10 surefire steps to ISA success

Feature by Cathy Adams of Money Observer

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Savings and Cash ISAs | **2 Comments**

With inflation rising it's more important than ever to consider seriously whether you should keep your money in a stocks and shares ISA rather than in cash. Cathy Adams suggests 10 tips to make the most of your allowance.

1 Watch the compensation limit

The Financial Services Compensation Scheme limit for compensation for *investments* is £50,000 per ***FSA***-authorised firm (and £85,000 for cash deposits.)

According to the ***FSCS***, it will cover up to this amount if a firm is unable to pay claims brought by investors as a result of misleading advice or negligent management, or because the company has gone bust.

2 Choose your time horizon

While you're likely to get better returns from a ***stocks*** and shares ***ISA*** over the long term, there's little point investing if you'll need access to your cash within five years. As a rule of thumb, an investment in ***equities*** should be left for at least five years to reduce the impact of short-term market ups and downs and on its long-term growth trend, whereas many cash investments can be accessed as and when you need them.

Your needs are likely to change over time: younger investors with a longer time frame for their ISA can focus on capital growth for their investment; as they get older, they may decide to switch to an income stream.

3 Tax

If you have a cash ISA, or hold ***corporate bond*** or gilt funds within a stocks and shares ISA, then there is no income tax to pay. But any dividends paid by the underlying companies in an equity fund have a 10% withholding tax 'credit' deducted. This applies to both ISA and non-ISA funds, but it cannot be reclaimed by ISA investors. So it makes best tax sense to hold cash, corporate bonds or growth funds that don't invest in ***dividend***-paying companies in your ISA, rather than equity income funds.

However, stocks and shares ISAs grow in value free of ***capital gains tax***; if you're investing up to your ISA limit in the markets each year and holding your funds for the long term, this could amount to a significant tax saving and could be a far more important consideration than the loss of the dividend tax credit.

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4 Use a fund supermarket

The advantages of going through a fund supermarket are on price, flexibility and choice. Using a supermarket, you can invest in a wide range of funds and keep them on a single platform. If you buy through a fund supermarket or an '***execution-only***' broker, there is usually no initial charge on the funds. In addition, supermarkets offer the flexibility to switch holdings quickly and easily online.

However, if you want to invest in individual shares or investment trusts, you can set up a ***self-select Isa*** wrapper. There will be dealing charges to pay on these investments, and typically also a separate annual fee for the Isa wrapper, but Interactive Investor is one sharedealing website that offers the wrapper free.

5 Diversify your portfolio

To reduce risk, don't put all your eggs in one basket. Invest across a range of asset classes including cash, property, equities and bonds. By spreading your investments between different asset classes and geographical regions, you can help to reduce the risk involved. There is often little correlation between the performance of different asset classes; for instance bonds have historically done well when shares fall in value.

It's also useful to understand how different asset classes and geographical regions contrast. 'You may want to take, say, a cautious approach, but if your portfolio comprises only similarly structured cautious funds there is a risk that you have not really diversified at all, because much of the portfolio will be invested in the same areas and behave in the same way,' adds Peter Chadborn, ***IFA*** at Plan Money.

Be aware, too, of the individual stocks held by the funds you are invested in, and avoid too much duplication. For example, many investors had multiple exposure to BP shares through their fund portfolios – and were hard hit when the Deepwater Horizon oil spill occurred and the share price subsequently plummeted.

How to transfer your cash ISA

6 Be contrarian

Don't be swayed by short-term hype. Look for a ***fund manager*** producing consistently decent results – even though they are few and far between.

Don't necessarily write off a fund that has had a less successful year if the manager has performed reliably in the past. And conversely, think hard before you jump on the bandwagon of this year's most successful funds. How much further is there to go for the markets in which they're investing?

7 Advantages of regular investing

For a stocks and shares ISA, it is wise to set up regular payments to drip-feed your money in – that way, you take the difficult business of 'timing the market' out of the equation. Instead, you pay in through both rising and falling markets: your contribution will buy more units when stocks are cheap, and fewer when they are more expensive.

Graeme Mitchell from Lowland Financial adds: "That way you are not putting all your ISA money into the market at one time, yet you have the potential for much better longer-term returns only possible with stocks and shares." Additionally, the average cost of the units you buy is lower than the average cost of a single unit over that time – a benefit known as pound cost averaging.

9 Rebalance your portfolio

It's important to ensure that the structure of your portfolio remains in line with your overall risk profile as the investments grow.

"Over time, the more adventurous funds in your portfolio will perform better and therefore make up a greater proportion of the portfolio, relative to the more cautious funds," says Peter Chadborn. "This will gradually shift your profile up the risk scale, so while you may be happy with the performance, be aware that you may have adopted a risk profile with which you were not initially comfortable." If you remain more cautiously inclined, you'll need to reduce the size of the best-performing holdings and boost that of the slower-growing funds.

Seven top shares to consider for your ISA

10 ISA as part of pension planning

Consider your ISA investment as part of your overall retirement planning. Pensions are a more tax-effective vehicle, with full tax relief on all contributions; you will pay tax on the income you eventually take, but you may well be in a lower tax bracket by then.

However, the cash can't be accessed until the age of 55. Most ISAs, on the other hand, can be accessed whenever you want, but also offer attractive tax benefits, as returns are free of tax. Fewer restrictions apply and they are generally simpler and more flexible than pensions. Income from ISA investments over the years could add a considerable tax-free sum to your total retirement income.

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