Income Trust Snapshot

ScotiaMcLeod views income trusts as tax-efficient equity investments that offer higher cash-on-cash (yield) returns to unitholders than the average common stock. The main attraction of holding an income trust is the regular cash distribution payment that in many cases is treated favourably for tax purposes. The ability for a trust to pay out distributions on a sustainable basis is a function of the success of its underlying business (to generate operating cash flow) within a tax-efficient structure that provides for minimal corporate income tax payments. Suitable businesses for income trusts are normally more mature with low to moderate growth prospects that would be expected to offer regular distributions from excess cash generated by their operations. Income trusts are more similar to common stocks than fixed income securities as there are no guarantees surrounding the distributions or the principal, nor are there set maturity dates. There is a wide variety of underlying businesses that income trusts are based upon including power distribution facilities, real estate properties, pipelines, restaurants, advertising and resource-based operations. There are currently 139 operating business-based income trusts that trade on the S&P/TSX in Canada with a market capitalization of approximately $90 billion.

Investment Performance

The primary benefit of investing in income trusts is the ability to fulfill income objectives. The majority of investment returns tend to be generated by the distribution stream while total returns may be enhanced or hindered by capital appreciation or depreciation of unit prices. Over the past few years in an environment of declining interest rates and equity market volatility, there has been strong investor demand for investment income, which has led to higher income trust prices. Over this period, the income trust index has significantly out-paced the stock index on a total return basis. While investors do not typically associate market outperformance with non-growth enterprises, the focus on sustainable cash distributions does impose a rigid investment discipline on income trust managers, which attracts and supports increased investor interest in this type of enterprise.

Investment Risks

The greatest risk to investing in income trusts is that the distributions are not guaranteed. Should a distribution payment be reduced, an investor's income stream will be reduced and the market tends to respond negatively to these announcements, resulting in lower market prices. One measure of distribution stability is the payout ratio (cash distributions dividend by available distributable income). It should be noted that payout ratios in excess of 100% of available distributable income can be an indicator of the need to adjust the distribution level. Standard and Poor's and DBRS publish stability ratings that convey opinions about the relative stability of the cash distribution stream across various income trusts. Other major risks include unit price volatility, which can be driven by, among other factors, changes in supply and demand and investor preference, the relative illiquidity of certain issues, and changes in the price of the commodities underlying specific trusts (most relevant for trusts in the energy and resources sectors). The strength of the trust's business model and the suitability of the underlying business to the trust model, as well as corporate governance, are all areas of interest for investors. As with any equity investment, changes in the level of interest rates can have a significant effect on trust unit.

- Portfolio Advisory Group, ScotiaMcLeod

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