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Helping you make informed investment decisions for your future

IS THERE *an income trust bubble?*

With a seven-year annualized return of over 18%, you may be tempted to overweight your portfolio with income trusts. However, history reminds us that such strong performance can trap investors into chasing the hottest performing trend, only to see their investments suffer when the bubble bursts.

If this scenario has a tinge of déjà vu to it, investors just need to recall the heady days of 2000, when high flying tech stocks were grounded by the reality of their earnings sustainability, company fundamentals, and overvaluation. Fast forward to 2005 and similar concerns are starting to crop up with regard to the hot income trust sector: Are the current income distributions sustainable? What happens when interest rates rise? Is the sector overvalued? How can investors identify quality income trusts?

Whether or not there is an income trust bubble on the horizon, having a strong understanding of the sector will allow you to make informed investment decisions and help you select an income generating product that is right for your portfolio. This edition of *Russell Investor* examines the current issues you need to consider when investing in income trusts.

ARE CURRENT INCOME TRUST DISTRIBUTIONS SUSTAINABLE?

In addition to their current market returns, the popularity of income trusts stems from investors' growing demand for tax-efficient investment income that can exceed what's available from bonds and Guaranteed Investment Certificates (GICs). However, while income trusts are often perceived to be like high-yielding bonds, the distributions paid out are not as secure. Therefore, one of the greatest risks to investing in income trusts is the reliability of continuing cash distributions.

It's important to remember that an income trust is tied to an underlying business, and in some cases, a business that is not growing. If the business climate in which an income trust operates slows down, the profits of the income trust will likely be negatively impacted, meaning that there will be less cash to distribute to investors. In such an event, the income trust often has to cut its distribution. This, in turn, commonly has a negative impact on the income trust's market price. Essentially, you run the risk of receiving less income going forward, and seeing the value of your investment fall. Many income trusts have experienced unit price erosion over the past year as a result of unsustainable distributions.

Income trust distributions may also be negatively impacted by rising interest rates. As rates rise, a company's debt payments rise, along with the cost of doing business. With higher costs digging into earnings, the company may need to reduce payouts to compensate for interest rate hikes. In addition, interest returns on bonds correspondingly increase with rate hikes. This may hurt income trust prices as bond yields rise relative to income trusts, but come with less risk.

A significant cut in cash distributions could be a great concern to investors who rely on their investment revenue to cover fixed living expenses. To avoid such a situation, investors interested in an income trust should carefully analyze the underlying business and scrutinize the cashflow projections of management to determine whether the distribution amounts are sustainable.

Both the Dominion & Bond Rating Service (DBRS) and Standard & Poor's (S&P) provide an impartial income trust stability rating that analyzes the stability and sustainability of distributable income. Rating categories for DBRS range from STA-1 to STA-7, with STA-1 being the highest level of stability and STA-7 being the lowest. The service's results for August 2005 show that stable distributions for income trusts are on the decline. Of the 65 income trusts rated on the DBRS Income Fund Index, only three were given a STA-1 rating (the highest level of stability and sustainability of distributions per unit). On the other hand, 14 income trusts were listed as STA-5 (weak distributions per unit stability and sustainability). Six income trusts had a STA-6 rating, which is the second lowest rating for distributions per unit stability and sustainability. Over 30% of income trusts on the index had below average distribution sustainability ratings (STA-5 and lower), further highlighting the importance of understanding the risk involved when investing in income trusts.

ARE INCOME TRUSTS OVERVALUED?

The fact that income trusts gained 24.8% (2004) and 38.3% (2003) over the past two years only adds to the reasons why investors should proceed with caution in this sector. A glance at the S&P/TSX Capped Income Trust Index's price/earnings ratio (P/E ratio) of 21.12 indicates that over-enthusiastic investors might be too willing to overpay in their effort to participate in the income trust rally. The broad market, as represented by the S&P/TSX Capped Composite Index, is not much cheaper, with a P/E ratio of 19.21. Granted, even if P/E ratios indicate that income trusts appear to be overvalued, continuing investor demand for income trusts, increased institutional investment, and current distribution levels may help some investors justify the high valuations that income trusts currently enjoy.

In addition to a relatively high P/E ratio, the fact that the yields of most income trusts are almost twice as high as earnings is a cause for concern. The S&P/TSX Capped Income Trust Index, which represents over 60 income trusts, has an earnings yield (+ 4.7%) that is lower than its current dividend yield of + 7.4%. This discrepancy once again raises the issue of distribution sustainability (Figure 1). However, there's the possibility that

earnings may rise to support the distributions, without any new capital spending. For example, an energy trust could discover a new oil site, a REIT could raise rent rates, or companies could take cost cutting measures to increase earnings.

Also, an income trust's distribution sustainability is not only determined by earnings; other factors such as pay-out ratios should be considered. The pay-out ratio is the income trust's actual distributions divided by the distributable cash (a company's net income, plus non-cash charges, less sustaining capital expenditures and debt amortization). While income trust distributions are currently higher than earnings, they are generally less than distributable cash. Keep in mind, however, that the Ontario Securities Commission considers distributable cash to be a non-GAAP (Generally Accepted Accounting Principles) financial measure, meaning distributable cash can be self-defined to some extent and can therefore be a more subjective figure.

1 **HOW LONG CAN THESE DISTRIBUTION LEVELS LAST?**

INDEX (AS OF AUGUST 12, 2005)	P/E RATIO	EARNINGS YIELD	DIVIDEND YIELD (DISTRIBUTION)
S&P/TSX CAPPED COMPOSITE INDEX	19.21	5.2%	1.6%
S&P/TSX CAPPED INCOME TRUST INDEX	21.12	4.7%	7.4%

SOURCE: TSX GROUP

HAS QUANTITY REPLACED QUALITY?

As of December 31, 2004 the income trust market in Canada consisted of 175 funds with a total market value of $121.2 billion.

While some businesses restructure into income trusts for sound economic reasons, other businesses, which the income trust structure may not ideally fit, have infused the market with new issues that may be lacking in quality and sustainability. Aside from the traditional oil & gas trusts and real estate investment trusts, investors now have to wade through an array of new income trusts representing anything from restaurant chains to waste management companies.

The current environment in the income trust sector uncannily mirrors the actions of firms that transformed themselves into dot-com companies (without developing an Internet-based business) during the technology stock rally of the 1990s. During the tech bubble, only a minority of businesses leveraging on the dot-com boom benefited from the Internet in the long run. These were companies whose operations were well positioned to enable practical integration of technology into their businesses.

The same is potentially true with respect to income trusts. Some businesses may be better off, given the nature of their operations, structured as corporations rather than as income trusts. Some of the new income trusts fall into this category and may be basing their distributions on overly optimistic scenarios. With an assortment of reduced distributions in 2005, there should be concerns about the suitability of the income trusts that have flooded into the stock market over the past several months.

TRUST YOUR ADVISOR

Due to the growing number of income trusts on the market, investors must look more closely than ever at the business model of income trusts before committing their money. Your Investment Advisor can help guide you through the growing complexity of the income trust market. Working with your Advisor can also help address your income needs at the total portfolio level, by offering effective income alternatives that can complement and diversify your income trust holdings.

PROTECTING YOUR *income with diversification*

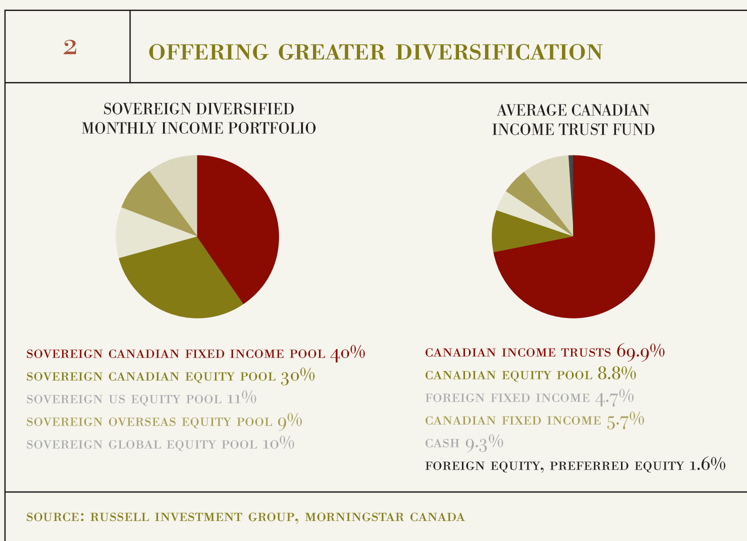
Income trusts may have a part in your investment portfolio, but depending too heavily on them may leave you vulnerable to unnecessary volatility and added risk. One way to lessen your risk is to balance your portfolio with other income-producing investments.

The Sovereign Diversified Monthly Income Portfolio (SDMIP) is an effective alternative for investors looking for tax-efficient distributions and offers a complement to individual income trusts or income trust funds. The SDMIP can also effectively transition profits made from income trusts and scaling down over-exposure to an appropriate asset allocation.

Though many investors have been enticed by the attractive yields income trusts have been able to

offer, this should not interfere with your basic asset allocation strategy. The SDMIP's income is generated through exposure to a diversified portfolio of Canadian equities (30%), Canadian fixed-income securities (40%), US equities (11%), overseas equities (9%), and global equities (10%). Its wide range of assets gives investors diversified exposure to more areas of the capital markets than the average Canadian income trust. When assets in a portfolio have a low correlation with each other and do not move in tandem, overall returns tend to be smoother and volatility is reduced.

The SDMIP's diversification has been further enhanced with the recent addition of the Sovereign Global Equity Pool, which helps investors expand their international exposure. Diversifying into global equities provides exposure to different business cycles across countries and industries. Global equity investing may not only reduce the potential for portfolio volatility, it also opens new opportunities for adding value and enhancing portfolio returns. In comparison, the average Canadian income trust fund has less than 2% invested in foreign equities and over 9% in cash holdings (Figure 2). Fully invested portfolios, such as the SDMIP, have a greater opportunity to capitalize on market rallies.



In regards to income stability, the SDMIP provides reliable monthly distributions currently set at 7%. (The distribution is comprised of both income and return of capital and is set for the year between 5% and 9%.) Mainly due to its exposure to equities, the SDMIP has the potential for capital gains, similar to stocks and income trusts. At the same time, the portfolio's mix of equities and bonds provides after-tax returns that potentially offer higher income than traditional fixed-income assets like GICs or a portfolio comprised of Canadian bonds.

IN SUMMARY

While income trusts may offer many advantages, investors musn't get lulled into complacency by the high returns and yields witnessed in the past few years. In particular, investors must be aware of the growing number of income trusts on the market that have low rankings when it comes to quality and distribution sustainability.

At some point the market may align the risk/return levels of the income trust group to that of other sectors. The key is to protect yourself by using income trusts in moderation and diversifying your portfolio with income alternatives such as the Sovereign Diversified Monthly Income Portfolio, which is an effective solution for investors seeking consistent cashflow.

COMMISSIONS, TRAILING COMMISSIONS, MANAGEMENT FEES AND EXPENSES ALL MAY BE ASSOCIATED WITH MUTUAL FUND INVESTMENTS. PLEASE READ THE PROSPECTUS OF THE MUTUAL FUNDS BEFORE INVESTING. MUTUAL FUNDS ARE NOT GUARANTEED, THEIR VALUES CHANGE FREQUENTLY AND PAST PERFORMANCE MAY NOT BE REPEATED.

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