EDISON

Acorn Income Fund

Back on top after small-cap renaissance

Investment companies

Acorn Income Fund (AIF) has come through a period of change with its impressive long-term record intact. The death of founding small-cap portfolio manager John McClure in June 2014 caused uncertainty and a widening in the discount, but co-managers Simon Moon and Fraser Mackersie at Unicorn Asset Management have provided continuity of management, and stock selection has driven outperformance and a re-rating in the shares. The fund blends the small-cap allocation with an income portfolio managed by Paul Smith at Premier Fund Managers, which helps boost income and reduce volatility.

12 months ending	Share price (%)	NAV (%)	ZDP price (%)	Numis Smaller Cos ex IC (%)	FTSE All-Share (%)
30/11/11	3.0	5.4	--	1.8	2.6
30/11/12	52.4	41.0	--	23.0	12.1
30/11/13	66.7	45.9	6.4	37.9	19.8
30/11/14	(15.3)	(2.5)	7.0	(0.6)	4.7
30/11/15	37.1	24.4	1.9	11.9	0.6

Note: Twelve-month rolling discrete £-adjusted total return performance.

Investment strategy: Flexible income seeker

AIF has a dual portfolio, with 70-80% in a smaller companies pool advised by Unicorn Asset Management and 20-30% in an income pool advised by Premier Fund Managers. The overall aim is to produce a high income with the potential for capital and income growth. It is not a 'barbell' strategy; all the stocks in the small-cap portfolio are expected to contribute to the yield and, while the income portfolio focuses on high-yield securities to provide extra income, it also helps to reduce volatility and offset the extra risk of a geared fund. Recently the small-cap portfolio has increased its focus on companies further down the size scale. Both the smaller companies and the income managers take a bottom-up approach to investing.

Market outlook: Global concerns continue

The volatility seen in the summer has receded somewhat, but risks remain, with geopolitical worry about events in and beyond the Middle East adding to fears over growth in China and a potentially imminent rate rise in the US. Growing concerns over the level of dividend cover for some large UK stocks could be ameliorated by looking further down the market cap scale, where many conservatively financed UK companies continue to offer attractive, well-covered yields.

Valuation: Close to par after significant re-rating

At 9 December AIF's shares were trading at a small 1.7% discount to NAV. Average discounts over one, three and five years of 8.3%, 4.3% and 8.1% respectively reflect a widening through the second half of 2014, culminating in a three-year high of c 18% in February 2015. Strong relative performance and a re-rating in smaller company shares following the UK election have seen AIF's discount narrow sharply to a level more familiar to longer-term investors, and any widening from current levels could be viewed as a buying opportunity. The board uses buybacks and issue at its discretion to manage the discount.

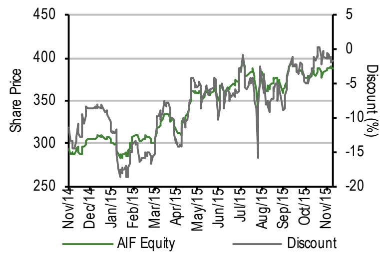
10 December 2015

Price	**388.0p**
Market cap*	**£61.3m**
AUM	**£87.8m**
NAV**	392.0p
Discount to NAV	1.0%
NAV***	394.8p
Discount to NAV	1.7%

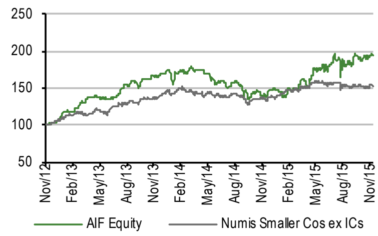
*Ords only. **Excluding income. ***Including income. NAVs at 4 December 2015. Price data to 9 December 2015.

Yield	3.5%
Ordinary shares in issue	15.79m
ZDP shares in issue	21.19m
Code	AIF
Primary exchange	LSE
AIC sector	UK Equity & Bond Income

Share price/discount performance



Three-year cumulative perf. graph



52-week high/low	399.0p	284.0p
NAV** high/low	404.5p	327.3p

**Including income.

Gearing (including ZDPs)

Gross*	43.0%
Net*	37.8%

*As at 31 October 2015.

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Edison profile page

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

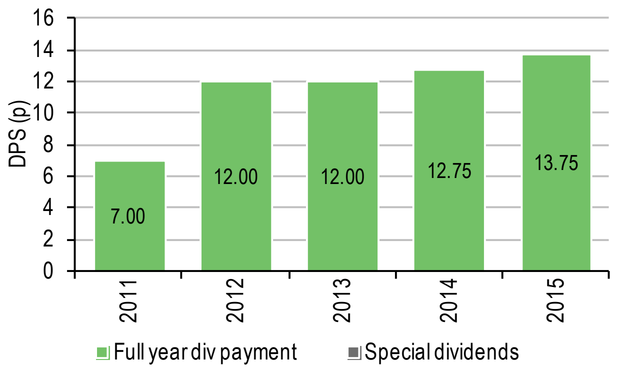
Exhibit 1: Investment company at a glance

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-income instruments, convertibles and high-yielding shares in other investment companies. Performance is measured against the Numis Smaller Companies (excluding investment companies) index.	■ 29 October 2015: Fourth interim dividend of 3.5p declared for the year ending 31 December 2015, bringing total dividend for the year to 13.75p. ■ 27 August 2015: FTSE 100 hedge position closed out, generating a profit of c 1.7p per share. ■ 26 August 2015: Half-year results for the six months ended 30 June. NAV TR +16.3% (ordinary shares) versus 11.8% for Numis Smaller Companies (excl investment companies) index. Ordinary share price TR +16.8%.

Forthcoming		Capital structure		Fund details	
AGM	August 2016	Ongoing charges	1.7%	Group	Premier Fund Managers Ltd
Annual results	March/April 2016	Net gearing	37.8% (through ZDPs)	Managers	Simon Moon, Fraser Mackersie (Unicorn), Paul Smith (Premier)
Year end	31 December	Annual mgmt fee	0.7% of total assets	Address	Eastgate Court, High Street, Guildford GU1 3DE
Dividend paid	Quarterly	Performance fee	15%, see p7		
Launch date	11 February 1999	Trust life	Indefinite	Phone	+44 (0)1483 30 60 90
Continuation vote	Five-yearly, next 2016	Loan facilities	None	Website	www.premierfunds.co.uk

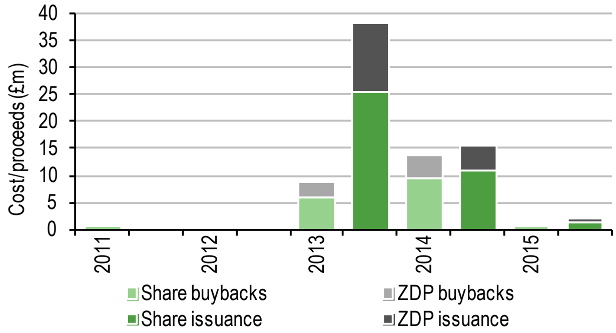
Dividend policy and history

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

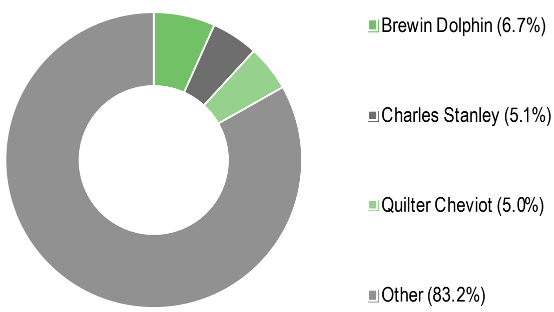


Share buyback policy and history

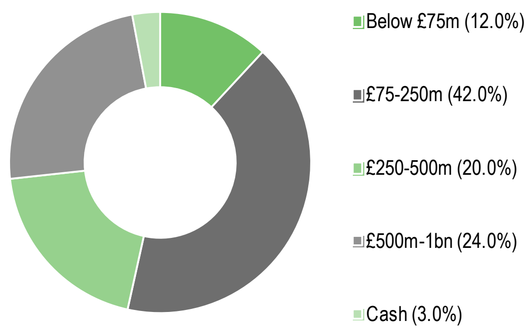
ZDPs are issued and bought back at the same time as ordinary shares in quantities such that the ratio of ZDPs to ordinary shares is maintained.



Shareholder base (as at 23 March 2015)



Portfolio exposure by market cap (as at 31 August 2015)



Top 10 holdings* (as at 31 October 2015)

Company	Market cap (30 Nov)	Industry	Portfolio weight (%) 31 Oct 2015 (% of gross)	31 Oct 2015 (% of ptfl)	30 Apr 2015** (% of gross)	30 April 2015** (% of ptfl)
Conviviality Retail	£336.0m	Off licences	3.6	4.6	N/A	N/A
Macfarlane Group	£59.8m	Packaging	3.1	3.9	3.1	4.2
Acal	£170.2m	Industrial electronics	2.7	3.5	3.6	4.8
Clipper Logistics	£272.4m	Distribution	2.7	3.5	N/A	N/A
Secure Trust Bank	£545.8m	Banking	2.7	3.4	2.9	3.9
Primary Health Properties	£469.5m	Real estate	2.7	3.4	2.9	3.9
Park Group	£163.0m	Financial services	2.7	3.4	N/A	N/A
James Halstead	£1,011.2m	Flooring	2.7	3.4	N/A	N/A
Alumasc Group	£61.5m	Building products	2.7	3.4	N/A	N/A
Safestyle UK	£184.3m	UPVC/building products	2.4	3.1	N/A	N/A
Smaller companies portfolio top 10			**27.9**	**35.6**	**27.9**	**37.5**
Income portfolio top 10			**5.2**	**24.3**	**6.6**	**26.0**

Source: Acorn Income Fund, Edison Investment Research, Morningstar, Thomson. Note: *All the top 10 holdings are constituents of the smaller companies portfolio. **N/A where not in 30 April 2015 top 10.

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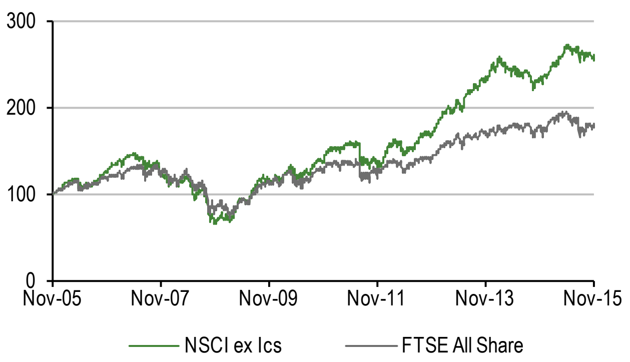
Market outlook: Silver lining for smaller companies?

The second half of 2015 has been characterised by volatility and uncertainty across global markets, driven by geopolitical fears over war and terrorism in the Middle East, declining growth in former global powerhouse China, and the imminent start of interest rate increases in the US. Set against this are reasons to be optimistic: GDP growth remains robust in the UK and US and is recovering in Europe, and low oil prices are providing a fillip to consumers in oil-importing nations such as the UK.

Every silver lining has a cloud, however, and with oil remaining below $50 a barrel, there is pressure on earnings – and therefore on dividends – for some of the UK's largest companies (and largest dividend payers) such as BP and Shell. This could weigh on sentiment towards large-caps in general. In such an environment, a focus away from the big index constituents and towards domestically focused companies with strong balance sheets and competitive positions in growing markets could literally pay dividends for investors seeking attractive total returns.

Exhibit 2: Market valuation and performance

Numis Smaller Companies and FTSE All Share index TR, 10 years



Valuation metrics (forecasts, December 2015)

	P/E 2015	Forecast P/E 2016	Div yld (9 Dec)
FTSE 100*	17.6x	14.5x	4.2%
FTSE 250*	15.4x	16.1x	2.6%
FTSE Small Cap*	16.0x	13.7x	3.2%
AIF small-cap portfolio	c 16x	c 14x	3.7%

Source: Thomson Datastream, Edison Investment Research (LH chart), Unicorn AM (RH table). Note: *Bloomberg figures.

Fund profile: Blending bonds and small-cap for income

AIF is a closed-ended investment company, incorporated in Guernsey and listed in London. It was launched in 1999 and seeks to achieve a high income, along with potential capital and income growth, by investing in UK smaller companies (70-80% of the portfolio) and high-yielding securities (20-30%). The smaller companies portfolio is advised by Simon Moon and Fraser Mackersie at Unicorn Asset Management, and the income portfolio by Paul Smith at Premier Fund Managers. Benchmarked against the Numis Smaller Companies (excluding investment companies) index, AIF has a strong record of outperformance over both short and longer periods, with a 10-year NAV total return of 266% (peer group average 107%). The fund is geared (c 40% net) through an issue of zero dividend preference shares, maturing in January 2017 with a final entitlement of 138p.

The fund managers: Moon, Mackersie and Smith

The managers' view: Focus on sustainable yields

As income managers, Moon and Mackersie are concerned by the declining level of dividend cover in the UK market. They point out that while in 2011 the average FTSE 100 company had sufficient net earnings to cover its dividend 2.5x, today the figure is closer to 1x, meaning some dividend cuts are all but inevitable. While some of this will be related to the lower oil price, the trend is too long-established to be dismissed as solely a commodity story. With earnings growth an important factor in dividend growth, the managers screen all current and potential holdings for this, as well as yield and dividend cover. Cover for the AIF small-cap portfolio is currently 2.0x, and if earnings rise in line with the managers' expectations of 10% for 2016, they say there should be dividend growth and potentially some special dividends from portfolio holdings as well. The managers have no exposure to oil, gas and mining stocks, and tend to eschew pharmaceuticals and biotech, as small companies in these sectors tend to be risky and most do not pay dividends.

The portfolio's high exposure to domestic earnings reflects the managers' positive view on the UK economy and the benefits to consumers from an environment where wages are rising faster than prices, and oil prices are low. The focus on sensibly financed, domestically orientated companies helped performance in the recent sell-off, which hit larger, more globally focused stocks harder.

While global merger and acquisition activity last year was the highest since 2007, this trend was not reflected in the AIF portfolio. The managers say they now see companies they own becoming more active in this area, pointing to the recent acquisition of Matthew Clark by top holding Conviviality Retail as an example. "We focus on niche companies in areas with high barriers to entry," they say, pointing out that such companies make attractive acquisition targets. IPO activity is also picking up after a quiet period, for example the recent flotation of low-cost travel accommodation stock Hostelworld. The managers say they hope to participate in another IPO before the end of the year.

Income portfolio manager Paul Smith's outlook is informed by caution over low liquidity in bond markets and potential volatility as the global interest rate cycle resets. With demand for bonds still high, he says terms on new issues increasingly favour the issuer over the buyer, a situation made worse by high bond prices, as the ability of many issuers to redeem their bonds early at or close to par results in a capital loss for investors. Smith is seeing opportunities on a credit-by-credit basis rather than across sectors. In a recent trade, he sold Sky and bought ITV, seeing the latter as more attractive as it produces its own shows rather than buying them in (with the accompanying risk that blockbuster assets such as *Game of Thrones* could be lost to a rival such as Netflix).

Asset allocation

Investment process: Flexible allocation for income and growth

AIF views a neutral allocation between its two portfolios as 75% in smaller companies and 25% in the income pool, with a working range of 70-80% small-cap and 20-30% bonds. This range is not set in stone and during the financial crisis, for example, the proportion in the income portfolio was higher. The board reviews the allocation at each board meeting and the managers regularly discuss and may make adjustments to it based on the outlook for their respective sectors, or portfolio management needs. For example, the smaller companies' managers may transfer the proceeds of a sale to the income portfolio if they do not have an immediate reinvestment opportunity.

The small-cap portfolio managers look for profitable, cash-generative companies with experienced and motivated management, strong competitive positions in growing markets and a progressive approach to dividends. Unicorn's long experience as a significant investor in smaller stocks means AIF's managers have good access to and relationships with companies, and meetings with current and potential holdings – as well as being an important part of the investment process – may help inform their views on the business and economic environment. Moon and Mackersie are also members of Unicorn's investment committee, which meets every two weeks and is a good source of ideas. AIF's smaller companies portfolio contains c 40 stocks. All holdings should contribute to the yield, and the managers look for attractive valuations and good dividend cover. Unicorn conducts its stock research in house and the managers also do their own dealing, allowing them to be patient in building positions in illiquid stocks. Stocks are often sold if strong capital performance means their dividend yields have fallen, with proceeds reinvested in other higher-yielding positions.

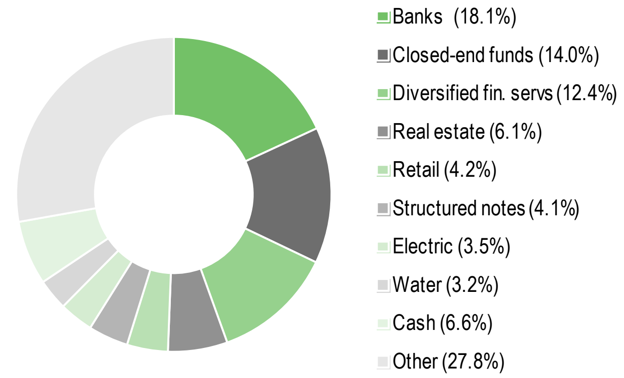
The three main aims of the income portfolio are to boost the overall yield, reduce volatility and offset some of the extra capital risk inherent in being a structurally geared fund. It has a greater number of holdings than the small-cap portfolio (82 at 30 September), with the small size of the pool allowing Smith to invest in bond issues that would be too small for managers of larger mandates to access. The portfolio is a blend of high-yielding securities such as corporate bonds, convertibles, preference shares and holdings in other closed-end funds (c 50% rated investment grade). While Smith takes account of top-down factors such as the regulatory environment (vital for assessing issuers such as banks), the economy and the outlook for interest rates, the choice of holdings is the product of bottom-up analysis, as is the case for the smaller companies portfolio.

Current portfolio positioning

At 31 October the AIF portfolio was 78.4% smaller companies and 21.6% income, towards the higher end of the equity range. This is a product of the small-cap managers' generally bullish view of their sector and caution on prospects for bonds at a turning point in the global interest rate cycle.

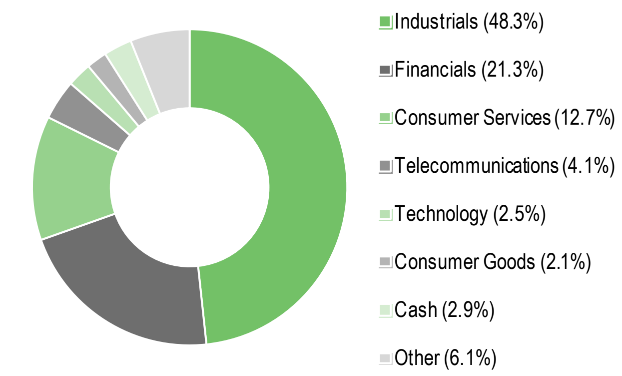
Smith's largest weightings are in financials, which have performed well for the income portfolio. However, he has reduced the position in bank-issued contingent convertibles (CoCos) after taking profits on issues where yields had become compressed because of price rises. The manager has also taken some profits in property, reducing the weighting by c 500 basis points compared with six months ago. The portfolio is overweight consumer names and Smith also has holdings in alternative plays such as an iTraxx crossover product linked to the default rate on European bonds, and a note linked to the performance of US financial equities relative to the S&P 500 index. Duration is actively managed and is currently low, at just under three years, in anticipation of a rising risk-free rate.

Exhibit 3: Sector exposure of income portfolio



Source: Acorn Income Fund, as at 31 October 2015

Exhibit 4: Sector exposure of smaller cos portfolio



Source: Acorn Income Fund, as at 31 October 2015

The smaller companies portfolio has its largest weighting in industrials, with building materials and logistics being key themes. Turnover has been higher than historically this year, partly because of a move down the market capitalisation scale: the average size of holdings has gone from £400m to £320m since the beginning of 2015 and Moon and Mackersie have sold out of all £1bn+ stocks. As a closed-end fund they say they are better placed to invest in smaller and less liquid companies, and AIF now has a lower average market cap than their open-ended Unicorn Income Fund. The managers are taking advantage of the more domestic focus of UK small-caps, with c 70% of the portfolio linked to the domestic economy. Smaller companies in this area bounced back strongly following the UK general election and have been an important source of performance.

Recent purchases include training and recruitment firm FDM, used car dealer Pendragon, Photo-Me International, and Hostelworld, a recent IPO that should yield 6% next year. Among the larger stocks sold were Electrocomponents, Premier Farnell, Berendsen and Interserve. Conviviality Retail has risen to the top of the stock list after the managers backed a recent capital raising for the company to acquire drinks supplier Matthew Clark.

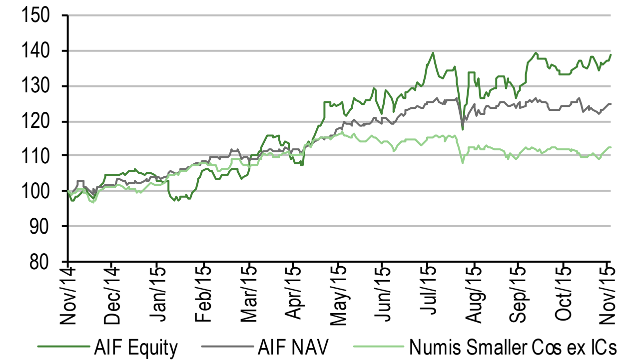
Performance: Strong record versus benchmark

AIF has a strong record of outperformance, with both share price and NAV total returns substantially ahead of the Numis Smaller Companies (excluding investment companies) benchmark over six months and one, three, five and 10 years. The most recent periods have been more challenging given the broad market sell-off in the late summer, although share price total returns are still ahead of the index over both one and three months (Exhibit 5). NAV volatility has mainly been lower than the benchmark, an effect of the bond holdings and significant given the level of gearing. Performance relative to the FTSE All-Share index, which has a far greater representation of larger companies, has also been strong over all but the most recent period (Exhibit 6). A period of exceptionally strong performance relative to the benchmark can be seen in Exhibit 7; the fund benefited strongly from the re-rating of smaller companies in the wake of the UK general election.

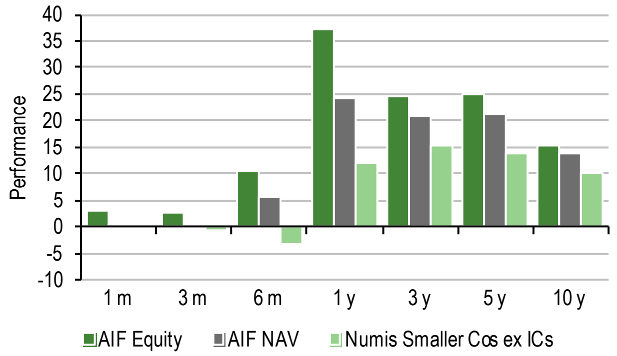
Over 12 months to 31 October, top contributors to performance include Clipper Logistics, Park Group, James Halstead, Safestyle and Alumasc, all up c 50-90% on a capital-only basis. The income portfolio has also outperformed the broader sterling bond market, as measured by the Merrill Lynch Sterling Non-Gilts index, by c 2.5-3% year to date (to 31 October). A FTSE 100 hedge also provided a small uplift in late summer.

Exhibit 5: Investment trust performance to 30 November 2015

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



Price, NAV and benchmark total return performance (%)



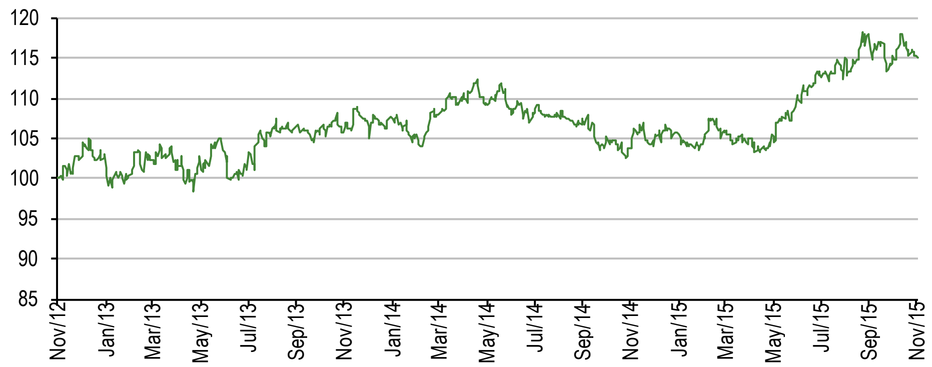
Source: Thomson Datastream, Edison Investment Research. Note: Three-, five- and 10-year performance figures annualised.

Exhibit 6: Share price and NAV total return performance, relative to indices (%)

	One month	Three months	Six months	One year	Three years	Five years	10 years
Price relative to NSCI ex ICs	2.9	3.3	14.1	22.6	26.2	58.1	59.7
NAV relative to NSCI ex ICs	0.0	0.4	9.4	11.2	15.4	36.8	40.4
Price relative to FTSE All Share	2.4	0.1	17.9	36.2	53.3	109.1	131.1
NAV relative to FTSE All Share	(0.5)	(2.8)	13.1	23.6	40.2	81.0	103.2

Source: Thomson Datastream, Edison Investment Research. Note: Data to end-November 2015. Geometric calculation.

Exhibit 7: NAV performance relative to benchmark over three years

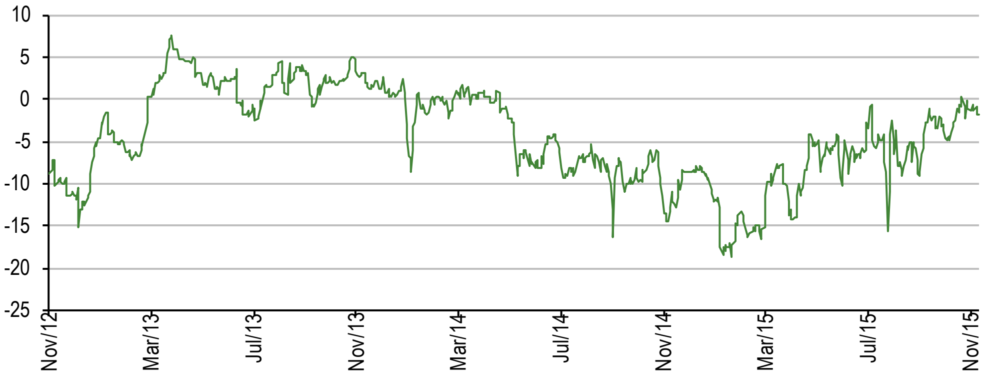


Source: Thomson Datastream, Edison Investment Research

Discount: Close to par after narrowing

At 9 December 2015, AIF's shares were trading at a 1.7% discount to NAV. This is close to a 12-month high following a period of uncertainty that began with the death of John McClure, and may be seen as a validation of the continuity of approach under Moon and Mackersie. Average discounts over one, three and five years are 8.3%, 4.3% and 8.1%. The board uses buybacks and issuance to manage a discount or premium. ZDPs and ordinary shares are bought back in amounts that preserve the gearing ratio. In the 12 months to 7 December, 200,000 ordinary shares were bought back at a cost of £580,000, and 317,000 ordinary shares were issued, raising £1.24m.

Exhibit 8: Share price discount to NAV (including income) over three years (%)



Source: Thomson Datastream, Edison Investment Research.

Capital structure and fees

Following the introduction of ZDPs in 2011, AIF has two classes of share. At 20 November there were 15.7m ordinary shares and 21.1m ZDPs in issue. The ZDPs mature in January 2017 with a final capital entitlement of 138p, 5.3% above the closing price on 9 December. AIF's gross assets would need to fall by 66.9% from their 30 September 2015 level for the ZDPs not to be repaid in full. The ZDPs currently represent gross gearing of 43.1% (based on 31 October gross assets). AIF's managers say it is too early to say what will happen to the fund's gearing once the ZDPs mature; options include a rollover issue of ZDPs, which would favour existing investors who do not want to crystallise a tax liability. A decision is likely to be taken following the continuation vote next August.

Premier Asset Management (Guernsey) receives an annual fee of 0.7% of AIF's total assets. Fees are paid to the investment advisers out of this. There is a performance fee of 15% of excess returns, payable if the NAV per share plus dividends has grown at over 10% compound since the last year end in which a performance fee was paid (in this case FY13). Ongoing charges for FY14 were 1.7%.

Dividend policy and record

AIF pays four dividends a year in March, June, September and December. The dividend has grown at a compound annual rate of 14.5% over the past five years and the total dividend for FY15 is 13.75p. The introduction of the ZDPs in 2011 allowed the repayment of bank borrowing, reducing interest costs and allowing the payment of a materially higher dividend (the 2012 dividend was 71% higher than in 2011). AIF's dividend was fully covered by income for FY14 and H115; although H215 may see a more challenging picture for corporate earnings, the managers' focus on companies with high levels of dividend cover should mean revenue is not significantly affected by any earnings disappointments. Based on the FY15 dividend, AIF currently has a dividend yield of 3.5%.

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Peer group comparison

AIF is a member of the Association of Investment Companies' UK Equity & Bond Income sector, which contains seven funds. AIF's NAV total return performance ranks it first in the group over one, three and five years; the second-placed fund over all three periods also has a tilt towards smaller companies, suggesting that this has been a differentiating factor in performance. AIF is also first for risk-adjusted performance as measured by the Sharpe ratio over one and three years. AIF has one of the highest levels of gearing in the sector because of its ZDPs. Its dividend yield is among the lowest, while ongoing charges are higher than average, and AIF is one of only two funds to charge a performance fee. AIF's 0.5% discount at 2 December is narrower than the weighted average for the sector, although several higher-yielding funds trade at a premium to NAV.

Exhibit 9: UK Equity & Bond Income peer group as at 2 December

% unless stated	Market cap (£m)	NAV TR 1 Year	NAV TR 3 Year	NAV TR 5 Year	Ongoing charge	Perf. fee	Discount/ premium	Net gearing	Dividend yield (%)	Sharpe 1y (NAV)	Sharpe 3y (NAV)
Acorn Income Fund	**61.0**	**22.8**	**75.8**	**155.8**	**1.8**	**Yes**	**-0.5**	**138.0**	**3.5**	**2.8**	**2.0**
Aberdeen Smaller Cos High Inc	47.5	17.2	66.8	99.4	1.6	No	-13.6	111.0	3.1	1.4	1.6
City Merchants High Yield	155.2	3.6	27.5	44.4	1.0	No	1.8	93.0	5.5	0.5	1.3
CQS New City High Yield	204.3	1.0	14.6	42.8	1.3	No	2.9	111.0	7.6	0.0	0.6
Henderson High Income	202.9	7.6	55.2	98.3	0.7	Yes	3.5	121.0	4.8	0.6	1.5
Investors Capital A Share	113.8	1.3	30.4	48.0	1.1	No	-5.1	104.0	5.0	0.1	0.8
Investors Capital B Share	114.4	1.3	29.6	61.3	1.1	No	-5.2	98.0	0.0	0.1	0.7
Investors Capital Units	116.5	-1.1	27.2	44.6		No	-8.2	94.0	3.7	-0.1	0.7
M&G High Income & Growth Unit	138.5	-1.8	38.9	75.6	2.0	No	n/a	276.0	13.0	0.1	0.5
M&G High Income Package Unit	405.8	4.4	36.5	67.1	0.9	No	-7.3	100.0	4.2	0.4	1.0
Sector weighted average		**4.0**	**36.2**	**67.4**	**1.2**		**-2.7**	**120.6**	**5.7**	**0.4**	**1.0**
AIF rank in sector	**9**	**1**	**1**	**1**	**2**		**4**	**2**	**8**	**1**	**1**

Source: Morningstar, Edison Investment Research. Note: TR=total return. Sharpe ratio is a measure of risk-adjusted return. The ratios shown 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 total assets less cash and equivalents as a percentage of net assets (100 = ungeared). * Investors Capital B shares pay a capital distribution rather than a dividend.

The board

AIF's board is made up of three non-executive directors. Chairman Helen Green has been in post since 2012 and has served as a director since 2007. Nigel Ward joined the board in 2011 and David Warr was appointed in 2012. The directors are all resident in Guernsey. Their backgrounds are in investment management and accountancy.

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