

# A Time for Time Deposits

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## Article Highlights

- Certificates of deposit (CDs) can meet an investor's need for safety, enhanced returns and liquidity.
- CDs are insured by the FDIC and can offer higher aftertax yields than Treasuries with similar maturity dates.
- The cost of cashing out a CD is known; bond prices can move up or down.

**T**he current market is a tough one for investors to navigate.

Equity markets appear to be all volatility and no return. According to Morningstar, the total return on U.S. equities for the last five years was only 0.33% per year, with large-cap stocks losing 0.23% per year.

Bonds have done better, due to the substantial decline in yields in recent years. Morningstar reports a five-year corporate bond return of 6.22% per year and an annual gain of 5.94% for U.S. Treasury bonds. However, with interest rates at or very near historical lows—at this time, the one-month Treasury yield is 0.15% and the five-year yield is less than 1.5%—further interest rate declines appear unlikely. If interest rates rise from current levels, intermediate and long-term bonds would suffer substantial losses. For example, if interest rates were to rise by 1%, a 20-year bond would lose about 12.5% of its value and a five-year bond would lose about 4.5%. Corporate bond defaults appear to have returned to low levels after peaking in 2008 and 2009, but yields on corporate debt are lower than they've been in over 40 years.

In this environment, investors have a number of potentially conflicting needs, including safety, enhancing returns, and liquidity. We believe that investors should be willing to consider a rather old-fashioned product—the bank time deposit or certificate of deposit (CD)—to meet these three needs. This article discusses the reasons why insured CDs would be a wise addition to many investors' portfolios.



## Safety

CDs issued by U.S. commercial banks and savings institutions are insured by the Federal Deposit Insurance Corporation (FDIC), which is an independent agency of the federal government. The FDIC manages the Deposit Insurance Fund (DIF), which is funded by premiums paid by member banks and savings institutions. The DIF is used to cover losses to insured deposits at failed institutions.

Although most investors are somewhat aware of a limit in FDIC insurance protection—\$250,000, up from the previous limit of \$100,000—fewer understand how easy it is to get around this limit.

The actual limit is \$250,000 per depositor per bank per account ownership category. One easy way to extend the insurance protection beyond \$250,000 is to open accounts at multiple institutions. The number of insured accounts an individual can hold at different institutions is limited only by the number of FDIC-insured institutions, of which there are currently more than 7,700.

A lesser-known way to extend the insurance protection is to have multiple accounts at the same bank but with different ownership categories. For example, one individual can have a \$250,000 regular account and a \$250,000 individual retirement account (IRA) in his name at the same bank. Both are fully insured, because their ownership categories are different. Married couples can have separate \$250,000 accounts (both insured) and a \$500,000 joint account, for a total of \$1,000,000 in fully insured deposits. Indeed, the FDIC website

**Table 1: Best One-Year CD Yields on September 1, 2010**

| APY (%) | Institution                      | Stars | Minimum (\$) |
|---------|----------------------------------|-------|--------------|
| 1.51    | newdominionDIRECT.com            | 1     | 3,000        |
| 1.50    | Ascencia, a division of PBI Bank | 3     | 500          |
| 1.50    | TriState Capital Bank            | 3     | 50,000       |
| 1.48    | Bank of Internet USA             | 4     | 1,000        |
| 1.46    | giantbank.com                    | 2     | 2,500        |
| 1.45    | Nationwide Bank                  | 4     | 500          |
| 1.45    | Colorado Federal Savings Bank    | 4     | 100,000      |
| 1.44    | Ally                             | 4     | 5,000        |
| 1.43    | Aurora Bank                      | 2     | 0            |
| 1.42    | Goldwater Bank                   | 2     | 1,000        |

provides an example of a married couple with \$3,000,000 in fully insured deposits in different ownership categories at the same bank. (See [www.fdic.gov/deposit/deposits/insured/faq.html](http://www.fdic.gov/deposit/deposits/insured/faq.html).)

The FDIC's website has a tool that allows investors to verify that an institution is a member of the FDIC. CDs that are fully insured are generally known as retail CDs, while those with larger balances that are not insured (or not fully insured) are known as jumbo CDs. Other issuers who are not members of the FDIC may offer investment products that they call CDs, but these are not insured. This article focuses entirely on insured, retail CDs.

### Enhanced Returns

Given their FDIC insurance protection and fixed maturity, retail CDs are readily compared to U.S. Treasury securities. One difference between the two is that the interest earned from investments in U.S. Treasury securities is free from state and local taxation. This means that, for some investors, a retail CD must earn a higher stated (pretax) return than the yield on a U.S. Treasury of the same maturity in order for the aftertax yields to be the same.

State and local tax rates vary widely across the U.S. Seven states have no state or local income taxes. Investors living in these states can compare CD and Treasury yields directly. Also, if a CD investment is placed in a tax-exempt or tax-deferred account such as an IRA

or 401(k) retirement plan, the CD and Treasury yields can be directly compared. In other states, marginal tax rates are as high as the 11% top rates levied by Hawaii and Oregon. Two states, New Hampshire and Tennessee, tax interest and dividend income, but not wages.

Considering only taxes, the investor will prefer a retail CD to a U.S. Treasury security of the same maturity when the aftertax yield on the CD is greater than the yield on the Treasury. Mathematically, this can be determined by calculating:

$$r_{CD} \times (1 - t_{s\&l}) > r_{Treas}$$

Where:

$r_{CD}$  = the yield on the CD,

$t_{s\&l}$  = the combined marginal state and local income tax rate, and

$r_{Treas}$  = the yield on the U.S. Treasury security.

(Note that the investor must consider the marginal tax rate—the taxes paid per dollar of additional or new income—not the average tax rate paid on all income.)

This means the investor will benefit from a retail CD rate higher than  $r_{Treas} \div (1 - t_{s\&l})$ .

According to the Federal Reserve Board, on September 1, 2010, the five-year constant maturity Treasury (CMT) yield was 1.41%. For investors living in one of the seven no-tax states, a retail CD with a yield above 1.41% would be preferable to that Treasury investment. A resident of Hawaii or Oregon would

need a yield of at least 1.59% to prefer a CD, while residents of other states would need a yield of somewhere between 1.41% and 1.59%. According to Bankrate.com, the national average annual percentage yield (APY) on five-year CDs on September 1, 2010, was 1.81%. This is interesting, because it indicates that the average (randomly selected) CD available across the U.S. provided an aftertax return premium of at least 0.22% and as much as 0.40% over the same-maturity Treasury security.

Similarly, the one-year CMT yield was 0.25% on September 1, 2010, implying that the most heavily taxed investor would prefer any retail CD offering more than 0.28%. According to Bankrate.com, the average annual percentage yield on one-year CDs was 0.63% on that date, at least 0.35% more than could be earned from an investment in Treasury bills.

Better yet, while investors in Treasury securities will all earn the same market-determined yield, retail CD yields are administered rates. That is, the banks and savings institutions offering them advertise the rate they are willing to pay. Some pay substantially more than others.

Tables 1 and 2 show the best rates available on one-year and five-year retail CDs on September 1, 2010, according to Bankrate.com, along with the name of the institution offering the rate, the institution's Bankrate.com safety rating (from a low of one star to a high of five stars; however, since all institutions are members of the FDIC, all CDs are FDIC insured) and any minimum required deposit amount. Rates, minimum required deposits, and other terms and conditions were verified on September 1, 2010, and September 2, 2010, on each institution's website.

These rates are really quite surprising. For a one-year investment horizon, a retail CD investor in the highest tax state could earn from 1.01% to 1.09% more on an aftertax basis than they would from investing in Treasuries. For investors in non-tax states, the advantage is as much as 1.26%, or a return six times as large as the return offered by the U.S. Treasury security. Over a five-

year investment horizon, for an investor in the highest tax state, the advantage of investing at the lowest of the listed CD yields is 0.84% per year. An investor living in a non-tax state with a large enough opening balance could earn as much as 1.90% per year more than the five-year Treasury yield, or well more than double that yield.

### Liquidity

Retail CDs and U.S. Treasuries differ most widely in their liquidity characteristics. Liquidity refers to the time and expense needed to turn an investment into cash.

U.S. Treasury securities have an active secondary market in which billions of dollars of securities trade each day with low transaction costs. Indeed, the market for Treasury securities is one of the most liquid in the world. Prices are determined by supply and demand. The price for which an investor can sell an existing Treasury security is inversely related to the yield the buyer requires—the lower the price that is paid, the higher the yield the buyer will earn. So, while a Treasury security can be sold quickly and with low transaction costs, the price received may be higher or lower than the price originally paid, depending on whether market interest rates have fallen or risen, respectively, since the security was purchased.

Unlike Treasury securities, retail CDs do not trade among investors in a secondary market. Instead, as with open-ended mutual funds, they are redeemed by the institution that issued them. Retail CDs commonly have an early withdrawal clause or option that allows the investor (depositor) to essentially sell the CD back to the issuing institution prior to its stated maturity for face value plus accrued interest less a pre-established early withdrawal penalty. Just as institutions are free to set different yields on their CDs, they are free to charge different penalties for early withdrawal—and they do.

Thus, both Treasury securities and CDs provide liquidity, but with different potential outcomes. If an investor faces

**Table 2: Best Five-Year CD Yields on September 1, 2010**

| APY (%) | Institution                            | Stars | Minimum (\$) |
|---------|----------------------------------------|-------|--------------|
| 3.31    | USAA (higher minimum)                  | 4     | 175,000      |
| 3.05    | USAA (higher minimum)                  | 4     | 95,000       |
| 3.02    | American Bank & Trust (Wessington, SD) | 3     | 500          |
| 3.00    | USAA                                   | 4     | 1,000        |
| 2.90    | Discover Bank                          | 3     | 2,500        |
| 2.85    | First Internet Bank of Indiana         | 3     | 1,000        |
| 2.75    | American Express                       | 4     | 1            |
| 2.75    | newdominionDIRECT.com                  | 1     | 3,000        |
| 2.75    | Colorado Federal Savings Bank          | 4     | 5,000        |
| 2.74    | Ally                                   | 4     | 1            |
| 2.72    | Bank of Internet USA                   | 4     | 1,000        |
| 2.65    | AIG Bank                               | 4     | 2,500        |

an unexpected need for cash, the cost of getting cash from a CD is known: It is the early withdrawal penalty. The cost of getting cash from a Treasury security is unknown. If interest rates have risen, the Treasury security will have to be sold at a lower price; however, if they've fallen, the Treasury security might be sold for a gain.

### A Valuable Option

A financial advantage of the fixed penalty for early withdrawal of a CD would occur if market interest rates were to rise substantially. In such a case, it can be advantageous for an investor to close the CD, pay the penalty, and invest the proceeds in a new CD paying a higher interest rate. This sort of financially motivated withdrawal is not available to the investor in a Treasury security because the Treasury security's price will have declined to fully reflect any increase in market interest rates.

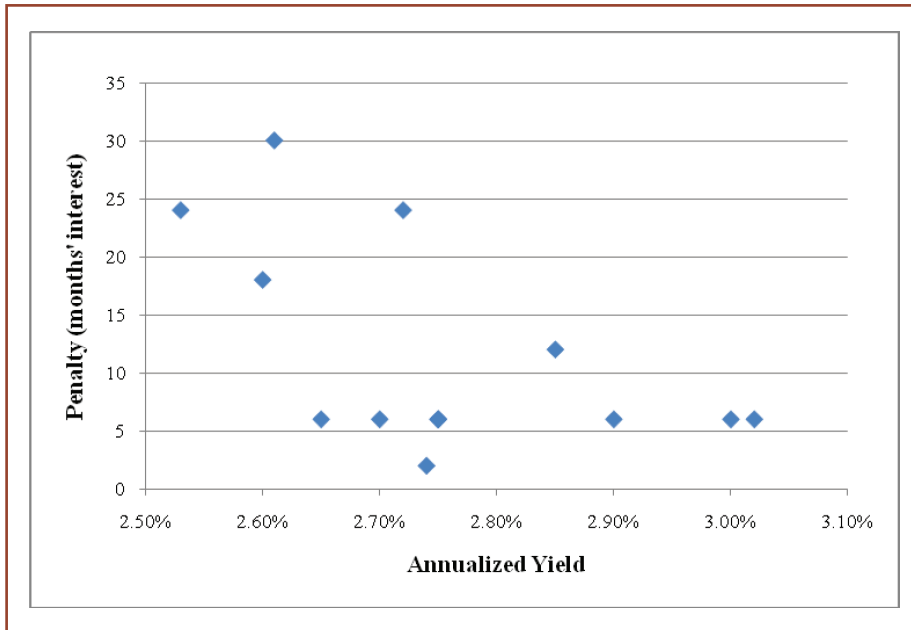
Table 1 lists the 15 best annual yields available on one-year CDs. The early withdrawal penalties charged on these CDs varied from one month's to six months' interest. Table 2 lists the best yields on five-year CDs. The early withdrawal penalties charged on these varied even more, from two months' interest to 2½ years' interest. Figure 1 plots five-year CDs from 12 different issuing banks according to their annualized yield and early withdrawal penalty.

Half of the 12, including the three offering the highest rates, charged an early withdrawal penalty of six months' interest. More interesting, the highest penalties were charged by institutions offering among the lower rates. Clearly, it pays to consider both the rate being offered and the early withdrawal penalty being charged.

In fact, it might be worthwhile to accept a slightly lower yield, if it is paired with a substantially lower early withdrawal penalty. To see this relationship, let's consider a simple example. Suppose you consider two five-year CDs. The first offers a 3.0% annual percentage yield but has an early withdrawal penalty equal to 24 months of interest. The second offers a 2.5% annual percentage yield with an early withdrawal penalty of six months of interest. If interest rates remain relatively stable or even decline over the next couple of years, you'd be better off with the higher yield—assuming you know you won't need the money for any reason for five years. Suppose, instead, interest rates increase quite a bit over the next year and you find you could earn 4.0% on a new four-year CD.

If you had invested in the 3.0% CD, you could not take advantage of this higher rate because the penalty for early withdrawal is so high. With no early withdrawal, your total return from the 3.0% CD would be 15.93% over the five years (i.e.,  $1.03^5 = 1.1593$ ). If you were to close the existing CD at the end of

**Figure 1. Five-Year CD Yields and Early Withdrawal Penalties**



the first year, pay the 24-month early withdrawal penalty (6.0%), and reinvest the proceeds in a new four-year CD, your total return would be only 13.27% [i.e.,  $1.03 \times (1.00 - 0.06) \times (1.04)^4 = 1.1327$ ].

In comparison, if you had invested in the 2.5% CD with the lower early withdrawal penalty, you could improve your total return from 13.14% to 18.41% by closing your existing CD, paying the penalty of six months' interest (1.25%), and opening a new four-year CD offering the 4.0% interest rate. This is a case when the early withdrawal option found in retail CDs has value.

### Another Alternative?

Aside from U.S. Treasury securities, investors might consider another alternative: a money market deposit account. When offered by FDIC member banks and savings institutions, money market deposit accounts offer the same insurance protection as retail CDs. Unlike CDs, money market deposit accounts have no stated maturity and no penalty for withdrawal, but the rate earned can

change each day. It is up to the issuer to determine the rate it pays. Rates for these accounts found on Bankrate.com on September 1, 2010, were somewhat below those offered on one-year CDs. The best available rate was 1.35%, 0.16% lower than the best available one-year CD yield. Some institutions offer higher teaser rates that are guaranteed for some period of time.

We are convinced, however, that a better alternative to a money market deposit account is to invest in a five-year CD with a relatively low early withdrawal penalty. On September 1, 2010, Ally bank offered a 2.74% annual yield with a withdrawal penalty of only two months' interest, or 0.46%. If an investor put money in this CD, held the CD for only four months and paid a penalty for early withdrawal, he or she would be better off than having earned the best available money market deposit account yield of 1.35%.

### Our Advice

Here's a list of our suggestions for

investors entering the retail CD market.

**Shop around.** Use a website like Bankrate.com to find the best available rates. Your local bank branch is rarely going to offer a competitive rate. You probably don't need to worry about the institution's "star" rating, because your CD will be insured by the FDIC. However, if a troubled bank is shut down there may be some delay before deposit funds are available.

**Verify terms.** Once you've identified a few good rates, go to each institution's website and verify the rates and minimum deposits. When we gathered data on September 1, 2010, we found better rates on the institution's website than listed on Bankrate.com in a few cases and worse rates in a couple of other cases.

**Early withdrawal.** Find out what the early withdrawal penalty is and factor that into your investment decision. It's worth a slightly smaller yield to get a much lower penalty, as interest rates might increase substantially or you might face a sudden, unanticipated need for cash.

**Verify insurance.** Before you invest, use the FDIC website to verify that the institution is a member of the FDIC. Don't trust the institution's website on this. There's some evidence, as cited by journalists, that uninsured issuers have either falsely claimed FDIC membership or used bait-and-switch tactics to lure investors into uninsured products.

**Rollover.** When you invest in a retail CD, make sure you know what will happen to your money when the CD matures. Some institutions automatically roll maturing CDs into a new CD with the same maturity as the old one, but at whatever rate the institution happens to be paying at that time. Other institutions have different policies. You may need to contact the institution just as the CD is maturing so that you can provide instructions on what you want done with the proceeds. ▲

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