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Hedge Funds Suffer A Painful Drubbing As Short Sales Sour 2
Struggling Goldman Reports a Steep Drop in Quarterly Profit 4
Goldman Seeks a Way Out Of Venture With Apple 6

THE WALL STREET JOURNAL.

Hedge Funds Suffer A Painful Drubbing As Short Sales Sour

By Jack Pitcher
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Betting against U.S. stocks has gone poorly for Wall Street speculators.

July's gains left hedge funds closing out so-called short positions and cutting risk at the fastest pace in years, according to data from Goldman Sachs's prime brokerage unit, which caters to hedge funds. The cumulative dollar amount of short covering by hedge funds in June and July combined was the largest over a two-month period since 2016.

Short sellers borrow shares and then sell them, aiming to buy them back at a lower price later and pocket the difference.

The vast majority of U.S. short selling is done by hedge funds, which seek to generate positive returns no matter the direction of stock indexes.

The heavy short covering is providing yet another tailwind for stocks, which have rallied this summer on optimism that a strong economy can withstand higher interest rates. When a rally catches short sellers off guard, they can be forced to buy the shares back at a high price to limit further losses, creating additional demand that can make prices go even higher.

On Tuesday, the S&P 500 slipped 0.4%, extending a recent decline from its 2023 highs hit last month.

"A lot of people have been skeptical of the market, and as they're forced to cover short positions, that's obviously adding fuel to the rally," said David Kelly, chief global strategist at J.P. Morgan Asset Management.

U.S. and Canadian equity short sellers racked up $53.5 billion in mark-to-market losses on short sales in July, and have lost $175.2 billion betting against the market this year, according to data from S3 Partners. Every sector was unprofitable for short sellers in July.

Hedge funds came into 2023 with relatively little leverage, or borrowed money, after cutting risk for most of last year in anticipation of a recession. But after missing out on some of the market's surprise rally this year, they have added significant leverage in an attempt to catch up and juice returns. Hedge funds charge their investors high fees and are under pressure to generate larger returns to justify the expense now that rates are higher and investors have low-risk options to earn yield.

Many on Wall Street have been wary of stocks' recent rally, and especially the high valuations of megacap **technology** companies that have been a primary driver of gains. But as major indexes have continued to climb, funds have been closing their short positions and getting more long exposure as a result.

Billionaire Carl Icahn said Friday his firm would wind down bets that the stock market would collapse, which have inflicted heavy losses. His firm Icahn Enterprises is itself under attack from an activist short seller, and its shares are down 54% this year.

"Our returns have been overwhelmed by our overly bearish view of the market," Icahn said in a letter to investors.

Mike Edwards, deputy chief investment officer of New York hedge fund Weiss Multi-Strategy Advisers, said the heavy short covering in July was a "pain trade" for many funds that hit their predetermined thresholds to close out losing trades and stop further losses.

"The last four or five weeks have been characterized by capitulation on that front," Edwards said. "You have strategists start to say, you can't fight this rally any more. I assure you that's coming after they've seen some of their biggest clients capitulate, not before."

Several major banks have published rosier market forecasts in recent weeks, and JPMorgan Chase said on Friday it no longer anticipates a recession in 2023.

A Goldman index of the 50 most shorted U.S. stocks surged 32% in June and July, The S&P 500 was up 9.8% over the same period.

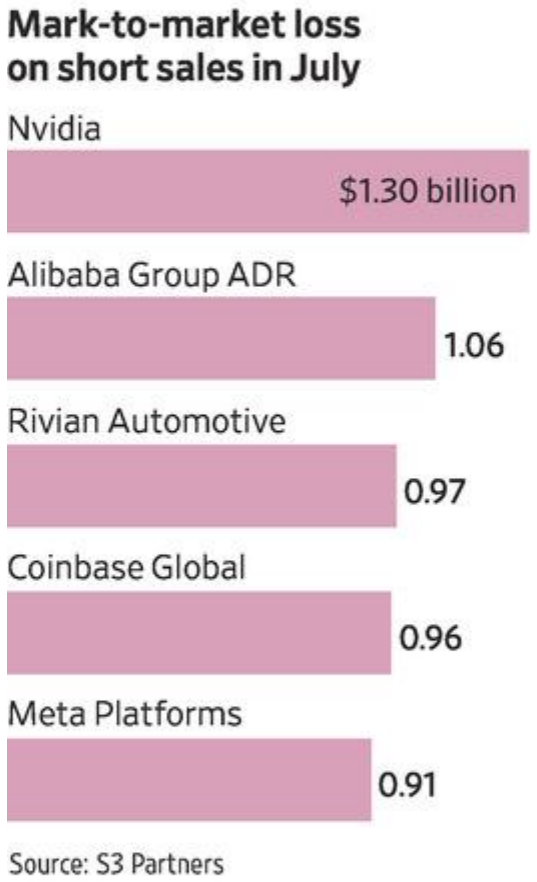
Long-short equity hedge funds, which take both kinds of positions, have underperformed benchmarks this year, mostly because of losses on short sales.

"The recent underperformance is almost completely driven by a sharp deterioration in short side returns," Goldman analyst Vincent Lin wrote in July.

While all of the short covering has pushed total leverage at hedge funds down from its extremes of the year, it was still hovering around a record high in late July, according to Goldman.

Some investors see heavily leveraged hedge funds as a risk in the market, since they can be forced to sell securities to meet margin calls from their brokerages.

"All this leverage has contributed to the market rally. And it's a risk for the market when and if it comes unwound," said Alex Chaloff, chief investment officer at Bernstein Private Wealth Management.



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Struggling Goldman Reports a Steep Drop in Quarterly Profit

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The News

Goldman Sachs on Wednesday reported quarterly profit that fell short of even dampened expectations, another reminder of the troubles facing one of Wall Street's premier names.

The investment bank, which has spent much of this year unwinding mistakes of years past, reported a profit half as large as that of its rival Morgan Stanley, to say nothing of larger lenders.

At Goldman, the pain was distributed across the board, in its investment bank, sputtering consumer arm, slowing trading operations and commercial real estate portfolio. David Solomon, the bank's chief executive, called it "obviously a tough quarter."

Perhaps in an indication of how low analyst projections had been, shares rose nearly 1 percent on Wednesday.

The Numbers

Goldman Sachs reported a profit of $1.1 billion in the second quarter, down more than 60 percent from a year earlier.

The bank highlighted write-downs in the value of its commercial real estate portfolio, a $1.2 billion hit to profit, and the **buy**-**now**-**pay**-**later** firm GreenSky, which subtracted nearly $700 million from its earnings. Goldman acquired GreenSky less than two years ago, as part of an ill-fated foray into consumer lending.

Quarterly revenue, at $10.9 billion, was 8 percent lower than it was a year earlier.

The bank employed 44,600 people at the end of June, down 2,400 from a year earlier. Goldman has gone through at least three rounds of layoffs this year, taking head count down 8 percent so far this year.

Takeaways

This seems to have been a rip-the-Band-Aid-off quarter for Goldman. The real estate write-down, in particular, appeared to pack potential losses into the period.

There are, however, good reasons for the move. Remote or hybrid work appears here to stay, and that has bleak implications for office space and landlords in many cities. Having already conceded some losses in that area, Goldman can now shift attention to other areas of the business like investment banking, which tends to ebb and flow.

"It definitely feels better over the course of the last six to eight weeks than it felt earlier in the year," Mr. Solomon said.

Context

The big question for Mr. Solomon is whether he can convince investors -- and many inside his own firm -- of a return to the much-feared Goldman of yore.

The bank is nearly a year into an extended apologia for its consumer woes, which at one point included Marcus, a consumer division named after the company's founder, credit-card offerings and savings accounts aimed at the mass market. The bank said this year that it had lost more than $3 billion tied to those efforts since December 2020.

The bank is still unwinding most of the business, at a loss, and it may expect more ugly headlines until that is finished.

What's Next

Unlike more diversified lenders like JPMorgan Chase, Goldman relies heavily on its Wall Street franchise, and corporate activity has been muted in the face of economic uncertainty, rising interest rates and the like. That means that if there is a prolonged chill in deal-making, there may be little that the bank can do to fully insulate itself.

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Goldman Seeks a Way Out Of Venture With Apple

By AnnaMaria Andriotis
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Goldman Sachs Group is trying to end its partnership with Apple.

The Wall Street firm is in talks with American Express to take over its Apple credit card and other ventures with the tech giant, according to people familiar with the matter.

Goldman went public with plans to scale back its consumer business late last year, but it appeared committed to the Apple relationship. The bank recently extended the partnership through the end of the decade, agreed to support Apple's "**buy now**, **pay later**" offering and launched a bank account with the tech company.

Now it is in talks to offload those businesses and its credit-card partnership to Amex, according to people familiar with the discussions. Goldman has also discussed transferring its card partnership with General Motors to Amex or another issuer, some of the people said.

A deal with Amex isn't imminent or assured, people familiar with the conversations said, and it could take a while to transfer the partnership in any case. Apple would have to agree to a transfer. The tech company is aware of the talks, which have been ongoing for months, the people said.

A retreat from Apple and credit cards would effectively end Goldman's consumer-lending business. The bank has already stopped issuing personal loans, and it is trying to sell GreenSky, the home-improvement lender it bought just last year.

Exiting the Apple partnership would also seal the fate of Goldman's grand plans to become a full-service bank. Goldman, a firm best known for dominating the Wall Street businesses of investment banking and trading, first made a play for Main Street with its Marcus high-yield savings account in 2016. Three years later, it expanded into credit cards with its splashy Apple partnership. Goldman reached a deal for GreenSky in late 2021 and closed on the purchase early last year.

Goldman quickly became a presence in the bidding wars for co-branded credit-card deals, long the territory of megabanks like JPMorgan Chase and Citigroup that have giant consumer arms.

That changed when Goldman decided to scale back its consumer ambitions late last year following an internal review. Goldman ended talks with T-Mobile to launch a credit card and stepped away from bidding on new programs, The Wall Street Journal reported in February. A few months later, Goldman said it would look for a buyer for GreenSky.

Still, Goldman stayed close to Apple. On a call with analysts in October, Chief Executive David Solomon talked up the relationship after announcing the bank's broader retreat from full-service consumer banking.

"It's a very, very strong partnership where there's a lot of opportunity," Solomon said at the time. The bank launched a savings account with Apple in April.

Solomon has fielded a lot of internal criticism for presiding over the costly consumer foray. In January, Goldman disclosed that it had lost about $3 billion on the consumer-lending push since 2020.

Should Goldman get out of the credit-card business and sell GreenSky, its consumer business would be reduced to its original product: the Marcus savings account.

The bank has said it has no plans to stop taking consumer deposits.

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