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GREEN LIGHT

Home-grown veg offers the best value for Lainey Keogh | SUNDAY p5

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It may not be as dramatic as acquiring a rare idol but, just like Indiana Jones, it pays to be aware of the risks as well as the rewards when investing in a buy-to-let property

SECRETS OF BUY-TO-LET

Experts say it's a no-brainer for cash buyers, but borrowing from the bank to get into the BTL market carries considerably more risks, writes **Mark Channing**

INVESTING in residential property is a no-brainer for people who have the cash, according to a leading commentator on the Irish property market.

Writing in a report on the private rental sector published last month, John McCartney, director of research for the estate agency Savills, said residential property investors could reap attractive returns compared with other asset classes.

"With rents back to boom-time levels, income yields on residential property are much more attractive than the returns that are available to investors who leave their money in the bank or buy a bond," said McCartney. "On top of this, investors are generating wealth from capital appreciation — it's a no-brainer for people with the cash."

Recent figures revealing a surge in rents and property prices appear to support the investment case for using cash to buy property.

Earlier this month the property website Daft.ie published a report on the rental market that showed rents have soared to an all-time high, with the average national rent up 11.7% in the year to September.

House prices increased 7.2% nationally in the year to August, according to the Central Statistics Office, with predictions for further growth in the coming years.

Despite booming rents and house prices, experts say savers and investors should tread carefully before ploughing money into a buy-to-let property.

Garry Manning of the broker OMAC Mortgages & Finance in Dublin said: "Investing in a buy-to-let [BTL] can make a good return, but you need to know what you are doing and go in with your eyes wide open. You have to work out if it's actually worth the effort after you factor in all the costs."

We help you weigh up the pros and cons.

WHAT ARE THE RETURNS?

Yield — the ratio of a property's annual rent in relation to its price — is the most important measure used to work out your return on investment. A property that costs €300,000 to buy and can be rented for €10,000 a year generates a gross rental yield of 3.3%.

Double-digit yields, both in Dublin and nationally, are possible for investors in the current market, with apartments generating the best returns. For example, a one-bedroom apartment in Dublin 10 generates a gross yield of 11.2%, according to Daft.ie. Average yields for one-bedroom apartments in the cities of Cork, Limerick, Waterford and Galway, meanwhile, are between 9%-11%, according to Daft.ie.

By comparison, the average interest rate paid for cash on deposit is just 0.15%, according to the Central Bank of Ireland. However, experts warn against basing your investment decision on gross yields, but advise focusing on what you are left with after paying all taxes on rental income and other related expenses.

"People might look at the yields and think they're attractive, but you have to remember they're gross yields," said Manning. "The net yield after tax and expenses is what you should look at."

Rental income earned from a buy-to-let property is subject to income tax — 52% for higher rate taxpayers — immediately slashing yields by more than half.

Investors who finance the property using a BTL mortgage have to factor in the cost of mortgage repayments which are on a capital and interest basis.

Interest-only mortgages, which investors traditionally used to finance property purchases, are not currently available, and all BTL mortgages must be repaid on a capital plus interest basis.

However, the specialist lender Dilosk plans to offer investors BTL mortgages on an interest-only basis for up to 10 years from early in 2017.

BTL investors also incur a host of other expenses which eat into returns. Some of these, such as local authority rates, maintenance costs, insurance, management and agents' fees, and letting expenses, can be used to reduce your income tax bill. Others, such as the local property tax, cannot be offset against rental income.

Barry Flanagan, of Taxback.com, said: "It is important to note that pre-letting expenses, meaning expenses incurred prior to the date the property was first let, are also not allowed."

BTL mortgage holders can claim 75% of mortgage interest against rental income. Last month it was announced the rate would rise to 80% in 2017, then increase gradually to a 100% deduction by 2021.

John Leahy, the founder of Irishlandlord.com and author of the book Renting in Ireland, said: "If you're a cash buyer and it's a choice between leaving the money in the bank or investing in property, then BTL is a profitable option. However, if you're using a mortgage it's very hard to make the sums add up."

WHAT ELSE CAN HIT PROFITS?

Periods when the property is empty and not generating rental income will eat into your return, as will the cost of maintaining the property.

"You shouldn't assume the property will be rented 100% of the time, even in this very high-demand market," said Leahy. "You're going to have vacancy periods in between lettings, so your financial calculations should assume at least one month's void period."

Leahy said BTL investors should also budget for the cost of ongoing maintenance, and ideally landlords should be building a "sinking fund" to pay for unexpected or expensive repairs.

Experts say you should also run your calculations to account for a possible fall in rents. Patricia Hinch, director of Regency, an Irish residential property developer, said: "You should stress test the returns against various scenarios, for example a 20% reduction in rental levels, to ensure that you can manage any potential softening in the market."

WHAT ABOUT CAPITAL APPRECIATION?

Even though house prices are going up, experts say you should not invest in a BTL on the basis of making a return from capital appreciation. Davy, the stockbroker, recently revised up its forecast for house prices, predicting annual increases of 7% in 2017, 6% in 2018 and 5% thereafter.

"If the property goes up in value, then that's a bonus, but it's a flawed investment assumption to believe that property always gives you a capital gain," said Leahy. "At some point you're going to reach a ceiling, and no one knows where that ceiling is."

Leahy said many landlords remained trapped in negative equity after the property crash. Almost 100,000 Irish homes are still in negative equity, according to the Economic and Social Research Institute.

Meanwhile, almost 20% of landlords are in arrears on their mortgage, according to the Central Bank.

WHAT ARE THE OTHER PITFALLS?

First-time investors in property often underestimate the work involved with being a landlord. "Owning a BTL property can seem like a very straightforward proposition. However, there are many pitfalls," said Hinch. "Disputes with tenants can be stressful and costly, and there are also strict regulations around rent reviews and termination of leases."

For these reasons, she said that it could make good sense to use a letting and managing agent until you become more familiar with your obligations and with the processes involved.

Leahy also warned BTL investors to factor in the "hassle factor" of being a landlord. "Property prices and rents going up make it look like sense on paper, but you have to look at the broader picture," he said.

"If being a landlord really is so lucrative, then why don't more people do it?"

MARKET MOVERS
MARK SEAVERS

Mark Seavers is chief investment officer at Davy Asset Management, which has €4bn of assets under management. His responsibilities include the Davy Defensive High Yield Fund, which recently celebrated five years in the Irish market. Available from New Ireland, the fund is open to investors with a minimum lump sum of €5,000, or those who agree to invest at least €200 a month.

Philosophy

The fund aims to provide investors with exposure to an equity portfolio of global, high-quality, dividend-paying stocks while providing protection against significant market falls in equity markets.

The fund buys ''protective puts''. which it uses as a form of insurance to protect investors from big sell-offs in equities. ''The underlying equity book is defensive in itself, but we also have a second layer of 'put protection' meaning we have insurance in place at all times for when things get rough,'' said Seavers. ''Ultimately we give away some of the potential upside in order to provide added downside protection when markets are weak.''

Performance

The fund has achieved an average yearly return of 8.3% in the five years to the end of October 2016 while its three-year annualised return is 7.1%.

According to Seavers, the long bull market in equities, which has coincided with the fund's lifetime, has given it few opportunities to showcase its prowess at protecting on the downside.

''During most of the fund's five-year existence, markets have been trending upwards so the protection the fund was buying has been a bit of a drag on performance,'' he said. ''However, any time there has been a massive lurch downwards in markets, such as at the beginning of 2016, the fund has proved itself and protected investors from the full impact of the fall.''

Buying and selling

Global names such as Johnson & Johnson, Altria and PepsiCo feature among the fund's top 10 holdings.

''Some of our top 10 stocks have been around for more than 100 years and are companies that have consistently delivered good dividend income,'' said Seavers. ''The likes of Johnson & Johnson, Pepsi and Altria are great, well-managed companies that can churn out dividends on an ongoing basis,'' he said.

German chemicals giant BASF has been a recent addition to the portfolio.

''There is growing evidence of stability in some of the BASF's end-markets which we believe will lead to a recovery in earnings for the company,'' said Seavers.

Outlook

Following a long period of relative stability, Seavers believes volatility is likely to stalk markets for the foreseeable future.

''I don't see us going back to the sorts of consistently low levels of volatility we've seen in the years since the fund was launched up until last year. Volatility is here to stay,'' he said.

According to Seavers, this favours the fund's defensive strategy. ''There is an inherent defensiveness in high-yield equity portfolios that should benefit investors as we negotiate the year ahead. In this context, with its added layer of downside protection, this fund is potentially a very good place to be.''

Weaker players — not Lionel Messis — drive investing scores

GARY CONNOLLY

Though I'd confess to being a fairly apathetic fan of soccer, a comprehensive survey of European football matches spanning a seven-year period piqued my interest. It revealed some very counterintuitive results and a surprise common link with investing.

It turns out that corner kicks have little effect when it comes to increasing a team's chances of scoring, and, even more surprisingly, having more shots on goal doesn't guarantee success.

In The Numbers Game, authors Chris Anderson and David Sally examined 8,232 matches in the five big European leagues from 2005 to 2011, and found that the team that had more shots on target won only 50%-58% of the time.

Of particular interest to me, however, was the authors' argument that the beautiful game is a weak-link sport; that weaker players have more of an effect on a team's success than the stronger players. Having another superstar is positive, but having a better 10th or 11th player scores more wins. Lionel Messi needs several passes from his team-mates to set him up to do something sublime. Basketball by contrast is a superstar-linked game; Michael Jordan can power ahead alone.

Investing is another weak-link profession. Investment outcomes are determined more by how good your worst investments are, not your best ones.

The Canadian writer and journalist Malcolm Gladwell uses the analogy of air travel to expand on this theory. Air travel efficiency is limited by how good your appalling airports are, not how good the efficient ones are. Delays in New York airports — La Guardia, JFK, Newark — ripple across the country, Gladwell argues, and cause problems everywhere else. If you were trying to make air travel more efficient, these are the airports you would try to fix.

In soccer, you should improve the 45% player, not the superstar. In investing you should focus on limiting the downside not shooting for the stars.

The authors cross the line in terms of applying the science by identifying that substitutes should be made in the 58th, 73rd, or 79th minute. Reaching too far into the data for reasonable conclusions is a risk that also applies to investment decisions.

Investing is very often treated like a science. The investment management industry employs a crowds of people whose job it is to scour data and come up with investment strategies for clients.

There's a wide continuum in the way these results are reported — from candour to gilding the lily and beyond. In my years of researching investment products, I've watched companies operate at every point along that continuum.

There are plenty of things that won't show up in any kind of statistical analysis, in both soccer and the stock market.

No formula can adequately measure the series of intangible factors that have an impact on performance, a player's attitude or how some players seem to manage to make everyone around them much better.

In investing, formulas fall hopelessly short of capturing the complexities of capital markets. I am not suggesting that investment markets are not quantifiable. I am making a more limited claim: for those aspects of investing that are quantifiable, is the investment industry doing enough to ensure that conclusions it is drawing don't reach too far? I'd say it isn't.

Treating investing like a science inevitably leads to drawing conclusions that are spurious; I often see investment products and strategies that overreach.

In sport, the consequences of this are more limited than they are in investing. The analogy with soccer is far from perfect. Football fans crave excitement, entertainment and bragging rights. The Messis give you that and they sell more shirts.

Investing is rather more serious, and when excitement is craved, it almost always ends badly. Get your thrills from a bookmaker. A good financial adviser should bore you to tears.

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