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Betting Against Goldman Is Like Betting Against the House

By BRETT ARENDS

It's a fair bet that the SEC lawsuit against Goldman Sachs won't be the last of its kind.

After all we've just come out of the biggest financial crisis in 80 years. As the regulators lift the rocks they'll find plenty to go after.

So what does this mean for investors? Should you bail out of the big banking stocks while you can? Or is this going to blow over?

Anyone who wants to take a position on this either way is gambling on a lot of unknowns. I'd rather put a small stake on some high-octane stock options than a bigger stake on the stock themselves. With the options, you stand to lose less money if things swing dramatically against you.

Why the caution?

Take a look at the bear case.

Depending on what emerges, these banks could have enormous exposure. The total losses in the mortgage meltdown are huge in relation to the equity of the banks.

And it's not as if the bank stocks are really cheap. Yes, Goldman is down to about 8 times forecast earnings, and 1.3 times book value. But all such numbers in the banking sector should be taken with a grain of salt. Thanks to leverage, and the volatility of the industry, bank stocks can prove classic "value traps"–looking really cheap just before they collapse.

Most ominous: Shares in the top banks have now rebounded so far from last year's crash that they are now valued, in aggregate, nearly 20% more than they were in August 2008, just before Lehman collapsed. Burst bubble stocks typically take many years to recover. At these levels, bank stocks look like they have already priced-in a lot of the good news.

If you're looking for further grounds for caution, take a look at the analysts. They're too bullish. The SEC lawsuit on Friday sent Goldman Sachs stock tumbling from nearly 15%. How could we guess, even before looking, that the day before most analysts had been on record telling their clients to buy? According to data from Reuters, of the 22 Wall Street analysts covering Goldman, 16 had buy or outperform recommendations, and six had it as a "hold."

(A year ago, when the stock was much cheaper, the analysts were much more cautious. Plus ça change.)

And it's not just Goldman. Today the analysts are heavily bullish on J.P. Morgan, Morgan Stanley and Bank of America. Even that ugly duckling Citigroup has seven fans, compared to just two outright bears.

One more worry: Banking reform and new regulations. President Barrack Obama and Senate Banking Committee Chairman Chris Dodd (D., Conn.) are pushing for reforms that are intended to crack down on some of the Wall Street banks most lucrative operations. Whatever emerges from the drive is hardly likely to help bank profits, and may well hinder them.

But even though there's plenty of grounds for caution, someone betting against the Wall Street banks is also taking a big, big risk.

It's not just the rebounding economy, although, yes, that should be good news for the banks.

It's not even the current profits, even though Goldman has just reported a fat quarter.

And it isn't even that big banks like Goldman have now been deemed "too big to fail."

It's simpler than that.

Betting against Wall Street is like betting against the house. These guys are well connected.

Wall Street is the number two source of campaign funding for politicians across the board, according to the Center for Responsive Politics, a non-profit that tracks money and politics. The only industry more important: Lawyers.

Since 1990, investment firms and their staff have given a staggering $683 billion to federal election campaigns. While Democrats have done better in recent elections, this industry is not partisan: Over two decades the donations have split 51% to Democrats, 48% to Republicans. The GOP got a majority of the money from 1996 through 2004.

It's no mystery why. Politicians hit up the bankers for the same reason Willy Sutton hit the banks. That's where the money is.

So long as this remains the case, it's hard to see Washington, D.C., under either party, coming down too hard on the Wall Street banks.

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