Another Winter of Discontent?

Change Your CD Investment and Raise Your Return

By Cameron Short

If you have traditionally kept money in short-term certificates of deposit, rolling your money year after year into another CD, you've found yourself reinvesting at lower and lower rates. If you have CDs coming due soon, you already know that your renewal rate could be as low as 2 percent. Plus, interest on CDs is taxable; your net return after taxes could be less than the rate of inflation.

Before you renew your CDs, take a look at the alternative investments outlined in this article. Keep in mind, though, that CDs are federally insured and offer a fixed rate of return while both the principal and yield of investment securities (in particular, stocks and mutual funds) will fluctuate with changes in market conditions.

Municipal Bond Mutual Funds

For investors with a time horizon of five years of more (including many investors who habitually roll over their one- or two-year CDs), mutual funds can be an attractive alternative. If you are a conservative investor, funds that invest in municipal bonds offer significant advantages, including professional management, diversification, monthly income and taxable-equivalent yields (net of sales charges) generally higher than CD returns. The minimum investment can be as low as $1,000. Some funds investing in the municipal bonds of specific states offer income exempt from federal, state and local income taxes.

before you invest be sure to request and carefully read the fund's prospectus. It contains important information, including management fees and expenses.

Before you invest be sure to request and carefully read the fund's prospectus.

Government Bond Mutual Funds

These funds, which invest in a diversified portfolio of government securities and are professionally managed for a maximum return, are a compelling alternative for yield-oriented investors. Government bond mutual funds are long-term investments, however, and you must be willing to accept some fluctuation in investment value in return for an opportunity to get higher current returns.

Government funds offer monthly income that can be automatically reinvested if you like. The minimum investment can be as low as $1,000. Be sure to read the fund's prospectus carefully before you invest.

Government Securities

Government securities include Treasury bills, notes and bonds, all of which carry a high credit rating and a low degree of risk. Government Securities are also available in other lesser-known forms, including these:

Ginnie Mae Securities. Ginnie Mae is a nickname for GNMA, the Government National Mortgage Association, a wholly owned corporation of the United States government. Each Ginnie Mae security represents a share in a pool of Federal Housing Administration and Veteran's Administration mortgages.

Ginnie Maes offer investors the highest yield of any security with a direct federal guarantee. Your regular monthly payment includes principal and interest and will be the same amount unless a prepayment of principal is included. As with mortgage payments, the interest portion will be higher in the beginning.

You can purchase newly issued Ginnie Maes, whose principal has been paid down substantially, for as little as $5,000.

Zero Coupon Strips. STRIPS represent direct ownership in interest or principal payments on US. Treasury notes or bonds. Like all zero coupon securities, STRIPS are purchased at a substantial discount to their maturity value and, if held to maturity, lock in a fixed yield. STRIPS ate intended for long-term, tax-deferred investing, and can be the perfect way for you to build wealth for the future. They mature four times a year (February, May, August and November), with maturities as long as 30 years, making it easy to target specific future needs, such as your retirement or your child's education.

because accumulated unpaid interest on zero coupon Treasuries is taxable, you should use STRIPS in an IRA or other tax-differed accounts.

Fixed-Rate Annuities

One of the few remaining tax-advantaged investments, an annuity, simply defined, is a contract between an investor and a life insurance company that is guaranteed by the insurance company. You pay a premium (ordinarily a minimum of $5,000) and in turn, the insurance company pays interest on that premium for a specified period, known as the accumulation phase. Under current law, interest compounds tax deffered, meaning that the interest won't be taxed until you take it out. IRS tax penalties may apply prior to age 59½.

Income Stocks

Many high-quality stocks pay dividends that are at or near current CD rates. And while the value of a CD held to maturity never rises above your original investment, stocks have the potential to rise in value. (Be aware that shares of stock when sold, may be worth less than your original investment.) Also, the dividends on many high-quality stocks have risen consistently over the decades.

An alternative investment to your CD could offer you both the low level of risk and the higher return you're seeking. This is the year to raise your returns! ❑

About the Author
Cameron Short is vice president-investments for Gruntal & Co., Pittsburgh.