By Dan Hallett, CFA, CFP

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Reality check

Clarington Canadian Income faces high hurdle

Last week, I expressed my beef with mutual funds that offer a fixed level of distributions. In particular, I featured the Clarington Canadian Income fund, and its fixed payout policy. For this fund to raise its unit price back to its original $10 and simply maintain the 8 cent per unit monthly distribution, the fund would have to return a total of 12, 11, and 10 per cent per year, over the next one, five, and ten years, respectively, using recent unit prices. This week, we look at why disappointment will soon set it for investors that are relying on this fund's generous distribution.

The math

That 10 per cent return needed for Clarington Canadian Income to sustain its distribution without dipping into capital over the next ten years is net of the fund's 2.54 per cent management expense ratio (MER). Hence, if we look at gross returns (i.e. before the MER), the fund will have to produce a return of 12.54 per cent annually (0.10 + 0.0254 = 0.1254 or 12.54 per cent). Roughly half of this fund is invested in bonds (43 per cent) and cash (7 per cent). The rest is in foreign stocks and, to a lesser extent, Canadian stocks.

The bonds in this fund have an estimated current yield of about 6.1 per cent. Since it makes up 43 per cent of the fund, the bonds' contribution to the fund's total return is 2.62 per cent per year (0.061 x 0.43 = 0.0262 or 2.62 per cent). The seven per cent allocation to treasury bills currently yields an estimated 2 per cent per year – for a contribution to total return of 0.14 per cent per year (0.02 x 0.07 = 0.0014 or 0.14 per cent). Hence, the total of bonds and cash will contribute an estimated 2.76 per cent annually to the fund's gross total return.

If interest rates rise, that "current" yield will increase on the bonds and cash, but the bonds will suffer price declines, which will likely offset any pick up in yield. (And don't forget that rising rates is also bad for stock prices.) Hence, for simplicity, I've assumed flat interest rates – a very optimistic assumption given today's ultra-low interest rates. Since the fund needs a total annualized return of 12.54 per cent annually before fees, the stock portion must kick in the remainder – 9.78 per cent (0.1254 – 0.0276 = 0.0978 or 9.78 per cent).

While a return of less than ten per cent sounds pretty feasible over ten years, don't forget that stocks only make up half of this fund. So that means the stocks in this fund must produce a gross return of 19.56 per cent annually (0.0978 ÷ 0.5 = a gross return of 0.1956 or 19.56 per cent annually) for the next ten years just to maintain the current distribution. Even with a greater emphasis on stocks, the return requirement from that component would still approach 16 per cent annually before fees.

I'm sorry to tell you that it just isn't feasible, in my opinion.

A glimpse of the future

If I'm right about the return needed to sustain the current distribution not being feasible, the fund will have two choices: reduce the distribution or risk eroding the fund's unit price over time. Do you believe it's possible to erode the capital with such a high distribution over a long period of time? Fund supporters might argue that the managers are very astute and, over time, will probably make up for this high distribution. I would disagree, though it wouldn't have anything to do with my assessment of the manager's skills.

Take a look at Mackenzie Financial's Industrial Income fund. It also fixed its distribution at a high level ($0.25 quarterly per unit – between 10 and 12 per cent of the unit price for many years) some time ago. It used very long-term bonds to sustain this and it worked for a while because rates were high and falling. However, even that environment wasn't favourable enough to save capital from eroding.

The original Industrial Income fund – the A units – has seen its unit price fall nearly 30 per cent over the past sixteen years – that's an annual compound loss of more than 2 per cent per year. Yes, distributions have been made consistently, which would have produced a decent total return if reinvested. However, this distribution has been paid out at the expense of future inflation protection and preservation of the original investment.

The other problem is that the distribution five and ten years from today will not be worth nearly as much as it is today. The result: Having the distribution increase with inflation is sacrificed at the expense of higher payouts today. The payout is so high to start with, that the fund has no chance of growing the capital. Effectively, the investor is left to reinvest a portion of the distribution if capital is to be fully maintained and/or grow.

Reinvesting distributions

My cautionary tone is only aimed at those depending on the overly generous distribution to pay for living expenses. If most or all of the distribution is reinvested, the depletion of capital is really not an issue. However, I am making an assumption that most investors in the Clarington Canadian Income fund are using the distribution to pay for living expenses (i.e. taking it in cash). Otherwise, why would they pay such a generous distribution; and why would they offer a nearly identical fund, Clarington Canadian Balanced, which is run by the same team and distributes only "realized income and capital gains". (Clarington Canadian Balanced does, however, charge a substantially higher 2.9 per cent MER.)

Tax implications of a return of capital distribution

Recall that when you receive a distribution and have it reinvested back into more units of a fund, it raises your cost for tax purposes (ACB – adjusted cost base). When reinvesting distributions that are simply a "return of capital" there is no change in the ACB. In fact, when taking a return of capital distribution "in cash", your ACB is reduced. The distribution isn't taxed when received because it's not income – it's capital – but you reduce your cost, which means larger capital gains later when you sell.

Final say

I should clarify again that Clarington's distribution policy on their Canadian Income fund is that they'll continue to pay the current monthly 8 cents per unit as long as they think it can be sustained. Otherwise, they will cut it.

To sustain the current distribution and preserve capital, the 10 per cent annualized return needed over the next ten years is unrealistically high. Further, if interest rates rise over the next ten years, which is likely, it may be that much tougher to leap that high hurdle. In my opinion, Clarington Canadian Income fund will have no choice but to cut its distribution within the next twelve to twenty-four months.

If you deal with a financial advisor, s/he should clearly explain the fund, its distribution policy, its supporting investment strategy, and the implications thereof.
If you depend on this fund's distribution, start adjusting your expectations now, before you're forced to.

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