GUEST COLUMN

Where to find credibility in income trusts

LOOK IN THE INDEX

Gaelen Morphet

INCOME TRUSTS HAVE FINALLY come of age. Standard & Poor's, the company that provides benchmarks for stock exchanges around the world, announced in January that it would be adding income trusts to the S&P/TSX Composite Index by the middle of this year.

S&P will continue to provide a parallel index that excludes income trusts. However, the index holding income trusts will be considered the broad, or "flagship," benchmark for the Toronto Stock Exchange. I believe that over time, the broader index will become the accepted index, and the one without income trusts will become antiquated.

Over the years, there have been a number of concerns about the income trust market. In my view the inclusion in the flagship index endorses income trusts as legitimate investment alternatives, and investors can feel less skeptical about their value as solid investment choices.

Inclusion of income trusts in the index recognizes these securities as part of the investable universe and gives Canadian investors more companies to invest in. The result is that the S&P/TSX Composite Index will grow to perhaps as many as 300 components from its current 220, in what was a previously shrinking universe. We see income trusts as a whole universe of overlooked, under-followed companies.

Including income trusts in the broader index will mean a significant increase in demand, as larger institutional portfolios, which use the S&P/TSX Composite as a benchmark, adjust their holdings to include the newly added components. However, more demand than supply usually leads to an overvaluation. And we believe it is important not to lose sight of valuation. If some of the income trusts we own become overvalued as a result, we will sell them and look for better value.

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In any case, it is now very clear where income trusts belong in a portfolio. We consider them to be equities, and high-yielding equities at that. They are indirect investments in an underlying business, but possess the risk characteristics of the equity market.

The benefit income trusts have over equities is that they are higher-yielding vehicles. Like a bond, an income trust offers investors an income stream, or yield. Unlike a bond, which is debt rather than equity, an income trust unit does not pay a guaranteed return, and there is no guarantee of principal. If the underlying company stumbles, cash distributions and unit price can fluctuate, signifying a certain degree of risk.

Higher yields don't always imply more risk. Investors should be cautious here. In recent years, investors have put a premium on trusts with growth characteristics. The yield on many of these high-growth trusts is much lower. Companies ideal for the trust structure are stable companies with more modest growth. Higher growth expectations mean higher risk, and therefore the yields should be higher, not lower.

We use the same process for choosing income trusts as we do for other equities. We look for the same things we would look for in stocks: a limited downside for valuations and a strong financial condition. We do the same due diligence and want to have the same confidence in the balance sheet, corporate governance issues, and management that we would have for any company. Actually, the management track record is even more important for an income trust than for a regular stock. We need to feel confident that management will maintain the stability of distribution, because that is the assumption that income trusts trade on.

The primary purpose of an income trust is to distribute cash from an underlying business directly to unitholders in a tax-efficient manner. The tax-deferred aspect of that yield makes them more attractive than a fixed-income vehicle, like a bond or debenture, where the yield is entirely interest income and therefore taxable to individuals at their top marginal rate.

FOCUS ON STABILITY

As an income trust manager, I am more focused the stability of the distribution than on its growth.

We currently hold a number of income trusts that meet our rigorous standards of quality and stability of distribution. These include **RioCan REIT** (TSX: REI.UN; recent $18.77; recommended by Gordon Pape*), **Labrador Iron Ore Royalty Income Fund** (TSX: LIF.UN; $27.711), and **North West Company Fund** (TSX: NWF.UN; recent $30.75). All are all high-quality income trusts that have solid underlying businesses. They are well managed with steady distributions and low debt levels. Their profiles and characteristics suit us as value managers. However, if their valuations were to become excessive, as I mentioned, the valuation would supersede the other characteristics that we find important, and we would not hesitate to replace them.

** See details in box on Page 8.*

One argument often made against them is that income trusts perform well only in a low-interest rate environment. It is hard to know, because the income trust universe has really only expanded in the past few years, during which interest rates have been relatively low in Canada.

However, we believe that the addition of income trusts to the S&P/TSX Composite Index means that the trusts will take on the characteristics of the underlying business, much like common stocks do. Both institutional and retail investors will begin to be more selective in security choices, using greater discrimination, choosing trusts based on their individual merits. We believe that this will lead to a healthier, more competitive market.

We also think that another consequence will be that income trusts will be less subject to the influence of interest rate variability.

For example, real estate income trusts (REITs) are much more responsive to interest rate fluctuations than other sectors. Energy trusts, on the other hand, are driven more by changes in world oil prices. And business trusts all have their own underlying fundamentals that have a critical influence on the business — the price of a certain commodity, for instance, like lumber or copper.

Just as we differentiate between the different areas of the stock market, so too we have quite different valuation parameters for each area of the income trust market: REITs, energy roy-

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alty trusts, power trusts, and business trusts. The oil-and-gas royalty trusts tend to trade at higher yields because they have to replace declining production through exploration, development, and acquisitions, which involves taking on more risk. There are a number of different types of REITs, but all are influenced by expected real estate prices, vacancy rates, and interest rates.

While it is important to know what drives the underlying businesses when you assess each type of trust, history may not be the best measure for evaluating trusts. Many trusts don't have a long history, so it takes more due diligence to evaluate their merits.

Davis + Henderson Income Fund (TSX: DHF.UN; recent $22.13; recommended by Gordon Pape*), **Bell Nordiq Income Fund** (TSX: BNQ.UN; recent $16.34), and **Yellow Pages Income Fund** (TSX: YLO; recent $13.80; see David West's article on Page 4) are all relatively new trusts, but the underlying businesses have proven track records. I believe that their viability is sustainable, regardless of interest rates and other variable economic issues.

I believe that investors who look at the Yellow Pages Income Fund, for instance, will be really surprised by how solid and dependable the fundamentals of the business are. They will then be more open-minded and willing to look at other income trusts beyond Yellow Pages. That way, if the more liquid large-cap income trusts eventually become overvalued, investors will become more comfortable about considering smaller-cap issues.

Oil and gas royalty trusts, REITs, power trusts, consumer trusts, and industrial trusts all have different risk-return characteristics. Knowing the nuances of the income trust market is important. It's vital to determine that a trust can continue to deliver stable, sustainable distributions. This is not always immediately apparent, because of trusts' complex structures.

Remember that one of the tenets of portfolio management is that judicious diversification can offset risk while enhancing return. As a consequence, I believe that most retail investors are better off buying income trusts in a fund of trusts than purchasing them individually.▼

** See details in box below.*

INVESTMENT UPDATE

♦ **RIOCAN REIT** (TSX: REI.UN; recent $18.77; originally recommended by Gordon Pape as Counsel REIT March '94/Second Report at $12.08*; last mentioned May '04/Second Report as a hold/buy below $14 May '04/Second Report). ☛ ***Current advice:*** Hold.

♦ **DAVIS + HENDERSON INCOME FUND** (TSX: DHF.UN; recent $22.13; originally recommended by Gordon Pape February '03/Second Report at $13.23*; last mentioned March '04/Second Report as a hold at $18.70). ☛ ***Current advice:*** Hold.

** Previous buy prices are calculated as the average of the daily closing prices for the week after* The MoneyLetter *was mailed.*

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