

Fellow Shareholders:

# When we reported to you last,

the world's financial system and the global economy remained in the grips of uncertainty. Our industry had been shaken to its foundation in the wake of severe volatility, a sharp deterioration in equity values and extreme illiquidity across most credit markets. Governments, regulators and market participants were forced to confront simultaneously the unwinding of several financial institutions, ensuring short-term market stability, shoring up investor confidence and enacting measures to secure the long-term viability of the global capital markets.

By the end of 2009, owed in no small part to actions taken by governments to fortify the system, conditions across financial markets had improved significantly and to an extent few predicted or thought possible. Equity prices largely rebounded, credit spreads tightened and market activity was revitalized by investors seeking new opportunities, all of which imply renewed optimism, if not the beginnings of a potential recovery.

While improving financial conditions are often a precursor to better economic ones, the economy nevertheless remains fragile. Unemployment is high, consumer spending tepid and access to credit for many smaller businesses continues to be elusive. The effects of unwinding leverage embedded in the system may linger for some time. As the global economy works its way to recovery, the roles that we play for our clients become even more important as companies and investors position themselves to emerge stronger following the crisis.

The firm's focus on staying close to our clients and helping them to navigate uncertainty and achieve their objectives is largely responsible for what proved to be a year of resiliency across our businesses and, by extension, a strong performance for Goldman Sachs. In 2009, the firm generated net revenues of \$45.17 billion with net earnings of \$13.39 billion. Diluted earnings per common share were \$22.13 and our return on average common shareholders' equity was 22.5 percent. Book value per common share increased 23 percent during 2009, and has grown from \$20.94 at the end of our first year as a public company in 1999 to \$117.48, a compounded annual growth rate of 19 percent over this period.

This past year, clients came to Goldman Sachs because of our ability to integrate advice, financing, market making and investing capabilities with sophisticated risk management. Importantly, during the crisis, we were able to commit capital when market liquidity and capital were scarce. Our duty to shareholders is to protect and grow our client-focused franchise by remaining true

to our teamwork and performance-driven culture. Our shared values have allowed us to be nimble and reactive, yet governed by prudent, long-term thinking.

In this year's letter, we will address some of the steps Goldman Sachs took to further strengthen our capital, liquidity and competitive position in 2009. We will discuss the firm's client franchise and our contribution to well-functioning markets in times of distress and, on an ongoing basis, by operating at the center of global capital markets. We also will report to you on how our integrated business model, diverse revenue streams and risk management practices serve as the core of our strategy. Importantly, we will focus on how our people and culture have been and remain fundamental to the firm's success. Finally, we will review the regulatory reform agenda as well as certain developments that attracted considerable attention over the course of the year.

## EXTRAORDINARY MEASURES

Looking back on 2009, it is impossible to know what would have happened to the financial system absent concerted government action around the world. Institutions were hoarding cash and were unwilling to transact with each other. This had extreme consequences for even the healthiest of financial institutions and companies. Through aggressive measures ranging from liquidity and funding facilities to direct investment programs, the government arrested the contagious fear that had engulfed the global financial system and averted more acute circumstances. We believe such efforts were absolutely critical to protecting the financial system and ensuring the continued viability of the global economy. Goldman Sachs is grateful for the indispensable role governments played and we recognize that our firm and our shareholders benefited from it.

In June 2009, the firm repaid the U.S. government's investment of \$10 billion in Goldman Sachs as a participant

*right*  
Lloyd C. Blankfein  
Chairman and  
Chief Executive Officer

*left*  
Gary D. Cohn  
President and  
Chief Operating Officer



in the U.S. Treasury's TARP Capital Purchase Program, which was designed to promote the broader stability of the financial system. We subsequently repurchased the warrants acquired by the U.S. Treasury in connection with that investment which, when combined with preferred dividends paid, represented an additional \$1.4 billion, or an annualized 23 percent return for U.S. taxpayers.

#### CONSERVATIVE FINANCIAL PROFILE

In light of the events of the last two years, we believe it is important to highlight for our shareholders that Goldman Sachs did not and does not operate or manage our risk with any expectation of outside assistance. Given our roots as a privately-held partnership, we have always focused on maintaining a conservative financial profile and view liquidity as the single most important consideration for a financial institution.

Having steadily increased our Global Core Excess pool of liquidity for several years, it stood at roughly \$170 billion in cash or highly liquid securities, or almost 20 percent of our balance sheet at the end of 2009. Keeping this pool of liquidity is expensive, but, in our judgment, it is money well-worth spending. Leading up to 2008, we reduced our exposures even though it meant selling at prices many thought were irrational. When the crisis hit, we raised nearly \$11 billion in capital—\$5 billion of preferred equity from Berkshire Hathaway and \$5.75 billion

in common equity—without any knowledge that TARP funds would be forthcoming.

While the past two years have validated our conservative approach to liquidity and to managing our risk, they have also prompted significant change within our organization. Specifically, we have embraced new realities pertaining to regulation and ensuring that our financial strength remains in line with our commitment to the long-term stability of our franchise and the overall markets.

We became a financial holding company, now regulated primarily by the Federal Reserve and subject to new capital and leverage tests. Since May 2008, our balance sheet has fallen by approximately one-quarter while our capital has increased by over one-half. Over 90 percent of our shareholders' equity is common equity. The amount of level 3—or illiquid—assets is down by 40 percent representing less than 6 percent of our total assets. In 2009, our Basel I Tier 1 capital ratio increased to 15 percent, well in excess of the required minimum.

#### IMPORTANT ROLES WE PLAY ON BEHALF OF OUR CLIENTS

Maintaining a sound financial profile is vital if we are to be effective in meeting the needs of our clients. Among the roles we play for our largely institutional client base are advisor, financier, market maker, asset manager and co-investor.

### Strategic Advice

Our advisory business serves as our primary point of contact with our clients and is often the genesis for sourcing other opportunities to serve them. In some instances, business garnered from our long-standing investment banking relationships is captured from a financial reporting perspective in the revenues reported within other segments, particularly within our Trading and Principal Investments segment. For instance, we have been successfully building our risk management solutions business within investment banking—encapsulating our strategy of integrating advice, capital and risk management expertise. Since 2005, revenues from this business have grown 32 percent compounded annually. This trend is consistent with our business model and operating philosophy which are predicated on the firm functioning as an integrated whole.

While classic advisory revenues in 2009 reached a near cyclical low, the latter half of the year yielded greater levels of strategic dialogues, reflecting an improvement in CEO confidence. Although it is difficult to predict what types of transactions or which industries will rebound most quickly, our broad and deep franchise allows Goldman Sachs to remain knowledgeable and relevant across multiple sectors, and poised to serve our clients. Over the past five years, Investment Banking has advised over 1,000 clients in 67 countries, solidifying our leading market share position and allowing us to retain industry-leading positions in cross-border, acquirer, target and strategic defense advisory league tables.

### Financing for Growth

Our investment banking relationships are also the basis for most of our financing mandates. As a financial intermediary, Goldman Sachs acts to match the capital of our investing clients with the needs of our corporate and government clients, who rely on financing to generate growth, create jobs and deliver the products and services that drive economic development. Since the beginning of 2007, we have underwritten over \$750 billion in corporate debt and over \$450 billion in equity and equity-related products across approximately 1,900 offerings for 800 clients globally.

We have a long history of helping states and municipalities access the capital markets. Since entering the public finance business in 1951, Goldman Sachs has been one of the most significant industry participants and over the past decade has helped states and municipalities raise over \$250 billion in capital. In 2009, we were the number one underwriter for the Build America Bond program, which allows states and municipalities to meet their borrowing needs and invest in infrastructure projects. We also helped finance over \$28 billion for nonprofit institutions including education services, healthcare and government entities.

### Market Intermediary

Through our role as a market maker, we commit and deploy our capital to ensure that buyers and sellers can complete their transactions, contributing to the liquidity, efficiency and stability of financial markets. Throughout the crisis, we made prices when markets were volatile and illiquid and extended credit when credit was scarce. Fixed Income, Commodities and Currencies (FICC) and Equities, our market intermediation businesses that comprise our Securities Division, were meaningful drivers of our strong firmwide performance last year.

By remaining close to our clients, we were able to direct our human and financial capital to those businesses within our market making franchise that most reflected clients' interests and needs. Another important component of growth has been the dynamic that, as clients grow in size, the scope of the business that they execute with the firm also increases. In 2009, 2,500 of our clients were active across both Equities and FICC products, which is up 25 percent from 2006.

### Client-Driven Risk Exposures

Given concern by some over the nature and level of risk that financial institutions undertake, it is important to note that for Goldman Sachs, the vast majority of the risk we take and the revenues we generate is derived from trades that advance a client need or objective.

By way of example, in 2009, an energy consumer asked us to help protect it against a rise in the cost of fuel, concerned that an increase would affect its ability to grow. To accomplish this, Goldman Sachs structured a long-term collateralized hedge facility. We then entered into hedges to offset the fuel price risk that we had assumed. As part of our normal accounting and risk management, we regularly revalue the amount of collateral necessary to be posted when fuel prices declined during the life of the transaction. We also routinely hedge our client counterparty risk in addition to receiving collateral. In the end, we were able to structure the transaction at a fair price for our client and generate an attractive risk-adjusted return for the firm and our shareholders. This is representative of the risk we assume and manage daily to allow our clients to focus on their underlying businesses.

### Co-Investing

Co-investing is another way we directly align the firm's interests with those of our clients. Two-thirds of our corporate investing opportunities are sourced from our investment banking relationships. In addition, the vast majority of money committed to our investing funds comes from our clients, who seek to partner with us. While returns fluctuate based on equity market performance and other factors, our merchant banking businesses have provided much needed capital to our investment banking clients and achieved strong returns for our investors and shareholders over the long term. This business

generates management fees as well as incentive fees based on the funds' performance. As a result, our merchant banking business helps diversify the firm's revenues.

The focus of our funds spans the capital structure, including senior debt, mezzanine and private equity funds. During periods of 2009 when public market liquidity dried up, our senior loan and mezzanine funds, in particular, extended needed capital to a variety of companies whose growth opportunities would otherwise have been limited.

There also is significant diversity within the funds themselves. Our corporate equity fund portfolio represents eight different industry groups with no one industry contributing more than 25 percent. Looking ahead, we remain well-positioned, together with our clients, to invest in attractively priced assets.

### Managing Assets

Managing our clients' assets remains an important growth opportunity for Goldman Sachs and we continue to allocate significant time and resources to building our asset management businesses within our Investment Management Division and expanding our portfolio management capabilities. At the time of our IPO in 1999, our goal was to double assets under management (AUM) over five years. We were successful, and by May 2008, we had doubled AUM once again. Our success follows a track record of strong investment returns for our clients.

As with all of our businesses, our client base is diverse, numbering 2,000 institutional clients and third-party distributors, and over 25,000 private wealth management accounts. Our range of products across money markets, fixed income, equity and alternative investments is offered through distribution channels to institutional, high-net-worth clients and third-party retail clients around the world.

To advance our strategy, in 2009, we doubled our third-party distribution sales force and significantly increased our institutional and private wealth management coverage. Included in our expanded coverage focus are government sponsored organizations, corporate pension funds, insurance companies and growth markets such as Brazil, the Middle East and China.

## INVESTMENTS IN GROWTH

### BRICs and Emerging Markets

We continue to believe that this will be the century of the BRICs and other high growth markets. They have helped lead the global recovery and, in our minds, are even more compelling now. As a result, the emerging markets remain integral to our growth strategy.

At the beginning of the crisis, many wondered if or to what extent the BRICs and other growth markets would be able to decouple from the more established economies. Such a decoupling had little precedent. Today, it appears that the growth markets are helping lead the recovery in the global

economy. They continue to attract capital from abroad and, also, are making significant, long-term investments to position themselves for the future.

We believe Goldman Sachs is similarly well-positioned to expand our franchise in step with these countries' growth. We remain focused on implementing a familiar strategy—expand our advisory client coverage, build underwriting capabilities, develop sales and trading expertise and grow our wealth management business.

### Investing in People and Communities

While Goldman Sachs serves a wide range of clients with individual needs and goals, we also believe that financial institutions have a larger obligation to the financial system, the broader economy and the communities in which their employees work and live. For us, this means helping new enterprises succeed and grow, catalyzing economic development and financing community projects that create a better quality of life for more people. Given that our firm is most successful when economies and markets thrive, this is in our interest and that of our shareholders.

The firm's Urban Investment Group is helping to create thousands of affordable housing units and funding businesses in underserved communities, helping to bring together money and innovative ideas to revitalize cities across the United States. By making investments, loans and grants, and through service initiatives, we are working to transform distressed neighborhoods into vibrant and sustainable places of opportunity. As one example, with a \$61 million investment in the New York Equity Fund, Goldman Sachs is providing 569 units of much-needed affordable housing for low-income New Yorkers as part of a wider effort to rehabilitate 47 buildings across Harlem, the South Bronx and Brooklyn.

We are pleased to report that our *10,000 Women* initiative, which we introduced to you in last year's shareholders letter, has exceeded our own expectations and is today providing underserved female entrepreneurs with a business education through partnerships with more than 70 academic institutions and nonprofits in 20 countries, including India, Brazil, China, Afghanistan, Rwanda and the United States. Our early experience is confirming research by the World Bank, Goldman Sachs and the United Nations that educating women can lead to real economic growth and healthier, safer and better-educated communities.

### *10,000 Small Businesses*

Based on the results of *10,000 Women*, Goldman Sachs announced in 2009 a new effort called *10,000 Small Businesses*. This \$500 million, five-year program aims to unlock the growth and job-creation potential of 10,000 businesses across the United States through greater access to business education, mentors and networks, and financial capital. It is based on the broadly held view of leading experts that a combination of

education, capital and support services best addresses the barriers to growth for small businesses.

The program's business and management curriculum is supported by a \$200 million commitment to community colleges and universities to build educational capacity and to provide scholarships to underserved small business owners. Goldman Sachs has committed \$300 million through a mix of lending and philanthropic support to Community Development Financial Institutions to help get capital flowing to small businesses. The program's critical support services will connect small business owners with mentoring, networking and advice available through our various *10,000 Small Businesses* partners.

As with *10,000 Women*, the people of Goldman Sachs will give freely of their time and professional skills to serve as mentors and guest lecturers, as well as to participate on selection committees. We believe this approach is in keeping with the best tradition of our firm, aligning our philanthropic and growth development efforts with our core competencies and expertise.

#### *Goldman Sachs Gives*

We also announced a \$500 million philanthropic contribution to the firm's donor-advised fund, *Goldman Sachs Gives*, which was established in 2007. The firm's compensation for partners was reduced to fund this charitable contribution, reflecting the firm's tradition of philanthropy.

We have asked our partners to recommend charitable organizations that focus on the critical areas of creating jobs and economic growth, building and stabilizing communities, honoring service and veterans and increasing educational opportunities.

#### OUR PEOPLE

While an often used phrase, it is true in every way at Goldman Sachs: Our people are our most important asset. We do not have material "property, plant and equipment" assets. Rather, we have talented, entrepreneurial professionals who are dedicated to the firm's mission of supporting economic growth. In 2009, our people sat on 1,500 nonprofit boards, and 23,000 of us volunteered for over 800 local nonprofits through our Community TeamWorks program. In short, our people are central to who we are, to the cohesiveness of our culture, and to our ability to generate attractive returns for shareholders.

Throughout 2009, we stayed true to our focus on people. Every member of our management committee participated in on-campus recruiting, while another 120,000 recruiting hours were undertaken by people across the firm. Through GS University, we provided 350,000 hours of training and leveraged our senior leaders as faculty to provide learning opportunities to our people more broadly. Last year, for example, over 5,000 courses were taught by the firm's managing directors and vice presidents.

As demonstrated in the way we source opportunities and serve our clients, Goldman Sachs operates with a one-firm philosophy. Our people are rewarded for their accomplishments by how they work and succeed in teams, with the long-term interests of the organization always coming before those of the individual. We believe this partnership ethos, which reflects the firm's long-standing business principles, is a competitive advantage that drives the company's overall performance.

#### PAY FOR PERFORMANCE

Providing the best advice and execution to our clients means, in turn, providing our people with attractive career opportunities and long-term incentives. We have not been blind to the attention on our industry and, in particular, on Goldman Sachs, with respect to compensation. We have adopted very specific compensation principles, which we presented at our 2009 Annual Meeting of Shareholders to ensure an even stronger relationship between pay and performance.

These principles are designed to:

- Encourage a real sense of teamwork and communication, binding individual short-term interests to the institution's long-term interests;
- Evaluate performance on a multi-year basis;
- Discourage excessive or concentrated risk taking;
- Allow us to attract and retain proven talent; and
- Align aggregate compensation for the firm with performance over the cycle.

Consistent with our principles, in December, we announced that for 2009 the firm's entire management committee would receive 100 percent of their discretionary compensation in the form of Shares at Risk which have a five-year period during which an enhanced recapture provision will permit the firm to recapture the shares in cases where an employee engaged in materially improper risk analysis or failed sufficiently to raise concerns about risks.

Enhancing our recapture provision is intended to ensure that our employees are accountable for the future impact of their decisions, to reinforce the importance of risk controls to the firm and to make clear that our compensation practices do not reward taking excessive risk.

The enhanced recapture rights build off an existing clawback mechanism that goes well beyond employee acts of fraud or malfeasance and includes conduct that is detrimental to the firm, including conduct resulting in a material restatement of the financial statements or material financial harm to the firm or one of its business units.

In addition, our shareholders will have an advisory vote on the firm's compensation principles and the compensation of its named executive officers at the firm's Annual Meeting of Shareholders in May 2010.

Finally, Goldman Sachs does not set aside an actual pool for discretionary compensation or "bonuses" during the course

of the year. We accrue an estimate of compensation expenses each of the first three quarters. Only at year end, with the visibility of our full-year performance, do we make final decisions on compensation. While the previous quarters' accruals attract much attention, our full-year compensation and benefits to net revenues ratio ultimately represents the firm's compensation expense. In 2009, that ratio was the lowest ever since we became a public company—35.8 percent.

While 2009 total net revenues are only 2 percent less than the record net revenues that we posted in 2007, total compensation and benefit expense is 20 percent lower than in 2007, equating to a nearly \$4 billion difference in compensation and benefits expense between the two periods. Our approach to compensation reflected the extraordinary events of 2009.

### REGULATORY REFORM

Goldman Sachs has pledged to remain a constructive voice and participant in the process of reform, and has been forthcoming in recognizing lessons learned and mistakes made. We have provided a number of recommendations concerning how large financial institutions should account for their assets, how risk management processes can be enhanced, and how new regulations can keep pace with innovation.

Given that much of the financial contagion was fueled by uncertainty about counterparties' balance sheets, we support measures that would require higher capital and liquidity levels, as well as the use of clearinghouses for standardized derivative transactions. More broadly, we support proposals that would improve transparency for investors and regulators and reduce systemic risk, including fair value accounting. In short, we believe that sensible and significant reforms that do not impair entrepreneurship or innovation, but make markets more efficient and safer, are in everyone's best interest.

During our history, our firm has demonstrated an ability to quickly and effectively adapt to regulatory change. As an institution that interacts with thousands of entities, we benefit from the general elevation of standards, and will continue to work towards meaningful changes that improve our financial system.

### OUR RELATIONSHIP WITH AIG

Over the last year, there has been a lot of focus on Goldman Sachs' relationship with AIG, particularly our credit exposure to the company and the direct effect the U.S. government's decision to support AIG had or didn't have on our firm. Here are the facts:

Since the mid-1990s, Goldman Sachs has had a trading relationship with AIG. Our business with them spanned a number of their entities, including many of their insurance subsidiaries. And it included multiple activities, such as stock lending, foreign exchange, fixed income, futures and mortgage trading.

AIG was a AAA-rated company, one of the largest and considered one of the most sophisticated trading counterparts in

the world. We established credit terms with them commensurate with those extended to other major counterparts, including a willingness to do substantial trading volumes but subject to collateral arrangements that were tightly managed.

As we do with most other counterparty relationships, we limited our overall credit exposure to AIG through a combination of collateral and market hedges in order to protect ourselves against the potential inability of AIG to make good on its commitments.

We established a pre-determined hedging program, which provided that if aggregate exposure moved above a certain threshold, credit default swaps (CDS) and other credit hedges would be obtained. This hedging was designed to keep our overall risk to manageable levels.

As part of our trading with AIG, we purchased from them protection on super-senior collateralized debt obligation (CDO) risk. This protection was designed to hedge equivalent transactions executed with clients taking the other side of the same trades. In so doing, we served as an intermediary in assisting our clients to express a defined view on the market. The net risk we were exposed to was consistent with our role as a market intermediary rather than a proprietary market participant.

In July 2007, as the market deteriorated, we began to significantly mark down the value of our super-senior CDO positions. Our rigorous commitment to fair value accounting, coupled with our daily transactions as a market maker in these securities, prompted us to reduce our valuations on a real-time basis which we believe we did earlier than other institutions. This resulted in collateral disputes with AIG. We believe that subsequent events in the housing market proved our marks to be correct—they reflected the realistic values markets were placing on these securities.

Over the ensuing weeks and months, we continued to make collateral calls, which were based on market values, consistent with our agreements with AIG. While we collected collateral, there still remained gaps between what we received and what we believed we were owed. These gaps were hedged in full by the purchase of CDS and other risk mitigants from third parties, such that we had no material residual risk if AIG defaulted on its obligations to us.

In mid-September 2008, prior to the government's action to save AIG, a majority of Goldman Sachs' exposure to AIG was collateralized and the rest was covered through various risk mitigants. Our total exposure on the securities on which we bought protection was roughly \$10 billion. Against this, we held roughly \$7.5 billion in collateral. The remainder was fully covered through hedges we purchased, primarily through CDS for which we received collateral from our market counterparties. Thus, if AIG had failed, we would have had the collateral from AIG and the proceeds from the CDS protection we purchased and, therefore, would not have incurred any material economic loss.

In this regard, a list of AIG's cash flows to counterparties indicates little about each bank's credit exposure to the company.

The figure of \$12.9 billion that AIG paid to Goldman Sachs post the government's decision to support AIG is made up as follows:

- \$4.8 billion for highly marketable U.S. Government Agency securities that AIG had pledged to us in return for a loan of \$4.8 billion. They gave us the cash, we gave them back the securities. If AIG hadn't repaid the loan, we would simply have sold the securities and received the \$4.8 billion of value in that way.
- An additional \$2.5 billion that AIG owed us in collateral from September 16, 2008 (just after the government's action) through December 31, 2008. This represented the additional collateral that was called as markets continued to deteriorate and was consistent with the existing agreements that we had with AIG.
- \$5.6 billion associated with a financing entity called Maiden Lane III, which was established in mid-November 2008 by the Federal Reserve to purchase the securities underlying certain CDS contracts and to cancel those contracts between AIG and its counterparties. The Federal Reserve required that the counterparties deliver the cash bonds to Maiden Lane III in order to settle the CDS contracts and avoid any further collateral calls. Consequently, the cash flow of \$5.6 billion between Maiden Lane III and Goldman Sachs reflected the Federal Reserve paying Goldman Sachs the face value of the securities (approximately \$14 billion) less the collateral (approximately \$8.4 billion) we already held on those securities. Goldman Sachs then spent the vast majority of the money we received to buy the cash bonds from our counterparties in order to complete the settlement as required by the Federal Reserve.

While our direct economic exposure to AIG was minimal, the financial markets, and, as a result, Goldman Sachs and every other financial institution and company, benefited from the continued viability of AIG. Although it is difficult to determine what the exact systemic implications would have been had AIG failed, it would have been extremely disruptive to the world's already turbulent financial markets.

## OUR ACTIVITIES IN THE MORTGAGE SECURITIZATION MARKET

Another issue that has attracted attention and speculation has been how we managed the risk we assumed as a market maker and underwriter in the mortgage securitization market. Again, we want to provide you with the facts.

As a market maker, we execute a variety of transactions each day with clients and other market participants, buying and selling financial instruments, which may result in long or short risk exposures to thousands of different instruments at any given time. This does not mean that we know or even think that prices will fall every time we sell or are short, or rise when we buy or are long.

In these cases, we are executing transactions in connection with our role of providing liquidity to markets. Clients come to us as a market maker because of our willingness and ability to commit our capital and to assume market risk. We are responding to our clients' desire either to establish, or to increase or decrease, their exposure to a position on their own investment views. We are not "betting against" them.

As a market maker, we assume risk created through client purchases and sales. This is fundamental to our role as a financial intermediary. As part of facilitating client transactions, we generally carry an "inventory" of securities. This inventory comprises long and short positions. Its composition reflects the accumulation of customer trades and our judgments about supply and demand or market direction. If a client asks us to transact in an instrument we hold in inventory, we may be able to give the client a better price than it could find elsewhere in the market and to execute the order without potential delay and price movement. This inventory represents a risk position that we manage continuously.

In so doing, we must also manage the size of our inventory and keep exposures in line with risk limits. We believe that risk limits are an important tool in managing our firm. They are established by senior management, and scaled to be in line with our financial resources (capital, liquidity, etc.). They help ensure that regardless of the opinions of an individual or business unit about market direction, our risk must remain within prescribed levels. In addition to selling positions, we use other techniques to manage risk. These include establishing offsetting positions ("hedges") through the same or other instruments, which serve to reduce the firm's overall exposure.

In this way, we are able to serve our clients and to maintain a robust client franchise while prudently limiting overall risk consistent with our financial resources.

Through the end of 2006, Goldman Sachs generally was long in exposure to residential mortgages and mortgage-related products, such as residential mortgage-backed securities (RMBS), CDOs backed by residential mortgages and credit default swaps referencing residential mortgage products. In late 2006, we began to experience losses in our daily residential mortgage-related products P&L as we marked down the value of our inventory of various residential mortgage-related products to reflect lower market prices.

In response to those losses, we decided to reduce our overall exposure to the residential housing market, consistent with our risk protocols—given the uncertainty of the future direction of prices in the housing market and the increased market volatility. The firm did not generate enormous net revenues or profits by betting against residential mortgage-related products, as some have speculated; rather, our relatively early risk reduction resulted in our losing less money than we otherwise would have when the residential housing market began to deteriorate rapidly.

The markets for residential mortgage-related products, and subprime mortgage securities in particular, were volatile and unpredictable in the first half of 2007. Investors in these markets held very different views of the future direction of the U.S. housing market based on their outlook on factors that were equally available to all market participants, including housing prices, interest rates and personal income and indebtedness data. Some investors developed aggressively negative views on the residential mortgage market. Others believed that any weakness in the residential housing markets would be relatively mild and temporary. Investors with both sets of views came to Goldman Sachs and other financial intermediaries to establish long and short exposures to the residential housing market through RMBS, CDOs, CDS and other types of instruments or transactions.

The investors who transacted with Goldman Sachs in CDOs in 2007, as in prior years, were primarily large, global financial institutions, insurance companies and hedge funds (no pension funds invested in these products, with one exception: a corporate-related pension fund that had long been active in this area made a purchase of less than \$5 million). These investors had significant resources, relationships with multiple financial intermediaries and access to extensive information and research flow, performed their own analysis of the data, formed their own views about trends, and many actively negotiated at arm's length the structure and terms of transactions.

We certainly did not know the future of the residential housing market in the first half of 2007 any more than we can predict the future of markets today. We also did not know whether the value of the instruments we sold would increase or decrease. It was well known that housing prices were weakening in early 2007, but no one—including Goldman Sachs—knew whether they would continue to fall or to stabilize at levels where purchasers of residential mortgage-related securities would have received their full interest and principal payments.

Although Goldman Sachs held various positions in residential mortgage-related products in 2007, our short positions were not a “bet against our clients.” Rather, they served to offset our long positions. Our goal was, and is, to be in a position to make markets for our clients while managing our risk within prescribed limits.

#### LOOKING AHEAD

We want to recognize the extraordinary focus and commitment of our people despite the turbulence and challenges of the past year. In many ways, our financial performance masks the considerable pressures and distractions that we had to confront. Of course, in this way, we are no different from many other organizations that are coping with a complex and difficult environment. But, our people stayed focused, they worked together, and, today, we are well-positioned to continue delivering strong returns for our shareholders.

Heading into 2010, we are gratified that our core constituencies—our shareholders, our clients, and our people—remain close and committed to Goldman Sachs. Our shareholders continue to convey a strong belief in our business model and strategy, and in the importance of protecting the quality of our franchise. Our clients look to us to advise, execute and co-invest on their most significant transactions, translating into strong market shares. And our people remain as committed as ever to our culture of teamwork, to the belief in their responsibility to help allocate capital for the benefit of clients, and to the firm's tradition of service and philanthropy.

As the last two years demonstrated, no one can predict the future. While we are encouraged by the prospects for a sustainable economic recovery, we continue to place a premium on conservatism and prudence. At the same time, we are focused on opportunities that can continue to grow our business and generate industry-leading returns through the strength of the firm's core attributes. We have a clear strategy to integrate advice and capital with risk management for our clients. We have a diverse set of businesses. We have an expanding global footprint. We have established a proven culture of risk management. And, we have deep client relationships with a broad range of companies, institutions, investing organizations and high-net-worth individuals.

We are keenly aware that our legacy of client service and performance, which every person at Goldman Sachs is charged with protecting and advancing, must be continually nurtured and passed on from one generation to the next. To our fellow shareholders, we are pleased to report that we have never been more confident of that commitment or long-term outcome.



Lloyd C. Blankfein  
Chairman and Chief Executive Officer



Gary D. Cohn  
President and Chief Operating Officer