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An Alternative to CD's

"Not All Income is the Same"

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It is often believed those who invest in Certificates of Deposit would not be suited to purchase stocks. There is a clear difference between the two investment choices and the risks are not the same. However, the question should be which investment choice best meets the objectives of the investor and whether the risks are reasonable.

Those utilizing CD's generally have two objectives, with the first being the production of income and the second being little or no investment risk to their principle. The protection of their principle is achieved through the institutions' insurance which includes FDIC for most banks and NCUA for credit union accounts. The difficulty today is the level of income produced by the CD and whether the income will meet the investor's needs. According to Bankrate.com, early August rates for a five year $100,000 CD are 2.35%. There were only two institutions offering this rate, with the remaining banks offering lower rates. The typical CD investor is accustomed to earning four to six percent on their funds and the income from this rate is forcing them to take a 35% to 55% decline in their available income.

Those investing in CD's often forget two very important factors. All interest earned is subject to income taxes which can range from 10% to 28% depending upon their personal tax bracket. Also, while the principle is guaranteed to be returned, due to inflation it may not be able to purchase the same amount of goods and services at the end of the term as it could when first invested. According to the U.S. Department of Labor and the Bureau of Labor Statistics, for $100,000 invested five years ago and maturing June 2017, it takes $106,918.69 in June of this year to purchase what $100,000 could buy in July 2012.

To recap, those able to invest $100,000 in a five year CD will earn $2,350 per year but net after taxes $1,997.50 if they are in the 15% tax bracket. If the next five years provides the same inflation impact as the last five, their $100,000 purchasing power will fall to $93,444.20. Interest rates are remaining near record lows following years of expectation they would return to a more normal range. It may be time for the CD investor to carefully consider other options.

In my opinion, it would not be prudent for a CD investor to throw in the towel on CD's and move 100% into stocks or mutual funds. However, they might consider moving 20% to 25% into a well-diversified portfolio of stocks and funds. The downside to this type of change is the guarantee of their principle will no longer exist and most likely there will be a fee paid for the purchase of each investment. If this objective is given up and a cost is incurred, are the benefits that favorable? For many, I believe they are.

Insights Continued:

It is currently possible to build a portfolio of stocks and funds which provide a yield of 3% to as much as 4%. A quick search will show there are stocks with yields much higher than these rates, but in my opinion may bring additional risk to the portfolio which may not be desired. Limiting the selection to companies who have paid dividends for a minimum of five years and have a history of increasing those dividends will help reduce some of the risks. To be even more conservative, a ten year history of increasing dividends could be used.

A portfolio yielding 3% to 4% would represent a 27% to 70% increase in income over the current CD rate. As an additional benefit, dividends are classified as ordinary or qualified, and qualified dividends are taxed at capital gains rates rather than ordinary income like interest. For those taxpayers who are in the 15% income bracket, they may find their qualified dividend income being taxed at 10%, and possibly not at all. This is an improvement over the tax impact on interest income. Unlike a five year CD where there is often little flexibility in accessing part of the CD before the end of the term, even a small amount may be accessed for a small fee and sometimes free of charge in a portfolio of stocks and funds. Unlike CD's which offer no protection against the impact of inflation, equities have a history of being an inflation hedge. For this type of portfolio, the future value at the end of a five year period cannot be predicted and could be worth more or less than its starting value; history tells us most of the time the portfolio will grow in value, but is not guaranteed.

Consider the potentially higher income, lower tax rate on the income, flexibility of access, and a better hedge against inflation, then this investment option deserves a look for most investors.