

New CDs Could Offer Advantages if Interest Rates Rise

Perhaps the biggest sacrifice potential investors will have to make is in the initial rate the CD will pay.

With interest rates at historic lows and the markets on a roller coaster ride, investors who seek stability haven't had many options available to them lately. But that is starting to change. According to a recent study by *Bankrate.com*, banks are increasingly adding "rising rate" CDs to their menus.¹

These certificates of deposit are designed to increase their rate of return as interest rates rise, giving investors some upside flexibility to offset the risks of locking their money away for a specified period of time, which can be up to five years. The CDs come in three varieties: bump-up, step-up, and liquid.

- A **bump-up CD** allows investors to raise their rates a specified number of times during the course of the CD's term.
- A **step-up CD** will rise at predetermined intervals -- the investor has no say in when this will happen.
- A **liquid CD** allows an investor to transfer money out of the CD to reinvest into another CD with a higher rate.

All three of these products come with caveats and restrictions -- and the penalties can be heavy. Among the issues to watch out for:

- **Low initial rates.** Perhaps the biggest sacrifice potential investors will have to make is in the initial rate the CD will pay. Banks are taking on certain risks by allowing investors to change their rates if they rise, so expect the initial yield on these CDs to be far less competitive and appealing than regular CDs.
- **Widely variable yields.** While the initial yields will often be lower than regular CDs, it pays to shop around. In April 2011, *Bankrate.com* found that the spread varied from a low of 0.15% to a high of 1.36%, a fairly significant difference.
- **Variable terms.** Some banks will allow only one bump-up per term, while others allow investors to change their rate twice or more. Some liquid CDs cap the amount investors can withdraw to reinvest in another CD at 50% or less. As with any type of investment, be sure to read all the fine print carefully before investing.

"There's one consistency and that's if you're going to have the benefit of higher rates later, you're going to have to give up something on the front end," said Greg McBride, *Bankrate.com* senior financial analyst.

"There's a trade-off."

###

© 2011 McGraw-Hill Financial Communications. All rights reserved.

June 2011 — This column is provided through the Financial Planning Association, the membership organization for the financial planning community, and is brought to you by Paul Lemon, CPA/PFS, CFP®, a local member of FPA.