BMO Nesbitt Burns®

Investing For Income: *High Yield Alternatives*

Portfolio Strategy
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Increasingly investors are turning to their investments and savings as sources of income. Historically, debt securities, such as bonds and GICs, have been favoured for their predictable and stable income stream.

There are several benefits to investing in debt securities, including a senior claim on the issuer's assets. Moreover, there is a legal obligation by the issuer to make interest payments and repay the debt at maturity. However, the main drawback to investing in debt securities is that bond interest is subject to a higher tax rate than other types of income. This tax treatment, combined with persistently low interest rates, is causing investors to look to alternatives for higher after-tax yields.

An investor who is seeking tax efficiency will discover that there are many income-oriented alternatives. Specifically, certain common shares pay out quarterly dividends at a modest rate. Preferred shares, income trusts and closed end income funds also offer relatively attractive yields. In addition, convertible debentures and equity linked notes offer investors a combination of income and the potential for capital appreciation. Distributions are paid monthly or quarterly and may consist of dividends, capital gains or 'return of capital'. Distributions that are designated a return of capital are taxable only upon disposition of the asset, and are subject to the same tax treatment as capital gains. As illustrated in *Table 1* on the following page, these types of income are granted more favourable tax treatment than interest income.

Table 1
2005 Combined Federal And Provincial Top Marginal Tax Rates For Individuals

	Interest (%)	Capital Gains (%)	Dividends (%)
British Columbia	43.70	21.85	31.58
Alberta	39.00	19.50	24.08
Saskatchewan	44.00	22.00	28.33
Manitoba	46.40	23.20	35.08
Ontario	46.41	23.20	31.33
Quebec	48.22	24.11	32.81
New Brunswick	46.84	23.42	37.26
Nova Scotia	48.25	24.13	33.06
P.E.I.	47.37	23.69	31.96
Newfoundland	48.64	24.32	37.32

Source: KPMG (current as of December 20, 2004)

Dividend Tax Credit

Dividends from Canadian corporations are eligible for the dividend tax credit, which results in a lower federal tax rate for dividends than interest income. An investor will notice that their T3 or T5 form shows the actual amount of dividends as well as a higher amount of taxable dividends. That is because dividend income is grossed up by 25% in order to arrive at total taxable income. Federal tax is applied to this amount, but is then reduced by the dividend tax credit. As outlined in *Table 2*, the net effect is that an investor in the highest tax bracket would be subject to a 19.6% federal tax rate on dividends compared to 29.0% for interest income and 14.5% for capital gains.

Table 2
Top Federal Tax Payable on $1,000

	Capital Gains	Canadian Dividends	Interest
Income	$1,000.00	$1,000.00	$1,000.00
Grossup 25%	0.00	250.00	0.00
Total Taxable Income	500.00	1,250.00	1,000.00
Federal Tax 29% of taxable income	145.00	362.50	290.00
Dividend Tax Credit (2/3 of grossup)	0.00	(166.67)	0.00
Total Federal Tax	$145.00	$195.83	$290.00
Top Federal Marginal Rate	**14.5%**	**19.6%**	**29.0%**

While equities and equity related securities are generally considered to be riskier than bonds and GICs, they can be used selectively to enhance cash flow and tax efficiency. By diversifying an income portfolio to include both debt and selected equities, it is possible for an investor to enhance after-tax returns while reducing risk. In this article, we review the features, risks and benefits of selected income alternatives.

In addition, we highlight a number of high-yield alternatives to help investors achieve their desired investment income requirements. As with any investment, individuals should consider their personal investment goals and risk tolerance prior to making an investment decision.

Common Shares

In the current environment, the yield offered by certain common shares is not only competitive with bond yields but, in some cases, more attractive. Moreover, these blue chip, high-yielding common shares tend to increase their dividend over time, particularly during profitable periods. While it is also possible to experience a dividend cut during periods of financial difficulty, this tends to be the exception to the rule.

Some investors purchase common shares for capital appreciation potential rather than dividend income. Capital gains are taxed at a lower rate than interest and dividends. As such, common shares represent one of the more tax efficient investment alternatives due to the ability to defer capital gains until the investment is sold, and to the preferential tax treatment of capital gains and dividends.

Common shares offer investors a modest quarterly income stream, as well as dividend and capital growth potential. While common shares offer an alternative for income-oriented investors, they carry greater risks than high-grade debt securities and preferred shares. When investing in common shares, an understanding of equity market risk is a prerequisite, and share price variability must be tolerated.

BCE (BCE)
CIBC (CM)
Emera (EMA)
Royal Bank (RY)
Russel Metals (RUS)

Convertible Debentures

Growth oriented investors may also wish to consider convertible debentures, which offer both interest income and capital appreciation potential. Like a conventional bond, a convertible debenture pays interest semi-annually and has a par value and maturity date. However, it also allows the debenture holder to convert into the underling common shares. This conversion feature provides the potential for capital gain if the underlying common shares perform well.

In evaluating convertible debentures, an investor must consider: (1) the potential for the underlying common shares; (2) the issuer's credit rating; and (3) the yield-to-redemption.

Convertible debentures offer equity-oriented investors a combination of regular interest income and capital appreciation potential. Because convertible debentures contain equity-like and debt-like features, an understanding of equity market risk and credit risk is essential.

Algonquin Power 6.65% due July 31, 2011 (APF.db)
CHIP REIT 6% due November 30, 2014 (HOT.db.A)
Cineplex Galaxy 6% due December 31, 2012 (CGX.db)
Northland Power 6.5% due June 30, 2011 (NPI.db)

Preferred Shares

'Preferred' shares are a class of equity that rank junior to debt and senior to common shares as to the distribution of income and claim on the issuer's assets. Most preferred shares offer a fixed quarterly dividend that exceeds the company's common dividend yield. As with bonds and GICs, investors purchase preferred shares for their regular income stream rather than for growth.

Unlike debt interest, preferred share dividends are not a legal obligation and are payable only when declared by the Board of Directors. However, failure to declare preferred share dividends would have very serious implications — the share price would fall substantially, investors would suffer a loss of income, and the issuer's credit rating and ability to raise capital in the future would be impaired. Before a preferred share dividend may be cut or omitted, the common dividend must first be eliminated.

Preferred shares offer investors more tax efficient income than bonds and debentures, but rank below debt securities on the issuer's balance sheet. Preferred shares offer a higher yield than the company's common shares, but growth potential is limited.

Brascan Floating-Rate (BNN.pr.B)
Brookfield Properties 5% Retractable (BPO.pr.J)
Sun Life Financial 4.8% Fixed-Rate (SLF.pr.B)
Weston 5.2% Fixed-Rate (WN.pr.C)
Falconbridge 4.58% Fixed-Reset (FAL.pr.B)

Income Trusts

Income trusts are equity investments designed to provide a relatively high level of income. The income trust sector encompasses a wide variety of businesses, from oil and gas producers and forestry products to real estate, power generation and transportation. The trust sector has expanded rapidly in recent years, and now includes businesses such as media, consumer products, industrials and restaurants. Shareholders are entitled to substantially all of the operating cash flow generated by these assets. Distributions are paid monthly or quarterly.

Income trusts do not offer a fixed coupon rate, par value or maturity date. Moreover, distributions may vary as they are tied to the profitability of the underlying operations. In evaluating income trusts, an investor must consider: (1) the type of business the trust is exposed to; (2) the predictability of distributions; and (3) management's ability to manage risk and enhance returns.

Distributions may consist of interest, dividends and/or return of capital (ROC). As with all investments, tax on interest and dividends is payable annually. ROC distributions are considered a reduction in the cost base of the unit for tax purposes and any tax payable thereon is deferred until disposition. Distributions on REITs and power trusts tend to contain a relatively large ROC component, while most business trust distributions are fully taxable as interest.

Income trusts offer equity oriented investors a higher level of cash flow than most bonds, common shares and preferred shares, and may contain a tax deferral component. An understanding of equity market risk is essential, and variability of cash flow should be tolerated.

BFI Canada (BFC.un)
Boralex Power (BPT.un)
Davis & Henderson (DHF.un)
Penn West Energy (PWT.un)
RioCan REIT (REI.un)
Yellow Pages (YLO.un)

Closed End Income Funds

As with income trusts, closed end income funds trade on the stock exchange and pay out monthly or quarterly distributions. Typically, the fund invests in a portfolio of diversified high-yielding equities, income trusts, and/or high-yield debentures. The objective is to provide professional management and to generate a relatively high and tax efficient income stream. The portfolio manager usually sets a target distribution at inception, but distributions may vary over time depending on changes or developments in fund holdings. As with income trusts, any return of capital distributions reduce the fund's cost base, and tax thereon is deferred until disposition.

Closed end income funds offer equity oriented investors a higher income stream than many bonds, common shares and preferred shares, and are among the most tax efficient income investments. An understanding of equity market risk is essential, and variability of cash flow should be tolerated.

Barclays Advantaged S&P/TSX Income Trust Fund (BAI.un)
Brompton Equal Weight Income Fund (EWI.un)
SCITI Trust (SIN.un)

Equity Linked Notes

Equity linked notes offer exposure to equity markets with a guarantee of principal repayment at maturity. The sector has evolved over the years, and today many linked notes offer periodic distributions and/or the opportunity for leveraged returns, in addition to principal protection.

Normally a note is linked to the performance of a diversified portfolio of income trusts or mutual funds. Monthly distributions from the note are tied to the distributions generated by the underlying securities. When held outside of a registered account, distributions are fully taxable as interest income. To enhance tax efficiency for non-registered accounts, Bank of Montreal offers a unique structure that allows investors to characterize distributions as return of capital. Typically, BMO's notes pay out approximately 75% of the distributions from the underlying portfolio while the balance is reinvested for capital growth.

Equity linked notes offer a relatively high periodic income stream, which may be taxable as return of capital. The income stream is not fixed, and may vary depending on developments in the underlying portfolio. When investing in equity linked notes, an understanding of equity market risk and, in some cases leverage, is essential; variability of distributions should be tolerated.

BMO Dynamic Principal*Plus* ROC Note Yield Class, Series 1 due Nov. 10, 2014 (JHN401)
BMO MSP ArMADA Note Maxxum Yield ROC Class, Series 1 due Nov. 5, 2012 (JHN501)

Throughout this report we have highlighted a variety of high yield alternatives to help investors achieve their desired investment income requirements. We note the interest rate environment has been supportive of high-yield equities for some time. Although we believe that interest rates will rise modestly over the next 12 months, we expect them to remain low by historical standards and to provide support for longer-term investments, such as the ideas highlighted in this report. However, if interest rates rise more than anticipated, the relative attractiveness of the yields offered by these income-oriented alternatives would likely diminish and valuations could come under pressure.

As with any investment, individuals should consider their personal circumstances, investment goals and risk tolerance before making an investment decision. Your BMO Nesbitt Burns Investment Advisor will be pleased to provide further information on these specific ideas as well as other income alternatives.

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Investors should not rely solely on this report for specific advice regarding personal taxation. Investors should consult a professional tax advisor regarding their individual situation.

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