COMMENT

When numbers speak volumes

Some refreshing candour on trusts from the pundits

AL ROSEN

Public comments regarding income trusts are finally starting to level out somewhat, with more pundits increasingly commenting on the financial-reporting and valuation weaknesses in the income-trust sector.

This is a refreshing change from the blind cheerleading that investors were inundated with until just a few months ago. We're even starting to see some admissions that more than a few poor-quality trusts made their way to market in the past few years.

Despite the more balanced media reports, there are still some trust cheerleaders willing to pull out all the stops. The income-trust pep squad is generally populated by the companies themselves, their underwriters, their lawyers and income-trust trade groups.

These people clearly have a vested interest in protecting the fees and windfalls they have generated from unwavering support of the trusts. However, some are clearly starting to hurt their credibility by describing any criticism of the trusts as "uninformed and irrational."

Thankfully, the Kool-Aid gang is being increasingly countered by the comments of value fund managers, investment advisors and, thankfully, a growing number of analysts. Some fund managers clearly dislike many of the trusts, referring to several of them as Ponzi schemes and a bastardization of the name "income trust."

You see, fund managers, unlike conflicted lawyers and lobbyists, understand that you may have a nice yarn factory or sodium chlorate plant, but if it's priced at four times its value, then you have an investment problem on your hands, as opposed to a business problem.

99 OUT OF 100 SALESMEN RUIN IT FOR THE REST OF THEM

My primary warning over the past three years regarding the income trusts has been that poor and incomparable financial reporting is being used to mask over-valuation in many cases. This doesn't mean that there are not high-quality trusts out there — it just means I'm surprised at how many weak offerings were brought to market. As a result of the obscured financial reporting, many trusts were priced to perfection, and bound to fall at the first operational hiccup.

So, which side is to be believed — the pep squad or the critics? In these cases, I tend to side with the people who are buying the product, rather than those who are blatantly trying to flog it. Institutional fund managers have a fiduciary duty to purchase sustainable investments.

However, this duty clearly does not extend to the people selling certain investments to some managers. You know what they say about salesmen: 99 out of 100 ruin it for the rest of them.

Thus, when there are clearly opposing views, it frequently helps to look at how the numbers stack up, in addition to examining the motives of those on each side.

Many investors still believe income trusts are more stable investments than common equities. In short, the numbers show this is merely a marketing myth. In a report to clients last November, we outlined how a greater percentage of business-trust IPOs were trading below their issue price, compared with common-equity IPOs.

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More than half the new issues are down rather than up

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Indeed, over half of the new business trust issues were down instead of up.

That's not exactly what one would expect from an investment class characterized as being populated by stable and mature businesses.

The only explanation is that the businesses might be mature and otherwise stable, except for the fact that their cash reserves have been drained in an effort to maximize the market price of their units.

When many were priced to perfection, they only had one direction left to go.

Unfortunately, many of the investors who piled into weak trust issues were income seekers, rather than capital risk takers. In short, they got the complete opposite of what they needed.

I want you to brace yourself and look at the chart adjoining this article. It's an ugly reminder of the worst that retail investors have been sold thus far.

It represents 20% of the business trust IPOs since the start of 2001, all with unit prices that have declined by more than 30%.

That's strange because I don't remember any of the income trust PR shills noting that investors had a one in five chance of losing 30% of their investment.

IN SHORT, RECOGNIZE THE RISKS AND TREAD CAREFULLY

On the other hand, I do remember a lot of remarks about low risk and stability.

The trusts in the chart alone have been responsible for blowing up more than $1.9-billion of investor capital.

So what's to keep cheering about?

Well, the underwriting fees, of course, which were $188-million on these offerings alone.

It's no wonder that value fund managers and many investment advisors have treated trusts with a withering eye of late.

There's a high chance of serious capital losses.

To find the good trusts — and there are good ones — investors need to tune out the PR noise and focus on financial statement fundamentals.

Distributable cash and payouts ratios can be easily manipulated, so the focus needs to be on pre-tax profitability.

If the profits are not there to justify the value of the units, then you could be looking at a very risky investment.

In short, recognize the substantial risks, and tread carefully.

Financial Post

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FALLEN TRUSTS

Business trusts down 30% or more since their IPOs ($ millions)

	Size of Offering ($)	Decline in Value($)	Decline in Value (%)
HEATING OIL PARTNERS	$135.0	-$135.0	-100%
SPECIALTY FOODS	$201.3	-$194.1	-96%
FMF CAPITAL	$197.5	-$182.7	-93%
ASSOCIATED BRANDS	$117.6	-$104.9	-89%
BOYD GROUP	$9.0	-$7.5	-83%
SPINRITE	$202.9	-$153.4	-76%
ADVANCED FIBER	$130.8	-$91.7	-70%
ART IN MOTION	$80.3	-$53.1	-66%
ENTERTAINMENT ONE	$141.4	-$88.5	-63%
CLEARWATER SEAFOODS	$232.9	-$138.8	-60%
ARRISCRAFT	$66.8	-$36.7	-55%
GENERAL DONLEE	$89.5	-$47.0	-53%
SFK PULP FUND	$444.4	-$226.6	-51%
MENU FOODS	$129.0	-$61.9	-48%
HOT HOUSE GROWERS	$66.0	-$31.0	-47%
CLEAN POWER	$212.0	-$93.5	-44%
CANWEL BUILDING	$43.5	-$19.0	-44%
GRANBY INDUSTRIES	$73.8	-$29.9	-41%
HARDWOODS DISTRIBUTION	$144.1	-$58.1	-40%
SUN GRO HORTICULTURE	$220.2	-$79.9	-36%
GIENOW WINDOWS & DOORS	$165.0	-$52.8	-32%
STEPHENSON'S RENTAL	$70.1	-$21.7	-31%
MADACY ENTERTAINMENT	$75.4	-$22.7	-30%
TOTAL	$3,248.6	-$1,930.7	[illegible]

SOURCE: ACCOUNTABILITY RESEARCH

NATIONAL POST