

Thought for the Week, April 19th, 2010

Goldman Sachs Fraud Surprise

On February 18, 2010 we bought Goldman Sachs (GS) in our equity biased portfolios. Our analysis showed it to be **the best financial company in the world** with respect to business model and balance sheet strength. It was just too cheap to be ignored. JP Morgan was second on our research list!

Since that time, it appreciated well, rewarding us with an 18% appreciation, beating even the S&P 500 Index, as shown below. Our approximate purchase **price was \$154**.



Today, the SEC announced an investigation into Fraudulent Activity at Goldman Sachs (<http://finance.yahoo.com/news/Goldman-Sachs-charged-with-rb-2893620804.html?x=0>)

This took us completely by surprise – imagine that, we don't know everything! As soon as we saw the news, we sold our positions at an approximate **price of \$165**. It closed at \$160.

Do we think it might recover as the story surfaces: we don't really consider this as they have now **failed our High Quality Test**. Investors can run around buying attractive stocks, but they must be aware of the risks – sudden dramatic risks such as this.

Our risk analysis attempts to highlight and **disregard companies with a tendency for negative news or earnings events**. These are generally the companies with the most risk of 'Blowing Up'.

Goldman Sachs illustrates two points, in our opinion:

1. We aim to **invest in the highest quality companies**; this type of surprise disqualified a company from inclusion in our portfolios.
2. To add value to a client's investment portfolio, you should be **watching 'The Screens' and data flows every minute of every day**.



In our opinion, the investigation has an element of political motivation. If Goldman was allegedly misleading investors in this way, it's fair to say the **other investment banks might have been doing something similar**.

While we are heartened that the **regulatory bodies are prepared to 'Show some Teeth'** to one of the 'untouchables', it will be interesting to see just how deep their bite is!

We also felt that **Goldman may have been preparing to go private** – this will obviously have a bearing on the timing and pricing of that decision.

What Next?

- **If Goldman continues to decline**, we will have been justified in our actions and will probably look for a price where Goldman is too cheap to resist.
- **If Goldman recovers quickly**, we will not regret our decision. We actively avoid companies that tend to negatively surprise – in our opinion they possess higher probabilities for losing capital.

We live in interesting times!