

Income Trusts

Are They Really "The Only Game In Town"?

The TAMRIS Consultancy

13 October 2005

History tells us that the biggest risks to investors' financial security have been strategies that place undue reliance on short term financial returns from volatile investments within portfolio structures that expose financial security to short term financial risks. Income trusts used inappropriately and excessively represent such a strategy.

The TAMRIS Consultancy is concerned over the potential consequences of inappropriate use of income trusts in individual investor portfolios, the conflicts of interests in the whole conversion process and the lack of balanced and true disclosure of the risks, the costs and the benefits of income trust securities.

At the same time as the corporate profile of these vehicles are changing from mature high cash flow entities to more growth orientated business development vehicles, they are also being touted as more efficient corporate management vehicles without the track record and the proof to support these arguments. The changing nature of these investments, their increasing risk profiles and the increasing reliance the private investor has put on them is cause for concern.

While investment risk issues are foremost in TAMRIS's mind, secondary issues such as the effect of retrospective tax changes on income trust valuations and yields are also of concern.

Income trusts are equity investments and, their income distributions and the capital value of their units are exposed to short term stock market and economic risks just as any other equity investment.

Income trusts do not have the capital certainty of low risk assets and cannot be relied upon within short term portfolio planning to provide either a certain income or a certain capital at specific point in time.

Where they are used it is critical that a portfolio can cope with a significant decline in both distributions and capital value without impacting on the ability of the portfolio to meet the investor's financial needs over time. A portfolio's ability to provide future financial needs must also be able to cope with the lower capital growth potential of these investments, if included.

The risk for many small investors is that this higher risk/long term asset class has taken the place of lower risk shorter term investments such as cash and fixed interest investments as well as supplanting more balanced, less complex ordinary shares without a proper assessment of valuations and risks.

A risk event such as a collapse in the market, an economic recession or, a decline in the value of commodity prices underpinning many income trusts, would cause irreparable harm to the financial security of small investors who have placed over reliance on these investments.

A Bank of Canada working paper into income trusts in September 2003 stated the following. "Standard & Poor's has compared the risk on income trust units to high-yield bonds, stating "***in terms of relative risk, [an income trust unit is] subordinate to, and therefore riskier than, its high yield cousin.***" "

According to a recent (June 2005) report from Standard and Poors, the quality of the Canadian income trust market is declining.

"Standard & Poor's Ratings Services is beginning to see some trends such as the emergence of funds with higher business risk, risky acquisition strategies, higher leverage, and aggressive payout policies. This all adds to the market's complexity and exposes a fund's target distributions to potential cuts and suspensions."

"Standard & Poor's publicly rates 36 income funds...; however, once you include our 187 benchmark ratings, the median stability rating for the sector moves from 'SR-2' to 'SR-4', which is more reflective of Standard & Poor's opinion on the variability and sustainability of the Canadian Income Fund sector's cash flow generation (see chart 5). Benchmark ratings are internal ratings done for our fund of funds rating analysis and are reviewed regularly."

It must also be pointed out that the S&P stability ratings are not absolute risk ratings. They are relative risk ratings and rate individual income trusts relative to the risks of the other income trusts in the market. SR ratings cannot therefore be taken as a guide to absolute risk, important within a small and relatively high risk sample universe.

An example of the declining quality of the Income trusts market can be seen in the accepted conversion of Pacific Northern Gas and the following is taken from one the documents dealing with the conversion decision.

"We start with the proposition that PNG is a relatively high risk utility, the highest risk utility in the country, and I don't think anybody would disagree with that proposition. It's in a situation because of its business risks that it doesn't have access to debt markets, third party debt markets. It needs a way to be able to access capital markets to achieve a degree of financing flexibility that it doesn't have today because of its business risks, in conjunction with a way to maintain or lower it's customer rates to stay competitive."

Risk/return profiles

Also, of questionable value is the risk/return analysis on income trusts. While over the last few years these investments have exhibited a lower risk and a higher return profile than the main market index, it must be noted that higher yielding lower growth stocks were under valued relative to the market in 2000 and much of the risk/return data relates to this. Additional elements of the risk/return data must also presumably relate to the good demand for income trust shares (influenced by low interest rates) and the strong performance of commodity/energy based investments. Historical risk/return analysis says nothing about current risk/return relationships or valuation risks.

Additionally, low correlation with the market and fixed interest investments is also cited as a reason for including income trusts. Again the above factors will have influenced correlation. Other factors to take into consideration have to be the fact that the market is new and most new issues have occurred post 2001 (correlation data is going to be difficult to interpret) and, that the movement of many income trust share prices has been influenced by short term factors specific to income trusts during this period. Excess demand affects pricing.

It is possible in the short term for income trusts to be more sensitive to market and interest rate movements and to exhibit a much closer correlation to their sister asset class (equities) than they have exhibited over the last 5 to 6 years..

The question is, do income trusts offer real value and real benefits?

The main benefit to investors of income trusts is their very high yield and over the last few years the perception that these investments also provide considerable capital growth, which they have, for reasons that are not directly associated with their long term structure.

However, the often stated benefit to new investors in income trusts of the tax benefits of the flow through distribution is not as strong an argument as many investors would be led to believe.

Income trust conversion is driven by the incentive to get a better deal for existing shareholders. At or prior to the announcement of conversion the stock price rises, significantly. In many instances (TAMRIS has not gone through all conversion histories), the change in price more than adjusts for the income tax benefit to new income trust purchasers.

As such, the avoidance of some 35% of corporate tax is countered by the loss of the dividend tax credit (say 20%) and by share price appreciation that often exceeds the remaining 15%. While this is a simple analysis and does not deal with all the yield issues, it is never mentioned in any analysis of income trusts and their risks.

Additionally, not only do existing holders get the share price appreciation but they are often awarded generous dividends from cash accumulated. Note the C\$8m dollars for the Bird Construction shareholders and the following comment from the Precision Drilling conversion.

"Pursuant to the proposed plan of arrangement, shareholders would also receive a pro rata share of 26 million common shares of Weatherford International Ltd. owned by Precision and of up to Cdn \$850 million of cash."

When a company goes ex dividend, its share price falls, not so with income trust conversion announcements.

And it does not stop there. According to the Bank of Canada working report on income trusts in September 2003, the "gross underwriting fee on an income trust IPO is 5% to 6%,...Legal fees for issuers' counsel on a trust commonly range from \$500,000 to \$1 million or more, with fees for underwriter's counsel generally being about one-half to two-thirds of that amount." Let us not include the costs of mutual fund holdings in these investments.

We should not of course ignore the costs of the reorganisation and the risks the new structure poses to the ability of the company to meet planned distributions over time. While there are many supposed benefits of an income trust structure these are just as equally weighted by the arguments against such a structure. Since many income trusts have yet to face a full economic cycle, the jury on the positive arguments is still out.

Other factors also need to be considered.

- The longer term benefits of the ordinary share should not be overlooked. At 50% of the rate of taxation on income, long term capital gains are a very important aspect of long term portfolio return. Capital allocated to short term yield would lose much of this long term capital benefit. What goes around comes around, you do not get something for nothing and other well worn clichés spring to mind.
- It is also worth noting that if income trusts are so great, that it is probably better for ordinary investors to hold diversified portfolios of ordinary shares and benefit from both the appreciation in their value as well as the income tax benefits of the trust conversion than to pay chase the conversion and pay a premium for the income.
- It may not make sense to jump wholesale on to the bandwagon. Many of the new trusts are higher risk growth orientated ventures, the impact of which is yet unknown given that none have gone through a full market and economic cycle and stood the tests of our capitalist regime. Until income trusts become a dominant part of our market place, the demand for such shares may also overprice their long term benefits. The risks of overindulgence in the unknown should be well known.
- If the price of the shares on conversion rise, so will the price of units fall on changes to their regulation or the tax regime for conventional ordinary shares.

Risk disclosure

There is little or no meaningful risk disclosure about income trusts. Yes, the prospectuses talk about distributions depending on x, y and z but the actual risks to achieving x, y and z are not spelled out.

Most commentary, including the press and marketing materials all point out the benefits of income trusts. Small mention is made of the risks, but the full nature and the potential effects of the risks are not disclosed.

The Canadian financial service's market place is still deeply and fundamentally a transaction led market place and, in a transaction led market place the benefits of a transaction are first and foremost and the risks last and least.

The OSC has also highlighted concern over the disclosure of distributable cash, but even here the recommendations provide little information, in an easily accessible format, to assess risks. Recommendations appear more to satisfy capital market integrity than appropriate investment advice.

Excerpt from CSA STAFF NOTICE 41-304 - INCOME TRUSTS: PROSPECTUS DISCLOSURE OF DISTRIBUTABLE CASH

Based on the disclosure that income trust issuers have provided, it is often difficult to assess the transparency of the estimated distributable cash information. Specifically, the discussion surrounding each reconciling adjustment often provides limited information on the underlying significant estimates and assumptions used to determine the adjustment. In addition, it is difficult to assess whether the reconciliation includes all adjustments that would be necessary for full, true and plain disclosure of estimated distributable cash.

Long term capital depletion & portfolio structure

A key issue driving the demand for income trusts is the fact that most portfolios are incapable of meeting an individual's financial needs from yield alone. This is especially so during periods of low interest rates and historically high market valuations.

The choice for the investor is to either live of yield and dividend interest alone, to increase the risk and return profile of a portfolio or to safely manage capital depletion over time.

Many investors do not want to take option 1.

Many investors by overindulging in income trusts are actually taking option 2, without realising it, with potentially disastrous consequences if the normal and real risks of the business cycle reassert themselves.

For example, a portfolio is structured to meet financial needs from income trust yield. The economy moves into recession and the distribution on the income trusts fall. In this instance, the investor has a choice, reduce their expenditure or sell investments to supplement the income lost. Because the income trusts have been pushed to the front of the portfolio there may well be insufficient lower risk assets to meet financial needs, resulting in either the sale of equities and income trusts. Such a portfolio approach exposes the individual investor to excessive risk and uncertainty.

The other option is to carefully manage the balance between asset classes and to carefully deplete the capital on their portfolio over time. Such a strategy could include careful use of income trusts. However, very few advisors in the industry are able to structure portfolios that are capable of safely managing capital depletion over time and of safely including income trusts within their structure.

No investment can ever be included within a portfolio on its own merits alone. Its impact on the ability of the portfolio to meet short and long term financial needs has to be assessed and, likewise its position (both its

size and its time frame relative to financial needs) within the portfolio needs to be such as to manage its natural risks without detracting from the portfolio’s ability to meet financial needs over time.

Importantly, there is no reason to suggest that an income trust structure is a more efficient vehicle for generating total return over long periods of time for the individual investor. As such, there is every reason to believe that taking a higher level of income now will impact on longer term return in the future. In the world of total return you have a choice, but you need to be aware of the choice.

If income trusts are to be used, their long term risk/return profile, as part of a portfolio constructed to meet financial needs over time, needs to be effectively modelled. This means conservative modelling of risk and return, not the assumptions used by the conversion prospectuses to garner capital.

TAMRIS’s main concern over income trusts is not whether they are better vehicles than ordinary shares etc etc, but the impact they can have on the private investor’s financial security. Proper structure (valuation and allocation), planning and management and conservative modelling of their long term risk/return profile is key.

As S&P stated in 2003, the average risk profile of these investments is below that of high yield bonds. High yield bonds can be safely included within a portfolio, but not at levels that many investors currently have income trusts in their portfolios. A Toronto Star article by Ellen Roseman of 5 October “Investors Praise of Income Trusts” which raised the plight of the ordinary investor made for horrific reading and spurred the production of this document.

Ethics

Traditionally companies have changed their capital structures through mergers or takeovers. Such a transaction was always predicated on the basis that the company taking over could realize more value than the existing management.

Both sets of shareholders had the opportunity to benefit and both sets of shareholders were represented by their own directors. Within an income trust conversion the directors of the company that convert are also the trustees of the income trust.

TAMRIS therefore believes that income trusts pose considerable ethical issues relating to the conflicts of interest inherent in the transaction. The directors who have an obligation to their shareholders are often the same individuals (trustees) who have an obligation to their unit holders. How the two roles can realistically tally, given that the two sets of investors receive two different sets of returns, pay different prices and accept, by virtue of this, different levels of risk, is questionable.

Add in the underwriters and the legal fees and, it is all too easy to conclude that the new income trust investor is being short changed and that conversion is a neat way of enhancing return first and foremost to existing holders. How can the industry make sure that the unit holder is effectively represented?

Expertise needed to manage income trusts?

Income trusts are complex equity vehicles and require an understanding of the specific risks and structures of the vehicles. Is the individual investor well placed to understand these risks? No. Is the average advisor well placed to understand these investments? No. They need specialist knowledge to manage the special risks associated with them. They are not plain vanilla stocks with higher yields and similar growth profiles.

A paper by Paul Halpern and Oyvind Norli titled “Income Trusts: Old Wine in New Bottles” and, sponsored by MFC Global Finance, stated the following.

“We believe it is necessary to engage a manager with specific knowledge in income trusts to manage an income trust portfolio....there are unique factors that require specific information and

understanding...While due diligence is important in any investment it takes on increased importance in the income trust market. For income trusts, stability and (to a lesser extent) growth of distributions are crucial. Since distributions are a large part of distributable cash flow, there is little room for management error or large fluctuations in cash flow. ... Another factor is the level of disclosure for an income trust.....Problems include lack of disclosure of compensation¹ apart from aggregate levels and, in some situations, of trading in public units."

A good example of the type of inappropriate analysis of the risk of income trust investments can be found in the Benefits Canada website in a September 2003 issue dealing with income trusts. In this analysis conducted by an Aon Canada consultant it was stated that a good way to value an income trust was to compare the yield on the trust to the yield on a longer dated corporate bond of similar quality.

<http://www.benefitscanada.com/content/legacy/Content/2003/09-03/income.pdf>

Income trust review

There is clear concern for the financial health of the private investor who has bought income trusts based on the current tax regime. While TAMRIS does not support the current tax treatment regime, since a wholesale move towards an income trust structure would cause significant structural damage to the Canadian economy (TAMRIS supports a lower overall tax regime and more efficient government), it does feel that by repealing the tax benefits of these investments retroactively, that the smaller investor would be hit hard and unfairly so.

It seems wrong that the financial services' industry and its legions of advisors have troughed on the conversions, it seems wrong that prior shareholders have gained, it seems wrong that the new private investors in these investments should be disadvantaged.

If legislation is retroactive, income trust valuations will fall heavily and the restructuring costs will not be insignificant.

Other material problems

The industry is unable to manage the needs of the majority of individual investors and to offer cost effective portfolio management services that manage long term capital depletion and the risks of capital depletion.

The costs of many investments and their management services are far too high for the current yield/return environment.

Personal income tax rates in Canada are too high and many of the more productive nations around the world have much lower tax rates. Combine high taxes, high wealth management charges and poor financial management and, no wonder the individual investor is buying income trusts to the extent they have.

¹ Relates to external management contracts.

Conclusion

Should investors be jumping on the income trust bandwagon?

- Not if there are ordinary shares available that provide better long term value, easier and more understandable share structures and better business models.
- Not if it means displacing low risk investments that would otherwise be needed to provide income and capital security in the event of significant stock market and economic risk.
- Not if the capital depletion can be more effectively and easily managed without their inclusion.
- Possibly, if they offer value, have been properly valued by a professional and have been carefully selected to meet the risk profile demanded by an individual's risk preferences and financial needs and, their impact along with the impact of all other investments within a portfolio have been modelled to assess the ability of structure to meet financial needs and cope with market and economic risks.. But what of the risks of the current review and any change to the taxation of corporations that may affect the relative valuation between the two structures? These need to be factored in.

No one should ever jump on any bandwagon. If a bandwagon exists at all, it is a bad sign.

All investment decisions should be made with full knowledge of the structure of an investment, of the risks of an investment, of the valuation of an investment and of the effect of the inclusion of that investment within a portfolio and, on its ability to add value to the ability to manage both risk and return and long term financial security.

As stated, the TAMRIS Consultancy is concerned over the potential consequences of inappropriate use of income trusts in individual investor portfolios, the conflicts of interests in the whole conversion process and the lack of balanced and true disclosure of the risks, the costs and the benefits of income trust securities.

TAMRIS is an **Asset Management Research & Investment Rights** consultancy dedicated.... *"towards improving the structure and quality of wealth and asset management for the private investor, to creating a competitive financial services market place, to educating those in positions of responsibility about the reality of and the need for the integration of the management of assets and the management of financial needs and, to rid the industry of endemic and institutionalised financial abuse."*