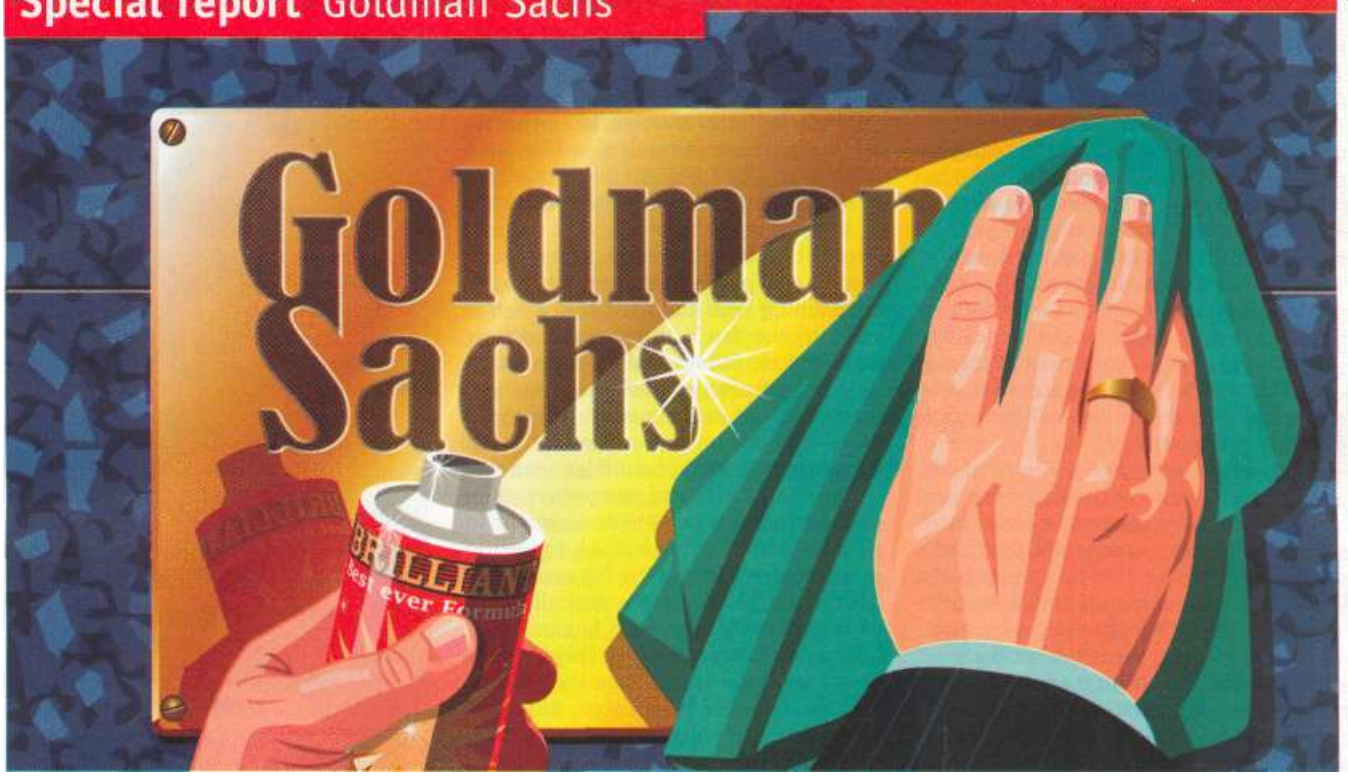


# Behind the brass plate

NEW YORK

**An investment bank's magical hold at the summit of its industry**

SHAREHOLDERS who attended Goldman Sachs's sixth annual meeting as a public company on March 31st had two main reasons for wanting to be present: to express thanks for Goldman's ability to produce vastly more profits than anyone ever imagined possible; and, if they were really lucky, to gain some new insight into how that success was achieved.

The secret of Goldman's success is the stuff of constant speculation, above all among the investment bank's competitors, none of which has come close to matching its sustained record of superior performance. Back before Goldman went public in 1999, the firm was looked upon with a certain awe—a secretive, private partnership, the last truly large such entity in American finance, that consistently minted money without having to disclose anything. In 2006, despite public filings that are so large they can be more easily measured in weight than in pages, Goldman Sachs remains just what it was in 1999, only more so: it is a hugely profitable enterprise—return on equity during the first quarter of this year approached 40%, notwithstanding a compensation scheme for employees that would make the old partners jealous; and it remains something of an enigma.

Over time, that enigmatic quality has only increased, defying predictions that the greater transparency supposed to accompany going public would reveal to the world Goldman's secret formula. In part, this is deliberate. Its primary source of profit has shifted from banking to trading, and the firm is intentionally quite vague about how, and precisely where, those trades are made or, equally relevant, from whom the profits are coming. One line in its accounts, "fixed income, currency and commodities" (referred to as FICC) accounts for a huge chunk of revenues (see chart i) and this is because...well, no one outside Goldman knows exactly why.

Adding to the fog, the Goldman that exists today is quite different from the one of a decade ago, when its results were opaque but its operations were primarily American, with an emphasis on standard investment-banking services such as underwriting, brokerage and merger advisory. Today, non-American revenues are growing particularly fast and should exceed 50% of the total before long. More than a third of the firm's profits come from activities that either did not exist at the time of the public offering or were too small to matter. Inevitably, these businesses, such as derivatives, brokerage for hedge funds, swapping power-plants, and the like, are hard to understand and harder still to predict.

Goldman is more dependent on trading for its profits than most of its rivals. It puts more of its capital at risk. Today's business focus increases the importance of managing conflicts of interest with its customers to unprecedented levels. So far, Goldman has been remarkably adept at avoiding the snares that have caught its rivals. But it should not be taken for granted that Goldman will remain Wall Street's number one.

There is a certain irony that one of Goldman's great strengths is its expertise in arranging mergers. One of its wisest decisions has been (largely, but not entirely) to evolve organically, rather than following industry fashion, as with its nearest rival, Morgan Stanley, which chose to merge

**Spot the growth** 1

Goldman Sachs's performance

$bn, revenue

| | 2001 | 2005 | CAGR* 2001-2005, % |
|---|---|---|---|
| Investment banking | 3.84 | 3.67 | -1.1 |
| Sales & trading | 9.99 | 14.13 | 9.1 |
| *Fixed income* | *4.05* | *8.48* | *20.3* |
| *Equities* | *5.94* | *5.65* | *-1.3* |
| Securities servicing | 1.13 | 1.79 | 12.2 |
| Principal investments | -0.62 | 2.23 | na |
| Asset management | 1.47 | 2.96 | 19.0 |
| **Total** | 15.81 | 24.78 | 11.9 |

Source: Boston Consulting Group

*Compound annual growth rate

with Dean Witter in 1997. Instead, Goldman has recently evolved mostly in ways that involve taking on far more risk. This is not immediately obvious. As Goldman's profits have increased, its credit rating has too. Not once since its public offering has its return on equity slipped below 10%, a stunning accomplishment given years in which equity markets tumbled, underwriting evaporated, the economy seemed briefly to go into recession, and the September nth attacks brought down two skyscrapers just blocks from its headquarters. Even so, the firm's balance sheet, strategy and reputation are all becoming steadily more stretched.

One of the attractive qualities of old-fashioned investment banking over most other businesses was that, as a pure intermediary between companies that had a need for money and investors that had a need for return, demands for capital were minimal-desks, telephones, and a bit of money to support securities for the brief time it took to transport them from the issuer to the holder. Goldman had long been a bit different, because it put its own capital at risk in a successful arbitrage desk. But its recent evolution has pushed this need for capital into the stratosphere.

**Fingers in every pie**

These days, Goldman applies capital not only to what has traditionally been perceived as proprietary trading—punts on the market—but to other businesses as well. Some of these, such as executing trades for clients in return for a commission, used to have no risk at all. With increasing frequency, investors no longer want a straight broker. They want someone to take on the risk of the transaction, and that someone must put up money and possibly suffer losses or make an outsized gain. For a firm that is in a position to see what is going on in the markets, and Goldman through its various trading entities touches about one-third of all the share trades in America's financial markets, this can be an excellent business. But bad things occasionally happen.

Goldman's public offering was delayed because of the implosion in 1998 of Long-Term Capital Management, a heavily leveraged hedge fund, and the resulting financial chaos. In the aftermath, it vowed to bring down its financial risk, but it has since risen almost back to its peak. Similarly, over the past two years, Goldman's "value at risk", or the amount it can lose in a really bad (but not really, really, really bad) day has risen strongly. And for all its trading prowess, even Goldman does not make money all the time. Its trading desk has more "losing days" than any of its Wall Street rivals (see chart 2).

Recent years have not been kind to the standing of investment firms. No company talks about ethics and principles more than Goldman, and scanning headlines it is easy to believe that Goldman has avoided the scandals that have besieged its rivals. In truth, its success has been relative, not absolute-a result of brilliant public relations, the egregious follies of others, and, possibly, particularly good lawyers.

In Goldman's latest lok, a filing to the Securities and Exchange Commission, there is a lo-page densely written chapter on pending legal claims that is a list, of sorts, of the firm's stupid underwriting, questionable moves and ongoing actionable risks (meaning there are probably many more at earlier stages), tempered a bit by the reality that any wealthy firm faces extortion from plaintiff lawyers.

From a purely legal perspective, none of these claims is likely to do Goldman in, nor for that matter hurt it much. Indeed, legal settlements favour the big established firms because they have typically been structured to cause a bit of financial pain but no permanent damage. Only big firms have the resources and experience to provide the requisite compliance. But might these claims, if substantiated, put off clients? Should they?

One of the great concerns at the time of Goldman's offering was, appropriately enough, the pressure of meeting quarterly earnings from Wall Street. The fear was that these would shift its approach from, in the famous phrase of its former leader Gus Levy, "greedy, but long-term greedy," to the more conventional sort that could destroy its standing with clients. Whether Goldman was, in fact, really different in its approach to vice, or virtue, than any other Wall Street firm is the cause of some debate, but beginning in the 1960s the bank graduated from the second-tier to pre-eminence at least in part because it was perceived by its clients as the one to trust. Symbolically, for years it advised on few hostile takeover bids.

This role has, theoretically at least, become increasingly tenuous as Goldman has moved from being mostly an agent (as an underwriter) to a principal, as a trader and direct investor. Inevitably, in setting a price either for a security or a company that it might buy or sell, Goldman is no longer looking after only its client's interest. Indeed it has become harder to distinguish between who is a Goldman client and who is a Goldman competitor.

Examples abound. Would General Motors be better off if Goldman had merely sought out a buyer for the property arm of its financing operation, instead of itself joining the buy-out group, as it recently did? The bank cites numerous times when it advised on a deal and then provided a hedge of some sort that immunised the buyer from a risk. Presumably from the buyer's point of view, Goldman's profit from the hedge (which is often the most lucrative part of the deal) is irrelevant, except


that it means Goldman as an adviser was not looking out only for the client. Is this bad? It is a matter of judgment.

In terms of its investment banking, Goldman now finds itself on so many sides of a deal simultaneously that the mind boggles. Goldman's merchant-banking arm competes with clients (and counts them as customers), and its proprietary arm may trade against them. At the same time as it represents a firm, it could be shopping it for sale, attempting to buy it itself, or competing for an acquisition on behalf of another client. Occasionally-but only occasionally—these roles become so apparent that the conflict becomes public.

**Interesting conflicts**

The most cited example is its role in the recently completed merger of the New York Stock Exchange and Archipelago, where it represented both sides while having an ownership stake in one, an ex-chief operating officer on the other, and an underlying business (trading) which had customers whose interests in competitive markets potentially diverged from Goldman's own interest in consolidation. In America this is considered banking nirvana-fees from all sides and clients who, mostly, do not recoil. Elsewhere these kinds of conflicting interests come with costs. In Britain several unsolicited offers from Goldman's private-equity group have cost it at least one customer and caused a flap. In Japan a series of successful direct investments by Goldman has caused its standing in merger advisory to plunge as companies shy away from sharing information with a possible bidder.

• This aggressive approach is thought to have contributed to a minor regulatory complaint that, in turn, led to the cancellation of Goldman's contract as the sole non-Japanese firm distributing funds through the country's massive postal savings bank.

Mostly though, Goldman's formidable reputation works in its favour. One of its fastest-growing businesses has been proprietary asset management, an area it once avoided out of concerns that it would create conflicts with the institutional money managers who were prized clients. Goldman argues that the business offers genuine advantages. Clients can join in merchant-banking deals that would otherwise be unavailable, and have access to hedge funds.

This assumes, however, that Goldman does a good job. The proof that it does, according to Goldman, is that assets under management have grown ten-fold over the past decade, and now approach $600 billion. Its mutual-fund business, the only part that provides public, verifiable results, has expanded from $5 billion in 1996 to $37 billion now, according to Financial Research Corp, a Boston-based fund tracker. Typically, such growth is driven by performance, but Goldman's results, as evaluated by Morningstar, which analyses funds, are distinctly mediocre, with fees slightly above average, and the wide disparity of individual returns that is common among sales-oriented brokerage firms (which throw up all manner of offerings, hoping a few will stick). A hedge-fund tracking service says this is broadly true in what it sees as well, but-a crucial caveat—it does not see everything and Goldman, for regulatory reasons, can legitimately say it is prohibited from publicising its own results. A few of the bank's funds or investment partnerships might have done particularly well and explain why it has attracted so many assets. But it is also possible that Goldman's growth is a bit of Oz, a magical name obscuring something far more ordinary behind the curtain.

The same sort of issues arise in Goldman's equity research, a product that is often considered the public face of underwriting acuity. In an annual poll by Institutional Investor, Goldman ranks as mediocre. Many investors contend it is no more compelling than the research put out by any of the big banks and is not as good as that of more specialised firms, notably Bernstein. Company executives, however, who have privileged access to Goldman's analysts and bankers, say they have high regard for their research.

And, as is always with Goldman, there may be more behind the curtain. One management consultant recalls offering a chief executive a detailed analysis of a firm or industry. The consultant said that his firm could do a superb job in two months. The executive said he could call Goldman in the evening and get an excellent report the next morning. This kind of research is not available on its website.

All of which goes to what Goldman has long contended is its chief strength-its employees. The bank is an unusually selective institution. To get hired at Goldman requires surviving extraordinary vetting. The 200 or so business-school students who arrive every year begin by submitting a cv. A small fraction win interviews, a tiny fraction survive the first round, and another 10 rounds may follow. To encourage the widest pool, every senior manager takes part in recruiting, paying two visits to a top university, the definition of which has broadened from the best known to places with predominantly black students and overseas colleges. Candidates from unusual backgrounds or with unusual circumstances can receive extraordinary scrutiny. Suzanne Nora Johnson, a vice-chairman, was hired from a law firm after 150 interviews, which if not a record should be.

**Hank's come hither**

Once an offer is made, an intense seduction follows which, if acceptance is in doubt, can include a telephone call from Hank Paulson, Goldman's chief executive. Increasingly, other investment banks have copied the intensity of Goldman's efforts.

Once hired, the intensity may actually increase. Everyone at every investment bank works hard, but people at Goldman are reputed to work at least as hard, maybe harder. Intense loyalty and commitment are required. Internal voice mails are routinely sent out to vast groups of people with the expectation that all will be returned-fast. At Goldman, a request from another division asking for an insight, a contact or some other form of help is not to be ignored. To see a Goldman employee on the street is to witness someone listening to voice mails or pounding a BlackBerry, often to another Goldman employee. This is broadly true for a fair part of New York, but at Goldman the communication demands seem more extreme.

At the time of Goldman's share offering, there was deep concern that without the lure of partnership, the junior bankers would flee to more lucrative firms. Departures began even before the first trades in Goldman's shares settled and have continued ever since. Hedge funds and private-equity industries are seeded with precisely the kind of former Goldman employees that no firm could possibly want to lose-intense, energetic, and entrepreneurial, with strong client relationships.

However, the ebb of successful money managers from the bank's proprietary trading operations to hedge funds has often been accompanied by their decision to use Goldman as their broker, or to provide Goldman's clients with preferred access to their funds. Few of its leading employees have moved on to work for the other investment banks. To have Goldman on a cv is, often enough, to be in demand. A head-hunter says the first challenge is to convince someone from Goldman that anywhere else is not a step down.

And there has been no shortage of people who want to stick around. Goldman operates as a strict hierarchy, with a fair number of its 24,000 employees aspiring to be chosen as one of the 1,200 managing directors, who in turn aspire to be among the 300 "participating" managing directors, in essence partners with a slice of the profits. The selection is not always fair, suffering from the usual politics and whatever other flaws that beset every company, but it is a potent managerial tool. Elevations occur every other year, with one due this autumn.

Less visible, in preparation for the process, are what essentially amount to demotions. The level of "participation" enjoyed by one of the top 300 may be thinned according to his contribution to profits. Often enough, someone important is quietly asked to leave. This is one of Mr Paulson's most critical roles. He apparently does it well enough that word rarely leaks out in the firm. Sometimes even the person being dismissed is unaware they are being forced out—there is a brief discussion about a more interesting future.

Typically, senior Goldman employees are on several charitable boards and, invariably, there is a lot of personal wealth to be invested, given away, or, after a lifetime in an office, spent on something grand. Goldman, says Mr Paulson, is a hard place to be hired, a hard place to be promoted and a hard place to stay. And if you want an explanation of how Goldman endures, that, perhaps, is the best explanation of all. •

Fonte: The Economist, v. 379, n. 8475, p. 71-73, 29 Apr. 2006.