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Industry must define itself, critics say

'Not many can offer independent and critical voice'

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Now that David Dodge, the governor of the Bank of Canada, has weighed in on the matter of standardizing the definition of distributable cash, maybe something will happen -- at least faster than otherwise would have been the case.

Dodge, who is known for a philosophy of "tell it like it is," was asked about income trusts, a capital structure that has become very popular with Canadian issuers and investors because of the promise to pay out most of their earnings.

Dodge, who one year back, criticized the country as having a "Wild West" approach to securities regulation, said he was worried about the accounting side of income trusts.

"There are basically no standards for distributable cash and the accounting industry are working on this," said Mr. Dodge in a session before the Senate's banking, trade and commerce committee.

While income trusts are a long way from running the country's monetary policy, working out what to do has kept those involved in the income trust business very busy. There is a lot of heat but not much light. Indeed nothing has been resolved for the key measure in a $200-billion-plus industry. Meanwhile new issues of income trusts keep being registered -- and ultimately approved by the regulators.

"Provincial securities commissions have not been exercising their duty of investor protection. If they were, the income trusts would not have been approved for the public market on such flawed accounting and financial reporting," said a recent report by independent analyst Diane Urquhart for the National Pensioners and Senior Citizens Federation." That report is available on www.sipa.ca.

Meantime the press releases keep coming. For instance:

-Sept 29, 2006. David Wilson, chairman of the Ontario Securities Commission, said that by year end, the country's largest securities regulator will unveil new rules "to more clearly define how income trusts report distributable cash. What we are working on is exactly how distributable cash should be calculated," adding that the new rules will be "clarifying in nature to help the industry apply principles on a consistent basis."

- Oct. 3, 2006. The Canadian Securities Administrators released a survey that showed a major disconnect between what retail investors should be doing and what they actually do.

Wilson from the OSC said that "taking time to do some research before investing your money is time well spent. Our goal is to help Ontarians take a more active role in their financial affairs and become better equipped to protect their money."

All very admirable stuff even if there is an obvious question: Why does the regulator approve all the new trust issues despite the lack of consistency between trusts on a key measure.

"We can't be expected to attend accounting classes and do our own research on investing. And financial advisors should not be permitted to give us inaccurate information," said a recent release from the National Pensioners and Senior Citizens Federation.

- Jan. 16, 2006. Standard & Poor's releases a two-part study on income funds and the perception of distributable cash.

"The current state of distributable cash calculations and related disclosure leaves much to be desired," said S&P, which noted that there were 19 different names (among 40 trusts it examined) "used to characterize the same concept of generating and making available, cash for distribution."

S&P said the distributable cash calculation "is plagued with distortion and information risks that, if left unattended, will undoubtedly result in misinformed investment decisions."

So what do the experts say?

Vancouver-based Leith Wheeler Investment Counsel is one of the country's best value managers. Recently it devoted its outlook publication to the question of income trusts. And it's not a fan. Here are some highlights:

- Over the past decade, more than $100-billion of paper (either income trusts or closed-end funds that invest in trusts) has been sold to the public -- deals which have generated more than $5-billion of revenues for the underwriters and brokers.

As well, the issues have generated large revenues for the lawyers and accountants who structure the deals and for money managers who manage them. "This fee gravy train has created a huge contingent of trust cheerleaders and not many people are in a position to offer an independent and critical voice," said the four page report.

- The out-performance of trusts over the past five years relative to the S&P/TSX composite index "has also led to a receptive investor market and a proliferation of low-quality trusts and, in some cases, suspect financial reporting and crazy deals for trust management."

- And while some of Leith Wheeler's clients own trusts, the list is short and the overall exposure in client accounts is relatively small. The trusts it does own "have strong business models, trustworthy management and that trade at reasonable valuations -- the same fundamentals we use to evaluate common stock."

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