From right: HENRY M. PAULSON, JR. Chairman and Chief Executive Officer
JOHN A. THAIN President and Co-Chief Operating Officer
JOHN L. THORNTON President and Co-Chief Operating Officer

Fellow Shareholders:

It was a challenging year for Goldman Sachs. The business environment was perhaps the most difficult in recent history, marked by weak or negative growth throughout much of the world, international uncertainty, the third consecutive year of broad equities market declines and the continued aftermath of the technology/telecommunications bubble collapse.

As a firm, we cannot control the external forces that shape the business climate. What we can control is how we manage our business and execute our strategy. On those terms, Goldman Sachs' 2002 results demonstrated the firm's resilience and ability to produce a solid performance for shareholders.

Net earnings for the year were \$2.11 billion, on total net revenues of \$13.99 billion. Earnings per diluted share were \$4.03, down 5% from 2001. Return on shareholders' equity was 11% for the year, and return on tangible shareholders' equity was 15%. Evident in this performance were both the strength and diversity of the Goldman Sachs franchise and our discipline concerning expense reduction. This performance also reflected, as it has throughout the 133 years since the firm's founding, in good times and bad, the quality of the people of Goldman Sachs and their ability to develop and execute business.

BUSINESS RESULTS

Investment banking activity and net revenues for the industry declined throughout the year. Those declines are clearly seen in our investment banking results, although relative performance remained strong. Once again, Goldman Sachs ranked first in announced and completed global mergers and acquisitions, and we advised on seven of the ten largest deals completed during 2002.[1] We were also the leading underwriter of global public equity offerings in 2002, and ranked second in global initial public offerings.[1]

Within our Trading and Principal Investments business, Fixed Income, Currency and Commodities (FICC) produced record net revenues for the firm, demonstrating the ability to serve clients and take risk prudently. In particular, we were able to avoid significant credit losses as the business environment deteriorated and spreads widened. Performance was strong across most of our FICC businesses, particularly in currencies, mortgages and fixed income derivatives. Net revenues declined in our Equities trading business, reflecting weaknesses in global equities markets in what continues to be a very difficult environment. At the same time, however, we continued to strengthen our equities franchise in the most important trading centers across the globe. And, as a result of the fuller integration of Spear, Leeds & Kellogg, we are truly at the cutting edge of technology-driven innovation and efficiency. Principal Investments had another disappointing year, with further declines in the value of several technology and telecom investments more than offsetting favorable results from the real estate portfolio. During the year, however, we were successful at finding a number of very attractive investments in which to participate, and we continue to believe this is a particularly good time to be an active investor.

Asset Management and Securities Services continued its strong performance in 2002. Despite significant equities market depreciation, assets under management declined only slightly, reflecting net inflows. This is, we believe, an affirmation of our investment track record as well as our focus on client service.

MANAGEMENT DISCIPLINE

In response to the difficult operating environment, we reduced operating expenses by 11% from the prior year's level. Non-compensation expenses were pared back and we made painful but necessary reductions to our workforce, taking great care not to impair our ability to compete today or in the future. Compensation is, of course, our largest expense and we imposed rigorous discipline in making 2002 bonus awards. Most professionals saw reductions in total compensation, starting with the firm's senior management.

Finally, we took important steps throughout 2002 to refocus the entire Goldman Sachs organization on our business principles, which begin and end with an absolute insistence on integrity. In particular, we have a major continuing initiative aimed toward insuring that we exhibit unimpeachable professionalism in everything we do and reinforcing our culture. That culture, with its emphasis on client service, teamwork, strict compliance and excellence, is our greatest strength, but it requires constant reinforcement, particularly in difficult markets and under adverse conditions. Safeguarding our culture will continue to be one of our highest priorities in 2003.

RESTORING INVESTOR CONFIDENCE

The continuing after-effects of the late 1990s technology/telecommunications bubble posed significant challenges to the financial markets and our industry in 2002. The huge losses associated with the bubble's collapse severely affected investor confidence — which in turn was further shaken by the large and highly visible corporate scandals that emerged beginning in late 2001.

All this led to a storm of public criticism and calls for new laws and regulations. Notwithstanding some of the rhetoric, much of the criticism has been warranted, as are many of the regulations recently enacted or proposed. And while it is simply wrong to say that investment banks, such as Goldman Sachs, created the market bubble, it is true that, in common with much of the media, academia and the business community, we misjudged it.

The more important point, at least for us at Goldman Sachs, is that we understand and accept our responsibilities as one of the gatekeepers of the financial markets. With the benefit of hindsight, it is clear that we all could have done better. We are committed to learning from our mistakes. Against this backdrop, in 2002 there were dramatic changes in the legal and regulatory environment. The New York Stock Exchange proposed new corporate governance listing rules. U.S. regulators mandated CEO and CFO certification of corporate financial statements. Law enforcement agencies began aggressive enforcement actions aimed at misconduct. And the U.S. Congress passed the Sarbanes-Oxley Act in an attempt to strengthen confidence in U.S. corporations, accounting and financial markets.

In the financial services industry, public scrutiny focused on the role and quality of investment research. Even before the public controversy of 2002 arose, we had taken a series of decisive steps, commencing in February, to protect further the integrity of our research and to improve its quality. During the months that followed, we worked closely with regulators and other investment banks in crafting the provisional settlement announced on December 20. While many of the new rules were initiated primarily to protect retail investors — not our market segment — we are determined to make them work. In addition, we are supportive of a proposed industry initiative that generally would prohibit allocations of initial public offerings to officers and directors of public companies. The new rules for research and for IPO allocations applicable in the U.S. may well form a template for our industry throughout the world.

We have also attempted to play a positive role in the debate on corporate governance, accounting and regulatory reform, and, among other things, participated in the development of the Sarbanes-Oxley Act in the United States. As with the research settlement, there are areas of the Sarbanes-Oxley Act that need to be clarified to prevent unintended consequences to the competitiveness of the U.S. capital markets. At the same time, one of the strengths of the U.S. system has always been its ability to respond to crisis with quick self-correction. Passage of the Sarbanes-Oxley Act was part of that process, and we support it as an important step towards rebuilding investor confidence.

We believe that only by putting appropriate corporate governance mechanisms in place, and otherwise aligning the interests of management with shareholders, can there be sufficient focus on shareholder interests. In that connection, we refer you to our statement on “Promoting and Protecting Shareholder Interests” that follows.

SIGNIFICANT TRANSACTIONS

On February 7, 2003, Goldman Sachs entered into a series of related transactions with Sumitomo Mitsui Financial Group, Inc. (SMFG) that include an investment of ¥150.3 billion ($1.25 billion) in convertible preferred stock of SMFG, the provision by SMFG of credit loss protection to Goldman Sachs and a broadening of cooperative initiatives between our two firms. We believe these transactions have strategic significance and real benefit to both organizations and their shareholders. For Goldman Sachs, it enables us to pursue three important objectives. First, it deepens our participation in Japan and Japanese financial markets, through an investment in one of that nation’s largest and best-managed institutions. Second, the credit protection component will enhance Goldman Sachs’ ability to offer credit commitments to investment-grade clients while mitigating in part the credit risk of doing so. Finally, the agreement with SMFG extends the range of cooperative initiatives between Goldman Sachs and SMFG, and areas on which we anticipate working together will include the disposition of non-performing assets, investment banking and asset management. This transaction is especially meaningful, given the long and successful relationship between our firms, including Sumitomo Bank’s historic capital investment of $500 million in Goldman Sachs initiated in 1986.

BOARD OF DIRECTORS / MANAGEMENT CHANGES

In December, we announced that William George, former Chairman and CEO of Medtronic, Inc., was joining our Board of Directors. Bill fills the seat Steve Friedman left when he retired to become Assistant to the President for Economic Policy and Director of the National Economic Council. We will miss Steve's contributions to the Board, although we are gratified that President Bush will have the benefit of his counsel. And we are fortunate to gain a new director of Bill's caliber. Morris Chang and Meg Whitman also resigned as directors late in 2002. We are grateful for their dedication and insights as directors. In February 2003, in light of the announced retirement of Bob Hurst, the Board nominated Lloyd Blankfein, a Vice Chairman of Goldman Sachs with responsibility for our securities businesses, to stand for election to our Board of Directors at the April 1 Annual Meeting. We look forward to having Lloyd as a new director and we thank Bob for his contributions to our Board.

Over the past year we changed the ranks of our senior leadership to meet the challenging business environment and to ensure the best possible service to our clients. Lloyd Blankfein, Bob Steel and Rob Kaplan were appointed Vice Chairmen and asked to take on expanded management responsibilities. In addition, Masanori Mochida, Suzanne Nora Johnson, John Weinberg, Gary Cohn, Chris Cole, Michael Evans, Scott Kapnick, Peter Kraus, Eric Mindich, Tom Montag, Eric Schwartz, Michael Sherwood and Andrew Melnick joined the firm's Management Committee over the course of 2002. These individuals bring a wealth of talent and experience and a diversity of perspectives to the Committee.

CONCLUSION

One of the most meaningful tests of individuals and organizations is how well they handle adversity. In 2002, the people of Goldman Sachs rose to meet the challenges of the environment and events with great distinction and considerable success.

We anticipate that the coming year will continue to be difficult, with slow growth in most of our major markets. The international situation, particularly in the Middle East and Asia, is of concern to us all, and will affect market conditions in ways that cannot be predicted. And we believe that close scrutiny of the securities industry and its role in the late 1990s bubble will continue.

However, there is no question that today Goldman Sachs is a stronger firm than we were only a year ago, and well positioned to benefit from the broad secular forces that, despite recent setbacks, are driving profound and lasting global change. As a result, we have even greater confidence in Goldman Sachs' longer-term prospects and success.

HENRY M. PAULSON, JR.
Chairman and
Chief Executive Officer

JOHN A. THAIN
President and
Co-Chief Operating Officer

JOHN L. THORNTON
President and
Co-Chief Operating Officer

(1) Thomson Financial Securities Data—January 1, 2002 through December 31, 2002.