

The BWMG Long View

INCOME TRUSTS—WHY CONSIDER?



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Why Invest?

Income trusts, in our view, are not a separate asset class but a different form of equity interest in a Canadian business entity, i.e. a unitized trust instead of a corporation. They have become very popular because of some interesting attributes, such as:

- Low correlation with Canadian stocks and bonds;
- Tax-efficient historical return of 11.5% (vs. 0.6% for the S&P/TSX composite index for the 5¼ years to March 2003);
- Much higher yield than Canadian stocks (9.7% over that same period);
- Income trust “index” now includes eight sectors (including oil and gas, pipelines, real estate, cold storage, electrical power, coal, iron ore, forestry), so it is becoming easier to be better diversified by industry sector.

How to invest?

Since we view the income trust sector as a subset of the Canadian equity market, any exposure should be integrated into a comprehensive investment plan. Also, there is a shortage of quality money managers with a track record of suitable length (we have a few in our data base). Index Funds are another alternative that have recently been made available. Funds that combine income trusts with other securities can be useful hybrids to achieve a specific investment goal, such as a “high yield” mandate. We expect mainline money managers will increasingly use Income Trusts in their model Canadian equity portfolios as the risks evolve.

What are the risks?

Since trusts are equities the investor has all the normal equity risks, hence security selection and diversification remain critical, but there are several unique risks, including:

- Interest rate risk, since many are sensitive to rising rates;
- The liability of a unit holder to exposure within the trust, since the “corporate veil” is not there to protect the investor (this theoretical risk will reduce if provinces legislate!);
- CCRA risk that the tax treatment may be changed to reduce the tax advantages as pressure increases in Ottawa to capture the foregone tax revenue;
- General tax risk that a reduction of tax rates on Canadian dividends may make stocks more attractive, reducing the appeal of trusts;
- Liquidity may be an issue, since trusts are still not admitted to membership in the S&P/TSX, although the number/capitalization size has dramatically increased.

The biggest risk may be the sustainability of the cash distributions, particularly the “return of capital” portion, if the underlying operating business assets and the associated tax deductions are depleted.

Tax efficiency of income trusts?

Income trusts are more “efficient” yield producers than bonds because some of the distribution may be capital gains (only 50% is taxed), or even dividends. However, the major advantage over bonds or stocks is that a portion of the distribution may be a tax-free “return of capital”. However, the cost base is reduced, which increases the taxable capital gain on sale of the unit. They are also Canadian content for purposes of Registered Plans, but why use them that way? Interest should be deductible on amounts borrowed to invest in income trusts except for the pro-rata portion relating to any “return of capital”.

All-in-all, quite useful alternative investments for a taxable investor, but the tax accounting will be quite challenging!

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Toronto, October 2003