May 3, 2010

Spring Quarterly Commentary

"What experience and history teaches is this: that nations and governments have never learned anything from history, or acted on principles deduced from it."

Georg Wilhelm Friedrich Hegel, 1770-1831

Philosophy Professor, Universities of Heidelberg and Berlin

Lectures on the Philosophy of History, 1830

Last week's big fat $147 billion Greek bailout led by the IMF and Germany has prevented the cradle of western civilization from default, at least for the time being. Greece is a fine example of Professor Hegel's dictum, having gone bust five times since 1828. Rioting in the streets notwithstanding, maybe Greek tragedies and sovereign bankruptcies are not so bad after all, lenders excepted.

The original thirteen American colonies might be cited as an exception to the Hegelian statement, but we wonder how durable their magnificent creation will prove to be in light of current unsustainable trajectories on the fiscal front.

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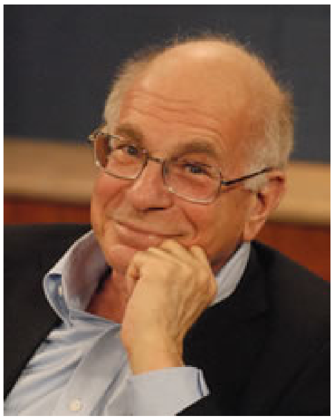
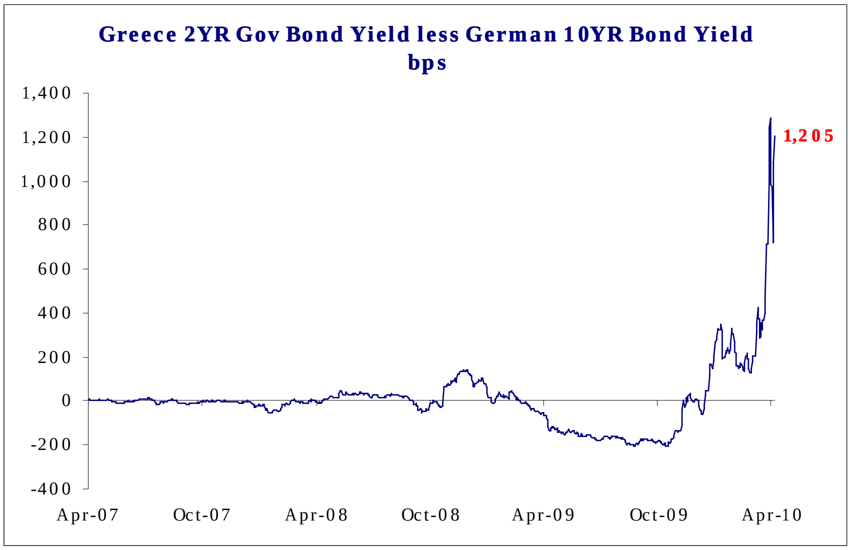
As in Greece and America, a crisis must unfold, or appear to unfold, for any meaningful change to occur. The stock and bond markets are currently consumed with evaluating the risks to the status quo from the crisis in Greece...and Goldman Sachs.

Each crisis carries with it the chance that certain parts of the investment landscape may be altered in such a way as to cause losses for investors. But the simple fact is that by the time most armchair investors have been alerted to impending tragedy,



the tragedy has already largely occurred. This is why being reactive is seldom a prescription for loss avoidance, and seldom are such crises viewed by investors as opportunities for gains. This may be due to the fact that investors do not treat a dollar of incremental gain as the mirror-image of a dollar of loss. As Nobel Laureates Daniel Kahneman (left) and Amos Tversky (below) found in their work on investor behavior, a dollar of loss is greeted with far more consternation than a dollar of gain is with euphoria. This fact of asymmetrical reaction to a 50-50 occurrence probability, combined with the knowledge that some investors have just lost their shirt if exposed to these tragedies, cause most investors to not think in terms of the investment opportunity presented by crises. How many people were giving serious thought to buying Citigroup at $1.00 per share fourteen months ago, even though at the time it could have been argued that the downside was 100% and the upside was 1000%?

Greece: Although there is a chance Greece might withdraw from the euro, having grossly failed to meet and sustain the Maastricht criteria, and return to the drachma, such a course might be even more punishing to their sovereign debt than just staying in the euro and accepting the terms of a bailout. Most believe the bailout led by Germany and augmented by the IMF is the best course available. Greece represents 2.7% of euro zone GDP, a small amount. The importance to Brussels and the world



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is that these actions or lack of actions may establish precedents for other "PIIGS" (Portugal, Italy, Ireland, Greece and Spain), and there is even beginning to be talk of spillover to the pound sterling and the U.K. A generalized lack of confidence in sovereign debt is where this leads, and gold prices are responding accordingly by going up...new highs in euro terms and close to new highs in dollar terms at $1176 per ounce. Standard & Poors expects Greek sovereign debt would trade at 40 cents on the dollar should the bailout combined with its draconian fiscal and taxation impositions not be instituted.

As for Goldman Sachs, we have mixed feelings. From the government standpoint, although denied, it looks to us like the troika of Securities and Exchange Commission, Congress and U.S. Department of Justice have deliberately orchestrated this attack, possibly to increase the chance that a financial reform package can make its way through Congress. We recall that during the Enron scandal, accounting firm Arthur Anderson collapsed and 28,000 people lost their jobs, 27,900 of whom were completely innocent. So if enough reputational damage can be sustained in the media by the bully-pulpit accusers, the old saw about innocent until proven guilty may be moot with punishments meted out ahead of the verdict...unfortunately, to many innocents along with a handful of the presumably guilty. Collateral damage can be so great as to render an ultimate innocent verdict too little too late.

We are disappointed that Senator Carl Levin of Michigan did not spend more prep time to make himself knowledgable in investment issues. He made no distinctions between "agency" and "principal" trading. In "agency" trading, the broker is simply a middleman, or agent, who arranges for a buyer and seller to meet at a price and none of the firm's capital is deployed. Therefore opinions as to whether something is undervalued or overvalued are completely irrelevant.

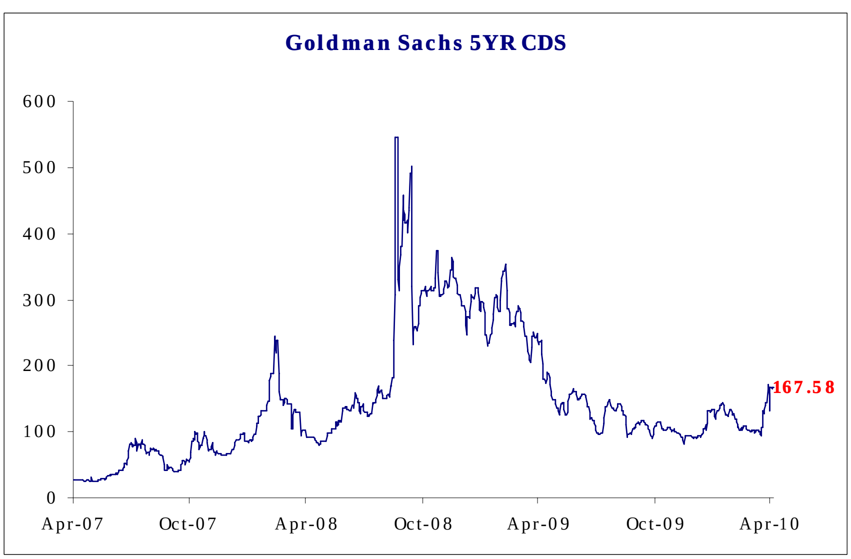
In "principal" trading, the broker uses firm capital to take the opposite side of the trade from the client or counterparty. About fifteen years ago, the number of "market makers" in stocks, for example, started to shrink dramatically because decimalization caused spreads between bids and offers to contract... instead of eighths and quarters, spreads became a few pennies. This "market maker" consolidation, stemming from inability to make money in an environment of shrinking spreads, caused large institutional investors like Vanguard, Fidelity, T. Rowe Price, Franklin-Templeton, et.al. to request of the larger brokers like Goldman to use their (Goldman's) firm capital to facilitate client trading, i.e., if they wanted to sell 500,000 shares of a relatively illiquid stock at 9:15 AM on a Tuesday, they wanted Goldman to buy it from them at a minor concession to the last trade, and be on the opposite side of the trade to provide liquidity where there otherwise would be none. This does not necessarily mean that there is a Goldman opinion on every one of thousands of less liquid stocks. Even if there were a firm opinion, there is no guarantee the opinion is right, or that the opinion's longer-term time horizon will have any impact on shorter-term trading. Presumably the price at any given point in time is the balance point between bullish investors and bearish investors.

Senator Carl Levin also does not understand what a short sale is, as he repeatedly referred to "buying a short" instead of "selling short," "initiating a short," or "covering a short". The thunder of the government's representatives has been heard and a fusillade of invective unleashed upon a few bright young fellows coerced into coming before this tawdry panel in hopes of ensnaring them into saying something for which they will be tarred and feathered at a later date! The whole process has an unseemly quality to it, reminiscent of the inquisition. We say, let the courts decide these issues and keep the cheap politics at bay.

The collapse of the housing market, in our opinion, was caused by a combination of 1) lax underwriting standards, 2) under-reserved mortgage insurance providers, 3) an excess of government-created tax-avoidance incentives encouraging flows of capital to housing that should never have been going there in the first place, 4) unrealistic appraisals and 5) a general mentality that believed housing prices would never go down on a national basis just because they hadn't for many years. It is unfortunate that certain corners of Wall Street profited from the housing collapse, as most Americans want shared pain if there is to be pain. A high-profile Goldman Sachs is guilty of the sin of making giant sums of money while other common folk were being turned out of their homes in foreclosure.

To blame Goldman Sachs for lack of disclosure as if trading these instruments required a fiduciary standard (which is not the case) is a substantial stretch. This is something akin to saying that a municipal bond issued by the state of California cannot be traded without the broker providing an opinion as to whether the State of California is going bankrupt, and if so, when. Price is the final arbiter of value. We presumably have rating agencies for the purpose of assessing solvency, though the timeliness of their responses has left much to be desired. The SEC case will rest on whether there was adequate disclosure between two buyers and one seller, in a $2 billion principal trade where Goldman was broker to both sides... using regulations in

Credit Default Swap: Cost of Insuring Against Default



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existence at the time. Typically in trading, it is never divulged by the broker who was on the other side of your trade... in an agency trade they will tell you who the contra-broker was but never the contra-party. In a principal trade, you may assume your broker was shorting your purchase to you if you were a buyer, or selling to you from his inventory should he have any inventory. Goldman acted as principal in this instance.

The SEC must prove that Goldman not only had knowledge of hedge fund manager John Paulson's input into the mortgage selection process, but also that Abacus (the entity determining which mortgages were to be included) accepted Paulson's input, that Abacus withheld this from two buyers and that this was "material". Since it was known which mortgages went into the synthetic CDO irrespective of who suggested they be put there, it may be difficult to establish a "material" omission. In other words, that it was inadequate for the buyers to only know which mortgages were in the synthetic CDO, but that they should have also known that Paulson was the contra-party shorting the instrument (which was necessary, otherwise there was no trade for them to purchase) and that Paulson had suggested certain mortgages, and further, that Abacus in creating the synthetic instrument had in fact taken some but not all Paulson advice. Abacus apparently accepted 55 out of 123 mortgages suggested by Paulson for inclusion. It is important to understand that there would have been nothing to buy if no one was willing to be on the sell side of this potential trade, so the buyers had to have known that someone somewhere had said "if you will synthetically place these mortgages in this instrument, it will yield such-and-such, and I am willing to sell it or short it to you." The fact that the SEC charges are "civil" and the Justice Department's would be "criminal," increases the seriousness of these procedures, and Goldman risks the fallout from reputational damage long before guilt or innocence will be established.

This is a sad chapter in our history, especially since Goldman is known for only employing the best and the brightest, is responsible in no small measure for the preeminence of American investment banking on the world scene, and has been the go-to

firm for American Presidents seeking a knowledgable and influential Secretary of the Treasury. All large Wall Street brokers/banks were doing the same things Goldman Sachs was doing, and there has been little regulatory law to dictate how this business should be done or not be done. The SEC case rests on "materiality" and disclosure. We shall see. Hopefully the flames will not be fanned by someone seeking political fame and high office. This scapegoating witch hunt is bad enough.

"What the heck. Posterity can pay."

We are of the opinion that the bull market in equities is intact, in spite of the foregoing, but that a pause in the heretofore relentless upward move is likely. More clarity regarding outcome may be required for the market to progress forward given the crises of the two "G's" along with the Chinese efforts to quell property price inflation that for some recent months and in some cities has run as high as 20% per month. So far, Chinese efforts have seemed to mostly spill over to the equity markets.

We thank our clients for their support and equanimity in the current environment.

Very truly yours,

Alan T. Beimfohr　　　　　　　　John G. Prichard, CFA

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