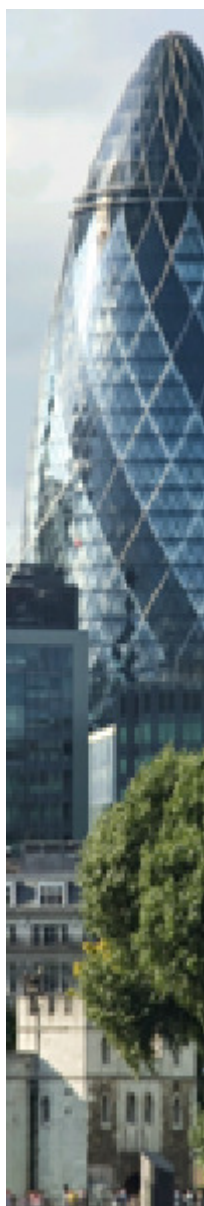


We're now hurtling towards the 'ISA Season' so this edition focuses on the many misconceptions people have with regard to ISAs.



The ongoing misunderstanding of ISAs

Whilst everyone is of course entitled to their opinion, one key element of an advisers work is ensuring these opinions are based on fact.

One of the common misconceptions I encounter is that an ISA is, in itself, an investment and therefore you can have a 'good' and 'bad' ISA. Furthermore, the public perception of ISAs is often somewhat negative.

An ISA is, in fact, a 'tax wrapper' – just like a bond or pension. One analogy is that an ISA is a box into which you put investments. The investments put into the box grow virtually tax free and the proceeds create no personal tax on the individual. The choice the consumer has is what to put in the box – cash, corporate bonds, gilt investments, commercial property funds, stocks and shares or equity funds. Quite often, the box contains a portfolio made up of a combination of these assets.

It is therefore the items you put in the ISA which drives the performance – not the ISA itself. If you pick a poor fund, then the ISA will provide a very tax efficient return on a poorly performing fund. If you pick well, the ISA will provide a very tax efficient return on your investment.

One relatively complicated element which may also lead to a misunderstanding is the ISA allowance. This is currently £10,200 for tax year 2010/11 and up to £5,100 of this can be used to hold cash (i.e. a 'Cash ISA'). The rest can be invested in the range of investments previously noted. If nothing is invested in cash then all of the years allowance can be used for other investments. Furthermore, if an ISA allowance isn't used – it's lost forever.

Given the tax efficiency of an ISA and the fact it can hold a broad variety of investments, it is generally accepted practice that, as far as is possible, cash deposits and investments should be held in an ISA in order to maximise returns as a result of the tax efficiency.

A simple example involves comparing the returns on cash; a cursory look at some cash rates for instant access deposits shows that 2.9% per annum can currently be achieved both inside and outside of an ISA. For a higher rate tax payer, the ISA will therefore indeed deliver a total return of 2.9% and this doesn't need declaring on a tax return. The non-ISA will, however, deliver a net return of 1.74% and will also need to be declared to HM Revenue and Customs. If tax paying clients are not using their ISA allowances and hold cash and investments outside of ISAs, the simple question would be – why? For higher rate taxpayers, this question is even more pertinent.

Chills for the UK economy

The UK economy contracted unexpectedly during the fourth quarter of 2010 after activity

Surviving recession

TIP NO 5: DON'T JUST HEAD FOR CASH

was hampered by unusually cold weather. According to preliminary estimates from the Office for National Statistics (ONS), the economy shrank by 0.5% quarter on quarter.

The economy contracted during the final three months of 2010 after growing by 0.7% during the third quarter and by 1.1% during the second quarter. On a slightly brighter note, however, this did mean the UK posted its first full year of economic growth since 2007, expanding by 1.4% during 2010.

The contraction was led by a sharp fall in activity in the construction sector, which declined by 3.3% during the quarter while in December alone, UK retail sales fell 0.8% month on month as UK shoppers found themselves thwarted by the weather. In direct contrast, the manufacturing sector actually expanded by 1.4%. Nevertheless, the ONS emphasised that, even excluding the disruption caused by the bad weather, economic growth would have been no more than “flattish”.

The shock contraction in economic growth raised fresh speculation about the possibility of a “double-dip” recession and, as the coalition government continues to administer its tough austerity measures, triggered concerns that the UK’s economic recovery might have run out of steam.

Nevertheless, these are preliminary estimates that are subject to change; indeed, the ONS explicitly warned that this time, revision is even more likely than usual. It is therefore certain that economists are likely to closely scrutinise any and all forthcoming releases of economic data.

During a recession, it is very tempting to get out of the stock market and head for the safety of cash. However, this strategy can be risky. Stockmarkets are volatile so, just as they can fall quickly, they can also recover quickly, with no warning. If equities are the right asset class for you, moving out when you have already suffered a loss could mean missing out when they finally begin to recover. Moreover, inflation can impact the purchasing power of cash over time. You can be assured that you will not lose the capital value of money when invested in cash but it should not be considered entirely “risk-free”!



Time for your own review

As you can probably guess from the many contradictory reactions to the spending cuts, no one can really tell which way the economy will go in the short term. As an investor, therefore, you could be forgiven for not knowing how to position your portfolio whilst we find out. However, some rules never change and the first, making sure your holdings are well diversified, is exactly for times like this. Over expose yourself to a single asset class –say, equities –and its performance will mirror only the fortunes of the equity market.

However, if you choose a range of asset classes from across different countries, the different elements will all perform differently. If one does badly, the chances are another will do better and compensate for some of that downside.

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