Acorn Income Fund

Green shoots of recovery

Investment companies

11 February 2015

Acorn Income Fund (AIF) seeks a high income and the possibility of growth from a portfolio split between small-cap equities (70-80%) and high-yield bonds (20-30%). Long-term performance has been exceptional, with NAV total returns of c 200% over five years. A combination of deteriorating sentiment towards smaller companies and investor uncertainty following the death of founding small-cap portfolio manager John McClure in June 2014 caused the discount to widen. McClure's co-managers provide continuity of management and, with recent NAV performance looking better, there is scope for the shares to re-rate to a level more in line with long-term averages.

12 months ending	Total share price return (%)	Total NAV return (%)	Total ZDP price return (%)	Total return Numis Smaller Cos ex IC (%)	Total return FTSE All-Share (%)
31/01/12	(2.9)	5.6	N/A	(1.8)	(0.3)
31/01/13	69.7	39.4	9.5	25.6	16.3
31/01/14	34.9	39.9	5.0	31.8	10.1
31/01/15	(8.6)	(5.4)	6.8	(2.6)	7.1

Source: Thomson Datastream

Investment strategy: Dual focus to achieve income

AIF has two pools of assets with different managers: the small-cap equity portfolio (currently 73.5% of assets) is managed by Simon Moon and Fraser Mackersie at Unicorn Asset Management, while Paul Smith at Premier Fund Managers runs the income portfolio (26.5%). Both pools are the product of bottom-up stock selection. The equity managers seek companies with strong competitive positions, motivated management, cash generation and a focus on dividends, while in the income portfolio the relatively small pool of assets means the manager can access small issues of interesting higher-yielding securities that would be inaccessible to managers of larger bond portfolios.

Equity outlook: Good news and bad news

The run-up to the May 2015 general election could cause short-term volatility for investors in the UK, while fears over recession in Europe and the spectre of deflation, exacerbated by falling oil prices, could also weigh on sentiment. More positively, the introduction of QE in the eurozone may spark a reassessment of prospects, and the lower oil price is viewed as good news in many quarters. In uncertain times, a focus on dividends (see page 3) could help overcome near-term market wobbles.

Valuation: Scope for current discount to narrow

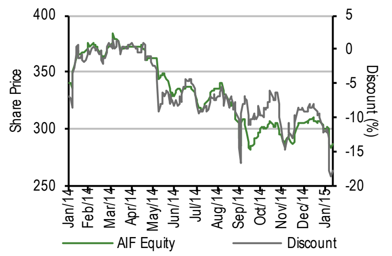
After trading at a premium for much of the first half of 2014, falling appetite for small-cap shares combined with the untimely death of founding smaller company portfolio manager John McClure saw AIF drift to a discount from June onwards. At 10 February 2015 the shares stood at a 17.6% discount to cum-income NAV, compared with 12-month average of 6.0%. Continuity of management, a strong long-term performance record and the likelihood of outperformance in a rising market because of the structural gearing all support the view that the discount could narrow in time.

Price	**287.3p**
Market cap*	**£44.6m**
AUM	**£76.9m**
NAV**	343.5p
Discount to NAV	16.4%
NAV***	348.8p
Discount to NAV	17.6%
Yield	4.4%

*Ords only. **Ordinary share, excl income. ***Ordinary share, incl income. Data to 10 February 2015.

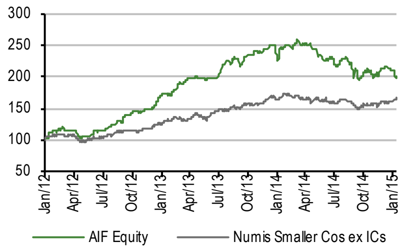
Ordinary shares in issue	15.524m
ZDPs in issue	20.838m
Code	AIF
Primary exchange	LSE
AIC sector	UK Equity & Bond Income

Share price/discount performance*



*Ordinary shares, including income.

Three-year cumulative perf. graph



52-week high/low	384.0p	282.0p
NAV* high/low	377.9p	316.7p

*Ordinary shares, including income.

Gearing (including ZDPs)

Gross	47.7%
Net	46.0%

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Edison profile page

Acorn Income Fund is a research client of Edison Investment Research Limited

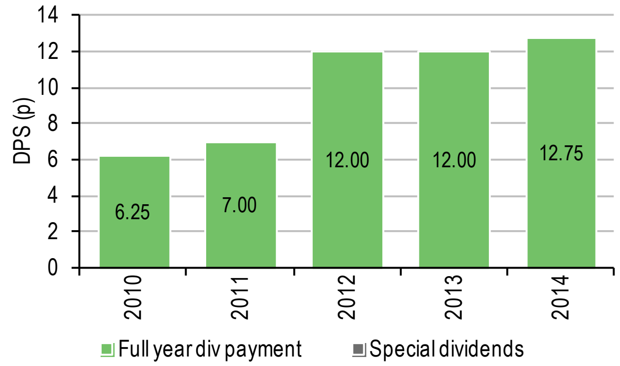
Exhibit 1: Investment company at a glance

Investment objective and fund background	Recent developments
AIF's objective is to provide a high level of income with the opportunity for capital growth. The fund is geared using zero dividend preference (ZDP) shares. The portfolio is split into two pools, one (70-80% of assets) is invested in UK small-cap equities, the other is an income portfolio containing fixed-interest instruments, convertibles and high-yielding shares in other investment companies. Performance is measured against the Numis Smaller Companies (excluding investment companies) Index.	20 November 2014: Fourth interim dividend of 3.25p declared for the year ending 31 Dec 2014, +8.3% compared with a year earlier. 21 August 2014: Half-yearly results for the six months ended 30 June. NAV TR +1.52% vs -0.59% for Numis Smaller Companies Index.

Forthcoming		Capital structure		Fund details	
AGM	August 2015	Ongoing charges	1.8% on net assets	Group	Premier Fund Managers Ltd
Annual results	April 2015	Net gearing	46.0% (through ZDPs)	Manager	Simon Moon, Fraser Mackersie (Unicorn); Paul Smith (Premier)
Year end	31 December	Annual mgmt fee	0.7% of total assets (min £100k)	Address	Eastgate Court, High Street, Guildford GU1 3DE
Dividend paid	Quarterly	Performance fee	Yes, see page 7		
Launch date	11 February 1999	Trust life	Indefinite, subject to five-yearly continuation vote (next in 2016)	Phone	+44 (0)1483 30 60 90
Continuation vote	2016 AGM	Loan facilities	None	Website	www.premierfunds.co.uk

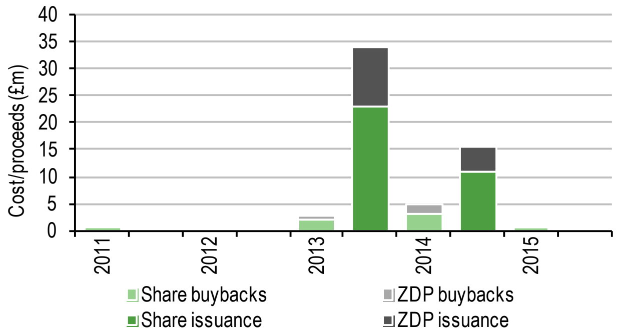
Dividend policy and history

Quarterly dividends paid in March, June, September and December. Higher dividends since 2012 facilitated by ZDP issue, which eliminated interest costs.

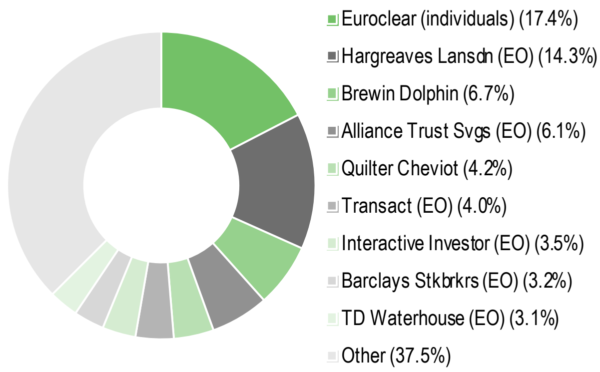


Share buyback policy and history

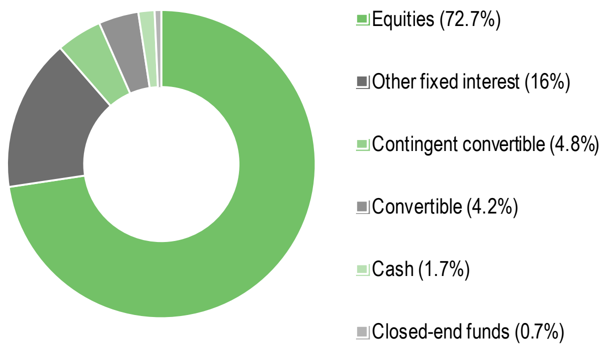
ZDPs are issued and bought back at the same time as ordinary shares in quantities such that the ratio of ZDPs to ordinary shares is maintained.



Shareholder base (as at 10 January 2015)



Distribution of portfolio (as at 31 December 2014)



Top 10 holdings (as at 31 December 2014)

Company	Portfolio	Industry	% weight
Acal	Smaller companies	Industrial electronics	4.1
Secure Trust Bank	Smaller companies	Banking	4.1
Primary Health Properties	Smaller companies	Real estate	4.0
Hill & Smith Holdings	Smaller companies	Specialist industrial products	3.8
Brewin Dolphin Holdings	Smaller companies	Investment management	3.5
Berendsen	Smaller companies	Industrial laundry service	3.5
Tyman	Smaller companies	Door and window components	3.3
Safestyle UK	Smaller companies	UPVC/building products	3.3
Cineworld Group	Smaller companies	Cinema operator	3.3
British Polythene Industries	Smaller companies	Plastics and packaging	3.3
Equity portfolio top 10 (% of equity portfolio)			**36.2**
Income portfolio top 10 (% of income portfolio)			**27.1**

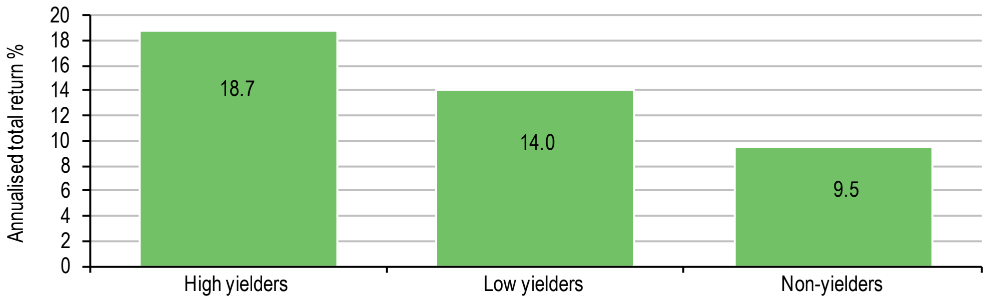
Source: Acorn Income Fund, Edison Investment Research, Morningstar, Bloomberg

Equity outlook: The importance of dividends

Studies show that dividends (both yield and dividend growth) are a vital part of long-term equity returns. Reinvested income compounds over the long term, and companies that pay dividends are, almost by definition, more focused on cash generation. Yet the managers of Acorn Income Fund point out that with 89% of UK dividend income coming from the FTSE 100 index, investors may be overexposed to just a few companies: according to the Capita Dividend Monitor, the top 15 payers paid out 63% of FTSE 100 dividends in Q314. The study also showed payouts from FTSE 100 firms fell 1.1% compared with the third quarter of 2013, while FTSE 250 companies raised their dividends by 7.6% year-on-year (16% excluding special dividends, which were higher in Q313).

Analysis by the compilers of the Numis Smaller Companies Index, which covers the bottom 10% of companies listed on the UK main market by market capitalisation, demonstrates the importance of yield in total return for small companies: as shown in Exhibit 2 below, over the long-term high-yielding smaller companies produced annualised total returns almost twice those of non-yielders, and one-third more than low-yielding smaller companies.

Exhibit 2: Annualised returns from Numis Smaller Companies Index, 1956-2014 (%)



Source: Numis, to Q214

Fund profile: High income from small-cap and bonds

AIF is a Guernsey-domiciled closed-ended fund, launched in 1999 and listed in London. It blends investment in mainly smaller UK companies (70-80% of the portfolio) and higher-yield securities (20-30%) to produce a high level of income, along with the potential of capital and income growth. At 30 January AIF's dividend yield was 4.25%, and over five years it has achieved an NAV total return of 197.8%. The income portfolio (20-30% of assets) is managed by Paul Smith at Premier Fund Managers. The smaller companies portfolio is managed by Simon Moon and Fraser Mackersie at Unicorn Asset Management. Having been named co-managers in December 2013, the pair have had sole charge of the portfolio since the unexpected death of founding manager John McClure in June 2014. AIF is geared (46% net) through zero dividend preference shares, issued in 2011 and maturing in January 2017 with a final capital entitlement of 138p.

Managers: Simon Moon, Fraser Mackersie, Paul Smith

The managers' view: Positioned for UK recovery

Smaller companies portfolio managers Simon Moon and Fraser Mackersie are expecting volatility in the run-up to May's UK general election. However, with the UK economy looking stronger they have increased their focus on domestic earnings, and predict that companies continuing to meet or beat earnings expectations will lead to renewed interest in the small-cap sector. While the portfolio is built from the bottom up, stocks held do fall into a number of themes, including UK recovery, financials (which the managers say go hand-in-glove with recovery), logistics and international earnings. Domestic exposure is now c 70%, with these companies expected to benefit from the effect of lower oil prices on consumers, and expectations of interest rate rises being pushed further into the future. Stocks with exposure to economic recovery and consumer spending include Marston's and Conviviality Retail (pubs and off licences), Safestyle and Epwin (property maintenance), Cineworld and used-car dealership Lookers.

Moon says the managers have been expecting an increase in M&A activity within the portfolio, given that money is still cheap and they hold "an exceptional array of niche companies at compelling valuations". While this has not yet happened, he says any uptick in activity would be good for calming market nerves after a difficult year.

In the income portfolio, Paul Smith says the defining feature for bond markets has been a decrease in liquidity, which has a disproportionate impact on managers of larger bond mandates. While credit spreads could still tighten to historic lows, he argues they should be wider given the liquidity premium and the risk of defaults, although he notes that as expectations for interest rate rises are pushed back, default rates are pushed back too, and there could be "an old-fashioned credit correction" once rates rise and companies find they can no longer refinance their debt at such favourable terms. "It is becoming increasingly important to look for unique opportunities and in a small portfolio like this you can take advantage of those," he adds.

Asset allocation

Investment process: Stock selection the key for both pools

AIF holds 70-80% in the smaller companies portfolio and 20-30% in the income portfolio, with 75/25 viewed as a neutral allocation. The balance is reviewed at each board meeting and the managers of both portfolios regularly discuss the allocation based on the outlook for each asset class.

The managers of the smaller companies portfolio focus on identifying companies with experienced and well motivated management, products or services supplying growth markets, sound operational and management controls, good cash generation and a progressive dividend (one company in the portfolio, A&J Mucklow, has increased its dividend annually for more than 50 years). Meetings with companies are an important part of the process, both before and after investment. The managers note that stocks with higher dividend yields tend to perform better in total return as well as income terms, and say the companies they own should be able to increase earnings and dividends hand-in-hand. Holdings may be trimmed or sold if dividend yields have fallen following a period of strong capital performance, with the proceeds reinvested in higher-yielding stocks.

The income portfolio has a longer stock list than the smaller companies portfolio (79 versus 41 at 31 December) but this is still viewed by management as quite an aggressive, concentrated position. It invests in higher-yielding securities such as bonds, preference shares and convertibles, and up to 15% of the total portfolio can be held in other closed-ended funds. The purpose of the income portfolio is to reduce overall volatility and boost yield. Like the smaller companies pool, the income portfolio focuses on bottom-up security selection rather than top-down asset allocation calls.

Current portfolio positioning

At 31 December 2014 AIF held 73.2% of gross assets in its smaller companies portfolio, with 26.8% in the income portfolio. This is a slight tilt towards the income portfolio versus the neutral weighting of 75/25. There were 41 stocks in the smaller companies portfolio, with an average market capitalisation of c £400m, while the income portfolio held 79 securities. The forward portfolio yield on the smaller companies portfolio is c 3.8%; for the income portfolio there is a c 5% distribution yield and an effective yield of 3.7%.

Sector allocation in both portfolios is an output of stock selection, although the sector split of the smaller companies portfolio is quite narrow (see Exhibit 3), with a large proportion in industrials and most of the balance in financials and consumer services stocks. Turnover in the smaller companies portfolio over the past year has largely been driven by yield, with full exits from plastic packaging firm RPC and thermal processing specialist Bodycote, and a significant reduction in plant hire firm VP coming after significant share price gains left dividend yields looking unattractive.

Exhibit 3: Sector allocations of smaller companies portfolio (at 31 December 2014 unless stated)

	Trust weight (%)	Trust weight (%) 31 May 2014	FTSE All-Share weight (%)	FTSE Small-Cap weight (%)	Active weight vs FTSE Small Cap (% points)	Trust weight/FTSE Small-Cap weight
Industrials	59.6	63.7	10.2	32.9	26.7	1.8
Telecommunications	3.0	0.0	5.0	1.3	1.7	2.3
Utilities	0.0	0.0	4.1	0.0	0.0	n/a
Basic Materials	1.9	1.9	7.5	2.4	-0.5	0.8
Financials	21.5	17.1	22.8	22.6	-1.1	0.9
Consumer Services	13.5	15.6	11.7	15.7	-2.2	0.9
Oil & Gas	0.0	0.0	13.2	3.8	-3.8	0.0
Health care	0.0	0.0	8.9	5.3	-5.3	0.0
Consumer Goods	0.0	0.0	15.0	6.5	-6.5	0.0
Technology	0.0	0.0	1.6	9.5	-9.5	0.0
Cash	0.6	1.8	0.0	0.0	0.6	n/a
Total	**100**	**100.0**	**100**	**100**	**0.0**	

Source: Acorn Income Fund, FTSE, Edison Investment Research. Ranked by active weight, excluding cash. Note: rounding errors mean some figures may not sum.

In the past six months five new positions have been taken. Concrete screed machinery maker Somero has been held in Unicorn's other portfolios for some time but was added to AIF as it has begun returning cash to shareholders in meaningful fashion. Telecom Plus, which operates the aggregation service Utility Warehouse, was bought after share price weakness saw yields rise to attractive levels. Manx Telecom was added at a yield of 6.5%; the managers had seen the company before its IPO in early 2014 but did not buy until after an autumn visit to the Isle of Man, where Moon says he was impressed with the company's strong market position in telecoms (it has 75-80% market share), reinforced by well-resourced data centres serving the business community. Building products company Epwin was bought at IPO; like holdings Safestyle and Tyman it supplies building products such as windows and drainpipes. Finally, a small position was added in Brazil-focused investment company Ocean Wilsons, following a change in its dividend policy resulting in a significant increase in the payout.

Duration in the income portfolio has remained steady at 4.25 years, with gilt futures used to offset higher interest rate sensitivity in pockets of the portfolio. There continues to be a relatively high weighting in contingent convertibles (CoCos) and related securities, which make up 19-20% of the pool and yield between 3.5% and 10.25%. Convertibles issued by property companies and closed-end funds also feature, benefiting from rising underlying share prices as well as positive yields to maturity and relatively short duration. Because of the small size of the portfolio Smith is able to gain access to small issues, such as a Tesco retail bond bought in December after a credit downgrade.

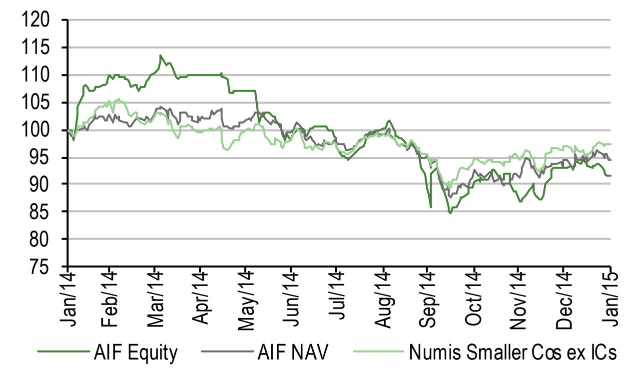
Performance: Set for recovery after one-year wobble?

AIF's strong record of medium- and longer-term outperformance can be seen below in Exhibits 5, 6 and the right-hand chart in Exhibit 4. Performance over the past year has been weaker, with share price total returns lagging both the benchmark and the NAV performance following a widening in the discount. With sentiment towards smaller companies having declined more than the actual performance of the asset class, NAV returns are ahead of share price returns over all periods of one year or less, reversing the picture seen over longer periods.

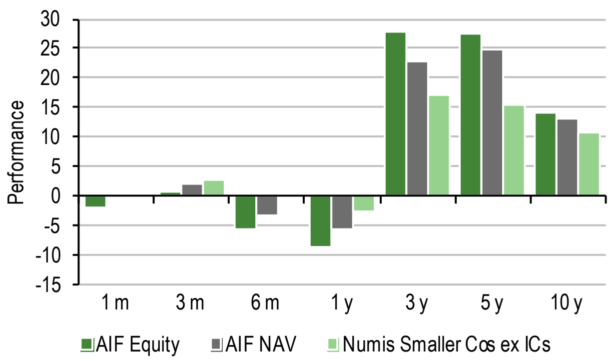
The managers point out that AIF's structural gearing means it is likely to underperform a falling market. However, by the same token, when markets turn the fund is likely to perform better than indices and peers with lower gearing. This trend can be observed in Exhibit 6: after falling more than the benchmark during the financial crisis of 2008/9, AIF then comfortably outperformed in the recovery phase and has seen only minor spells of relative underperformance in more recent times.

Exhibit 4: Investment company performance to 31 January 2015

Price, NAV and benchmark total return performance, one-year rebased



Performance - price, NAV and benchmark total return* (%)



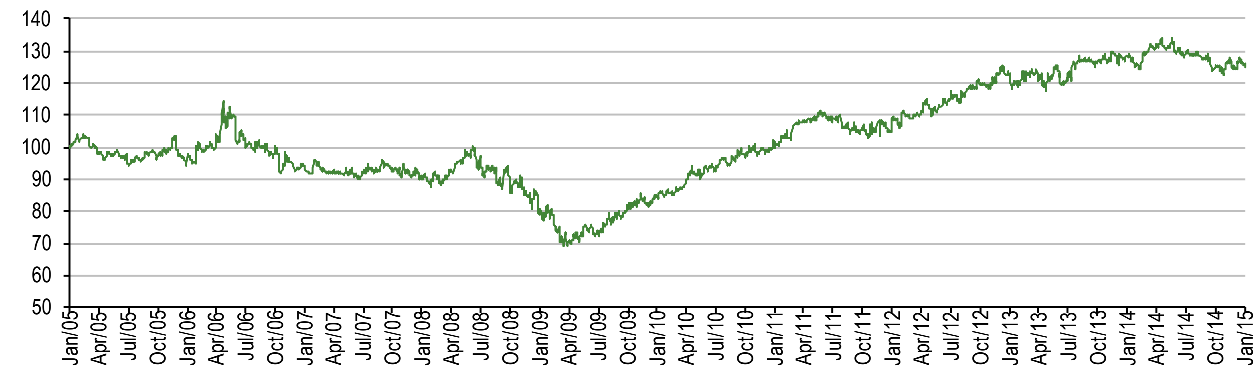
Source: Thomson Datastream, Edison Investment Research. Note: *Three, five and 10-year performance annualised.

Exhibit 5: Share price and NAV total return performance, relative to benchmarks, to 31 January 2015 (%)

	One month	Three months	Six months	One year	Three years	Five years	10 years
Price relative to Numis Smaller Cos ex ICs	(2.2)	(1.9)	(5.9)	(6.1)	29.8	65.7	33.9
NAV relative to Numis Smaller Cos ex ICs	(0.1)	(0.7)	(3.5)	(2.9)	14.5	48.1	24.9
Price relative to FTSE All Share	(4.3)	(2.9)	(7.9)	(14.7)	52.6	109.3	77.8
NAV relative to FTSE All Share	(2.3)	(1.7)	(5.5)	(11.7)	34.6	86.9	65.8

Source: Acorn Income Fund, Thomson Datastream, Edison Investment Research. Note: Geometric calculation.

Exhibit 6: AIF NAV total return vs Numis Smaller Companies ex-IC total return, over 10 years, rebased to 100



Source: Acorn Income Fund, Thomson Datastream, Bloomberg, Edison Investment Research

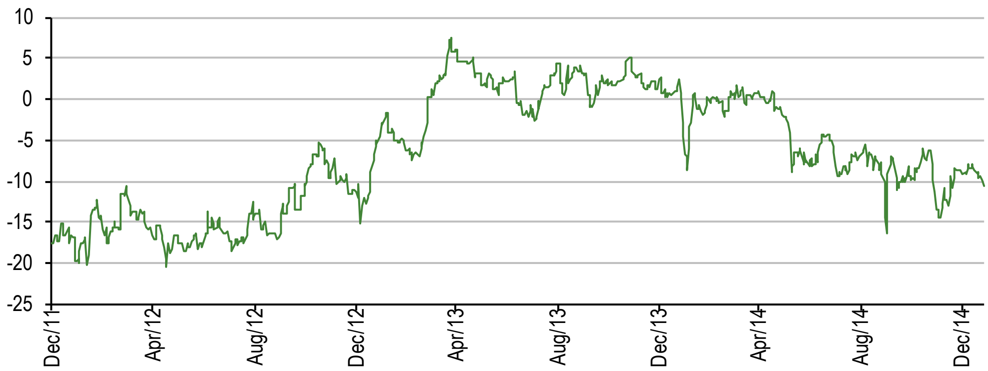
Discount: A year of two halves

2014 was a year of two halves for AIF's shares. The untimely death of founding smaller companies portfolio manager John McClure in June coincided with a period of relative weakness for the asset class, and after trading at an average discount to NAV of 1.3% in the first half of 2014, AIF's discount averaged 8.5% in the second half. At 10 February 2015 the ordinary shares stood at a cum-income discount of 17.6%. The average discount for the past 12 months is 6.0%, which is narrower than the average over three or five years (6.4% and 9.8%).

AIF traded at a premium for much of the early part of 2014 and the fund issued 2.9m ordinary shares worth £10.7m (ZDPs were issued to maintain the existing ratio and raised £4.5m). From late

June to the end of the year, 925,000 shares were bought back at a cost of £3m, with a further 100,000 shares bought back so far in 2015. Having worked hard to get AIF to a sustainable size (shares worth a net £21.2m were issued in 2013, in addition to the net £7.7m raised in 2014), the board is reluctant to shrink the fund through too vigorous a defence of the discount, and this is a position supported by key shareholders. Further buybacks are, however, a possibility if the discount does not narrow.

Exhibit 7: Discount/premium to cum-income NAV over three years



Source: Thomson Datastream, Edison Investment Research. Discount with debt at fair value, including income.

Capital structure and fees

At 10 February AIF had 15,523,889 ordinary shares and 20,837,959 zero-dividend preference shares in issue, with 1.7m ords and 2.3m ZDPs held in treasury. The ZDPs have a maturity date of 31 January 2017 and a final capital entitlement of 138p, c 4.5% higher than the ZDP price at 10 February 2015. The ZDPs' final capital entitlement is currently c 2.7x covered by gross assets, which would have to fall by 62.5% over the next two years for the ZDPs not to be paid in full. The ZDPs represent the portfolio's only gearing, which stood at 46% net (47.7% gross) in late January.

Premier Asset Management (Guernsey) acts as the manager of AIF, and receives an annual management fee of 0.7% of total assets (subject to a minimum of £100,000), out of which it pays fees to the investment advisers. Management fees are charged 75% to capital and 25% to income. AIF has become its own Alternative Investment Fund Manager (AIFM) under the AIFM Directive. A performance fee of 15% of outperformance may also be payable if the NAV per share plus dividends has grown at a compound rate of more than 10% a year since the last year-end high water mark at which a performance fee was paid. A performance fee of £0.5m was paid in FY13 but the high water mark was not exceeded in FY14.

Dividend policy and record

AIF's primary objective is to provide a high income for its shareholders, along with the opportunity of capital and income growth. Dividends – paid quarterly, in March, June, September and December – have been materially higher since 2012, when the replacement of bank debt with the ZDPs allowed for an income-boosting reduction in interest costs (costs relating to the ZDP are charged against capital). A fourth interim dividend of 3.25p was declared in November 2014, bringing the total dividend for the year to 12.75p, a 6.25% increase on the previous year. Dividends were fully covered by income in FY13 and the manager has stated that income in the equity portfolio was higher in 2014 than in 2013, so it would be reasonable to expect a further increase in the fund's modest revenue reserve when the results for FY14 are released. AIF's yield was 4.4% based on the FY14 dividend and the 10 February share price of 287.3p.

Peer group comparison

AIF is a member of the Association of Investment Companies' UK Equity & Bond Income sector, a diverse group of eight distinct funds. In spite of the sector's name, not all the constituents invest in bonds. None of the peers closely matches AIF's split of 70-80% smaller company shares and 20-30% fixed income; the nearest are Aberdeen Smaller Companies High Income, which has only 10-15% in bonds, and Investors Capital Trust and M&G High Income, both of which have a larger-cap focus in their equity portfolios. In a year in which smaller companies were less favoured, AIF and the Aberdeen trust were the only funds to post a negative NAV total return over 12 months, with AIF at the bottom of the sector. However, over three years it is placed second, and is comfortably first over five (and 10) years. Charges are somewhat above average and there is also a performance fee. Gearing is the highest in the sector, although like the trust with the second-highest gearing (Small Companies Dividend), this is structural gearing through the existence of ZDPs. In a high-yielding sector, AIF's 4.2% yield is slightly below average. Risk-adjusted performance as measured by the Sharpe ratio has suffered over one year but is above average over three years.

Exhibit 8: UK Equity & Bond Income investment trusts

% unless stated	Market cap (£m)	TR one year	TR three years	TR five years	Ongoing charge	Perf. fee	Discount(-) /Premium	Net gearing	Yield	Sharpe NAV 1 year	Sharpe NAV 3 years
Acorn Income Fund	**47.8**	**-6.0**	**93.4**	**197.8**	**1.8**	**Yes**	**-10.1**	**146.0**	**4.2**	**-0.3**	**1.8**
Aberdeen Smaller Cos High Inc	40.6	-3.3	79.6	132.5	1.6	No	-18.4	117.0	3.5	-0.2	1.8
City Merchants High Yield	152.2	5.4	41.4	57.2	1.0	No	3.2	92.0	5.3	2.1	1.5
Henderson High Income	198.1	8.8	69.9	104.9	0.7	Yes	2.8	124.0	4.7	1.3	1.9
Investors Capital A Share	112.6	4.3	39.6	61.4	1.2	No	-10.8	110.0	4.9	0.8	1.2
Investors Capital B Share	112.0	4.3	49.4	77.1	1.2	No	-11.3	110.0	0.0	0.7	1.0
Investors Capital Units	112.7	3.7	38.9	60.5	1.1	No	-14.8	106.0	2.8	0.6	1.2
M&G High Income Package Unit	402.1	5.9	47.7	76.4	0.9	No	-5.8	100.0	3.8	0.7	1.4
New City High Yield	195.7	4.2	34.9	59.8	1.3	No	8.6	106.0	6.6	1.9	1.5
Small Companies Dividend	25.9	1.3	115.0	184.2	2.2	Yes	-14.1	132.0	4.5	0.9	2.1
Sector weighted average		**4.8**	**50.9**	**81.4**	**1.1**		**-3.8**	**108.1**	**4.6**	**1.0**	**1.5**
AIF rank in sector	**8**	**10**	**2**	**1**	**2**		**5**	**1**	**6**	**10**	**4**

Source: Morningstar, 21 January 2015, Edison Investment Research. Notes: TR = total return. The Sharpe ratio is a measure of risk-adjusted return. The ratios we show are calculated by Morningstar for the past 12- and 36-month periods by dividing a fund's annualised excess returns over the risk-free rate by its annualised standard deviation. Net gearing is shown here as total assets less cash/cash equivalents as a percentage of shareholders' funds.

The board

AIF has three non-executive directors. Helen Green has been on the board since 2007 and was appointed chairman in 2012. David Warr has been a board member since 2012 while Nigel Ward joined in 2011. All the directors are resident in Guernsey and have backgrounds in accountancy and investment.

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