Detroit Free Press

This high return has high risk

By Susan Tompor
April 20. 2008

As investors watch the mortgage meltdown and the carnage from the credit crunch, they're getting more nervous about the outlook for some investments once deemed as good as cash.

Clifford Notter, who retired 13 years ago as a pipe fitter from General Motors Corp.'s Poletown factory, has a huge chunk of his retirement savings in GMAC Demand Notes. He's getting a 5% annual yield on his money -- a far nicer return than a savings account.

Unlike a savings account, though, GMAC Demand Notes are not FDIC-insured. The higher yield comes with a higher risk -- especially if GMAC LLC, an auto and home lender, would somehow end up filing for bankruptcy protection.

It's all spelled out in the prospectus at www.gmacfs.com. The demand notes are a short-term, unsecured debt obligation of GMAC. The accounts offer check-writing privileges, like a money market account, but this isn't a money market account. The Demand Notes are not guaranteed by General Motors or GMAC.

Notter, 72, knows this. Yet the 5% yield helps boost his income in retirement. The Eastpointe retiree has not moved his money -- but he has made plenty of calls to the company and others to see if he could be buying trouble. He worries, but he waits.

Tough times at GMAC

No one knows how things might turn out for GMAC. In 2007, Detroit-based GMAC posted a net loss of $2.3 billion after a $4.3-billion loss at its mortgage unit Residential Capital LLC.

But anytime there is increased risk, it's wise to reconsider if you really want most of your money in one company's stock or one company's unsecured debt. No one has had trouble accessing money in GMAC Demand Notes, according to GMAC. About $6 billion is invested in GMAC Demand Notes. There has not been an excessive outflow or inflow of money, according to GMAC spokesman Michael R. Stoller in Detroit.

Demand Notes are available to GM and GMAC retirees and employees, and others with a relationship to GM, including dealers and stockholders. Other companies, including Ford Motor Credit Co., also offer smaller investors a spot to park cash with similar types of corporate notes. The safety of GMAC Demand Notes came into question in 2005 amid speculation of a potential bankruptcy at GM. GM survived, and savers were OK.

At the same time, GMAC is facing serious challenges during the credit crunch.

GMAC Bank -- which does not issue the Demand Notes -- is dealing with a regulatory issue that could hurt GMAC's struggling mortgage subsidiary.

The issue, which must be resolved by Nov. 30, dates back to an agreement reached in 2006 with the FDIC when Cerberus Capital Management LLP and its co-investors bought a 51% stake in GMAC from General Motors Corp.

Based on the original agreement, which included various options, Cerberus and GMAC now have requested that the FDIC grant a waiver to allow GMAC to keep GMAC Bank, a source of low-cost money for Residential Capital.

If the FDIC does not grant the waiver, GMAC has disclosed that it could be required to sell GMAC Bank or face a situation where the bank would no longer be insured by the FDIC.

Either of those requirements would "materially adversely affect our access to low-cost liquidity and our business and operating results," according to the GMAC regulatory filing.

Credit crunch throws in a wrench

David Kudla, CEO of Mainstay Capital Management in Grand Blanc, said some clients who became jittery about GMAC Demand Notes about two years ago started putting more savings into higher-yielding certificates of deposit at GMAC Bank to get FDIC insurance.

He still sees that as a good strategy. There is some risk, which he views as small, with the GMAC Demand Notes. But Kudla suggests that savers will need to watch what happens with the waiver at GMAC Bank.

Last week, GMAC Bank was offering one of the highest yielding CDs in the country. A one-year certificate of deposit at GMAC Bank had an annual yield of 3.9%, according Bankrate.com. The minimum deposit was $500.

Bob Bilkie, president of Sigma Investment Counselors in Southfield, warns that investors must consider the risks when they put cash in any uninsured high-yielding account, such as Demand Notes.

"It's dangerous to start compromising on credit quality, just to get the yield," Bilkie said.

Let's go off track here for a bit and consider another, unrelated fallout in the credit crunch.

Brokers at major investment firms throughout the United States once marketed auction-rate securities as "good as cash."

But this spring, investors couldn't get their hands on their cash. They're sitting and waiting until the troubles work out. Class-action suits and arbitration claims are piling up.

Ross Rogers, president of Comerica Securities, said Comerica customers who had auction-rate securities also ran into problems. He said auction-rate securities had been a good investment, but the credit crunch meant that auction-rate debt market began to fail.

"The market just literally froze up," said Rogers, who said he believes the market will work itself out of its troubles.

Demand Notes are not auction-rate securities. Yet, there is an important lesson to be learned.

Unforeseen twists can wreak havoc with any investment, even those that seemed to be as good as cash.