

BROKERED CDs

Fixed income market insights from Advisors Asset Management, Inc.

A traditional **Certificate of Deposit (CD)** is a time deposit instrument sold by banks, savings and loans (“thrifts”), and credit unions. A CD permits an investor to safely deposit money and earn a reasonable rate of return over the deposit period.

Also known as “**non-negotiable**” CDs, traditional bank CDs are offered by financial institutions directly to their customers and cannot be traded in the secondary market. CD interest rates are typically higher than savings account or money market rates.

Similar to a bank CD, a **brokered CD** also pays a set interest rate that is generally higher than a regular savings account. Both are debt obligations of an issuing bank, both repay your principal with interest if held to maturity, and both are FDIC-insured up to \$250,000 (per account owner, per issuer). However, brokered CDs can also be purchased from multiple banks and held in a single account, allowing advisors to effectively expand an investor’s FDIC protection beyond the \$250,000 limit.

Brokered CDs, also known as “**negotiable**” CDs, are sold to brokerage houses first, who then re-sell them to investors. Unlike bank CDs, brokered CDs are designed to be transferrable between investors in the secondary market through transactions facilitated by brokers. Access to a secondary market may allow a purchaser to exit their CD at a competitive price and avoid early withdrawal penalties. Investors should understand that some brokerage CDs can be quite illiquid in the secondary markets and there is no guarantee an acceptable bid will be found.

Types of CD Payouts

The standard payout structure of a CD is quite simple. It is a direct investment contract between the issuing bank and the depositor which pays out interest either periodically, such as monthly or semi-annually, or at maturity along with the principal. However, some banks add special features in an attempt to better meet both their needs in raising funds and investors’ needs in seeking an attractive, safe investment choice.

- **Fixed Interest Rate:** Standard fixed interest rate CDs are the most common types of CDs. They pay out periodic fixed interest, then return principal upon maturity.
- **Variable Interest Rate:** Variable interest rate CDs pay out periodic interest that is tied to an interest rate index, such as the prime rate or the consumer price index, or a U.S. Treasury rate. These CDs have their interest rate reset periodically based on changes of the reference index.
- **Bump-up Rate:** Bump-up CDs help protect the investor from getting stuck with a low interest rate over the life of the CD in a rising interest rate environment. This could be particularly attractive to an investor in long-term CDs. If interest rates rise and the issuing bank, in response to rising rates, begins offering a higher rate on a similar CD, an investor is given the right to “bump-up” the rate to the higher rate for the remainder of the CD’s life. Investors are usually given one opportunity to bump-up rates in this manner over some term period. In exchange for this protection, banks will pay a slightly lower initial interest rate compared to a standard CD without such an option.

Reasons to Consider Brokered CDs:

- ▶ **FDIC Insurance**
- ▶ **Flexibility**
- ▶ **Convenience**
- ▶ **Liquidity**

Advisors Asset Management, Inc.

Deeply rooted in the fixed income markets since 1979, Advisors Asset Management, Inc. (AAM) has provided financial professionals with comprehensive access to the bond market in conjunction with simple and efficient trading support. Our long-standing relationships and Capital Markets expertise allows establishment and maintenance of an attractive inventory of securities, offering advisors the opportunity to capitalize on pricing, yields, and quality issues.

AAM’s seasoned fixed income trading team is comprised of more than 20 professionals, who average over 16 years of industry experience. Our open-architecture offering system provides advisors access to all major ECNs, as well as our own inventory. For almost 40 years, AAM has been a trusted resource for financial advisors and broker/dealers. In addition to the fixed income markets, AAM offers access to structured products, unit investment trusts (UITs), mutual funds, managed accounts, and ETFs.

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- **Step-up Rate:** Step-up rate CDs provide a set schedule of rates which step-up in size at various intervals. For example, a 36-month step-up CD may begin an initial period at a low rate, but then step-up said rate once after the 9th month, a second time after the 18th month and a third time after the 27th month.
- **Liquid:** Liquid CDs permit investors to withdraw some of the invested funds at certain points in time before the CD's maturity without penalty. In exchange for this right, the Bank pays out a somewhat lower interest rate on the invested amount compared to a standard CD.
- **Zero-Coupon:** A zero-coupon CD does not pay out interest at regular intervals, but all at once alongside the principal, at maturity. An investor buys a zero-coupon CD at a discount to face value and in-turn, receives back face value at maturity. The difference between the purchase price and face amount is the only interest earned over the life of the CD.
- **Market-Linked/Equity-Linked:** Some banks offer CDs whose periodic payout is tied to the performance of a market index like the S&P 500 or a commodity index. As the index increases, the payout to the CD investor goes up based on the "participation rate" defined in the contract. That is, if the participation rate is 50%, the CD investor will receive half the performance of the reference index. Market-linked CDs may define a base rate the investor always receives to protect him or her in the case the reference index falls.

Features and Benefits

- **FDIC Insurance:** CD accounts qualify as deposit accounts at depository institutions, and as deposit accounts, are insured by the Federal Deposit Insurance Corporation (FDIC) or the National Credit Union Administration (NCUA) for up to \$250,000 per depositor per each institution where CDs are held. The FDIC insures accounts held at banks and thrifts, and the NCUA insures accounts held at federal credit unions. Because the insurance applies per account holder per each institution, it makes sense for an investor in CDs to hold no more than the insurable amount at any one institution.

FDIC insurance is subject to certain limitations and requirements. Visit www.fdic.gov for additional information.

- **Convenience:** Brokered CDs provide access to multiple banks' CDs. Because brokered CDs are securities, purchasing one requires none of the paperwork required when purchasing a bank CD. By consolidating a number of brokered CDs in a single brokerage account at a single financial institution, investors can reduce paperwork, streamline the purchase process, simplify the procedure of managing multiple maturities, and potentially expand FDIC coverage under one account.
- **Wide Range of Maturity Classes:** CD maturities range from 30 days to 5 years, or more. Investors can diversify investments into different maturity bands creating a ladder structure of investments that can help mitigate interest rate risk.
- **Taxation:** The interest on CDs is taxable as ordinary income in the year in which the interest is earned. For traditional CDs which pay out interest regularly, the interest is earned in the year it is received. However, for zero-coupon CDs, interest income is considered to be earned in the year in which it accrues from an accounting perspective, even though the actual amount may not be received until the CD matures in a subsequent tax year. This is a form of taxable "phantom income" investors should watch out for before making an investment.

Investors may be able to defer taxes on CD interest by holding it in a tax-deferred Individual Retirement Account (IRA) or 401K. ***As tax matters can be complex and varied for different investors in different situations, investors should always consult a tax adviser for specific advice on their particular situation.***

Potential Risks

- **Inflation Risk:** Inflation risk is the risk that inflation (the rise in prices of goods) outpaces the interest earned on the investment, and therefore, the investment yields back to the investor less purchasing power than what was originally put into the investment. Inflation risk is more viable for longer-term CDs since inflation becomes harder to predict over longer time horizons.
- **Call and Reinvestment Risk:** Call risk applies to CDs that have call features embedded within their terms. It is the risk that the investment will be called away by the bank before the CD's maturity, causing the investor to lose all future interest rate payments he or she was expecting to earn. The investor will then need to find a replacement investment with comparable or better rates of return. If such an investment cannot be found, the investor may have to settle for less attractive terms than what the original CD provided.

On a smaller scale, reinvestment risk also applies to any returned interest payments from a CD. Said interest may need to be reinvested, but it may not be possible to find another investment vehicle as attractive as the CD from which the original interest was received.

- **Market and Interest Rate Risk:** Market risk would mainly apply to brokerage CDs an investor may wish to sell in the secondary markets before maturity. General interest rate levels may move in a certain way which impacts the resale value of the CD in the secondary market. In general, the prices for fixed rate CDs will fall as interest rates rise. If the market value falls significantly, the investor may be forced to sell the CD at a capital loss.

- **Early Withdrawal Penalties and Liquidity Risk:** If the investor must withdraw funds early from a bank CD, they may not be able to do so without incurring significant penalties which could cancel a significant portion of interest earned to date, and sometimes even take away from the original principal investment. The nature of the contract limits the liquidity made available to investors to raise funds if needed.

Some of this risk can be mitigated by investing in brokerage CDs which can be sold in the secondary market at any time without penalty, but even with these, the secondary market itself may have limited liquidity and so the investor may not be able to find an adequate bid at which to sell the investment.



NEXT STEPS

To learn more about brokered CDs, contact your financial professional who can answer questions and provide access to current offerings, as well as assist you in structuring a portfolio that meets your individual investment goals and risk tolerance.

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