Fortress Goldman showing some faults

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Investment bank expected to post weak results for second-consecutive quarter, leading some to wonder whether the firm is losing its touch

Goldman Sachs GS-N has always seemed an impregnable powerhouse. But when the big Wall Street investment bank releases third-quarter earnings before the market opens Tuesday, shareholders should be bracing for disappointment.

Goldman has a reputation for usually reporting superlative results, but for the second-consecutive quarter, analysts expect weak numbers, this time owing to flagging summer trading volumes. The quarter before, earnings were hit by a $550-million (U.S.) settlement of embarrassing government charges that Goldman duped its clients about a risky subprime mortgage investment just as the U.S. housing market began to tank.

The question for investors: Are the recent spate of poor results and the damage the firm has sustained to its reputation signs that the Wall Street money machine is losing its touch? Or do they represent rare missteps, soon to be forgotten when profits recover?

Critics of Goldman contend the tony firm should really be viewed as a hedge fund that happens to do some banking on the side. In past years, its profits have depended heavily on how shrewdly its traders have rolled the dice on the firm's own investments, rather than on the more stable earnings generated by continuing banking activity.

But practically the entire analytical community is in the worst-is-over camp. Of 29 analysts that follow Goldman, not one has a "sell" rating on Goldman stock. Only four rate it a "hold" - although that number does include Meredith Whitney, one of the few analysts to accurately predict the clobbering banks took during the financial panic. Fully 25 analysts are in the bull camp, according to Bloomberg.

The bull case is simplicity itself. According to this view, while Goldman's profits are down, they're poised to recover. Earnings for the third quarter will likely be around $2.05 a share, and the figure will rise sharply to $3.49 in the fourth quarter because of the usual seasonal pickup in trading activity, says Richard Staite, a London-based analyst who follows U.S. banks at Atlantic Equities LLP.

Mr. Staite has an "overweight" rating on the stock, with a $170 target over the next 12 months. The gain, if achieved, would be a nice rise from current prices around $152. (Goldman closed Friday at $150.69.) And other analysts are even more positive, including the team at Sanford Bernstein, which projects Goldman can crack the $200 barrier.

To be sure, U.S. banks have a litany of problems, including regulatory risk, high loan losses, and the risk of lawsuits over practices before the crash. It's also harder for them to make easy profits because interest rate margins, the difference between what banks pay to borrow short term and
receive in yield from long-term instruments, is shrinking. But Mr. Staite says Goldman has the potential to weather these risks better than competitors.

"I think that Goldman will remain best in class," Mr. Staite predicts.

'Most Hated Bank in America'

Outside of the investment community, however, some market watchers take issue with the firm. Goldman, they say, has become the symbol in the United States of greedy bankers. Among the most unflattering comments is one last year from a Rolling Stone magazine story that dubbed Goldman a "great vampire squid" sucking money out of the U.S. economy. Goldman is currently fighting back through image-improving advertising.

"It's the most hated bank in America, and not just by crazy activists from the right or the left, but also within the financial sector," says Randall Wray, financial blogger and economics professor at the University of Missouri-Kansas City.

Mr. Wray contends Goldman has an unstable business model. Recently, about 80 per cent of net revenue has come from trading and principal investments. New financial reforms will place some restrictions on the ability of banks to trade for their own account.

Goldman has been playing down views that its reliance on trading is risky. Earlier this year in a presentation, the company said that over the 262 trading days from the second quarter of 2009 to the first quarter of this year, it had losses only on 11 days.

One of the biggest unquantifiable risks for the bank is whether there will be a Part 2 in the financial crisis. Mr. Wray says continuing problems in U.S. residential mortgages, home equity loans, commercial real estate and leveraged buyouts hint at more bad news to come.

"We've had a series of [financial] crises, each one arguably deeper and worse than the previous one till we finally had the biggest one since the 1930s. We've had really very little resolution in the past three years of the problems that caused the crisis," Mr. Wray says.