



Third Quarter Ended September 30, 2005

Income Trusts: Ottawa's Benign Neglect Has Ended

The trust structure was fostered by the Canadian government to attract capital to the commercial real estate market after the bust in the early 1990s and to bolster the Canadian energy industry during the low-price oil environment that dominated the middle of the 1990s. This market successfully grew to a market capitalization of \$20 billion by 2000 and currently stands at roughly \$180 billion. Additionally, and largely unanticipated by the Ministry of Finance, between 2000 and today, the market capitalization of all non-real estate, non-energy trusts has increased from less than \$5 billion in 2000 to approximately \$80 billion at this time. Furthermore, this number was expected to continue growing rapidly as Canadian capital markets had removed five impediments that had held back the growth of the Trust market:

- The association of unlimited liability with trusts ownership
- The presence of foreign ownership limits
- The absence of Trusts in the benchmark indexes
- The dearth of institutional buyers
- The lack of a significant conversion premium

The third quarter was a period of seismic changes within the Trust market. There were two critical government announcements during the quarter that significantly impacted the market:

- September 9th Announcement: The initiation of a consultation period ending December 31st and notice to the markets that changes were coming.
- September 19th Announcement: The Ministry of Finance would no longer be offering advance tax rulings for companies wishing to convert to a trust structure

The second announcement destroyed more than \$9 billion in investors' equity in four days. With these actions the Federal government is ending its unofficial policy of benign neglect towards the Trust market and has offered a very strong suggestion that there is a strong bias against the trust structure.

These announcements were motivated by the perceived adverse consequences that the Liberal Government believed this transformation would have on Canadian capital markets and the economy as a whole. Although there are intelligent and knowledgeable opinions on whether these changes will be unfavorable or otherwise, the Liberals fear that the rapid growth in the Trust market will lead to potentially significant and adverse changes in productivity, business investment, foreign ownership, pension funds and tax revenues. Notwithstanding the current Liberal Government's numerous speeches regarding the importance of all these issues, there is a broad consensus that the government's current behavior is primarily driven by a fear of losing tax revenue.

Potential solutions available to the government include:

- Revision of the dividend tax credit system
- Reduction of Canadian Corporate Taxes
- Elimination of interest deductibility for trusts
- Restriction on Flow-Through Entities and trust ownership
- Addition of a withholding tax on trust distributions

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At this point, there is strong support within the financial and economic community for a harmonization of corporate and personal taxes, which would remove the tax incentive for companies to move to a trust structure. This course of action would involve a combination of corporate tax cuts and an increase in the current dividend tax credit (a reduction of personal taxes on dividend income). This option is expected to cost the federal government roughly \$1 to \$4 billion. Unfortunately, there is a significant doubt concerning the Liberal government's ability and willingness to act in the best interest of Canadians on this issue; these low expectations are held in part, because of Liberals' need to rely on NDP support in the House of Commons and the promise of an imminent Federal election.

At Brownstone we are executing a number of strategies to enhance performance for our investors. Chiefly, during the past quarter we maintained an underweight position in the Trust market. In addition, we have focused our investments in companies with proven business models, stable revenues, and compelling valuations; metrics which we feel are prerequisites to the regular and increasing distributions that the trust model demands. Examples of trusts that meet our criteria include:

- Sunrise Senior Living
 - The company operates senior & assisted-living facilities. We anticipate that the company will continue enjoying stable and growing revenues because of positive demographic trends and its attractive facilities in desirable locations
 - Growth prospects provided by management's proven ability to make accretive acquisitions
- Keystone North America
 - Operates cemeteries in US rural markets with populations less than 150,000 people
 - Historically this business has enjoyed stable to rising revenues with robust margins
 - Growth prospects are provided by the ability to acquire additional facilities at compelling valuation multiples and the ability to improve operating performance
- Energy Savings Income Fund
 - Offers homeowners the ability to protect themselves from rising energy prices by locking into 5-year fixed-price contracts for heating and electricity
 - The company is growing revenues and adding new customers by meeting a key need in the consumer market; one that we believe will be accentuated by the rising prices for natural gas and the commensurate rise in home heating bills that will follow



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