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GMAC Demand Notes – The New Risks

(June 30, 2008)

GMAC Demand Notes were designed to 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. Therefore, it is possible for investors to lose 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. We felt the risk 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 assets than in traditional money market accounts. In fact, investors who followed our advice and stayed with GMAC Demand Notes earned about 5% more return over the past 2½ years compared to traditional money market accounts.

However, circumstances have changed considerably. 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. More recently, the downturn in the real estate markets, coupled with unforeseen difficulties in the subprime mortgage industry, have hurt GMAC's mortgage subsidiary, Residential Capital LLC (ResCap). In June 2008, both GMAC and Cerberus were scrambling to help ResCap raise enough cash to meet its own needs and satisfy commitments to lenders.

Declining values of gasoline guzzling pickup trucks and sport utility vehicles are now looming over GMAC, adding to its problems with souring mortgages. The resale value of these vehicles in the used car market has dropped sharply. GMAC is quickly becoming saddled with inventories of thousands of these vehicles as they come off leases or are repossessed from owners unable to keep up with payments.

Another concern is born from our ongoing analysis of GMAC's financial statements. We have seen a disturbing trend in the ratio of earnings to fixed charges for the Demand Notes business segment. As recently as 2004, this ratio was 1.45 - meaning that the Demand Notes unit earned 45% more than it needed to pay its fixed charges. In 2005, this ratio declined to 1.28, still very profitable. In 2006, the ratio fell again, to 1.15. In 2007, however, this ratio deteriorated more rapidly. In the first quarter (March 2007), the ratio fell to 0.94, or less than one-to-one coverage. This means that available earnings were insufficient to cover fixed charges, likely a result of the difficult environment for making new mortgages and the higher rate of defaults. By September 2007, the ratio fell to 0.87, which in dollars was a $1.4 billion shortfall, according to GMAC's financial statements.

Challenges at GMAC and increasingly difficult operating conditions for GM, GMAC's minority owner, caused Standard & Poor's Ratings Services to place GMAC on "CreditWatch with negative implications" on June 20, 2008.

The declining financial condition of GMAC along with other developments has caused us to now take a more cautious position concerning GMAC Demand Notes. Risk of a bankruptcy filing was (in our opinion) very remote when we reported on Demand Notes in our December 2005 research report. Now, the once very profitable GMAC relies on cash infusions to quell speculation of its financial distress.

Overall, GMAC Demand Notes have provided investors with a very worthwhile income investment, but times have changed. 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. This has historically been the case with GMAC Demand Notes as they offer a compelling yield to compensate investors for additional risk. Traditional banks will pay a much lower yield on money market accounts compared to Demand Notes, but the guarantee may now be worth the opportunity cost for some investors. We recommend investors at least evaluate their current position in GMAC Demand Notes and no longer consider Demand Notes the virtually riskless investment they once were.

Bottom line: Demand Notes can remain a part of an investor's overall asset allocation strategy, but this position should be considered carefully and should be diversified with other income alternatives that are not exposed to the current risks we have outlined in this report.

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UPDATE FOR THIS ESEARCH REPORT

Update: GMAC Demand Notes – The New Risks (December 11, 2008)