A MONEYWEEK SPECIAL INVESTMENT REPORT

MoneyWeek

The buy to let timebomb: what property investors need to know now!

MoneyWeek Research

Why now is not the time to invest in buy-to-let

Rewind to the year 2000. Back then, few people had ever heard of buy-to-let. Even fewer had actually contemplated becoming private landlords themselves. But over the course of the last 15 years, something interesting has happened – investors have piled into the market.

In 2009, buy-to-let mortgages comprised just 8% of all new loans. By 2014, this figure had ballooned to 13%. And now, according to the Bank of England, 15% of all mortgage debt outstanding is owed by buy-to-let landlords.

There have clearly been some compelling reasons for investors to jump onto the buy-to-let bandwagon. Last year, research from lender Paragon found that buy-to-let investments have outperformed most alternative asset classes over the past 18 years.

But this could be about to change. The positive investment climate surrounding this sector is unravelling – and fast. The government is scrabbling to make the buy-to-let market less attractive to investors. And if you're currently considering taking your first steps into the buy-to-let market, think again. A rash move could well put your own future financial security at risk.

In this report, MoneyWeek arms you with the tools you need in order to make a well-informed decision about becoming a buy-to-let investor. We explain why the sector has proved so popular in recent years, how it is changing, and finally why – for now – you may be best to avoid the buy-to-let brigade and invest your money elsewhere.

The rise of the 'buy-to-let' market

Let's start with the basics. The term 'buy-to-let' refers to the purchase of a property, not to be lived in by the buyer but rented out to tenants. The owner is a landlord, with the primary aim of making a commercial profit. This comes from rental income and – hopefully – the growth in value of the property over time (a capital gain).

In order to secure a buy-to-let property, investors need a very specific type of mortgage. A buy-to-let mortgage works differently to a residential mortgage. It tends to be more relaxed about factors such as the owner's annual income. Why? Because mortgage repayments and interest should be covered by rental payments.

One reason why buy-to-let has become so popular among private investors over the past decade is due to rock

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bottom interest rates, which have hit at an all-time low of about 0.5%. Low rates have taken the some of the pain out of mortgage repayments and left little incentive to keep savings tied up in the bank. Meanwhile, volatility in the share market has deterred many from investing in stocks and shares. In many ways, there's a certain comfort to be taken in good old fashioned bricks and mortar – an investment you can reach out and touch.

Our housing market is now profoundly distorted

Ultra-low interest rates have been a good thing for buy-to-letters. However, on a wider scale, they have had a profoundly distorting impact on the UK housing landscape. Sure, low rates attract buyers by keeping monthly mortgage payments low. But this, in turn, sustains very high median house prices. These are now well over seven times the gross median salaries in England, compared to the pre-crisis trend of around 4.5 times.

According to the Office for National Statistics (ONS), the average UK house price is £284,000, which means that a 15% deposit would equate to the average annual pretax salary. This sounds extreme, but it may actually be underestimating the problem.

Santander claims that the average deposit from its own first-time buyers is typically £53,000 – almost two-and-a-half times the national average salary for 22 to 29-year-olds, £21,609. Given these figures, it's no wonder that more than 50% of first-time buyers now need help from their parents.

During the 1990s, the average age of a first-time buyer was 27/28. But now, according to the Mortgage Advice Bureau, most first-time buyers are well into their 30s – specifically, 37 – before they can go it alone. It doesn't help that low interest rates on savings accounts have driven national household savings below 3.8% of post-tax income, their lowest point since 2008.

Another point to note is that the Bank of England is now forcing lenders to stress test BTL mortgages to see whether those taking them out can deal with interest rates of up to 5%.

The message here is clear. It's a real struggle for first-time buyers to get onto the housing ladder, which is dominated by private landlords charging sky-high rents. In line with public sentiment and vocal opposition, the Chancellor George Osborne has announced a couple of key changes to the way that the buy-to-let market works. And if you're considering becoming a buy-to-let investor, these are likely to have a big impact on your decision.

The government is working to make buy-to-let less attractive

Up until now, buy-to-let investors have enjoyed a few overwhelming advantages over first-time buyers. One is that they tend to be older (and therefore, better off) which gives them a stark advantage when it comes to putting down a deposit. Secondly, buy-to-let investors have the option of securing an interest-only mortgage. This means that they pay only

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monthly interest rather than mortgage repayments – recouping the cost when the property is sold, instead of gradually repaying the lender with a view to one day owning the premises.

Historically, buy-to-let investors have also received preferential tax treatment. Landlords pay income tax on the rent they receive. This amount is determined in line with their normal income tax banding – 20% for basic-rate taxpayers, 40% for higher-rate payers, and 45% for additional-rate payers. According to the current rules, landlords are able to deduct costs – such as mortgage interest – from their profits before they pay tax. But the Treasury says that this gives them an advantage over other home buyers, who don't have the same option.

In response, Chancellor George Osborne addressed the issue in the Summer Budget 2015. He announced that the Treasury will restrict buy-to-let tax relief on interest payments to the basic rate of income tax – a substantial reduction from 40% or 45%, down to just 20%. This process will begin to be phased in from April 2017, and completed by 2020.

From April 2016, the Treasury is also scrapping "wear and tear" allowance. At present, this allows 10% of rental profits to be written off for notional wear and tear, even if there has been no actual expenditure in that year. It will be replaced with a relief that allows landlords to only deduct the costs they have genuinely incurred on replacing furnishings in the property.

These changes are good. While many buy-to-let investors help others while helping themselves, others can be little better than slum landlords. But, the important point for us – as potential buy-to-let property owners – is that once tax relief changes take place, the investment climate will begin to look a little different.

Imagine you're a buy-to-let investor, in a head-to-head battle with a first-time buyer over a property. According to the current rules, you're likely to win. You will probably pay a higher interest rate of 4% for buy-to-let, compared to just 3% for the first-time buyer. But once you consider the first-time buyer's mortgage repayments, their interest is effectively bumped up to 5.7%. Not only that, but you'll also have another advantage – claiming tax relief of up to 45%, lowering the effective interest paid from 4% to 2.2%. That makes a property with the average gross yield of 4.2% (2.9% net) profitable enough that you can afford to gazump the first-time buyer.

But – and this is a big but – when tax relief is restricted to the 20% base rate, your effective borrowing cost will rise from 2.2% to 3.2%. This may well be on the wrong side of your comfort zone. Although gross yields average 4.2%, they only come in at 2.9% net – less than the new effective cost of debt. In the meantime, if interest rates rise the buy-to-let advantage will be further eroded.

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This puts prospective buy-to-letters in a difficult position – made even more daunting by Osborne's decision to charge anyone buying a rental property or second home an additional 3% in stamp duty. If you bought a property for £175,000 this year, you would have paid £1,000 in stamp duty. But that cost will soar to £6,250 by next April.

These changes may not be the death knell for buy-to-let, but they will certainly help to create an increasingly level playing field for first-time buyers, who haven't really had a look in over the last 15 years.

Meanwhile, we can be fairly sure that there is only one way that interest rates can move from here – when they finally do – and that's up. That will be painful for buy-to-letters. The economics of buy-to-let are very sensitive to low rates. In 2005 there was a visible slowdown in buy-to-let activity – it fell about 25% below trend – following a one-year, 1% rise in base rates that took place the year before. So in the long run, the solution to the UK's distorted housing market will be the renormalisation of rates.

Want to buy property? Buy offices, shops and warehouses instead

The truth is that if you want to invest sensibly in buy-to-let property, what matters – as with any sensible investment – is the income that it'll produce for you over time.

You can't guarantee substantial capital growth – particularly given that it's hard to see interest rates dropping much from current levels. And therefore, the key point about the ex-chancellor's changes is that they will make it harder to get a decent yield on buy-to-let, across the board. That has to make it less attractive as an asset class overall.

If you're still dead keen, remember that – again, as with any other asset class – your yield should reflect your risk. You might be able to get double-digit yields in less salubrious areas of the country, but that's because they're riskier bets than a waterfront flat in central London. And if you can only muster up a single-digit yield, are you really better off with a single buy-to-let property than a portfolio of blue-chip dividend-paying stocks, say? In short, it's hard to make the case for buy-to-let right now. This is not the time to begin a career as an amateur landlord.

However, if you're keen to invest in property, you might be better off looking at offices, shops and warehouses – in other words, commercial property. This isn't as tricky as it might sound. You don't have to buy an office yourself with a mortgage – instead you can invest with a professional commercial property fund manager, which will give you access to a wide range of business properties across the UK (or even the world), all without the hassle of having to chase rents or fix boilers.

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In the December 16th issue of MoneyWeek, our funds expert Max King took a look at some of the most promising investment funds you can use. Here's what Max had to say.

"After three years of double-digit returns, 2016 was dull for property investors. The IPD UK Monthly Property index, which tracks the performance of £45bn-worth of real estate investments, returned under 1% year-to-date. Meanwhile, the listed property stocks, which dropped sharply after the Brexit vote, recovered most of the ground they lost, but still ended the year lower.

"In contrast, European property markets have fared better as investor demand for income has pushed up values, while there has also been rental growth in some cities. This divergence of performance between the UK and Europe makes **TR Property Investment Trust (LSE: TRY)** one way to consider playing the sector. Of the £1.2bn portfolio, 92% is invested in property shares, with the remaining 8% directly in property. Marcus Phayre-Mudge, the manager, shrewdly began reducing UK exposure in 2015, so nearly 70% of the equity portfolio is in Europe. Shares in the fund are about 13% cheaper than the value of the underlying portfolio (known as the net asset value, or NAV). Over the last five years, returns have compounded at 17.5% per annum, 4% ahead of its benchmark index. This makes the management fee of 0.5% of net assets look good value, though there is a modest and well-deserved performance fee on top. Finally, a prospective dividend yield of nearly 3% is attractive.

"Phayre-Mudge believes European property shares will continue to perform well, driven by demand growth and a lack of supply in many sectors. Sentiment is very negative in the UK, he says, but companies have been prudent in reducing debt and cautious on new developments. While he is not yet ready to raise UK exposure, the case for doing so is strong. The Autumn Statement projected only a mild economic slowdown in 2018-19 (and even that could prove too pessimistic), and the fall in sterling makes UK property an attractive investment for overseas buyers.

"This reasoning could justify some direct investment in the specialist London companies in the TR portfolio. **Shaftesbury (LSE: SHB)** focuses on areas of the retail market that continues to do well, such as shopping and leisure "villages" in central London. **Great Portland Estates (LSE: GPOR)** develops and manages offices in central London, primarily in the West End, where supply is severely constrained, but also in the City. **Derwent London (LSE: DLN)** refurbishes tired-looking office buildings, thereby adding lettable space and raising rentals, in off-prime locations. **CLS (LSE: CLI)** has prospered through its focus on the previously neglected "south of the river market". If you have the time, consider going to look at some of the properties these firms own. There is no part of the stockmarket where direct research is more straightforward."

Hopefully that's given you some ideas about other areas of the property market to explore. In the meantime, this is unlikely to be the end of the buy-to-let saga. As debates about affordable housing continue to rage around Westminster, expect plenty of developments to disrupt the status quo in coming months. The best thing you can do – whether you're a prospective landlord or a property owner – is to keep on top of these changes and understand what they mean for your money. And **the best way to do that is by subscribing to MoneyWeek magazine**.