



WSB Investments Group
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Certificate of Deposit

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What is it?

Certificates of deposit (CDs) are receipts for funds deposited at a financial institution. The CD entitles you to a set rate of interest plus the amount of your original deposit (your principal) at a specified time called the maturity date.

Essentially, you agree to leave a specified sum of money on deposit for a set period of time. Funds may be withdrawn before maturity; in such cases, however, a premature withdrawal penalty will apply. A typical penalty might be the loss of interest for a quarter.

Individual CDs can be purchased for as little as \$100. Institutional and jumbo or negotiable CDs can cost \$100,000 or more.

Fixed-rate CDs offer a specified interest rate for the term of your CD. The rate is pegged to the duration of the CD--the longer you are willing to tie up your money, the higher the rate. Maturities range from six months to five years or more.

With jumbo or negotiable CDs, yields and terms are often negotiated by the investor and the depository institution. Maturities of jumbo CDs are generally one to three months. Although these CDs may not be redeemed before maturity, they can be traded on the open market.

CDs sold through brokerage firms

Most stock brokerage firms sell CDs issued by financial institutions. Such CDs are also federally insured. Brokerage CDs provide several additional advantages:

- They can be sold before maturity without incurring any early withdrawal penalty, although the selling price will depend on how much another investor is willing to pay for it
- Interest rates are potentially higher than the rates available at your local bank.
- Brokerage firms offer CDs issued by banks and thrifts located throughout the country

Foreign and other CDs

In addition to jumbo CDs, a variety of other types of CDs are issued in denominations of \$100,000 or more, and most often used by institutional investors such as mutual fund companies, banks, and insurance companies. These CDs include:

- Eurodollar CDs, issued by banks outside of the United States, with interest and principal paid in U.S. dollars. These can be sold as variable rate CDs or at a fixed rate that is usually pegged to the London Interbank Offered Rate (LIBOR).
- Yankeedollar CDs, sold by U.S. branches of foreign banks.
- Asian Dollar CDs, issued by Singapore branches of U.S. and Japanese banks. Interest and principal is paid in U.S. dollars. These are fixed rate CDs that pay interest pegged to the Singapore Interbank Offer Rate (SIBOR).
- Variable rate CDs (Floaters), issued by major banks and U.S. branches of foreign banks. These are usually issued with maturities of six months, with interest rates reset every 30 days at a rate pegged to LIBOR.

Strengths

Relative safety

CDs are considered one of the safest of investments because they are generally short term and have minimal exposure to inflation. There may, however, be some reinvestment risk. For more information, see Tradeoffs.

Simplicity

CDs are simple to understand, set up, and use. They operate much like passbook savings accounts created for a specified term.

FDIC insured

Like certain other institutional accounts, CDs are insured up to \$250,000 (through December 31, 2009 only, after which the amount returns to \$100,000) per depositor per bank by the Federal Deposit Insurance Corporation (FDIC) (retirement accounts also are generally insured up to \$250,000, which will not change after December 31, 2009). (There are comparable insurance programs at credit unions.) The insurance applies to each ownership format per bank. For example, if you had an individual account, a joint account with a spouse, and a retirement account at the same bank, and each account had a balance of \$250,000, then all three accounts would be fully insured by the FDIC for a total of \$750,000.

Higher interest rates than some investments

Because CDs are term deposits (they tie up your money for a specified period), they tend to pay a higher rate of interest than savings accounts and money market deposit accounts.

Some liquidity

Because they represent short-term investments, CDs are fairly liquid. If you need to draw money out before the term is complete, you may do so, but you may incur a penalty for early withdrawal.

Tradeoffs

Premature withdrawal penalty applies

With CDs, you agree to leave a specified sum of money with an institution for a specified period of time. If you withdraw your money before the maturity date, you will be obligated to pay an early withdrawal penalty, such as the loss of interest for a quarter. Therefore, if an emergency arises and you need your cash sooner than expected, you could stand to lose a portion of your expected interest (but not your principal).

May be reinvestment risk

Interest rates change over time. If they fall substantially while your money is tied up in a CD, you will be unable to reinvest your CD funds at the previous rates, since comparable CDs will offer lower yields. If you want to earn a higher rate, you'll have to invest in another type of vehicle and probably bear additional risk.

Tip: You can reduce your exposure to interest rate risk and reinvestment rate risk by investing in CDs with different maturity periods. By investing in CDs that mature at different times, you free up your money periodically to take advantage of changes in interest rates. This investment technique is known as laddering your CDs. For more information, see Laddering Techniques.

Opportunity cost

An opportunity cost is always involved when you invest in so-called "safe" investments. Investment choices, like CDs, are generally referred to as safe because they carry relatively little risk of losing principal. However, you

sacrifice the potential for higher returns of investment options having a higher degree of risk.

Tax considerations

Generally, interest earned on CDs is taxable on an annual basis and should be reported as interest income on Schedule B of your individual federal income tax return. Early withdrawal penalties charged on CDs are deductible on the federal level.



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