

CALGARY HERALD

Rosen report shows trust dangers

Jay Bryan

Thursday, November 24, 2005

The debate over Ottawa's treatment of income trusts might be ending with what looked like a smart change in tax policy announced Wednesday.

For the past two months, investment firms that profit handsomely from packaging and selling the popular securities, which trade like stocks, have accused Finance Minister Ralph Goodale of attacking the financial security of retirees by re-examining taxation of the trusts.

What was Goodale's supposed sin?

He said in September that the special status of income trusts -- a kind of company whose units offer high cash payouts because they pay little or no tax -- should be reconsidered. This is supposedly why most trust units have fallen in value this autumn.

Whatever the truth of this assertion, and it always looked exaggerated, Goodale has ducked the controversy by acting indirectly.

Now it appears that while he won't tax trusts, he'll achieve a similar result by slashing taxes on dividends from regular public companies. That would have much the same impact by cutting the incentive for companies to turn themselves into trusts.

Many analysts believe that encouraging companies to pay dividends is good for the economy, because the discipline of sharing profits with investors makes managers work smarter and makes it harder for them to finance foolish empire-building.

A new report on business income trusts -- published just before Wednesday's tax announcement -- also suggests that an end to the income-trust fad would be a good thing.

It says a big part of this market, business income trusts, is headed for a price meltdown of 20 per cent "based on abuses in financial reporting, valuation and marketing by corporate insiders and professional advisors." Other income trusts also look overpriced, says the report.

The report from Accountability Research Corporation, headed by a well-known Toronto forensic accountant, **Al Rosen**, said investors have been systematically misled about the sustainability of the generous cash payouts they receive and also about the risks involved in business income trusts.

Energy and real-estate income trusts use similar murky accounting and are also quite likely to be headed for a fall, says the report. But they aren't targeted in detail because

they don't add the extra operating risk carried by business income trusts, said Blair Carey, an investment analyst with Accountability Research.

At least in the case of oil wells or office buildings, payouts are coming from a tangible asset.

The number of income trusts has exploded because investors are willing to pay much more for the very same company once it is converted to a trust.

Why? In Rosen's opinion, because they are deceived into thinking that the very generous cash payouts -- with the yield on a unit's price recently averaging 8.9 per cent among the 50 biggest business trusts -- are safe income, something like a bank's dividend, but twice the size.

But that's far from true. Rosen calculates that among the 50 largest business trusts, payouts exceeded recent net income by 58 per cent.

His conclusion: such payouts can't last, and once they drop to a sustainable level, unit prices will follow them down.

On top of this risk, he sees others. The average business trust is much smaller than the average blue-chip industrial or banking stock, and small-capitalization stocks are generally regarded as risky investments, inappropriate for the very retirees who have been such avid income-trust buyers.

Beyond this, income trust prices are highly sensitive to interest rates, which are widely viewed as headed up. If long-term bond yields rise by one per cent, the report calculates, income-trust prices will fall by 14 per cent as some investors rush to safer investments.

Parts of Rosen's critique aren't universally shared, although he is far from the only investment expert to see income trusts as a bubble that would have popped with Goodale's help or without it.

William Kovalchuk, president of Claret Asset Management, tends to agree that income trusts have been hyped by the investment world and that at least some of them are highly risky, but also sees some as fine investments. It all depends on the underlying financials, which a professional can usually figure out.

However, he agrees that securities regulators have policed income trusts even more ineffectively than most public companies. Given their terrible record with other companies, that's saying a lot.

"I don't know how a small investor is supposed to figure any of this out," he said.