

## Boenning Morning Comment

*This report is prepared for us by Tower Bridge Advisors*

April 19, 2010

Stocks sank on Friday. It was a tale of two stories. The first was Google (GOOG-\$550#\*). Google announced earnings that exceeded expectations but it wasn't an explosive beat-and-raise quarter so traders took profits. There is nothing in the Google news that should have serious implications for other stocks and the market overall.

The other story was Goldman Sachs (GS-\$160) and it was so big, it is still reverberating this morning. The SEC has charged Goldman and one of its employees, Fabrice Tourre, with civil fraud claiming that the firm failed to disclose to investors all the details surrounding the sale of a synthetic derivative CDO pool of sub-prime mortgages. I am not going to spend any time this morning discussing the legal issues in the case. A court will decide that. Rather I will try to discuss where this case leads the financial markets and try to assess whether there are any broad implications beyond the rather spectacular headlines.

To set the table, let me make three points. First, this case demonstrates the moral dilemma that exists when big Wall Street firms try to straddle too many fences and play on two many sides of the battle. Goldman was packaging and selling a pool of sub-prime loans to some large institutional investors. It wanted to entice them to buy the loans. It was working in association with a large hedge fund that had a negative view of the same sub-prime universe. It put its own money into place in the mortgage market and, at some point in time, changed gears and began to bet against the very same universe as it was selling mortgages to willing buyers. Goldman wants everyone to believe that it was simply acting as intermediary or agent as both buyer and seller but the picture the public is going to see is one of avarice, a very shrewd financial organization that preys on less informed substantial buyers to sell them a pool of toxic waste they knew was destined to fail. If you think back to the old Drexel Burnham days of the leveraged buyout (LBO) boom of the late 1980s and the heyday of Michael Milken, this is almost exactly the same plotline. Isn't it ironic that the sequel to "Wall Street", the movie, is about to come out? There is no question that the moral outrage stemming from this action is going to increase the chances that Congress will pass some form of financial reform that will increase regulatory oversight on derivatives. I will get back to that in a moment.

Second, it is clear that the Goldman case is not an isolated instance. Hedge funds and investment bankers teamed up on multiple occasions to create toxic CDO pools that got sold to unsuspecting investors. There are two key factors that enabled this to happen. The first is that the rating agencies rated many of these pools AAA when it was clear to almost any semi-intelligent investor that the underlying assets shared absolutely no AAA characteristics. Wall Street banks and other mortgage originators convinced the agencies that the wrapper, the structure of the securitization itself, provided the safety to secure a AAA rating. That proved to be completely wrong. Savvy investors who understood that knew these packages were overpriced as a result and they could make substantial money on the short side of the trade. The other factor was also the result of a mispricing. When the hedge funds wanted to lay a bet against these synthetic mortgage pools, they did so by buying credit default swaps, a form of insurance that allowed them to speculate in an exceedingly leveraged way that the sub-prime mortgage pools would fail. They were able to do that because the insurance companies vastly underpriced the insurance probably relying on the AAA ratings. Over the next few weeks we are bound to be barraged by countless other examples of failed CDO pools of sub-prime mortgages structured in precisely the same manner. The web site Propublica gives one very good example. Michael Lewis' new book, "The Big Short" spends a lot of time on the same subject.

Third, these pools almost always involve the repackaging of existing mortgages into synthetic pools that are either designed to reduce risk or to increase risk. Traditionally, Wall Street's role was as an intermediary between sources of capital and users of capital. Over the past decade, Wall Street has found that repackaging and reselling of existing financial instruments and their derivatives could be as profitable or more. It isn't just CDO pools of sub-prime mortgages. It also includes trading commodity futures, exotic options strategies, black box hyperfast trading of stocks, etc. Part of what Congress is grappling with today is how to control all this new activity. It doesn't want to ban anything, at least not for now. But it does want to increase reporting and transparency. It wants to know where the capital imbalances might be.

History clearly demonstrates that Wall Street will sell anything at anytime if it can find a willing buyer. The Goldman tale of sub-prime mortgage CDOs isn't any different from the Internet IPO fiasco ten years ago. Fabrice Tourre is today's Henry Blodgett, as Goldman is today's Drexel Burnham. Gordon Gecko keeps getting reborn. In my lifetime, there have been countless IPO booms where nonsense gets created and sold. I have lived through the eras of leveraged government bond funds, oil and gas limited partnerships, real estate partnerships with 2:1 writeoffs guaranteed not to lose any money, the Orange County municipal bond scandal and on and on and on. There is nothing that will stop this behavior except for laws and regulations that increase the risks to the agents/sellers of these products. One might think the Goldman news will lead to steps that would do just that, but I doubt that is so. It has never been accomplished or, frankly, even been tried in the past, and I doubt there is a real appetite now. It isn't up to Congress to decide what you should or shouldn't buy. It is only up to government to force sellers to disclose adequately all the possible risks. That is what a prospectus does. Indeed, the offering statement governing the Goldman CDOs subject to SEC scrutiny are filled with all sorts of disclaimers and risk statements that may prove sufficient to protect Goldman in a court of law.

So where does all this lead us? First, there are few likely broad economic consequences of the SEC action away from risks to Goldman, other investment bankers and some hedge funds. Even there, I doubt the direct economic damage will be huge. There may be an echo impact in the stock market this morning, but before long earnings and the economy will once again be the dominant influence on the stock market. However, I do believe that the prospects for financial regulatory reform increases, and it will be difficult for the Republicans to make a case to the public that doing nothing is better than what is currently on the table. If the net result hurts the profitability of some banks and brokers, few are going to shed tears. Nothing is being proposed to stop their primary function as financial intermediary. To the extent that reporting and disclosure requirements crimp their ability to do all the fantastical trading that they have been doing, so be it.

But I don't want to overstate the moral case either. Savvy traders and investors will always take advantage of mispricings. That is how the smart ones get rich. And they do so because other investors with deep pockets make bad misinformed choices. That is how financial markets have worked for centuries. Congress will try and fix yesterday's problems but that won't prevent a new form of toxic investment to infect markets in the future. The best regulators can do is recognize bubbles early enough to try and take action to limit their impact. History shows they have a very poor track record in that regard.

Futures suggest a moderately lower opening.

Today Kate Hudson is 31. Ashley Judd is 42.

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Additional information is available upon request.

\* - Boenning and Scattergood may act as principal in buying this stock from or selling it to the public.

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