EDISON

Acorn Income Fund

High yield and capital performance

Investment trusts

Acorn Income Fund (AIF) targets a high level of income and aims to generate both income and capital growth from a mixed portfolio of smaller cap UK-listed equities (70%-80%), and an income portfolio of fixed-interest securities, and investments in high-yielding investment companies (together 20%-30%). It is benchmarked against the Numis Smaller Companies Index (ex-investment companies). The income portfolio supports dividend-paying capacity and provides some off-set to the NAV volatility implied by a concentrated portfolio of equities (30-40) and relatively high gearing (52% gross, including the zero dividends preference shares (ZDPs)). AIF has built up an impressive long-term record of outperformance of its benchmark (AIF has beaten the index by more than 15% over the past year), and is now looking to expand its asset base. AIF is seeking shareholder approval to issue new ordinary shares and ZDPs.

12 months ending	Total share price return* (%)	Total NAV return* (%)	Total ZDP price return* (%)	Total return Numis ex IC* (%)	Total return FTSE All-Share* (%)
19/03/10	91.4	98.2	N/A	71.9	55.6
19/03/11	68.8	44.1	N/A	19.9	6.0
19/03/12	12.9	15.9	N/A	8.6	7.8
19/03/13	54.0	38.0	N/A	23.3	13.7

Note: *Twelve-month rolling discrete performance.

Investment strategy: Balanced portfolio

AIF divides its portfolio into two distinct pools of assets, one investing in listed equities and the other investing largely in fixed-interest securities. The split between the two pools shifts, within broad parameters, to reflect market conditions and opportunities. The equity pool is invested in a focused portfolio (30-40 stocks) of smaller cap UK-listed equities (typically less than £1bn market cap at the time of acquisition, managed to produce an above-average yield relative to the benchmark (3.8% vs 2.7% for the index at the start of 2013). The income portfolio enhances dividend-paying capacity and reduces the NAV volatility implied by a concentrated small-cap portfolio and the relatively high level of gearing (52%).

Outlook: Favouring equities with overseas earnings

The equity portfolio is at the upper end of the target range (c 78%) as the managers see relatively little value in low fixed-income yields, and risks from inflation and eventually rising interest rates. Adjusted duration in the fixed-income portfolio is 4.5 years. The managers believe the prospects for capital and dividend growth remain attractive in the smaller cap equity portfolio and are focusing on stocks with exposure to customers and markets in faster-growing international markets.

Valuation: Attractive relative to peer group

AIF's discount to NAV is 6.2%, narrower than its three-year average of 14.4%, and very slightly wider than the average for its peer group. The discount differential relative to the peer group looks anomalous given AIF's strong relative performance record. AIF's gearing may be one factor. AIF's relatively small size may also be an issue; growing the fund and increasing the liquidity of their shares would help.

26 March 2013

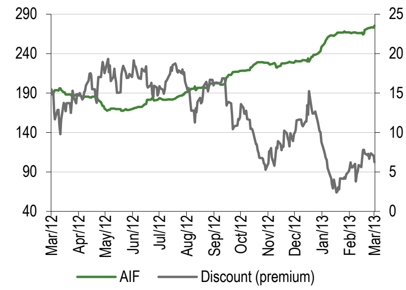
Price	**279.50p**
Market cap*	**£24m**
AUM	**£38.6m**
NAV**	293.8p
Discount to NAV	6.2%
Yield	4.4%

*Ordinary shares

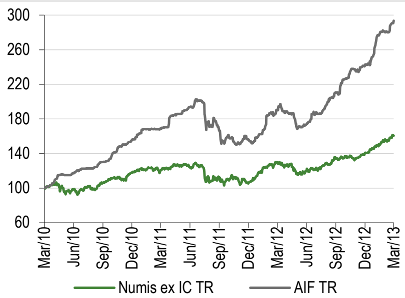
**Including income, as at 19 March 2013.

Ordinary shares in issue	8.7m
Code	AIF
Primary exchange	LSE
AIC sector	Uk High Inc

Share price/discount performance



Three-year cumulative perf. graph



52-week high/low	279.50p	167.50p
NAV* high/low	294.9p	199.5p

*Including income.

Gearing (including ZDPs)

Gross	52%
Net	50%

Analysts

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

Exhibit 1: Trust at a glance

Investment objective and fund background

AIF's objective is to provide a high level of income with the opportunity for income growth and capital growth over the life of the company. AIF is geared through a ZDP stock. 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 sterling fixed-interest instruments, reverse convertibles and high-yielding shares in other investment companies.

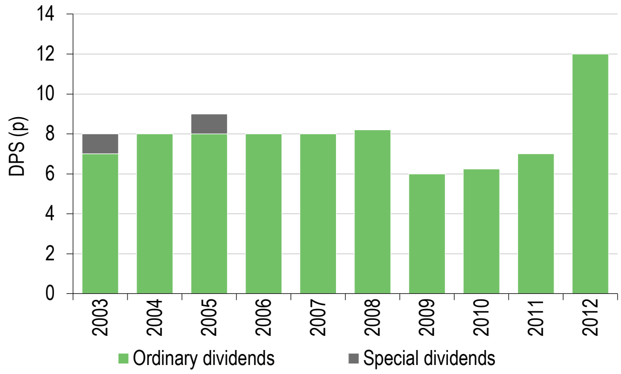
Recent developments

22 Mar 2013: Proposals for ordinary share and ZDP issues announced.
2 Jan 2013: Numis Securities appointed corporate broker and financial adviser.
19 Nov 2012: Release of IMS.

Forthcoming		Capital structure		Fund details	
AGM	August 2013	Total expense ratio	2.3%	Group	Premier Fund Managers Ltd
Preliminary results	April 2013	Net gearing	50%	Manager	John McClure, Paul Smith
Year end	31 December	Annual mgmt fee	0.70% of net assets	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	Phone	+44 (0)1483 306090
Continuation vote	2016 AGM	Loan facilities	None	Website	www.premierfunds.co.uk

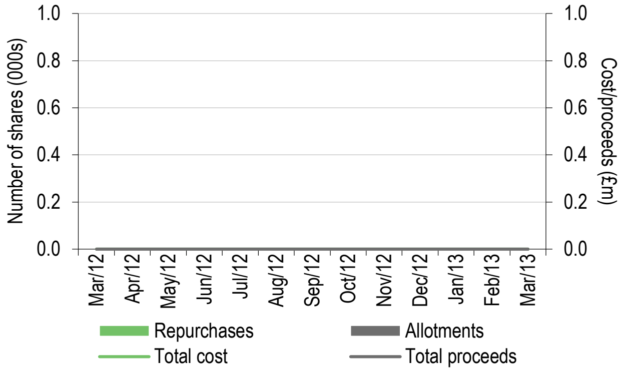
Dividend policy and history

Quarterly dividends paid in March, June, September, December. 2012 dividends enhanced by ZDP issue.

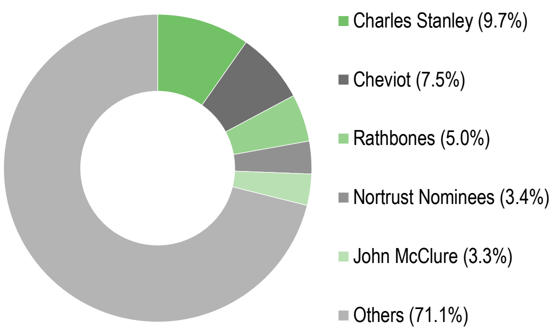


Share buy-back policy and history

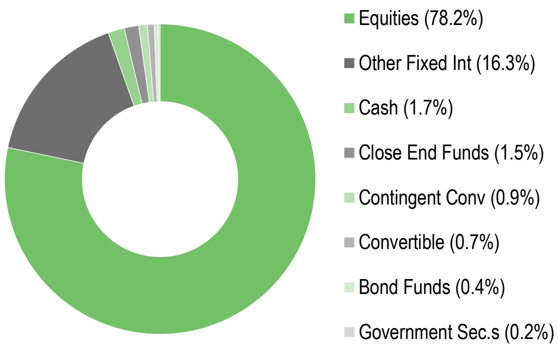
Renewed annually, the trust has authority to purchase up to 14.99% (see page 7) and allot up to 10% of issued share capital.



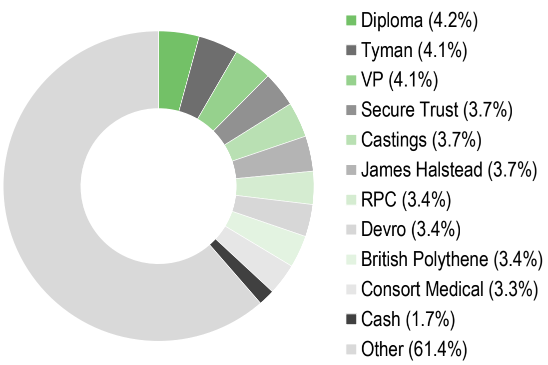
Shareholder base (as at 19 March 2013)



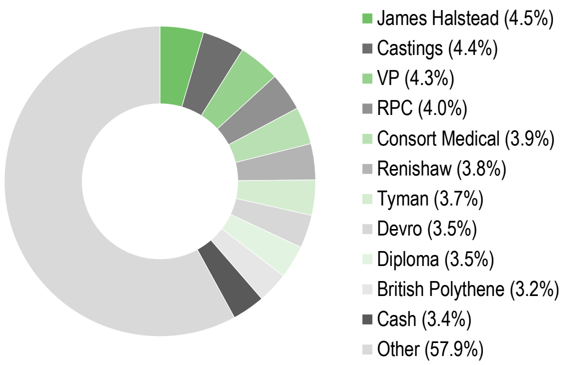
Distribution of portfolio (as at 28 February 2013)



Portfolio composition *(as at 31 January 2013)



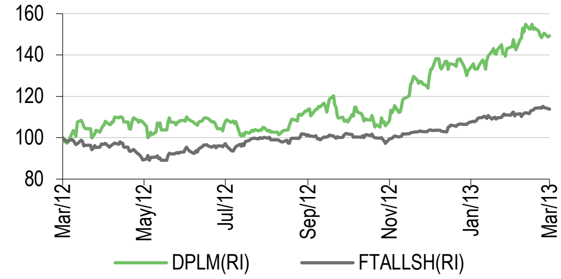
Portfolio composition *(as at 31 August 2012)



Source: Acorn Income Fund, Edison Investment Research. Note: *As a percentage of gross assets.

Exhibit 2: Top five UK small-cap equity positions at a glance

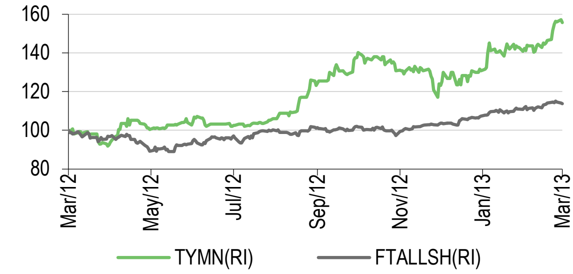
Diploma	Code: DPLM LN	Market cap: £695m



Div yield (trail. 12 months)	2.61%
Industry/Sector	Support services
Listing	LSE – Full
Website	www.diplomaplc.com

Diploma supplies a range of technical products and services in life sciences, seals and controls. Almost 80% of sales and operating profit is made outside the UK. It grew its dividend by more than 30% last year and actively targets progressive dividend growth while maintaining 2x dividend cover. The manager also likes its ungeared balance sheet and strong cash flow. Its recent IMS showed underlying revenue growth of 5% despite "challenging conditions" in its controls business.

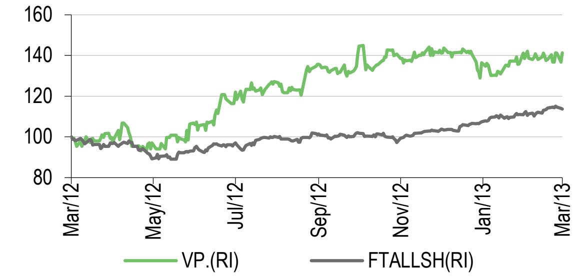
Tyman	Code: TYMN LN	Market cap: £252m



Div yield (trail. 12 months)	2.58%
Industry/Sector	Industrials – Building materials
Listing	LSE
Website	www.tymanplc.com

Tyman (formerly Lupus) is a leading manufacturer of hardware for windows and doors (supplied to the US and UK building trade) and textile products (mainly used in photocopiers and printers). Tyman suffered as a result of the downturn in house building after the credit crisis. The manager sees it as a play on recovery in the US housing market. It had to suspend its dividend in 2009 but in 2012 it paid 4.5p, up from 3.5p in 2011.

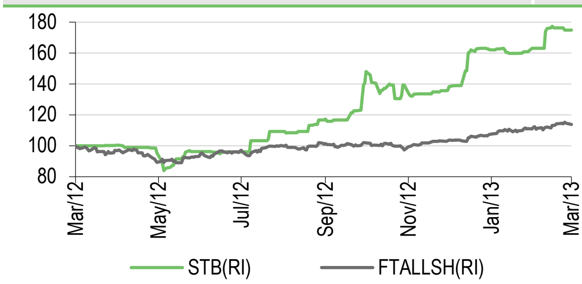
VP	Code: VP. LN	Market cap: £138m



Div yield (trail. 12 months)	3.73%
Industry/Sector	Support services
Listing	LSE – Full
Website	Vpplc.com

VP is an equipment rental company servicing the construction, civil engineering, rail, water, oil and gas, outdoor events and house building industries. The oil and gas division was hit by lower LNG production, but the company has won new business to compensate. Construction is weak, but infrastructure is offsetting this. It expects results in line with consensus. Its dividend has grown 2.5x over the past 10 years. The manager believes demand for its services is recovering.

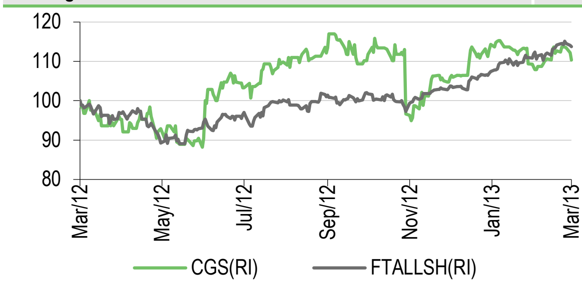
Secure Trust Bank	Code: STB LN	Market cap: £289m



Div yield (trail. 12 months)	0.84%
Industry/Sector	Financials
Listing	AIM
Website	www.securetrustbank.com

Secure Trust is a UK retail bank offering deposit and fee-based current accounts, motor finance, retail point-of-sale finance and personal unsecured lending. The manager likes STB's strong balance sheet and that all of its lending is financed by its customer deposits (unlike conventional banks that have to rely on wholesale funding). When STB was acquired for AIF's portfolio, the manager believed the value of STB's private bank, Arbuthnot Latham, was not reflected in its valuation.

Castings	Code: CGS LN	Market cap: £146m



Div Yield (trail. 12 months)	3.92%
Industry/Sector	Industrials
Listing	LSE – Full
Website	Castings.plc.uk

Castings PLC is an established iron castings and machining group based in the UK. The manager likes its overseas exposure, 80% of production is exported to markets around the world and 80% is supplied directly to multinational constructors of automotives. Its dividend grew by 7.9% in 2012. Although Castings recently warned that full-year results would be marginally below expectations, it expects declines in demand to plateau, but Europe remains problematic.

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

Fund profile: Two pools, geared with ZDPs

AIF was launched in April 1999, is domiciled in Guernsey and listed on the LSE. It was established with a discontinuation vote, first scheduled for 2006, which was defeated, although the board felt shareholders should be given a chance to realise their investment at close to asset value by way of a tender offer held in 2006. As a result, the size of the fund shrank by 70%. In 2011, shareholders again voted for continuation of the company and will have another opportunity to do so in 2016. Premier Asset Management has been the designated investment manager of AIF since 2007 and Unicorn Asset Management is retained as investment adviser and manager of the smaller company equity investments.

AIF has a balanced portfolio, which is split into two distinct pools, both of which generate income for ordinary shareholders. The larger pool, managed under advice from John McClure (initially at Granville and later Unicorn Asset Management), is invested in small capitalisation, UK-listed equities with a focus on above-average yield. The equity portfolio yield was c 3.8% compared with c 2.7% for the benchmark Numis Smaller Companies (ex-Investment Companies) Index at the start of 2013. The smaller pool is an income portfolio consisting of fixed-interest securities and shares in high-yielding investment companies. The income pool was initially managed by Collins Stewart Asset Management, but early in 2007, the management contract was moved to Premier Asset Management. Paul Smith and Nigel Sidebottom are responsible for the income pool at Premier. The income pool normally accounts for 20-30% of AIF's assets. In addition to its diversification and income generating role, the income portfolio is also used to manage short-term liquid assets in the trust.

AIF has traditionally employed structural gearing in the portfolio, in the form of bank debt. In 2011, the maturing bank debt (£6m facility) was replaced with a larger, £12m, issue of ZDPs. The main impacts of this were to significantly increase the gearing of the portfolio and to reduce interest payments (increasing cash flow for dividends), replacing the interest bill with a charge on capital, accruing to the ZDP class at c 6.5% pa.

As shown on page 2, John McClure has a large personal investment in the company (3.3% of the issued capital), aligning the management of a substantial part of the portfolio with that of investors.

Potential share issues: Proposals to be put to shareholders

AIF is planning to issue new ordinary shares and ZDP shares, subject to shareholder approval, at an Extraordinary General Meeting. The company believes that there is substantial investor demand that is difficult to satisfy in the market given limited trading volumes. Existing shareholders would potentially benefit from an expanded free float as well as a larger asset base over which to spread fixed costs. Ordinary shareholders will be asked to approve the issue of new ordinary shares without pre-emption. To avoid diluting existing ordinary shareholders, AIF is proposing the new shares be issued at NAV or above or, if below NAV, in conjunction with a further issue of ZDPs at a premium to their asset value. This would have the effect of enhancing NAV for ordinary shareholders to compensate. This needs to be balanced with the need to maintain gearing at acceptable levels, and so AIF is proposing that ZDP issuance will be limited to a level whereby the ratio of assets to ZDP maturity value does not fall below 1.85x.

Outlook: Equities favoured over fixed interest

The low interest rates and monetary expansion prevailing since the credit bubble burst has proved very beneficial to investors in fixed-interest securities. However, it is hard to see how bond yields will tighten from here and investors in search of income are turning increasingly to equities, which, while well off their low-point valuations, appear to offer a clearer opportunity for capital and income growth. In the UK, inflation has been running ahead of target levels for some time now, suppressing real rates of interest, and this environment increases the importance of growth in income. However, global economic growth is still anaemic and so dividend sustainability, which in general relies on economic growth and corporate profitability, is a key risk and stock selection will be a large determinant of relative performance.

The fund managers: John McClure and Paul Smith

The managers' view: Equities preferred to bonds

John McClure sees opportunities to continue to add value from the larger UK small-cap portfolio. He recognises that much of his investment universe is not well covered by third-party research and that this creates the opportunity to benefit from market inefficiencies in stock pricing. He believes investors in search of income will continue to be attracted to dividend-paying equities in pursuit of the potential for income growth and some capital protection against inflation. He also believes that investors will increasingly turn to smaller companies to provide a more diverse source of growth and income. McClure believes that investing in above-average yielding, smaller capitalisation companies has provided attractive returns versus larger capitalisation stocks over time and cites a recent Numis Smaller Companies Index Annual Review (Dimson and Marsh, London Business School) as evidence of this. This concludes that a portfolio of high-yielding small caps established in 1955 (as far back as data is available for the Numis Smaller Companies ex-Investment Companies index) and rebalanced at the start of each year, would have been worth 10x the value of an equivalent portfolio of low-yielding small caps by the end of 2012.

In current market conditions, the manager aims to make new investments in stocks that yield between 3.8% and 6%. Obviously, he remains wary of investing in the highest-yielding stocks in his universe, as this can often signal the unsustainability of dividends. McClure's positive view is in spite of a generally negative outlook for the UK economy and he has positioned his portfolio to benefit from overseas growth while benefiting from UK corporate governance standards. He estimates that 45% of the earnings on the small cap equity portfolio are generated outside the UK.

In contrast, Paul Smith is less optimistic about the prospects for fixed-interest markets due to low yields and the risk that monetary expansion will continue to fuel inflationary pressures and eventually trigger an increase in interest rates, and fixed-income capital loss. As a result of this view, the income portfolio, the majority of which is fixed income, is at the lower end of its targeted range and the manager believes he can best add value through credit analysis, while limiting interest rate risk by keeping duration short. The current duration of the portfolio is 4.5 years.

Asset allocation: Determined by the board

Investment process: Balanced approach

AIF adopts a balanced investment approach, which allocates investments between small-cap UK-listed equities and a predominantly fixed-rate income portfolio within fixed parameters. Over shorter periods, tactical asset allocation determines the exact weightings within those parameters. The income portfolio allocation reduces the volatility that might otherwise be associated with a highly geared, focused small-cap equity portfolio.

The asset allocation between UK small-cap equities and the income portfolio is reviewed by the directors at every board meeting. The managers of the two portfolios also co-operate closely with each other and make recommendations to the board. In considering the split, the board considers advice from the managers, the current allocation in relation to the targeted ranges (70-80% for small-cap equities and 20-30% for the income portfolio), and the fundamental attractions of the two asset classes.

UK small-cap equity portfolio

Unicorn Asset Management is a bottom-up investor, picking stocks from a wide universe of companies that has been screened using quantitative analysis. Stock selection drives sector allocations in the portfolio. The universe comprises listed UK equities with market capitalisations between c £20m and c £1bn; there are around 1,750 companies in all. The initial screening uses proprietary quantitative modelling, which highlights factors such as yield, and dividend growth. This generally reduces the universe to around 400 stocks, which is further reduced by excluding certain sectors, such as biotech, Lloyds insurers, oil exploration and mining, as the manager feels it can add little to market consensus on these difficult-to-analyse sectors. The very highest-yielding stocks may also be excluded where it is thought to be an indication that dividends are likely to be unsustainable, or where there is no identifiable catalyst for a re-rating. Now down to a universe of 300 or so companies, the manager, assisted by two in-house analysts, selects a portfolio that focuses on those that appear to offer the highest yields and the best prospect of dividend growth, to form the basis of a focused 30-40 stock portfolio. The manager indicates a preference for companies where management's interests are aligned with those of shareholders and where there is an identifiable catalyst that would encourage the stock to be re-rated. He is wary of stocks that may remain unloved almost indefinitely, and believes this may apply to much of the smaller end of the AIM market. The manager is unlikely to buy any stock that does not trade at an above-average yield relative to the market (although he may do so when he expects the stock to produce above-average dividend growth) and, in contrast to some competing funds, the manager will never buy a stock that does not pay a dividend.

Turnover in the portfolio is low, averaging approximately 10% per year and some stocks in the portfolio have been held since launch. The factors likely to trigger a sale from the portfolio are uncertainty about dividend sustainability (or surprise cuts) or market appreciation, either to a point where the dividend yield is no longer attractive or above the c £1bn market cap target range.

Income portfolio

The income pool is split between government securities (1%), other fixed-interest securities (82%), convertibles (4%), holdings in higher-yielding investment companies (7%), bond funds (2%) and contingent convertibles (4%). In practice, it is managed as a "best ideas" fund, with the split between the elements determined by the risk/reward ratios of competing investment candidates. The aim is to achieve a yield target set by the board and capital appreciation is welcome, albeit a secondary objective.

For Paul Smith, the fixed-interest element represents a very liquid, nimble bond portfolio, investing relatively small amounts into liquid markets. Smith heads a team of four working on credit portfolios at Premier, assisted, when appropriate, by Premier's equity research team. AIF may hold non-sterling (including an element of emerging market) bonds (although all currency exposures are hedged back into sterling). The majority of holdings are in investment-grade bonds. Subject to market conditions, turnover on this portfolio can exceed 100% per year. Premier may use gilt futures to adjust the pool's duration. With fixed income investments, the longer the duration, the greater the risk to capital values if interest rates rise. The current duration is 4.5 years and the manager currently prefers credit duration to government duration.

Premier invest within a range of risk parameters set by the board (the majority are not disclosed, but shares in other investment companies may not exceed 15% of the company's portfolio).

Current portfolio positioning: Bias to equities

As shown in Exhibit 1, at the end of February 2013, 78.2% of the portfolio was invested in the equity portfolio. There were 30 holdings, with the top 10 holdings accounting for 47.3% of the segment total. The income portfolio was 20.0% of the total and cash represented 1.7%. The allocation to the income pool is at the lower end of the permitted range, in accordance with the views of both sets of investment managers.

The equity manager is a stock picker, based on the availability of yield and dividend growth, and sector allocations are a derivative of this. Exhibit 3 shows the sector weightings that result from stock selection and this indicates a particular bias toward industrial companies and away from consumer goods, oil and gas, and basic materials. AIF's bias to smaller capitalisation stocks means that it will tend to be underweight some sectors, such as financials and telecommunications, relative to the broader UK market (as represented by the FTSE All-Share Index). AIF's industrials weighting includes many companies that derive a significant proportion of their revenue overseas, in line with the manager's view outlined above. The underweight in consumer goods, and to a lesser extent, consumer services, reflects the manager's unease with the strength of the domestic UK economy. The bias away from oil and gas and basic materials is in accordance with the overall investment approach.

Exhibit 3: Sector allocations as at 28 February 2013

	Trust weight (%)	FTSE All-Share weight (%)	Trust active weight (%)	Trust weight / FTSE All-Share weight
Industrials	66.3	9.7	56.6	6.9
Cash	1.7	0.0	1.7	N/A
Technology	1.2	1.7	(0.5)	0.7
Healthcare	4.2	7.0	(2.8)	0.6
Utilities	0.0	3.8	(3.8)	0.0
Consumer services	6.2	10.2	(4.0)	0.6
Telecommunication	0.0	5.8	(5.8)	0.0
Financials	16.2	22.4	(6.2)	0.7
Basic materials	0.1	9.8	(9.7)	0.0
Consumer goods	4.3	14.1	(9.8)	0.3
Oil & gas	0.0	15.7	(15.7)	0.0

Source: Acorn Income Fund, Bloomberg, Edison Investment Research

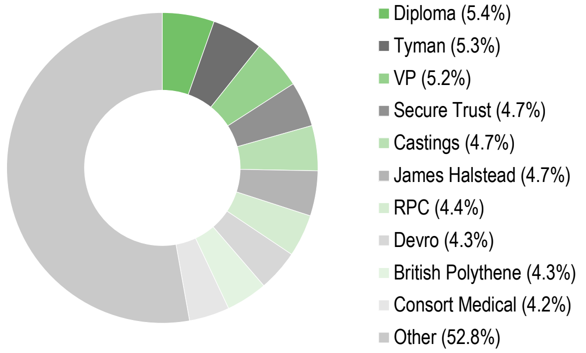
Recent activity

As Exhibit 4 shows, within the equity portfolio the manager has taken profits from the holding in Renishaw as good performance drove up its market cap beyond the £1bn upper band and its yield declined. Secure Trust has moved into the top 10 as it has performed well. Within the pool, the manager has targeted exporters and stocks with international earnings (AIF estimates c 45% of the earnings of the stocks in the small-cap equity pool are generated overseas). Given his view on the UK economy, the manager is avoiding house builders and stocks with exposure to the UK high street (including retail property). However, he has bought Lookers, a UK vehicle distributor, as he believes there is pent-up demand for replacement vehicles. AIF also holds A&J Mucklow, a West Midland industrial property company, as the manager believes there is increasing demand for space in the area. The yield on the equity portfolio is currently c 3.8%.

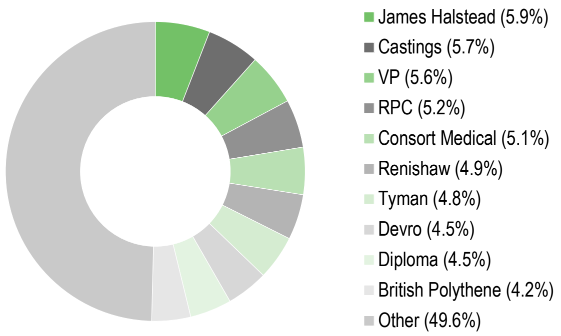
Within the income portfolio, the managers recently added a holding in Real Estate Credit preference shares to the pool and these have risen to become the largest holding in their part of the portfolio. This replaced the holding in Invesco Leveraged High Yield. The manager recently acquired a US$ BSkyB bond, which he believes offers better change of control protection than other bonds from the same issuer. Given his inflation concerns, the manager has some exposure to index-linked gilts and is using gilt futures to reduce the duration of the portfolio (from c 5.5 years to c 4.5 years).

Exhibit 4: Equity and income pool composition as at 31 January 2013, as compared to six months earlier

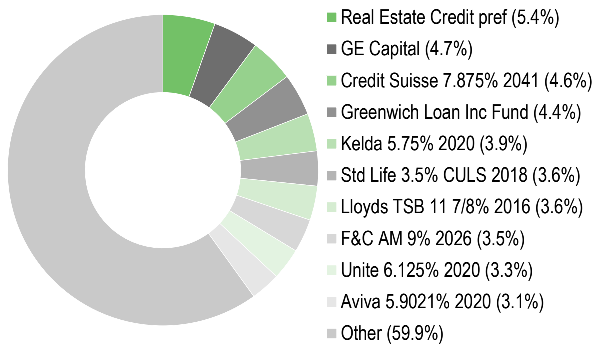
Small-cap pool composition *(as at 28 February 2013)



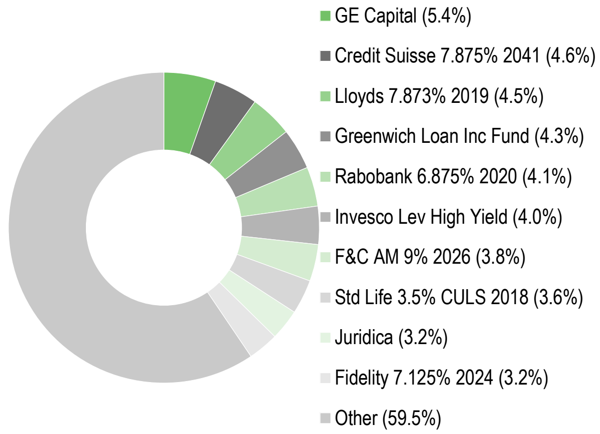
Small-cap pool composition *(as at 31 August 2012)



Income pool composition *(as at 28 February 2013)



Income pool composition *(as at 31 August 2012)



Source: Edison Investment Research, Acorn Income Fund. Note: *As a percentage of the assets attributable to each pool.

Recent performance: Impressive returns

As Exhibits 5 and 6 show, AIF's ordinary shares have outperformed relevant indices over most time periods. Unfortunately, the manager provides no attribution data that would enable investors to identify the source of this performance with greater precision.

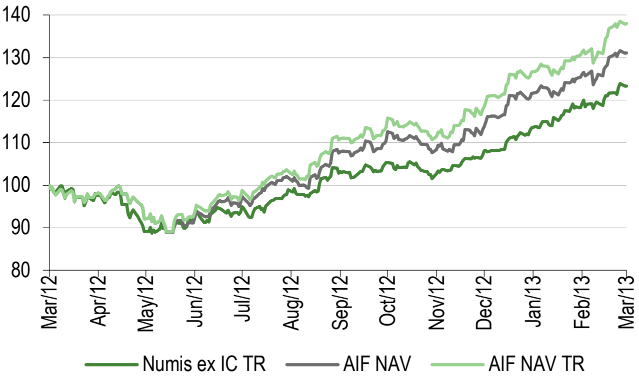
In 2012, performance was aided by a number of holdings in the equity portfolio. Among AIF's largest investments, Renishaw rose by 106%, VP by 55% and Diploma by 63%.

Taking a slightly longer perspective, AIF made money in the income portfolio in the wake of the credit crunch by acquiring positions in contingent convertible (CoCo) bank bonds on double-digit yields. Once these had been re-rated (on the back of improving bank balance sheets), the positions were switched into senior bank debt. These have also performed well. More recently, the pool benefited as the bank debt was switched into debt issued by diversified financial companies, which subsequently re-rated. As an example, AIF's holding in F&C Asset Management 9% 2028 bonds was re-rated by c 35% in capital terms over the course of 2012.

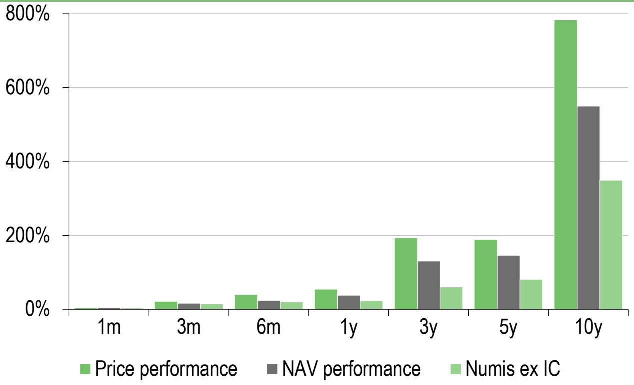
The replacement of bank debt with ZDPs in 2011 effectively doubled the gearing on the ordinary shares and has the effect of both magnifying changes in the capital performance of the underlying portfolio and enhancing income returns (as the cost of the ZDPs is charged to capital). The ZDP gearing was a major contributor to AIF's performance in 2012. The gross return on the portfolio was 30.5% over the course of 2012, the ZDP gearing (which was proportionately higher at the start of the year) elevated this to 48.1%. The total return on the Numis Small Cap ex-IC Index was 30% over the same period, so AIF did well to beat this despite having only c 80% of its portfolio in equities.

Exhibit 5: Investment trust performance

Price, NAV and benchmark total return perf, one year rebased



Price, NAV and benchmark total return performance (%)



Source: Acorn Income Fund, Datastream, Edison Investment Research

Exhibit 6: Share price and NAV total return performance relative to benchmarks, to 19 March 2013

	One month	Three months	Six months	One year	Three years	Five years	10 years
Price relative to Numis ex-IC TR	0.9	7.3	20.0	30.7	132.9	108.0	434.1
NAV relative to Numis ex-IC TR	1.7	2.4	4.9	14.7	69.9	64.8	200.5
Price relative to FTSE All-Share TR	1.5	10.4	23.9	31.6	123.4	72.8	213.3
NAV relative to FTSE All-Share TR	2.4	5.6	9.4	17.4	72.8	49.1	118.3

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

Discount: On a narrowing trend

During a period of strong NAV performance, the discount on AIF's ordinary shares has narrowed over the past year and now stands at 6.2%, much narrower than its three-year average of 14.4%. AIF has powers to repurchase 14.99% of its issued ordinary share capital, renewed annually at the AGM. Repurchasing shares of investment companies of AIF's size can be counter-productive as potential new investors are discouraged by the associated reduction in their liquidity, and AIF last repurchased shares in May 2011. Repurchased shares are held in treasury and may be reissued at a premium to asset value. AIF may repurchase unlimited numbers of ZDPs at a discount to their net asset value. AIF may only repurchase ordinary shares to the extent that the cover on the ZDPs will continue to exceed 1.85x. The ZDPs are trading at a premium of 8.2%, equivalent to a net yield to redemption of 4.35%.

Exhibit 7: Discount over three years

Source: Thomson Datastream, Edison Investment Research

Capital structure: Ordinary shares and zeros

AIF's share capital comprises ordinary shares of 1p each and ZDP shares, which rank higher than the ordinary shares in the event of a liquidation of AIF. There are 8,724,790 shares in issue and 215,000 held in treasury. Other than the ZDPs, AIF does not employ any other form of long-term gearing and has undertaken not to borrow money while the ZDPs are outstanding. AIF's manager receives a management fee of 0.7% pa of gross assets, calculated monthly, payable quarterly in arrears and charged 75% to capital and 25% to income. The manager pays fees to the investment advisers from the management fee. To the extent that AIF's annual expenses exceed 1.5% of gross assets, the manager will reduce its fees accordingly, but in exchange for this, the management fee is subject to a minimum annual payment of £100,000. The manager is also potentially entitled to a performance fee equivalent to 15% of AIF's outperformance (NAV plus dividends declared) over a benchmark defined as the NAV at the time a performance fee was last paid compounded by 10% pa. The last performance fee was paid in 2006, and the target to beat for 2013 is 393.2p. No performance fee was payable for 2012. Ongoing expenses in 2012 were 2.3% (2011, 2.3%). NB This is a percentage of net assets. AIF has unlimited life, although ordinary shareholders have the opportunity to vote on whether the company should continue at the AGM in 2016.

ZDP shares

There are 12 million ZDPs in issue. These were issued at a price of £1 and their asset value accrues at an effective rate of 6.5% pa to give them a final capital entitlement of 138p on 31 January 2017. The proceeds of the ZDP issue have been invested in income-producing assets, but the associated expense is charged to capital and this boosts the income available to ordinary shares. There are no covenants associated with the ZDPs, and therefore to an ordinary shareholder, gearing with ZDPs is less risky than gearing with an equivalent amount of bank debt. The ZDPs do have a bullet-point repayment, but the ZDPs' final entitlement is covered 2.2x by AIF's net assets. The board will most likely propose how they intend to fund the repayment (by raising funds from the portfolio from a new issue of ZDPs or another suitable method) well in advance of January 2017, in the light of market conditions prevailing at the time. ZDP holders will receive their full entitlement, provided AIF's assets do not shrink by more than 18.3% pa. The NAV of the ordinary shares is calculated after deducting the accrued par value of the ZDPs.

Dividend policy and record: Smoothed returns

The board tasks the managers with at least maintaining the dividend each year. The directors aim for a smooth progression of dividend growth for shareholders and have in the past declared special dividends when AIF has received one-off income. When AIF replaced its bank debt with ZDPs in 2011, it eliminated debt interest payments and boosted distributable income, enabling a sharp increase in the total annual dividend from 7p to 12p. AIF paid four quarterly dividends of 3p per share each over the course of 2012 and declared a dividend of 3p per share, payable on 2 April 2013 for Q113. The directors stated on 22 February that based on current projections, that rate of dividends can be sustained for the rest of the year. EPS in 2012 was 12.33p and distributable reserves at 31 December 2012 stood at c £300,000.

Peer group comparison

AIF sits within the AIC's UK High Income peer group. The peer group comprises seven investment companies, each of which have a different approach to generating a high level of income for shareholders. Acorn's balanced portfolio approach is similar to that of Aberdeen, Henderson and Investors Capital. Within this peer group, Exhibit 7 shows AIF is the best-performing investment company over all time periods. On a risk-adjusted basis, looking at the one-year Sharpe ratios, Acorn still leads the peer group in price terms and is above average in NAV terms.

AIF's ongoing charges are the third-highest of the peer group, reflecting its size and the impact of the gearing, but lower than the average for the peer group, which is skewed by the Jupiter trust.

AIF's discount is wider than the average for the peer group (which is skewed by the wide discount on the poorly performing Jupiter trust). AIF's high gearing reflects the ZDP issue. AIF has by far the highest dividend growth of the peer group, reflecting the impact of the ZDP issue and the nature of its portfolio.

Exhibit 8: Peer group comparison as at 19 March 2013 (UK high-income sector)

Company	Share price total return on £100			Ongoing charges (%)	(Disc)/ prem.	Net gearing (100=no gearing)	Five-year dividend growth (%)	Div. yield	Sharpe ratio Price One year	Sharpe ratio NAV One year
	One year	Three years	Five years							
Average	24.9	73.5	77.5	2.5	(4.2)	117	(10.8)	4.2	1.8	2.0
Acorn Income Fund	54.0	193.5	189.1	2.3	(5.6)	150	46.2	4.4	2.4	2.1
Aberdeen Small Cos High Inc	53.2	115.7	70.6	1.8	(4.7)	119	(60.0)	3.3	2.3	2.3
City Merchants High Yield	6.3	27.7	61.5	1.9	5.0	97	N/A	6.0	1.6	1.8
Henderson High Income	21.7	60.9	76.3	0.9	2.8	121	(0.6)	5.4	2.2	2.1
Investors Capital A Share	17.8	32.4	46.0	1.2	(6.7)	111	(13.7)	4.8	1.3	1.5
Investors Capital B Share	10.7	21.4	46.2	1.2	(5.7)	111	N/A	0.0	1.0	2.1
Jupiter Dividend & Growth	13.9			9.4	(17.1)	98	N/A	2.3	1.3	1.6
New City High Yield	15.1	43.3	84.2	1.3	4.7	106	15.5	6.1	2.2	3.0
Small Companies Dividend	31.6	92.8	46.0	2.4	(10.4)	141	(52.2)	5.4	2.2	1.9

Source: Thomson Datastream, Edison Investment Research

Given the disparity of investment approaches in the UK High Income peer group, we thought it might be useful on this occasion to also show AIF in the context of the UK Growth and Income peer group and this is displayed in Exhibit 9 below. Once again, AIF is the best-performing investment company over all time periods. On a risk-adjusted basis, looking at one-year Sharpe ratios is above average for the peer group, ranking fourth of 21 in price terms and third of 21 in NAV terms. Its ongoing charges are the highest of this group and its discount one of the widest. AIF's gearing is the highest of this peer group, but again, the introduction of the ZDPs has boosted its five-year dividend growth number to the top of the group. AIF's yield is in the upper quartile of this group.

Exhibit 9: Peer group comparison as at 19 March 2013 (UK growth and income sector)

Company	Share price total return on £100 One year	Three years	Five years	Ongoing charges (%)	(Disc)/ prem.	Net gearing (100=no gearing)	Five-year dividend growth (%)	Div. yield	Sharpe ratio Price One year	Sharpe ratio NAV One year
Average	23.2	59.8	69.4	1.0	(1.6)	111	7.0	3.8	1.8	1.7
Acorn Income Fund	54.0	193.5	189.1	2.3	(5.6)	150	46.2	4.4	2.4	2.1
BlackRock Income and Growth	19.9	27.6	23.1	1.3	(0.7)	108	2.4	3.4	1.4	1.1
City of London	19.6	53.0	68.6	0.5	2.2	110	21.1	4.1	1.9	1.9
Diverse Income Trust	37.3	N/A	N/A	1.9	5.0	103	N/A	3.3	3.2	2.5
Dunedin Income Growth	22.1	54.2	61.5	0.7	(0.2)	105	3.9	4.1	1.8	1.5
Edinburgh Investment	17.4	62.1	85.0	0.7	5.1	119	10.4	3.9	1.3	1.1
F&C Capital & Income	14.1	30.5	42.3	0.8	(0.6)	104	16.4	3.8	1.6	1.6
Finsbury Growth & Income	33.7	91.8	134.7	0.9	1.2	104	5.7	2.2	2.2	2.3
Invesco Income Growth	17.7	56.5	60.8	1.0	(5.3)	111	14.2	3.9	2.6	2.0
JPMorgan Claverhouse	20.3	32.9	39.4	0.7	(6.7)	115	14.8	3.7	1.2	1.3
JPMorgan Elect Managed Inc	16.4	31.4	30.0	0.7	(2.3)	99	(21.5)	3.8	1.6	1.6
Lowland	31.7	106.6	74.3	0.7	(3.9)	113	15.0	2.7	2.4	2.1
Merchants Trust	16.9	44.6	48.6	0.6	(2.8)	121	4.5	5.4	1.3	1.5
Murray Income Trust	16.7	55.2	60.7	0.8	1.4	107	10.1	4.0	1.4	1.5
Perpetual Income & Growth	21.2	63.1	81.8	1.0	(2.0)	115	39.1	3.4	2.1	2.0
Schroder Income Growth	25.3	51.2	75.9	1.1	(0.8)	103	20.4	4.5	1.7	1.7
Shires Income	24.0	52.7	63.3	1.1	2.3	123	(39.1)	5.2	2.1	1.9
Standard Life Equity Income	25.8	44.1	58.0	1.0	(2.9)	106	16.3	3.7	1.9	1.5
Temple Bar	20.6	58.3	107.7	0.5	2.5	99	11.5	3.3	1.8	1.9
Troy Income & Growth	13.6	41.1	19.6	1.2	1.2	96	(61.5)	3.4	1.3	1.5
Value & Income	19.6	45.7	63.4	1.4	(21.0)	126	10.0	3.8	1.2	1.8

Source: Thomson Datastream, Edison Investment Research

The board

All the directors are independent and non-executive, but they have considerable influence on returns as they determine the asset allocation policy. The chairman is Helen Green (appointed as a director in 2007 and as chairman in 2012). There are two other directors, Nigel Ward (appointed December 2011) and David Warr (appointed 2012). The average length of service is c 2.5 years.

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