Best Income Trusts to Hold through 2013 and Beyond

The federal government's new tax on income-trust distributions took effect on January 1, 2011. Many trusts have already converted to corporations, or plan to do so. Others will continue to operate as trusts. Real estate investment trusts (REITs) are exempted from the new income-trust tax.

In evaluating investments, many investors focus on what we'd call 'investment outputs', such as earnings, dividends, cash flow, return on equity, sales growth and so on. These are all important, of course, but you shouldn't focus on them to the exclusion of what you might call 'investment inputs', such as the factors we use in assigning our TSINetwork quality ratings.

Investment inputs are harder to work with than investment outputs, since it takes a judgment call to determine their risk or value.

To give you a better idea of what we mean, here's a list of a dozen investment inputs that we look at before recommending a trust:

The 11 factors we use to judge trusts

1. Do you have any doubts about the integrity of the insiders? (If so, there's no reason to go on to any of the following.)

2. Did the trust buy its assets in the midst of a recent boom, or has it owned them for some time? Bidding for assets in the midst of a boom tends to be risky, since it can lead to unpleasant investment surprises.

3. Which of the five sectors is it in—Manufacturing & Industry, Resources & Commodities, Consumer, Finance or Utilities? In trusts, as in ordinary stocks, the first two tend to be riskier, the last two tend to be safer, and Consumer is somewhere in between.

4. How much debt is the trust carrying? You need to gauge the debt in relation to all assets, including hidden assets and those that appear on the balance sheet. Too much debt in relation to assets can lead to a steeper downturn in distributions when the business hits a snag.

5. Is the business dominant or at least prominent in its industry? If the answer is no, risk is higher.

6. How much of its cash flow is it paying out? Paying too much leaves a trust vulnerable to a cut in distributions, which can have a devastating effect on the unit price.

7. Has its cash flow and profitability shown acceptable performance in relation to the rest of its industry? If it can't make money when business is good, when can it make money?

8. Are there any special factors worth considering? With resource trusts, you need to look at how long reserves are likely to last; with real estate investment trusts (REITs), you need to look at the quality of tenants, length of leases and the possibility of improving the use or expanding the occupancy of existing properties.

9. Is the industry stable or cyclical? If cyclical, is it currently in a high or low part of the cycle?

10. Is the trust (or the industry it's in) the subject of a lot of favourable broker and media attention? If so, investor expectations may be excessively high, and that leaves the trust vulnerable to a steep downturn on any hint of bad news.

11. Is the current and prospective yield high enough to justify the risk? High yield may signal danger rather than a bargain.

Analyzing these 11 factors has helped us avoid many income-trust disasters of the past few years, while zeroing in on lower-risk trusts that have generally done well for us. Here are four examples:

H&R REAL ESTATE INVESTMENT TRUST $24.01 (Toronto symbol HR.UN; TSINetwork Rating: Extra Risk) owns stakes in 42 office buildings, 115 industrial properties and 138 retail properties across Canada. H&R has a 98.7% occupancy rate.

H&R recently opened The Bow, a $1.33-billion, 1.7-million-square-foot office building in Calgary. Encana Corp. has leased the entire building for 25 years.

The REIT raised its yearly distribution rate by 8.0%, to $1.35 a unit, in January 2013. The units now yield 5.6%.

H&R REIT is a buy.

BROOKFIELD RENEWABLE ENERGY PARTNERS LP $31.27 (Toronto symbol BEP.UN; TSINetwork Rating: Extra Risk) took its current form in November 2011 as a result of the merger of Brookfield Renewable Power Fund (old symbol BRC.UN on Toronto) with the extensive hydroelectric and wind power holdings of Brookfield Asset Management (symbol BAM on Toronto). The combined entity owns 185 power plants in Canada, the U.S. and Brazil generating 5,304 megawatts of electricity.

We think the merger is positive for Brookfield Renewable unitholders. The company recently raised its annual distribution rate from $1.38 per unit to $1.45. That gives it a yield of 4.6%, based on today's price. The move also enhances the company's growth prospects.

Brookfield Renewable Energy Partners is a buy.

ALLIED PROPERTIES REAL ESTATE INVESTMENT TRUST $34.11 (Toronto symbol AP.UN; TSINetwork Rating: Extra Risk) owns office buildings in 10 major Canadian cities that contain over 8.3 million square feet of leasable area.

These properties are mainly 19th and early 20th-century light industrial buildings that have been restored and converted to office and retail space. They usually feature high ceilings, natural light, exposed beams, interior brick and hardwood floors. The REIT has a 92.2% occupancy rate.

Allied's $0.1133 monthly distribution gives the units a 4.0% yield.

Allied Properties REIT is a buy.

RIOCAN RETAIL REAL ESTATE INVESTMENT TRUST $28.82 (Toronto symbol REI.UN; TSINetwork Rating: Average) is Canada's largest real estate investment trust.

RioCan has properties in all 10 provinces. The trust specializes in large outdoor malls, and owns 346 retail properties, 11 of which are under development. Most are in suburban areas, where land is generally cheaper than in towns and cities. In the past few years, RioCan has expanded in the U.S., where it now owns or invests in 52 malls.

The trust's annual distribution of $1.41 gives the units a 4.9% yield.

RioCan REIT is a buy. C134