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Investment Newsletter – November 2006

Anatomy of An Opportunity

This month we'll look at a surprise announcement by the Canadian government that provides an example of the opportunities that come up from time to time when the market over reacts to bad news. On October 31st, Canada announced they would start taxing Trusts as if they were corporations starting in 2011. Over the next two days prices of trusts dropped 13-21% and by November 14th when trust prices bottomed, one of our holdings was down 31%. There are several points to make here but first a bit of background.

Trusts are legal entities that can own assets and carry out a business just as corporations do. In Canada trusts do not pay tax on their income but they must distribute virtually all of it to the owners of the trust units which are the equivalent of shares in a corporation. Units in these trusts trade in the U.S. just like stocks. For U.S. holders, Canada withholds 15% of the dividends as a tax and this is the only tax paid by holders. (Energy trusts typically trade at prices such that annual dividends provide a yield of 10-15%). The prior government was voted out of office when they tried to tax the trusts and the current government promised during the election last year not to tax the trusts; hence the surprise at the announcement.

The reason the government made the announcement is that they felt they had to stop the trend of large Canadian companies converting to trusts and reducing the government's tax revenues. The specific incentive was that two of Canada's largest telecommunications companies had announced plans to convert to trusts. Conversions were becoming common to avoid the combined 41.5% tax rate on corporate income. The announcement effectively ends all new conversions and thus preserves the current level of tax revenue.

The resulting decline in trust prices wiped out $25 billion of wealth in Canadian assets and produced a lot of angry Canadian voters. Given that the date for applying the new taxes is 4 years off, it seems likely that significant opposition to the plan to tax the existing trusts will force a change in the announced plan. The likely solution will be to "grandfather" existing trusts and allow them to continue under the prior rules. Alternatively the government could mitigate the impact by lowering the proposed tax rate or providing additional means to shelter the income.

In any case, even if the tax is imposed, the trusts are likely to shelter some percentage of their income with depletion and depreciation deductions. They could also compensate for the tax by increasing the amount of debt in their capital structure since interest will then be tax deductible. Going forward, when the trusts are buying new assets to boost reserves, a higher effective tax will cause them to pay less for reserves and thus pass on the tax hit to sellers of reserve assets.

Some Simple Analysis

Clearly the threat of increased taxation reduces the likely future cash flows and therefore the value of the trusts. How much is the question. We want to quantify our expectations for the key variables and see what that implies for the hit to value from this announcement. First of all, note that the tax will not be imposed until 4 years from now. Using a required rate of return of 11% a dollar taxed away 4 years from now is worth only $\left(\frac{\$1}{1+11\%}\right)^4$ = \$.66 today. This means that more than a third of the value of a trust should come in dividends before the tax is scheduled to be imposed.

Now, to calculate the actual tax increase, we will assume that the trusts will produce taxable income of just 75% of the current projections of future dividends (i.e. they shelter 25% of their dividends with depletion, depreciation, or other deductions). Therefore the increase in the effective tax burden is: 75% * 41.5% - 15% = 16%.

Taking the future value as .66 per \$1 of current value we get a present value of future taxes of 10.6%. Therefore, if we were 100% certain that the full tax would be enacted on the existing trusts, we should cut the price we would pay by 10.6%. Compare this to price drops ranging from 13-31% and we see that the market has clearly overshot the reduction in value. Now if we factor in a some probability that the government doesn't want to lose the next election so they spare the existing trusts, then the price reduction should be even less. Conservatively, I estimate at least a 20% chance they will back down over the next 4 years. Thus using 80% as the likelihood of paying the tax hit, our price drop should only be 8.5%.

What is Going On?

Prices falling much farther than justified by a quantitative analysis of the news is very typical. In my view this results from a trader mentality, meaning people expect everyone else to sell so they rush to sell first regardless of the price they will get. Perhaps they are reasoning they will buy it back even cheaper. In any case, we get to buy the stock at a discounted price and therefore we can earn higher returns going forward. Eventually, more analytically oriented investors do the math and bid the prices back up to normal. This may, however, take quite a while. In the meantime, energy trusts are paying yields of up to 16%. On November 14th one of our holdings was trading at a yield of 20%! Even if the price doesn't go up, that's a very good return for such a low risk asset.

The other point here, with regard to market inefficiency, is to note that it took 14 days for the downward momentum to finally stop. This is also typical. It is difficult to predict this adjustment period but what you can do is buy slowly so that you get at least some of the stock at the lowest prices.

A Note on Tax Loss Strategy

If you already held trust shares when this event took place you would likely have some loss positions (assuming you bought not long ago). You can use this to reduce your taxes by selling the particular trust and buying a different trust in the same sector (i.e. oil and gas). This way you will make the gains when it goes back up but you are able to deduct the loss[1] currently.

Conclusion

The market occasionally over reacts to bad news and when this happens you must grit your teeth and buy, not sell. Usually, a relatively simple analysis can provide good insight into the magnitude of the market miss-pricing. Such opportunities have given us a 60% return so far in 2006 in our Special Situations Fund. If you want to retire sooner or with a bigger nest egg, you need to have the fortitude to buy smart when others are selling. Or, relax and let us do it for you.

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[1] You can deduct an unlimited amount against other investment gains but only $3,000 per year against ordinary income.