



TSX Sector Strategy #7

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Falling Bond Yields Support Another Strong Year for Trusts

Jeff Rubin and Peter Buchanan

Market Weight	4%	Recommended Weight	8%
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Summary

- We've raised our weighting in income trusts to 8%, as part of a portfolio realignment to leverage off another 60-basis-point decline in long Canada bond yields over the next 12-15 months.
- While little over half of last year's return, we expect the *CIBC World Market Income Trust Index* to yield a total return of 15% in 2005, significantly higher than the return from either the bond or stock market. In addition to another 5%-pts of distribution income, we expect to see trust valuations rise by a further 6% between now and year-end.
- With little over half the beta of a typical stock, income trusts also provide capital protection against downside movements in the TSX. In the 2002 bear equity market, trusts outperformed stocks by the widest margin yet.
- Removal of legal obstacles and Standard and Poor's decision to soon include trusts in its TSX benchmark, paves the way for growing institutional involvement in this market.

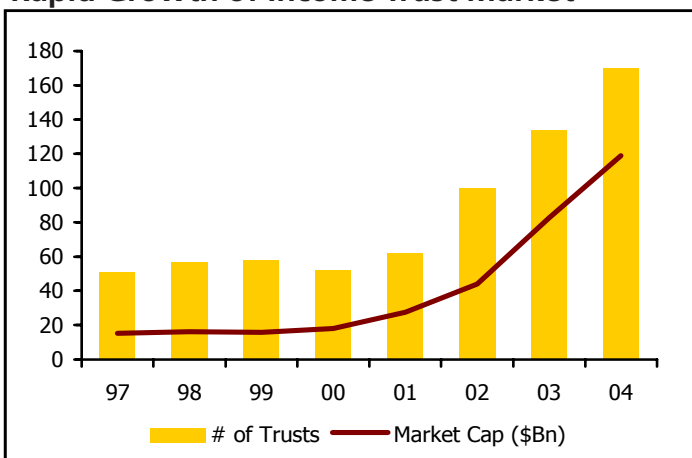
Key Indicators

	<u>April 29</u>	<u>2005</u>	<u>2006</u>
CIBC WM Income Trust Total Return Index	205	228	250
Average Yield:			
Canadian Income Trust	8.2%	8.0%	8.0%
30-Year GoC	4.6%	4.3%	4.0%

Trust in Lower Rates

From its meagre scale a decade ago, the income trust market has grown by leaps and bounds, reaching a market capitalization of \$120 billion last year (Chart 1). The 330% increase in market cap over the last three years eclipses the growth rate of all other asset classes. What's driving the income trust market, and will returns continue to outpace those from more traditional stock and bond investments?

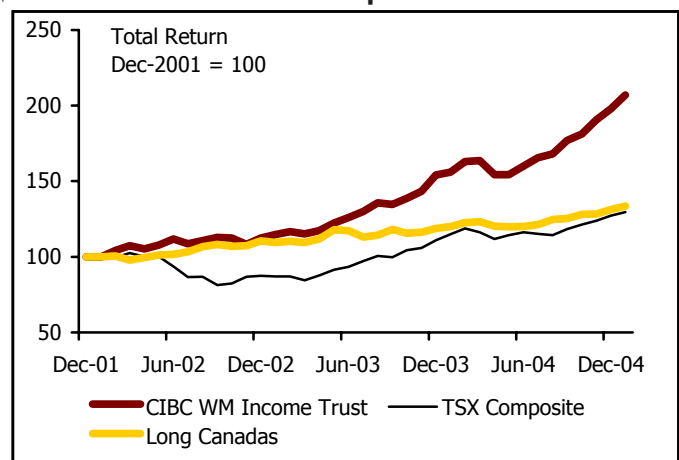
Chart 1
Rapid Growth of Income Trust Market



Income Trusts Outperformed Other Asset Classes

Income trusts have consistently outperformed both stocks and bonds over the last three years (Chart 2). The performance gap has been substantial: 14%-pts above the TSX in 2004, 10%-pts in 2003, and

Chart 2
Income Trusts Have Outperformed



25%-pts in 2002. The greatest outperformance came in a year of negative equity market returns (2002), attesting to the independence of the trust market from the performance of the broader equity market.

Trusts offer a number of advantages, the greatest being the avoidance of corporate income tax. In addition, the need to pay out cash flow on a monthly basis keeps management highly disciplined while common ownership of the debt and equity enhances financial flexibility. But the primary dynamic behind income trusts was to put earnings in the hands of investors. Whereas dividends accounted for only 1.8%-pts of the 14.5% total return from the TSX last year, distributions accounted for fully a third of the 28.5% total return from income trusts. Yields make trusts an attractive alternative to dividend stocks. Today's 8-8.5% cash yield provided by the typical TSX-listed income trust well surpasses even the highest dividend-paying stock (Chart 3).

Market Shifting from Retail to Institutional Base

Originally trusts were designed for yield-hungry retail investors. Potential unlimited liability arising from trusts discouraged wide-scale participation by pension plans. However, recent statutory changes in Ontario and Alberta and previously enacted Québec legislation have removed unlimited liability risks, paving the way for more institutional involvement. Institutions are already bolstering their exposure, buying over 40% of the new trust issues coming on the market in 2004,

Chart 3
Total Return by Component, 2004

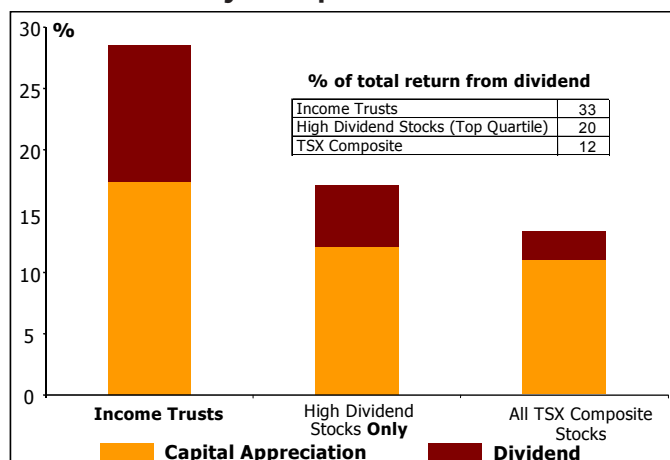
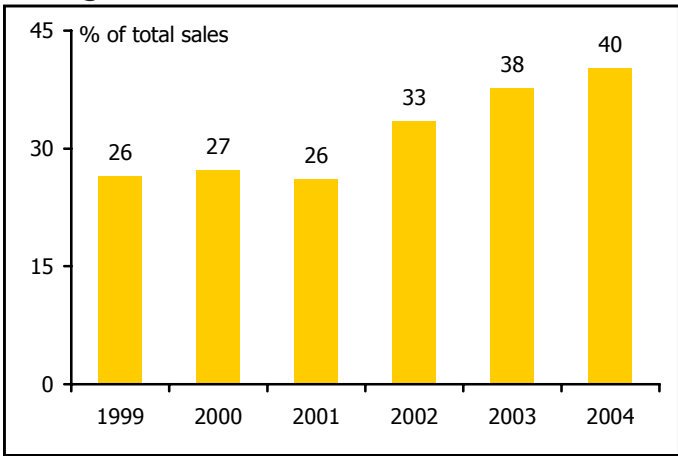


Chart 4
Rising Institutional Share of New Trust Issues



up from only 26% in 2001 (Chart 4). That figure will rise further as Standard & Poor's decision to include income trusts in the TSX Composite will compel institutional investors to add more weight to their trust portfolios.

From their inception in the real estate and oil and gas sectors, trusts have evolved into a broad asset class with representation from all walks of the economy. Over the last two years, the most rapidly expanding part of the market has been outside the traditional area of REITs and oil and gas royalty funds. Stable cash flow and low capital expenditures made both sectors ideally suited to the trust mechanism. However, in recent years, the growth of the trust market has been spearheaded by business trusts which now account for a third of the total market capitalization compared to barely 12% just 3-4 years ago (Chart 5). Business trusts have offered investors the greatest return pick-up over

Chart 5
Business Trusts Fastest Growing Sector

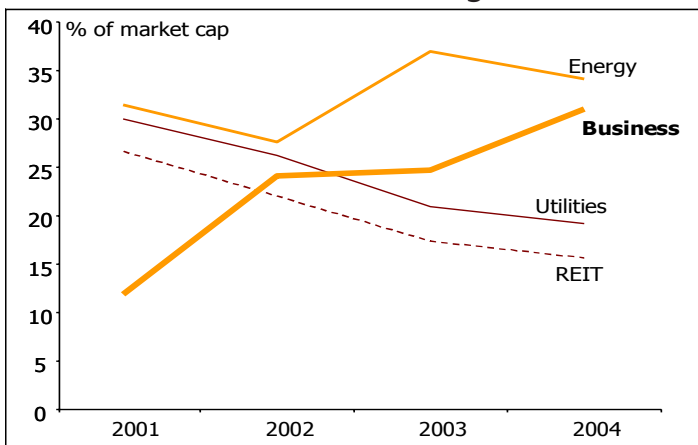
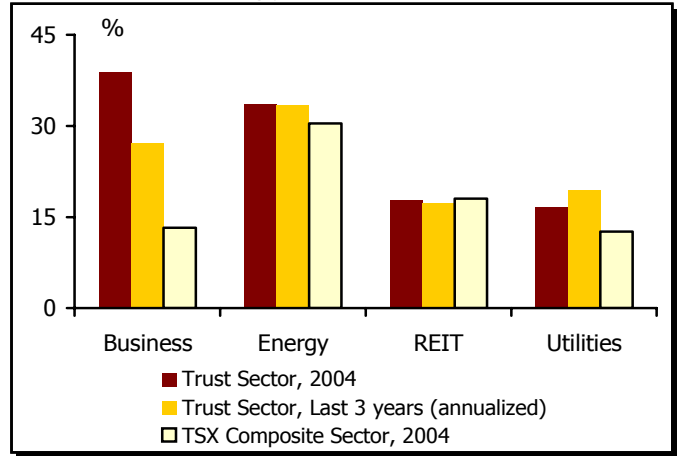


Chart 6
Business & Energy Trusts Provided Best Returns

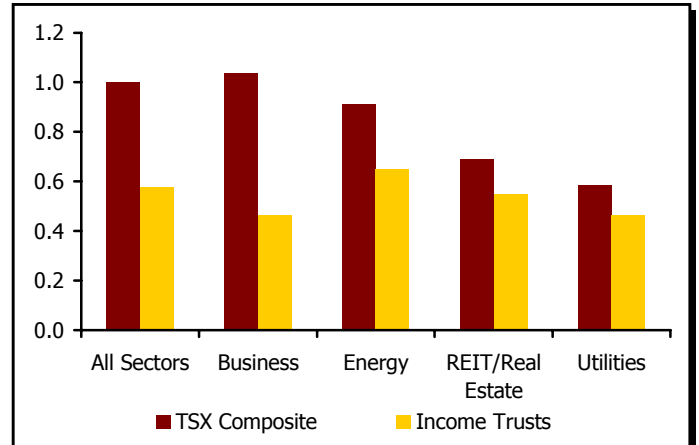


comparable segments of the TSX of all segments of the trust market (Chart 6).

Interest Rates and the Income Trust Market

Aside from offering higher returns, income trusts can shield investors against stock market volatility. The beta of the typical income trust is about 0.6, implying that the average trust is little more than half as sensitive as the typical stock to movements in the broad equity market (Chart 7). While income trusts outperformed stocks during the TSX's rough patch 2-3 years ago, trusts are not recession-proof. Nor are they insulated from firm-specific risks. Trusts' ability to pay unit-holders depends, ultimately, on the health of the underlying cash flows. Trusts that have had business difficulties and cut distributions have been penalized heavily in the market. Nor can trusts offer investors protection against economic downturns.

Chart 7
Betas—Income Trusts vs. Conventional Stocks



Unlike the coupon on a fixed income instrument, trust distributions can fall precipitously during a recession. Hence, fixed income assets should outperform trusts just as they should outperform stocks during those periods.

Income trusts do, however, provide the greatest leverage to falling interest rates of all asset classes, including bonds. That's partly due to the positive cash flow implications of lower rates. Moreover, the yield of the average trust is typically hundreds of basis points above that of the typical bond.

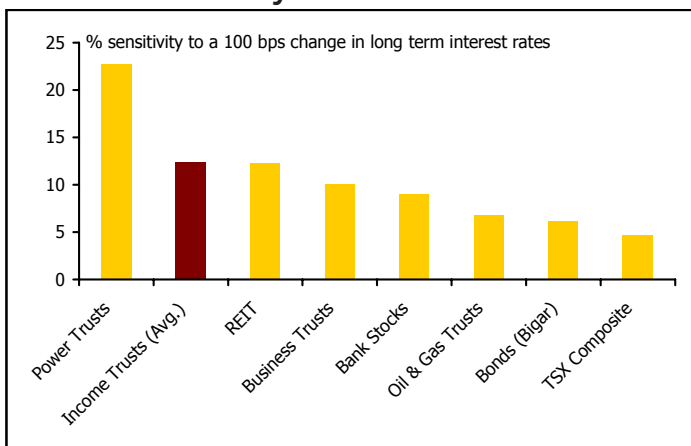
Over the past decade a 100-bp decline in long-term interest rates has normally resulted in a 12.4% appreciation in the share price of the typical income trust (Chart 8). That's double the 6% or so average capital appreciation for the bond market. And it's roughly triple the sensitivity of the Canadian equity market as a whole to long-term interest rate swings. Even bank stocks, a traditional equity market vehicle for playing falling interest rates, are a third less sensitive to rate moves than the typical income trust.

Power trusts are the most rate-sensitive part of the trust market. Every 100-bp decline in rates levers a 22% rise in power valuations, a greater sensitivity than even the long bond. The hypersensitivity of both power trusts and REITs to interest rates mitigates the adverse impact of economic downturns, since such conditions normally bring an easing in monetary policy. Business trusts, which have the least sensitivity to rate changes, are the most vulnerable to recessions. By the same token they offer the greatest reward for improving economic conditions. During the 2000-2001 recession, the broad trust market outperformed business trusts by about 10% but that pattern reversed itself as the economy revived (Chart 9).

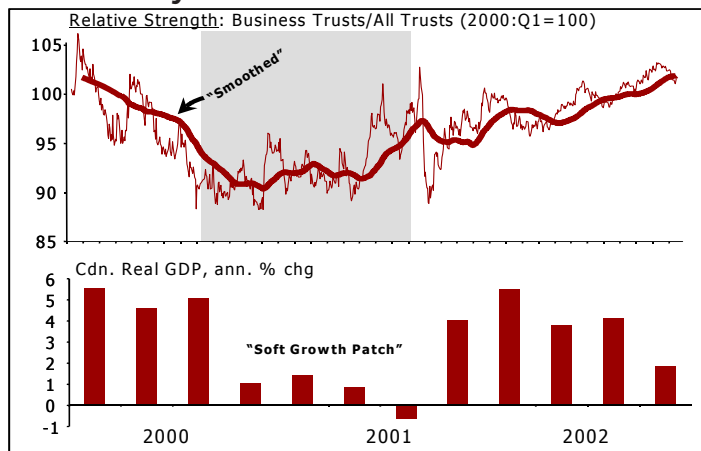
Trust in Lower Rates

In a world of declining bond yields, income trusts are likely to win favour with an increasing number of both retail and institutional investors. While they currently account for only 4% of our CIBC World Markets benchmark, they are likely to increase their weight. More importantly they are likely to generate superior returns in an environment of falling bond yields and moderate economic growth.

**Chart 8
Interest Sensitivity**



**Chart 9
Business Trusts Most Sensitive to Economy's Performance**



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