22 12 2009 What You Should Know About Goldman Sachs

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So you're thinking about investing in **Goldman Sachs** (NYSE: GS), are you? Part of me can't blame you. The reasons people hate Goldman -- government connections, market dominance, endless supplies of capital -- also bring ungodly profits.

That makes some believe that Goldman will always and forever be a fantastic investment. Maybe they're right. But I'll give an alternative view. If there's ever been a time to be worried about Goldman's earnings potential, I'd say it's right now. Let me tell you why.

First, trying to piece together the gritty details of a bank like Goldman -- or **Wells Fargo** (NYSE: WFC) or **Morgan Stanley** (NYSE: MS) or **Bank of America** (NYSE: BAC) -- is a lost cause. The most critical bits of information needed to understand how banks operate get conveniently veiled. Banks don't disclose much. They'd rather not get into details. They're horrendously complex black boxes of hell that few can truly decipher. Refer to the fall of 2008 if you don't believe me.

Nonetheless, we can gain meaningful conclusions from broad observations. If I wanted to invest in Goldman, I'd want to answer two very basic questions:

- Where is it making money?
- What's likely to happen to those segments going forward?

That's what I'll try to do right now.

Where the money comes from

We call Goldman an investment bank, but this is about as accurate as calling **Coca-Cola** (NYSE: KO) an aluminum-can company. Investment banking is an appetizer for Goldman's main course: trading.

Over the past few quarters, here's how Goldman's business segments break out:

Percentage of total revenue

Segment	Q3 2009	Q2 2009	Q1 2009
Investment banking	7%	10%	9%
Asset management	12%	11%	15%
Trading/principal investments	81%	78%	76%

Goldman is a trading shop ... that much is obvious. But this doesn't tell us much. What is it trading? Stocks? Homes? Gold? Eggs?

Trading and principal investments is made up of several segments. The largest and most important is called FICC, or fixed income currency and commodities.

Why is it the most important? Because not only does trading make up the majority of total revenue, but FICC is the majority of trading. You get a better understanding of this by looking at FICC as a percentage of total revenue:

Segment	Q3 2009	Q2 2009	Q1 2009

FICC percentage of total revenue	48%	49%	70%

So more than half of Goldman's total revenue this year came from FICC.

Goldman isn't just a trading shop, but more specifically a *fixed-income* trading shop.

Answer to question No. 1: FICC has been driving Goldman's recent earnings.

2. What now?

It hasn't always been this way. FICC was big in the past, but not nearly as big as today. In 2006 and 2007, FICC made up about 35% of revenue. Trading arms at **JPMorgan Chase** (NYSE: JPM) and **Citigroup** (NYSE: C) have experienced similar jumps. Fixed income is on fire this year.

Why the sudden surge, you ask? To some extent, it's because there's less competition sans Lehman Brothers and Bear Stearns. But for the most part, it's interest rates.

Fixed-income trading is based almost entirely on the spread between short-term and long-term interest rates. Right now, the spread is astronomically wide thanks to the Federal Reserve's zero-interest-rate policy. Traders can borrow short-term money at 0% and invest it longer-term products that yield, 3%, 4%, 8%, whatever. If you're wondering how banks are minting money while the economy slogs along, that's your answer.

Today's interest-rate environment is banking nirvana. It's about as good as it gets.

Seriously, though: When borrowing costs are 0%, that's *really* about as good as it gets.

A hard reality for the fixed-income market is that there's only one place for short-term borrowing costs to go: *up*. You can't get better than zero. And make no mistake: Interest rates will go up someday.

What happens then? Short-term rates are far more volatile than long-term rates, so higher short-term rates typically squashes fixed-income spreads. For example, from 2004 to 2006, the Federal Reserve raised short-term rates from 1% to 5.25%, but the yield on 10-year Treasury notes only increased from roughly 4% to a peak of 5.2%. The spread got substantially tighter.

And when that spread tightens, the money machine behind FICC's explosion, and, hence, Goldman's record earnings, will start to turn off. The easy, brainless, riskless -- yet torrential -- profit machine of Goldman's will begin to fade as the spread it's been exploiting tightens.

Answer to question No. 2: Higher interest rates, which are virtually assured at this point, will cramp FICC's future profits.

Moving on Now tie everything together:

- FICC has been the main driver of Goldman's earnings.
- FICC is on fire because of record-low interest rates.
- There's only one place for interest rates to go: up.
- When that happens, FICC's earnings, and, hence, Goldman as a whole, could get squeezed.

Now, perhaps Goldman will time everything perfectly and exploit the heck out of interest rates when they do move. That wouldn't surprise me in the slightest.

But if there's ever been a time when it's safe to say the odds that Goldman's earnings power will *increase* are low, while the odds that it'll *decrease* are quite high, it's today.