Eidelman Capital Management

Quarterly Letter **June 2009**

Dear Clients & Friends,

What a difference a few months make. Last quarter, the economy and stock market were in a free fall. Big financial institutions were failing and governments were frantically trying to pass stimulus and bailout plans to stabilize the world financial markets. Since then, the S&P 500 stock market index has roared 37% from the low. Frozen credit markets have thawed and Fed Chairman Ben Bernanke went on *60 minutes* and stated that he was seeing "green shoots" of economic revival. Market sentiment seems to have switched from, "We are heading for the next great depression" to, "The economy will turn around soon and we don't want to miss the rebound." So now that the market has rebounded sharply, do we agree that the recession is over and the market will continue its rise or will it plunge to new lows?

Honestly, we don't know. We could make a strong case why either scenario is possible so we are taking the approach that anything can happen. The S&P 500 index has backed off recently from its June high, reflecting concern the stimulus is not having its desired impact and worry the recovery could take a long time. Last quarter I wrote that the best times to invest have been when valuations were low and investor sentiment was pessimistic. I said, "In short, the best time to buy was when nobody wanted to invest in stocks." These lessons of history repeated and the market jumped on rebounding investor confidence. We're very happy the market recovered and that we were well positioned to take advantage of the market surge.

So what are our trusty indicators saying now? The extreme pessimism has waned. Consumer confidence has doubled off its lowest reading, investor sentiment has rebounded from deep pessimism back to its historical average, and large quantities of insider buying have reversed to selling. Based on these market indicators, we find the market less attractive than we did last quarter. Nevertheless, we are still finding opportunities in individual investments.

To shed some light on some investments that impacted the value of portfolios, I will touch on the Sallie Mae (SLM) and GMAC bonds, which both appreciated significantly in the second quarter. SLM bonds shot up on news that Sallie Mae signed a deal with government to continue being a primary loan servicer. In addition, Jim Cramer touted SLM stock on his TV show as his "speculative stock of the year." We believe SLM bonds could appreciate further because they could be upgraded by the rating agencies. GMAC bonds also shot up on news that GMAC received a $7.5B equity investment from the US government and signed a deal to provide auto financing to Chrysler dealers. I will outline this investment further in the next section "GMAC Bonds: Safer than Treasuries?"

(continued on next page)

Another of our larger holdings, L.A. Regional Airport Bonds, which was in a legal battle with United Airlines over past due lease payments, was finally granted the favorable court ruling we were anticipating. United was ordered to pay our L.A. Airport Bonds $100 per bond plus 6 ½ years of tax-free back interest at 6.875% which is worth an additional $44 a bond. We believe this money will be paid out in short order and an appeal is unlikely.

As we so often mention, our strategy is to find great individual investments. We are seeing some of the world's greatest companies with iconic brands trading at very reasonable valuations including Coca Cola, Proctor & Gamble, IBM, and Pfizer. In addition to these blue chips, we continue to find some diamonds in the rough among undervalued value stocks, but admittedly, it has become harder as the recent market surge lifted these stocks to new heights.

To further our goals of providing great client service and education, we are starting a new quarterly video commentary on our website http://www.eidelmancapital.com/commentary. It's timely because a lot of what I talk about in the next section reflects the complexity of bond investing. Hopefully, you will attain more confidence and clarity watching us discuss our latest investment ideas. If you have any questions or suggestions, please contact me at tom@eidelmancapital.com.

Sincerely,

Tom Eidelman
Vice President

GMAC BONDS: SAFER THAN TREASURIES?

BY TOM EIDELMAN

In March 2009, the credit crisis was at an extreme. Stocks, bonds, and housing prices were collapsing, and General Motors (GM) was on the verge of bankruptcy. Most investors were nervous holding high yield bonds and any investor daring enough to even think about General Motor Acceptance Corp (GMAC) bonds were thinking: GM + Financial company + credit crisis = Sell!

On the other end of the risk spectrum, investors flocked to the safety of US guaranteed Treasury bonds. Demand was so high that yields fell to 2.5%, the lowest levels in 50 years. Think about that for a minute: In exchange for a guaranteed return, investors were willing to accept just 2.5% a year for 30 years. Investors who sold “riskier” stocks and bonds for Treasuries slept better over the next few days thinking that their money was safe. They knew the return was low, but at least they wouldn’t lose anything right? Not exactly. I’m going to explain why most investors got it backwards and the GMAC bonds were a safer investment than Treasuries.

Asset Protection, High Return Potential

GMAC provides auto financing to General Motors dealers. Once owned by GM, GMAC was spun off and sold to a private equity company, Cerberus. The most important point to note is GMAC is an independent entity from GM and neither company guarantees the other’s debt. We had numerous clients call us and ask us why we were buying GM bonds. I don’t blame them, as GM was about to go belly-up. Of course, our answer was that we weren’t buying GM bonds, we were buying GMAC bonds. Even still, GMAC bonds seemed risky to many.

They were rated CCC (below-investment grade) by S&P and yielded 22%. GMAC was still a financial company tied to General Motors with a struggling residential mortgage division. How on earth could we consider these bonds safe?

It is critical to note that we purchased the majority of our GMAC bonds in April around $.30 on the dollar. To evaluate risk, we calculated the recovery value of our bonds in a worse-case scenario. As impossible as it sounds, we figured that if GMAC went bankrupt, suffered extreme losses in every division, and paid out everything they had left; they would still have enough assets to pay our bonds $.83 on the dollar (See Chart A). This means we thought we could double our money even if the company went bankrupt. The best part is that we thought a turnaround was much more likely.

Chart A

Worst Case Scenario Summary	Amount ($B)
ResCap Division goes Bankrupt	7.2
GM defaults on all obligations to GMAC	4.4
All securitized investments are worthless	8.5
Double GMACs loss provisions	4.0
Addl losses on hedges, goodwill, leases	4.4
Addl operating losses	2.0
(1) Total GMAC Losses	**30.5**
(2) Stockholder's Equity	22.0
(3) Total Losses on Bonds (1)-(2)	8.5
(4) Unsecured Bonds Outstanding	50.0
(5) Remaining Value of Bonds (4)-(3)	41.5
(6) Value of Bonds per dollar (5)/(4)	**$ 0.83**

High Potential Returns: GMAC Upside

Given GMAC’s dominant position in auto financing and government financing assistance, we believed they would return to profitability. If GMAC’s business could stabilize, we thought these bonds should trade in line with other high-yield bonds around 15%. If such an outcome occurred over two years, this would cause the GMAC bonds to double in price plus pay a 22% in interest each year.

GMAC Update

Since purchasing the GMAC bonds, several positive events have occurred. The US government invested an additional $7.5B of equity in GMAC, providing further protection to our bonds. Second, GMAC signed a deal with Chrysler to provide their dealers with auto financing, increasing GMACs addressable market and improving their turnaround potential. In addition, as the credit crisis has abated, high-yield bond yields have fallen to an average of 12%; justifying an even higher price for GMAC bonds. To yield a comparable 12%, the GMAC bonds would need to appreciate another 33% in addition to the 13% interest they are paying each year.

In summary, the GMAC bonds had low risk and a high potential return because of the low price we paid. Such a scenario occurred because of the credit crisis and fear surrounding General Motors. Investors shunned GMAC bonds which created an opportunity to buy when others were fearful. We believe just the opposite occurred in the Treasuries market.

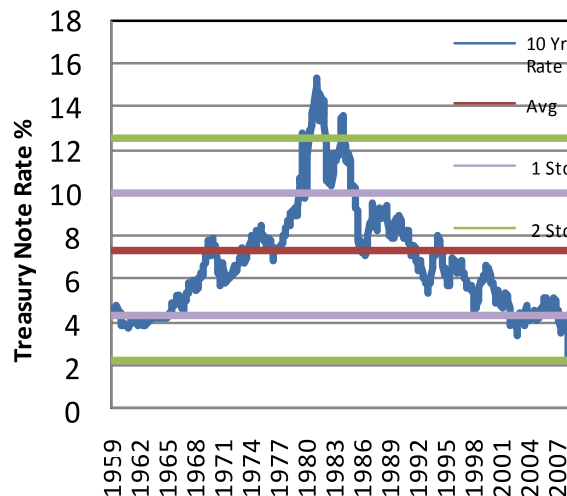
Treasury Bonds: Return-Free Risk

Treasury bonds are long-term debt obligations of the US government. They are rated AAA (the highest rating) by the rating agencies and are often considered risk free because interest and principal payments are guaranteed by the US government. If the government runs out of money, they can just print more. For this reason, Treasury bonds are considered by many as the "safest" asset in the world. So how can we say they are risky?

Treasury Bubble & Interest Rate Risk

Just because Treasury bonds are guaranteed doesn't mean they aren't overpriced and riding for a fall. Due to desperation for safe assets, many investors stampeded into US Treasuries. Such buying created an investment bubble akin to the internet bubble of the late 90s and the recent housing bubble. 10-year Treasury notes officially qualified as a 2 standard deviation bubble when yields fell to 2.06% on the first trading day of 2009 (See Chart B).

Chart B: 10-Year Treasury Rates (1959-2009)



While 30-year rates have risen from record lows, we believe they will rise much further. Jeremy Grantham of GMO is famous for his saying that every single financial bubble in stocks, real estate, bonds, currencies, and commodities has popped and reverted to its long-term average with no exceptions. We don't think the Treasuries bubble of 2009 will be an exception.

The forces of supply and demand support higher future interest rates. A colleague of ours put it this way: "Say I've been selling t-shirts for a certain price for many years. Now, I'm stuck with warehouses full of shirts and forced to sell 3 times more t-shirts than last year. Won't I need to cut the price to sell 3 times as much?" Similarly, the US government currently has the largest level of public debt and budget deficits since WWII. In 2009, The US government will need to find buyers for almost three times the debt that was issued last year. Shouldn't the US government need to cut the price of their bonds and offer higher interest rates? Shouldn't rates at least be equal to the historical average rate? We believe so.

Now here's the bottom line. If interest rates rose from their current low rates of 4.25% to their long-term average of 8%, 30-year Treasury bond prices would fall a whopping 41%! See Chart C. Such an outcome sure seems risky to me. Now risk can't be looked at alone. Do Treasury bonds offer a good return for this level of risk?

Chart C: Treasury Bond Return if Interest Rates Immediately Rise to 30-year Average

Maturity Date	Yields		% Decline if Rates Revert to Avg
	Current	30-yr Avg	
10-year	3.50%	7.40%	**-26.9%**
30-year	4.25%	8.00%	**-41.0%**

Upside: Paltry Returns

Even if held to maturity, long-term Treasuries offer meager returns at best. Yields of 4.25% are well below historical averages of 8% and unattractive relative to municipals and corporate based on historical spreads. These yields are even worse when considering taxes and inflation. After accounting for taxes and inflation, returns on bonds should be around zero (See Chart D). Such low estimated returns may even turn out to be too optimistic. If taxes or inflation are higher in the future, real after-tax returns on bonds would be even lower. As you can see, Treasury bonds offer guaranteed low returns with a high degree risk if interest rates go up.

Chart D: Estimated Returns on Treasuries

Maturity	Nominal Return	After Inflation	After Inflation & Taxes
10 yr Treasury Notes	3.5%	0.8%	**-0.4%**
30 yr Treasury Bonds	4.3%	1.6%	**0.1%**

Assumptions:
Future CPI equal to past 20-year avg of 2.7%
Taxes equal to 35%

Buying the TBT

We believe the best way to profit from overvalued Treasury bonds and rising interest rates is by purchasing the Proshares UltraShort 20+ Year Treasury fund (TBT). This fund seeks twice the opposite returns of a 20 year Treasury fund. You may be thinking "Wait a second, didn't you just write an article in Barron's preaching the inadequacies of such leveraged ETFs?" Yes, we did; however, we believe due to less volatility, historical correlations, and constant monitoring, the TBT will successfully accomplish our goals.

Conclusion

The credit crisis created tremendous opportunity. Some traditionally "risky" assets like the GMAC bonds were trading at such discounts that investors could reap large gains even if the worse-case scenario occurred. On the other hand, traditionally "safe" investments like US Treasuries were driven to such extreme levels that they offered virtually no return while incurring significant interest rate risk. Which investment do you think was safer?