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THE END OF A YEAR TO FORGET

This is the time of year when I review the performance of the recommendations I made in Income Investor over the last three and a half years and this year is not a year to look back on with any pleasure. The Canadian stock market and others around the world have experienced their worst bear market in a quarter of a century, and in some cases the declines have been breathtaking. The S&P/TSX is down 40% at time of writing, the S&P500 42%, the FTSE100 35% and the Nikkei225 48% (all in local currency).

However, there are several points which should give some solace to investors. Firstly, bear markets of this magnitude do not exceed the 45-50% falls seen from their peak over the last year unless this is the Great Depression, a scenario which none of Guardian's investment management firms believe is the case. The worst post war bear markets before this year in Canada were in 1957 and 1974, when the TSX's predecessor, the TSE300, lost over 45%, in both cases, the following year saw a rebound of over 25%. The extraordinary amount of stimulus and intervention by the authorities to say nothing of the rapid fall in interest rates from 4.5% to 2% in Canada and from 5.25% to 1% in the US, will result in liquidity flowing initially into financial markets such as equities and then eventually into the real economy, although, as the dire situation of the Big 3 Detroit automakers reminds us, there may well be high profile casualties along the way.

For readers of Income Investor, three of my recommendations actually produced positive returns this year, two due to takeovers (CHC Helicopters 7.375% bonds and Teranet) and one (Shaw Communications 7.5% bond) due to a switch recommendation earlier this year. Holders of CHC Helicopters will actually have a capital gain as the takeover price was $104 vs. $99.75 purchase price. This is a situation that investors may well experience when they receive their tax returns from mutual funds this year, as a number of companies were taken over such as Fording Coal, Teranet, Sleep Country and ATS Andlauer, to name some of the holdings in Guardian income trust funds, and will find themselves faced with having to pay capital gains tax in a year when their assets will have declined in value significantly.

The solution in this case is to sell some positions which have fallen in value and realize an offsetting capital loss. If one has capital gains in any of the 3 preceding years, these losses can also be used to offset these gains, leading to a tax refund from Canada Revenue, and if one does not have any realized capital gains, then the losses can be carried forward indefinitely, to offset any future capital gains.

Amongst the recommendations that I have made the two which I am going to recommend selling to realize a capital loss are the two which have reduced their payouts below the level they were distributing when the recommendations were made. These are Keystone North America, the funeral home operator, and BFI Canada, the waste management company. Both have converted from income trusts or in Keystone's case, an income participation security, into ordinary corporations, and reduced their payouts accordingly. In the case of Keystone, this was done in conjunction with a capital reorganization, and was only a 16% reduction, which, for taxable Canadian investors, would have resulted in them receiving the same net income due to the dividend tax credit on company dividend distributions. In the case of BFI Canada, which was discussed extensively in these pages, the reduction was an unexpectedly large 73%, although the management relented a little in the face of opposition form major income oriented shareholders, by doubling the payout to $1 per share for 2009, before settling at the new level of 12.5 cents a quarter against 15.15 cents a month as a trust beginning in 2010.

Keystone, my second recommendation in April 2005, had been yielding 10% at time of purchase, so the total return from this security up until the reduction in payout in May 2008 was a negative 13%, but after the cut and with the bear market accelerating through the summer, the price has fallen another 63% including dividends since mid May this year, making a total negative return of approximately 35%. This is very disappointing, because Keystone management has delivered on the promises it made when it went public, using its stock to purchase small regional operations, extract cost reductions by making those acquisitions in areas close to existing operations and concentrate in rural areas where there was less competition. The stock price has not reflected the growth in the company's revenues, forecast to be U$130m this year, and earnings before interest tax and depreciation (EBITDA), and although EBITDA margins were down in the third quarter ended Sept 30th due to higher energy and labour costs, the recent fall in energy prices and the rise in the U$ against the C$ should reduce the margin squeeze. Keystone is a small company which has been caught up in the major bear market of 2008 with no fundamental justification, but although the $0.84 cents p.a. distribution looks safe for the foreseeable future, this is a situation where it will be a while before the stability and security of the business model is recognized again.

BFI Canada is an example of management misreading the nature of their investor base. While recognizing that the change in trust taxation had led to an inability to grow the business through issuing stock for acquisitions, as had occurred with IESI purchase in 2006 which made BFI Canada the fifth biggest waste management company in North America, the unnecessarily large reduction in the distribution alienated income oriented investors without attracting more growth focused replacements. The company's intended NY listing has not yet occurred and despite a respectable set of Q3 numbers to end September 2008, with EDITDA up to $81.9m from $76.3m with Canadian revenues showing 11% revenue growth and North East US up 5.5%, brokers are lowering their price targets on a general decline in valuations for waste management companies. Even with margins set to benefit from declining diesel costs for the fleet of garbage trucks, BFI Canada seems to have picked exactly the wrong time to switch away from an investor base that looks for reasonable growth in a slow growing industry with high barriers to entry and pays out much of its cash flow to investors in favour of growth investors when the valuations such institutions will pay are falling due to the credit crisis. The price has declined by two thirds since recommendation in November 2005, although investors have received almost 7% annually in income, reducing the negative total return to 45%.

Therefore the scorecard for sales in the portfolio this year is three positions taken over or sold for moderate positive total returns since purchase of between 14% and 25% (the CHC Helicopters and Shaw Communications bonds and Teranet) and two sold for total negative returns since purchase of between 35% and 45% (Keystone and BFI Canada). Last year, there was one gain of 48% on CIBC and one loss of 28% on ING Canada. The reason for selling Keystone and BFI Canada rather than other recommendations, some of which have declined substantially as well this year, and which will be reviewed in the regular December issue, is that they reduced their distributions from their original level. The purpose of making recommendations to readers is to give them companies which will deliver a good income return, hopefully with some increase in the income over time, and while Guardian funds have retained their BFI Canada position, waiting to see if the management delivers on its growth strategy and to the additional $0.50 per share payout in 2009, Income Investor subscribers do not have to wait to see if those promises are met when there are so many other attractive income opportunities available at present.