We originally published this report in Jan-13 (see below). In this update, we note that GS now plans to list the unit on NYSE, as Goldman Sachs BDC Inc (ticker: GSBD). At the end of 2013, GSBDC had net asset value of $575m; GS owns just under 20% of the firm.

GS appears to have made the right and early call when it established GS Liberty Harbour: the sector boomed over the past two years, and other banks have taken note. In Feb-15, Credit Suisse launched its own specialty finance operation, Credit Suisse Park View BDC Inc.; reporting within CSAM, the unit is seeking to raise $500m by selling shares. Morgan Stanley is also considering a launch of its own unit, and we expect others will follow, too.

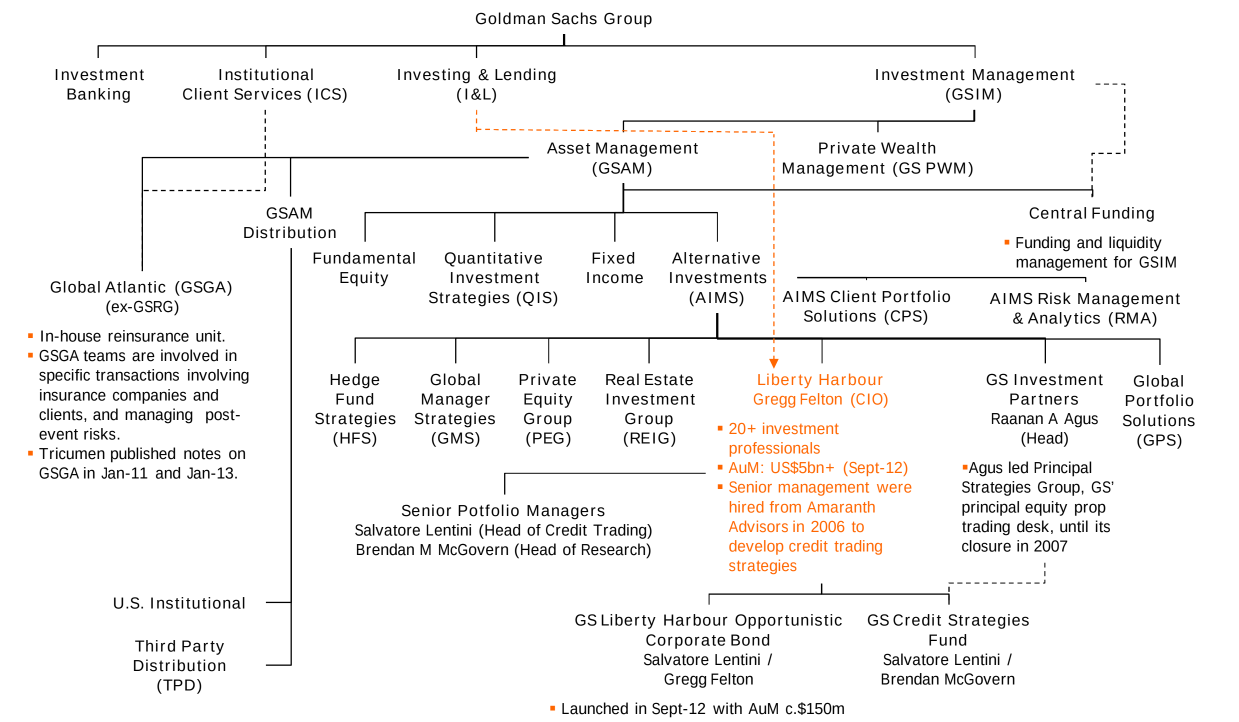
GS Liberty Harbour and principal investing

- GSAM Liberty Harbour's new credit fund may commingle $600m from outside investors with $150m of GS' own funds. The bank is adapting to the evolving risk regulations very effectively...
- ... reminding us in turn that the risk cannot be 'macromanaged' from outside.
- We expect regulators will adjust Volcker and similar rules to reflect the active market realities.

A few days ago, Reuters broke the story about Goldman Sachs Asset Management unit, Liberty Harbour, which is looking to raise $600m for a fund that will provide loans to mid-size companies; the bank could contribute an additional $150m of its own money.

Liberty Harbour is led by CIO Gregg Felton. GSAM hired him and his 16-strong team from Amaranth Advisors, a hedge fund which closed down in late 2006 after losing $6bn on natural gas bets. The team had the specific brief of developing a credit strategies desk at GSAM. This they did, and rather well: Liberty Harbour's 20+ investment professionals managed $5bn as of Sept-12, and we hear the team has suffered very few departures since their Amaranth days.

GS Liberty Harbour (as of Jan-13) [1]



Source: Goldman Sachs, Tricumen.

Reuters rightly emphasised the 'business development' aspect of the new fund: it will seek to invest in debt of 'underserved middle market' – a term beloved by buyout specialists – and thus stay (or, steer) clear of 'Volcker Rule'. Goldman Sachs has, of course, been at forefront of trying to find a way around

[1] Further detail on the Group's divisions is available on request.

this rule: for example, GS Investing & Lending (I&L) runs MS Mezzanine Partners (AuM $26bn as of Jan-13), which extends mezzanine credit to buyout firms; and GS Special Situations Group's (GSSG) Multi-Strategy Investing (MSI) team, which reportedly invests $1bn of GS' own money.

The Volcker Rule has yet to be finalised, but it seems to us that GS approach will be difficult to defeat. Even if regulators figure out a way to split prop trading from investments (e.g. MSI aims to hold its investment for 60+ days thus falling outside the scope of Volcker), it would take a brave regulator to do anything that would seem to slow the flow of debt finance to the mid-size companies.

Details aside, to us, this is a welcome opportunity to reiterate our oft-stated argument that risk management cannot be 'macromanaged' by outside regulators. Ultimately, the ability to control risk comes from within a bank, and – as we stated in our May-12 'Basel Committee trading book proposals' note - there is no substitute for intelligent analysis of day-to-day P&L accounts, especially when it relates to products generating significant revenue.

And that's where GS – among others - gets it right, far more often than not. In Apr-10, GS' then CFO David A Viniar – who retires this month - testified in front of the Senate Permanent Subcommittee on Investigations. His testimony[2] is worth quoting at some length (the italics are ours):

"Most fundamentally, our approach is to understand the risks we are taking, analyze and quantify them, and keep a firm grip on their current market value. We carry virtually our entire inventory of financial instruments at fair market value, with changes reflected in our daily P&L. This enables us to make informed decisions in real time about the risks we're taking and respond nimbly to opportunities or threats. Such daily monitoring was a key reason we decided to start reducing our mortgage risks relatively early as market conditions were deteriorating at the end of 2006."

"Through the end of 2006, we were generally long in exposure to residential mortgages and mortgage-related products. While this position was the direct result of our market-making activities, it was within our risk limits and we were comfortable holding it. That December, however, we began to experience a pattern of daily losses in our mortgage-related products P&L as we marked down the value of our mortgage-related inventory to reflect lower market prices. P&L can itself be a very valuable metric and I personally read it every day."

Viniar then called a meeting during which the bank decided to reduce its exposure "… consistent with [GS] risk protocols."

In short, GS' top management noticed small P&L losses in the supposedly upbeat market; analysed relevant portfolios (ably aided by the proprietary Groupwide risk platform, SecDB); quickly moved to reduce the exposure; and avoided significant losses.

Prop losses never came close to destabilising the system: according to BIS figures, prop trading losses accounted for less than 4% of the total losses sustained by 15 US and UK banks between Jan-07 and Mar-09. Sponsors (here, GS Liberty Harbour) should be encouraged, rather than barred, from investing alongside their clients. We believe that ultimately, regulators will adjust the Volcker Rule and similar 'perish-all-risk' efforts to reflect the market realities.

[2] Available at www.hsgac.senate.gov/download/stmt-viniar-david.

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