Goldman Sachs Exchanges: Great Investors

Bigger markets, more alpha: Capstone's Paul Britton on running a derivatives hedge fund

Paul Britton, Founder and CEO, Capstone Investment Advisors

Tony Pasquariello, Global Head, Hedge Fund Coverage, Goldman Sachs

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Tony Pasquariello: Welcome to another episode of Goldman Sachs Exchanges Great Investors. I'm Tony Pasquariello, global head of hedge fund coverage in Global Banking and Markets and co-head of One GS. And today, I have the great pleasure of sitting down with my friend Paul Britton. Paul is the founder and CEO of Capstone Investment Advisors, a global investment firm with about 11 billion in assets under management. Capstone focuses on derivatives and strategies that capture alpha and protect against downside risk. Capstone recently celebrated its 20th anniversary, and so this will be a great opportunity to discuss how the investing landscape has changed in the past two decades and where opportunities could be now. Paul, thanks for doing this. Thanks for being here.

Paul Britton: You're welcome. Glad to be here. Thank you for the invite.

Tony Pasquariello: So I want to get your take on the current environment, but let me just go back to the beginning. Let's just start the beginning of Capstone, what were the origins? What was the impetus? Why did you decide to launch the business in 2004?

Paul Britton: My DNA is in the options market-making space, and we built a relatively successful firm. And then I moved over to the states in 2000-2001 to look to expand our European operations into the US. By kind of 2003-2004, I realized that the market-making business and the providing liquidity business was really becoming a technology arms race. So the more CapEx you would spend, the higher probability that you had of being the most successful in the game. So it felt to me like it was a winner-takes-all game.

And who knows? Today I could be sat here of having Capstone Securities and competing alongside Goldman Sachs Securities or Citadel Securities. I think that's a relatively low probability outcome. So I said you know what? I think that there's an opportunity to -- it always frustrated me of not knowing what was going on on the other side of the world and what was going on in other asset classes.

So I said you know what? I'd like to build a global business. I'd like to build a business that encompassed every asset class. And I think this is useful for institutional investors. And I certainly didn't have that fully formed in terms of what the endgame looked like, but that really was how I thought about it at the beginning, to build a big global business that covered every asset class.

Tony Pasquariello: Right. And who knows? But I think we probably agree, the instinct was probably correct, that the path you struck was the right one.

Paul Britton: Listen, I can't complain. Sat here with you.

Tony Pasquariello: 11 billion of AUM later.

Paul Britton: Yeah. And I remember distinctly people being like, "Gosh, mate, if you ever get to a billion dollars!"

And that sounded incredibly scary to me. And then you just trust the process, you trust the people around you, and you're sharing your story and your vision with investors to be able to see whether investors buy into that narrative and that story as well.

Tony Pasquariello: And along that path, when was the first moment where you thought, okay, I think I'm onto something big?

Paul Britton: So I remember distinctly January of 2008 -- this story ends badly, by the way. But it was one of those first aha moments where I'm like, "Wow! This could actually really work." And it was MLK Day in January of 2008. And one of the large European banks disclosed that they had a potential issue, and there was an awful lot of volatility on that holiday day in the US. And we made a decent amount of money. And that was one of the moments where I'm like, "Oh, this is -- I get this." You have sizable capital where you can put reasonable amounts of risk on, and you're going to get rewarded for that. And that was my first kind of aha moment of saying, all right, this has to be a scalable business and I see how this can really work.

Tony Pasquariello: And if you push forward to, say, the year 2020, was that another signpost when you said what we have built in scale is here to last? Because that was a spectacular year for what you do.

Paul Britton: Yes. The January 2008 story was great. We made a lot of money for investors. We did spectacularly well, but it gave us, looking back on it, a real false confidence. And then it went spectacularly wrong in Q4 2008, where we realized that -- or I realized that we didn't have the appropriate rigor framework around risk that we needed to. And then fast forward to 2020, where you had an extraordinary event. It was -- now, you know, there was lots of sleepless nights. But you could feel that the framework was there. And the level of comfort that gives you as an investor, as a business owner, knowing that all the processes are in place, people know exactly what to do, that was a very gratifying year. And not because we made money for investors. It's just that things worked as they should have done, and that really comes from the experience, the lessons, the mistakes, candidly, the stupidity of things we've done in the past. And then 2020 was really a test to see whether we've learned or not.

Tony Pasquariello: And was there any other moment or period of time, again, along those 20 years that were particularly difficult for you or for the business? Outside of the fever pitch of, you know, a crisis like '08 or 2020?

Paul Britton: I think that the most difficult from an investment standpoint was definitely Q4 of 2008. I'm not particularly religious, but I remember going to the bottom of Broadway at the intersection of Wall Street. There's a beautiful church called Trinity Church, right by here.

Tony Pasquariello: Trinity Church.

Paul Britton: And I remember distinctly going there on a regular basis, not because I was seeking solace from a higher power but I found it so overwhelming of what was going on and I needed a place of solace and a place to try and collect my thoughts and definitely ask for help from a higher power to be able to try and help me get out of this mess I'm in. And so I ended up having these wonderful conversations with these terrific vicars and priests at Trinity. And then I'd come in on a relatively frequent basis, and they'd be like, "How are the volatility markets today?"

Tony Pasquariello: Right, right!

Paul Britton: And so that was a moment in time of extreme stress, but acknowledging that you're literally putting one foot forward and learning from the process. So from an investment standpoint, but that ultimately defined the firm.

Tony Pasquariello: Sure. Big pivot off of this, let's talk about the derivatives market. It is a hallmark of what you do, how you take risk, how you manage risk. You're an options guy. I came up in the business an options guy. The derivatives market has expanded hugely in the past decade or two, particularly I'd say in the kind of COVID/post COVID era. Has that opened up the opportunity set for what you want to do, or has it made it more crowded, more difficult? How has that all played to your strengths or to your detriment?

Paul Britton: So when we started this back in 2004 and we took in institutional money in 2007, that discussion around what size, what capacity could you really be, I always was very -- I was surprised by investors would always push back on us becoming bigger than 500 million because when I looked at the size of the derivatives market, it was just enormous even back in those days. And so 20 years ago, I think the derivatives market was really used by the professional community and less in -- and there were certainly big pockets of retail participation.

But what I think has happened over these past 20 years is the evolution of the derivatives market to make them more mainstream and to make them more appealing to a broader audience. And there's lots of people that I think have done a very good job around the exchanges, the dealers, the banks, etc., to be able to figure out ways of enhancing the derivative offering to a wider group of participants.

For us, that's good. Meaning that, as long as there is more volume going through those pipes, then that should translate into a higher alpha proposition. Just simply that if there's more volume going through those pipes and there's more volume going through our filters, then that should translate into a higher alpha proposition for our investors.

Tony Pasquariello: It sounds like one part of that is liquidity begets liquidity. In other words, if the market is getting bigger because of more market participants, you can take more risk and scale your risk. But also, it's going to create alpha opportunities because not all of that money, not all of that capital flow will be as elite, perhaps, as you all. Is that fair?

Paul Britton: Yeah, and it's not even elite. It's that the great thing about the derivatives markets is people use them for different reasons. If everyone just focused on the volatility component of the derivatives markets, that would be a challenge for us. They don't. They focus on using derivatives for a whole variety of different reasons. And even when you speak to some participants of the derivative markets who are sizable participants in them and sizable users of derivatives, they don't really care about the same alpha factors that I do.

Tony Pasquariello: Right.

Paul Britton: That's not to say that we're elite. It just means that we're after something different to the average participant and the average user of the derivatives markets, and that's what I think makes what we do relatively unique and a relatively unique source of alpha for investors.

Tony Pasquariello: Got it. And then you are a US-based firm. You're a downtown-based firm.

Paul Britton: Yes.

Tony Pasquariello: Which I think actually owes some of its heritage to 9/11 and your commitment to stay downtown post 9/11.

Paul Britton: Yes, yes.

Tony Pasquariello: But you're running very much a global business, so how much of your time is spent in non-dollar markets? Obviously, the US market is enormous, top to bottom, but are you also taking a fair amount of risk across Europe, across Asia, on and on?

Paul Britton: If you think about the global footprint, you can draw parallels to where the largest pools of volume is, that typically correlates into our risk taking.

Tony Pasquariello: Okay.

Paul Britton: In terms of saying that our largest risk exposure has always historically been the US just simply because the volumes here in the US have been the greatest. An interesting market that we're looking at and exploring and have some exposure in is also the China markets. They have a very large, deep equity market, less on the derivatives side. But that is essentially how we think about our exposure from a risk standpoint. Volumes first, that should equate to the alpha pie being the greatest. And then our role is simply mining that alpha and then extracting alpha from those markets.

Tony Pasquariello: Okay. And then let's just flash forward to the current day. There is a lot going on in the world.

Paul Britton: Yes. Yes, there is.

Tony Pasquariello: We have this kind of upending of a traditional political order. We have a very disruptive set of technologies, in part, colliding in real time. We have a very concerning and dynamic geopolitical backdrop. The VIX is at 15. How do you square that circle?

Paul Britton: I square it because, if you think about what is trying to be accomplished for this new administration, you have, on one side, a very pro-growth, pro-business agenda, which you imagine would be constructive for asset prices. The way that the agenda is being formulated and being presented is unconventional, and that's I think the push and pull of what markets are trying to digest.

If we're sat at this table in three years time and we look back as to where we were sat here today, I imagine that we're going to look at one another and say, "Well, that was pretty obvious. Why didn't we do that? Or why didn't we have more of that?" But because it's an unconventional, unpredictable manner of how policies are being implemented, I think that can be confusing and draw anxiety from the marketplace.

So if you didn't have that, you could maybe make the case that the VIX could be lower because clearly President Trump's policies and campaign pledges were very pro-growth and very business friendly. And so you would imagine that would be supportive of risk assets and thus less volatility in the system.

I also think that there is an enormous amount of dispersion.

Tony Pasquariello: Which is a big business for you.

Paul Britton: Which is a big business where one day you have a stock or a sector that perhaps gets mentioned and that can cause terrific volatility, but it's stock or sector led. And that is a not necessarily at the macro level. So not to get too technical, but clearly realized correlation is extremely low because you've had an awful lot of dispersion across different sectors, different stocks, etc. But ultimately, the indexes just haven't really moved that much. You've had big moves across the different sectors and stocks but not necessarily that has translated into big index-led moves here in the US.

Tony Pasquariello: I want to ask one question, which is, I think at your core, you are still a risk manager. You still retain that trading instinct, the risk management instinct. You're running a big business. You have many people working for you. But you wake up August 5th. I'm not sure where you were. I was in the middle of nowhere. I was 20 miles from the Arctic Circle, and I thought, well, this will be interesting. And the VIX is at 65.

Paul Britton: Yes.

Tony Pasquariello: I presume you kind of take off the CEO hat for a moment and you put on the head of trading, head of risk management hat?

Paul Britton: Yeah. The way I try and describe it is a business is a large casino, and people come into the derivatives casino and our odds are 51-49 on a regular day. When you get those types of events of the VIX moving at that level of distress going through the market, you have the ability, you have -- the odds change. And the odds go to 55-45 or 57-43. And so I just encourage my teams to say we want to play more because the odds now are more in our favor. For whatever reasons, there's more alpha available.

And so you have to trust your process. You have to trust your infrastructure, your systems. You got to trust your instincts to be able to bet more and to be able to -- and "bet," meaning that --

Tony Pasquariello: Play offense.

Paul Britton: Play offense. And put risk on. And that is still a work in progress because it's difficult to do that when the VIX is at 65.

Tony Pasquariello: Sure. Humans are human.

Paul Britton: Humans -- let's shut the casino down, right? You know, like, I don't want to play because you don't know.

Tony Pasquariello: Sure.

Paul Britton: You just don't know.

Tony Pasquariello: Sure. I'm super curious what the answer to this question is. Because again, I've known you a long time, and I would have guessed a good bit of what we've covered so far. But I have no idea how you're going to answer this question, which is, away from the hedge fund community, one of the biggest themes in recent years has been the rise of private assets. Private equity, of course. Venture capital, of course. And then more locally, private credit. Does it matter for what you do? Does that create opportunity or challenges for what you do day to day?

Paul Britton: It's kind of the after effects. So I think the private industry has done an unbelievable job, has delivered outsized performance in certain areas, but it's a different part of the portfolio. I think some of the issues that we see historically over these past two, three years, the hedge fund industry and the private industry are competing for the same dollar. And we, the hedge fund industry, wants to be able to demonstrate to the end investor as to why we should play that role within the portfolio. And the private industry is doing exactly the same.

I think over these past two, three years there's just been a conversation, a dialogue, around institutional investors around this notion of liquidity. And so I think there's a dialogue, an ongoing dialogue, of saying, all right, how much liquidity do we need within a portfolio, an institutional portfolio? And that impacts Capstone in a couple of ways.

One, you've seen hedge fund allocations -- and Goldman wrote about this in a great piece that you just put out -- that, because the privates are not distributing as much over these past two, three years, that impacts allocations across the broader sector.

Tony Pasquariello: To everything else.

Paul Britton: To everything else. So we've seen some of that occur. And then secondly, we've engaged with institutional investors around how do you think about liquidity in your portfolio when you do have a large private allocation and you are running these assumptions of saying, okay, you do have a drawdown, what do you think your net distributions and net outflows, capital calls are going to be? And so it's interesting that it's less about, like, a tail hedge, but it's more about of a liquidity function.

Tony Pasquariello: Super interesting.

Paul Britton: That they look to be able to say we don't want to be in a position, if the market's down 25% and we have to raise liquidity, because with capital calls, we don't want to be selling equities. So we want to be able to think about ways where we can have a strategy that helps us deal with that liability that we know we have. And I think that makes all the sense in the world.

The way I think about it is that, if the private market has demonstrate over the last 20 years that they can deliver 300 basis points over the benchmark, then I think it makes all the sense in the world to say let's invest 20 basis points, 30 basis points, 50 basis points, to help that portfolio be more liquid rather than just simply relying on it to pay out over 7-, 10-year cycle. Why not use some of that outperformance to make a good strategy great? And those are interesting conversations for us.

Tony Pasquariello: Super interesting. I kind of want to go back to Paul Britton, the CEO. How do you think about managing people and risk?

Paul Britton: Working at Capstone is an unbelievable experience. I'm slightly biased. But it's very fast paced, and I say to people, like, if it's not fast paced, that's a problem.

Tony Pasquariello: That's right.

Paul Britton: That's a real problem because the evolution and the innovation in the business goes at such a rate that, if you aren't fast paced and you aren't moving, then you're dying.

Tony Pasquariello: Right.

Paul Britton: And that's the thing that keeps me up at night. It is like you've got to drive the car at a sensible pace. Meaning, you can't be in a position where you are going too fast because you can run the risk of having a wreck and coming off the road. But the thought of going too slow and seeing who's behind us in our rearview mirror, that motivates me. And that's what keeps me up at night.

Tony Pasquariello: It is an element, too, of the hedge fund business, which is a little bit unique, which is every day it's a bit of a knife fight.

Paul Britton: It is.

Tony Pasquariello: Every day --

Paul Britton: It is.

Tony Pasquariello: -- you're going to compete every single day.

Paul Britton: Every single day.

Tony Pasquariello: And it's not to say other fields of investment are any easier, but the lived experience in a trading seat is very demanding.

Paul Britton: Yes!

Tony Pasquariello: All right, here's a tough one. You're going to come back here in five or ten years. We're going to sit down. We'll do this all over again. If you had to hazard a guess, what do you think we'll say about the path that the market took?

Paul Britton: That we've been on?

Tony Pasquariello: Or the economy took?

Paul Britton: I think that these past 17 years have been an anomaly, post GFC, with the intervention -- maybe that's a strong word -- participation, contribution of central banks over these past X amount of years I think was an anomaly.

Tony Pasquariello: Their presence.

Paul Britton: Their presence and their participation. And I think that central banks were critical in that early phase of stabilizing markets. And I don't really have a better answer or solution of what they did to be able to ensure that the financial markets survived and the financial system rebounded from where it was. But I think they just overstayed their welcome. And I think that they got enamored with this notion of getting into the growth game with all good intentions of saying, "I think that we can play a role of being a growth partner to this economy." And I think that won't happen again.

Now, I think that's also this notion of having a Fed put is the size of that put I think has gone down dramatically. And so that to me, who runs a trading organization, really, it's just much more interesting.

Tony Pasquariello: That's right.

Paul Britton: And it would frustrate me of seeing central banks be very active in wanting to carve markets, wanting to participate in markets which I didn't think necessarily they had a place. And let free markets do what they should do. So I think that's the biggest change over the next 5-10 years that we will see. I think that translates into the elasticity of markets being greater.

So this notion of you could see perhaps the VIX at 10 where really the fair value of it should be at 15. But because of liquidity issues or whatever it is that you're going to get the elasticity. And that will be the same on the upside as well.

And then I also think these correlations that we have relied on historically, I'm not too sure whether they're as stable or as reliable as what we have become comfortable with.

Tony Pasquariello: Yes. I sent this around a couple weeks ago, but we did some very basic analysis on the performance of a 60-40 stock-bond portfolio as compared to a hedge fund portfolio and kind of the five years that mark the end of the secular stagnation, new normal era. So call it 2015 through '19. And in the past five years of the COVID/post COVID era. And it kind of gets to your point which is, when the stated policy goal was to get to the zero bound and suppress volatility, no surprise. 60-40 outperformed hedge funds, actually only by a little bit, but they did nonetheless. And that stuff is generally accessed for very little cost.

Against that, in the past five years, hedge funds have meaningfully outperformed almost 2x 60-40 on better volatility, on lower volatility.

Paul Britton: On risk-adjusted returns, yeah.

Tony Pasquariello: And so my guess is I think you are on the same page. Now, we're not unbiased in this regard because we're rooting for hedge funds of course. But my guess is, if you're right, then the future will be favorable for active management and for what hedge funds do, the best hedge funds do.

Paul Britton: And I think that there has to be -- like economies. They're having to deal with the COVID responses. They're still having to deal with the COVID responses because of the seismic response that central banks made. And that's going to be felt for many years to come. And so this notion of the -- between 2008 and 2020 -- that you would have a coordinated response from the G5 of, okay, we're all going to lower rates by 25 basis points, whatever that is, I think that's gone. And that really is I think good news for the industry because now you don't have this coordinated response. You have real dispersion around policymaking and central bank interventions or responses, etc. And I think that's good from an alpha perspective.

Tony Pasquariello: Okay. A couple questions for the road, quick ones. What skills do you think make a world-class investor?

Paul Britton: Follow your process. Process will always get you out of trouble. And be curious.

Tony Pasquariello: Got it.

Paul Britton: So curious around don't believe that your process is always going to be -- your process can always be improved, refined, augmented, and you get that through being curious.

Tony Pasquariello: So be disciplined but be curious.

Paul Britton: Yes.

Tony Pasquariello: That's an interesting pairing.

Paul Britton: Yes.

Tony Pasquariello: What's your greatest strength as a CEO?

Paul Britton: I think consistency is key in great CEOs. That people want to feel as though that they know what they're going to get. Now, there'll be lots of people within my organization being like, you know, we don't --

Tony Pasquariello: "Last Tuesday!"

Paul Britton: Yeah. "I don't know whether that's that accurate, Paul." But I try to be as consistent as possible so that people always know what they're going to get, whether that's good or bad. But they know what they're going to get.

And secondly is to, as a CEO, show some vulnerability. People --

Tony Pasquariello: As a human.

Paul Britton: Yeah. People --

Tony Pasquariello: You're human, too.

Paul Britton: People respond to this notion of, when I'll sit in a meeting and be like, "I really didn't understand any of that," and there's lots of people that will be like, "Is he really as dumb as what I think he is?" And having that vulnerability and humility to be able to say, "I'm really sorry, I just didn't understand any of that," it then allows people to be like, "Oh, okay. I can show vulnerability as well."

Tony Pasquariello: Got it.

Paul Britton: And then you create I think a better culture.

Tony Pasquariello: What's the best piece of advice you've ever received?

Paul Britton: It was from my grandparents. And my grandfather was a fruit and veg trader. And he always told me the importance of working hard. And then I had this crazy Scottish grandmother who was just an avid, avid traveler. And they certainly weren't wealthy, but any opportunity, they'd always be going around the world. And that's what she said to me. She says, "The greatest gift is seeing the world."

Tony Pasquariello: Which investor do you admire most?

Paul Britton: That's a good question. I'd have to say, I didn't know Mr. Simons, the late Jim Simons, but I'd always try and find a time of listening, if he did talks, etc., talking about curiosity. Can clearly he had an IQ 10,000 percent more than me. But you could always tell that there was a level of curiosity which allowed him to always be at the forefront of what they did.

And I think his philanthropy was, he always spoke so much about his mission, his purpose, and that really resonated with me.

Tony Pasquariello: He had the great quote, "I did a lot of math, I made a lot of money, and I gave most of it away."

Paul Britton: Away. And that's to me, again, that's humility and what our greatest purpose should be.

Tony Pasquariello: That's right. Where do you spend your time outside the office?

Paul Britton: So I used to, for those of you who are listening to from audio, I'm wearing a boot. I have torn my Achille's on a tennis court. So I love tennis. I love sports. I've always been active in sports. And now I am not so active with a repaired torn Achille's.

Tony Pasquariello: Last question. What are you most excited about in the world right now, Paul?

Paul Britton: I think there's an awful lot of discussion around the impact of AI. There's not a day, an hour goes past where we're discussing the impacts of it at Capstone. It's moving so quickly, and I'm fascinated as to see where it ends up. I'm fascinated to see the role it can play within industries, within my business. And it's got even more fascinating in terms of just you feel as though the price point and the accessibility is going to be a game changer, which that really excites me from understanding how to use this within our businesses over the next three to five years.

Tony Pasquariello: And as we sit here today, has it made a meaningful change in the productivity of Capstone as yet in the game?

Paul Britton: We're a relatively small firm, right, compared to Goldman Sachs. We have 330, 340 staff. But we have an ambitious goal and target of trying to save 50,000 hours. And I do these small get-togethers called Cap Chats with five or six individuals within the firm. And my message is quite straightforward. It's if you have a workflow, a work function that is repeatable every day, you have to be thinking about using this technology to be able to automate it because, if you don't, then you are at risk.

Because in three or five years' time, I believe -- and there's definitely a segment within my organization that thinks within nine and twelve months, this is all going to be done. And I think that's the interesting question. But if you have a repeatable task, I don't want you to doing that because I want you to doing tasks and work that are higher value. And that's good for me. That's good for you. And I think that's how humans stay ahead of the game with this first phase.

So that's how my message within my firm is. This is an unbelievable tool that has to be harnessed to be able, to the first phase, is to be able to reduce the repetitive workflows that we have within the organization so that we have the ability to work on other higher-value workflows.

Tony Pasquariello: Okay. Well said. We're going to leave it there. Paul, thank you for doing this.

Paul Britton: Thank you so much. Thank you so much for the invite.

Tony Pasquariello: Thank you all for listening to this episode of Goldman Sachs Exchanges Great Investors, which was recorded on February 20th, 2025. I'm Tony Pasquariello. If you enjoyed this show, we hope you'll find us on Apple Podcasts, Spotify, YouTube, or wherever you listen to your podcasts and leave us a rating and a comment.

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