Certificates Of Deposit

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1) Certificates Of Deposit: Introduction

Safety is a hallmark of the traditional certificate of deposit (CD) sold by a bank or credit union. Investors seeking a low-risk investment expect that many CDs, when held to maturity, will return the full amount of the original investment, even if the institution issuing the CD collapses. A federally-insured bank CD has the backing of the Federal Deposit Insurance Corporation (FDIC), and CDs at credit unions are often guaranteed by the National Credit Union Administration (NCUA). Of course, these institutions have limits on what they will insure. Until October 2008, the FDIC insured up to $100,000 in a single account.

The well-publicized government bailout bill that passed in October 2008 prompted a temporary increase in the FDIC's insurance cap to $250,000. But, the FDIC will only be required to cover $250,000 per insured account until December 31, 2009. At that time, the requirement will expire. Because the increased limit is temporary, this tutorial will presume the original insurance coverage limit of $100,000 for an individual account.

The FDIC and NCUA offer more protection for retirement accounts than individual
accounts. CDs held in an individual retirement account (IRA) are insured up to $250,000. Accounts set up under a different set of provisions, such as a trust, can be covered to a higher amount. A trust with three beneficiaries, for example, can hold up to $300,000 in insured deposits. (Get the most out of your retirements savings, read "11 Things You May Not Know About Your IRA.")

Joint insured accounts have a limit twice that of individual accounts: $200,000. A married couple with a joint account and individual accounts can receive $400,000 of insurance for their deposits. Add the limit of the couple's joint account to the limit of each individual account ($200,000 + $100,000 + $100,000 = $400,000).

Investors without joint accounts can increase their total coverage by opening CDs at multiple institutions. Putting $100,000 in each of three banks, for instance, yields $300,000 of coverage. The married couple from the previous example can benefit from accounts at multiple institutions by setting up $400,000 in insured accounts at one bank (two individual accounts and one joint account) and then doing the same thing at a different bank or credit union. By investing through multiple institutions, it is possible to deposit an insured amount of money limited only by the number of financial institutions involved. Keep in mind that each set of accounts must be at different financial institutions, not at a different branch office of the same institution. (Find out how CDs hold up when the market it down; read "Are CDs Good Protection For The Bear Market?")

Investing in more than one bank or credit union also provides an opportunity to invest larger covered amounts. For example, if Juan has $500,000 to invest in CDs, but doesn't want to put all of the money into one account because the insurance will cover only up to $100,000, he can split the $500,000 into $100,000 increments and invest them separately in five different institutions. This way, his entire $500,000 is covered.

If opening multiple accounts is impractical, there is another option. The Certificate of Deposit Account Registry Service (CDARS) offers up to $50 million in FDIC insurance coverage with a single bank deposit. The bank spreads the money across multiple institutions participating in the CDARS program.

2) Certificates Of Deposit: Safety And More!

Most investors consider a CD to be a safe, conservative place to hold assets. The assets don't just sit there, though. They 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, but they are near the current rate of inflation, in general.

When comparing the interest rates of various CDs, it is important to understand the
difference between annual percentage yield (APY) and annual percentage rate (APR). APY is the total amount of interest the CD will earn in one year, taking compound interest into account. APR is the stated interest earned in one year, without taking compounding into account. (To learn more, read APR Vs. APY: How The Distinction Affects You.)

Compounding involves the timing of interest calculation (or payment). A CD that pays interest only once a year will yield (in a year) only the exact amount of interest paid. When interest is paid several times a year, the yield total is the sum of the interest from each payment. Because the interest paid during the year earns interest in the account just as the original deposit does, compounded yield is greater than the yield for a once-a-year calculation.

For example, if Yuko purchases a one-year, $1,000 CD that pays 5% semiannually, she will receive an interest payment of $25 after the first six months ($1,000 x 5% x .5 year). The $25 payment begins earning interest of its own, which over the next six months amounts to $0.625 ($25 x 5% x .5 year). As a result, the yield is actually 5.06%, instead of 5%, for a CD that pays 5% only once a year. The .06 may not seem like much at first, but compounding adds up as both the principal and interest continue to earn interest over time.

While traditional CDs are popular with investors, CDs are also available in a variety of configurations, offering a range of features and investment strategies. Read on to learn about the various models of this conservative place to stash your cash.

3) Certificates Of Deposit: The Basic Model

A certificate of deposit is not a physical piece of paper issued by a bank or credit union. It is an account set up under certain terms. The basic elements include the amount of deposit, the rate of interest (or return), the frequency of calculating interest, and the time frame (or term) marking the duration of the account. The deposited money and its earnings are typically "locked away" from the investor until the maturity date.

For a basic CD, the term is a predetermined period of time, such as three months, six months, one year, or five years. In exchange for not withdrawing the investment or earnings during the term, the investor receives a fixed rate of interest – an interest rate that does not change for the entire period. Sometimes, a minimum deposit amount is required, with larger deposits paying higher interest rates.

Penalty fees usually keep investors from withdrawing money from the account before the agreed-upon date. Because the bank often uses money from CD accounts to perform other activities, such as lending, the bank is in a difficult position 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 are the penalty fees? The federal government, which insures many CD accounts, has required a penalty of at least seven days' worth of simple interest on money withdrawn six days or less after the initial deposit. Beyond this minimum, CD issuers are free to set their own penalty limits, and the penalties can be substantial.

Short-term CDs, such as those with a term of 30 days, may pay no interest at all if the money is removed prior to the maturity date. CDs with maturity dates of two to 12 months often impose penalties equivalent to three months' worth of interest. CDs with a maturity date longer than three years may impose a penalty of 180 to 365 days of interest for early withdrawal. There are exceptions, however. If 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.

Not only is the rate of interest typically greater for larger deposit amounts, 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 "hands off," the greater the overall yield can be. An exception is when there is an inverted yield curve. At this time, short-term term CDs may pay higher rates than long-term CDs because the market is less confident about long-term purchases. (Read The Impact Of An Inverted Yield Curve to find out what happens when short-term interest rates exceed long-term rates.)

Some investors do not reinvest the CD's interest when it is calculated. Instead, they receive regular interest checks from the bank or credit union, providing a steady stream of income. Not reinvesting the money into the CD account has the downside of reducing the overall yield that is possible through compounding. Investors who want to maximize returns should reinvest the interest each time it is calculated so the interest will earn interest, too.

4) Certificates Of Deposit: Bells And Whistles (Part I)

Beyond the basic model, there are CDs with many features. We'll explore some of the various options, beginning with add-on CDs and ending with zero-coupon CDs in the next section. Some of the features mentioned are stand-alone options, while others can be mixed and matched within the same CD.

Investors should conduct their research carefully to identify the features best suited for their needs.

This tutorial can be found at: http://www.investopedia.com/university/certificate-of-deposit-cd/default.asp
Add-On CDs
An add-on CD gives investors the opportunity to make additional deposits beyond the deposit required to open a CD account. The new deposits are added to the existing balance and earn the same rate of interest. This can be a particularly attractive feature when interest rates are in decline. If rates fall, new CDs will offer a lower rate of return than existing CDs. Adding money to the old CD 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. A typical minimum might be $500, for example.

Bear CDs
Bear CDs pay an interest rate that fluctuates inversely to the value of an underlying market index. In other words, the interest rate paid on the CD increases as the underlying market index decreases in value. When a bear market is anticipated, investing in a bear CD provides a guaranteed return of the investor’s principal and the opportunity to make money as the underlying market index declines. This type of CD is used for two main purposes: speculation and hedging. Speculation involves trying to profit from market movements by purchasing prior to an expected gain or loss. 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 in the market investment.

Brokered CDs
While traditional CDs are sold through banks and credit unions, brokered CDs are sold through financial advisors and other intermediaries. Much like mortgage brokers, financial advisors and intermediaries have access to a wide range of products offered by a variety of different companies. Investors can compare the rates and terms offered by a variety of providers when researching (or "shopping") for a brokered CD. (Learn how to effortlessly contribute to a CD, read Step Up Your Income With A CD Ladder.)

Unlike CDs purchased through a bank, brokered CDs can be bought and sold in the secondary market just like stocks and bonds, although this exposes investors to the possibility of loss. For example, when investors purchase a CD that is paying 4% interest right before interest rates climb to 4.5%, buyers will not be willing to pay face value for the 4% CD because there are now CDs on the market offering a better rate of return. Some conservative investors use a broker to find the CD that best matches their investment needs so they can hold that CD to maturity.

Brokered CDs come in multiple varieties, some of which are not insured by the FDIC. Before purchasing a brokered CD, investors should determine whether the CD in question is insured. Most large, reputable, national brokerage firms carry only FDIC-insured products, but it is always best to do some research before investing.

Bull CDs
Bull CDs pay an interest rate that rises with the value of an underlying market index. In other words, the interest rate paid on the CD increases as the underlying market index increases. This type of CD is most often used by investors looking for a safe investment that also gives them exposure to the stock market. The CD’s interest rate does not lose value if the market falls in value because the CD provides a guaranteed minimum rate.

Bump-Up CDs
Bump-up CDs give investors the opportunity to raise, or "bump up", the interest rate on their investment if interest rates in the marketplace increase. This is an attractive option when rates are rising. Consider, for example, a situation in which an investor purchases a two-year CD that is paying 3%. Then, six months after the purchase, interest rates rise to 4%. Rather than being stuck at 3% for the next year-and-a-half, the investor can opt to bump up to a higher rate. Some CDs even permit more than one bump.

The trade off on bump-up CDs is that they start out paying a lower initial interest rate than other CDs of similar maturities. If standard two-year CDs are paying an interest rate of 3%, a bump-up CD might offer an initial rate of 2.75%. If rates rise quickly, however, bumping up moves the investment to a higher rate. The ideal situation is having the opportunity 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. On the other hand, if interest rates rise slowly or not at all, the bump-up CD could earn less than the potential yield of the standard-rate CD held to maturity.

Callable CDs
Callable CDs can be redeemed (or "called") by the issuing bank prior to their stated maturity, usually within a given time and at a predetermined call price. Callable CDs are attractive to investors because they pay a higher interest rate than non-callable CDs. A bank adds a call feature to a CD so it does not have to continue paying a high rate if interest rates drop. For example, if a bank issues a traditional CD that pays 4.5% and 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. By "calling" the CD, the bank can stop paying the higher rate to the investor and can issue a lower-paying CD to another investor. Callable CDs typically pay a higher rate to compensate the risk investors take that their CD might be called during the term. (To learn more, read Callable CDs: Check The Fine Print.)

Fixed-Rate CDs
Fixed-Rate CDs pay a steady, fixed rate of return over the entire course of their term. Traditional bank-sold CDs are a common example of this type of CD.

5) Certificates Of Deposit: Bells And Whistles (Part 2)
The list of features that CDs offer is long and impressive. We explored a number of the varieties in Certificates Of Deposit: Bells And Whistles (Part 1) and will review some additional complex and interesting variations below.

**Index-Linked CDs**

Index-linked CDs, also known as market-linked or equity-linked CDs, provide the opportunity to generate investment returns that are similar to those provided by well-known major market indexes, such as the Standard & Poor's 500 Index (S&P 500), the Dow Jones Industrial Average (DJIA) or Nasdaq, with the security of the principal protection provided by traditional CDs.

Index-linked CDs strongly appeal to 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. To meet this need, index-linked CDs link the returns that investors earn to the returns generated by one of the major equity market indexes. Some offer to match 100% of the return generated by a given index. Others match a specific percentage, such as 90%. If the index declines, some index-linked CDs offer a guaranteed minimum return, while others guarantee only the return of the original investment.

Keep in mind that if the chosen index declines in value, the return on investment may be as low as zero. This raises the issue of opportunity cost, because the money might have generated positive returns had it been invested elsewhere. Tax implications are another issue to consider because earnings generated by index-linked CDs are taxed in the year generated. To delay tax liability, the certificate can be purchased in a tax-deferred account, such as an IRA (IRA).

**Jumbo CDs**

Jumbo CDs, sometimes referred to as negotiable CDs, require a minimum investment of $100,000. They typically pay higher rates of interest than other CDs and are often bought and sold by large institutional investors, such as banks and pension funds. They are referred to as "negotiable" because they can usually be sold in a highly liquid secondary market, but they cannot be cashed in before maturity.

**Liquid CDs**

Liquid CDs permit investors to withdraw money from their accounts without incurring any penalties. Terms and conditions vary widely according to the issuer. To remove money without paying a penalty, the investor may need to maintain a minimum account balance. Also, the bank may pay a lower rate of interest than a traditional CD, to provide the investor with the ability to take money out of the account. The number of permitted withdrawals varies by provider.

**Uninsured CDs**

Uninsured CDs are not insured by the Federal Deposit Insurance Corporation (FDIC),
which insures many certificates of deposit for individual accounts, or by the National Credit Union Administration (NCUA), which covers many credit union deposits. In some cases, CD amounts are uninsured because they exceed the insurance coverage limit.

In other cases, uninsured CDs are purchased by investors seeking a higher rate of interest than the rate available through insured CDs. Because the safety of insurance is one of the most attractive features CDs offer, conservative investors often avoid purchasing uninsured products or opening CDs in a single financial institution above the insurance-coverage limit.

**Variable-Rate CDs**

Some variable-rate CDs pay an interest rate that moves up and down based on the changes in an underlying interest-rate index. These CDs stand in contrast to traditional CDs, which pay a fixed rate of interest. Variable-rate CDs offer an opportunity to earn a higher interest rate when the underlying index moves in the right direction (upward), but can also result in earning an interest rate that is lower than the rate offered by fixed-rate CDs if the underlying index moves in the wrong direction (downward).

**Yankee CDs**

Yankee CDs are negotiable CDs issued in the U.S. by foreign banks. They generally have investment minimums of $100,000 and appeal primarily to institutional investors.

**Zero-Coupon CDs**

Zero-coupon CDs do not pay interest, but are traded at a deep discount, rendering a profit at maturity when the CD is redeemed for its full face value (or worth). For example, it may be possible to purchase a $100,000 zero-coupon CD for half price: $50,000. After holding the CD for a term of 10 years, it could be cashed in for its face value of $100,000. The tradeoff is that phantom interest accrues each year, and the investor must pay taxes on it, despite not actually receiving any money. Holding a zero-coupon CD in a tax-deferred account provides a way to postpone paying the taxes.

6) **Certificates Of Deposit: Maturity And Strategies**

The strategy an investor uses in choosing a particular CD from all of the available options has to do with how the money in the CD will be used and what place it has in the investor’s overall portfolio.

**Buying One Safe CD**

One of the most common strategies involves purchasing a single CD as a safe, short-term place to store cash to fund a purchase or investment in the near future. 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, for example. With these CDs, investors plan an appropriate maturity date when they will need the money. 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 essential to this strategy.

Another strategy is to purchase a single CD as a conservative place to store money for the long-term. Some investors do not want to put their money into stocks, for fear of a decline in value. Instead, they put their money into a long-term CD that is insured against loss and that offers a rate of return that meets their investment goals. The longer the term, the higher the interest rate, in general. There are terms of one, two, three, four and five years – up to 10 years, with various half increments, such as 18 months and 30 months. The point is to earn as much return as possible for the length of time the money is invested.

Customizing the maturity schedule helps investors meet a need for the money long-term. With this method, investors put money into a long-term CD but reinvest the money in a short-term CD after the first CD matures. In this way, the investor can keep the money invested until right before it is actually needed.

**Setting Up a CD Ladder**

Sometimes, investors want to receive a CD's interest in a regular check, instead of reinvesting the interest into the account. With the income generation strategy, investors receive periodic payments that help them reach other financial goals. This strategy can also be implemented by purchasing multiple CDs that generate income. Staggering the different CDs' dates of interest payment can be beneficial, too.

Staggering the maturity dates of multiple CD accounts creates a CD ladder, with each CD as a "rung" of increasing term lengths. As time passes and the CDs mature, each bottom rung continually becomes the top rung. An investor might choose CDs lasting three months, six months, one year, and two years, for example. When the three-month CD matures, the money is invested in another CD account that will mature after the two-year CD. Then, the six-month CD is reinvested (at the end of its term) for a later maturity than that of the new CD, and the one-year CD (when it comes due) even later than that. In this way, the ladder continues on and on. This can provide investors with the security of knowing that cash will be accessible at regular intervals if they need it for something unplanned. It also allows income generation at staggered dates of interest payment.

Although laddered CDs require maintenance, picture the extra interest earned from splitting $100,000 into 10 separate $10,000 CDs. Some are in short-term accounts, and some are in long-term accounts that earn more interest. Each is timed so that the interest payments are spread out – with little time between payments. An investor who takes the interest by check (instead of reinvesting) benefits from the steady income generation of the CD ladder.
If the investor had instead put the entire $100,000 into one short-term account, the account would have calculated only one interest payment per year, quarter or whatever schedule applies. The payments would be spread out; the investor might go for long stretches of time without receiving an interest check. And, the interest would not be as high as with the laddered plan. Investors who are willing to keep pace with changing income needs and changing interest rates can certainly benefit from designing and maintaining an appropriate CD ladder. (*Step Up Your Income With A CD Ladder* provides more information about how these instruments offer safe capital, predictable cash flow and simplicity.)

**A CD as Part of a Growth Strategy**

CDs can also be used as part of a [conservative growth](http://www.investopedia.com/university/certificate) strategy. Investing in an index-linked CD, such as a bull or bear CD, provides opportunity for greater returns than those associated with traditional CDs, while still offering insurance protection. This strategy allows investors to take advantage of stock market changes without facing the losses that can be involved in the market. With this method, the CD investment can grow beyond the potential of a traditional CD.

**Hedging and Speculating**

CDs can even be used in [speculation](http://www.investopedia.com/university/certificate) and [hedging](http://www.investopedia.com/university/certificate) strategies. With speculation, investors plan for an increase (or decrease) in the market by purchasing CDs that will increase in value under certain, expected circumstances. With hedging, investors buy CDs that work opposite other investments so they can avoid an overall loss if one part of the market declines.

7) **Certificates Of Deposit: Details To Consider**

The presence of [inflation](http://www.investopedia.com/university/certificate) makes the typical CD a less attractive option for investors seeking long-term growth. While CDs do increase in value, their interest rates tend to move with inflation rates. If inflation is 3% and the interest rate is 3%, the CD’s value increases, but only in accordance with inflation. When inflation is factored in to the equation, the CD does not add value to the investor’s portfolio. It is important for investors, then, to put their money into CD accounts offering interest rates greater than inflation, if at all possible. (Read *Coping With Inflation Risk* to learn more.)

Another factor that may make CDs less attractive to investors is an automatic [rollover](http://www.investopedia.com/university/certificate). This feature is not attached to every CD, but investors will want to know if it is part of their CD investment. An automatic rollover predetermines what will happen to a CD when it matures. If investors do not act quickly to reinvest the money according to a personal plan (such as a CD ladder), the bank does it for them. This locks the money into a new account, making it inaccessible - apart from paying withdrawal penalties.
Simply investing in a CD that does not have an automatic rollover will prevent the problem.

Unattractive penalty fees can discourage investing in CDs as well. An account that requires six months' interest for withdrawing money early on an account that is only two months old can take a significant toll on the CD investment. The four months' interest that would have accumulated is taken directly from the account's principal, resulting in a net loss. Again, to avoid this situation, investors need only to research features and requirements to select the CD investment they prefer.

**Selecting the Best Investment**

Examining the terms and conditions of a potential CD is key to selecting the best investment. Knowing what to expect in withdrawal fees and closure fees goes a long way toward an appropriate account decision.

Consider a **callable CD** that has been purchased to provide income. While it may pay a higher rate of interest than a non-callable CD, if the CD is called, the income drops to zero. If the call happens at an inopportune time, income generation could become a real challenge for the investor.

Similarly, it is important to know whether the CD permits partial withdrawals. In some cases, even if the investor is willing to pay a penalty, removing even a small portion of the principal prior to the maturity date may trigger an automatic closure of the CD. Also keep in mind that banks can delay withdrawals to stop a run on the bank. While **bank runs** are uncommon, they do occur, so investors should consider this possibility.

When examining the terms and conditions, investors should look at when interest payments are calculated. The more frequently they are calculated, the greater the annual **yield**, in general. Some CDs begin calculations on the date of deposit; others begin from the start of the month following the deposit. In this case, investing mid-month could result in no income generation for two weeks. Some CDs even start calculations from the start of the next quarter, a situation that could result in weeks or months of no interest accumulation, depending on the investment date. Similarly, the stop date for calculations can vary significantly. Some CDs end calculations on the date of withdrawal, while others stop at the end of the previous month or even the end of the previous **quarter**.

Investors can locate the right CD for their needs by taking all of the details into consideration.

**8) Certificates Of Deposit: Conclusion**
Let's recap what we've learned in this tutorial:

- Safety is a hallmark of the traditional certificate of deposit (CD) sold by a bank or credit union.
- Investors seeking a low-risk investment expect that many CDs, when held to maturity, will return the full amount of the original investment, even if the institution issuing the CD collapses.
- A federally-insured bank CD has the backing of the Federal Deposit Insurance Corporation (FDIC), and CDs at credit unions are often guaranteed by the National Credit Union Administration (NCUA).
- 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, but they are near the current rate of inflation, in general.
- While traditional CDs are popular with investors, CDs are also available in a variety of configurations offering a range of features and investment strategies.
- The basic elements include the amount of deposit, the rate of interest (or return), the frequency of calculating interest, and the time frame (or term) marking the duration of the account.
- In exchange for not withdrawing the investment or earnings during the term of a basic CD, the investor receives a fixed rate of interest – an interest rate that does not change for the entire period.
- Sometimes, a minimum deposit amount is required, with larger deposits paying higher interest rates.
- Penalty fees usually keep investors from withdrawing money from the account before the agreed-upon date.
- Building on the basic model are CDs with many features.
- Add-on CDs, bear CDs, brokered CDs, bull CDs, bump-up CDs, callable CDs and fixed-rate CDs are some of the options.
- Other options include index-linked CDs, jumbo CDs, liquid CDs, uninsured CDs, variable-rate CDs, Yankee CDs and zero-coupon CDs.
- The strategy an investor uses in choosing a particular CD from all of the options has to do with how the money in the CD will be used and what place it has in the investor's overall portfolio.
- CDs can be used for short-term storage, long-term storage, income generation, conservative growth, speculation, hedging and more.
- Examining the terms and conditions of a potential CD is key to selecting the best investment.
- Investors can locate the right CD for their needs by taking all of the details into consideration.