SIPA Sentinel

November 2005

SIPA has a mission:
- **to aid public awareness of how the investment industry operates;**
- **to provide guidance to those who have a complaint about investments with a bank, broker, financial advisor, or other seller of financial products;**
- **and to advocate improvement of industry regulation and enforcement.**

Small Investor Protection Association - A voice for the small investor

SIPA Sentinel

The SIPA Sentinel is issued bi-monthly. From time to time we include articles and re-prints that offer opinions on subjects related to investing and regulation. These are meant to help increase investor awareness, and SIPA may not share these opinions.

Income Trusts

Many small investors are investing in income trusts and may not understand the related risks. In 2003 SIPA spoke out to caution investors. Dr. Al Rosen is the most prominent critic of income trusts. This issue focuses on income trusts.
According to the TSX Group, "An income trust is an exchange-traded equity-type investment that is similar to common stock. By owning securities or assets of an underlying business (or businesses), an income trust is structured to distribute cash flows from those businesses to unitholders in a tax-efficient manner. Because of the focus on distributions, income trusts are usually based on mature business with steady cash flows."
Goodale's comment on income trusts has finally brought income trusts forward as an issue. The Income Trust industry is up in arms. Investors who are unaware of the risks are complaining that their source of income will be destroyed. But are income trust investments as secure as they believe? The bankruptcy of Heating Oil Partners Income Fund earlier this year, and the plunge in Clearwater Seafoods when distributions were suspended has alerted investors that Income Trusts can prove to be risky investments.

A Member's Comments on Income Trusts

I am not an investor in income trusts, predominately because I do not understand the business model.
I have followed closely a couple of trusts; the figures do not add up. For example:
A trust that I followed was marketed on the basis of solid existing management, having signed 5-year agreements, plus non-trading provisions for management owned units.
After approx. 2 years, that management, en masse, takes 'early retirement', taking with them a further $1½ million in 'early retirement allowance'. The company claims to be saving great sums of money in future compensation.
A year ago, the company made $.42 per share, yet paid out $1.50. Current figures are (they 'increased' distribution) revenue of $.84 per share and distribution of $1.64. Yet, they claim, there is all sorts of 'distributable cash'
The Board lets the President go. The Chair of the Board resigned. The company arranged for a new credit line of $90 million.
The market cap of this organization is $145 million. Investors get a distribution of 11.55% at present on their investments (At 11.55%, that amounts of a pay out of $16.75 million as far as I am concerned, yet they only make $6.3 million as per the latest financial report).
I would be 'delighted' to make 11.55%. In fact, you would be receiving this email from the Bahamas.
However, none of the figures add up. Why did management 'bail out', despite having a contract to stick around for 5 years?
Possibly all is well, I simply cannot figure out how that could be.

If 'income trusts' are permitted to state as their largest asset 'good will', I logically have to stay away from that asset class.
Fred

Dr. Al Rosen speaks out on Income Trusts

Dr. Al Rosen, Ph.D., FCA, FCMA, CPA (USA), CFE, FHKSA, CIP, CA.IFA
Dr. Al Rosen is one of Canada's leading forensic accountants who has given expert accounting testimony in Canada's highest courts; is a fellow of the Chartered Accountants of Ontario and Alberta, a certified fraud examiner, and a specialist in investigative and forensic accounting. For 15 years he served as a technical advisor to three Auditors' General of Canada.
Dr. Rosen has taught accounting at universities across North America. He graduated from the University of British Columbia in 1957 and later earned his M.B.A. degree from the University of Washington. In 1966, he obtained his Ph.D. from the University of Washington. He founded Rosen & Associates Ltd. in 1990.

Who do you trust?

By Al Rosen

Income trust managements get to choose the process they will use to calculate distributable cash.

There are roughly 120 diversified business income trusts on the market today compared to about a dozen or so just four years ago. During this rush to market, investors have had to consider the impact of several rotating issues, including the risk of investor liability, the legality of certain tax structures, the inclusion of trusts in market indexes, corporate tax leakage, the impact of rising interest rates, potential limits on institutional ownership, taxation at the investor level, and many more distracting factors. This has meant little time has been afforded to a very significant issue: the unique financial reporting of income trusts.

Trusts are usually valued on a presumption of continuing, stable cash distributions. There have been numerous examples of what happens to the unit price of a trust when distributions are cut. So, it's not surprising that investors have a preoccupation with the apparent stability of their distributions. For this, most investors will look toward a trust's reporting of distributable cash and what portion of that amount is being sent their way in the form of regular distributions.

But, the distributable cash figure itself is an invention of each trust. Company management teams decide the process they will use to calculate their own distributable cash. Thus, by definition, the figures are not very comparable between companies because there aren't any standard financial reporting rules or even quasi-regulatory guidelines for companies to use. This will undoubtedly lead to unnecessary pyramid-like losses for investors when some of the more cyclical trusts try to stretch out their lives by borrowing funds or selling more units to pay their distributions.

Unfortunately, many investors will likely catch on too late when some of the trusts start to play with their distributable cash figures. This is due, in part, to the fact that it is easier to misguide investors about distributable cash than about income (which, if you've read some of my past columns, you already know is extremely malleable).

The calculation of distributable cash can be very confusing for investors to grasp. To arrive at the figure, sometimes companies will tabulate what adjustments they have made to either income or cash from operations. Some companies, however, don't even do that. For example, Yellow Pages Income Fund (TSX:

YLO.UN), one of the largest business trusts in Canada, doesn't provide a reconciliation of its 2004 distributable cash to any figure in its financial statements. Rather, the only reconciliation provided is made to an "adjusted EBITDA" figure for YPG LP, a subsidiary of the income fund. This leaves hapless investors alone in trying to navigate the gap between the $337 million in distributable cash and the $107 million in net income reported by the fund.

This confusing presentation simply creates additional questions on top of the standard queries for any income trust when it comes to distributable cash. Among them: what management assumptions were made regarding the capital expenditures needed to maintain current revenue? Furthermore, the distributable cash issues come on top of the questions required of any company reporting net income (on which distributable cash figures are based).

My past columns have dealt extensively with how to fabricate income via the excessive accounting choices that are afforded to management in Canada. And it would be a mistake to assume that such opportunities for chicanery are cancelled out in the process of calculating distributable cash. So-called cash income, as well as cash from operations, can easily be tweaked through revenue recognition games because distributable cash often ignores changes in working capital. In many ways, Canada is flimflam heaven.

The message here is that the lifeblood of any trust investment is its distributable cash figure, which is calculated from a two-step process. The first is the calculation of traditional income, which is wide open to management manipulation. The second is the addition of further management-chosen, non-standardized adjustments. In the end, the so-called cash is easier to fudge (and possibly a riskier basis for investment) than net income.

Larry Elford, a former broker, writes about income trusts

Income trusts, principal protected notes, structured products

By Larry Elford

Some investors are being led into investments that they do not understand, and might not be suitable for them as far as risk, income, or returns. Some are so confusing that the layman has no hope to understand, and many turn to professionals for advice. With most investment professionals compensated by either sales commissions, or by fees based on gathering in client assets (which is another selling job), there are strong conflicts of interest generated within the investment industry. They are not always resolved in favor of the client. I manage an advocacy forum for the public at www.investoradvocates.ca in order to try to point out where industry behavior contradicts industry promises.

SIPA (Small Investor Protection Association) has asked me to write something that might be of help to investors on the above topics, as they are much talked about right now. I will do my best to shed some light or lend some outside perspective on them from my experience. It is in no way complete and comes with some bias of my own, so you will have to take it not as advice, but rather as commentary.

First, never invest in anything that you do not understand. I never fully understood the whole deal with income trusts. I suspect many, many advisors were lured to them by commissions instead of by their suitability as investments. Some have naturally, or coincidentally turned out to be fine, but too many have followed like bad movie sequels following on the heels of one good movie.
Investment firms stand on both sides of the same fence when they try to solicit firms to sell off ownership of parts of their business, while valiantly trying to convince their other clients (the retail investor) to buy

into them. It is a difficult fence to straddle, but when fees can be generated on both sides they straddle it none-the-less.

Second, never invest in anything that cannot be explained to a six-year-old child, in a few minutes, with the help of a crayon. This advice comes not from me, but from some of the smarter investment people in the industry. Sounds bizarre, but think of all the finance scientist types who show up in boardrooms, with suits on and PowerPoint presentations blaring to tell the world (or the investment community) how their latest magic money machine cannot fail. Hindsight usually proves that the more charts, graphs and pages of incomprehensible material that accompanied such presentations, the more likely the investment was doomed from the outset.

Income trusts are becoming a tease, in my opinion. Certainly some have succeeded, and some have gotten lucky with commodity prices or being in the right industry at the right time. While I like them for the ability to avoid double taxation by our revenue department, which seems fair. They have gotten out of hand, and they have never been well understood nor well explained by the investment community. Calling them trusts has lured far too many clients into thinking they have something akin to a GIC, safety wise. Not the case. The tease of the income they hope to produce is also responsible for blinding both clients and advisors as to the real nature of the investment and the risk.

They appear to me to be abused by an industry that is willing to package up nearly anything that they think can be pushed on a less than sophisticated public for a fee.

What exactly is a structured product and why would you invest in one?

I checked the definitions of structured products from many investment dealers on the Internet, and found a wide variety of explanations. They seem to be investments built of various bits and pieces of other investments, like bits of bonds, bits of stocks, bits of options on bonds, stocks, commodities or other. When I was working in the business I even go a phone call from Toronto one day, asking me if I thought I could sell investment products to my clients based on the weather. Yes, you heard correctly. The scientists in the new issue department were actually considering the idea of selling investments where results were based on the ups and downs of the weather. Looking back now, with hindsight, it appears obvious that this particular investment had shades of Enron attached to it, but at the time it simply sounded foolish, to say the least.

The difference between investment advisors who sell products like this and those who do not can sometimes be summed up in a few words, formed by some advisors as the first question they consider when evaluating any new investment. "What is the commission?" If that is the first question your advisor tends to ask at new investment presentations, it is very likely you are going to end up with some rather strange and unusual investments that you do not really understand. On behalf of those investment professionals who truly aspire to be professional, I will apologize to the public that the industry is still overflowing with sales types posing as professional advisors.

Lets look at the next investment that I happen to like, but also may be some kind of structured product by definition. How can I bash them, and like them at the same time? These I can actually understand.
They can be called principle protected notes, index linked notes, or many things, but the ones I liked had these attributes:

1. They carried a promise of your money back (on maturity date only) so you know that if you are willing to wait for the maturity date, you can have 100% of your investment back. That is a no lose promise if it is issued by a quality issuer. It is worthless if issued by a fly by night issuer.

2. They carried some upside (but no downside) potential by having the rate of return they pay based on a relationship to some stock, interest rate commodity, or other. (For example you could have a note that will pay you the rate of gain (but not the loss) of the top twenty oil companies in the world over the next five years) This was a nice way to have less risk and still participate in markets I figured.

3. They carried no management fees each year, so your only cost might be to buy and or sell them. If bought at new issue, fees were paid by the issuer, so client was not paying directly, and if held to maturity they are paid out fully with no fees. Thus I found the better ones to be a low risk and cost effective way to participate in markets.

4. They were not cluttered with terms, conditions, jargon, fine print, limitations and restrictions. Some are. Some are not. A professional advisor will know them as well as they know their own back yard and should be able to steer you properly. (And in your interest)

5. They struck me as a perfect way to participate in the potential for longer-term growth that many of us seek, while protecting ourselves from market crashes and panics in the long term.
I see they are still issuing these, almost daily, and they are gaining in popularity. Some appear to me to have annual management fees attached to them, which would increase the cost while also decreasing any returns to investors. As with anything, as they become more and more popular, they become less and less competitive or attractive.

I thought these were about the best investments (the better built ones) I could find back when I was looking for investments that would allow me to participate in the upside of markets, while having a downside protection guarantee built into them. I still like them for this reason.

They are, however, not generally income producing investments, and not suitable for all. I found them suitable for longer-term growth investors, or with those not necessarily needing lots of income, but wanting their money working hard towards growth objectives.

Speaking of suitable, I found income trusts to be misrepresented and mis-presented to the public at times due to the income they hoped to produce. They were basically taking the risk and earning the return of a stock, or equity in many cases. Only by bleeding off income, at times even when it was not produced were some able to maintain the income payments. It was like burning the furniture to heat your home. The heat feels good, but it might not be sustainable. They would be better referred to as "income hope" products than income trusts in my biased opinion.

Canada needs a consumer watchdog agency to oversee the money industry. Provincial Securities regulators have demonstrated repeatedly that they are not qualified for, nor perhaps even aware of their role. Self-regulatory industry trade bodies have demonstrated the problem of self-interest. Cover-ups, gags, confidentiality agreements with or without the force of duress, have been placed upon settlements made by the powerful players in the investment industry, so the true extent of financial abuse may never be fully disclosed, and thus might not be much closer to being corrected. Much easier to hide the financial abuse of our elderly, pay off the odd complaint that makes it through ten or so years of battle with the big bank or investment firm, and keep the profits from all the rest................

I still believe in fairy tales, and I still believe the Canadian investment industry will change from a sales driven and conflict riddled industry to one of professionalism and integrity, given enough time and the disinfectant of enough sunlight.

Author can be reached at investoradvocate@shaw.ca

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Andrew Teasdale writes about The Need for a Second Opinion

ANDREW TEASDALE & THE TAMRIS CONSULTANCY

Andrew Teasdale is an Economist and an Investment Planning and Asset Management expert with over 20 years experience in the financial services industry. He has managed private client portfolios (in the UK), been responsible for a top 5 accountancy firm's portfolio management service in the 1980s, ran an Investment Counselling firm in the 1990s (UK), advised professional firms on their asset management operations and provided economic, market and fund research and analysis for to up to 20 firms of advisors.

He has researched and developed systems and methodologies for the integrated management of assets and financial needs, developed software for the UK financial services market and his advanced systems were adopted in 2000 by a European Virtual Private Banking venture. He has also written educational courses for the UK financial services industry. In Canada he holds the Canadian Investment Managers designation, which he took to assess the primary educational standards of the industry.

Have you ever wanted to know whether your advisor is doing a good job, but did not know where to turn to? Have you ever asked for a second opinion and ended up with "you should move your money to me"? If you have concerns over your advisor, want a second opinion or need help in selecting an advisor, where do you go and who can you trust?

Getting financial advice is a bit like going to the dentist. You know that you have to trust the dentist because you have no other option, but at the bottom of your stomach you pray that they know what they are doing. Fortunately dentists are highly trained and the vast majority know exactly what they are doing. Unfortunately, most financial advisors are not highly trained and few know what they are doing.

This is where the TAMRIS Consultancy comes in. TAMRIS is really an independent financial services quality control consultancy that monitors the advice, the expertise, the resources and the business and service processes of companies that manage your money. TAMRIS does not earn a return from advising on the buying or selling of products and specific securities, nor does it earn its return from managing assets or from wealth management referrals. It also does not publish newsletters recommending investments nor does it earn any return from advertising industry products or services. TAMRIS is completely independent of the conflicts of interest inherent within the financial services industry.

But just what is wrong with the investment industry and why is a company like TAMRIS needed? Managing your money to meet your financial needs and objectives should be a relatively simple affair, if everyone in the industry were capable of doing it, had the resources, the expertise and the systems and operated solely

in your interests. But, not everyone can do it, has the resources, the organisation or the structure to deliver. In fact, there are a number of key problems in the industry.

1. There is scarcity of expertise and resources needed to manage financial needs, expertly and professionally.

2. There is no formally accepted method for the management of assets to meet financial needs over time. The most dominant method of constructing portfolios does not consider financial needs when constructing portfolios nor can it deal with time or protect investors from the real time risks they face.

3. Because of problem 2, most of the software systems used to deliver asset management to the retail investor cannot manage the structure of assets to meet financial needs over time. So why do these systems exist? They exist to distribute the industry's products and transactions, because the natural scarcity of expertise and resources would otherwise prevent their delivery. But this solves the industry's problems, not the individual investor's problems.

4. The fourth problem is that most of the industry does not integrate the management of financial assets with the management of financial needs. In fact, no portfolio designed to meet financial needs can be constructed without a direct relationship with the size and timing of those needs.

    - Much asset management expertise does not view structuring your portfolio to meet future financial needs an asset management objective, but a financial planning exercise. Financial planners lack the modelling and investment expertise needed to effectively integrate the management of your assets and your financial needs over time.

5. The fifth problem is that your financial objectives are not the most important objectives of the financial services industry, the capital markets or the financial regulators. The main responsibility of the regulators is to foster fair and efficient capital markets and to maintain public and investor confidence in the integrity of those markets. While its objective is also to protect investors from unfair, improper and fraudulent practises, it only lays down a basic minimum standard for the delivery of wealth management services and advice.

    - There are in fact two markets (the financial markets and the market for financial services or advice), one is regulated the other is not. Regulators often cite their need to balance the needs of the investor with the needs of the capital markets. In fact, a more efficient market for the provision of financial advice would actually provide much more liquidity to financial markets, not less.

6. The sixth problem is that the education provided to the investor (let alone the advisor) is insufficient for him or her to assess whether an advisor is capable of managing, or is managing their assets and financial needs properly. The average investor is unable to determine on their own the appropriateness of the expertise, resources, systems, service and value that they are receiving. Much of the education that does exist is focussed on easing the selling process by providing arguments that support the solution or the recommended transaction.

Clients often have to rely on trust that their advisor can do the job and that the securities regulators will create an environment that ensures only those capable of providing advice are able to give it. The problem is that the securities regulators have no control over the first four problems and because of their responsibility towards the capital markets, cannot subjugate the needs of the market to the needs and the rights of the investor.

These six problems are in point of fact, each and every one of them, surmountable. It is possible to deliver wealth management solutions at a fraction of the current cost, to provide enhanced management of risk and return and to deliver superior asset management expertise to each individual investor, regardless of their wealth. It would mean, of course, rocking the "gravy boat". The industry is inefficient, outmoded and uncompetitive and investors more often than not are the prey and the participants the predators.

It is the individual investor who must demand better service and better standards. The trouble is, the individual on their own does not possess the expertise and the knowledge to demand this. This is why TAMRIS exists.

The TAMRIS website, http://moneymanagedproperly.com provides a wealth of further information on the problems in the industry and expands on the topics of "investment rights", "is your money being managed properly" and "what your wealth manager should be doing for you".

National Post's Dabrowski on Principal-Protected Notes

"A lot of principal-protected notes are garbage and they're not going to make people money"

The National Post headline repeats what Andrew Dabrowski heard from a senior industry. The failure of Portus Alternative Asset Management Inc. affected 30,000 investors who poured $800 million into the fund of hedge funds that Portus sold, mostly to retail investors. Because hedge funds are restricted to accredited investors (generally those with assets over $1 million and salary of over $200,000) the industry developed Principal Protected Notes based on hedge funds that could be sold to small investors. Investors need to be aware that the industry develops new products that enable the industry to circumvent the rules and avoid restrictions. Also the industry will gain exemption orders that exempt them from the rules. The regulators are either unwilling or unable to provide meaningful investor protection. Sonita Horvich interviewed James, Chair of Canada's Alternative Asset Management Association (AIMA) and CEO of Arrow Hedge Partners Inc. and quotes him as saying:

> *"It is hard for the retail investor to assess hedge fund products. They can be complicated. Smaller retail investors who want to buy hedge funds have to do so through structured products – principal protected notes or PPNs. These carry additional fees of about 1.5% per annum on top of the existing fee arrangements for hedge funds."*

For anyone who ever doubted where the investment industry's interests lie we include the following comment attributed by the Financial Post to Ron Kosonic, a lawyer specializing in hedge funds at Borden Ladner Gervais LLP:

> *"There's a lot of clever people out there. Somebody will find something that's going to be appealing to the general public, while at the same time staying outside the securities regulations."*

Tier 1 Securities - TruCs, BOaTS, BaTS, HaTS, CaTS, CLiCS, GREATS, MaCS, SLEECS

Financial institutions are offering innovative Tier 1 securities. Barry Critchley in the Financial Post quotes a market participant "The problem with this product is that consumers shouldn't be buying this stuff ... Investors are taking equity-like risk but are receiving debt-like returns. The security being offered doesn't pay enough return given the risk. Investors may end up owning a perpetual piece of paper."
Critchley quotes the participant "We have convinced OSFI [the regulator] that it's equity-type paper because it's Tier 1, but we convinced the buyer it's debt," a situation that doesn't sit well "in these days of full, true and plain disclosure."
It seems the annual rate is low which should suggest security, however if there is a problem with the company the issuer is under no obligation to make payments to investors, similar to income trusts. Asked for his opinion, Ken Kivenko says in his colourful way "Most of these are CraPS".