BRIEFINGS

MIND THE £££ WEALTH GAP

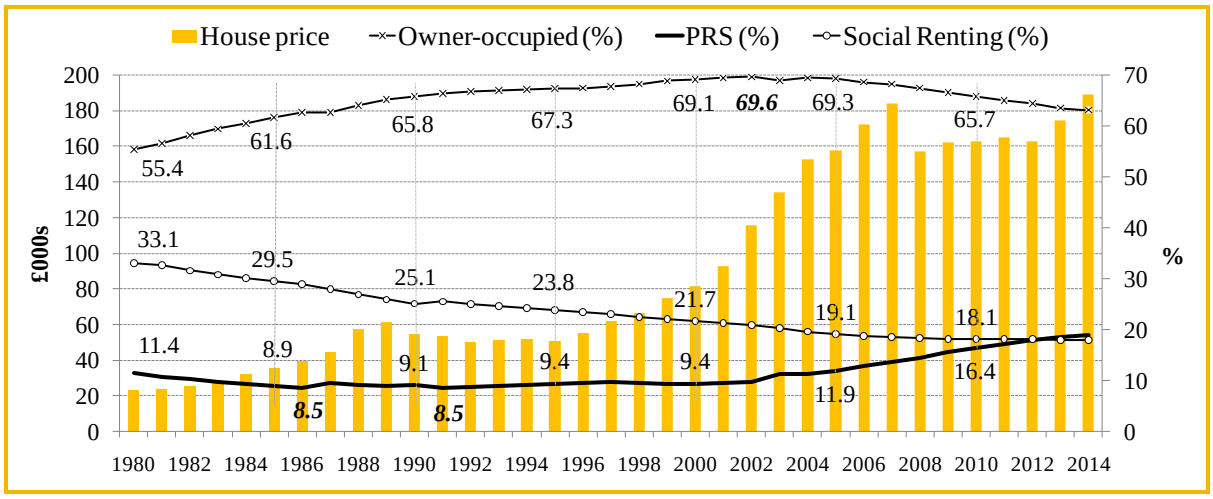
Intergenerational Justice and Family Welfare

The case for property investment through privately rented homes

The private rental sector (PRS) as an investment vehicle

The PRS has seen a steady increase since 2000 (Figure 1). This reflects complex societal changes which are taking place across the UK and beyond. The supply of private rental property has clearly been stimulated by the deregulation of private tenancies, and the availability of Buy-to-Let mortgages since the 1990s. Increased demand from students, mobile professionals, international migrants and those willing but unable to buy their first home has also stimulated the supply of the PRS alongside the contraction of other renting options through Right-to-Buy policies. While increasing house prices have made homeownership less attainable for many, it has increased the attractiveness of buying-to-let for those individuals who were able to invest. Given that the growth of the PRS cannot be truly understood without reference to the broader investment landscape, this briefing documents long-term investment returns of residential property versus those of other assets, particularly savings products, government bonds, equities and commercial property.

Figure 1: Trends in house prices and tenure (the UK)



Source: author's analysis and graphics (Nationwide House Price Index and Office of National Statistics).

Individual landlords' approach to investment

Based on previous research,[1] Tables 1 and 2 show that individual landlords—this excludes those who are renters themselves (8% of all landlords) or who let exclusively to lodgers—tend to be more familiar with various other forms of investment besides direct investment in residential property. Although the proportion of landlords holding shares, unit or investment trusts, and other financial assets is about twice as much compared to non-landlord homeowners or all adults, the majority actually invest exclusively via residential property. Indeed, landlords are clearly more inclined to view property as the best way to invest as well as the safest way to finance retirement.

Involvement in buy-to-let activities—unlike homeownership—is freed from the need to provide one's own home, and is therefore open to more flexible options. Landlords may chose to diversify their asset portfolio—that is they are not restricted to keeping all their eggs in 'bricks and mortar'—in order to balance the risks of sudden falls in house prices or difficulty in selling if required. If one type of asset outperforms, landlords may decide to redirect their other investments. It is therefore interesting to know how investment returns in residential property compare to those in other assets over the long term. This is explored through a focus on the most popular assets held by individuals in the UK that is savings products, governmental bonds, equities (company shares), commercial property and pension plans.

Table 1: Saving and investment practices (%)

	Saved over past 2 years:		Having financial wealth ≥£70k	Property best way to invest	Have:			
	Yes	≥£5k			Cash ISA	Stocks/ shares	Units & invest. trust	Other finan. invest.
Landlords	**68**	**21**	**26**	**63**	**61**	**31**	**11**	**11**
Non-landlord homeowners	**57**	**11**	**13**	**32**	**54**	**18**	**7**	**2**
All adults aged ≥16	**48**	**9**	**8**	**32**	**41**	**12**	**5**	**2**

Source: see footnote 1.

Table 2: Opinions on financing retirement (%)

	Safest way by:		Eligibility for occupational pension	Expected way to finance retirement:			
	Pension scheme	Property investment		Other property	Pension scheme	Savings	Down-sizing
Landlords	**26**	**49**	**39**	**70**	**68**	**60**	**31**
Non-landlord homeowners	**43**	**20**	**41**	**9**	**77**	**48**	**32**
All adults aged ≥16	**36**	**21**	**29**	**9**	**61**	**41**	**21**

Source: see footnote 1.

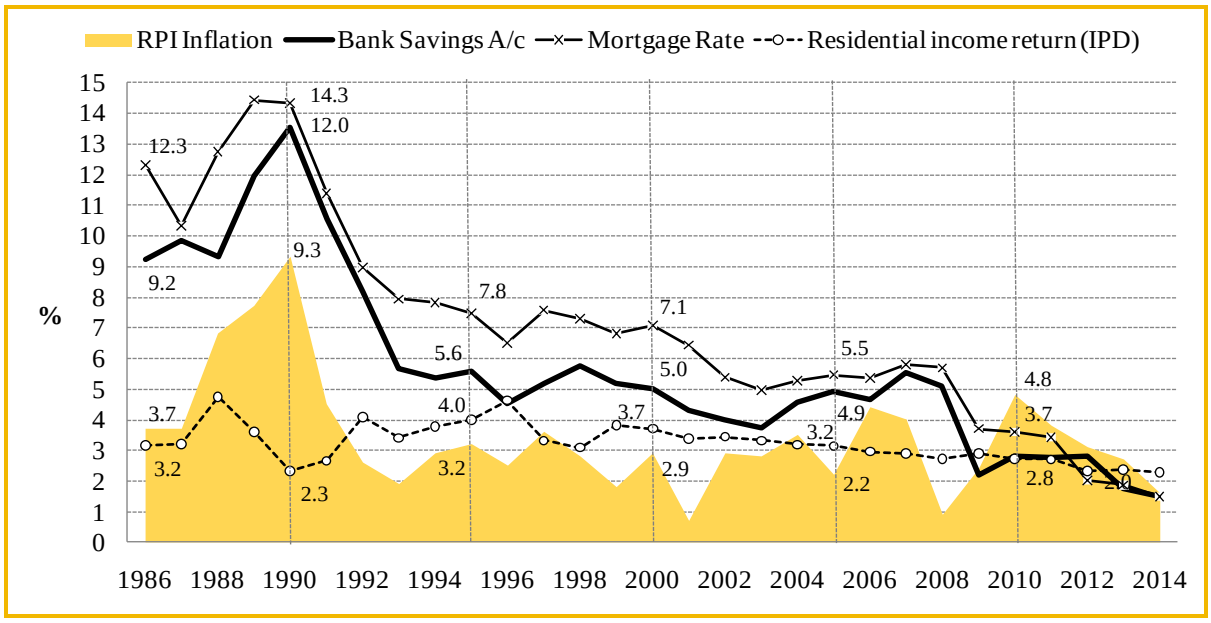
[1] Lord C, Lloyd J & Barnes M (2013) *Understanding Landlords. A study of private landlords in the UK using the Wealth and Assets Survey*. London: SSC; Lloyd J (2013) *Whose Home? Understanding landlords and their effect on public policy*. London: SSC.

The investment landscape

Savings products. Income from government bonds, bank deposit and savings rates have all fallen to historic lows having being below inflation since 2009 (Figure 2). Savers with large deposits have seen the income received falling at a time when the cost of mortgages has also fallen to historic lows. Savers therefore have been disadvantaged against mortgagors. Consequently individuals may decide to increase their residential investment through the PRS (or homeownership, e.g. by upsizing) in order to benefit from rental income, potential capital growth, low mortgage rates and a more efficient use of their savings.

Indeed half of the PRS dwellings have been acquired since 2000. Unsurprisingly, annual gross Buy-to-Let mortgage lending rose from £3.1bn to £45.7bn during 1999-2007. Currently, 80% of all individual landlords have at least one Buy-to-Let mortgaged property; they are also more likely to have an interest-only mortgage than homeowners. Furthermore, rather than keeping/placing large sums in nonperforming bank accounts, some individuals bought with cash from inheritances, pension funds, savings or own businesses (25% of all lets were acquired with cash).

Figure 2: Trends in savings and mortgage rates versus inflation



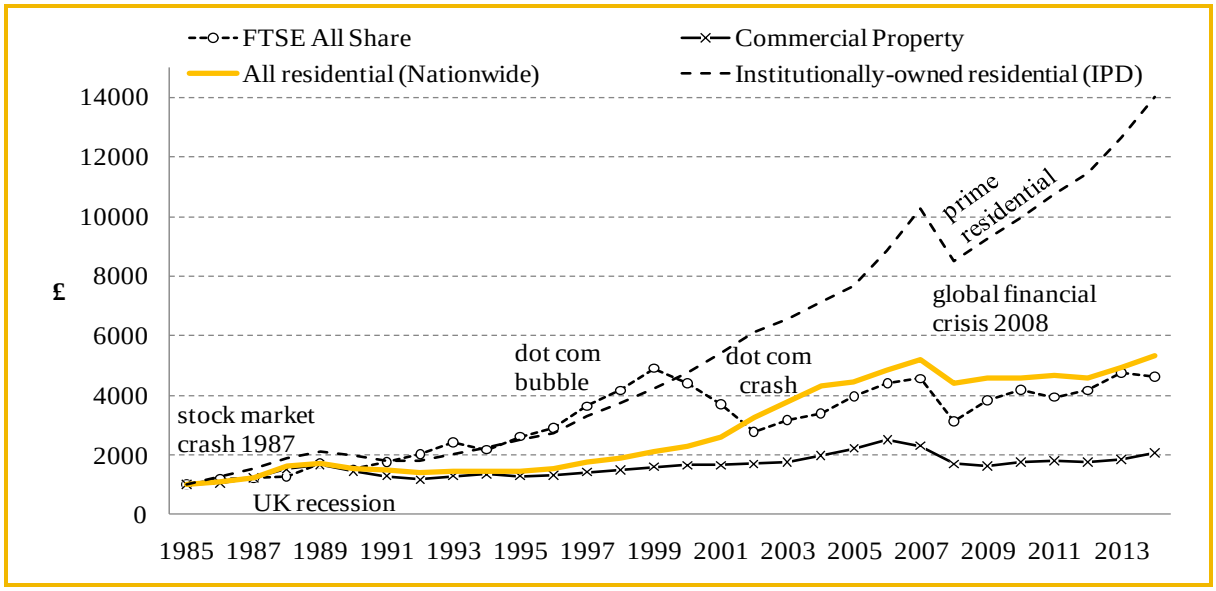
Source: author's analysis and graphics.[2]

Note: 'Residential income return' represents the annual rental income divided by property value and is one of the most common measures of rental yield (this yield allows one to compare income return across assets, e.g. with saving rates). You will note the relative stability of this yield over time compared to other assets, which is one of the attractions of investing in property.

[2] BoE (2015) Explanatory notes: quoted household interest rates. Bank of England: London; IPD (1986-2014) *IPD UK Annual Property Index 1985-2014*. Investment Property Databank, London; Nationwide (2015) House Price Index. Nationwide, Swindon; Swanlowpark (2015) Compares price inflation, savings accounts and index-tracker funds.

Equities (company shares). Historically (and until 2000), this market provided higher rates of total return than most other investment vehicles. However it has only just recovered from the dot.com crash, which meanwhile increased the attraction of other assets, including property investment (Figure 3). Most individuals do not feel confident investing in equities as share prices tend to register large daily swings which are difficult to monitor by non-professional investors. Indirect products, such as unit trusts, share ISAs and tracker funds have recently gained some traction. Nonetheless Figure 3 and Table 3 clearly show that residential property has outperformed equities given the outstanding growth in house values in most regions and places, and particularly so among prime residential rental properties whose rates of return have been exceptional.

Figure 3: Capital changes in selected assets (indexed to £1,000 in 1985)



Source: author's analysis and graphics.[2]

Table 3: Medium-term total returns after inflation by UK assets (%)

Year to end 2013	1 year	3 years (pa)	5 years (pa)	10 years (pa)
Equities	**17.4**	**10.0**	**5.0**	**5.5**
Government bonds	**-9.6**	**1.5**	**2.5**	**3.5**
Index linked gilts	**-3.9**	**3.7**	**2.7**	**3.2**
Treasury bills	**-2.3**	**-3.0**	**-0.5**	**1.3**
Commercial property	**7.8**	**4.3**	**2.9**	**5.6**
Residential property (IPD)[a]	**10.3**	**7.3**	**6.2**	**10.2**

Source: author's analysis.[2]

[a] This combines returns from rental income and capital growth for institutionally owned prime residential properties, predominantly located in the South East and London.

Property. Property has long been used in forming institutional portfolios for it facilitates (geographical) diversification, provides a stable rental income, has potential for capital growth, protects against inflation and carries lower risks than other assets. While the UK government would welcome institutional investment in the PRS, institutions tend to concentrate their portfolio in commercial rather than residential property.[3] While commercial property is beyond the means of most individuals—some funds, however, offer the possibility of indirect investment in commercial property through monthly investment of as little as £50—they can access the residential market with which they are more familiar. Moreover, Figure 3 clearly shows that on average residential property's capital growth outperformed the commercial one (but institutions have been reluctant to get involved in the PRS because of difficulties in managing a large housing portfolio). Unsurprisingly, investing in 'bricks and mortar' by means of homeownership and landlordism has become a popular way of saving for retirement (Table 2). However letting out does not provide the most tax efficient way of investing, as pension plans do.

Pension plans. These are advantageous investment schemes as they are tax-free and allow for portfolio diversification. However, they lack flexibility and control in accessing the funds if required for personal welfare. Moreover, pension reforms have transferred risks from employers to individuals resulting in less individuals saving through these schemes. In the UK only about 50% of employees are enrolled in an occupation pension scheme. Minimum contribution rates are unlikely to generate sufficient retirement income for many, hence increasing households' reliance on housing wealth. Compared to homeowners, landlords were more likely to believe property was the safest investing strategy. Table 2 showed that 70% of landlords were indeed planning to sell or rent out other properties than their homes in order to fund retirement and they were also slightly less likely to contribute to a pension plan. In fact, over a quarter of all landlords did not trust pension plans (as opposed to 12% of non-landlord homeowners and 8% of the adult population, respectively).

Taxation. Tax plays an important part in terms of the total returns of any investment. Property taxation differs according to ownership (e.g. untaxed if held in a pension plan). Owner-occupied residential property has long enjoyed a privileged regime through tax on imputed rents being abolished in 1963 ('Schedule A' for those who may remember); mortgage interest tax relief having been supported during 1969-2000; stamp duty waved up to certain thresholds; and no capital gains tax is paid on sale.

Conversely, commercial and residential rental property is taxed on capital gains and rental income after deduction of all expenditure, including repayments of mortgage interest. However, the current UK government aims to install fairer terms between individual landlords and homeowners—and arguably less so between individual and institutional landlords. First, the 2015 budget reduced the extent of mortgage interest relief from 40% to 20% (to be gradually implemented until 2020) and scrapped the automatic 10% rent deduction for wear and tear; additionally, the stamp duty for any second property, including PRS dwellings, was increased by 3 percentage points on top of the corresponding figure for owner-occupied property. Second, the 2016 budget has excluded PRS property held by individual landlords from the general reduction in capital gains tax (of which any institutional landlord will benefit).

[3] Haddock M (2010) The case for property in the UK and in Europe, CB Richard Ellis.

Conclusions

This briefing has shown that, on average and particularly during the last two decades, total returns from investment in residential rental property have outperformed those from other investment vehicles such as savings products, government bonds, equities and commercial property. Given the low interest rates adopted by central banks since 2009, any UK mortgagor, whether a homeowner or a buy-to-let landlord, has been better off than anyone saving in a bank account, including through a tax-free ISA. Moreover house prices have by now recovered in many regions and places, delivering some capital growth in addition to rental income (but many instances of negative equity still remain). However, keeping all one's eggs in one basket is always risky—even in the well performing 'bricks and mortar' one—but about half of all landlords do so. They are at risk of sudden house price falls, difficulty of selling a property if required, changes in taxation, and expected increases in mortgage interest rates.

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