

# Wall Street Journal

## 'Indexed' CDs Aim to Balance Risk and Safety

By [KELLY GREENE](#)

Investors seeking both safety and a hedge against inflation are snapping up a product that hasn't attracted much attention in recent years: market-indexed CDs.

Unlike traditional certificates of deposit, which earn a preset interest rate for a specific term, an indexed CD is linked to one or more financial indexes, such as the Standard & Poor's 500. If the market index to which your CD is tied rises in value, you capture at least a portion of that return. If the index falls, you still get your original deposit back. That deposit is also protected by the Federal Deposit Insurance Corp., up to standard limits.

Indexed CDs aren't without potholes. Many investors assume—wrongly—that the products work much the same as traditional CDs. One big difference: You can liquidate a regular CD at any time and get back your principal, although you may lose a portion of the interest you have earned. But with indexed CDs, you have to keep them for the full term—typically four to five years—in order to be guaranteed you will get back your principal plus any earnings. And some indexed CDs also have complicated terms that can result in yields that vary greatly from what investors expect.

Still, as stock indexes have risen some 40% from recent lows hit in the spring, investors increasingly are looking for ways to get some exposure to the stock market while being able to sleep at night. "As people get about five years from retirement, up through retirement, it's not about how much they can make. It's about how much could they lose," says Mark Cortazzo, a certified financial planner in Parsippany, N.J. "They know they should be in equities, and with [indexed CDs] they get most of the gain, and somebody else assumes the risk."

Buddy Deluce, a 61-year-old engineer in Crane, Ind., sold his mutual funds last year after they lost 25% of their value. "I couldn't afford to take any more hits. I even considered leaving it in cash," Mr. Deluce says. Seeking an alternative, he put about \$50,000 of his remaining savings into a 15-year indexed CD linked to Treasury bond rates.

### **13% Yield in First Year**

The CD, issued by [HSBC Holdings PLC](#), yields a guaranteed 13% in the first year. For the following 14 years, the yield reflects the difference between the rate on 30-year Treasury bonds and five-year Treasury bonds, up to a maximum

12%. If the long-term rate in a specific quarter is lower than the short-term rate, which isn't common, the investor doesn't collect any interest for that period.

Indexed CDs have been around for two decades, but sales climbed 46% to \$1.66 billion from January through May, compared with \$1.15 billion at the same time last year, according to Arete Consulting Ltd., a financial-industry information provider. The products, issued by banks, are typically sold through financial planners and stockbrokers.

### Leaving Money on Table

One example: [Barclays PLC](#)'s Barclays Bank offered an indexed CD this month based on the S&P 500 with a five-year term. It promises to match the index's full gain—up to a maximum of 50%. That means if the index climbs 80% over those five years, you would leave money on the table. But if the index fell and you held the CD for the full term, you would still be left with your original investment.

Investors who cash out early can lose some of their money. Stephen Palumbo, a 62-year-old retiree in Randolph, N.J., who works with the financial planner Mr. Cortazzo, in October 2007 bought a four-year CD linked to three commodities to hedge against a possible rise in inflation.

The commodities—oil, copper and zinc—plummeted more than 50% in value over the next 18 months. So Mr. Palumbo cashed out his indexed CD in January to seek out other investments. He ended up recouping 92 cents on the dollar. "I wasn't unhappy," he says, noting that other investors have fared much worse in recent months. "It was a good introduction to commodities," he says.

### Fine Print

Investors need to read the fine print for risks. For example, some indexed CDs have what are called "barriers" or "knock-out rates." These terms, found in the CD's contract, can limit the return for the investor, sometimes in surprising ways. Let's say your CD has a "barrier" of a 60% return on the S&P 500. That means that if the index rose more than 60% during the investment term, you wouldn't get any interest.

With the market's recent volatility, "many of those barriers were breached" on these types of indexed CDs, says Lisa Smith, vice president of Bankers Financial Services LLC in Johnston, Iowa. Of course, investors also wouldn't receive any interest if the market index fell during the investment term.

It's also important not to make assumptions about the figures used to measure an index's rise or fall. Some CDs use average quarterly or annual returns through the investment period, while others measure movement from "point to point," meaning from the start of the term to the end.

## **Whose Average?**

“We really like point-to-point investments,” says J. Scott Miller, a managing partner of Private Wealth Management LLC in Blue Bell, Pa. That’s because CD issuers can use a variety of averaging methods, which, depending on the market environment, could result in no paper gains for the investor—even if the market ended higher at the end of the term, he says.

Some indexed CDs base their returns on two or more indexes, which may make it hard for investors to gauge the true risk involved. “We want them to be tied to no more than two indexes, and we look for big indexes, like the S&P 500 or the Russell 2000,” says Dryden Pence, chief investment officer of Pence Wealth Management in Newport Beach, Calif.

Financial planners generally recommend buying indexed CDs within individual retirement accounts, which are tax-deferred. That’s because if you hold an indexed CD in a taxable account, you may owe tax each year on what is called “phantom” income, generally a small predetermined amount listed in the CD’s disclosure statement.

Write to Kelly Greene at [kelly.greene@wsj.com](mailto:kelly.greene@wsj.com)

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