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The moral of the trusts fiasco

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My husband and I don't own income trusts. Our investment manager wouldn't let us. "Too risky," she would say. We used to be unhappy about this because it seemed like everyone but us was getting rich. Now we're happy, because it turns out she was right.

The chickens have come home to roost for a lot of dumb clucks (a.k.a. retail investors). They've been thoroughly plucked, and are they ever mad. But who should they be mad at? Not the Harper government, which did what any government would do. Instead, they should be mad at the investment industry, for selling them a bill of goods. They should be mad at the securities commissions for turning a blind eye. And they should be mad at themselves, for forgetting the basic rule of Investing 101: *Caveat emptor.* If something looks too good to be true, then it probably is.

Every few years, some new financial craze takes small investors for a ride. Last time, it was tech stocks. They were wildly speculative, and everybody knew it. But income trusts were different. They were marketed as safe, conservative products, something akin to a GIC. And the biggest target market was seniors -- a group with little financial sophistication and a very low capacity for risk. The pitch was that income trusts paid out nearly twice as much as bonds, but were almost as safe. For many seniors whose fixed incomes have been depressed by low interest rates, the pitch was irresistible.

In fact, many income trusts are highly risky, which makes them totally unsuitable for seniors. "Where was the investor protection?" demands Diane Urquhart, a top financial analyst. She's been warning of the perils of income trusts for quite some time. But nobody listened. There was too much money to be made. As the income-trust craze snowballed, investment bankers, financial advisers, and other middlemen raked in hundreds of millions. Billions more flowed into the pockets of company executives, who gorged on bonuses and stock options and windfall profits as their companies miraculously soared in value after being converted to income trusts.

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Meantime, small investors got greedy. They figured that if a little bit of income trusts was good, a lot was even better. They forgot the other rule of Investing 101: Diversify. It's these people who are the maddest, because they lost, proportionately, the most. But the parties they should be maddest at are themselves.

The dirty secret of income trusts was that a lot of them paid out more than they were earning. A common practice was to jack up the initial distributions in order to entice investors. That, in turn, would goose the value of the company far beyond its underlying worth. They were houses built on sand. Last year, the Canadian Accounting Standards Board reported that income trusts were overvalued by between 39 per cent and 50 per cent, and that distributions averaged 60 per cent more than earnings. In other words, investors were encouraged to buy ridiculously overvalued companies -- and pay steep commissions for the privilege.

"I don't expect seniors to do their own homework," says Ms. Urquhart. "The financial industry has the duty of care to provide products that are appropriately designed." And where were the securities commissions? Good question. "All those authorities who should have ensured proper specification of the yield turned a blind eye."

But oh! It was great while it lasted! The management of a company called Teranet raked in $167-million when it went public as an income trust. In another deal, a New York private equity firm bought a humble yarn manufacturer called Spinrite for $81-million. For converting it to an income trust, the equity firm made a quick profit of $87-million. Shortly afterward, the amateur knitting craze abruptly ended. Spinrite's value fell by half, and it cancelled all its juicy distributions.

The pain hasn't ended yet. Ms. Urquart says that income trusts (which remain sheltered from tax for four more years) have farther to fall before they reach reasonable valuations. If you can't afford to lose any more of your capital, sell now. And start asking your financial adviser some tough questions.

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