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Income trusts are still a minefield

41 have suspended or reduced payouts. Strong trusts will remain prime takeover targets through 2010

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Unitholders of the Yellow Pages Income Fund looked like a contented group at last week's annual meeting in Montreal.

President Marc Tellier even was asked for an autograph by one young investor.

A record first-quarter profit of $121 million, two hikes in the monthly distribution over 15 months and a nice rebound in the unit price since Finance Minister Jim Flaherty's income-trust tax bombshell last October have restored Yellow Pages' lustre.

The news was not so cheery, though, for holders of the XS Cargo Income Fund.

It slashed its monthly distribution by 50 per cent, which triggered an immediate tumble in the unit price to $5.50 from $8. The reduction in payout was the second in three months for the Edmonton-based closeout retailer.

The XS Cargo example is more typical of what has been happening lately in the business-trust sector in Canada.

Diane Urquhart, an independent consulting analyst, has calculated that a whopping 41 of 156 business trusts in Canada - better than one in four - have suspended or reduced their distributions.

Urquhart, an outspoken critic of how income trusts have been marketed in Canada, said a lot of seniors are now paying the price for that misrepresentation with reduced revenue streams and depreciating assets.

Not everyone is disillusioned with the asset class, which snowballed from $15 billion in 1997 to $200 billion in 2006. In a time of scarcity for high-yielding assets, it's "pretty much the only game in town" for Canadians who need and want yield, said John Priestman, managing director of Guardian Capital LP, though he cautions that a weighting beyond 20 per cent is risky.

"In our opinion, income trusts are still the best equity income vehicles available to Canadian investors," Priestman said this month in a conference call.

"They trade about the same valuation level as common stock, but provide materially higher pre-tax and after-tax yields. Shifting into Canadian stocks or bonds will result in lower risk-adjusted returns for investors."

The sector is a bit of a minefield, though, Priestman acknowledged.

"There are some truly terrible income trusts out there, and it's important to remember that the trust universe has a huge bifurcation in quality."

Priestman said the fund he manages at Guardian confines its income-trust holdings to 35 to 40 names, and not necessarily the highest-yielding ones.

"In our opinion, there are probably only 50 to 75 excellent trusts and, obviously, moving forward (toward 2011, when existing trusts will be taxed like corporations), quality is going to count more than ever. Marginal trusts will be very challenged. Trusts with high debt, high-payout ratios can't grow into the taxable status."

Strong trusts, however, are and will remain prime takeover targets through 2010, and the ones that transition back to a corporate structure - as Yellow Pages Income Fund intends to do - still figure to be among the highest-yielding dividend-paying stocks in Canada, Priestman said.

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