

## Seeking Financial Collapse

### Telling Half the Story

**Richard X. Bove**

Vice President Equity Research  
Financial Sector

[rbove@rochdalesecurities.com](mailto:rbove@rochdalesecurities.com)

813.909.1111

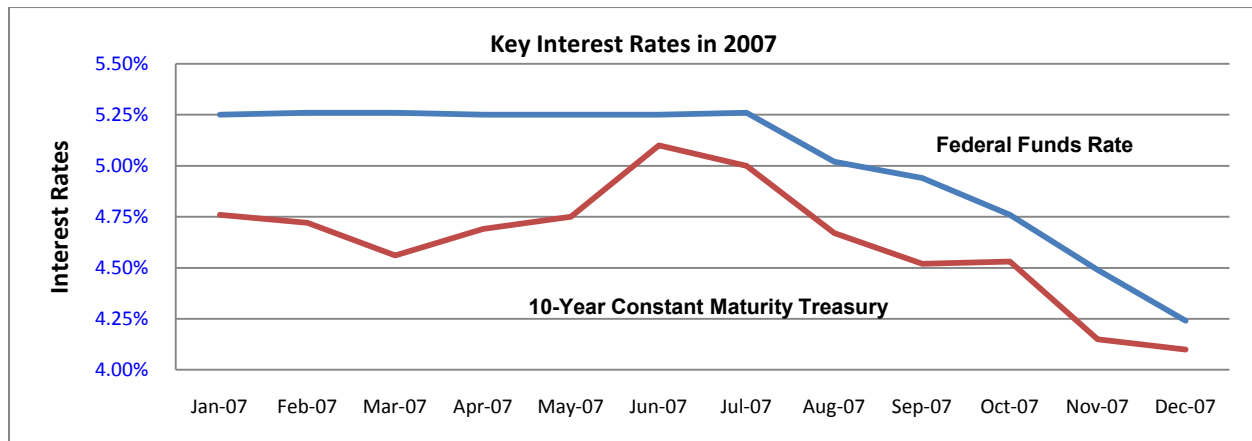
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Neither I nor, I believe, Rochdale Securities own Goldman Sachs stock. I do not do business with the company. Rochdale does not have what would be described as a congenial relationship with Goldman Sachs. Thus, there is no need for me to make positive statements about that company. I mention this because I am trying to present a balanced view of the Goldman Sachs issue so I can discuss the broader point about psychology and the markets.

### The Balanced View

#### Buyers

In 2007, the constant 10-Year Treasury to Federal Funds yield curve was inverted and rates were declining for most of the year.



This presented a problem for large institutional investors, notably pension funds. These funds needed to purchase instruments with high risk adjusted returns to meet their actuarial assumptions. If they did not reach their goals the companies sponsoring these pension funds would be forced to make cash injections into the funds.

In essence, if the pension administrators could not find high yield vehicles the sponsoring company's earnings would have been pressured by the need to increase benefit/compensation costs. This led institutions to seek instruments that provided what was hoped to be safe high yielding returns.

The synthetic derivatives market was believed to be an ideal place to create such securities. By working with investment banking firms the pension funds could attempt to fashion high yielding securities that they deemed to be safe by using proxy sub-prime mortgages. The demand for this type of product is believed to have run into the tens of billions of dollars.

#### Sellers

At the same time, there were growing convictions among other market participants that the housing market was overheated and that there would be a collapse in mortgage related securities. In August 2005, when I was in the employ of Punk Ziegel (since acquired by Ladenburg Thalmann) I wrote a comment entitled "This Powder Keg is Going to Blow." Those parties believing the markets were going to collapse also wanted to create synthetic securities that they could sell, using sub-prime mortgages as proxy securities.

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### Market Function

Thus, ideal conditions were in place to create a market in synthetic securities that would meet the needs of both the buyers and the sellers. Since the market was in synthetic securities it was oriented to large, supposedly, sophisticated investors. By definition these investors, on both the buyer and seller sides of the markets, were deemed to know what they were doing.

Goldman Sachs (GS/\$160.70/Buy) apparently created the desired securities to meet the demand of both sides of the markets. Presumably, numbers of other firms did the same.

### **Securities and Exchange Commission (SEC) Lawsuit**

Let me make another disclaimer here. If it is discovered that Goldman has broken securities laws the company should be severely punished. However, I am not sure that the firm broke any law based on the information provided in the SEC civil suit.

The SEC does not believe that Goldman made proper disclosures in the creation of one of these synthetic securities. It believes that the firm willfully concealed information that would have apprised the buyer of the great risks in purchasing the security in question. Moreover, the SEC feels that Goldman made misrepresentations to sell the product. Therefore, in a civil, not criminal action, it is suing Goldman Sachs for fraud.

Goldman Sachs argues that it was not involved in any wrong doing and it will contest this action in the courts. I am not a lawyer, but it would appear that Goldman may have a relatively good position in this case. This was not a retail product sold to unsophisticated investors. This was a product in high demand by sophisticated investors. The best example of this is that sophisticated investors bought billions of dollars in this and other like instruments.

Moreover, it appears that the SEC is promulgating new standards with this lawsuit. One wonders if the SEC could have created new regulations rather than suing Goldman Sachs to achieve the same result.

### **Market Reaction**

In a land where everyone, particularly those on Wall Street, is guilty of everything that they are charged with, the revelation of this lawsuit created a resounding demand for justice. The price of Goldman Sachs stock fell by \$23.57 per share to \$160.70 per share in a few hours. The decline in Goldman stimulated a sell-off in all financials and this in turn brought the market down by 1.13% or 125.91 points.

The decline in other financials was due to comments by the SEC which seemed to indicate that there are other participants who may be sued for similar infractions. Whether these comments were made to inform investors that others were in fact likely to be sued or for political purposes to produce a punitive banking bill is unclear.

### **Think Back**

Just 20 months ago, a similar frenzy was created around the nation's banking system. Nobel pundits, Senators and Congress people, the press, analysts, and investors continuously proclaimed that the banking system was going to fail. The frenzy created caused lenders to withhold their funds and this in fact precipitated a systemic collapse.

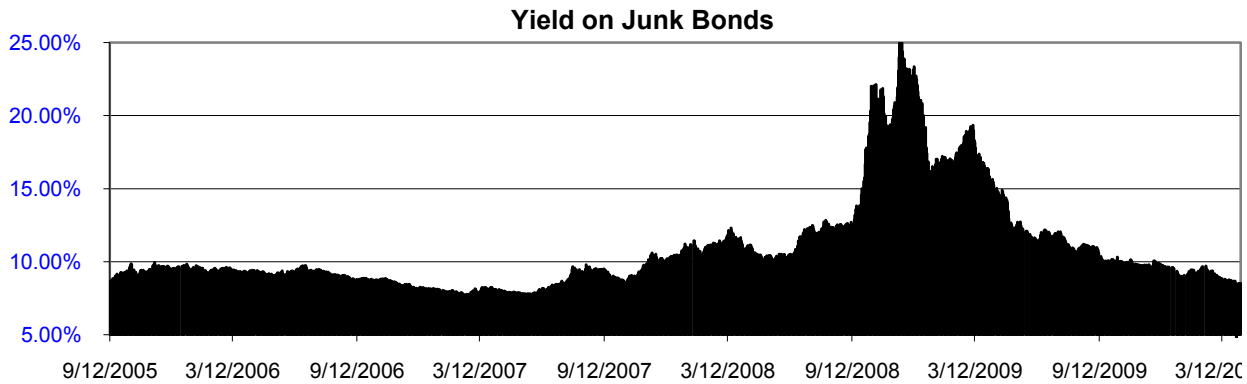
Once confidence was restored in the system by the bold and decisive actions of the government, it became evident that the money was available to keep the banking system going. In fact, most of the money the government extended to the banks was paid back with a sizable profit. What was revealed by the events following the crisis is that despite the staggering losses suffered by the financial system due to imprudent lending, there were enough funds in the system to deal with the problem.

The critical issue in getting the money to solve the massive problems was not whether the funds existed to do this. The money was there. The key was investor and lender psychology. When lenders and investors believed the system would fail they withheld their funds (Mr. Gresham would understand perfectly what happened) forcing the government and the regulators to inject their money. Funds poured back into the system keeping it solvent when holders of these funds became convinced that their money was safe.

Note the change in the yield on junk bonds, on the next page, as a support for this view.

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When investors were frightened, the yield climbed above 25.0%. It has now plunged to under 8.5%. The difference was not driven by alleviation in loan losses. They continue to grow. It was not the result of a surge in money supply. Despite Fed actions, it appears that the real money supply is actually declining. The difference is psychology -- pure and simple.



### Death Wish

Yesterday, the creators of the national psychology were doing their utmost to crash the system again. The President made a strong statement condemning derivatives. The SEC implied more lawsuits were coming against the nation's largest banking companies. The media pounded on Goldman Sachs telling only half of the story. Legal pundits weighed in on the horrors created by Goldman Sachs and other financial companies, and, Gresham-like, investors fled these stocks.

There seems to be a concerted effort once again, by all supposed responsible parties, to prove to Americans that the financial system is corrupt, and that Americans cannot be treated fairly by dealing with it. No one has apparently learned that if all interested parties join together in condemning the financial system it will collapse. The stage is being set another bone chilling crisis.

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**Rochdale Securities LLC**  
**750 E. Main St., 7th Floor**  
**Stamford, CT 06902**  
**Main 203.274.9100**

### Management

### Trading

**Dan Crowley**  
 President  
[djc@rochdalesecurities.com](mailto:djc@rochdalesecurities.com)  
 203.274.9101

**Kevin Cassidy**  
 Senior Vice President  
 Chief Operating Officer  
[kjc@rochdalesecurities.com](mailto:kjc@rochdalesecurities.com)  
 203.274.9116

**Kris Talgo**  
 Senior Vice President  
 Trading Co-Head  
[klt@rochdalesecurities.com](mailto:klt@rochdalesecurities.com)  
 203.274.9125

**Hal Tunick**  
 Senior Vice President  
 Trading Co-Head  
[ht@rochdalesecurities.com](mailto:ht@rochdalesecurities.com)  
 203.274.9124

### Analyst Team

### Merger Arbitrage and Special Situations

**Richard X. Bove**  
 Vice President Equity Research  
 Financial Sector  
[rbove@rochdalesecurities.com](mailto:rbove@rochdalesecurities.com)  
 813.909.1111

**Jaison Blair, CFA**  
 Sr. Equity Research Analyst  
 Retailing  
[jblair@rochdalesecurities.com](mailto:jblair@rochdalesecurities.com)  
 203.274.9161

**Hayley B. Wolff**  
 Sr. Equity Research Analyst  
 Consumer - Leisure  
[hbw@rochdalesecurities.com](mailto:hbw@rochdalesecurities.com)  
 203.274.9160

**Barry D. Kaplan**  
 Merger Arbitrage and  
 Special Situations  
[bdk@rochdalesecurities.com](mailto:bdk@rochdalesecurities.com)  
 203.274.9121

### Institutional Sales

**Keith Arnott**  
[jka@rochdalesecurities.com](mailto:jka@rochdalesecurities.com)  
 732.758.6981

**Trey Bauer**  
[tbauer@rochdalesecurities.com](mailto:tbauer@rochdalesecurities.com)  
 203.274.9137

**Richard Bennett**  
[rbw@rochdalesecurities.com](mailto:rbw@rochdalesecurities.com)  
 732.758.6982

**Joseph Bove**  
[jab@rochdalesecurities.com](mailto:jab@rochdalesecurities.com)  
 813.963.2999

**Patrick Burke**  
[prb@rochdalesecurities.com](mailto:prb@rochdalesecurities.com)  
 203.274.9127

**Pete Doehla**  
[pkd@rochdalesecurities.com](mailto:pkd@rochdalesecurities.com)  
 203.274.9128

**Allen Jordan**  
[anj@rochdalesecurities.com](mailto:anj@rochdalesecurities.com)  
 203.274.9120

**Andy Massey**  
[apm@rochdalesecurities.com](mailto:apm@rochdalesecurities.com)  
 813.963.2888

**David Miller**  
[dmiller@rochdalesecurities.com](mailto:dmiller@rochdalesecurities.com)  
 203.274.9131

**Niall Morrissey**  
[nmm@rochdalesecurities.com](mailto:nmm@rochdalesecurities.com)  
 203.274.9130

**Richie Oddo**  
[ro@rochdalesecurities.com](mailto:ro@rochdalesecurities.com)  
 732.758.6988

**John Ratkoski**  
[jratkoski@rochdalesecurities.com](mailto:jratkoski@rochdalesecurities.com)  
 732.758.6986

**Kristen Talgo**  
[klt@rochdalesecurities.com](mailto:klt@rochdalesecurities.com)  
 203.274.9125

**Hal Tunick**  
[ht@rochdalesecurities.com](mailto:ht@rochdalesecurities.com)  
 203.274.9124

**Jeff Wicker**  
[jdw@rochdalesecurities.com](mailto:jdw@rochdalesecurities.com)  
 925.253.1030

### Fixed Income Division

**Michael Glover**  
[msg@rochdalesecurities.com](mailto:msg@rochdalesecurities.com)  
 212.205.5080

**Brandon Dunn**  
[btd@rochdalesecurities.com](mailto:btd@rochdalesecurities.com)  
 212.205.5080

**Craig Bonder**  
[csb@rochdalesecurities.com](mailto:csb@rochdalesecurities.com)  
 212.205.5080

**Brett Houghton**  
[bth@rochdalesecurities.com](mailto:bth@rochdalesecurities.com)  
 212.205.5080

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BUY 23  
HOLD 48  
SELL 29

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**Buy** Company has demonstrated that it is a value creating concern; the return on capital (as adjusted) exceeds its cost of capital. Stock is currently trading in a range that does not exceed its intrinsic value. Stock is expected to out-perform the market over the next twelve months.

**Hold/Neutral** Company either is not creating value (i.e., its costs exceeds its return on capital) or it is trading at a price equal to or in excess of its intrinsic value. Expectation is at best stock will perform in-line with market. If not currently held, the stock should be avoided.

**Sell** Company's cost of capital exceeds its return on capital; and the company has no intrinsic value or is trading at a significant premium to its intrinsic value. Expect stock to under-perform the market over next twelve months.

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-- Richard X. Bove