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Goodale tosses wet blanket on income trusts

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Dollars and Sense/David Christianson

INCOME trusts have generally been the darling of the Canadian investment markets for the last few years. The two big attractions are the regular distributions of cash that these trusts pay out and the rising values.

Every year, a higher percentage of the Canadian population is retired and looking for high, regular income from their investments.

Several factors have contributed to the high rate of return and fairly steady price increases of trusts. One is just the fact that the prices HAVE gone up -- Canadians love to invest in something that has recently gone up in value, and that increase has been sustained for years now in the case of income trusts.

Since a significant portion of income trusts own oil and gas properties, obviously the steady rise in the price of oil toward record prices has increased the profits, distributable cash and, therefore, the underlying unit price of these trusts. That helps raise the average return figures.

Another factor is the accelerating enthusiasm of corporations to convert to trusts, to raise their value because conversion means avoiding the payment of corporate income taxes. Instead, the tax liability is passed on to the individual unitholders.

Last week, though, the federal finance minister threw a huge wet blanket on this celebration.

Ralph Goodale announced that the federal government would no longer be issuing advance tax rulings on proposed income trust conversions.

Up until that point, companies planning on such a conversion would usually provide their plan to Ottawa and receive a (non-binding) ruling that their plans fit within the current rules.

I think the minister's announcement bordered on irresponsible, coming as it did two weeks after the government announced consultations with "stakeholders" on tax issues related to trusts between now and Dec. 31, 2005.

Making the two announcements at the same time would have made sense. Making this one two weeks later sent mixed messages and the chill of uncertainty through the market.

The immediate effect on income trust prices was significant, with some trusts dropping well over five per cent.

Bigger hits came from companies that were either in the process of converting or whose stock price had appreciated on the speculation that they might convert. These companies included CanWest Global (down four per cent) and especially CI Fund Management Inc. (down 11 per cent initially).

Existing trusts generally suffered less, but it sure takes the shine off Sept. 30 performance reports.

It appears to me that the average trust is down five to seven per cent since the announcement. Some managed funds of trusts are down less. The Bissett Income Fund (F-class), for example, is down less than two per cent in the last month, and is still up 9.5 per cent on the year so far.

To keep this in context, the fund's 12-month return to Aug. 31 was over 28 per cent, according to Globefund.com. This is just under the returns for a representative sample of trusts, the Globe Canadian Income Trusts Peer Index.

I guess the real question you're asking is, "Are trusts a good investment going forward?"

On the positive side, you can buy trusts today with a higher yield and cash distribution than you could two weeks ago. If your goal is to receive the maximum spendable income from your investment dollars, this is good news.

If you were buying trusts on the speculation of higher share prices, then you were always buying your trusts for mostly the wrong reason. The current state of uncertainty will certainly put a damper on these appreciation prospects and the purchase of trusts for pure speculation.

A recent report by Scotia Capital suggested that unitholders of oil and gas royalty trusts were projected to receive about $4.4 billion in distributions this year.

However, with the recent run up in oil prices, there could be an extra $2.5 billion of cash in these trusts, if oil remains at $60 (US) a barrel in 2006.

This list actually excludes a number of large trusts, including Canadian Oil Sands Trust, so the real total is higher. I'm not sure the unit prices really reflect these prospects, though they are obviously a lot higher than a year ago.

Trusts must be treated as individual investments and selected every bit as carefully as the purchase of shares of a corporation. If the trust operates a mature, stable business, then it can fulfil its desired purpose of providing steady, predictable cash flow.

If instead it is a trust that may have converted inappropriately from a corporation (one that was growing quickly in a very cyclical or speculative area), then it will be a risky trust investment, just as it would have been a risky stock to buy.

My advice is to pick carefully, and select what's appropriate for your situation. Don't buy a trust that is paying out more than it's making. If yield -- spendable income -- is your goal, then pick trusts with a low payout ratio, a stable business and low probability of surprises.

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