

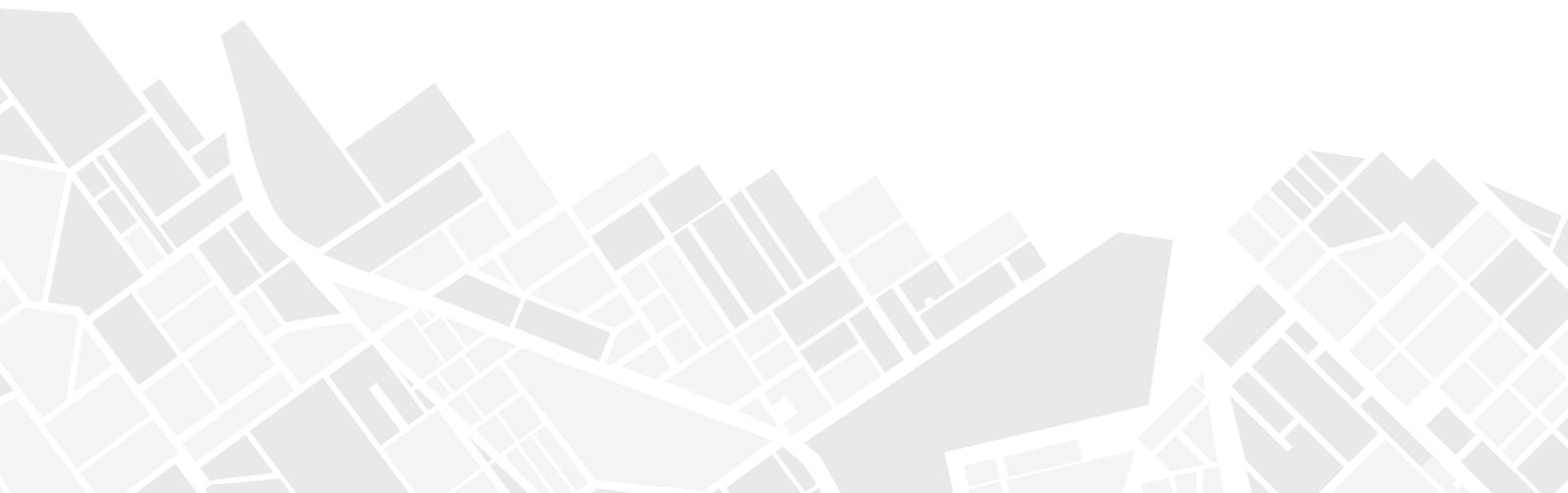
LANDBAY[®]

Buy-to-Let Comes of Age

Eighteen years of investment performance data on buy-to-let and other major asset classes

April 2015

By Rob Thomas, Director of Research
The Wriglesworth Consultancy





Index	Page
Executive summary	3
Section 1 Introduction	9
Section 2 Investment returns compared	10
Section 3 Breakdown of returns between income and capital gain	14
Section 4 Buy-to-let returns under alternative reinvestment assumptions	18
Section 5 2014 investment performance	26
Section 6 Future projections and review of 2013 projections	28
Section 7 Methodology	30

Executive summary

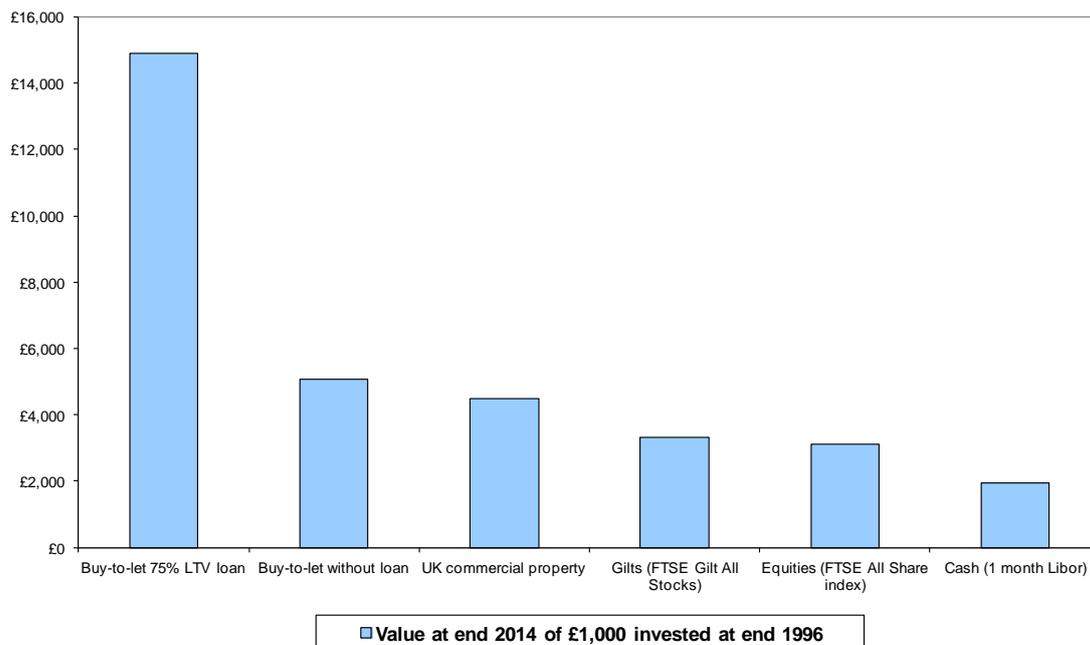
There are now 18 years of data on the performance of the buy-to-let market since it came into being with the launch of the buy-to-let mortgage initiative by the Association of Residential Letting Agents (ARLA) and leading buy-to-let mortgage lenders.

This paper uses this 18 year track record to update the report we produced one year ago examining how buy-to-let investors who purchased in 1996 have fared relative to investors in the other main UK asset classes.

The key findings are:

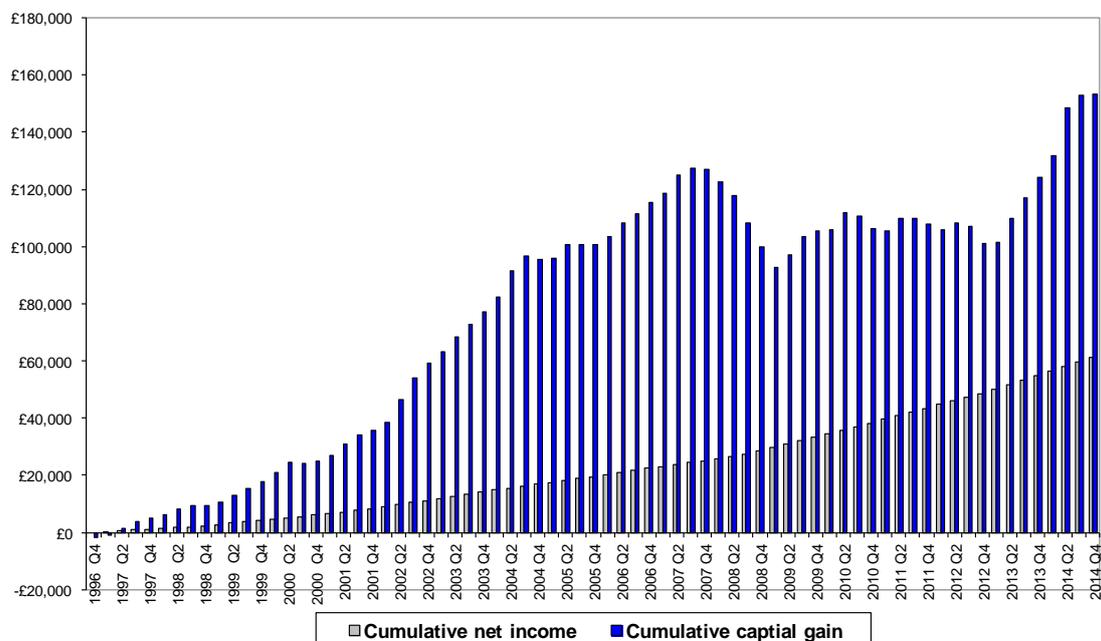
- **Buy-to-let has been the best performing investment of the past 18 years, providing average returns that comfortably outstrip those of other major asset classes.**
- **Every £1,000 invested in an average buy-to-let property purchased with a 75% loan-to-value (LTV) mortgage in the final quarter of 1996 would have been worth £14,897 by the final quarter of 2014, a compound annual return of 16.2%.** The same investment in UK commercial property would have grown to £4,494 (compound annual return of 8.7%); in gilts (UK government bonds) to £3,329 (compound annual 6.9%); in UK equities (shares) to £3,119 (compound annual 6.5%); and in cash to £1,959 – a compound annual return of 3.8% (see Chart 1).

Chart 1 – Cumulative total returns for the main UK asset classes (1996-2014)



- A buy-to-let purchaser buying entirely with cash would have seen each £1,000 invested grow to £5,071 by the end of 2014 – a compound annual return of 9.4% - outperforming all other asset classes but significantly underperforming the buy-to-let investor who borrowed 75% of the purchase price.
- 29% of the average geared (mortgaged) buy-to-let return came in the form of net income (cumulative excess of rents over costs), and the average property would have provided net income of over £6,400 in 2014.
- Nonetheless, capital gains have been substantial: an investment of less than £16,000 (comprising deposit and purchase costs) for the mortgaged investor would have delivered £153,400 from cumulative capital gains alone by the end of 2014. The cumulative returns from income and capital gains are shown in Chart 2.

Chart 2 - Cumulative returns from income and capital gains (mortgaged investor)



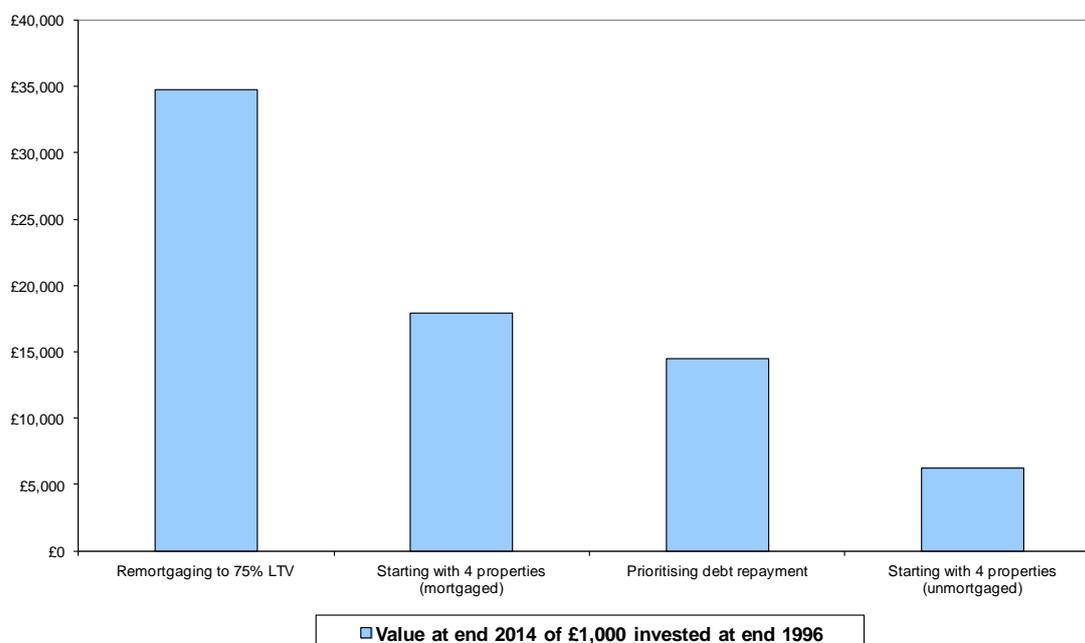
Alternative approaches to reinvesting income produce very different results:

- The findings outlined above use the most conservative realistic reinvestment assumptions for buy-to-let. For the mortgaged investor, we assume someone starting with a single property and only reinvesting their accumulated buy-to-let net income when this is sufficient to finance a 25% deposit and purchase costs on the average priced property in the market at that time. For the cash (unmortgaged) investor we assume a single property is bought and net income is only reinvested once enough cash has been accumulated to

purchase another property outright. In both cases we assume no return on cash while it is waiting to be reinvested.

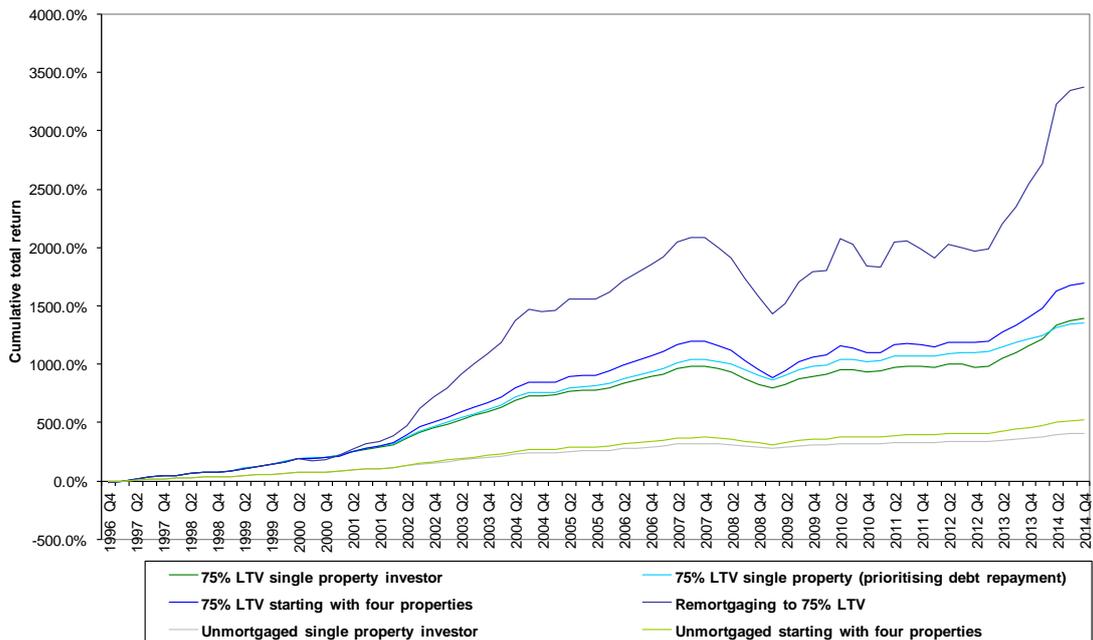
- Buy-to-let investors starting with four properties would have enjoyed correspondingly higher returns. Those investing without a mortgage would have turned each £1,000 into £6,217 and those using 75% LTV mortgages would have seen this stake grow to £17,967 (see Chart 3) as these investors could expand their portfolio more quickly than those starting with a single property.
- The average buy-to-let investor starting with a single property and a 25% deposit who prioritised mortgage repayment, using all net cash flow to reduce debt, could have paid off their mortgage in less than 13 years. By 2014 they would be generating an annual net income of £6,400. These investors would have turned £1,000 into £14,517 over in 18 years.

Chart 3 – Buy-to-let returns under alternative reinvestment assumptions



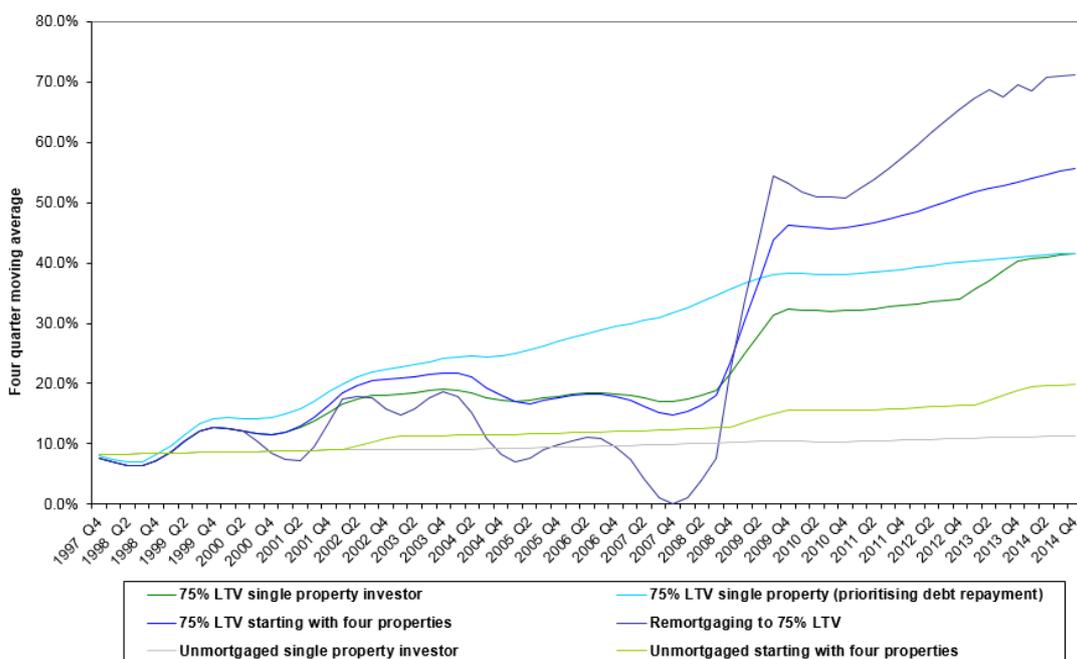
- One unique feature of buy-to-let compared with other assets is the extent to which the investor can borrow against it and, when property prices have risen, remortgage to provide cash to buy more property. We have calculated the returns for an investor who remortgages to a maximum average LTV of 75%. Starting with a single property such an investor would have accumulated 10 properties and turned £1,000 in 1996 into a staggering £34,732 by the end of 2014, a compound annual return of 21.8% and the highest returns of any reinvestment approach (see Chart 3). However, the remortgaging investor faces more volatile returns as Chart 4 illustrates and more risk.

Chart 4 – Buy-to-let reinvestment strategies – cumulative returns compared



As well as examining total returns we can focus on the net income that different reinvestment scenarios produce. Chart 5 shows the evolution of annual net income for the buy-to-let investor under different reinvestment scenarios, presenting net income as a percentage of the initial investment (using a four quarter moving average). This illustrates the benefit of gearing in boosting income, particularly since the sharp fall in interest rates in late 2008/early 2009.

Chart 5 – Annual net income – percentage of initial investment



Performance in 2014

Tables 1 and 2 show the performance of our buy-to-let total return index under these different reinvestment strategies in 2014 for the investor who started back in Q4 1996. Table 1 shows the net income the average buy-to-let investor could have expected expressed as a percentage of their original investment made in 1996.

Table 1 - 2014 net income under alternative reinvestment assumptions

	Initial investment in 1996	Net income in 2014	Net income in 2014 as % of initial investment
Remortgaging to 75% LTV	15,447	11,004	71.2%
Starting with 4 properties (mortgaged)	61,790	34,434	55.7%
Prioritising debt repayment	15,447	6,428	41.6%
Starting with 1 property (mortgaged)	15,447	6,427	41.6%
Starting with 4 properties (unmortgaged)	227,298	44,998	19.8%
Starting with 1 property (unmortgaged)	56,824	6,428	11.3%

Although rising rents and modest mortgage rates ensured that net income was strong, 2014 was a year when capital gains dominated returns. House prices rose by 8.3% between Q4 2013 and Q4 2014 to £189,000. To investors who started buying in Q4 1996, when prices averaged £55,000, these were substantial additional gains.

Table 2 – 2014 capital gains under alternative reinvestment assumptions

	Initial investment in 1996	Capital gains in 2014	Capital gains in 2014 as % of initial investment
Remortgaging to 75% LTV	15,447	116,521	754.3%
Starting with 4 properties (mortgaged)	61,790	145,575	235.6%
Starting with 1 property (mortgaged)	15,447	29,115	188.5%
Prioritising debt repayment	15,447	14,558	94.2%
Starting with 4 properties (unmortgaged)	227,298	101,903	44.8%
Starting with 1 property (unmortgaged)	56,824	14,558	25.6%

By far the most substantial gains accrued to those who grew their portfolios through remortgaging. By amassing 10 properties by 2014, last year's capital gains reached £116,500, eclipsing the original investment in 1996 (see Table 2). But even the investor who started with a single mortgaged property and chose not to release equity would have seen capital gains in 2014 alone of nearly double their original investment.

The outlook for buy-to-let returns

Table 3 – Future projections (Q4 2013-Q4 2023)

	Value in Q4 2024 of £1,000 invested in Q4 2014	Compound annual return	% of return from net income
Buy-to-let (no mortgage)	1,814	6.1%	45.3%
Buy-to-let (75% LTV mortgage)	2,874	11.1%	12.6%

- Table 3 shows projected returns for the next 10 years assuming 4% pa growth in house prices, 2% pa growth in rents and mortgage rates rising to 5.5% by 2022. They suggest that every £1,000 invested at the end of last year using a 75% LTV mortgage could be worth £2,874 by the end of 2024 – an average annual return of 11.1%. The corresponding annual return for an unmortgaged investor could be a more modest 6.1% (though this is still close to the rate of return of equities over the 1996-2014 period).
- These would be quite strong returns to achieve in the low inflation environment that we assume will prevail and again shows the benefit of using mortgage finance if property prices are rising even modestly. If these projections prove to be broadly correct buy-to-let looks set to maintain its reputation as a superior investment.

Disclaimer: This material is for informational purposes only. It is not intended as investment advice and we are not soliciting any action based on it. The material is based on information that we consider reliable, but we do not represent that it is accurate or complete and it should not be relied upon as such.

Section 1 - Introduction

One year ago we published *Buy-to-let comes of age: a comparative analysis of returns for buy-to-let and other major asset classes* which sought, for the first time, to benchmark average long term returns for buy-to-let investors against other major asset classes. The report considered returns over the period 1996-2013, as 1996 was the year that the Association of Residential Letting Agents (ARLA) and several mortgage lenders launched the buy-to-let mortgage initiative which ushered in the phenomenon which has universally become known as buy-to-let.

This report updates last year's benchmarking exercise by adding investment returns from 2014. It means we now have 18 years of data on the comparative investment performance of buy-to-let relative to equities, government bonds, commercial property and cash.

The buy-to-let total return index we have constructed to estimate returns is a powerful tool, charting the ups and downs property investors have faced over the past 18 years, revealing the relative importance of net income versus capital gain in the overall return and even allowing sensitivity analysis to be undertaken on the impact of varying key inputs such as mortgage rates, costs and other variables.

Investors need clear information to make informed decisions and we feel that there has been too little comparative information made available in a form that ordinary investors find accessible. With the new pension freedoms now in place the need for informed decision making is greater than ever.

In a sense buy-to-let has been more than just another asset class. It represents a democratising of the investment process because the main alternatives; equities, bonds, commercial property and cash are all 'professional' investments in the sense that they are managed by others. Buy-to-let has allowed investors to take control, cutting out a layer of management cost, which has enhanced returns.

Now, nearly two decades later, a new financing revolution is set to change buy-to-let as peer-to-peer lenders such as Landbay allow ordinary investors to lend directly to landlords, cutting out the traditional bank or building society sitting between the two. This paper should be of value to ordinary investors who want to lend to landlords as it sets out the relative robustness of the buy-to-let returns that help to underpin lenders' investment as well as those of the landlords themselves.

Section 2 - Investment returns compared

Table 4 – Cumulative total returns for the main UK asset classes (1996-2014)

Asset class	Value at end 2014 of £1,000 invested at end 1996	Compound annual returns	% of return from net income
Buy-to-let 75% LTV loan	14,897	16.2%	28.6%
Buy-to-let without loan	5,071	9.4%	42.9%
UK commercial property	4,494	8.7%	N/A
Gilts (FTSE Gilt All Stocks)	3,329	6.9%	N/A
Equities (FTSE All Share index)	3,119	6.5%	N/A
Cash (1 month Libor)	1,959	3.8%	100.0%

The investment returns shown in Table 4 show what £1,000 invested at the end of 1996 would be worth by the end of 2014 in the five main asset classes in the UK. As is standard in such comparisons, the returns have been calculated gross of tax as different investors face different tax rates. Income is reinvested in the asset.

Superior returns on buy-to-let

The first key finding of this report is that rented residential property (or so called buy-to-let) produced the highest return of any asset class. Even for the investor who used no gearing (i.e. bought property with cash) every £1,000 invested in an average buy-to-let property purchased in the final quarter of 1996 would have been worth £5,071 by the final quarter of 2014. This represents a compound average annual return of 9.4%.

Over this 18 year period, the landlord would have accumulated over £99,100 of net income (profit) from the property. However, this would have been insufficient to purchase another property outright so he/she would have ended the period with only the single property they bought back in 1996.

Enhancement of returns through use of borrowing

For investors who borrowed to purchase a buy-to-let the returns are significantly higher. Using identical underlying assumptions, the same property purchased with a 75% LTV buy-to-let mortgage (a fairly typical initial LTV) would, on average, over the same period have turned each £1,000 invested into £14,897, a return of just under 1,400% (and a 16.2% compound rate of return).

This investor would have accumulated enough surplus cash flow (net income) from their buy-to-let property to put down a 25% deposit and meet purchase/set up costs on a second property by 2012. By the end of 2014, their two properties would together be worth £378,000, providing total capital gains of £153,400 on an initial investment of £15,400. The investor's average LTV would be 43% and they would have an additional £15,700 in accumulated cash left over despite the purchase of a second property.

Returns on other asset classes

Turning to the performance of the other main UK asset classes, commercial property was the best performing asset class after buy-to-let. Every £1,000 invested at the end of 1996 would have been worth £4,494 by the end of 2014 based on our estimates. On the whole this has been a relatively benign period for commercial property supported by interest rates trending down, although the 2008-9 financial crisis did hit the capital value of commercial property hard.

Surprisingly, given the relative low risk associated of UK government bonds (gilts), these provided higher average returns than equities over the 1996-2014 period. The reverse was true over 1996-2013 but gilts had an exceptional year in 2014 with total returns of 13.9%. Each £1,000 an investor placed in gilts at the end of 1996 would have grown to £3,329 by the end of last year.

Equities, as measured by the FTSE All Share Total Return Index, outperformed only cash. The average UK equity investor can expected to have seen each £1,000 invested at the end of 1996 grow into £3,119 by the end of last year. This period was a patchy one for equity markets with both the dot com bust and the financial crisis taking a toll on returns. And 2014 was a poor year for equities with the FTSE All Share Total Return Index rising only 1.2% over the year.

Unsurprisingly cash produced the lowest returns out of the main asset classes, measured by 1 month sterling Libor. Even without tax, the cash investor would have failed to see their funds double over this 18 year period, with £1,000 growing to £1,959. Adjusting for inflation measured by the all items Retail Prices Index (RPI), the cash investor would have gained only 17% between 1996 and 2014. This result would seem to validate the widely held view that over the long term investors do poorly in cash.

Cash has been a particularly poor investment since the financial crisis. In the 6 years between the end of 2008 and the end of 2014, the cumulative return from 1 month Libor was 3.8%. Adjusted for changes in the RPI the cumulative return was -14.2%.

Other investment criteria

This report is focused on comparative investment returns. However, it is important to provide some context to the returns shown in Table 4 as returns are by no means the only factor that investors will take into account when considering where to place their money. Other key characteristics that need to be considered are whether an investment is active or passive, the expected volatility and liquidity, the ability to diversify risk and the level of investment charges.

Buy-to-let is an active not passive investment

Buy-to-let is fundamentally different from asset classes such as equities, gilts or cash. Whilst these other investments are passive – once the investment is made you are

relying on others to deliver the returns – buy-to-let is more akin to a business. Even when a landlord uses a managing agent to find tenants and manage their property, they will need to oversee the managing agent and they take on legal responsibilities related to important issues such as the safety of their tenants. For example, where the property has a gas supply, the production of an annual gas safety certificate is a legal requirement.

This sense in which buy-to-let is a business as well as an investment is what attracts many investors – they are making their own decisions rather than delegating them to others such as a management team whose financial interests may not be perfectly aligned with their own. Indeed, many landlords prefer to find tenants and manage their property themselves rather than employing an agent. This so called ‘sweat equity’ reduces costs and boosts returns.

Still, for investors who are not looking to devote much time it is important to remember that, unlike a share certificate which can be placed in a draw and left, buy-to-let can never be an entirely passive investment. As a result it will not appeal to all investors.

Volatility

You might expect the asset classes showing the highest level of price volatility to offer the highest returns as investors should need to be compensated for the risk associated with high volatility. However, over the period considered in this report this does not appear to be the case. UK equities, which consistently exhibit a high degree of price volatility, have provided comparatively lacklustre returns since 1996. By contrast residential property prices have shown low price volatility and yet provided the highest returns.

Liquidity

The flipside of UK equities’ high volatility is high liquidity. An investor can typically sell equities without delay, although the price they receive could be significantly lower than on the previous day. Gilts are also very liquid but with lower price volatility and, correspondingly, a lower expected return.

Residential property by comparison is illiquid – typically taking significantly longer to sell. This characteristic reinforces property’s role as a longer term investment. But for many investors looking for a long term home for their funds, this illiquidity is not a significant concern and the low price volatility of property trumps its comparative illiquidity.

Diversification

It should be relatively easier for the investor to diversify in financial assets like equities than in buy-to-let because of the lumpiness of buy-to-let investments (the substantial size of deposit required with even the cheapest buy-to-let properties).

However, investment studies have shown that the returns on residential property have a low correlation with financial assets. This makes buy-to-let an attractive investment for wealthier individuals with a heavy existing exposure to equities or bonds, as it should diversify their risks.

Investment costs

Our buy-to-let total return index builds in assumptions for the cost of entry. We assume that the average investor spends 3% of the purchase price on purchase and set up costs, which is then immediately written off in our calculation. In contrast the indices that we show for equities and gilts do not allow for the cost of accessing the investment. While these costs can vary significantly some investors do find that they can have a sizeable detrimental effect on returns particularly for investors seeking access to the equity market via managed funds.

Section 3 - Breakdown of returns between income and capital gain

While much of the media coverage of buy-to-let has focused on capital gains the reality is that many investors are seeking a steady income from their portfolios and in particular an investment that generates a decent income for them in retirement.

Unmortgaged buy-to-let

Using our total return index we can break down returns between net income and capital gains with some interesting results. For the unmortgaged buy-to-let investor, taking the 1996-2014 period as a whole, capital gain provided 57% of total returns and net income (i.e. the excess of rents over costs) produced 43%. Chart 6 shows the cumulative returns from income and capital gains for this investor, illustrating how these income and capital gain elements of return evolved over the 18 year period.

Chart 6 - Cumulative returns from income and capital gains (unmortgaged investor)

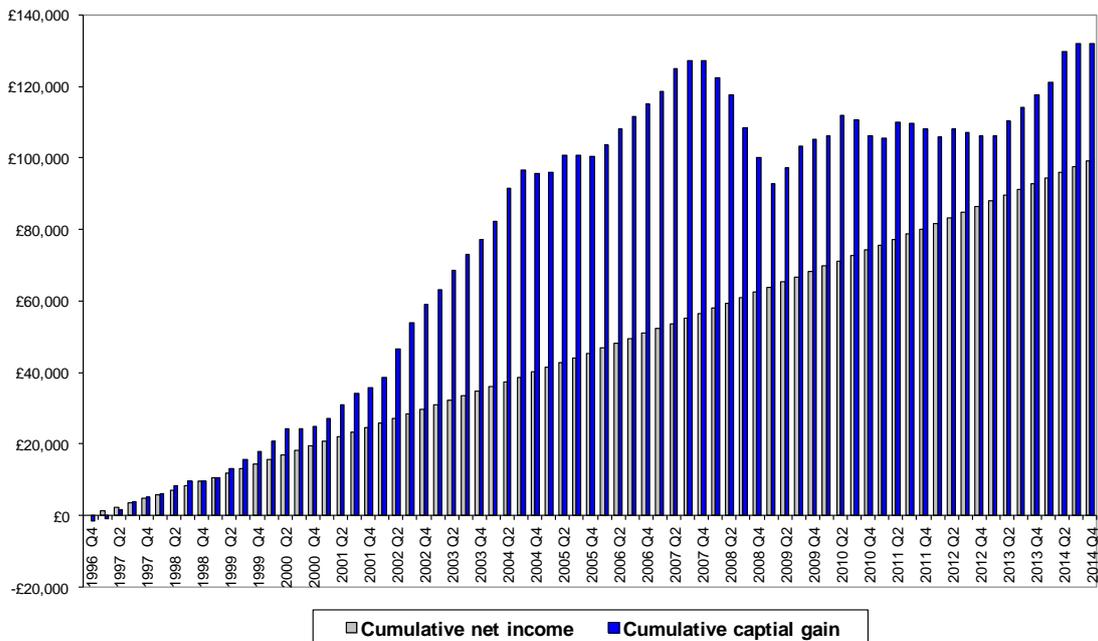


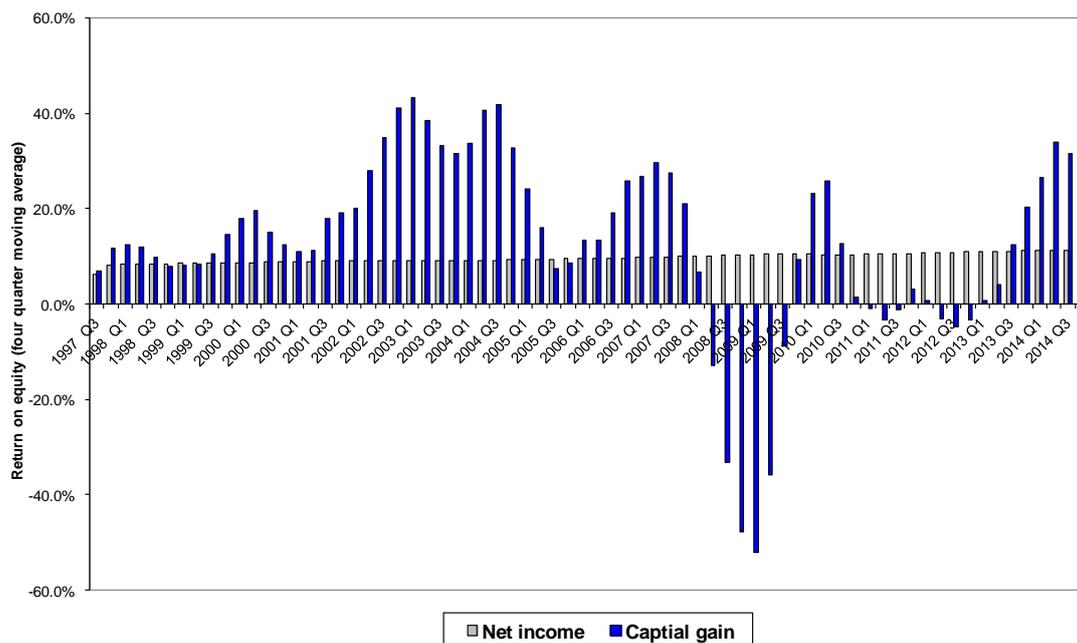
Chart 6 shows that capital gain is more volatile, reflecting periods when property prices are rising strongly such as the mid-2000s or falling such as in 2008. By comparison net income is a much more stable source of return for the buy-to-let investor – reflected in the consistent increase in the blue bars. Another positive feature of this flow of income is that, as rents tend to rise over time, net income will also show a gradually rising profile.

Thus while net income was £4,700 in 1997, by 2014 it had risen to £6,400, equivalent to 11% of the original investment. Over the whole 18 year period the investor

generated a net income of £99,100 on their initial investment of £56,800. For those looking for a retirement income this is a very attractive outcome.

Chart 7 reinforces the importance of income as a stable source of return for the unmortgaged buy-to-let investor. Rather than the cumulative returns shown in Chart 6 this shows annual returns (using a four quarter moving average) as a percentage of the initial investment. Clearly capital gains are much less predictable, although it is worth noting that using this four quarter moving average, capital values were lower in only 12 out of 70 quarters.

Chart 7 – Annual return on initial investment (unmortgaged investor)



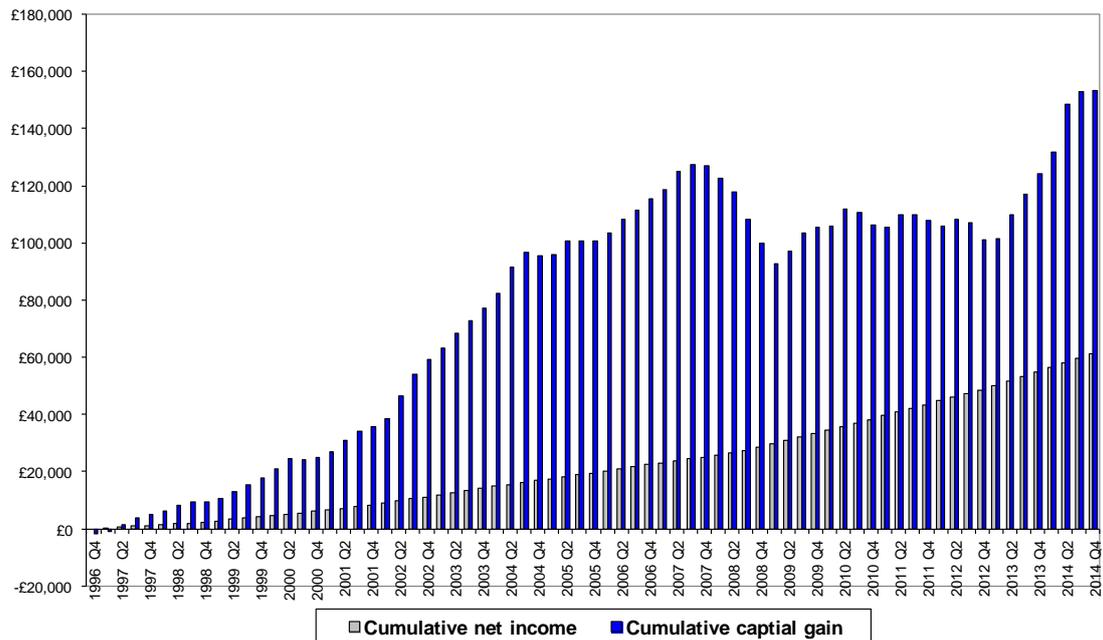
Mortgaged buy-to-let

Moving from an unmortgaged to a mortgaged buy-to-let investment alters the profile of returns. As Chart 8 illustrates, the relative importance of capital gain increases. For the geared investor, 71% of the total return between 1996 and 2014 was made up of capital gain with only 29% coming from net income.

Note that the profile of the capital gains shown in Chart 8 is initially identical to that shown in Chart 6 above, as the same average property is purchased by both investors and the other assumptions are identical. Only once the mortgaged investor has accumulated sufficient net income to put down a deposit and meet purchase costs on a second property (which occurs in 2012), does the level of capital gain begin to diverge.

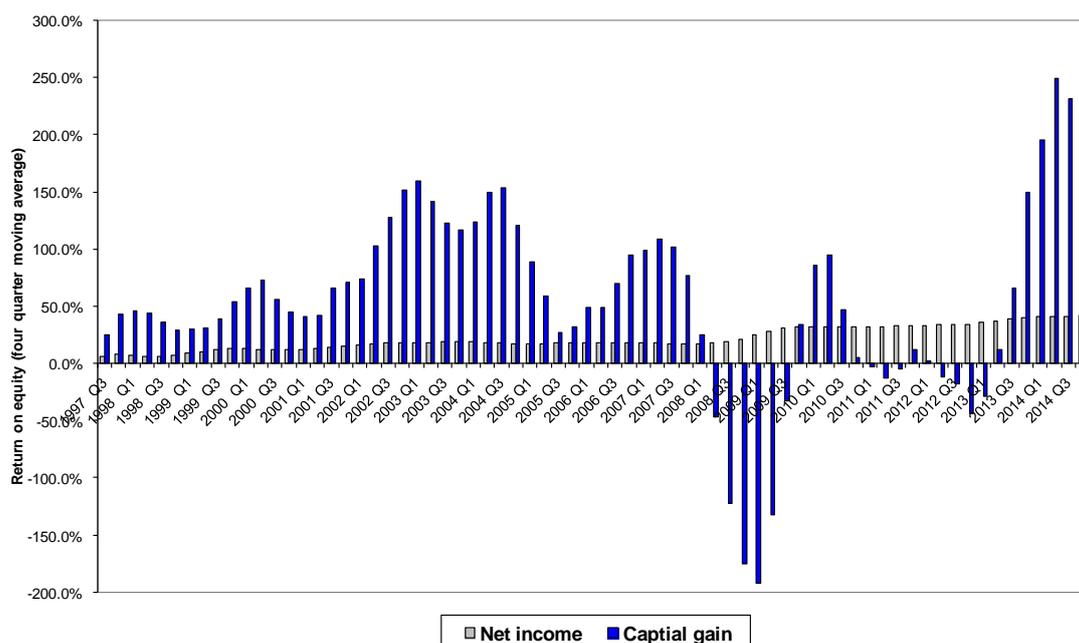
The lower income of the mortgaged investor reflects the additional cost of mortgage interest. But the key difference driving the higher returns for the mortgaged investor is that they bought the same property for an outlay of little over a quarter of what the cash investor spent. Returns on the initial investment are thus magnified.

Chart 8 - Cumulative returns from income and capital gains (mortgaged investor)



This boost to returns is illustrated in Chart 9, which shows annual (non-cumulative) returns as a percentage of the initial equity invested in the property, again using a four quarter moving average. Comparing Chart 9 and Chart 7, it is unsurprising to see that the annual returns from capital gains are far larger relative to the initial investment for the mortgaged buy-to-let investor: it mainly reflects the additional gearing they achieve from using a mortgage. Nonetheless, the scale of capital gains relative to the equity invested for the mortgaged investor is impressive, being for example consistently over 100% during 2003 and 2004 and again in 2014.

Chart 9 – Annual return on initial investment (mortgaged investor)



What is perhaps more interesting though is the difference in net income. While total net income over the whole 1996-2014 period is higher for the cash investor (£99,100 versus £61,300 for the mortgaged investor), by 2014 the mortgaged investor is enjoying net income of £6,400, almost identical to that of the unmortgaged investor despite the much smaller initial investment.

Expressing income as a percentage of the initial investment highlights the benefit of gearing. Although, as stated above, the unmortgaged investor received a greater cumulative income over the whole period, expressing this as a percentage of the initial investment shows that income alone came to 174% of the initial investment. But for the mortgaged investor it came to a much higher 397% of their original stake. Indeed, the net income of the mortgaged investor of £6,400 calculated for 2014 alone represents a 42% return on the initial equity invested in the property back in 1996.

Part of the reason the mortgaged investor does so much better is that by 2012 they had sufficient accumulated income to be able to fund the deposit and purchase/set up costs of a second averaged priced property. By contrast the £99,100 of net income accumulated by the cash investor was not sufficient for an outright purchase of a second property.

Section 4 - Buy-to-let returns under alternative reinvestment assumptions

Section 7 below explains the methodology we have employed for the reinvestment of income in buy-to-let. Section 7 explains why we believe we have used the most conservative realistic assumptions. In the case of the mortgaged investor we assume that the investor starts with a single property and does not reinvest their accumulated income until this provides them with sufficient funds to meet the cost of the deposit and purchase/set up costs on another property.

In the case of the unmortgaged investor we assume that they do not reinvest their income until they have saved enough accumulated income for another outright (unmortgaged) property purchase including costs. For both the mortgaged and unmortgaged investor we have assumed that no interest was received on accumulated cash while it awaited reinvestment.

In this section we look at average returns on buy-to-let under three different reinvestment assumptions: firstly, where the investor starts with a larger number of properties and can therefore reinvest accumulated income sooner; second, where the investor prioritises the repayment of their mortgage and thirdly where the investor remortgages to release equity to accelerate the reinvestment process. Total returns from these scenarios are summarised in Table 5.

Table 5 – Buy-to-let returns under alternative reinvestment assumptions

Alternative reinvestment methodology	Value at end 2014 of £1,000 invested at end 1996	Compound annual returns	% of return from net income
Remortgaging to 75% LTV	34,732	21.8%	14.9%
Starting with 4 properties (mortgaged)	17,967	17.4%	28.9%
Prioritising debt repayment	14,517	16.0%	36.7%
Starting with 4 properties (unmortgaged)	6,217	10.7%	43.7%

Alternative reinvestment assumption 1 - Larger initial investment

It is standard practice when calculating the total return on assets like shares or bonds to assume that income is reinvested back into the asset immediately. Applying such a methodology to buy-to-let would be unjustified however, because the lumpiness of property investments, even when mortgage finance is being used, means that investors cannot easily make small incremental investments in the way they may be able to do with shares and bonds.

However, we can provide a better like-for-like comparison with the approach to the reinvestment of income used for these other asset classes by considering an investor starting with more than one property. For many investors this is a more realistic approach, because it reflects their ability to plough more funds into buy-to-let, but the key point is it provides the more granular approach to income reinvestment that is the norm for other total return indices.

We can calculate a total return index for both mortgaged and unmortgaged larger scale investors. We have taken the example of an investor starting with four average properties, although of course we could have picked a different number. We turn first to the ungeared landlord.

Unmortgaged investor

As we saw in Section 2, the ungeared investor starting with a single property turned each £1,000 into just under £5,100. Applying the same assumptions, the investor who bought four properties at the end of 1996 would see each £1,000 grow to over £6,200 (see Table 8), achieving a compound return of 10.7% per annum.

Their cash flow would have enabled this investor to buy three additional properties, so from an initial investment of £227,300 they would have ended up with a property portfolio valued at £1,323,000 by the end of 2014. And during 2014 they would have received an income of just under £45,000, a substantial pension for an outlay of £227,300 just 18 years earlier. In total this investor would have made £1,186,000. However, the percentage returns are still well below those for the mortgaged investor, even one starting with a single property.

Mortgaged investor

A 75% geared buy-to-let investment in a single property was the best performing investment shown in Section 2, returning over £15,000 for every £1,000 invested. Taking the same level of gearing and applying it to the investor who starts with four properties increases the return to just under £18,000, a compound annual return of 17.4%.

The main reason for the higher return for the larger scale investor is that they have enough cash flow to start increasing their portfolio sooner and building it up to a greater extent. The investor starting with a single property ends up with two. The investor starting with four adds another six.

This greater growth in the size of the portfolio is the source of higher returns. Total capital gains amount to £745,800 – 12 times the original investment of £61,800. By contrast the mortgaged investor starting with a single property achieves capital gains of 10 times the original stake. But the returns from income are also higher – 5 times against 4.

The positive impact of gearing is also illustrated by comparing the larger scale mortgaged investor to the cash investor shown in Section 2. The cash investor had turned £56,800 into £288,100. Taking a similar sum (£61,800) but using it to buy four properties by taking on 75% LTV loans on each would have turned it into £1,110,200. And although, as you would expect, a larger proportion of the returns were from capital gain, the geared investor would also have ended up with a far higher net income by 2014 of £34,400 against £6,400 for the unmortgaged investor.

Chart 10 - Cumulative income and capital gains (larger scale geared investor)

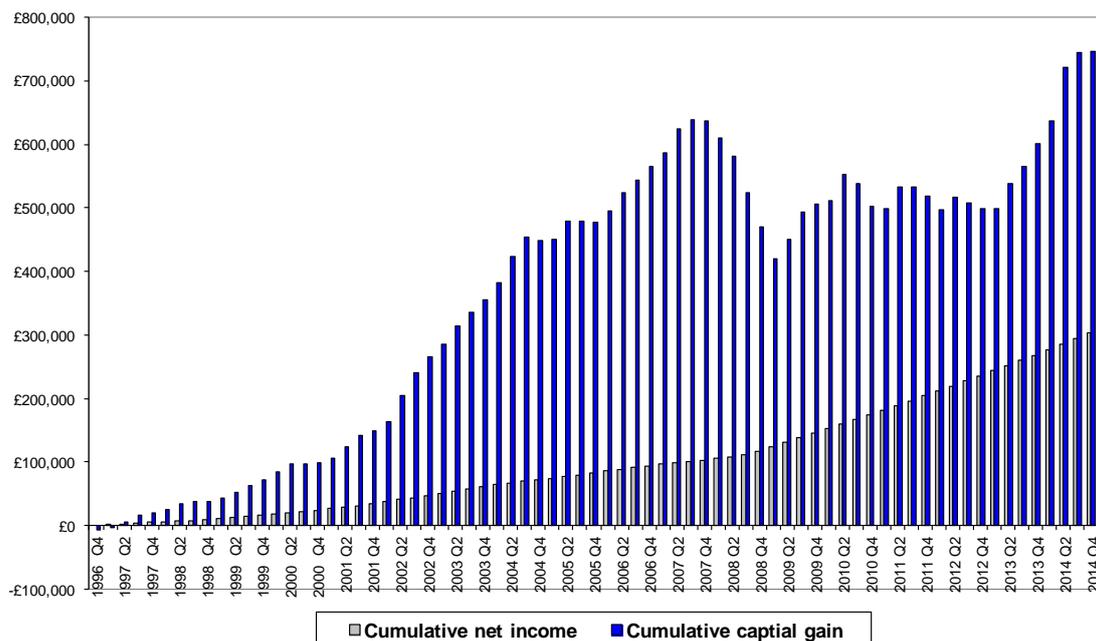


Chart 10 shows how these returns break down between income and capital gain for this geared investor. At 71%, the proportion accruing from capital gains is almost identical to the geared investor starting with a single property. What is markedly different though is the scale of the increase in income. For example, between 1997 and 2014 the investor starting with a single property would see their net income rise from £1,200 to £6,400. The investor starting with four properties would enjoy a rise from £4,700 to £34,400.

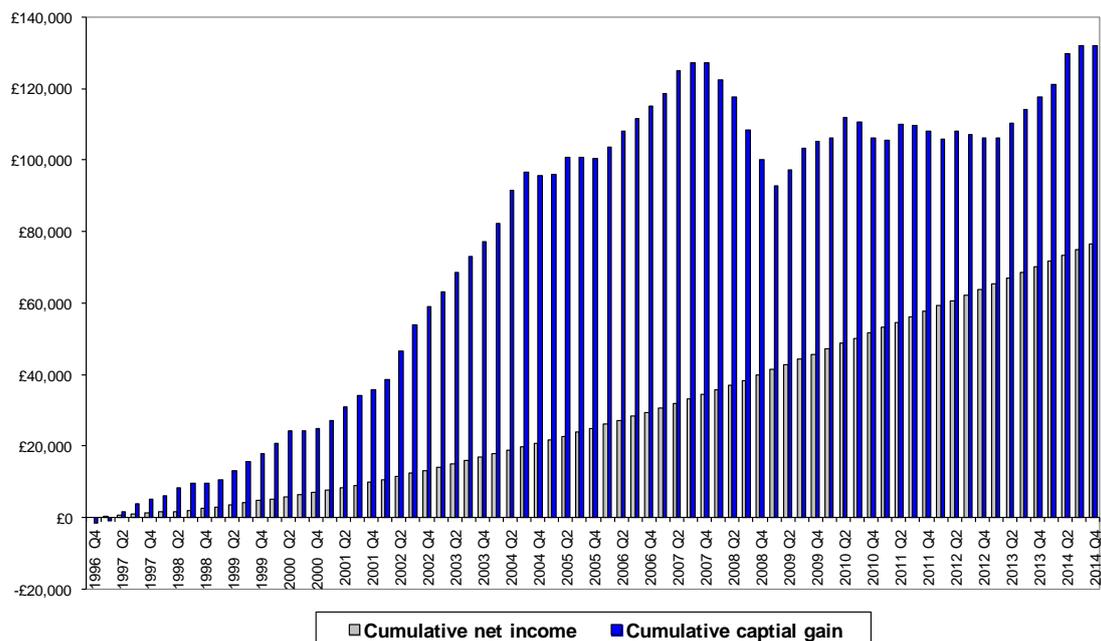
Alternative reinvestment assumption 2 - Prioritising debt repayment

An alternative strategy to reinvesting income in additional properties is to use any surplus cash flow to reduce the outstanding mortgage balance. This might appeal to an investor who is approaching retirement and wants to maximise income.

Again we can calculate a total return index using the same underlying assumptions. For an investor starting with a single property with a 75% LTV loan (identical to the starting point for the geared investment returns shown in Section 2), each £1,000 invested would have been worth over £14,500 by the end of 2014, giving a compound annual return of 16.0%.

This is slightly lower than the returns for the geared investor shown in Section 2, as the investor who prioritises debt repayment will not have the resources to fund another property purchase by 2014. Debt repayment is the safer option, limiting the risk that a future spike in mortgage rates could leave the landlord having to subsidise the property from other sources but it also limits the upside potential for returns in the longer term.

Chart 11 - Cumulative income and capital gains (prioritised debt repayment)



Alternative reinvestment assumption 3 - Regearing portfolio

One unique feature of buy-to-let compared with other assets is the extent to which the investor can borrow to invest. As Section 2 above illustrates, this ability to borrow can significantly enhance returns. However, with all the other investment strategies discussed in this paper we have assumed that once the investor has purchased a property they do not increase the debt secured on it regardless of any subsequent increase in its market price.

Clearly investors who have accumulated large amounts of equity in their property portfolios will in practice be in a position to tap this equity to buy more properties. So we now turn to consider what returns could have been achieved by an investor who withdrew equity to accelerate the growth of their buy-to-let business.

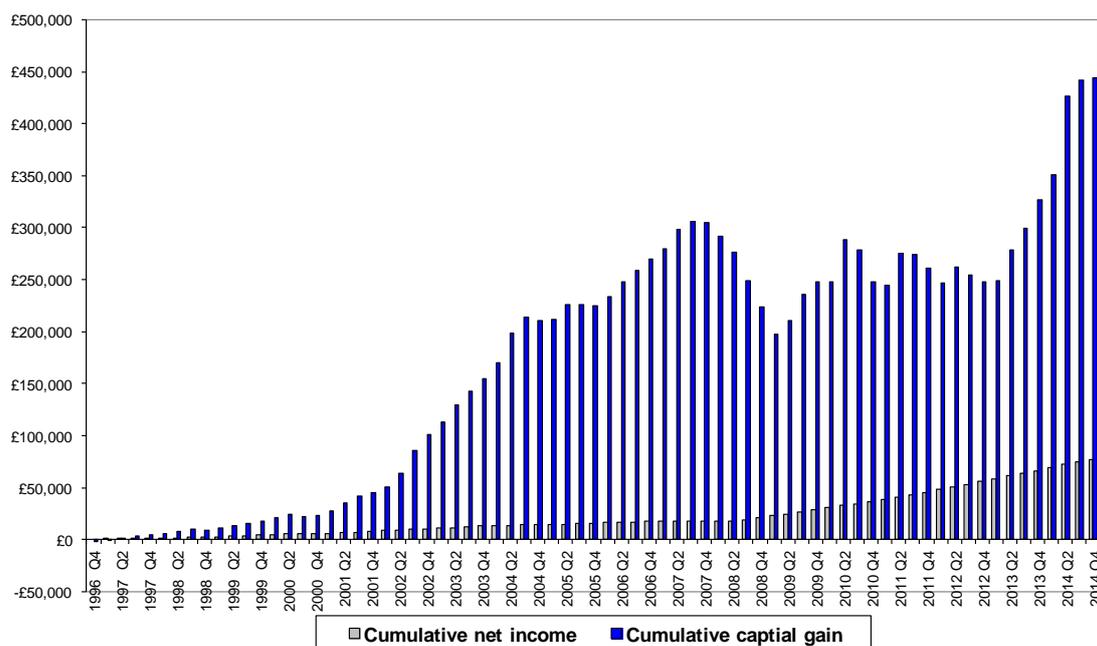
We have used three simple rules to calculate a total return index for a buy-to-let investor who remortgages to fund additional property purchases. First, we assume the investor targets a maximum LTV of 75% for their portfolio. When the sum of sub-75% LTV equity and cash is sufficient to finance the purchase of another property with a 75% LTV mortgage (including paying for purchase/set up costs), the investor increases the debt on their existing portfolio back up to the 75% LTV level (we assume that a 1% fee is paid on additional advances when they are taken out).

Second, if the average LTV on the portfolio goes above 75% because house prices subsequently fall, we assume that the investor will make no additional property purchases even if they have sufficient accumulated cash for another deposit. And thirdly, even if the investor has the financial resources to purchase another property

they will not do so if the prospective rental income on the next purchase is insufficient to cover all operating costs including mortgage interest in that quarter.

This third rule simulates the constraint that cash flow imposes on the investor's ability to borrow independently of, and in addition to, LTV. In our index it prevents the investor from purchasing any properties between Q2 2002 and Q1 2009, as net yields are too low during this period to match the cost of mortgage interest on a 75% LTV loan.

Chart 12 - Cumulative income and capital gains (remortgaging investor)



This remortgaging strategy produces higher returns than any of the other reinvestment strategies examined in this paper. Starting with an investment of £15,400 in a single property, this investor would end up with 10 properties with a combined value of £1,890,000 and total returns of £521,100. This is an astonishing performance which would see every £1,000 invested turned into £34,700, a compound annual rate of return of 21.8%. In 2014 alone the investor would have seen their property portfolio increase in value by £116,500, 7½ times the initial investment made in 1996.

What this scenario helps to illustrate is how buy-to-let has not only provided very strong returns for average investors since 1996 but how it has enabled a cohort of ambitious investors to become seriously wealthy. The combination of strong house price growth and the ability to gear a portfolio has allowed a new class of millionaires to emerge in a way that has generally not taken place with investors in the other asset classes we have considered. Names like the Candy Brothers, who started as buy-to-let investors before moving into development, and Fergus and Judith Wilson are high profile examples of this new class.

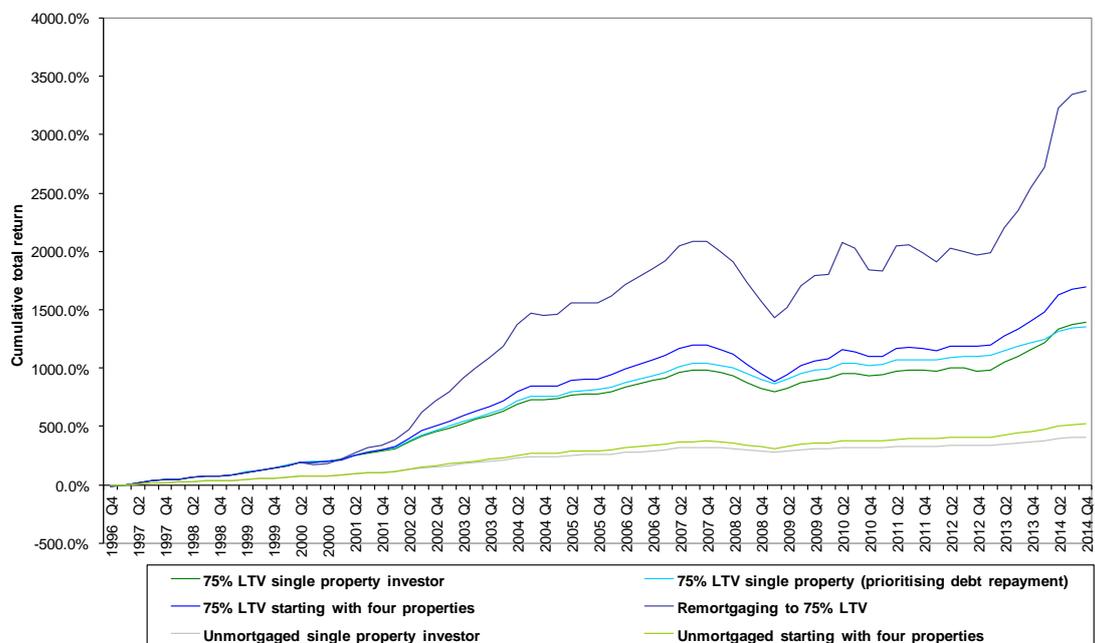
However, this remortgaging investor will face higher volatility of returns and higher risk. With over £1.4m of debt they will be vulnerable to a rise in interest rates – a 1% rise in mortgage rates in Q4 2014 would have resulted in net income turning negative - and if house prices fall their LTV can rise above their target maximum 75%.

However, it should be remembered that these returns are generated by following an entirely mechanistic reinvestment formula. In reality investors will have discretion over what to purchase and when. A range of options are open that could allow the ambitious investor to optimise their investment performance while mitigating risk. For example, they could seek out properties with higher than average net rental yields when mortgage rates are high, allowing the investor to expand their portfolio more quickly than our example. Alternatively, they could avoid buying property when net income is only marginally positive, lowering their level of risk.

Reinvestment strategies compared

What these alternative reinvestment scenarios show is that buy-to-let investors have quite a range of options when it comes to strategies for developing their businesses. Typically the higher the level of gearing the higher the returns have been, although as explained above, the risks become greater too. This is illustrated in Chart 13 which compares the cumulative returns for each reinvestment scenario. It shows how remortgaging boosted returns as house prices rose in the mid 2000s and again in 2013 and 2014. But it also shows the sharper reversal the remortgaging investor experienced in 2008 as house prices fell back.

Chart 13 – Buy-to-let reinvestment strategies – cumulative returns compared



The strategies that buy-to-let investors adopt are likely to be determined by their overall objective – do they want to become property magnates in which case they

will probably want to remortgage to release equity for further purchases, or are they just looking for additional income in retirement?

For the majority of buy-to-let investors it is reasonable to suggest that, after focusing more on growth in the early years, they will want to shift toward a focus on income generation as they move towards old age. For these typical investors buy-to-let has compared very favourably with other investments and conventional pensions in generating an income in retirement.

Chart 14 – Annual net income – percentage of initial investment

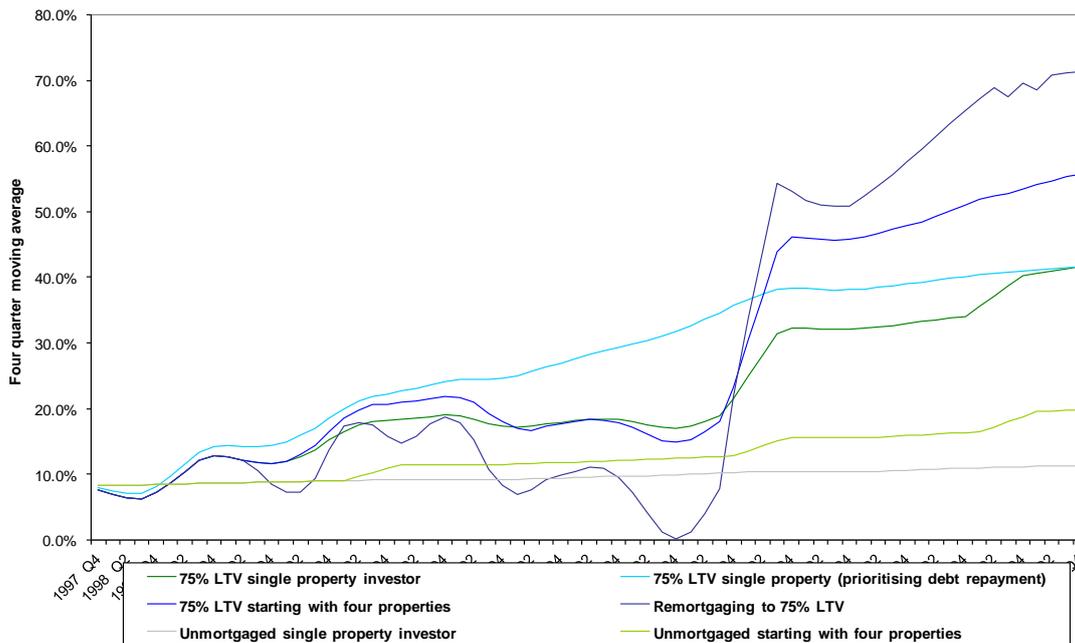
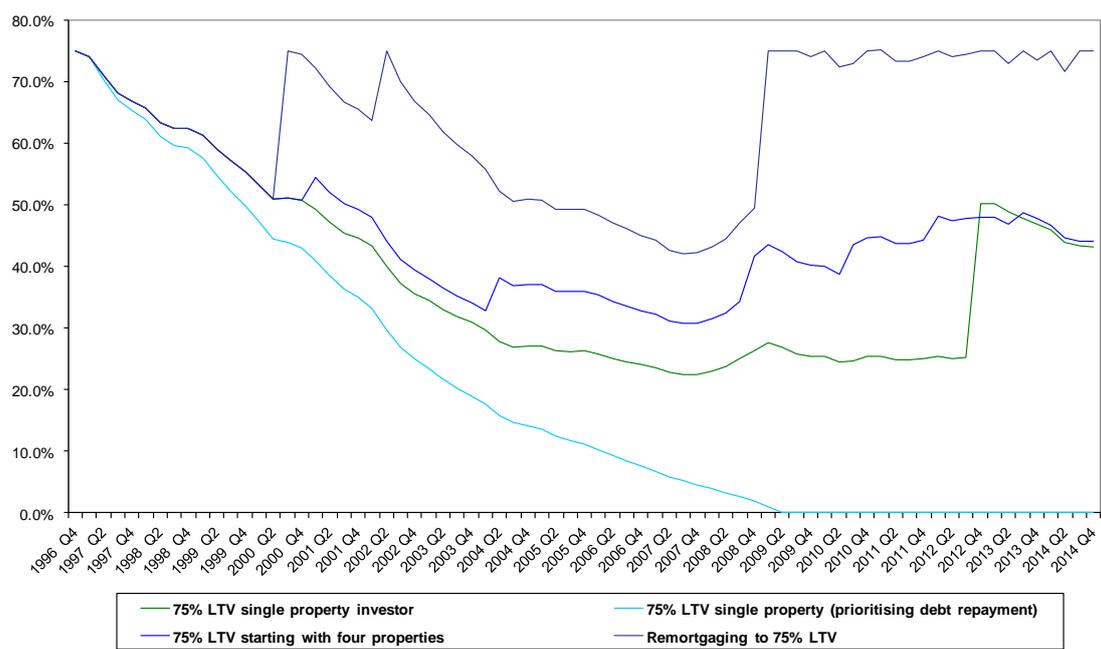


Chart 14 shows the evolution of annual net income for the buy-to-let investor under different reinvestment scenarios, presenting net income as a percentage of the initial investment (using a four quarter moving average). This illustrates the benefit of gearing specifically in boosting income, particularly since the sharp fall in interest rates in late 2008/early 2009. For most of the 17 year period, the unmortgaged investor scenarios had the lowest net income relative to their initial investment. The remortgaging investor has had the highest relative income since the fall in interest rates although their income briefly turned negative in Q2 and Q3 2007 when mortgage rates rose.

Chart 15 shows the evolution of LTVs for the mortgaged reinvestment scenarios. This illustrates how house price growth has pushed LTVs down, with only the remortgaging investor ending up with more than 50% LTV. For the investor who starts with a single property with a 75% LTV mortgage and expands their portfolio only from accumulated cash flow, by the end of 2014 the average LTV is just 43.3%. If they had started with four properties they would have a very similar LTV at the end of 2014.

Chart 15 – Loan-to-value (LTV) ratios for mortgaged buy-to-let total return indices



Section 5 – 2014 investment performance

Tables 6 and 7 show the performance of buy-to-let in 2014 under different reinvestment scenarios for the investor who started in Q4 1996. Table 6 shows the net income the average buy-to-let investor could have expected in 2014 expressed as a percentage of their original investment back in 1996.

Table 6 - 2014 net income under alternative reinvestment assumptions

	Initial investment in 1996	Net income in 2014	Net income in 2014 as % of initial investment
Remortgaging to 75% LTV	15,447	11,004	71.2%
Starting with 4 properties (mortgaged)	61,790	34,434	55.7%
Prioritising debt repayment	15,447	6,428	41.6%
Starting with 1 property (mortgaged)	15,447	6,427	41.6%
Starting with 4 properties (unmortgaged)	227,298	44,998	19.8%
Starting with 1 property (unmortgaged)	56,824	6,428	11.3%

Although rising rents and modest mortgage rates ensured that net income was strong, 2014 was a year when capital gains dominated returns. House prices rose by 8.3% between Q4 2013 and Q4 2014 to £189,000. To investors who started buying in Q4 1996, when house prices averaged £55,000, these represented substantial additional gains.

Table 7 – 2014 capital gains under alternative reinvestment assumptions

	Initial investment in 1996	Capital gains in 2014	Capital gains in 2014 as % of initial investment
Remortgaging to 75% LTV	15,447	116,521	754.3%
Starting with 4 properties (mortgaged)	61,790	145,575	235.6%
Starting with 1 property (mortgaged)	15,447	29,115	188.5%
Prioritising debt repayment	15,447	14,558	94.2%
Starting with 4 properties (unmortgaged)	227,298	101,903	44.8%
Starting with 1 property (unmortgaged)	56,824	14,558	25.6%

By far the most substantial gains accrued to those who grew their portfolios through remortgaging. By amassing 10 properties by 2014, last year's capital gains reached £116,500, eclipsing the original investment in 1996 (see Table 7). But even the investor who started with a single mortgaged property in 1996 and chose not to release equity would have seen capital gains in 2014 of nearly double their original investment.

Table 8 – 2014 returns as % of investment accrued by Q4 2013

	Net income in 2014 as % of investment as at Q4 2013	Capital gain in 2014 as % of investment as at Q4 2013	Total return as % of initial investment
Remortgaging to 75% LTV	2.5%	26.6%	29.1%
Starting with 4 properties (mortgaged)	3.7%	15.7%	19.4%
Starting with 1 property (mortgaged)	3.3%	15.0%	18.3%
Starting with 4 properties (unmortgaged)	3.6%	8.0%	11.6%
Prioritising debt repayment	3.2%	7.2%	10.3%
Starting with 1 property (unmortgaged)	2.4%	5.4%	7.9%

An alternative way of considering 2014's investment performance is to look at the returns for the year as a proportion of the investment as it stood in Q4 2013. This would be appropriate for the buy-to-let investor who was considering whether to remain in property. Had they started investing in 1996, they would have build up considerable equity by the end of 2013 and might want to know whether they could be better off cashing in their property investment and investing the equity elsewhere.

Table 8 shows the 2014 returns as a percent of the investment as it stood in Q4 2013. It shows that net income in 2014 represents a modest return when considered against the capital tied up at the end of 2013, ranging from 2.4% to 3.7%. But the 8.3% rise in house prices in 2014 ensured that the overall return on capital was much greater, ranging from 7.9% for the unmortgaged investor to 29.1% for the remortgagor. What Table 8 illustrates is the extent to which seasoned buy-to-let investors are now dependent on capital gains to generate more than modest returns going forward.

Section 6 – Future projections and review of 2013 projections

2014 outturn compared to last year's projection

Last year's report provided a forecast of what buy-to-let returns might look like over the subsequent decade based on some simple projections for house prices, rents and mortgage rates. We concluded that, for those entering the buy-to-let market in Q4 2013, compound annual returns could amount to 6.3% for the unmortgaged investor and 11.3% for the 75% LTV mortgaged investor if house prices rose by 4% a year, rents by 2% a year and mortgage rates climbed to 5.75% by 2020.

We can compare the first year of our forecast with the outturn for 2014. House prices outperformed the forecast by 4.1% while rents underperformed by a modest 0.4%. Interest rates were in line with the forecast.

In last year's forecast, the returns in the first year were 9.0% for the geared investor and 4.6% for the ungeared one. These figures included the cost of writing off all purchase costs. Re-running the figures with actual 2014 data for house prices and rents shows that returns would have been far higher than the forecast suggested, at 24.2% for the geared investor and 8.8% for the ungeared investor.

Key assumptions for this year's projection

In constructing a projection for buy-to-let returns, we seek to make assumptions that are as neutral as possible. Firstly, our basic assumptions about costs and voids are the same as those used in the rest of the paper. Turning to the key macroeconomic variables, we assume that inflation will average 2% per annum over the 10 year period of our projection, in line with the Bank of England's target rate, and that real household income growth will also average 2%. This produces nominal household income growth of around 1% per quarter.

Our assumptions about inflation and real income growth provide an anchor for our projection for house prices and rents. We assume that house prices will grow in line with nominal incomes (4% a year or 1% a quarter) as these reflect the purchasing power of home buyers. We assume that rents will rise in line with inflation in general (2% a year or ½% a quarter). Compared to past trends this understates the performance of house prices, which have grown faster than nominal incomes over the past two decades. But it overstates the performance of rents which have grown more slowly than prices over the past decade.

However, there are reasons to believe that past trends in house prices and rents may not be the best guide to the future. House price growth cannot outstrip nominal income growth indefinitely while given strong projected growth in rental demand it seems unlikely that rental growth will fail to keep up with broader inflation.

The only other assumption we need to make concerns the path of mortgage rates going forward. This comprises two components: Bank of England Bank Rate and the spread that lenders require over Bank Rate. Here again we have tried to be as neutral as possible, assuming that Bank of England Bank Rate gradually normalises, rising by 0.5% in mid 2016 and each subsequent year until reaching 3.75% by 2022, after which we assume it remains flat. We also assume that the average investor will be able to borrow at 2.5% above Bank Rate, falling to 1.75% from 2016, as we assume that mortgage margins will return to more normal levels by then. As a result, mortgage rates rise to 5.5% by 2022.

Results

Table 9 – Projected buy-to-let returns (Q4 2014-Q4 2024)

	Value in Q4 2024 of £1,000 invested in Q4 2014	Compound annual return	% of return from net income
Buy-to-let (no mortgage)	1,814	6.1%	45.3%
Buy-to-let (75% LTV mortgage)	2,874	11.1%	12.6%

This year's projections are shown in Table 9. They suggest that every £1,000 invested at the end of last year using a 75% LTV mortgage would be worth £2,874 by the end of 2024 – an average annual return of 11.1%. The corresponding annual return for an unmortgaged investor would be a more modest 6.1% (though this is still close to the rate of return from equities over the 1996-2014 period).

In view of the low rate of inflation we are assuming (2% per annum) these are strong returns and again show the benefit of using mortgage finance if property prices are rising even modestly. If these projections prove to be broadly correct buy-to-let looks set to maintain its reputation as a superior investment.

Section 7 - Methodology

Our buy-to-let total return index

For each of the main asset classes that we are benchmarking buy-to-let against (cash, gilts, equities and commercial property), we have either taken recognised external benchmarks of total performance or have used estimates based on available information. Series like the FTSE All Share Total Return Index and Libor are widely used by fund managers and investors to compare returns. For buy-to-let we have constructed our own total return index. All indices are compiled without tax deductions.

To construct our buy-to-let total return index, for capital values we have taken the Nationwide House Price Index. For rents we have taken the average level of rent determined by LSL rental data for December 2014 and extrapolated this all the way back to 1996 using the Office of National Statistics (ONS) private rent series used in the construction of the Retail Price Index (RPI).

In constructing our buy-to-let total return index, where assumptions need to be made we have taken a conservative approach. We have assumed that landlords spend 25% of their rental income on operating costs (all outgoings except financing or mortgage costs). This is consistent with a landlord that uses the services of a managing agent i.e. a letting agent who finds tenants and manages the property. A landlord who chooses to manage their own property should face comparatively lower costs and therefore achieve higher returns, although costs vary considerably depending on factors such as the age of the property and whether it is rented to one or several separate tenants.

We also needed to make an assumption about the level of voids – periods when the property is not rented out - and about any rent arrears that are ultimately written off. There is limited time series data available on voids and write offs but there are estimates of the general level. Taking the available information into account, we have assumed that the average landlord faces around 22 days a year of void/unpaid rent – the overwhelming majority of which would be made up of voids.

We have assumed that mortgaged landlords paid 1.75% above Bank of England Bank Rate on loans taken out before the second quarter of 2008, 4% above Bank Rate on loans taken out between Q2 2008 and the end of 2012 and 3% above from 2013. Finally we needed to make assumptions about the costs of buying and, where applicable, furnishing the property. We have assumed that upfront costs average 3% of the purchase price and these costs are written off straight away.

As stated above, to construct our total return index we have used the Nationwide House Price Index for capital values and the December 2014 estimate of rent levels from LSL Property Services. In doing so, we are implicitly assuming that the average rented property is equal in value to the average property in the Nationwide Index.

Fortunately we can check whether this is the case as LSL Property Services produce a figure for average gross rental yields, which was 5.1% at the end of 2014, implying that the average capital value of the rented property they track was £180,500, compared to the Nationwide average price of £189,000. This is consistent with the widely held view that the average rented property is somewhat cheaper than the overall market average. It suggests that our rental yields and therefore the returns recorded in our total return index are somewhat understated. This is consistent with our approach of using conservative estimates wherever possible.

Our approach to reinvestment of income in buy-to-let

One key element in the calculation of total returns where the treatment of buy-to-let needs to depart from the assumptions used for asset classes like cash, equities and gilts is on the reinvestment of income. With cash the reinvestment of income is straightforward. Interest is simply credited to the cash account and thus rolls up. To calculate total returns for equities or gilts, income is reinvested back into the asset as it accrues. This is a reasonable approach as the fractional ownership of equities and bonds allows even small flows of income to be reinvested as they accrue.

The same cannot be said for buy-to-let. This reflects its lumpiness as an investment: a buy-to-let investor faces a minimum initial investment determined by the size of the deposit and purchase/set up costs. Although in theory this barrier could be overcome by a group of investors working together as a syndicate and thereby making a smaller individual investment, this possibility is not considered in this paper.

The basis upon which we have assumed that income is reinvested for a mortgaged buy-to-let investor is as follows: we assume the investor starts with a single property and only undertakes an additional purchase when they have accumulated sufficient cash flow from the first property to meet the cost of a deposit and purchase/set up costs on another property at the then market price.

The ungeared (cash) buy-to-let investor faces an even greater issue with lumpiness. For the buy-to-let investor who chooses to buy without recourse to a loan, we assume that surplus cash is only reinvested in another property when he/she has saved the full purchase price including purchase/set up costs.

We assume no return on surplus cash before it has been reinvested. In reality of course the investor is likely to park these funds in an interest bearing account so returns would be somewhat higher but we have ignored this possibility so that the returns we estimate are purely those relating to the buy-to-let investment itself.

The conservative nature of our reinvestment assumption for buy-to-let

A rising property market of course makes it more difficult for the investor to accumulate the funds necessary to expand their portfolio. Indeed, in the case of the

unmortgaged (cash) investor buying at the end of 1996, our total return index shows that they will not have accumulated enough net cash flow to purchase a second property by the end of 2014.

We believe that the methodology on reinvesting income that we have used that is explained above is the most conservative approach one could sensibly use. In reality the buy-to-let investor is likely to receive interest on accumulated cash flow and has a range of options open to them which would allow higher frequency of reinvestment of income.

For example, the investor could reinvest their income by buying a cheaper than average property. Some buy-to-let investors may be able to invest with other individuals, sharing the cost of purchasing a property. They may also be able to buy with a smaller deposit or they could remortgage existing buy-to-let properties to provide equity for additional purchases. Section 4 above examines these alternative approaches to the reinvestment of income.