

INCOME TRUST UPDATE

Late Tuesday, the federal government's finance minister, Jim Flaherty, announced proposed changes to the tax structure of income trusts in an effort to address perceived imbalances regarding taxation and productivity. Like most, Acuity was surprised by the announcement. While we are monitoring the situation very closely, we do not yet have a clear sense of whether this plan will be approved in its current form, or at all, and of what modifications may be made. Nevertheless, we are proceeding under the assumption that the statement is likely to be passed into law in some form, and accordingly are acting in a responsive and prudent manner.

First, it is critical to keep in mind that the underlying fundamentals of trusts have not changed. Regardless of their legal structure, businesses are generally operated to maximize long term shareholder value, some more successfully than others. Acuity has always analyzed businesses consistently with this goal in mind, whether they be stocks or trusts. Our emphasis has been on risk-adjusted return potential, taking into consideration factors such as proprietary advantages, management experience and ability, balance sheet strength, growth potential, free cash flow generation, and valuation. From this perspective, nothing has changed: we continue to strive to select excellent businesses with superior investment prospects, regardless of entity structure.

At present, we are combining our detailed knowledge of income trusts with an evaluation of the proposed tax rules and recent trading prices to identify investment opportunities. It is important to note that there are different circumstances for each trust. For instance, at this time it appears as though many real estate investment trusts (REITs) will not be affected by the proposal. In addition, the remainder of the asset class will continue to operate under the current flow through status for the next four years, which alone has significant value. Furthermore, many trusts, particularly commodity-based royalty trusts, have numerous options at hand to shelter a portion of their income streams from taxation. The average Canadian corporation pays just 20% income tax versus the current 34% corporate tax rate due to legitimate, long standing tax planning activities. We fully expect this situation to accrue to income trusts as well, which should lower the net impact of this proposal.

In general, the trusts best positioned to adjust to the proposed regime are those with lower debt levels, higher tax shields, and lower payout ratios. Acuity has traditionally focused on attributes such as these, and believes that as a result, the trusts we hold have a more favourable status than the asset class as a whole. For instance, several of our holdings already pay some corporate taxes, such as Canadian Crude Separators, and most maintain low payout ratios.

Over many years, Acuity has garnered a well-earned reputation for adapting to the changing conditions of a dynamic market. Every disruption provides astute, nimble investors with opportunities, particularly when irrational investors overreact. We believe that with respect to the current situation, the tax adjustment to future cash flows has already been priced into the market. Presently, a number of trusts are already trading below the value of their common stock peers, and represent compelling investment opportunities at excessively discounted prices, in our view.

In conclusion, Acuity is adapting to the potential new reality of the trust asset class and remains committed to doing whatever is necessary to protect your assets and maximize returns over the long term. We believe the concept of companies paying cash to stakeholders still exists and is well grounded in the Canadian capital markets. As such, we fully anticipate that there will be an ongoing need for high yielding securities, whether in trust or in stock form, and we intend to continue deploying these securities for the benefit of our investors.