

IT'S TIME TO WISE UP

TAX OR NO TAX, MANY INCOME TRUSTS ARE A SUCKER'S BET

We can't accuse many income-trust promoters of being especially creative. Nor can we award high marks to individual investors for having learned their lessons. Promoters need only throw around bogus financial figures and promises of too-good-to-be-true returns, and investors bite every time. The situation is getting so predictable that we ought to stop using the word "investors" and start calling ourselves "donors."

While the recent walloping of income trusts has been a shock for many investors, the full pain has yet to be felt. Prior to the federal government's Oct. 31 bombshell, resident expert Jack Mintz estimated that the tax disparity between trusts and regular corporations resulted in a price premium of roughly 33% for trusts. Since the announcement, most trusts have dropped, but not nearly by a commensurate amount. We think the difference in several cases is due to bogus financial reporting and the collective problem investors have with facing reality.

With many income trusts, investors are now being fed excessive, unearned distributions that stretch the cash reserves of the underlying companies. In some cases, these distributions need to be financed from bank loans and sales of new units. The unsustainable distributions are not justified by the earnings power of the company, but rather by the unregulated "distributable cash" figures issued by the trusts.

While tax-free status was a tangible value for trusts, much of the premium in

the market relative to corporations also represented overvaluation caused by the lack of financial reporting rules for trusts. This problem persists and will certainly lead to more losses for investors. Last year, we noted that the overvaluation of trusts due to lax financial reporting (albeit unwarranted) resulted in more of a price premium than the tax advantage.

That overvaluation of trusts still exists in the market today, and seems to be growing due to the recent tax announcement. Apparently, some investors are downplaying the reality of the income tax changes and are simply shifting some of the erstwhile tax benefit into an even greater price premium attributable to fuzzy financial reporting.

Legitimately, a certain degree of tax savings will persist for the grandfathered trusts until 2011. Given the short perspective with which many analysts value companies, perhaps they're concluding that the eventual elimination of the tax advantage doesn't have a large impact on current value. This wouldn't be a surprise because the whole mess was created in the first place by myopic analysts who ignored the longer-term capital investment needs of the trusts.

It's up to you if you want to go along for the ride this time.

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