

Welcome to the latest edition of Investment Bulletin, our update on developments in the world's stockmarkets.

We hope you find the contents of interest. If you have any questions, or would like to discuss any of the points raised, please give us a call.

Using your ISA allocation wisely

While ISAs are well known for being tax-efficient, it is also important to select the right kind of underlying investment. Using your ISA allocation wisely does not just mean picking a reliable and successful ISA provider, it also entails giving careful consideration to the actual assets themselves. The reason for this is that not all asset classes receive the same tax benefits within an ISA wrapper. This can be confusing.

For example, cash ISAs are free of income tax. If you decide to invest in bonds through your ISA, you also pay no income tax. Meanwhile, interest-paying bond funds qualify for a tax credit of 20%, so the income (whether paid as income or re-invested) is totally tax-free. However, if you do opt for such a scheme over the cash option, remember that, unlike cash, the latter can put the value of your capital at risk.

Some corporate bond funds also have exposure to UK government bonds (known as gilts), which are also free from income tax, and are even lower risk – the chance of the Government defaulting on its loans is negligible. Alternatively, you could choose a gilt fund, which invests in a range of government bonds. Do note that, if you choose to invest in gilts directly, you'll need to ensure the bonds have at least five years to run until maturity. With any bond ISA investment, the hope is that income payments will be supplemented by capital growth, but of course, there are no guarantees.

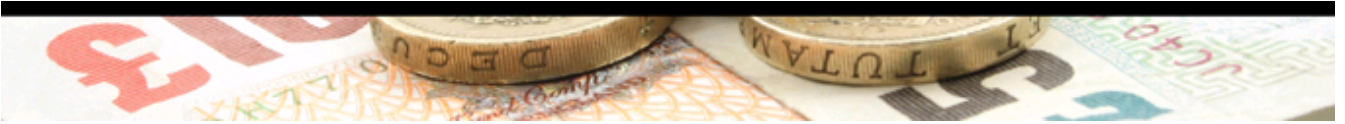
When compared with bonds, using your ISA to invest in stocks and shares is a little less effective from an income tax perspective. This is because, since April 2004, the rules have changed slightly. Basic rate taxpayers pay 10% tax on dividend income, which is taken before any dividend is received and now cannot be refunded, even within an ISA. Higher rate taxpayers, however, who would normally pay tax on dividend income at 32.5% outside an ISA, won't get back that 10%, but will save the remaining 22.5%.

Having said this, it is worth noting that although stocks and shares are seen as higher-risk investments, the asset class has outperformed bonds and cash over the long term and therefore the fact no capital gains tax is payable could be very important. However, none of this outweighs the need to ensure your investment choices are right for your needs. Only after you have got that right can you start thinking about how the tax breaks might help.

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Investment bonds

Investment bonds are investment products offered by life companies, usually available for lump sum investments. Within the bond, investors have a choice about how that money is invested from a range of funds.

Traditionally, the most popular have been with-profits, managed and distribution funds, each combining different asset classes under one roof. Today, however, fund choices are much greater, as life companies offer links to fund management houses alongside their internal range.

When you take out an onshore investment bond, your income and gains within the fund are subject to tax, which is then deemed equivalent to you paying basic rate income tax. Therefore, if you are a basic rate taxpayer, you will pay no more tax on that investment. If you are a higher rate taxpayer, you will have another 20% on the total growth. However, there are ways to mitigate this. For example, during the lifetime of the bond, you can withdraw up to 5% of the initial value of the investment every year for up to 20 years - that is, to a maximum 100% of the initial investment - without immediately becoming liable for additional tax.

When the investment bond is finally cashed in, you will be liable for higher rate tax on any gain. So, if you postpone this encashment until you are a basic rate taxpayer - perhaps after retirement or when you are earning less - you could end up with no further liability at all.



Taking the first step

Most investors start small, with a regular savings account, building a nest egg slowly. However, that nest egg might do better if some were invested in the stockmarket, which has historically outperformed all other asset classes over the long term. If companies perform well, they can grow your investment more quickly than a savings account. However, the downside is that if they do badly, your investment can fall in value. This can seem scary, but there are ways to reduce the risks. Take a long-term view and consider pooled funds to gain diversification across many different companies. You do not have to put all your nest egg in just the one basket.

Commodities

Commodities cover many materials, from agricultural products and energy to precious and industrial metals. Recently, prices have been strong, boosted by demand from the likes of India and China as they build up their infrastructure - demand that looks set to continue - and investors are excited by the growth prospects. To invest you could choose a pooled product investing in a range of different commodities, or invest through the shares of companies operating in the sector. A key benefit of commodities has been their historically low correlation with other asset classes. A diversified investment here could therefore help manage risk.

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