



Global Asset Management Inc.

# Market Insight



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## Calming The Income Trust Jitters

Uncertainty has dogged income trusts throughout the month of October. The September 19 federal government indication that it would change its tax rules has curtailed the appeal of the asset class for some.

There has been a decline in the income trust market over the month even though there has been no new bad news. In fact, since the government stopped issuing advance tax rulings on trust conversions, Standard & Poor's has reconfirmed its intention to continue its schedule of adding income trusts to the benchmark S&P/TSX Composite Index.

"We are pleased that the S&P decided to continue its program because it couldn't find a reasonable argument to change the timetable," says Gaelen Morphet, First Vice President of equities for TAL and manager of \$1.35 billion in income trusts. "It puts the government intervention into perspective."

Investors are wondering what to do amidst this uncertainty. Gaelen Morphet, who has been investing in income trusts for ten years, one of the longest income trust wealth management track records in Canada, warns against overreacting. One thing investors are worried about is that the government is considering an across-the-board tax on income trusts. "While that's a possibility, we think it is going to be some time before that decision is made," she says. "In the meantime the market is responding to the worst case scenario."

There has also been a decline in the overall equity market over the month, and income trusts are equity-linked vehicles. However, when you look at total returns over the period, including yields, in some cases income trusts are actually performing better than the overall market. This month the S&P initiated a provisional index that includes income trusts, and surprisingly the difference between the provisional index and the existing index is less than 1%.

TAL's income trust strategy is to invest in the more stable, value-oriented high-quality trusts with proven track records. This leads to a focus on more established oil and gas royalty trusts and REITs, and less exposure to the newer business trusts. Surprisingly, there have not been huge discrepancies between the good trusts and the bad trusts over the month. Originally the oil-based royalty trusts were holding up better but the decline has been indiscriminate. "Typically in a declining market, investors sell holdings with liquidity," Morphet says. "Then they wish they had all the highly-liquid ones back. We're holding on."

If income trusts do rebound, Morphet expects the higher-quality trusts to recover while the poorer quality ones will not. "My thought is that as yields become more attractive, with the average yield of income trusts at a 500 basis point spread over Government of Canada bonds, there is a pretty compelling case for income trusts," Morphet says. "When you re-examine the relative valuation of trusts compared to equities on this basis, they become more appealing. This will create an opportunity to go back into the sector until we have more clarity on the government's intentions."

Ever the conservative money manager, Morphet reminds investors that diversification is important and that income trusts, a specialty asset class, should only represent a portion of a client's assets.

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