

The VIEW from BURGUNDY

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HORSE SENSE

JIM GRANT, THE EDITOR OF *GRANT'S INTEREST RATE OBSERVER* and guest speaker at Burgundy's 2000 Client Day, once wrote in a typically elegant formulation that "the tricky thing about risk is that it is more threatening as it seems less obvious, and less threatening as it seems more obvious."¹ The recent stampede of new income trust listings compels us to make some observations about some less obvious risks involved in these interesting vehicles.

An income trust is a financial security that is used to distribute the cash flow a business generates back to its owners on a pre-tax basis. We applaud the creation of income trusts for stable businesses that have few growth opportunities. As owners of portions of companies via share certificates, we would rather have the cash profits earned by mature businesses paid to us directly than have management squander funds on inappropriate acquisitions.

That said, a caveat that we raised in the November 1997 issue of *The View* is once again in order. In today's low interest rate environment, income trusts are being sold to risk-averse investors who are shying away from low-yielding GICs. Many of the recent issues have been of volatile businesses that are unsuited to the income trust structure. So once again there is a mismatch between the risk preferences of the investing public and the innate characteristics of many income trust investments.

The underwriters and analysts are encouraging investors to value these securities based on the cash flow "yield" that is being paid out to investors. This may seem like a good place to start, until you consider that most of these issues are new and unproven, and the respective management teams are under enormous

pressure to maximize their Initial Public Offering price by maximizing the forecasted "yield." The only way to do this is to assume that real expenses, such as the depreciation of fixed assets, are not going to be incurred in the future.

It seems that every new issue prospectus that lands on our desks highlights the difference between an onerous historical depreciation expense and a much smaller level of ongoing "maintenance capital expenditures" necessary to keep the business operating at a steady state. As investors who scour the globe searching to invest in that rare anomaly – a business that needs very little ongoing capital – we find this assertion questionable. In the vast majority of cases, depreciation levels are appropriate over the long haul and companies that pay out their depreciation expense as if it were income are simply liquidating themselves. As we wrote in 1997, "you may be keeping the fire alight, but you're burning the furniture."

Canadian business owners are not the only ones to have noticed the income fund phenomenon. More and more sellers of U.S. assets have come north to flog their businesses to the income-starved Canadian public. When we put the question "Why list in Canada?" to the head of one such U.S. company, his frank answer, "Because I can get a higher price for my business," told the whole story. Generally, when U.S. issuers are attracted to the Canadian market, it is because something is amiss. It's not a canary singing in the mine, it's a Rottweiler barking at your bedroom door. So what is wrong this time?

The cross-border valuation arbitrage works because these American firms figure they can cut out the U.S. taxman. This is achieved by creating substantial

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amounts of intercompany debt – debt that is both issued from and to the income fund itself on a consolidated basis. This debt generates substantial interest expense for the operating company (and an identical amount of offsetting interest income at the income fund level) that serves to reduce earnings and therefore tax payable for the operating company.

The crux of the tax-avoidance argument is for the income fund's intercompany debt to be considered debt by U.S. federal income tax authorities. Consider this warning in the DG Foods prospectus, which is similar to many others that we have read: "There can be no assurance that the U.S. federal income tax laws and IRS (Internal Revenue Service) administrative policies respecting the U.S. tax consequences...will not be changed in a manner which adversely affects holders of the Units."² Furthermore, "there can be no assurance that taxation authorities will not seek to challenge"³ the tax-avoidance structure of the Fund. Moreover, "if such a challenge were to succeed... it could materially adversely affect the amount of distributable cash available to the Fund."⁴

We suspect that American tax authorities will not stand pat for long if substantial amounts of tax dollars that formerly were finding their way into U.S. government coffers disappear. Put not your trust in princes, especially if you're crimping their revenue streams. Buyers of U.S.-based Canadian income trust assets should factor this risk into their valuation calculations.

And there are other risks. The structure of income trusts puts management in shackles. With an overriding focus on the short-term generation and subsequent distribution of cash flow, flexibility is significantly impaired. True, company executives are less able to blow shareholder funds on aggressive expansion projects. But they are also unable to take advantage of value-creating opportunities. In some circumstances, the long-term success and even viability

of the organization may be threatened by the lack of strategic manoeuvring room.

Another key shortcoming of income trusts is reduced financial flexibility. We know that many of these new securities have been sold as "bond-like alternatives," but make no mistake: they are equity in the underlying business, pure and simple. And in any business, stuff happens. If a major customer is lost or a new competitor disrupts the marketplace, a corporation that can retain its earnings is in a far better position to weather the storm than one that must pay out everything except (probably underestimated) maintenance capital.

We would argue that prices of many income trusts currently do not sufficiently discount the risks we have mentioned. But there is another overarching risk that should always be considered – unlimited liability. We wonder how many investors fully comprehend that income trusts in Canada – unlike, say, Real Estate Investment Trusts (REITs) in the U.S. – do not offer the same limitations on liability that a corporate structure gives its owners. One of the great drivers of world economic growth was the invention of the limited liability corporation, where investors can only lose the capital that they put up. Think about how few of us would allocate our scarce capital to a project or firm if there were some threat, however small, that we could be on the hook for losses and liabilities well beyond the amount of our investment.

Here is the standard boilerplate in many income fund prospectuses: "There is a risk (that is considered by counsel to be remote in the circumstances) that a Unitholder could be held personally liable for obligations of the Fund (to the extent that claims are not satisfied by the Fund) in respect of contracts that the Fund enters into and for certain liabilities arising other than out of contract including claims in tort, claims for taxes and possibly certain other statutory liabilities." We agree that by holding the Fund's operating assets within corporate structures or limited

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partnerships, the likelihood that income trust investors could face unlimited liability is remote. But as we have repeatedly discovered in the 1980s and 1990s, remote does not mean impossible, and unlikely events transpire with surprising frequency. Just ask one of the former “Names” of Lloyds of London for his or her opinion on the subject of unlimited liability.

The flood of new listings of low-quality income trusts in 2002 should be enough to make any investor suspect that problems are just around the corner. Chippewa tribal lore relates that when you find you are riding a dead horse, the best strategy is to dismount. Investors who haven't been looking at the less obvious risks should be loosening the saddle girths on their income trust investments.

Prior Claim

As shareholders of corporations, we are owners of the residual portion of the wealth a company generates. If you look at net income available to shareholders, it is something that exists only to the extent that all those other people higher up on the income statement allow it to exist. And over the last two decades, events have conspired to make it very pleasant to be a shareholder.

Just look at the lines of the income statement and think about how those various expense categories have fared since 1982. First, cost of goods sold. Commodities have been exceptionally well-behaved, with very few of the fierce price spikes that characterized the 1960s and 1970s. Direct labour cost inflation has been kept in line by a combination of harsh headcount reductions and the rise of new, low-wage manufacturing bases overseas. Job cuts have also kept selling and administrative costs down. Interest costs have fallen steadily over the entire period and tax rates have generally been reduced. So the residual, not surprisingly, has grown over that period at a rapid rate.

But it didn't grow as rapidly as it seemed to. The national accounts estimates of earnings for corporate America peaked in 1997 and were flat to down thereafter. Yet the numbers that corporate America reported to its shareholders continued to clip along at 10% growth rates until 2001.

Obviously, accounting games were being played. As management became more and more vitally interested in the accounting numbers due to their compensation structure, they brought to bear more and more pressure on accounting standard-setters to retain questionable practices – like pooling of interests accounting for mergers and not expensing stock options – and to set up new approaches that allowed them to manipulate net income, such as the FAS 87 rules for pension accounting.

The pension rules were instituted in the mid-1980s. The rules responded to two major concerns of American managers. First, they did not want to show their pension assets and liabilities on their balance sheets, since these can be very large amounts. Second, they wanted the pension expense number to be manageable, and not introduce a high degree of volatility into the net income calculation. They succeeded on both counts.

Let's agree right up front that a place where actuaries, accountants and government tax rules meet is going to produce some pretty complex accounting. But simply speaking, there are two parts to the pension puzzle. There is the funded position of the pension plan, which is the amount the company would have to contribute to or withdraw from the pension fund in order for it to equal the estimated present value of the plan liabilities. And there is the pension expense, which is an attempt to measure the amount by which the company's pension liability has increased in a given year. We will talk about the funded position first.

Any company that has a defined benefit pension plan has a liability that exists sometime in the future.

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The size of that liability varies according to the size and age of the workforce, its rate of pay increase, its longevity and so on. Actuaries estimate this liability based on intricate mathematical models and projections. Companies (unlike governments) are not allowed to have an unfunded future pension liability, so they set aside funds on a systematic basis to offset this liability. Those funds are invested in financial assets.

The liability grows steadily and predictably most of the time. But the asset (the actual pension fund) is prone to prolonged spikes and swoons as the returns in the markets ebb and flow. There is, therefore, an ongoing mismatch between the size of the liability and the size of the asset, resulting in overfunded or underfunded positions. A company with a large unfunded pension liability has a large call on its capital resources sometime in the future.

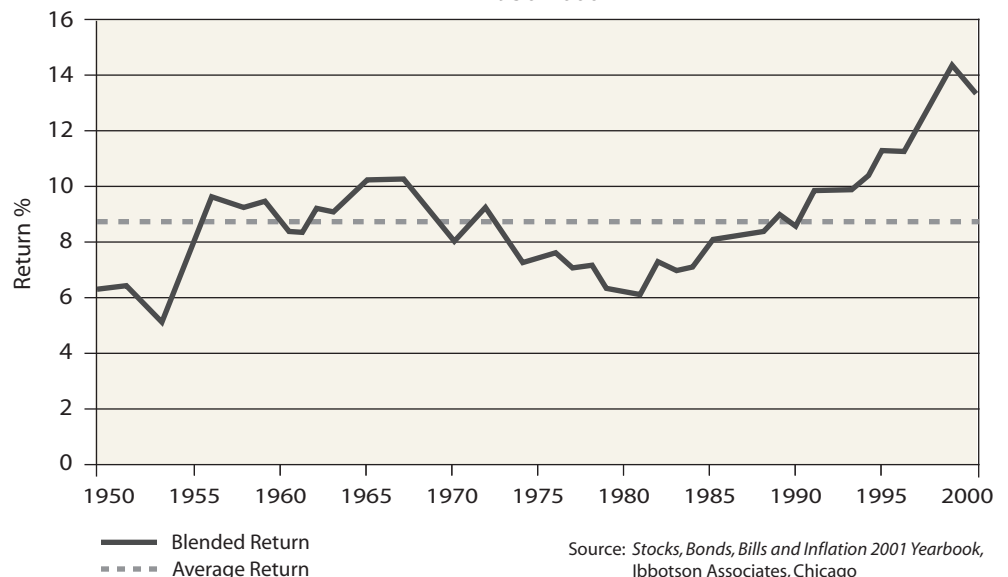
When the plan is overfunded, companies can take payment holidays and reduce or eliminate their pension expense on a temporary basis. In some circumstances, companies can even show profits from their pension funds. For some major companies, like GE, IBM and certain telecom companies, those rather suspect “profits” represented a significant portion of total reported net income in the late 1990s.

This brings us to the pension expense. The pension expense consists of three basic parts. These are the annual increase in pension liability caused by the unwinding of the discount rate, the addition to the liability caused by the addition of another year’s service by the workforce, and the offsetting assumed rate of return on pension fund assets.

Note that the expense is presented on a net basis – it incorporates both expenses based on the pension liability and an income stream based on the pension asset. Note also that the income stream is highly notional – it is an assumption rather than an actual return from the fund in the fiscal year. The return assumption is entirely subject to management’s control. If you increase the assumed rate of return on your pension fund assets, you reduce your pension expense and increase reported net income. So it should come as no surprise to anyone who is familiar with the mores of corporate America that almost all companies use too high an assumed rate of return on their plan assets.

To be fair, that problem is partly the legacy of the extremely high returns on financial assets in the 1990s. All trailing series of returns in the capital markets suffer from end-date sensitivity. What is surprising is the extent to which even a long-term return can be affected by recent strong performance. Looking over the 25-year trailing returns from 1950 on, it is clear that the returns from the late 1990s are an historical outlier of major proportions. The following chart shows the blended return on a portfolio that is 35% bonds and 65% equities.

ROLLING 25-YEAR RETURNS
(65% Equity/35% Long-Term Bonds)
1950-2000



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All observations from 1994 until 2000 are higher than any previous numbers. Including these years, the average of fifty 25-year return numbers is 8.8%, not far off the 9.2% average of all pension return assumptions for S&P 500 companies. But excluding the last six years, the average falls off to only 8.2%. And these numbers do not include the poor returns of 2001 and 2002 from the markets. A glance at the previous chart shows a very disturbing tendency for these returns to revert to much lower levels after periods of unsustainably high returns.⁵

Of the 360 companies in the S&P 500 Index with defined benefit pension plans, only 30 had return expectations less than 8% in 2001. Only seven were lower than 7%. And 58 companies assumed that their entire pension fund would be able to compound at over 10% in the long term – almost equal to the historical expectation on a 100% equity portfolio.⁶

Regrettably, even the highest-quality companies have indulged in these practices. Only one company in our current U.S. equity portfolio has an assumed return of above 10%, but nearly all the others are in the 9-10% range. And these return assumptions must be reduced as the reality of lower returns strikes home.

How will the necessary reduction of assumed pension fund returns affect reported profits in the next few years? Well, the median rate of assumed return on corporate pension funds is currently 9.2%. If that rate is dropped by 1%, the impact on corporate earnings of the 360 S&P 500 companies with defined benefit pension plans is estimated to be \$10 billion in annual pension expense. The ongoing level of GAAP earnings on the S&P 500 would be reduced by about 2%.

A few years ago, the SEC specified the use of a specific type of discount rate for plan liabilities in response to accounting games being played by corporate managements. It looks like it is time to remove games-playing opportunities from the asset side of the pension fund balance sheet as well.

Mandating the use of long-term returns from the Ibbotson Associates reports or another authoritative source as a maximum acceptable rate of return assumption would be a good start. As we have seen, that alone would force most companies to reduce their current untenable assumptions.

A better answer than playing with assumed pension returns would be to scrap the current system of pension accounting and unbundle the pension expense. Report the actual level of plan returns in one place on the income statement and the calculated level of expense in another. Companies will respond that such a treatment will lead to highly volatile earnings reports. But after the past five years of chicanery and deception, does anyone really believe that giving managements the discretion to smooth their income is a good idea? It's time to end once and for all the ridiculous conceit that anything as complex as a large company's comprehensive net income can grow at fixed increments over a long period of time with little variability.

In the final analysis, the pension expense is so notional that it does not really reflect corporate capital allocation.⁷ What drives the capital allocation process is the level of unfunded liability. And those liabilities are ballooning throughout the defined benefit system. As we mentioned, the pension liability has something inexorable and inevitable about it – it grows slowly, but surely over time. We have often rhapsodized about the power of compound interest when applied to an appreciating asset. Just as powerful and very frightening is that same compounding applied to a major liability. And when the offsetting asset is not keeping pace, the net liability position can quickly become a threat to the business.

Huge pension surpluses have already been wiped out in only a couple of years of poor market performance. Nortel, for example, had a pension overfunding of over \$900 million in 1999. As of 2001, that had become a

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\$1.6 billion unfunded liability. And given the returns in 2002, we would expect further bad news here. A couple more years of bad returns in corporate pension funds will allow these liabilities to outstrip the offsetting assets by a frightening amount.

Many companies will have to come up with very large capital contributions in order to offset these major unfunded pension liabilities. That capital, in turn, will not be available to increase dividends, buy back stock, or invest in new opportunities. It is a new age – one where management is much more capital constrained, and one where shareholders are going to have to be intensely aware of the prior claims on the cash flows and assets of their companies.

Endnotes

1. Grant, James. Grant's Interest Rate Observer.
- 2 - 4. Di Giorgio Corporation. DG Foods Prospectus. 2002.
5. Some companies in America appear to be assuming that such a reversion is in fact underway. Berkshire Hathaway is using only a 6.5% assumed return going forward. But then, maybe Buffett and Munger lack the investment skills of these other companies.
6. Much of the data in this report and a considerable amount of the simplified explanation of pension accounting come from an outstanding piece of research from Credit Suisse First Boston's accounting analysts, David Zion and Bill Carcache, both CPAs. The report is entitled "The Magic of Pension Accounting" and appeared on September 27, 2002. Work like this could quickly repair Wall Street's reputation for superficial and partial research.
7. Just in passing, it is astonishing that a company showing an expense this insubstantial on its income statement should object to expensing stock options.

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