

# **“Goldman Sachs – The Dark Side of Capitalism is Sometimes Unethical but Necessary”**

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The US Government is taking legal action against the top financial institution in both the US and the world. Is Goldman guilty or not? My opinion: what Goldman did was unethical and distasteful, but it wasn't illegal. Furthermore, without its attitude, capitalism in its current form cannot survive.

What are the truths on which we can all agree about the Goldman Sachs case?

- First, here can be no doubt that it developed mortgage instruments that were designed in part by a hedge fund that would profit if these instruments failed
- Second, there can also be no doubt that the Goldman Sachs people knew that these instruments might produce big losses for investors in these funds.
- Third, there is also no doubt that, as a result, Goldman Sachs profited massively from the failure of these funds because of its strategy to simultaneously bet against them. In other words, it was playing both sides of the deal.

Let's look at some other, no-less important truths:

- Goldman did not make people want mortgage assets. They wanted them with or without Goldman Sachs and would have bought them from other investment banks even if Goldman Sachs did not sell them. Furthermore people actually did buy the exact same types of financial instruments from other investment banks and also lost money with the exact same instruments with these other investment banks.
- Goldman people did not know that these instruments would produce losses. They were simply making a big hedge in case they did. Many Goldman Sachs people did not think they would fail, and the vast majority of investors, government regulators, and hedge funds that bought them also thought they would not fail. All the people who bought these funds were sophisticated investors who made their investments in the full knowledge that they could lose their investment. In other words, Goldman Sachs was simply selling what people wanted to buy. In this it was acting in exactly the same way as all the other US and foreign investment banks. However Goldman was the only one to employ a sophisticated hedging strategy which protected it against failure of these funds in the event that this actually happened.
- Goldman's profits made it one of only two (the other was JP Morgan) US investment banks that did not require massive US government bailouts and helped shore up a US banking system that would otherwise have failed. Without Goldman the chances are that the US banking system could have totally collapsed.

The government is saying that the Paulson hedge fund, that helped Goldman create the mortgage fund CDOs (credit default options) had a conflict of interest since it was short the

mortgage market and therefore had an interest in constructing a fund that would decline in value. However the government is not saying that it had the intention to do this, merely that it had a conflict. This is a problem for the US government. Wall Street is rife with conflicts of interest ranging from the companies that actually rated the securities such as Standard and Poor's to investment banks that short the stocks of their clients. These types of potential conflicts of interest are routine not only in the US but in the rest of the world. If the US government really wants to stop these conflicts of interests, it is really saying that it has to change the way capitalism works. We will have more to say about that particular issue later.

Investment banks such as Goldman exist for a number of reasons. First they exist to help their clients make money and to protect their clients' investments, however they have to do it. Secondly they exist to make money for their investors, shareholders and partners. It is possible that Goldman had a conflict since it was betting against its clients in order to make money for its investors and partners. Yet that is routine for all companies that must constantly choose between their level of profitability and the benefit they pass onto their customers, shareholders and investors. If Goldman was guilty of this sort of conflict then so is just about every other company in the world, whether they be investment banks or otherwise.

But in any case Goldman did not bet against its client because it had the intention of defrauding them. Goldman clearly had the intention of taking a position on the other side of the deal to protect its position in the event that the market declined. In other words, it was protecting its position so that it would not lose money if it was wrong.

In the event, it did prove to be wrong, the market did indeed turn against it, and its mortgage fund therefore lost huge amounts of money. But its foresight in going short the fund had the intended impact of protecting its overall position. Goldman employed a strategy that every other investment bank, mutual fund and financial institution in the world uses, that is, short bets to hedge long positions. It made money simply because it bet against the market because it was hedging its bets. If its bet had gone bad it would have lost money just like other investment banks. Then the government, Goldman's investors and partners would have complained that it was foolish in making such a stupid fund. Instead Goldman took the wise step of hedging its position. If other investment banks had taken such an approach it is quite possible that the US financial system would not have been in the tragic position it found itself in later.

An investment bank is a marketmaker. A marketmaker is an agent that creates, maintains, supports, and often saves markets. Often marketmakers have to risk their own money by taking losses so that it supports the market when it cannot maintain itself. By doing this, a marketmaker helps save the market from excess swings, short-term losses that could have been avoided, and it provides the market with liquidity, predictability and as much safety as possible for investors and market participants.

Any marketmaker must routinely go short in the market as well as going long in order to protect and support the market. Often a marketmaker will bet against not only its investors and partners, but also against itself in order to provide the trading stability and liquidity to maintain the markets as a safe place to be. Going short-long is routine for a marketmaker and it was routine for Goldman and all other investment banks at the time and it still is a routine strategy for financial institutions across the world today. The strategy that Goldman took in hedging its mortgage fund was normal and routine and indeed very wise. Goldman was simply being a good marketmaker, trying to provide the best possible framework for participants in the market, to hedge against it either going up or down excessively.

The US Government alleges that Goldman kept its investors in the dark by not telling them about Paulson's interest in a market decline and about the fact that it itself was short the market. But by

its nature a marketmaker cannot tell others of its hedges otherwise these strategies would not be effective and the nature of its investment offering would have to change dramatically. Secrecy is crucial to be hedging operations of a marketmaker otherwise other market participants will see what it is doing and then its strategies will become ineffective.

What people may see as being wrong in secrecy is actually a crucial part of being a marketmaker. If I buy a stock I can elect to keep this a secret so that my competitors are not aware of my possibly winning strategy. If I build a new product, I keep this a secret so that my competitors cannot copy me. Competitors in all markets know that secrecy is a key part of doing business. If the US government wants to ban secrecy in competition this might be a legitimate goal. However it is also a goal that would fundamentally change how capitalism works and it is, in any case, unlikely to be one that will be supported by many people.

The fact is that making a market requires that marketmakers deal on both sides. They often bet simultaneously against their investors, and their clients and themselves. This is just the nature of the beast. It might be distasteful to many people that this happens, but it is necessary to maintain and promote modern markets and to provide them with liquidity and predictability.

The distasteful fact is that market-making often makes necessary by its very nature the taking of positions that others do not know about. It is quite possible that some may see this as being unethical, as the US government obviously feels it was. But being unethical does not mean that an activity is illegal or even wrong. There are millions of people in both the US and China who engage in trading that some may see as being unethical that is not illegal or even wrong. We must face the unwelcome possibility that there is indeed a conflict between ethics and efficiency in the markets and that sometimes efficiency must win. Otherwise capitalism as we know it must end.

Fundamentally the Goldman issue presents us with a choice. Do we want an ethical society in which there is no financial innovation or even efficient market functioning or one which allows financial innovation, market efficiency and hedging in ways that many people find distasteful and some think should be made illegal? That is a question I can't answer. But it is one on which the US government has just taken its stand. It has opted for ethics rather than efficiency. It might even be right. But we need to understand the implications of the choice for our financial systems and the way of life that modern societies have chosen.

I have no problem for choosing the ethical route. But I do note that you can't have your cake and eat it too.

That is the issue with Goldman.

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