

High yields don't come free

In a vacuum, high yields are great. Everybody likes dividends, and investors can generate plenty of income from stocks. Royalty trusts, real estate investment trusts (REITs), and master limited partnerships average much higher yields than other types of stocks, even utilities.

But investors don't live in a vacuum, and those dividends come at a price — extra risk or low capital appreciation potential.

Risk and return

Consider first the three-month Treasury bill, a bond with no default risk and very little exposure to changes in interest rates. The T-bill yields 5.01%. Long-term bonds offer investors extra compensation for taking on interest-rate risk, and corporate bonds generally yield more than Treasury bonds of similar maturity, compensating investors for the risk of default. On July 3, 2006, the Merrill Lynch index of long-term corporate bonds yielded 6.3%, while the index of high-yield (junk) bonds yielded 8.5%.

In general, common stocks are considered riskier than bonds, providing more capital-gains potential at the cost of more price volatility. Historically, investors have been rewarded for taking on that extra risk, as stocks generally outperform bonds over long periods of time. From 1926 to 2004, large-company stocks delivered annualized returns of 10.4%, versus 5.9% for long-term corporate bonds, 5.4% for long-term government bonds, and just 3.7% for short-term Treasury bills.

Most stocks that pay very high yields are riskier than the broader market, and the large payouts reflect compensation to investors for bearing that risk. The S&P 500 Index of large company stocks yields 1.9%. In contrast, the average master limited partnership yields about 6%, and the average royalty trust a rich 9%.

Chasing income

REITs have historically delivered modest capital gains and paid high dividends. Royalty trusts and partnerships are a different story and tend to be riskier than REITs, with a commensurately higher potential reward. These entities can afford to pay large dividends because they are structured differently from operating companies and enjoy special tax benefits. The nature of those corporate and financial structures makes fundamental analysis difficult.

How they work

In a limited partnership, the general partners manage the business. Limited partners are entitled to a share of the cash flows, though they have no say in how the business is run.

Master limited partnerships are publicly traded partnerships in which investors become limited partners. Limited partners are not liable for the company's obligations.

Taxes on partnership interests can be complicated. Some of the payout can be tax-deferred, but because they are partners, investors must pay taxes on both the dividend payout and their share of the partnership's income.

REITs are companies formed to buy, sell, and manage real-estate assets. They are required by law to pay out at least 90% of income in dividends. Most generate cash from rents on managed properties, while some invest in mortgage loans. A few focus on land development.

Royalty trusts distribute cash flows from assets and distribute them to shareholders. Payouts often fluctuate depending on the performance of the underlying assets, usually oil or natural-gas fields. And that itself is the biggest risk of royalty trusts — cash flows depend on assets that are depleted over time, and it can be difficult for investors to determine how quickly management is depleting those assets to fund a large payout.

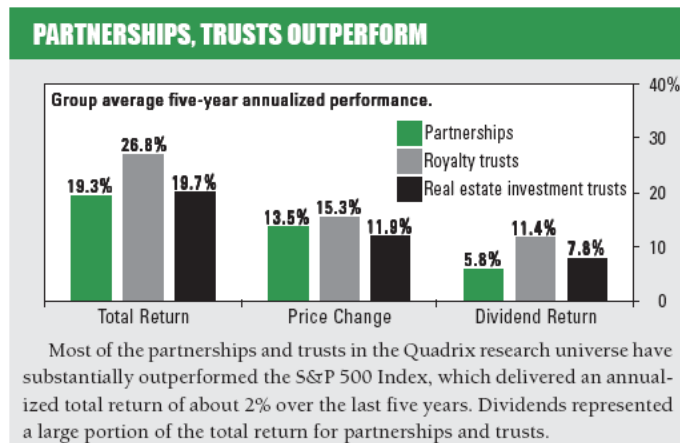
Because the dividends of royalty trusts are often volatile, their stated yields can be misleading. Investors should consider the dividend history of a trust before purchasing it, sticking to trusts with a history of steady or rising payouts.

Most trusts and partnerships are flow-through entities, meaning that income passes through the companies for distribution to investors without being taxed. Trusts and partnership can deduct these flow-through payments from their taxes. (Most companies cannot deduct dividend payments, so that money is taxed twice, once as corporate income, and again after payment to investors.) Most dividends from partnerships, royalty trusts, and REITs are not eligible for the 15% tax rate, and investors must pay tax on them at the same rate as ordinary income.

Worth the risk?

Over the last five years, partnerships and trusts have delivered impressive returns, with price appreciation above that of the broader market, augmented by high dividends. As the chart illustrates, the average partnership generated an annualized total return of 19% over the last five years, while the average royalty trust performed even better.

However, much of that outperformance stems from rising oil and natural-gas prices and the related strength of the energy



sector. Of the 60 master limited partnerships in our Quadrix universe, 70% are energy companies. And 22 of the 26 royalty trusts distribute cash flows from energy assets.

Those energy-related companies are unlikely to match historical returns over the next few years. A softening of the real-estate market, coupled with high REIT valuations, suggests REITs' profit and share-price growth also will come down to earth. While the *Forecasts* sees better opportunities for the year ahead than trusts and partnerships, we acknowledge that their high yields will appeal to income-oriented investors. Individuals should not invest too heavily in such stocks, but they make sense as a small portion of a diversified equity portfolio. If you wish to purchase trusts or partnerships, spread your bets among several stocks.