Volume 14 //

Acuity

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I don't need a pension plan, I've got property!

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> ‘It’s tangible, it’s solid, it’s beautiful. It’s artistic, from my standpoint, and I just love real estate.’
>
> Donald Trump

The British have been obsessed with property for several decades. Is buy-to-let property really a substitute for a well-invested pension pot? Is it a sensible choice in the face of low yields from deposits? When one takes a closer look at the financial and emotional burdens of managing buy-to-let property, the case for property may be less clear cut than some imagine. Sensibly structured pensions invested in robustly structured portfolios have a central role to play in most investors’ retirement planning.

Back in the headlines

A recent headline in the Sunday Times Money section shouted ‘Investors beat rising prices with buy-to-let’. The article itself began with the line ‘Investors have been piling into property to benefit from inflation-busting yields and record rents’. It could have been plucked from the heady days of the late 1990s and early 2000s when the papers were full of stories claiming that pensions were dead and buy-to-let was where the money was to be made. Oh dear!

The British public (obviously a sweeping generalisation) have long had an unhealthy obsession with property, viewing it as a route to quick riches through buy-to-let investments and as an ATM from which to extract short-term cashflow by extending cheap long-term mortgage debt on their residential homes. There’s no doubt that many have made good money from buy-to-let investments, which has, as a consequence, attracted many followers into an investment strategy that seems to be a sure thing – buy a property, get a mortgage, pay the mortgage with the rent, take some extra income each month and sell the property for a big capital gain. If only it were so straightforward. Much of this success has been down to timing and luck in many cases.

At the same time, the general theme that ‘pensions don’t work’ has become quite pervasive in the media and has been exacerbated by both real and misperceptions about their value as a central pillar of a sensible retirement plan.

This volume of Acuity seeks to take a harder look at the reality of both buy-to-let and more traditional pensions and the investments that sit inside them. As ever in investing, there are no absolute right or wrong answers or only one solution to a financial problem. But there is certainly the need to make informed decisions that rely on hard thinking and hard facts and not newspaper headlines.

I don’t need a pension plan, I’ve got property!

It is easy to see why, superficially, buy-to-let feels like an attractive option. We have all heard stories about other people’s buy-to-let success (rarely about the stress, struggles and failures of others). Instinctively we feel that we ‘get it’. There is also tangibility to property that does not exist with owning bonds and shares. In addition, taking on high levels of debt, as some do, does not feel that risky, as many people have experience of managing a mortgage on the home they live in. As Anthony Trollope apparently once said:

> ***‘It is a comfortable feeling to know that you stand on your own ground. Land is about the only thing that can’t fly away’***

We are also prone to being seduced by the stories that back the case for strong rental yields in the future along the lines of a growing population, more people renting as first time buyers struggle to get onto the property ladder and low supply. Finally, if the rent covers the mortgage, then what is the downside? Well, in reality it is material, as we will explore.

It is also easy to see why pensions have come in for such a bashing, not least because of the mis-selling scandals that tainted their image. The throw away comments that you sometimes hear - that pensions 'aren't worth it' or 'don't work' - are misguided. After all, a pension is just a tax break from the government where you immediately benefit from avoiding paying 40% or more tax on the contributions you make (for higher rate taxpayers) and a tax-friendly environment in which you receive income and capital gains tax benefits whilst the money is in the pot – benefits that should not be dismissed lightly.

Some perceive that pensions don't work because of the perception that the UK equity market has been disappointing over the past decade or so. But perception is not reality. In fact, from the start of 2000 which was the height of the market before the dot.com crash - so a pretty tough place to measure from - to the end of March 2012, the UK equity market, with dividends reinvested, is actually up a little under 60%; and even stripping out inflation, it is up around 10%. Emerging market equities would have more than doubled your purchasing power during this period. Surprising, but that is the reality. A well-structured portfolio, as we will see later, did a remarkable job during an emotionally tough period for investors.

Thinking of starting a business?

From the headline at the top of the article you could be forgiven for thinking that buy-to-let is a substitute for holding cash deposits. Savers, many of whom relied on deposit income to top up income, have been feeling the pinch of deposit rates below 1% (before inflation and tax). In fact over the past three years, the value of a saver's assets has decreased in purchasing power terms by over 10% by sitting in cash. An urgent hunt for higher yields has pushed many into either riskier traditional investments, like low quality 'high yield' bonds and higher yielding equities, or towards property. The perception that moving from cash to buy-to-let is just a short step up the risk ladder is wrong. In reality, it is leaping from one end of the risk spectrum to the other, particularly if an investor is borrowing to buy the property.

When individuals enter the buy-to-let market in this way, they are in fact starting a very highly geared (or leveraged) business with all the costs, tax and reporting issues and material risks that go with the territory. Successful buy-to-letting has to be run on such a basis if it is to avoid, or at least mitigate, the very material financial risks that it entails. Investors who go into the buy-to-let market without anything more than a naïve set of gross yield numbers, basic cost estimates and the hope of a rising market may not get the sort of outcome they are hoping for.

Borrowing to invest cuts both ways

How many investors would walk into their advisor or the bank and pronounce that they wanted to borrow up to three times the value of their investment portfolio to 'gear-up' their investments? Very few would probably be the answer, but those who did would most likely be quickly and politely shown the door. Yet for buy-to-let investors it is all 'come on in, take a seat'! What seems like madness in one case is considered to be sane in the other.

Property investing provides an easy opportunity to leverage or gear up their capital. Most buy-to-let mortgages demand around one third of the value of the property to be put down as a deposit - if you buy a £150,000 house you can put down £50,000 and borrow £100,000. Obviously, you could put down all £150,000 if you have it and not borrow anything, of course. That choice will depend on the investor's individual circumstances and risk preferences.

For those who go down the gearing route, the reward on their capital - and risk on the flip-side of the equation - increases in line with the multiple of their capital that they borrow. For example, if the property increases in price by 20% over a period of time, the geared investor in the example above will make £30,000, which on their capital invested is a return of 60%. If however the market declines by 20% they will lose £30,000 of their £50,000 capital invested. Borrowing to leverage assets cuts both ways. It is possible to lose more than the value of your equity capital – for example a loss of 35% would all but wipe it out. This is the curse of negative equity.

There have been two big falls since the mid-1980s, starting in 1989 and 2007. Property values around the country fell by between 20% and 35% on both occasions, as you can see below in Table 1, which provides some insight on these two big falls and is a reminder of the magnitude of the capital losses that investors would have suffered in these periods on their capital.

Table 1: Gearing magnifies losses – effect on £50,000 equity capital

Period	Inflation	Price fall	Ungeared	1 x geared	2 x geared	3 x geared	4 x geared
1989-1993	Before	-15%	£42,500	£35,000	£27,500	£20,000	£12,500
	After	-34%	£33,000	£16,000	-£1,000	-£18,000	-£35,000
2007-2009	Before	-22%	£39,000	£28,000	£17,000	£6,000	-£5,000
	After	-32%	£34,000	£18,000	£2,000	-£14,000	-£30,000

Data source: Halifax UK All House Price Index. Morningstar Encorr.
 Red = negative equity

On the upside, an investor investing in 1983 would have doubled the purchasing power (after inflation) of their capital with no gearing, based on the house price appreciation alone and before any positive yield on the property.

The devil is in the detail – getting to the net yield number

Many investors, particularly those new to the buy-to-let market, are easily seduced by the gross yields that can be achieved on properties. The average gross buy-to-let yield in the UK is currently 5.3% and the average rent is £750 per month[1], which implies an average property value of around £170,000. We will use these numbers as our example to work through. Let's consider the costs of a buy-to-let investment. These come in three stages: initial purchase and set up ready for tenants; ongoing costs; and sale costs. Investors need to keep a tight record of all of these items for HMRC. A cash flow model is essential to begin to understand the rewards and undoubted risks of running a geared (or even ungeared) buy-to-let business.

Initial costs: initial purchase and set up include the costs of purchase that all home-owners know only too well, including stamp duty and professional fees. The property may well need to be repaired and redecorated, white goods put in, new furnishings purchased if it is to be let furnished and gas and electrical equipment checked and certified. So far, so good.

Ongoing costs: these break down into annual costs and longer-term amortised costs to cover longer-term maintenance items. **Property is a naturally depreciating asset** – it falls to pieces, over time, if not looked after properly - and you need to invest hard cash into it to maintain or grow its value. Annual costs include insurance costs for buildings, landlord cover, and utility and white good maintenance, perhaps. You also need a general maintenance budget of, say, 1% of the property value for smaller items. If you buy a leasehold building then you may well have an annual service charge/sinking fund contribution to pay as well as the ground rent on the property. Many buy-to-let investors also use agents to manage the property to take some of the hassle out of it – 10% to 15% of the monthly rent is quite normal. There may well be void periods when no suitable tenants can be found. Finally, mortgage payments need to be deducted from the gross yield. Currently a two-year mortgage rate would probably come in at around 3%, often with a hefty up front arrangement fee.

The longer-term costs that are often either overlooked or grossly underestimated include repairs to boilers, central heating and appliances or worn out showers, cookers, carpets etc. – it is surprising how quickly rented accommodation begins to look shabby. The property will probably need to be redecorated every three to five years. Kitchens and bathroom may need replacing every five to ten years and don't forget guttering, drains, roofs, wiring, drives etc. that need some long-term care and attention. Tired looking properties are hard to rent in an increasingly competitive and discerning rental market.

Scouring the internet[2] you can begin to get a feel for what these costs are in aggregate from those who have been doing this for some time. The best rule of thumb appears to be to expect to budget for around 30% to 35% of the gross income for all general ongoing costs, before mortgage repayments. Any income remaining after costs - most of which are allowable against tax, including mortgage interest - will be taxed at the investor's marginal rate.

Sale costs: Finally, if you sell the property you will have to pay agents' fees and capital gains tax at the prevailing rate, although if the investor lives in it for a certain period of time they may be able to deem it to be their primary residence – which may not suit some investors, practically or morally.

So, when some basic numbers are calculated, the true net yield is far less compelling than the news headlines. These basic calculations are set out in the table below[3].

Table 1: Assumptions used in the example

Basic assumptions	£	%
Annual rent	£9,000	
Gross rental yield		5.3%
Occupancy %		95%
Property value	£169,811	
Investor's capital	£50,000	
Interest only mortgage	£119,811	
Mortgage interest rate		3.0%

Table 2: Net yields look a lot less exciting

Monthly budget	IN	OUT
Monthly rent	£750	
Vacant periods		£38
Monthly maintenance/management		£250
Mortgage interest		£300
Net income	£163	
Net rental yield before tax (on property value)	1.2%	
Tax @ 40%		£65
Monthly income net of tax	£98	
Net rental yield after tax (on property value)	0.7%	
Yield on investor's capital (£50,000) after tax	2.3%	
Annual income net of tax	£1,173	

Some buy-to-let investors may dispute the numbers and it is acknowledged that rental yields can vary quite widely across the UK, but it is a reasonable insight that provides a framework for making better informed decisions. On these numbers, an investor with no mortgage would have received a net yield after tax of a little over 2% on their capital – still below inflation.

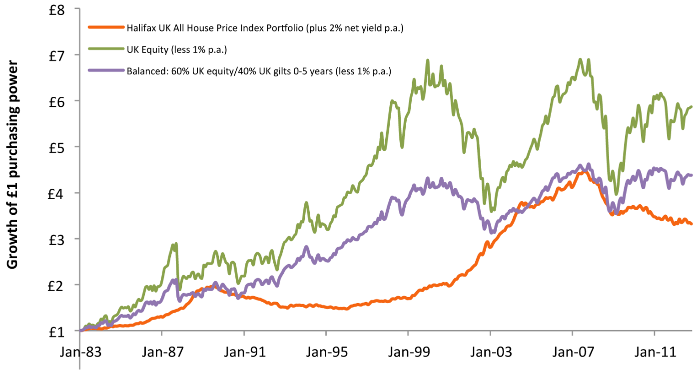
What is interesting about the numbers in the example is that if the mortgage interest rate is raised by only 1.5% then the net yield after tax is near enough zero, before inflation. It is worth remembering that rents do not necessarily go up just because interest rates do. Those who lived through the property market slump of the early 1990s and interest rates of 14% still remember the pain of both having to find cash from their own earnings to cover mortgage payments on rented properties and of a prolonged period of negative equity. It took over five years from the bottom of the market in 1993 to get back to the former peak, before inflation is taken into account. The geared buy-to-let investor would have had to find £900 per month in 1991 to cover the rental shortfall to meet the costs and mortgage payments! Many were forced to sell, creating a downward spiral on prices.

Given that after accounting for all reasonable costs yields are low, buy-to-let is in effect a strategy reliant on price appreciation for its long-term success.

Putting our investors' hat on

An astute investor will look at an asset class dispassionately and consistently, neither looking solely at yield or capital gain, but on a total return basis being the combination of the two. To make a better informed comparison, and to try and level out the playing field, if we assume a net post-tax yield of 2% on an ungeared buy-to-let investment and add this to the price return of the UK house price series, we can get a rough picture of how it has performed against other more traditional investment portfolios.

Costs of 1% per annum have been deducted from the traditional portfolios for fairer comparison. No initial set-up costs for the buy-to-let strategy have been deducted, even though these can be material. The outcome is illustrated in Figure 1 on page 5.



Note: UK equities = FTSE All Share Index (dividends reinvested), Balanced = 60% FTSE All Share, 40% FTSE Government 0-5 Gilts Index. Costs of 1% have been deducted from the traditional portfolios and portfolios were rebalanced back to the original mix once a year.

Figure 1: Ungeared buy-to-let versus traditional portfolios – simulated strategies

As you can see, the ungeared buy-to-let simulation delivered strong returns during the equity market crash of 2000-2003, but has suffered badly during the credit crisis. It was outperformed marginally by the equity/bond 'balanced' portfolio and materially by equities, over the period. Looking at the worst case downsides of each portfolio, one can see that ungeared property is similar in risk to the 'balanced' portfolio. That is what one would expect from a hybrid asset class that derives regular income by way of rent, similar to a bond, but with the capital appreciation potential of equities. Borrowing 100% of the capital invested would double the downside risk to capital making this approach comparable to equity investments!

Table 3: Downside risk - worst case returns over different horizons (after inflation)

Period	1 year	3 years	5 years	10 years
UK equity portfolio	-38%	-18%	-10%	-4%
Balanced portfolio	-22%	-9%	-4%	-1%
Buy-to-let	-18%	-7%	-6%	-1%

Data: Simulated returns as described in the note to Figure 1 above.

The valuable tax breaks on pension contributions

The very valuable tax breaks that are afforded to those who make pension contributions are an important part of the capital accumulation process. At a 40% rate of tax, a £50,000 pension contribution is worth £83,000 on a gross basis. Most buy-to-let investors invest capital that has been saved from after-tax income. Rarely is the Chancellor so generous. It is free money.

Property and pension plans – they are not mutually exclusive

Property has a place to play in investors' wider wealth plans, perhaps through an allocation to global commercial property as part of a well balanced and diversified traditional investment fund, by way of some sort of collective investment scheme, or even held directly as part of a self invested pension plan. Currently residential property cannot be held in a pension plan. Taking advice on what suits your personal circumstance makes sense.

Perhaps the biggest risk of the buy-to-let market is the concentration of risk in not just one narrow asset class – residential property – but in one house or flat, on one street in one town. This lack of diversification is an unattractive attribute for a plan to deliver wealth and happiness in retirement.

Conclusion – pension funds should remain as a core pillar of retirement

It would appear that on an ungeared basis, buy-to-let is the ownership of a small business that holds a depreciating asset that needs constant love and attention in order to achieve a rate of long-term return somewhere between bonds and equities that one might expect. As soon as one takes on gearing, the risks multiply in line with the multiple of times the investor's capital is geared, along with the potential rewards. The one thing that is certain is that it is a very big leap from the deposit-like alternative that many newspaper articles suggest that it is.

Buy-to-let is certainly not a quick road to riches. It has material costs and downsides unacknowledged by many who embark on such a course. It demands to be managed like a business with a detailed business plan and to receive the time and effort that such a small business deserves. For some that is an enjoyable past-time. For others it becomes a headache, a chore and a source of stress.

In our view, making the most of the tax breaks and investing assets in a sensibly structured, globally diversified investment portfolio makes enormous sense and should remain at the centre of any sensible retirement plan. And what price can you place on the time that you free up to do the really important things that enrich your and others' lives. Who wants to be at the beck and call of a tenant whose washing machine has broken down?

End notes

1. LSL Property Services as quoted in The Sunday Times, Investors beat rising process with buy-to-let, Page 1 Money section, 21 April 2013.
2. For example UKpropertyexpert.com '£250 per month per property. The real cost of buy-to-let?'
3. For the financially astute it would make sense to calculate the internal rate of return that any buy to let property opportunity could deliver from all of the cash flows involved and to see where the risks and return truly lies.

Other notes and risk warnings

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