How to Invest in a Certificate of Deposit (CD)

Tips

You'll earn more in a longer-term CD, but be sure you won't need the money before the term is up -- the penalties for early withdrawal can be severe.

Compare CD rates at Bankrate. Also see if you'd be better off with a high-yield online savings account.

Staggering your CD investments, a tactic called laddering, can give you periodic access to the money within your CDs.

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Certificates of deposit (CDs) make financial sense for people of all ages who want a low-risk investment to park cash they don't plan to use immediately. Maybe you want to use your cash to buy a car or make a down payment on a house pretty soon.

If you won't need your cash reserve the day after tomorrow or next week, you'll likely want that money to earn a better rate of return than your checking account offers—without taking on too much risk. This is when a CD is useful.

Two factors to consider when deciding whether a CD is right for you:

• **Your time horizon.** When will you need part or all of your cash? Do you have other cash resources to access in a pinch? If you have a sum of money and don't expect you'll need to use it for six months or longer, a CD may be ideal.
• **Interest rates.** The anticipated direction of interest rates will help you determine how long to tie up your money. If rates are rising (usually when inflation is on the rise), a short-term CD may be best. If rates are falling (usually when the economy is on a downswing), a longer-term CD may earn you more money, since you'll lock in a higher rate.

How to Invest
Before you shop for a CD, there are two numbers you need to know:
• **APR** —The annual percentage rate, or the interest rate a bank is offering on the CD.
• **APY** —The annual percentage yield, which tells you what you'll earn over the multiyear life of the CD as your money compounds.

What's compounding? Put simply, it's how your investment grows over time. Let's say you invest $10,000 in a three-year CD earning 5% annually. In the first year, your $10,000 investment will earn $500. In the second year, 5% of the new total ($10,500) will be $525. In the third year, 5% of $11,025 will be about $551. The total amount of money grows each year, so the amount representing 5% of your investment also grows. That's compounding.

You've decided a CD is an ideal investment for your cash. Here's what to do next:

1. Choose your term. Determine how long you want to tie up your money. This will depend on when you need the money or whether you have other cash assets to tide you over until the CD matures.

2. Pick your type. Decide which kind of CD suits you best. For example, if you want to invest for two years and don't want the risk of being stuck with a low rate, then a bump-up CD may be ideal. Afraid you'll need part of your deposit for an emergency? Consider a liquid CD. (Look here for an explanation of the basic types of CDs.)

3. Review the rates. Once you've selected the duration and type of CD you want, find out what rates are available at different banks.

Consider a ladder

One way to reduce a CD's drawbacks is to use a technique called "laddering." This strategy gives you regular access to part of your cash and protects you against rising interest rates.

Laddering is simple. Instead of investing one big chunk of cash in one CD, you divide your lump sum into equal parts and invest each in CDs of varying durations.

Here's how it works: Let's say you want to invest $15,000. By laddering, you would invest $5,000 in a one-year CD, $5,000 in a two-year CD and $5,000 in a three-year CD. Then, each time one of the three CDs matures, you would either take the cash or re-invest it in another three-year CD to keep your ladder in place.

Laddering provides three benefits:
• Penalty-free access to cash each time a CD matures.
• More favorable interest rates, since you're always investing in a longer-term CD.
• A shot at better returns if interest rates are higher when you re-invest.

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