Acorn Income Fund

Outperformance continues after strong run

Investment trusts

Acorn Income Fund (AIF) targets a high income and the opportunity for capital growth from a portfolio split roughly 80%/20% between UK smaller companies and a global income pool investing in bonds and other high-yielding securities. The trust has a fairly high level of gearing (c 39%) via zero-dividend preference shares. The low-turnover approach and focus on cash-generative businesses in the small-cap portfolio has seen its long-term trend of outperformance continue in a rising market, and the trust has grown in size significantly through the issuance of new shares and ZDPs.

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 (%)
30/04/11	60.8	47.6	N/A	22.0	13.7
30/04/12	1.1	2.7	N/A	0.0	(2.0)
30/04/13	73.6	34.8	9.4	24.3	17.8
30/04/14	26.9	33.7	5.7	23.0	10.5

Source: Thomson Datastream

Update: Continuity after death of John McClure

Since this note was originally published, John McClure – who had managed the small-cap portfolio of AIF since launch, first at Granville Asset Management and later at Unicorn Asset Management – passed away on 7 June 2014. Simon Moon and Fraser Mackersie, who had worked with McClure on the trust since 2008 and were named as co-managers in December 2013, will continue to manage the portfolio together.

Investment strategy: Barbell with equity bias

AIF's two pools of assets are managed by two different managers: the smaller companies portfolio by Simon Moon and Fraser Mackersie at Unicorn and the income portfolio by Paul Smith at Premier Asset Management. While the allocation between the pools will vary according to the market outlook, the small-cap portfolio will be in the range of 70-80% of assets while the income portfolio makes up 20-30%. The small-cap portfolio is a low-turnover, focused list of stocks chosen for defensive attributes including good cash generation and progressive dividends. The income portfolio takes a more active approach to enhance yield and reduces the volatility that may arise from highly geared equity exposure.

Equity outlook: Two steps forwards, one step back

With the UK economy in expansionary mode, the outlook should be positive for more domestically-focused small-caps, although market sentiment may have run ahead of the GDP recovery, with strong gains in 2012/13 stalling since the turn of the year. Valuations on UK smaller companies, which converged with the wider market in the 3Q13, are once again at a discount, suggesting further opportunity for the sector as long as the recovery is not inhibited by external factors.

Valuation: Close to par after active issuance

See page 6/7.

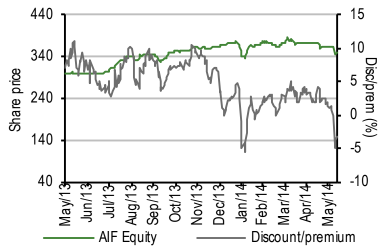
12 June 2014

Price	**347.6p**
Market cap*	**£57.5m**
AUM	**£87.1m**
NAV**	373.36p
Discount to NAV	6.9%
NAV***	377.56p
Discount to NAV	7.9%
Yield	3.45%

*Ords only. **Ordinary share, excl income. ***Ordinary share, incl income. Data to 11 June 2014.

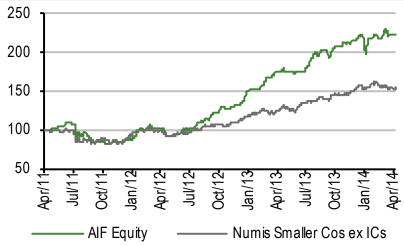
Ordinary shares in issue	16.543m
ZDPs in issue	22.206m
Code	AIF
Primary exchange	LSE
AIC sector	UK Equity & Bond Income

Share price/premium performance*



*Ordinary shares, including income.

Three-year cumulative perf. graph



52-week high/low	384p	297p
NAV* high/low	377.91p	291.05p

*Ordinary shares, including income.

Gearing (including ZDPs)

Gross	42.0%
Net	38.9%

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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

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.

Recent developments

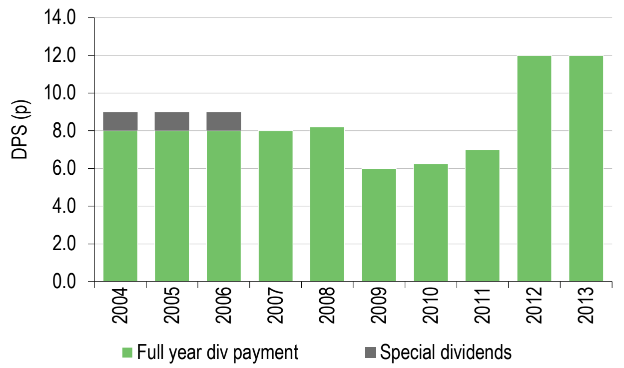
30 April 2014: Annual results for the year ended 31 Dec 2013. NAV total return +42.9% (benchmark +36.9%).

2 Sept 2013: Supplementary prospectus to issue up to 14m new ordinary shares and 19m new ZDP shares as part of AIF's ongoing placing programme.

Forthcoming		Capital structure		Fund details	
AGM	August 2014	Ongoing charges	1.8% on net assets	Group	Premier Fund Managers Ltd
Half-year results	August 2014	Net gearing	38.9%	Manager	Simon Moon, Fraser Mackersie; Paul Smith
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)14 8330 6090
Continuation Vote	2016 AGM	Loan facilities	None	Website	www.premierfunds.co.uk

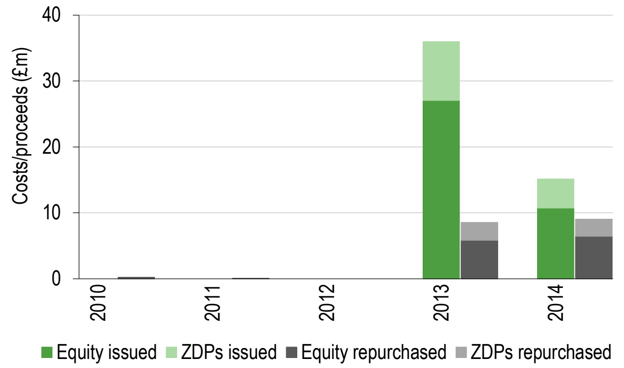
Dividend policy and history

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

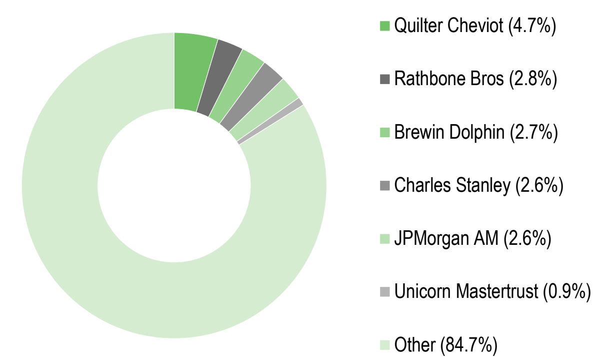


Share buyback policy and history

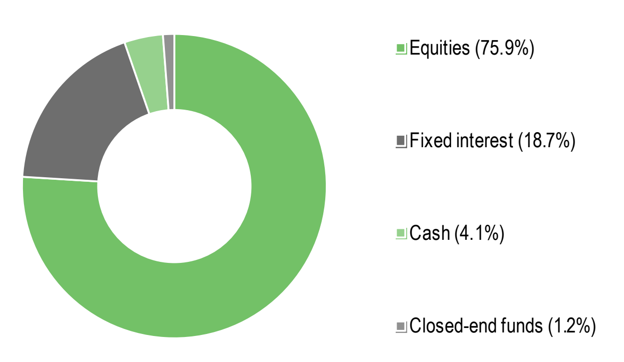
See page 6/7 for policy. Buyback figures shown in the chart include shares issued and transferred to treasury in order to meet future demand.



Shareholder base (as at 16 May 2014)



Distribution of portfolio (as at 30 April 2014)



Top 10 holdings (as at 30 April 2014)

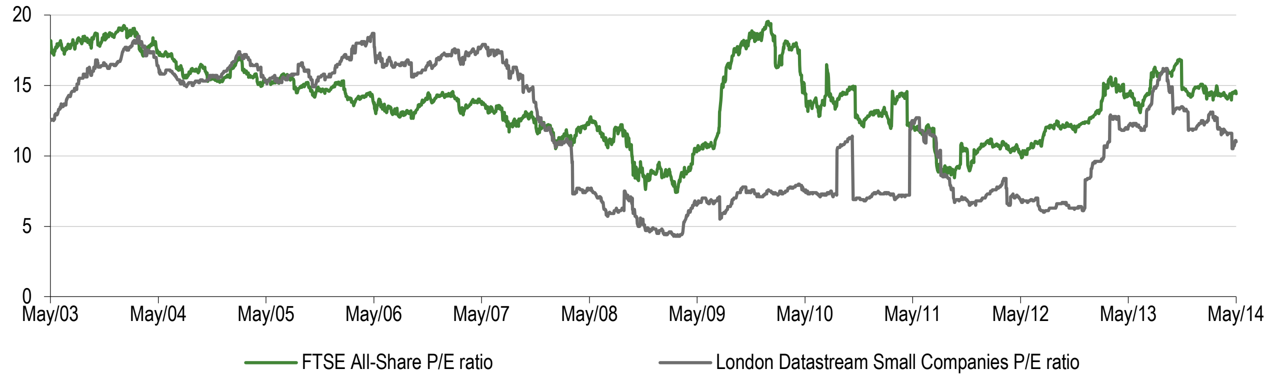
Company	Portfolio	Sector	% weight
VP	Equity	Support services	4.3
Cineworld Group	Equity	Travel & leisure	4.2
Electrocomponents	Equity	Electronic & electrical equipment	4.0
RPC Group	Equity	General industrials	4.0
Berendsen	Equity	Support services	3.8
Tyman	Equity	Construction & materials	3.7
Hill & Smith Holdings	Equity	Industrial engineering	3.4
Primary Health Properties	Equity	Real estate IT	3.3
Secure Trust Bank	Equity	Banks	3.3
Brewin Dolphin	Equity	Financial services	3.2
Equity portfolio top 10 (% of equity portfolio)			**37.2**
Income portfolio top 10 (% of income portfolio)			**25.0**

Source: Acorn Income Fund, Edison Investment Research.

Equity outlook: Pause for breath in small-cap charge

After a strong run in 2012 and 2013, with the Numis Smaller Companies (excluding investment companies) index up 29.9% and 36.9% respectively, the sector has paused for breath so far in 2014, the index falling by 0.6% between 1 January and 15 May. While the UK economy is growing well (GDP +0.8% in 1Q14, a 3.1% increase year-on-year), which should favour the more domestically orientated small-cap sector, continued fears over the likely pace of monetary tightening by the Bank of England are curbing investor enthusiasm. Against this backdrop, valuations of smaller companies have fallen back since the autumn and now once more stand at an appreciable discount (11x vs 14.4x at 15 May) to the FTSE All-Share P/E (Exhibit 2). With the large-cap FTSE 100 index having reached a 14-year high in early May, the relative valuations appear to favour smaller companies, although sentiment remains somewhat fragile.

Exhibit 2: London Datastream Small Companies Index P/E ratio, FTSE All-Share P/E ratio – over 10 years



Source: Thomson Datastream

Fund profile: Small-cap with added income

Launched in 1999 and domiciled in Guernsey, AIF targets a high income (current dividend yield 3.45%) with the potential for capital and income growth through a portfolio split between 70-80% UK smaller companies and 20-30% in an income portfolio of high-yielding securities. The smaller companies portfolio was advised from launch by John McClure, who is succeeded by co-managers Simon Moon and Fraser Mackersie at Unicorn. The income pool has been managed since 2007 by Paul Smith at Premier Asset Management. The income portfolio's primary purpose is to enhance the trust's yield and reduce the risk associated with a geared portfolio of small-cap equities, while lower volatility in the small-cap portfolio is further targeted by cautious stock selection focused on cash generation and sustainable dividends. Since 2011 the trust has been geared through zero-dividend preference shares maturing in 2017. In response to strong demand, since May 2013 the trust has issued 11.3m new ordinary shares and 12.1m ZDPs, more than doubling in size.

Managers: Simon Moon/Fraser Mackersie; Paul Smith

The managers' view: A tale of two asset classes

The success of John McClure's income-focused smaller companies strategy has led to significant asset growth in the Unicorn UK Income OEIC as well as AIF, and in December 2013 Unicorn elevated Simon Moon and Fraser Mackersie to co-managers in recognition of this. Moon and Mackersie say they continue to find small-cap opportunities, with the positive economic outlook, earnings upgrades and an improved new issue pipeline and M&A activity all supporting their bullish view. While the portfolio is low-turnover, the increase in assets over the past year has allowed the managers to participate in several IPOs, boosting the exposure to domestic earnings, where previously the portfolio had a more international bias.

One effect of the strong performance of small caps has been an increase in the size of companies in the benchmark Numis Smaller Companies (excl. investment companies) index, representing the smallest 10% of UK-listed stocks. When AIF was set up this universe covered companies up to £600m market cap, but the largest stocks in the NSCI are now around £1.5bn. In recognition of this, AIF has increased the maximum size of company in which it can invest, from £1bn to the equivalent of the largest stock in the NSCI. The managers continue to believe that better opportunities exist in smaller stocks, however (the average market cap of holdings is c £500m), and the amendment to the limit is more in the interest of flexibility than indicative of any change in investment approach.

Income portfolio manager Paul Smith, by contrast, remains cautious on the outlook for bonds, and this is evident in the weighting to the income portfolio being close to the minimum 20% level. Smith points out that companies are borrowing more, at lower coupons and with weaker covenants than ever before, and this represents a real risk to capital for many bond investors. The next move in interest rates is almost certain to be upwards, and the manager is negative on the outlook for rates but still sees opportunities in terms of the mispricing of credit risk. With the majority of bonds looking expensive and liquidity in the market very low, he is focusing on smaller issues and new bank debt such as contingent convertibles (CoCos). Smith increased duration in the portfolio at the end of 2013 through the purchase of longer-dated bonds such as Apple's, but has since moderately decreased duration to 4.25 years using gilt futures.

Asset allocation

Investment process: Income focus underpins both pools

The asset allocation of the overall AIF portfolio is between 70% and 80% in small-cap equities and between 20% and 30% in the income portfolio, which holds bonds and other high-yielding securities, including some investment company shares. The split between the two portfolios is reviewed at each board meeting, with input from the managers, who also regularly discuss the outlook for each asset class between meetings.

The smaller companies portfolio is built on a bottom-up basis, with the managers and analysts at Unicorn researching the market to find companies with experienced, motivated and disciplined management, strong competitive positions in growth markets, good cash generation and progressive dividends. Company meetings are a key part of the process and the team may meet management several times both before and after making an investment. Valuation is an important consideration, particularly because of the negative impact on dividend yields of overpaying for a stock. Investments are chosen on a three- to five-year view, but in practice many stocks are held for more than five years. While the managers are happy to 'run their winners', triggers for the sale of a holding would include a change in industry fundamentals, or a change in the company's strategy.

The income portfolio is more actively traded to enhance returns and has a longer list of holdings than the smaller companies portfolio. Its primary objective is to secure a high yield while decreasing the overall volatility of the trust, although capital appreciation has also been achieved. For the year ended 31 December 2013 the income portfolio was generally at the lower end of its 20-30% representation in the trust, but provided 33% of the income from investments.

Current portfolio positioning

At 30 April 2014 the allocation to the smaller companies portfolio was 78.8% of gross assets while the income portfolio represented 21.2%, reflecting the managers' respectively bullish and bearish views. In the equity portfolio there were 40 holdings, with the top 10 representing 37.2% of the pool's assets. The income portfolio had 70 holdings, with the top 10 making up 25.0% of the pool.

In the small-cap portfolio sector allocations are an output of stock selection, but the managers' focus on attractively valued, cash-generative businesses leads to a bias away from consumer goods, technology and materials and towards industrials, within which the highest weighting is to support services (25.4% of the pool at 30 April). Construction and materials is another significant subset of industrials, although here the managers are less keen on housebuilders and prefer suppliers of components, such as Safestyle, a double-glazing firm they bought at listing in 2013.

Exhibit 3: Sector allocations of smaller companies portfolio (at 30 April 2014 unless stated)

	Trust weight (%)	Trust weight (%) 30 April 2013	FTSE All-Share weight (%)	FTSE Small-Cap weight (%)	Active weight vs FTSE Small Cap (% points)	Trust weight/FTSE Small-Cap weight
Industrials	65.2	66.9	10.1	34.7	30.5	1.9
Consumer Services	14.6	6.1	10.6	18.4	-3.8	0.8
Financials	13.2	15.9	24.1	17.7	-4.5	0.7
Health care	2.2	4.5	8.3	2.8	-0.6	0.8
Consumer Goods	1.1	4.0	13.7	9.9	-8.8	0.1
Telecommunications	0.0	0.0	4.6	0.0	0.0	n/a
Oil & Gas	0.0	0.0	15.3	4.3	-4.3	0.0
Technology	0.0	0.0	1.4	6.9	-6.9	0.0
Basic Materials	0.0	0.0	8.1	5.3	-5.3	0.0
Utilities	0.0	0.0	3.8	0.0	0.0	n/a
Cash	3.7	2.6	0.0	0.0	3.7	n/a
Total	**100**	**100.0**	**100**	**100**	**0.0**	

Source: Acorn Income Fund, Bloomberg, Edison Investment Research

The increase in assets has allowed the managers to take several new positions without having to exit others. These have included the IPOs – all at single-digit P/E ratios – of Safestyle in December 2013, mail delivery firm DX Group in February and industrial equipment supplier Flowtech in May, although the managers remained on the sidelines in a number of other IPOs because of inflated valuations. They have also added to second-largest holding Cineworld on price weakness following the acquisition of Cinema City, a similar chain operating in Israel and Eastern Europe. Underscoring the importance of company meetings to the investment process, the managers say investor opinion seemed to be split between those who had met the incoming management and were positive about the deal, and those who had not and were negative. The only stock to exit the portfolio in the past year has been Silverdell, which ceased trading following problems at a subsidiary. However, the managers say the total loss was only 10-15% of the initial position, as they had already sold down the holding on valuation concerns before the problem emerged.

Financials are a theme both in the small-cap portfolio – where holdings include broker Numis, wealth manager Brewin Dolphin and Secure Trust Bank – and in the income pool, where the sector (including investment companies) represents two-thirds of the portfolio. While Smith has had a longstanding bias to the sector, he says the shape of his exposure to it has changed considerably in response to the challenges of finding value in an expensive market. A quarter of the income portfolio is now in CoCos, which are high-coupon, potentially loss-absorbing securities issued by banks to meet capital adequacy requirements, and are mainly rated BB. Closed-end fund exposure is lower than it has been in the past, and is notable for holdings in property specialists, such as the preference shares of Real Estate Credit Investors and shares in Tritax Big Box REIT. While bonds such as Apple were bought late last year to increase duration in the portfolio, duration has recently been scaled back (decreasing the portfolio's interest rate sensitivity) through the use of gilt futures.

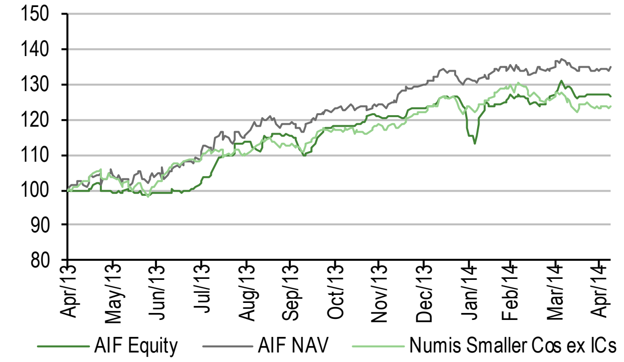
Performance: Strong absolute and relative returns

As Exhibit 6 illustrates, AIF has performed strongly relative to its benchmark since the market nadir in March 2009, although in the crisis period of 2008/9 it underperformed – unsurprisingly for a geared portfolio in a falling market. Strong absolute performance has been recorded over one, three, five and 10 years (Exhibit 4) on both a share price and net asset value basis, although since the turn of the year NAV performance has dipped as the small-cap sector has paused for breath. The income portfolio continues to outperform peers and major bond indices so far in 2014.

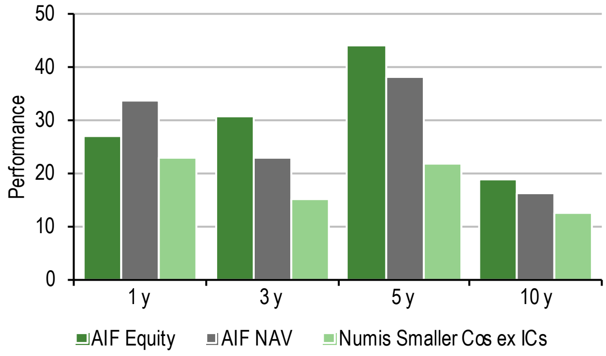
The focus on cash flow and dividends in the small-cap portfolio may be an important factor in AIF's long-term outperformance. A recent study by London Business School Professors Dimson and Marsh showed that a portfolio of high-yielding small-caps established in 1955 (as far back as data is available for the NSCI ex-ICs) and rebalanced at the start of each year would have been worth 10 times the value of an equivalent portfolio of low-yielding small caps by the end of 2012.

Exhibit 4: Investment company performance to 30 April 2014

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



Annualised performance - price, NAV and benchmark total return (%)



Source: Thomson Datastream, Edison Investment Research.

Exhibit 5: Share price and NAV total return performance, versus benchmarks (% points), to 30 April 2014

	One month	Three months	Six months	One year	Three years	Five years	10 years
Price versus Numis Smaller Cos ex ICs	2.4	10.5	2.4	3.9	70.0	351.6	231.7
NAV versus Numis Smaller Cos ex ICs	1.6	2.1	3.4	10.7	32.1	230.9	117.2
Price versus FTSE All-Share	(2.4)	5.3	4.7	16.4	95.3	421.9	331.6
NAV versus FTSE All-Share	(3.2)	(3.2)	5.7	23.2	57.4	301.2	217.1

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

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: Demand and supply now closer to balance

A significant narrowing of AIF ordinary shares' discount to net asset value since the later part of 2012 slightly reversed on the announcement of John McClure's death, with the shares trading on a cum-income discount of 7.9% at 11 June, compared with an average premium of 0.7% for the previous 12 months. An active programme of share issuance has helped to manage the premium, with 11.3m new ordinary shares and 12.1m new ZDPs issued since May 2013. Newly issued shares may be transferred to treasury and dripped into the market in response to demand. Shares may be issued at a discount to net asset value, but only where either ZDPs are also issued at a premium with the overall effect that NAV per share is increased, or to the extent that there is no increase in gearing. At 30 April the mid price of the ZDPs stood at a 6.3% premium to NAV.

During the past year the shares have traded in a range from a discount of 9.0% to a premium of 5.0%. In fact the trust's biggest cum-income premium to date was reached just outside the one-year period, on 25 April 2013, when it stood at 7.5%. Over five years the average cum-income discount is 10.8%, reflecting periods when the discount was much wider (reaching a three-year high of 20.4% in May 2012, and 26.7% in April 2010).

Exhibit 7: Discount/premium over three years

Discount/premium – NAVs with debt at fair value, excluding income*

Discount/premium – NAVs with debt at fair value, including income*

Source: Thomson Datastream, Edison Investment Research. Note: *Negative values indicate a discount; positive values a premium.

Capital structure and fees

AIF's share capital comprises 16.543m ordinary shares and 22.206m ZDP shares (excluding 1.335m shares and 1.791m ZDPs held in treasury) as at 29 May 2014. The ZDPs have a final capital entitlement of 138p on 31 January 2017, with their value accruing at an effective rate of 6.5% pa. The ZDPs' final entitlement is covered 2.8x by AIF's gross assets and ZDP holders will receive their full entitlement provided AIF's gross assets do not shrink by more than 29% pa. Other than the ZDPs, AIF has undertaken not to borrow money while the ZDPs are outstanding. As at 16 May 2014, AIF had gross gearing of 42.0% and net gearing of 38.9%.

Premier Asset Management (Guernsey) is the designated investment manager, with Premier Fund Managers acting as investment adviser to the income portfolio and Unicorn Asset Management as investment adviser to the smaller companies portfolio. The investment advisers are paid an annual management fee of 0.7% of total assets, subject to a minimum of £100,000. For the year ended 31 December 2013, a performance fee of £501,345 was paid, the first time such a fee had been paid since 2006. Performance fees are earned if the NAV per share plus dividends paid has grown at a compound rate in excess of 10% a year since the last high water mark. Ongoing charges for 2013 were 1.84% compared with 2.24% a year earlier, reflecting the large increase in assets under management providing a wider base across which to spread fixed costs.

Dividend policy and record: Quarterly income

In 2011, AIF replaced its bank borrowing with zero dividend preference shares, increasing gearing while decreasing interest costs. This allowed the dividend to be increased from 7p in 2011 to 12p in 2012, and this level was maintained in 2013. Dividends are paid in quarterly and the 2013 dividend was more than covered by revenue earnings of 13.4p per share (2012: 12.3p). Revenue reserves, although small, were also increased during the year and stood at 2.9p per share at the year end. Based on the 11 June 2014 share price, AIF has a dividend yield of 3.45%. With a second interim dividend for the year to 31 December 2014 of 3.25p announced on 11 June (up 8.3% on the first interim and last year's second interim), total dividends for the current year look likely to be at least equal to last year, and would be up 6.25% if the third and fourth interims are maintained at 3.25p.

Peer group comparison

There are eight investment trusts in the AIC's UK Equity & Bond Income peer group (renamed from UK High Income in early 2014). Capital structures and investment policies differ widely across the group. None of the trusts is directly comparable with AIF, although there are some similarities with Aberdeen Smaller Companies High Income (which has a lower weighting in bonds), Henderson High Income and Investors Capital Trust (both of which include larger companies in their equity portfolios). In NAV total return terms, AIF is ranked second, second and first over one, three and five years, only beaten by the Small Companies Dividend trust, which holds no bonds. AIF is the most highly geared in the sector. Its yield is somewhat below average but it has the best risk-adjusted performance over one and three years, as measured by the Sharpe ratio.

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	**59.7**	**27.1**	**84.5**	**354.9**	**1.8**	**Yes**	**(1.6)**	**140.0**	**3.3**	**3.5**	**1.5**
Aberdeen Smaller Cos High Inc	45.5	18.4	56.8	241.2	1.6	No	(12.0)	116.0	3.1	2.2	1.3
City Merchants High Yield	144.0	8.0	28.6	148.8	1.0	No	1.5	93.0	5.3	1.5	0.7
Henderson High Income	184.6	9.7	53.0	143.9	0.7	Yes	2.9	123.0	4.9	1.3	1.3
Investors Capital A Share	117.8	5.2	34.4	93.5	1.2	No	(8.3)	111.0	4.6	0.7	0.9
Investors Capital B Share	123.7	5.2	45.6	116.6	1.2	No	(3.9)	111.0	0.0	0.7	0.8
Jupiter Dividend & Growth	8.9	9.4	31.0		2.0	Yes	(7.5)	97.0	1.8	1.7	0.9
New City High Yield	190.9	4.7	28.1	110.5	1.3	No	5.9	106.0	6.4	0.4	0.9
Small Companies dividend	30.7	29.3	92.2	269.4	2.6	Yes	1.8	132.0	3.6	2.7	1.5
Sector weighted average		**9.4**	**43.8**	**150.5**	**1.2**		**(0.3)**	**112.3**	**5.0**	**1.2**	**1.0**

Source: Morningstar, 21 May 2014, 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 directors, all of whom are resident in Guernsey. Helen Green was appointed chairman in 2012 having been on the board since 2007. David Warr has been a board member since 2012 while Nigel Ward joined in 2011.

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