An investment too good to refuse? Lessons from the UK ISA season

ISAs offer tax-free income. What's not to love? We take a look at some of the pros and cons

Before April each year, “ISA season” opens in the UK. This is the term used to describe advertising by financial institutions encouraging people to put money into Individual Savings Accounts (ISAs) before the entitlements for the financial year run out. Interest income and capital gains are tax free when placed in an ISA. There are several types of ISAs with some specifically designed to help people put a deposit on a house. However, the most popular are cash and stocks and shares ISAs, which can be accessed quickly if need be and so are highly liquid.

It seems like a no-brainer. Who wouldn’t want some income legally free of tax? In many cases, taking out an ISA will make sense, but it’s not necessarily the case.

Avoid the rush

ISA season uses a well-known sales tactic from the behavioural toolkit – loss aversion. Nowadays this is known as FOMO – fear of missing out. Buy now or miss the juicy tax advantages. This is partly true. But you could buy after the deadline and still use the next year’s allowance, which currently stands at a maximum of £20,000. For those who have money sitting idly in a standard bank account that they don't need immediately, it may make sense to move before the end of the tax year. If not, there is no need to rush.

Some decisions, especially around money and taxes, need to be made by a certain date. Planning ahead by budgeting both for your regular income and expenditure but also for investment possibilities can help avoid being rushed into making a decision. When rushed, it is more likely decisions will be made in a hot state increasing the risk of doing something you will regret in the future.

Consider your choices

Tax advantageous forms of investments exist in several countries. The tax advantages of ISAs are clear and enticing. However, that does not mean these investments are necessarily superior. Placing money in an ISA means diverting savings from other investments. It may not be the best decision for you.

Consider two cases:

- First, some employers offer to match contributions to company pension accounts up to a certain percentage of a person's income. If an individual or their partner has not maximised this opportunity, they may be leaving money on the table. It would pay to think carefully before putting money into an ISA if it means other forms of saving in tax efficient ways are neglected.
- Second, some tax advantageous investment comes with strings attached. Consider the Lifetime ISA in the UK. This is principally designed to help people save for a house deposit. However, withdrawing money unrelated to buying a property can incur penalties. You may end up getting less than you started with. Consequently, if your plans change or you need the money for unexpected expenses, this can prove costly. It is important to be aware of the restrictions placed on some forms of ISAs.

Buying an ISA or any form of tax advantageous investment is only part of taking a responsible approach to your and your family's finances. It should be considered as only part of your wider financial plans.

Obey the basics

If buying a tax advantageous investment is right for you, don't forget the basic rules of investing. Keep the fees very low and diversify your portfolio by avoiding home bias. Research by Vanguard shows this is prevalent across the globe. Global tracker funds are typically the most convenient way to avoid these traps.

Also remember investments work best when held for a long time, preferably over five years. If you buy a tax advantageous investment such as a stocks and shares ISA, commit for the long term.

Avoiding risk

The tax advantages associated with some investments may drive some to avoid taking financial risk. Indeed that is what we see in the UK with ISAs.

In the 2017-18 tax year, data from the UK tax authorities shows that 72% of accounts taken out were for cash ISAs and only 26% for stocks and shares ISAs. If we look at the amounts subscribed, 57% were in cash and 41% in stock and shares. Of the total £608 billion invested in ISAs and their predecessors as of 2017-18, 44% is in cash and 55% in stocks and shares.

People may have excellent individual reasons for keeping a large amount of money stashed away in cash ISAs. However, taking a wider view than individual circumstances, this is unlikely.

The high level of cash in what should be considered a long term investment choice fits with various studies that find individuals are highly risk averse when it comes to money, but that is especially so for those on lower incomes. Research shows individuals on lower incomes tend to have lower risk portfolios but also diversify less. As a result, it has been shown here and here that people on lower incomes earn a lower rate of return on their investment than those on higher incomes. This is one of the factors contributing to growing inequality.

Exploiting tax free investments

Tax advantageous investments have their place in planning your finances.

If you are tempted and have enough spare cash for a tax advantageous investment such as an ISA, bite the bullet and follow the rich. Commit for over five years. Reduce cash. Buy a widely diversified portfolio of shares, possibly in a global tracker fund. Keep your cash in the bank. Use the advantages to invest.

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