Are GMAC Demand Notes Now Safe?

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Are GMAC Demand Notes now safe? It's become one of our perennial questions from many clients. Indeed, GMAC has been in the national spotlight even more over the past year and a half. The Treasury Department's continued funding has brought U.S. taxpayer ownership of the company to a majority stake of 56% as of December 31, 2009.

GMAC Demand Notes provide investors with a high-yielding savings vehicle. Consequently, many investors have replaced their traditional money-market account with a GMAC Demand Notes account. Indeed, the account provisions as they relate to check writing and other features are very similar to typical money market accounts. There is one very important distinction, however. Unlike money market accounts at the local bank, GMAC Demand Notes are not FDIC insured. In fact, they are actually unsecured and unsubordinated debt obligations of GMAC LLC. Therefore, it is possible for investors to take a loss on their investment if GMAC is unable to pay its obligations.

Many investors were surprised to learn how much risk they were potentially exposed to when rumors of a possible General Motors bankruptcy began to circulate in late 2005, following the Delphi bankruptcy filing. We felt the risk at that time was a bit overblown, especially by brokers and others who were selling fear to drive investors out of GMAC Demand Notes and into their proprietary products. So much so, that in December of 2005, we published our research report on the matter, "*GMAC Demand Notes - What's the Risk?*" to provide what we believed to be a sound and objective position. Since then, those investors who stayed with GMAC Demand Notes have enjoyed a much higher yield on their liquid assets than in traditional money market accounts.

However, circumstances have changed considerably over the past few years. In late 2006, GM sold a controlling stake in GMAC to a group of investors led by Cerberus Capital Management. Even though GMAC was (at the time) profitable, the move was taken to help shore up GM's liquidity and improve GMAC's credit rating. The coming downturn in the real estate markets, coupled with unforeseen difficulties in the subprime mortgage industry, hurt GMAC's mortgage subsidiary, Residential Capital LLC (ResCap). By mid-2008, both GMAC and Cerberus were scrambling to help ResCap raise enough cash to meet its own needs and satisfy commitments to lenders.

In mid-2008, the declining financial condition of GMAC along with other developments had caused us to take a more cautious position concerning GMAC Demand Notes. See our June 2008 report, "*GMAC Demand Notes – The New Risks*". Then, in the fourth quarter of 2008, GMAC successfully became a bank holding company. Shortly thereafter, the Treasury Department announced that it would purchase $5 billion in senior preferred equity with an 8% dividend from GMAC through the U.S. Treasury's Troubled Asset Relief Program (TARP). This measure provided GMAC the immediate liquidity that was imperative for it to continue operations. The U.S. Treasury provided a second capital infusion in mid-2009 bringing its investment in GMAC to $13.5 billion. In late December, a third capital infusion of $3.79 billion gave the U.S. government a 56% stake in the company.

The willingness of the U.S. Treasury to deepen its exposure to GMAC reflects the importance the government has placed in the company for the revival of the domestic automotive industry (specifically General Motors and Chrysler). As a Congressional Oversight Panel for the TARP program is now criticizing the continued capital infusions into the company, the question becomes - would the government let GMAC go under at this point? Keep in mind, as we pointed out at the beginning of this report, that GMAC Demand Notes are n<u>ot</u> FDIC insured. In fact, they are unsecured and unsubordinated debt obligations of GMAC.

To gain some insight into the relative risk of GMAC Demand Notes, we can look to the market itself. When debt is issued, a higher than average interest rate must be offered in cases where the debt is considered to carry above average market risk. The higher rate makes the debt attractive to investors who are willing to accept the higher risk in return for a higher yield. As of January 1, 2009, GMAC Demand Notes provided an annual yield of 5.25%. One year later, on January 1, 2010, the annual yield stood at 2.15%. This represents a reduction in the yield offered by more than half. While traditional, FDIC insured money market yields changed only slightly during this same period, the decline in the Demand Notes' yield was primarily the result of the market's perception of less risk in the investment. It is important to view this change in yield in the proper context, which is a reduction, not elimination, of market risk.

It's interesting to point out that on January 21, 2010, Fitch Ratings (a debt rating service) raised its credit rating on GMAC. Fitch said that the positive outlook was based on the view that with so much government support, GMAC's rating can't go any lower.

Overall, GMAC Demand Notes have provided investors with a very worthwhile income investment. The lack of a guarantee or FDIC insurance should be considered carefully by those who have come to think of Demand Notes as a preferred alternative to a traditional money market or other FDIC insured bank account.

As investment advisors, we always want to consider both the risks and the rewards of an investment alternative. When the rewards outweigh the potential risks, we counsel those seeking our advice to move toward those investment alternatives. Traditional banks will pay a much lower yield on money market accounts compared to Demand Notes, but the guarantee may be worth the opportunity cost for some investors. We recommend investors at least evaluate their current position in GMAC Demand Notes in light of some of the factors we have outlined in this report.

Current factors aside, certainly a very small allocation in GMAC Demand Notes among an otherwise broadly diversified income portion of an investor's portfolio is lower risk than the investor that holds half of his entire retirement savings in GMAC Demand Notes. (Yes, we have seen this.)
