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GOLDMAN SACHS: IS IT HARDBALL OR BEANBALL?

Edward J. O'Boyle, Ph.D.
Mayo Research Institute
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The reluctant and often defensive testimony of Goldman Sachs senior managers before a Senate subcommittee on April 27 compels us to raise this critical question. Was Goldman Sachs playing hardball or beanball? Senators Levin and McCaskill for sure made it clear that by shorting the very same financial product it had designed for its clients the financial giant was not acting in their clients' best interests. Goldman Sachs was playing beanball.

Recognizing that there is nothing illegal or necessarily unethical about turning a profit in a declining market and acknowledging that these senior managers did not distinguish themselves as standup guys, Mayo Research Institute argues in the following that Goldman Sachs was playing hardball.

To explain why it was hardball not beanball, it is necessary to understand the different ways that economic agents function in product markets and in financial markets. In product markets, every person engaged in a given exchange achieves a gain. Without that gain, exchange collapses. Buying and selling typically take place under conditions of certainty and transparency to help assure that justice is served. Exchange in these markets is a positive-sum experience.

While both parties to an exchange in a financial market *expect* a positive outcome, trading takes place under conditions of uncertainty in which one party bets that the price of the traded financial product will rise and the other that the price will fall. Both cannot be right. It follows that investing, hedging, and speculating involve a gain for one of the trading parties and a loss for the other. All three activities are zero-sum experiences.

Hedgers are risk-averse; they avoid risk at the expense of the greater gains possible. Speculators are risk-inclined; they take on risk in the expectation of greater gains. Investors can be risk-averse, risk-inclined, or both.

Every exchange in product markets entails gain for the persons involved provided they are well-informed and free to act: what is gotten in the exchange (use value) is more highly valued than what is given up (exchange value). Thus, every exchange has a positive-sum outcome. Under competitive market conditions, exchange value should not vary from one person to the next. While exchange value is determined by market conditions, use value is determined by the value systems of the different persons involved in the exchange. Exchange value is an objective piece of information. Use value, on the other hand, is a subjective human experience.

When Goldman Sachs *designs* a financial product for a client, both parties experience a positive outcome. The gain for Goldman Sachs is the fee it charges for designing a product that its client wants. The gain for its client is a product that is worth more than the fee that it must pay for that product. In that sense, Goldman Sachs is acting in the best interests of its client.

Without that gain, exchange cannot be carried out. However, there must be limits to the amount of gain in order to prevent one party from taking advantage of another and to assure that market exchange serves everyone fairly and effectively and not just those with the power and will to turn gain into excess. Those limits are grounded in the duties that human beings owe one another under the principle of equivalence.

Equivalence states that buyer and seller in the marketplace have two duties: exchange things of equal value and impose equal burdens on one another. Gain is realized when use value > exchange value. Even so, justice is served only when equal value means equal *exchange* value.

When a market is reasonably competitive, exchange value normally does not fluctuate markedly from day to day and is the same or nearly the same for all buyers on the same day. Thus gain is justified when use value > exchange value restrained by competition.

A problem arises when the market does not impose this restraint, agents are free to act without restraint, and thereby realize an ill-gotten gain. Equivalence informs both parties that the only justifiable gain is one that does not deprive the other party of the gain that is rightfully his/hers. Thus gain is justified when use value > exchange value restrained by faithful adherence to the principle of equivalence in a situation where competition alone does not provide the necessary restraint.

Our attention now turns to a futures contract. Even though such a contract on the date of delivery becomes a zero-sum agreement in which the party who was right regarding the price at a designated future date wins and the other loses, justice is served provided the terms are transparent and the hedger and speculator involved are free to act. Under the principle of equivalence they are exchanging things of equal value – a clearly stated price for a clearly specified commodity or financial product -- and imposing equal burdens on one another – the uncertainty and risk involved in future price movements *over which neither one has any control*.

If, however, one of the parties has control over future prices, justice is not served because uncertainty and risk are much lower for the one who controls those prices and the controlling party is imposing an unequal burden on the other. That contract is unjust and not ethically binding.

Speculators provide an important service to daily commodity and financial product markets. Speculators, especially those who are specialists in a specific commodity or financial product such as corn or the euro focus attention on future price movements. They are in fact specialists in future price expectations who put at risk their own money on the basis of their analysis of those expectations. Future price expectations in turn influence the daily market price from both the demand side and the supply side.

When Goldman Sachs *trades* a financial product for its own account, even if it designed that product, the other party is not its client even if it actually designed the product for that party. The other party is a trader who as with all traders in a financial market must look after his/her own best interests. Thus, when Goldman Sachs designs a product it must act in the best interests of its client. However, when it trades a product it has no such obligation.

Whatever the trader's underlying purpose, buying long is based on the premise that the financial product is undervalued and will increase in price in the future. Selling short is based on the premise that the product is overvalued and will decrease in price in the future. The person selling short pockets a gain if the future price is lower and takes a loss if the price is higher. As noted with futures contracts, selling short is not unjust as long as the terms of the contract are transparent and the parties are informed and free to act. If, however, one of the parties has control over the price in the future, justice is not served because uncertainty and risk are much lower for the one who controls that price and therefore the controlling party is imposing an unequal burden on the other. The gains are ill-gotten.

Were Goldman Sachs profits in 2007 from selling short ill-gotten gains? From the testimony of CEO Lloyd Blankfein, Mayo Research Institute reluctantly and tentatively concludes that those profits were not ill-gotten. From all appearances the other traders involved were free to act, no one had control over the price, and the parties were informed as to the risks involved.

We may not like the men from Goldman Sachs for appearing to be crude, haughty, and overpaid. None of that has anything to do with the hardball/beanball question. The Goldman Sachs managers were smarter than other traders. They took a very considerable risk in betting that the sub-prime mortgage market was on the verge of collapse. They were right and won. Others were wrong and lost. Had the losers been smarter, they would have been short. Though we would prefer that the Goldman Sachs traders were smart *and* likable at the same time, we must not condemn what they did because we don't like them.

Goldman Sachs played hardball and won in virtually the same sense that any trader who years ago shorted Sears and bought WalMart understood before other traders the power of WalMart's business model. Or bought Apple when it looked like it would be crushed by the PC and Microsoft.

In politics, the hardball tactics of negative advertising and mud-slinging are accepted because they win elections. Beanball tactics that involve deliberately deceiving and manipulating the public, as in the Watergate crisis, are condemned. Political veterans know the difference from experience. It's time for them to figure out the difference between hardball in financial affairs and beanball. The success of financial regulatory reform depends on it.

Edward J. O'Boyle is Senior Research Associate with Mayo Research Institute.
Offices in New Orleans, Lake Charles, and West Monroe
www.mayoresearch.org 318-381-4002 edoboyle@earthlink.net