

Income Trust Strategy for 2007

On October 31, 2006, Federal Finance Minister Jim Flaherty dropped the bomb on the income trust sector by announcing a new tax on the distributions paid to unit holders. The proposed tax changes have resulted in a downturn in market valuations, which we believe to be reasonable and not overdone. In our view, this reaction represents the erosion of the premium valuations that previously existed in the market for income trusts (measured by earnings and cash flow multiples), primarily due to trusts' advantageous tax structure; in particular, for non-resident and Canadian tax exempt investors. Now that this advantage has disappeared, the market has begun to value income trusts as high yield equities, and as a result many are now trading at market multiples in-line with their peers in their respective market sectors.

During the fourth quarter of this year, the Scotia Capital Income Trust Index (SCITI) posted a negative return of -5.5%, significantly under performing the broader Canadian equity markets – the S&P/TSX Composite Index posted a return of 10.4%. The underperformance of the SCITI during the fourth quarter is due to the surprise taxation imposed on the income trust sector. Since the announcement date on the October 31, 2006, the SCITI gave back gains generated during the first month on the quarter and posted a loss of 8.4%.

Total Return Indices								
	SCITI Overall	S&P/TSX Composite	SC Universe Bond Index					
YTD:	-2.22%	17.26%	4.06%					
Q4 2006:	-5.49%	10.43%	0.90%					

Segment	Consumer	Energy	Industrial	Power	Real Estate	Resource	Utils & Infra	Business
YTD:	1.91%	-9.67%	-12.03%	4.72%	26.03%	12.63%	-6.62%	-9.09%
Q4 2006:	-7.56%	-6.71%	-7.96%	-3.15%	8.89%	-7.75%	-11.55%	-8.80%

Source: Scotia Capital, Bloomberg.

While the Utilities & Infrastructure income trust sector has been the worst performing sub-sector during the fourth quarter, the weakness in the SCITI was primarily driven by the Energy sector, which currently comprises approximately 41% of the market capitalization of the index. While the Oil and Gas Royalty trusts have somewhat rebounded from the initial sell-off, following the tax announcement this sub-sector was initially hurt the most. In mid November, the Scotia Capital Energy Trust Index was down approximately 23%, under performing all other income trust sub-indices. The relative underperformance by this group is in part attributable to volatility in energy prices and the uncertainties that existed in the market regarding growth restrictions. On a more positive note, the Real Estate sector has been on fire, posting a return of 26% for calendar year 2006, and 8.9% during the fourth quarter. Gains were supported by the flood of merger and acquisition activity and the flow of funds into REITs after the announcement of the Tax Fairness Plan (since REITs for the most part are exempt from the distribution tax).



Investment Strategy in Light of This New Environment

Under the proposed new tax regime, the after-tax returns to investors are identical for a high dividend-corporation and a distribution-paying trust; also on an after-tax basis. Canadian taxable investors are theoretically in the same position as before the proposed taxation. We also note that the underlying businesses of the income trusts have not changed, and we expect most trusts to continue with their current distribution policies.

We also expect to see many conversions to the corporate structure after 2010, as most trusts will more than likely take advantage of the four year tax holiday. The federal government has indicated that trusts will be allowed to convert to the corporate structure on a tax-free basis. This is a positive for individual investors as the exchange of trust units for shares will not result in tax consequences. Ultimately, all Oil and Gas Royalty trusts will likely convert to a corporation after 2010, as the combined federal and provincial tax rate (Alberta) is lower than the 31.5% imposed tax rate on income trust distributions. Further, income trusts that conserve cash for reinvestment and growth will likely convert to a corporate structure after 2010, due to a punitive tax rate on retained cash within a trust structure under the new Tax Fairness Plan.

Overall, we recommend investors take a defensive stance towards investing in income trusts and focus on those trusts that exhibit sustainability. This means focusing on trusts that have strong business models, operate within sustainable distribution policies and have consistently operated within their distribution policy. Focus on income trusts that have conservative payout ratios (below 100%), and fund distributions and capital maintenance expenditures from cash flow from operations. Relatively speaking, these trusts are the least likely to cut distributions, and are more likely to be a takeover candidate. Further, in the current environment and under a broad portfolio context, we recommend investors to be underweight income trusts.

Your ScotiaMcLeod advisor can provide recommendations on which trusts meet these criteria and if these are appropriate for your investment portfolio.

Katie Tabesh, CA, Equity Advisor and Income Trust Specialist, ScotiaMcLeod Portfolio Advisory Group

This publication has been prepared by ScotiaMcLeod, a division of Scotia Capital Inc. (SCI), a member of CIPF. This publication is intended as a general source of information and should not be considered as personal investment, tax or pension advice. We are not tax advisors and we recommend that individuals consult with their professional tax advisor before taking any action based upon the information found in this publication. This publication and all the information, opinions and conclusions contained in it are protected by copyright. This report may not be reproduced in whole or in part, or referred to in any manner whatsoever, nor may the information, opinions, and conclusions contained in it be referred to without in each case the prior express consent of SCI. Scotiabank Group refers to The Bank of Nova Scotia and its domestic subsidiaries. TMTrademarks of The Bank of Nova Scotia.

