Income trusts: **What you need to know**

With some of Canada's largest companies converting themselves into income trusts, the time is right to take another look at this structure even though federal legislation has reduced its tax advantages.

Income trusts are attractive to investors for several reasons. First, this asset class has outperformed common shares and bonds during the past years. Also, their tax treatment is attractive in some cases and the word "income" in the name is comforting. However, income trusts are an equity sub-class whose risk is comparable to equities.

Income trusts raise capital to acquire, directly or indirectly, the income streams of business activities previously developed and then spun off by companies.

Examples are real estate income, revenues from oil and natural gas production or electricity generation, or as in the cases of Telus and BCE, subscription revenues from distribution networks. Income trusts undertake to distribute the maximum available funds. This undertaking increases the risk of liquidity shortfalls, particularly the under-financing of the capital expenditures needed to maintain production capacity.

Also, income trusts do not provide the security of fixed-income securities—neither income nor capital is guaranteed. Actually, their prices may be greatly affected during turbulent times. The graph below shows that their volatility is sometimes even higher than that of equities. Why are income trusts volatile?

Some examples

Here are a few examples of how income from income trusts can fluctuate:

- If oil prices tumble or if production costs jump following changes to environmental laws, income will fall
- Depletion of reserves or infrastructure depreciation can also impact royalties payable
- Real estate income is dependent on occupation and interest rates
- Interest rate increases result in higher financing and operating costs and affect the discounted value of cash flows.

Tax impact

What about the tax advantage? Federal tax rules were adjusted in 2006 to ensure that the total tax paid is comparable regardless whether income is generated by a company or a trust.

In addition, since most income trusts distribute monthly fixed income, if revenues are lower than the distribution, a portion of the distribution is in fact a return of capital invested. Tax on this portion is not payable in the short term and is deferred. Since the adjusted cost base (the acquisition cost taking into account the return of capital) is reduced, capital gains on resale are higher. Tax is thus deferred for non-registered portfolios.

Your manager's role

As with all types of investment, the greater the expected returns, the higher the risk. As for any investment category that becomes temporarily "hot," we must expect the pendulum to swing back when massive cash inflows start drying up.

Financial institutions offering managed products analyze income trusts and integrate them into their global portfolio strategy if appropriate. Highly concentrated investments are avoided within managed products and it is easier to rebalance portfolios when managers believe an asset class has made excessive gains.

On behalf of Private Investment Management, National Bank Trust and its managers evaluate daily the advantage of including income trusts in their portfolios or not. Income trusts are managed as equities, based on valuations and regardless of structure. As with any other investment, the tax aspect is one valuation criterion among many others.

For more information or if you have any questions, contact your advisor, who will be pleased to help you.

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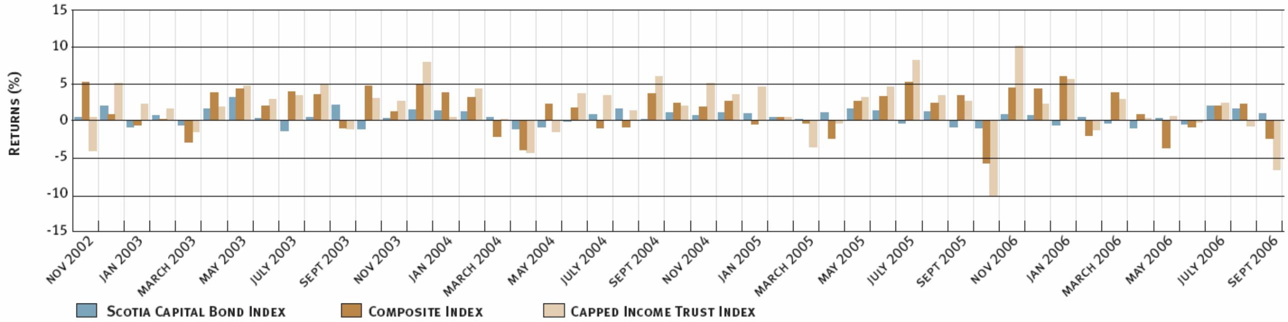
MONTLY RETURNS – NOVEMBER 2002—SEPTEMBER 2006

COMPARATIVE RETURNS: INCOME TRUSTS VS. EQUITIES AND BONDS (NOVEMBER 1, 2002 TO SEPTEMBER 30, 2006—47 MONTHS)



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