

COMMENT

Inaccurate information readily found

Regulators lax in preventing brokers' hype

AL ROSEN

A large Canadian brokerage recently issued a very schizophrenic "summer strategy" piece that focused on income trusts. It started with self-congratulatory backslapping, ostensibly for some previous predictions that private-equity firms would start purchasing income trusts because they had fallen in price. It then said it would be hard for investors to replace these trusts in their portfolios because the federal government had stopped the creation of new trusts.

Following the broker's train of thought, investors are receiving attractive takeover premiums for their income trusts, but that's somehow bad because there won't be a continuous supply of new trusts for investors to buy and then flip to private-equity interests.

The argument is strange not because it assumes that private equity wouldn't just snap up potential trusts before they go public, but rather because the broker blames the government's decision as the reason private equity is interested in trusts in the first place.

One of the main attractions of trusts was supposedly to take the cash in hand, rather than leave it on the table for management to squander. One would think the same idea would hold true when someone comes around to buy the entire company. It sure beats waiting around for the distribution to be cut.

The report says retirees will have trouble replacing the trusts because similar levels of cash

distributions are not available elsewhere (apparently nobody ever retired before income trusts gained popularity five years ago).

The clear distinction that wasn't made is that sustainable cash flows are necessary for retirement. High cash flows that only last a few years and then evaporate are not what retirees need.

The report then directly compares so-called cash "yields" on income trusts to traditional income-based yields received on bonds and common stocks. It's not clear why reverse mortgages and other borrowing schemes were left off the broker's list of alternative sources of short-term cash for retirees, since they offer the same principal deterioration

THE OSC SITE NEVER BOTHERS TO RECTIFY AN OBVIOUS MISTAKE

characteristics as many income trusts.

Roughly \$16.1-billion of income trust underwritings since 2002 have a negative capital return, meaning any cash distributions that were made have been completely wiped out (and then some) by losses in principal value.

The report was squarely aimed at retirees:

"An ever-increasing aging Canadian population will find it increasingly more difficult to generate a sustainable monthly cash flow stream from the Canadian capital markets to fund their golden years," so goes the report.

As mentioned a few months back in this column, quoting a "yield" figure that contains a return of capital is highly misleading for investors. Receiving \$100 in earned income on

a \$1,000 investment cannot be compared with getting \$100 of your original investment returned to you.

At the time, the Canadian Securities Administrators had recently issued recommendations allowing companies to continue to refer to distributions that include a return of capital as yield. By stark contrast, U.S. regulators long ago sent a message in the Prudential-Bache Securities deferred prosecution agreement that such misrepresentations were clearly not acceptable.

Given the lack of leadership exhibited by the Canadian Securities Administrators, it's no wonder that certain brokers pay little attention to differentiating between a return on capital and a return of capital.

The situation has deteriorated to the point where magazines will publish top-1000 lists that erroneously label cash distributions from trusts as "dividends" and then refer to the partial returns of capital as "yields."

Our securities administrators not only allow such misdirection when it comes to income trusts, they seem to actively promote the most common fallacies. Here's a gem from the Web site of the Investor Education Fund (funded by the Ontario Securities Commission): "Income trusts are like bonds and other investments that pay a set amount of income."

While the OSC-sponsored Web site goes on to correct its first error and note that distributions may stop at any time, it never bothers to rectify the most damaging mistake, which is that the distributions are frequently not income, but merely a return of investor's capital.

Thus, in the worst twist of all, it seems like some of the fines the OSC occasionally collects and earmarks for "investor education" really just end up facilitating future investor deceptions.

It's unfortunate that such a basic concept as separating earned income from owners' capital can be so deliberately twisted in order to mislead investors, and that our securities regulators can't be bothered to step in and make such an easy fix.

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■ Al Rosen is a forensic accountant at Accountability Research Corporation, an independent equity research firm.

alrosen

@accountabilityresearch.com