutional investors, like the Dusseldorf commercial bank to which Goldman sold the ABACUS deal, possibly consider doing business with Goldman?

Firms in the securities business--big ones like Goldman and small ones like Core--have various assets, but certainly the indispensable asset is the firm's reputation for integrity and honesty in dealing with its clients. In my dealings with Goldman since I began as young lawyer on Wall Street more than three decades ago, in my acquaintance with lots of Goldman people over the years, in my observations of their work, I have been an admirer of the firm. I have felt that however tough-minded they were in their work, they made a (generally successful) effort to do the right thing by their clients and customers. Unless the set of facts is entirely different from what is portrayed in the complaint, Goldman has done immeasurable damage to its reputation and to its business.

**By**

**Jack Mayberry**

*The Goldman story will unfold further, and a fuller account of how CDOs were developed and marketed lies ahead. We will not lack subject matter for these letters.*

Goldman's statement on Friday makes the point that the SEC complaint addresses a "single transaction". However, Goldman has proudly reported that its very senior executives became wary of the subprime market in 2006 and 2007 and changed the firm's investment positions in mortgage-related securities, so that the firm could benefit from the weakness it foresaw. It is almost certain that its senior executives, including Lloyd Blankfein, the CEO, and David Viniar, its CFO, were closely involved with the activities of the firm's unit that created the ABACUS CDO.

What else may we learn in coming months about Goldman's dealings in the subprime disaster? The Senate subcommittee chaired by Carl Levin has been investigating the unraveling of the financial system for many months; it has broad subpoena power, which it has been using in a concerted way. At least seven other large investment banks have received subpoenas from the SEC relating to creation and marketing of CDOs and other structured products. The Paulson hedge fund was not the only investment firm seeking the creation of mortgage-related securities by investment banks for purposes of shorting that market. It is entirely likely that the investigations will yield more civil charges--perhaps criminal ones, as well.

Goldman is an important firm and the SEC complaint against it provides an interesting story. The fundamental issue, though, is not the future of Goldman, but the soundness of America's banking system. The devastating financial losses and the horrible recession arose from failures in regulation and structure of the system. The very lax regulatory regime and the fantasy of self-regulation permitted dangerous mortgage underwriting practices and sales of devilishly complex derivative products. We can now see that these practices and products gave rise to terrible losses for the unsuspecting and unseemly gains for the financial insiders. That some of the gains arose from corruption and fraud has already been established; whether this CDO in the SEC's complaint was an instance of fraud has not been established. New regulatory schemes are near the top of Obama's agenda; the opposition to the developing legislation, by Republicans and by the banking industry, is implacable. The Goldman complaint may mark a new step in the political process, by shining a narrowly focused light on the way these products were developed, marketed, and used. Resistance to a sensible regulatory scheme may be more difficult for Republicans in the face of these allegations and the perception that Goldman and other big firms were rigging the system.

**Core's investment activities.** Apart from reading the financial press, we have been making some investments. Last week we sold a portion of our high-grade US corporate bonds, and with the proceeds are purchasing a position in high-yield US corporate bonds and in Dutch equities. There is nothing wrong with our high-grade corporate bond investments, except that, as bond prices have risen, the scope for further capital gains becomes ever smaller. Meanwhile, the lower-grade and higher-yielding sector of the bond market still has room to gain. As the economy improves, so do already-strong corporate balance sheets. Thus, the low-grade bonds become less risky, while still yielding more than 8 percent. As for our investment in the Netherlands, the unfolding crisis with Greek sovereign debt has driven down stock prices even in the very strong European countries like The Netherlands and Germany. We see value in Dutch equities.

*Each year Core Asset Management files with the SEC a form ADV with information about our company. If you would like a copy of Part II of Form ADV, please contact us.*

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