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## **The Goldman Mess**

*What we think really happened*

While the civil action announced by the SEC on Friday will create some major legal issues for all the large banks and brokers, the impact on our portfolios and the overall market should be minimal.

Still, understanding what happened might be of interest to some clients, as it is to us, so for those who want to know more---read on. (we're hoping that many of you have better things to do!)

The \$1 billion CDO in question was "synthetic"---in other words there were no mortgages or mortgage securities inside the instrument. Just like a futures contract, this CDO was merely a contract between two parties taking the opposite side of a bet---in this case, whether certain mortgages would payoff or go bust.

The futures contract analogy is key to understanding this transaction. When you want to "go long" (or buy) wheat for example, the broker needs to find someone to go short (or sell) so that a new contract can be created. This happens thousands of times each day, and it's been going on for over 100 years.

The new wrinkle added by Goldman and others was to apply this model to the trading of mortgages.

Goldman had buyers (in this case a German bank) who wanted to invest in the US mortgage market. They believed that house prices would stabilize or rise later in 2007. Paulson, the hedge fund operator, wanted to bet on a fall in housing prices. He called Goldman and said as much and suggested a list of mortgage securities that could be mimicked in a potential CDO.

All parties in this transaction could only be described as highly sophisticated. The German banks who wanted to buy more US mortgages wanted a short-cut to the harder work of finding actual mortgages and so were receptive to the Goldman solution of a "synthetic" alternative.

The alleged fraud involved not telling the German's that Paulson wanted to take the other side of the bet. However, Paulson did not become a well known figure until 2008, when his winnings from bets like this one netted his partners over 300%. If the Germans had been told that Paulson was betting against them, their most likely response would have been, "Who?"

The main point is that sophisticated investors entered into this transaction with strong opinions about the future of US housing. If house prices had continued to rise, Paulson would have lost \$1 billion instead of making it. Goldman apparently thought Paulson's negative view was wrong since they invested with the Germans and lost \$90 million in the process.

DOCK STREET ASSET MANAGEMENT

Individual investors should focus on only two points: 1) firms such as Goldman are very risky investments since no one really knows what they are doing to make a buck, and 2) being a client of Goldman (or any large bank) bears no resemblance to being a client of Dock Street. The second point needs some explanation.

Seventy percent of Goldman's business is trading the firm's capital. It would be as if Dock Street had its own stock portfolio, which was twice as large as the capital we invest for clients. Would we behave differently if that were the case? Would our clients get the same attention they get today? If we wanted out of a stock, would our clients be the buyers?

These thoughts and others are on the minds of Goldman clients today. Dock Street clients can at least take all this off their list of worries.

We keep things simple and clear. Our sole source of revenue is the fees we earn from managing client assets.

Best regards,



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