



Providing Financial Education



# Your guide to ISA's

ISA stands for Individual Savings Account, a tax-efficient wrapper offered under Government legislation as a way of encouraging you to save.

# Your comprehensive guide to Individual Saving Accounts (ISA's)

An ISA sits over your choice of a number of different investments to shelter them from further tax on any income or gains earned.

Within this, the limit for Cash ISAs - or for the cash element within a Stocks and Shares ISA - is £5,340. However, there is flexibility over how these limits can be used - you can, for example, put the maximum £5,340 in a cash account and £5,340 in a stocks and shares account.

Alternatively, though, if you place just £2,000 in cash, you can use the entire remaining balance - £8,680 in this case - to invest in stocks and shares. If you don't need cash at all, you can put the full £10,680 into stocks and shares.

In addition, you can transfer existing Cash ISA holdings to a Stocks and Shares ISA without impacting on your current tax year allowance. So, if you have £10,000 already sitting in existing cash ISA plans then this amount can be moved to a Stocks and Shares ISA, yet leave your entire current tax year allowance still available for new investment.

Please note however, that funds can only be transferred one way and can not be transferred back to a Cash ISA. When considering a transfer of existing holdings you should consider any exit penalties imposed and also the potential for loss of income/growth, following a rise in the markets, whilst the transfer remains pending.

There are just two types of ISA - the Cash ISA and the Stocks and Shares ISA - and the combined allowance for both in 2011/12 is £10,680.

INDIVIDUAL  
SAVING ACCOUNT

### What makes a good cash ISA?

Cash ISAs are simply cash accounts which earn the tax benefits of the ISA wrapper and are therefore amongst the most straightforward products in the financial market.

The capital in a deposit account will not grow, but the value will not go down and will earn interest for the entire time it is invested. Therefore, in order to find the best one, you would generally just need to look for the highest interest rate.

However, there are some differences to be aware of. The highest rate now may not be the best rate longer term. You should therefore either be prepared to keep checking rates on a regular basis and moving your money around or you might find a provider offering slightly lower but consistently competitive rate levels is better.

Some providers might tie your money up for a period of time. These accounts pay higher rates because the provider can plan their own investments better – but you may have to wait up to 90 days if you make a withdrawal. Regardless, always read the small print to see what, if any, rate guarantees and caveats apply.

In essence, even the seemingly simplest of products needs some research. Make sure you make the right choice before you commit and get tied in.

# INVESTING YOUR ISA

Of your £10,680 2011/12 allowance, you can choose to invest up to £5,340 in cash and the rest of the balance in stocks and shares.

Alternatively, however, if you don't need the cash ISA, or you believe your tax benefits are better used elsewhere, you can abandon the cash ISA completely and invest the full amount just into stocks and shares.

At the top end of the stocks and shares ISA market, there are Self-select ISAs. These allow you to choose your own investments, including the individual shares of any company listed on a recognised stock exchange. However, whilst the allowance is a significant amount of money for many people, in share dealing terms it is not very much – and if it is all invested in just one or two companies, the risk of losing out can be very high. Consequently – and particularly if your ISA investment is a significant proportion of your overall savings – it may be better to consider collective investment schemes.

## Collective investments

By investing in a collective investment, you are accessing not just one or two but many different companies or holdings. Known as diversification, this approach is designed so that should any company lose money, returns from other companies may help compensate for any losses. Collective investments offer access to a whole range of different options. Some cover many asset classes under the one roof – equities, property and bonds for example. Others concentrate their efforts in just one – which could be anything from UK blue chip equities right through to Japanese bonds. To make the choice easier for you, most unit trust and OEIC funds are sorted into sectors by the Investment Management Association (the IMA) so that, at least loosely, you can identify which are trying to achieve what.

Therefore, if you want a lower-risk fund that offers just a small exposure to equities, you may look at the 'Cautious Managed sector'. If you are looking to maximise long-term growth, and are prepared for a 100% exposure to equities, the UK All Companies sector is a good place to start – but if you want to be more adventurous, still there are equity fund sectors for every country in the world. Finally, if you are after an income, the bond sectors may be more appropriate, or perhaps a sector which offers a mix of these and equities.

When making your choice, you should also be aware of the charges. A collective investment includes all the necessary research, share dealing and paperwork required to ensure you are up to date and getting the most from your investment. In return, you will pay an upfront and on-going fee, the level of which will vary to reflect the complexity of the investment product. Therefore, a straightforward index tracker fund which mirrors a stock market's movements will be cheaper than a Japanese Smaller Companies fund which requires active management, in-depth research and a team of investment professionals to support it.

Finally, your tax position could affect your investment choice – but that's a different matter entirely, which would need a guide of its own. If you are interested in discussing your tax position further, please contact us. In the meantime, here is a summary. However, you should always remember that the value of your investment can go down as well as up and you may not get back the amount originally invested.

## The IMA Sectors

### UK Funds

- UK All Companies
- UK Income
- UK Equity & Bond Income
- UK Corporate Bond
- UK Gilt
- UK Other Bond
- UK Smaller Companies
- UK Index Linked Gilts
- UK Zeros

### Overseas equity

- Global Growth
- Europe inc UK
- North American
- European Smaller Companies
- North American Smaller Companies
- Global Emerging Markets
- Japan
- Europe ex UK
- Asia Pacific ex Japan

### Managed Funds

- Cautious Managed
- Balanced Managed
- Active Managed

### Other

- Global Bond
- Money Market
- Protected/guaranteed
- Specialist
- Technology & Communications

# NOT ALL TAX BENEFITS ARE EQUAL...

While ISAs are well known for being ‘tax-efficient’, your choice of investments can make a big difference to how beneficial they are for you.

Whilst all the income and growth you receive from your ISA is tax-free in your hand, how each asset class is treated whilst it remains invested is different – and this can be confusing.

Cash ISAs for instance, are entirely free of income tax. Therefore, if you earn £1 in interest, you receive the whole lot.

On a normal bank account, basic rate taxpayers currently pay tax of 20p on that £1 and higher rate taxpayers would be liable for another 20p.

Therefore you receive more income from this account than you would do outside an ISA.

However, cash ISAs make no capital gain and therefore if you are making profits on investments across your non-ISA portfolio, a cash ISA will be of no help in reducing the Capital Gains Tax burden on that aspect.

Similarly to cash, the interest on corporate bonds is also tax-free. The tax that is paid by companies distributing interest to bond holders is reclaimed on your behalf by your ISA provider and invested into your corporate bond fund to increase the number of units or shares you hold.

Unlike cash ISAs, the capital value can fluctuate, and there is therefore the possibility of a tax-free capital gain as well as tax-free income.

Of course, on the flip side, that also means there is the chance of a capital loss if markets move against the investment – and also a risk to your income if a company defaults.

As a result, corporate bonds generally pay a higher income than deposits as a way of compensating investors for taking on this additional risk.



The tax benefits on stocks and shares, however, are a little different. Under normal circumstances, basic rate taxpayers currently suffer a 10% tax on dividend income. This 10% tax payment is not refundable within an ISA, regardless of the tax position of the investor. You could argue, therefore, that a stocks and shares ISA offers little additional benefit to a normal basic rate taxpayer.

However, based on the historical performance, equities have offered greater long-term growth potential than any other asset class. With the exception of a few higher dividend paying companies, much of the benefit of investing in shares comes from capital growth, therefore the fact

that no Capital Gains Tax is payable is of benefit. In addition, for higher rate taxpayers, the benefit of not paying additional income tax on dividends cannot be understated.

Having said this, it is worth noting that whilst equities have provided greater long-term growth in the past, this is not guaranteed for the future. If you are investing in equities, always consider them as a long-term investment and that you may not get back what you originally invested, particularly in the first few years.

Before making any investment decision you should weigh up the tax advantages against the potential risks and likely returns of your ISA.

# USE IT OR LOOSE IT

One thing is not up for debate: you only receive one ISA allowance every tax year.

You cannot carry your allowance over to next year and therefore, if you do not do something about it, you will lose it.

Your annual allowance can be used at any time during the tax year. The deadline of April 5th helps to concentrate the mind and we generally witness an increase in ISA investments at this time of year.

However, you do not have to wait. You can use your allowance at any time – and many would suggest that the earlier the better, particularly with cash ISAs where the earlier you get in the more interest you earn.

For stocks and shares ISAs, there is an argument for trying to ‘time’ your investment so you buy in when the assets are cheap (in order to make more when they recover later).

However, if anyone had really uncovered the truth about how to time the market, we would all be millionaires by now. For the sake of a few pounds, if you are that concerned about investing in shares, perhaps you should reconsider whether the risk is appropriate for you.

Alternatively, try ‘drip feeding’ your allowance in on a monthly basis instead so that you can take both the rough and the smooth as markets fluctuate.

**Regardless of how or where you decide to invest your money, you must get in before April 5th. At the end of the tax year, your allowance is gone. Make your decision, have your conversations, do your research, but start it now and make sure you don’t lose out.**

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