An In-Depth Look at Certificates of Deposit

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Introduction to CDs

There are a lot of different ways to invest your money, each with a variety of risk factors. CDs, which are essentially promissory notes written by banks, are virtually risk-free. But due to their low yields they're often overlooked for riskier, higher-return investments. CDs are most attractive to investors who are seeking a low-risk investment that will, when held to maturity, return the full amount of the original investment even if the institution issuing the CD collapses.

But CDs can be good portfolio components even for individuals comfortable with risk because they offer guaranteed return, higher interest rates than savings accounts, are relatively stress-free, and are insured by the Federal Deposit Insurance Corporation, or FDIC. (CDs at credit unions are often guaranteed by the National Credit Union Administration, or NCUA.) In addition, for short-term goals a CD is a happy medium between bonds and cash where the spectrum ranges with a longer-term CD being more like a bond.

There are, however, limits to what the FDIC and NCUA will insure. The FDIC is only required to cover $250,000 per insured account, but an easy way around this if you have more than $250,000 in assets you wish to be in a CD is to split the total across as many different banks as needed to they are all fully covered.

There is more protection from the FDIC and NCUA on retirement accounts than individual accounts. CDs held in an individual retirement account (IRA) are insured up to $250,000. Additionally on accounts that are set up under a different set of provisions--like a trust for instance--may be covered to a higher amount.

- A trust with three beneficiaries may hold up to $750,000 in insured deposits.
- Joint insured accounts have a limit twice that of individual accounts i.e., $500,000.
- A married couple with a joint account and individual accounts can receive

$1,000,000 of insurance for their deposits. To calculate this total, you add the limit of the couple's joint account to the limit of each individual account i.e., $500,000 + $250,000 + $250,000 = $1,000,000.

When you go through multiple institutions, it is possible to deposit an insured amount of money that is limited only by the number of financial institutions where you create CDs

Keep in mind that each set of accounts must be at unique financial institutions. They cannot be at a different branch office of the same institution.

In our previous example of the married couple can benefit from accounts at multiple institutions by setting up $1,000,000 in insured accounts at one bank--that is two individual accounts and one joint account--and then doing the same thing at a different bank or credit union.

What if opening multiple accounts is impractical or just inconvenient? There is another option you can pursue.

The CD Account Registry Service (CDARS) offers up to $50 million in FDIC insurance coverage with a single bank deposit. The bank participating in the CDARS program spreads the money across multiple institutions.

The CD is considered to be a safe, conservative place to hold assets by most investors. The assets don't just sit there, though.

Assets earn interest in return. Traditional CDs typically yield returns greater than the rates offered by other insured investments, such as checking and savings accounts.

Rates vary from CD to CD. In general however, they are near the current rate of inflation.

It is important to have an understanding of the difference between annual percentage yield (APY) and annual percentage rate (APR) when comparing the interest rates of various CDs.

- APY is the total amount of interest the CD will earn in one year factoring in compound interest.
- APR is the stated interest earned in one year--not taking compounding into account.

A CD that pays interest only once a year will yield--yearly--only the exact amount of interest paid.

The rate of interest for CDs is typically greater for larger deposit amounts and it is often greater for longer terms, as well.

The rate of interest on a 30-day CD, for example, is generally less than the rate on a one-year CD. The longer an investor is willing to remain without his or her money, the greater the overall yield can be.

There is an exception that occurs when there is an inverted yield curve.

During an inverted yield curve, short-term term CDs may pay higher rates than long-term CDs because the market is less confident about long-term purchases.

Some investors may choose not to reinvest the CD's interest when it is calculated. These investors choose to receive regular interest checks from the bank or credit union, providing a steady stream of income.

However, not reinvesting the money into the CD account has the downside of reducing the overall yield that is possible through compounding.

It is recommended that Investors who want to maximize returns should reinvest the interest each time it is calculated so their interest earns interest.

CD Basics

Though the name suggests it, a CD is not a physical piece of paper issued by a bank or credit union.

A CD is an account set up under certain terms. The basic elements of a CD include

- The amount of deposit
- The rate of interest (return)
- The interest frequency calculation
- The term marking the account’s duration

The deposited money and its earnings are typically not available to the investor until the CD maturity date.

In basic CDs, the term is a predetermined period of time--three months, six months, one year, or five years.

The CD investor receives a fixed rate of interest--that is, an interest rate that does not change for the entire period- exchange for not withdrawing the investment or earnings during the term.

Sometimes, a minimum deposit amount for the CD is required--larger deposits pay higher interest rates.

To prevent investors from withdrawing money from the account before the agreed-upon date there are penalty fees.

Banks often use money from CD accounts to perform other activities, such as lending. Early withdrawal of the CD from the bank puts it in a difficult position.

Therefore, if asked to return the money early penalty fees compensate the bank for drawing from other funds to pay the investor before the end of the term.

How much can the penalty fees be?

The federal government has required a penalty of at least seven days' worth of simple interest on money that is withdrawn six days or less after the initial deposit.

Beyond this federally set minimum penalty, CD issuers are free to set their own penalty limits, and the penalties can be quite high.

If you have a short-term CD, such as those with a term of 30 days, it may pay no interest at all if the money is removed prior to the maturity date.

CDs with maturity dates of two to twelve months often impose penalties equivalent to three months' worth of interest. Those CDs with a maturity date longer than three years may impose a penalty of 180 to 365 days of interest if an investor makes an early withdrawal.

There are exceptions, however. If for instance the account holder dies or is declared mentally incompetent, fees may be waived.

Fees may also be waived if the CD is in a tax-deferred retirement account, such as a 401(k) plan or IRA.

Types of CDs

With a fixed-rate CD you get a steady, fixed rate of return over the entire term of the CD. A common example of this type of CD is the traditional bank-sold CD.

We have explored several of the features and varieties of features that fixed-rate CDs offer. Let’s take a look at some more complex and interesting variants.

An add-on CD gives investors the opportunity to make additional deposits beyond the initial deposit that the bank requires for opening a CD account.

When made, the new deposits are added to the existing balance and earn the same rate of interest. If interest rates are declining this feature can be a particularly attractive.

If rates fall, new CDs will offer a lower rate of return than existing CDs. Therefore, if you add money to the old CD it provides a better rate of return than what is available in the marketplace.

Most financial institutions that offer an add-on feature set a minimum dollar amount for additional deposits. Though the minimum varies by institution a typical minimum amount might be $500.

With bear CDs, the interest rate paid fluctuates inversely to the value of an underlying market index.

This means the interest rate paid on the CD increases as the underlying market index decreases in value.

When there is an anticipated bear market, investing in a bear CD provides a guaranteed return of the investor's principal and the opportunity to make money while overall underlying market index declines.

Bear CDs are used for two main purposes: speculation and hedging.

Market speculation involves trying to profit from market movements by purchasing prior to an expected gain or loss. On the other hand, market hedging involves trying to protect assets.

If investors hold assets that follow a market index, they may "hedge" by also investing in a bear CD to offset any losses they may have in the market investment.

Bull CDs pay an interest rate that rises with the value of an underlying market index.

Investors seek out this type of CD when they are looking for a safe investment that also gives them exposure to the stock market.

The bull CD's interest rate does not lose value if the market falls in value. This is because the CD provides a guaranteed minimum rate.

Brokered CDs are sold through financial advisors and other intermediaries, unlike traditional CDs which are sold through banks and credit unions.

Financial advisors and intermediaries have access to a wide range of products offered by a variety of different companies not unlike mortgage brokers. Investors can shop around and compare the rates and terms offered by a variety of providers when researching for a brokered CD.

Brokered CDs can be bought and sold in the secondary market just like stocks and bonds. This however exposes investors to the possibility of loss.

Let’s use an example to illustrate this.

When investors purchase a CD that is paying 4% interest right before interest rates climb to 4.5% you won’t be able to find buyers willing to pay face value for the 4% CD.

This is because there are now CDs on the market offering better rates of return. Conservative investors will sometimes use a broker to find the CD that best matches their investment needs enabling them to hold that CD to maturity.

There are multiple varieties of brokered CDs. Some of these brokered CDs are not insured by the FDIC.

You should determine whether the brokered CD in question is insured before purchasing it. Most large, reputable, national brokerage firms carry only FDIC-insured products.

Bump-up CDs give investors the opportunity to raise or "bump up" the interest rate on their investment. When interest rates are rising, this can be an attractive option. Some CDs even permit more than one bump-up.

Bump-up CDs start out paying a lower initial interest rate than other CDs of similar maturities. For instance, if a standard two-year CDs are paying an interest rate of

3%, a bump-up CD might only offer an initial rate of 2.75%.

If interest rates rise quickly, however, bumping up moves the investment to a higher rate. Ideally you want to bump up past the initial standard rate far enough that the investment yields more at maturity than a standard CD would have yielded if held the entire term.

Conversely, if interest rates rise slowly or not all, the bump-up CD could earn less than the potential yield of the standard-rate CD held to maturity.

Callable CDs can be redeemed at the discretion of their issuing banks prior to their stated maturity. This usually occurs within a given time and at a predetermined call price.

Because they pay a higher interest rate than non-callable CDs they are attractive to investors. The reason a bank adds a call feature to a CD is so it does not have to continue paying a high rate if interest rates drop.

Say, for instance, a bank issues a traditional CD that pays 4.5%. Then interest rates fall to a point where the bank could issue the same CD to someone else for only 3.5%. The bank would be paying a 1% higher rate for the duration of the CD it originally issued.

By "calling" or redeeming the CD, the bank can stop paying the higher rate to the investor and then turn around and issue a lower-paying CD to another investor.

Callable CDs will usually pay a higher rate to compensate the risk investors take that their CD might be called during the term.

Index-linked CDs, also known as market-linked or equity-linked CDs, give investors the opportunity to generate investment returns that are similar to those provided by well-known major market indexes, like the S&P 500, Dow, and the Nasdaq. This comes with the security of the principal protection provided by traditional CDs.

Investors who want to earn market-like returns on their investments but don't want to risk the loss of principal associated with investing in the stock market find Index-linked CDs strongly appealing.

Some index-linked CDs offer to match 100% of the return generated by a given index. Others match a specific percentage, such as 90%.

If there is an index decline, some index-linked CDs offer a guaranteed minimum return, and others only guarantee the return of the original investment.

It is possible that if the chosen index declines in value, the return on investment may be as low as zero.

Jumbo CDs, less commonly known as negotiable CDs, require a minimum investment of $100,000. They usually pay higher rates of interest than other CDs. These CDs are typically bought and sold by large institutional investors like banks and pension funds.

Jumbo CDs are referred to as "negotiable" because they can usually be sold in a highly liquid secondary market. However, they cannot be cashed in before maturity.

Liquid CDs allow investors to withdraw money from their accounts without incurring any penalties.

Depending on the issuer, the terms and conditions of the liquid CD vary widely. To remove money without paying a penalty, there can be a requirement for the investor to maintain a minimum account balance.

In exchange for the liquid CDs optionality, the bank may pay a lower rate of interest than a traditional CD. The number of allowed withdrawals varies from provider to provider.

Uninsured CDs are not protected by the Federal Deposit Insurance Corporation (FDIC) or the National Credit Union Administration (NCUA). In some cases, CD amounts are uninsured because they exceed the insurance coverage limit.

Sometimes uninsured CDs are purchased by investors seeking a higher rate of interest than the rate available through insured CDs.

Conservative investors often avoid purchasing uninsured products or opening CDs in a single financial institution above the insurance-coverage limit. This is because the safety of insurance is one of the most attractive features CDs offer.

Variable-rate CDs that pay an interest rate that moves up and down based on the changes in an underlying interest-rate index.

This is, of course, the opposite of a traditional fixed-rate CD.

Yankee CDs are negotiable CDs issued in the U.S. by foreign banks.

There is usually a minimum investment of $100,000. Yankee CDs appeal primarily to institutional investors.

Zero-coupon CDs are traded at a deep discount, do not pay interest, and render a profit at maturity when the CD is redeemed for its full-face value.

You could for example, purchase a $100,000 zero-coupon CD for half price or $50,000. You then hold the CD for a term of 10 years and it could be cashed in for its face value of $100,000.

Here the tradeoff is that interest--called “phantom” interest--accrues each year. The investor must pay taxes on this interest despite not actually receiving any money.

Strategies for Using CDs

An investor’s strategy in picking one CD over another depends in large part how the money will be used in the CD,

A common strategy among investors involves purchasing a single CD as a safe, short-term place to store cash.

This cash will then be used to fund a purchase or investment in the near future.

As mentioned, some short-term CDs can have a time frame as brief as 28 days. There are also one-month, three-month and six-month CDs in this category as well.

With short-term CDs, investors plan an appropriate maturity date when they will need the money. In this case, it makes no sense to select a CD that matures a long time afterward, even though the interest rate may be higher on a longer-term CD.

Timing is the key to the one-CD strategy.

Another one-CD strategy involves purchasing a single CD as a conservative place to store money for the long-term.

There are some investors who do not want to put their money into stocks fearing a decline in value.

What these investors do instead is put their money into a long-term CD insured against loss and offering a rate of return that meets their investment goals.

The rule of thumb is: the longer the term, the higher the interest rate.

In this case there are terms of one, two, three, four and five years--up to and including 10 years. This includes various half increments, such as 18 months and 30 months.

The point in this particular strategy is to earn as much return as possible for the length of time the money is invested.

When meeting the investors need for money long-term customizing the maturity schedule is essential. Using this method, investors put money into a long-term CD then reinvest the money in a short-term CD after the first CD matures.

By reinvesting the money in this way, the investor can keep the money invested until right before the investor needs it.

A CD ladder allows investors to receive a CD’s interest in a regular check in lieu of reinvesting the interest into the account.

In this income generation strategy an investors would receive periodic payments to help reach other financial goals.

One can achieve this strategy by purchasing multiple CDs that generate income.

There can also be some benefit in staggering the different CDs' dates of interest payment.

This staggering the maturity dates of multiple CD accounts creates what is known as a CD ladder.

Each CD acts as a "ladder rung" of increasing term lengths. As time passes and CDs mature, each bottom rung naturally becomes the top rung.

For example, an investor might select from CDs lasting three months, six months, one year, and two years. When the three-month CD matures, the money is invested in another CD account that will mature after the two-year CD.

This process is repeated when the six-month CD is reinvested -at the end of its term- for a later maturity than that of the new CD and then the one-year CD –at its due date- even later than that.

Reinvesting In this way, the ladder continues indefinitely.

Laddered CDs require maintenance. The advantage is the extra interest earned from splitting $100,000 into 10 separate $10,000 CDs.

Some of these CDs are in short-term accounts, and some in long-term accounts earning more interest. Each of the CDs is timed so that the interest payments are spread out--with little time between payments.

An investor who opts to take the interest by check--not reinvesting- benefits from the steady income generation of the CD ladder.

Imagine if that same investor had instead put the entire $100,000 into one short-term account.

This account would have calculated only one interest payment per year, quarter or whatever schedule applies. The payments would be spread out. Our investor might go for long stretches of time without receiving an interest check.

Additionally, the interest would not be as high as with the laddered plan. Any Investor who has the willingness to keep pace with changing income needs and changing interest rates will most certainly benefit from a CD ladder that is designed and maintained appropriately.

Strategic Concerns: Growth, Speculating and Hedging, Inflation, and Rollovers

CDs can form part an investor's conservative growth strategy.

Investing in an index-linked CD, like the bull or bear CD, provides opportunity for greater returns than those associated with traditional CDs. This comes at the same time the CDs provide insurance protection.

This method also allows the potential of the CD growing beyond what is possible with the traditional CD.

Speculating and hedging strategies offer investors plan around market fluctuations.

When an investor uses a CD in a speculation strategy, he plans for an increase-or decrease- in the market by purchasing CDs that will increase in value under certain, expected circumstances.

In a hedging strategy, investors buy CDs that work opposite other investments. This helps the investor avoid an overall loss should one segment of the market declines.

Inflation often makes the typical CD a less attractive option for investors seeking long-term growth.

CDs do increase in value over time but their interest rates tend to move with inflation rates. A CDs value increases if their interest rate is 3% and inflation is 3% but only in sync with inflation.

When you consider inflation and factor this variable in to the equation, the CD does not add value to the investor's portfolio.

Therefore, it is imperative for the savvy investor to put his or her money into CD accounts offering interest rates greater than inflation, if possible.

Automatic rollover is another factor that has the potential to make CDs less attractive to investors.

While the rollover feature is not applicable to every CD, investors will want to know if it is part of their CD investment.

An automatic rollover predetermines what happens to a CD when it matures.

If there is not an investment plan in place--like a CD ladder and If investors do not act quickly to reinvest the money in the CD, the bank does it for them.

The money would therefore be locked in a new account, making it inaccessible--apart from paying withdrawal penalties.

To avoid this happening simply invest in a CD that does not have an automatic rollover.

In addition to automatic rollover, unattractive penalty fees can discourage investing in CDs as well.

For instance, if you have an account that requires six months' interest for withdrawing money early can take a significant toll on the CD investment on an account that is only two months old. It money is withdrawn early, the four months' interest that would have accumulated is taken directly from the account's principal. This results in a net loss.

Again, avoiding this situation is relatively simple--make sure you research features and requirements to select the CD investment that is preferable to you.

Conclusion: Selecting the Best CD Investment For You

As you might expect, doing your due diligence and examining the terms and conditions of a potential CD is key to selecting the best investment. Also, if you know what to expect in withdrawal fees and closure fees, then this goes a long way in helping you make an appropriate account selection.

Let’s consider an example where and investor has a callable CD that she purchased to provide income.

While the callable CD may pay a higher rate of interest than a non-callable CD, if the CD is called, the income drops to zero.

What if the call happens at a time when the income from the CD is really needed?.

Income generation could then become a significant and possibly very dangerous situation for the investor.

Another important feature to know is whether the CD permits partial withdrawals.

There are some cases with certain CDs that even if the investor is willing to pay a penalty, removing even a tiny portion of the principal prior to the CD maturity triggers an automatic closure of the CD.

Banks can also delay withdrawals to stop a run on the bank. While bank runs are both unusual and uncommon, they do occur. Investors should consider this possibility as part of their overall consideration of a CD.

Investors should look at when interest payments are calculated when they look at the terms and conditions a CD they are considering, As a general rule of thumb the more frequently interest payments are calculated, the greater the annual yield.

Some CDs begin calculations on the date of deposit; others begin from the start of the month following the deposit.

In the latter case, investing mid-month could delay income generation for two weeks. There are even some CDs that start interest calculations from the start of the next quarter--a not-so-good situation that could result in weeks or months of no interest accumulation, depending on the investment date.

Similarly, the stop date for interest calculations varies significantly on CDs.

Some CDs end calculations on the date of withdrawal, while others stop at the end of the previous month or sometimes the end of the previous quarter.

Location the right CD for your investing needs requires a careful consideration of all of the details--not just one or two.