

Acorn Income Fund

Small-cap portfolio drives compelling returns

Acorn Income Fund (AIF) targets a high income and the opportunity for capital growth by investing the majority of its assets in smaller quoted UK companies, with up to 30% in a portfolio of higher-yielding securities such as bonds, preference shares, investment companies and structured notes. Its long-term performance record is compelling, with 10-year share price and NAV total returns of c 270-280%, and it also ranks second or first in its peer group (AIC UK Equity & Bond Income) for NAV total returns over one, three and five years. The fund is structurally geared using zero-dividend preference shares (ZDPs), which were refinanced in early 2017, extending their life until 2022 at a much lower gross redemption yield of 3.85% (previously 6.5%), meaning ordinary shareholders feel the benefit of gearing more quickly in a rising market. Hedging may be used to reduce risk in either portfolio, and AIF's ordinary shares currently yield c 4%.

12 months ending	Share price (%)	NAV (%)	Acorn ZDPs (%)	Numis Smaller Cos ex-ICs (%)	FTSE All-Share (%)
30/09/13	78.9	43.4	5.2	34.3	18.9
30/09/14	(10.4)	5.8	7.1	4.7	6.1
30/09/15	27.5	20.4	3.4	9.9	(2.3)
30/09/16	3.8	1.7	4.4	8.6	16.8
30/09/17	25.3	25.6	6.5	20.2	11.9

Source: Thomson Datastream. Note: All % on a total return basis in GBP.

Investment strategy: Dual structure boosts income

AIF has two portfolios, with the majority (c 70-80%) in small-cap equities, run by Simon Moon and Fraser Mackerlesie at Unicorn Asset Management, and the balance (c 20-30%) invested in high-yielding securities and managed by a team led by Paul Smith at Premier Fund Managers. Stock selection in both portfolios is bottom-up. The small-cap managers seek well financed, cash-generative firms with competitive advantages in growing end-markets, while the income portfolio adds diversification of capital and income returns, and helps to regulate the level of gearing.

Market outlook: Better value in small-caps?

Equity markets continue to rise, despite geopolitical tensions, a lack of clarity over Brexit, and the potential for monetary policy missteps. While smaller companies can be more volatile than larger ones, they currently stand on a c 10% forward P/E valuation discount (FTSE Small Cap versus FTSE 100) and have also outperformed year-to-date. A flexible asset allocation and a focus on quality companies generating dividends as well as growth could help to offset any near-term market wobbles.

Valuation: Potential for discount to narrow further

At 2 October, AIF's ordinary shares traded at a 5.4% discount to cum-income net asset value, while the ZDPs stood at a 3.2% premium. The ordinary share discount has been relatively stable in recent months at c 4-6%, having experienced a period of greater volatility since early 2016, and has the potential to narrow further given the exceptional long-term performance record. AIF has a dividend yield of c 4%, which compares favourably with its closest AIC sector peer.

Investment companies

3 October 2017

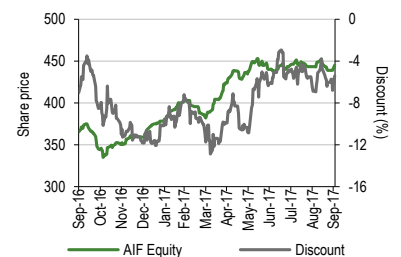
Price 445.5p
Market cap £70.9m
AUM £104.2m

NAV* 468.2p
Discount to NAV 4.9%
NAV** 471.0p
Discount to NAV 5.4%

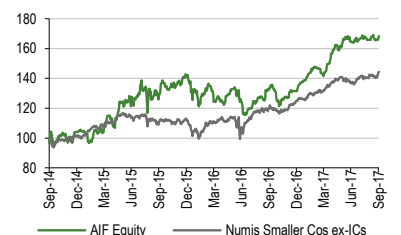
*Excluding income. **Including income. As at 28 September 2017.

Yield 3.9%
Ordinary shares in issue 15.9m
2022 ZDP shares in issue 21.4m
Code AIF
Primary exchange LSE
AIC sector UK Equity & Bond Income

Share price/discount performance



Three-year performance vs index



52-week high/low 453.0p 335.0p
NAV** high/low 491.3p 370.1p

**Including income.

Gearing

Gross* 40.0%

*As at 31 August 2017.

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Exhibit 1: Fund at a glance
Investment objective and fund background

AlF's objective is to provide a high level of income with the opportunity for capital growth. 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, as well as a range of other equity and bond indices.

Recent developments

- 12 September 2017: Third interim dividend of 4.5p declared for the year ending 31 December 2017, a 12.5% increase on Q316.
- 15 August 2017: Results for the six months ended 30 June 2017. Ordinary share NAV TR +17.3% and share price TR +25.2% versus +9.7% for Numis Smaller Companies (ex ICs) index. ZDPs appreciated in value by 3.85%.
- 6 June 2017: Second interim dividend of 4.5p declared for the year ending 31 December 2017, a 12.5% increase on Q216.

Forthcoming

AGM August 2018
Annual results March/April 2018

Capital structure

Ongoing charges 1.5% (30 June 2017)
Gross gearing 40.0% (via ZDPs)

Fund details

Group Premier Fund Managers
Manager Simon Moon, Fraser Mackersie (Unicorn), Paul Smith (Premier)
Address Eastgate Court, High Street, Guildford GU1 3DE
Phone +44 (0)1483 30 60 90
Website www.premierfunds.co.uk

Year end 31 December
Dividend paid Quarterly

Annual mgmt fee 0.7% of total assets
Performance fee Yes (see page 7)

Address Eastgate Court, High Street, Guildford GU1 3DE

Launch date 11 February 1999

Trust life Indefinite, subject to vote

Phone +44 (0)1483 30 60 90

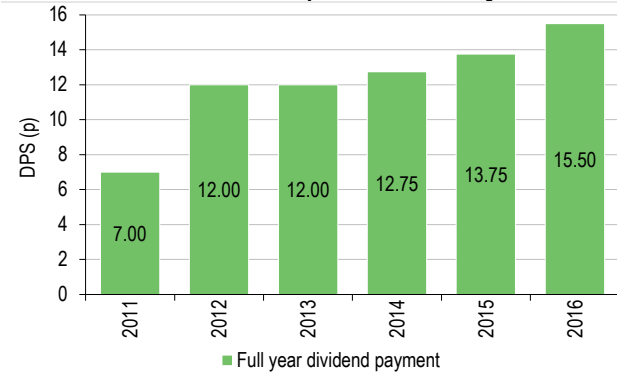
Continuation vote Five-yearly, next 2021

Loan facilities None

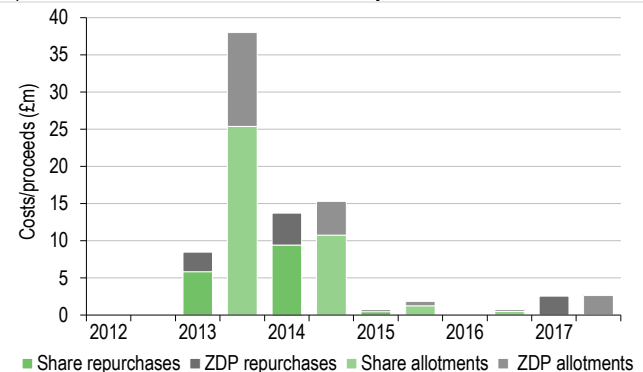
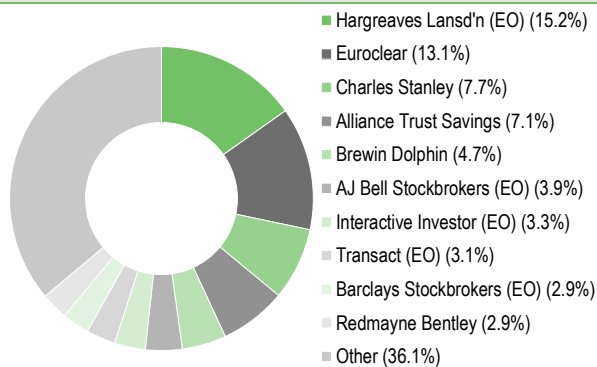
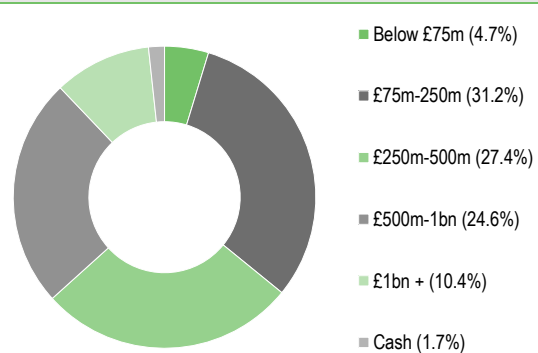
Website www.premierfunds.co.uk

Dividend policy and history

Quarterly dividends are paid in March, June, September and December; higher dividends since 2011 were facilitated by ZDP issue, eliminating 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 1 August 2017)

Small-cap portfolio exposure by market cap (as at 31 August 2017)

Top 10 holdings* (as at 31 August 2017)

Company	Sector	Market cap (£m)	% of gross	% of portfolio	% of gross	% of portfolio
		19 September 2017	31 Aug 2017	31 Aug 2017	31 Aug 2016**	31 Aug 2016**
Conviviality Retail	Off licences/distribution	676.5	3.5	4.3	3.3	4.1
Acal	Industrial electronics	218.9	3.0	3.7	2.8	3.5
Clipper Logistics	Distribution	399.1	2.9	3.6	3.0	3.7
FDM Group	IT staffing services	1,018.2	2.6	3.2	N/A	N/A
Somero Enterprise	Laser-guided concrete screeding	156.1	2.5	3.0	N/A	N/A
Macfarlane Group	Packaging	93.4	2.4	2.9	2.9	3.6
Midwich Group	Business support services	325.6	2.3	2.8	N/A	N/A
Secure Trust Bank	Banking	322.6	2.0	2.5	2.6	3.2
Numis Corporation	Financial services	299.5	2.0	2.4	N/A	N/A
Warpaint London	Cosmetics	114.6	2.0	2.4	N/A	N/A
Smaller companies portfolio top 10			25.2	30.8	42.0	32.6
Income portfolio top 10				5.7	31.7	6.0
					29.7	

Source: Acorn Income Fund, Edison Investment Research, Bloomberg, Morningstar. Note: *All of the top 10 are constituents of the smaller companies portfolio. **N/A where not in August 2016 top 10.

Market outlook: Potential for volatility to rise

Stock market indices in the UK and around the world have continued to make strong gains in 2017, seeming little troubled by factors such as the Brexit negotiations, elections in the UK and Europe, geopolitical tension in the Korean peninsula and US president Donald Trump's struggle to enact his policy agenda since taking office in January. Year-to-date the Numis Smaller Companies (excluding investment companies) index, a broad small- to mid-cap index covering the bottom 10% of the UK market by capitalisation, has produced a total return of 15.6%, compared with 8.6% for the FTSE All-Share, which is dominated by large-cap stocks and derives a greater proportion of its earnings from overseas. This suggests investors remain sanguine on the prospects for more domestically focused small-caps, which stand at a c 10% forward P/E valuation discount to large-caps (FTSE Small Cap versus FTSE 100). However, with considerable potential for stock market volatility to rise from its current very low level, small-cap investors may prefer to follow a strategy that focuses on quality and cash generation, perhaps in combination with higher-yielding, non-equity assets.

Fund profile: Unusual blend of small-cap and income

AIF is a London-listed, Guernsey-incorporated fund, launched in 1999 and aiming to achieve a high income and the potential for capital growth through a portfolio split between small-cap equities (70-80%) and high-yielding securities (20-30%). Premier Asset Management (Guernsey) is the fund manager, and the smaller companies and income portfolios are respectively advised by Simon Moon and Fraser Mackersie at Unicorn Asset Management in London, and a team led by Paul Smith at Premier Fund Managers in Guildford. Given the dominance of the smaller companies portfolio in the overall asset allocation, the fund uses the Numis Smaller Companies (excluding investment companies) index as its main performance measure, along with the FTSE All-Share, FTSE Small Cap and BofA Merrill Lynch Sterling Non-Gilts indices. The managers are unconstrained by indices in their portfolio construction; the small-cap portfolio is weighted towards the smaller end of the capitalisation spectrum, and includes many AIM-listed companies among its maximum 50 holdings.

AIF is structurally geared through ZDPs. These were first issued in 2011 with a fixed life until January 2017 and a gross redemption yield (GRY) of 6.5% pa. In advance of their redemption earlier this year, a rollover issue extended the ZDPs' life to February 2022 at a lower GRY of 3.85% pa, allowing ordinary shareholders to feel the benefit of the gearing more quickly in a rising market, while still rewarding ZDP investors with a better potential return than many cash or bond investments.

The fund managers: Moon, Mackersie and Smith

The managers' view: Business as usual amid UK uncertainty

Moon and Mackersie report that they continue to find plenty of opportunities in a market that has performed well but does not yet feel overheated. They remain focused on companies with high-quality management teams, commenting that such firms are less likely to miss earnings expectations (which can lead to heavy share price falls) because they tend to under-promise and over-deliver, rather than the other way round.

The managers continue to be aware of the potential political risks the UK faces during negotiations to leave the EU. In the run-up to the general election in June, they took profits on UK domestic companies, particularly those with a consumer focus, and kept some cash on the sidelines so that they could take advantage of any sharp share price falls (a similar strategy paid off well after the Brexit vote in June 2016). In spite of UK smaller companies' generally being more exposed to the domestic economy than larger companies, around one-third of the small-cap portfolio companies'

revenues come from outside the UK, which provides diversification as well as potential currency benefits should sterling weaken further. Weakness in some consumer-related stocks, such as mass-market cosmetics firm Warpaint and specialist bank Secure Trust Bank (STB), have provided opportunities for the managers to add to holdings; they still have faith in the underlying business models, which in the case of STB has improved as the bank has raised the quality of its loan book.

While the income portfolio – at less than 20% of the whole – is close to a historically low percentage, its manager Paul Smith comments that he continues to find investment opportunities even though bond markets in aggregate look unattractive. Chun Lee, a member of Smith's team at Premier, explains that the portfolio is run with an absolute return mindset, making it imperative to avoid highly priced long-dated bonds on paper-thin yields, where many years of prospective returns can swiftly be lost in a market sell-off. The natural duration of the portfolio is between four and five years, but a short gilt position is used to cut the overall duration to one to two years, meaning the portfolio is much less sensitive to interest rate movements.

Asset allocation

Investment process: Actively managed dual portfolios

The allocations between the smaller companies and the income portfolios are agreed between AIF's board, its manager, Premier Asset Management, and the investment advisers for the two portfolios, based on the opportunities available within each segment. The majority of both capital and income returns are expected to come from the smaller companies portfolio, while the income portfolio is managed with the aim of providing the benefits of diversification of income and capital returns, potentially boosting the portfolio yield, limiting volatility and helping to manage the level of structural gearing that exists through the ZDPs.

In the small-cap portfolio, managers Moon and Mackersie use quantitative screens to filter the large universe of small- and mid-cap stocks, assessing profitability, income (looking at both yield and dividend cover, a gauge of dividend sustainability and growth potential) and growth (a PEG ratio – P/E divided by earnings growth – below 1 is desirable), and qualitative measures such as competitive advantage and the attractiveness of end-markets. Certain sectors, such as utilities and healthcare, are rarely held, as few if any smaller stocks in these areas measure up to AIF's investment criteria. The managers frequently interact with current and potential holdings, undertaking c 400 meetings a year; given a lack of analyst coverage of many smaller stocks, investment ideas often arise from the team's own experience and networks. Moon and Mackersie have a strict 50-stock limit for the portfolio, and holdings must be profitable and well-financed, with high operating margins and strong positions in growing end-markets. A high starting yield is not essential, but where a dividend is not being paid, a company must be on a clear path to doing so. The managers do their own dealing, which helps them to be patient and flexible in building and selling down stakes. While positions may be sold if there are developments that call the original buy thesis into question, the most common reason for an exit is that a rising stock price has inflated a company's valuation and depressed its yield, giving the managers the opportunity to rotate into a better-value, higher-yielding idea.

The income portfolio team selects assets from a variety of areas, including government and corporate bonds, investment companies and structured notes, as well as looking after uninvested cash from the smaller companies portfolio. While the percentage of the total portfolio is smaller, the stock list is longer than for the small-cap portfolio, allowing a spread of risk and enabling the managers to invest in smaller issues such as retail bonds.

Hedging may be employed to limit risk. In the income portfolio, a short position in long-dated gilts limits interest rate risk by reducing the overall duration of the portfolio. In the past, hedges have also been used to offset risk in the smaller companies portfolio and limit the impact of structural gearing in a falling market. For example, in FY15 AIF bought a FTSE 100 put option at an index

level of 7000 and sold a put option on the same index at a level of 6000, resulting in a net profit of c 1.7p per ordinary share after the index fell by c 14% over the summer of that year.

Current portfolio positioning

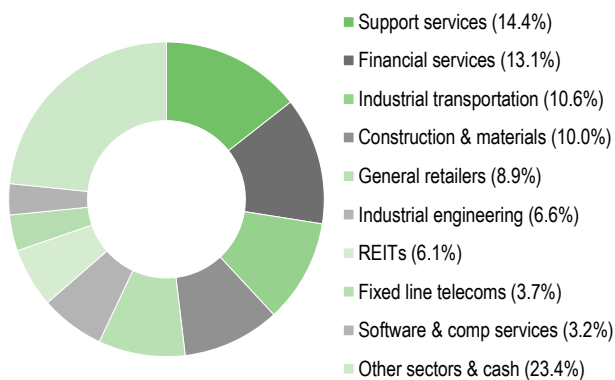
Within the target allocation of 70-80% smaller companies and 20-30% income, AIF's board views a 75%/25% split as a neutral position. Over the past year, the small-cap allocation has been at the top of the range, based on better available equity returns and unfavourable bond market conditions. Performance has driven the weighting past the informal maximum of 80%, and exposure stood at 81.9% at 31 August 2017, with an additional 0.9% of uninvested cash held in the income portfolio.

The smaller companies portfolio currently holds 49 stocks, close to the maximum permitted 50. So far in 2017, seven stocks have been added and eight have been sold. New holdings include two bought at IPO: currency hedging specialist Alpha FX and pensions consultant Xafinity Group. The other additions were fund manager Polar Capital; promotional products supplier 4imprint; Vesuvius, a supplier of disposable flow control components for the steel industry; commercial property fund Regional REIT; and industrial laundry firm Berendsen, which was also sold during the period, after a takeover bid. Both 4imprint and Berendsen had been owned by Moon and Mackerzie before in AIF or other Unicorn portfolios; 4imprint was revisited as the end of a capex cycle meant the company's high level of cash generation could be put to use in future dividend payments, while Berendsen had been sold at a near-high P/E valuation and was added back after a period of weakness.

Lavendon and UK Mail also exited the portfolio after takeover approaches, while other sales were fire safety firm Sprue Aegis, recruitment consultant Harvey Nash, in-home lender Morses Club, brokerage Jarvis Securities, and Photo-Me International. In each case the managers felt there were better opportunities elsewhere. The smaller companies portfolio retains a broad spread of sector exposures (Exhibit 2), while continuing to avoid healthcare and oil & gas, both areas where smaller companies can be highly speculative and are unlikely to pay dividends.

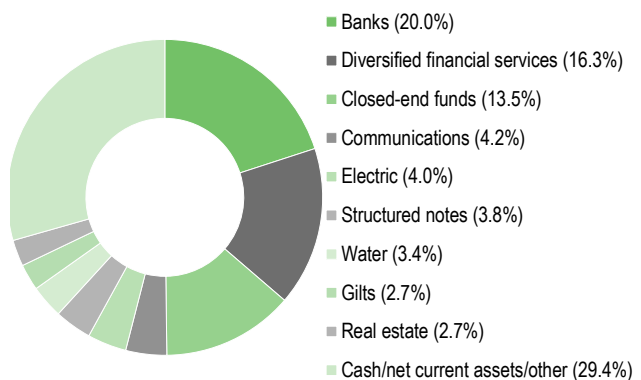
In the income portfolio (Exhibit 3), there were 75 stocks at the end of August 2017. Over the past 12 months, exposure to banks has increased as higher capital requirements and a stricter regulatory environment have made banks lend more conservatively, which Smith says provides greater alignment of interests for bondholders. Closed-end funds, the largest exposure 12 months ago, has fallen as a result of trimming JPMorgan Global Convertibles Income Fund after a new discount control policy sparked a strong share price recovery; a further short-term fall should be seen in the end-September numbers, following the maturity on 18 September 2017 of preference shares in Real Estate Credit Investments (the third-largest holding, at 4.8% of the income portfolio). Exposure to structured notes has also fallen after one of the holdings reached the end of its fixed life; the team is considering replacements.

Exhibit 2: Sector exposure of small-cap portfolio



Source: Acorn Income Fund, as at 31 August 2017

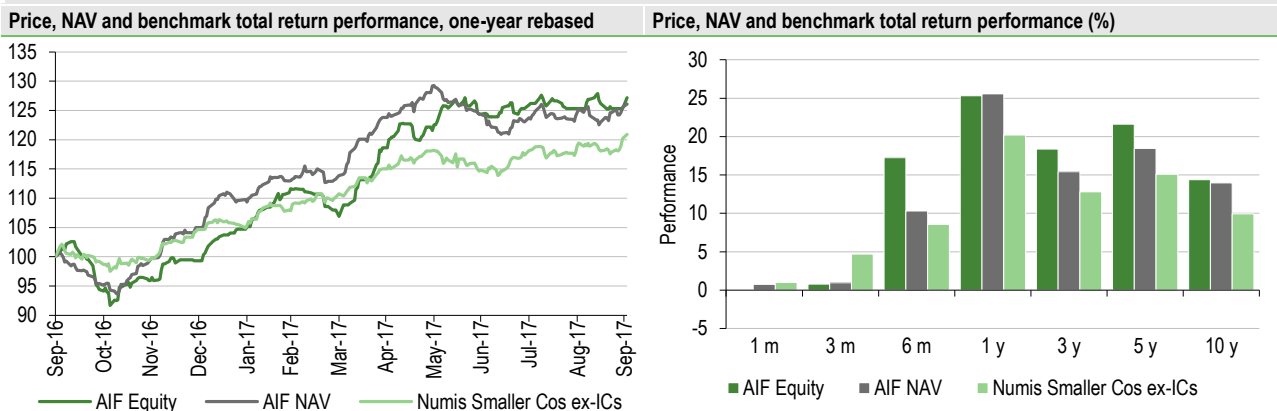
Exhibit 3: Sector exposure of income portfolio



Source: Acorn Income Fund, as at 31 August 2017

Performance: Strong rebound from volatile 2016

Exhibit 4: Investment company performance to 30 September 2017



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

After experiencing a volatile year in 2016, driven by investor risk-aversion and a brief but severe sell-off in UK smaller companies sparked by the surprise result of the UK's EU referendum, AIF's share price has recovered strongly in the past 12 months, narrowing the discount to NAV and matching the c 25% NAV total return. The majority of returns have been generated by the smaller companies portfolio, with the top contributors to performance so far in 2017 including off-licence and drinks distributor Conviviality Retail, audio-visual equipment provider Midwich, and technology-focused staffing specialist FDM Group. The strong one-year performance has also boosted performance over three years (annualised share price and NAV total returns of c 18% and c 14% respectively), while longer-term performance is also strong (Exhibit 4, right-hand chart).

While short-term performance has been affected by some company-specific disappointments in the smaller companies portfolio over the summer (which, in the main, the managers see as transitory), NAV and share price returns relative to both small-cap UK equities and the broader UK stock market have been positive over six months and one, three, five and 10 years (Exhibit 5). The income portfolio produces more modest returns but can help to limit the fund's overall volatility.

Exhibit 5: 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 Numis Smaller Cos ex-ICs	(1.0)	(3.7)	8.0	4.3	15.6	31.9	49.0
NAV relative to Numis Smaller Cos ex-ICs	(0.3)	(3.6)	1.6	4.5	7.2	15.6	43.6
Price relative to FTSE All-Share	0.4	(1.3)	13.2	12.0	29.9	65.1	119.0
NAV relative to FTSE All-Share	1.2	(1.1)	6.5	12.2	20.4	44.7	111.1

Source: Thomson Datastream, Edison Investment Research. Note: Data to end-September 2017. Geometric calculation.

Exhibit 6: NAV total return performance relative to benchmark over five years

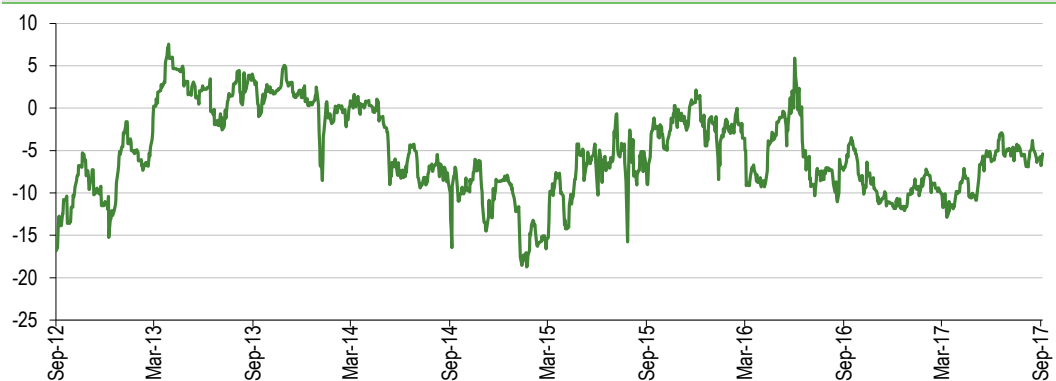


Source: Thomson Datastream, Edison Investment Research

Discount: Less volatile over past 12 months

At 2 October 2017, AIF's ordinary share discount to cum-income NAV stood at 5.4%, close to the five-year average of 5.3% and narrower than the one-, three- and 10-year averages (8.1%, 7.1% and 10.2% respectively). Prior to the death of small-cap portfolio manager John McClure in Q214, the shares had frequently traded at a premium, but saw a period of higher discount volatility from mid-2014 until the Brexit vote in mid-2016. More recently the discount has narrowed, and has been broadly stable at c 4-6% for the past three months. Given AIF's attractive yield and strong performance record, there is scope for the discount to narrow further from its current level.

Exhibit 7: Share price premium/discount to NAV (including income) over five years (%)



Source: Thomson Datastream, Edison Investment Research

Capital structure and fees

AIF is incorporated in Guernsey as a closed-end investment company, with two classes of share. There are 15.9m ordinary shares. In January 2017, a rollover issue of ZDPs replaced the 21.4m 2017 ZDPs with a new tranche, maturing in 2022 with a gross redemption yield of 3.85%. The ZDPs provide the fund with structural gearing, which stood at 40.0% gross at 31 August 2017. Shares may be bought back or allotted in order to manage a discount or premium; ordinary shares and ZDPs are issued or repurchased in quantities such that the gearing ratio is maintained.

Premier Asset Management receives an annual management fee of 0.7% of total assets, from which it pays fees to the investment advisers at Premier and Unicorn. A performance fee (15% of excess returns) may be paid if the NAV per share plus dividends has grown at a compound rate of more than 10% a year since the last year-end at which a performance fee was paid. The last time such a fee was paid was in respect of FY13. We calculate ongoing charges at 1.5% as at end-H117.

Dividend policy and record

AIF pays quarterly dividends to its ordinary shareholders in recognition of its aim to provide them with a high and growing income. Dividends are paid in March, June, September and December. Historically, dividends have been increased at the second interim (the first interim having been set at the level of the last three dividends of the previous financial year). However, in FY17 the dividend was raised at the first interim stage, and three dividends of 4.5p have been paid so far this financial year. On this basis it would be reasonable to assume that the total dividend for FY17 will be no less than 18p, which would be a 16.1% increase on the 15.5p paid in FY16. This represents a prospective yield of 4.0% based on the 2 October share price. AIF's revenue reserve was 14.2% higher at H117 versus H116, at 15.9p per ordinary share, or 11.4p after subtracting the third quarterly dividend (respectively equal to 0.9x or 0.6x the prospective FY17 dividend).

Peer group comparison

AIF is a member of the AIC's UK Equity & Bond Income sector, a small peer group of seven funds (not counting multiple share classes) that may blend equity and bond investment. The proportions in each asset class vary widely (from 100% equities to 100% bonds; under the sector rules, 80% of assets must be invested in the UK), and most of the funds have a larger-cap focus than AIF. AIF is one of the smaller funds in the sector. Its NAV total return performance is well above average, ranking second over one, three and five years and first over years. Over 10 years its NAV return is 141pp ahead of the second-placed fund. Ongoing charges are the joint-highest in the group, equal to the charges on the most similar peer, Aberdeen Smaller Companies Income, and AIF is one of three funds to levy a performance fee (note that returns are shown net of all fees). Gearing is also the highest in the peer group, while the discount is the fourth-widest. The 4.0% dividend yield is a little below the average for this high-yielding sector.

Exhibit 8: AIC UK Equity & Bond Income peer group as at 2 October 2017*

% unless stated	Market cap £m	NAV TR 1 year	NAV TR 3 year	NAV TR 5 year	NAV TR 10 year	Ongoing charge	Perf. fee	Discount (ex-par)	Net gearing	Dividend yield (%)
Acorn Income Fund	71.1	24.3	55.1	126.7	270.8	1.5	Yes	(5.6)	125	4.0
Aberdeen Smaller Companies Income	58.4	25.5	55.3	128.1	95.9	1.5	No	(15.8)	108	2.6
City Merchants High Yield	187.7	10.0	24.7	59.5	123.2	1.0	No	2.5	100	5.0
CQS New City High Yield	231.1	12.5	20.6	44.4	129.8	1.2	No	4.9	108	7.2
F&C UK High Income 'A' Share	122.0	7.9	24.3	58.4	82.0	1.1	No	(6.3)	100	4.7
F&C UK High Income 'B' Share	123.7	7.9	24.3	58.4	96.7	1.1	No	(5.4)	100	0.0
F&C UK High Income Units	132.9	4.4	20.3	53.0	75.6	1.0	No	(6.2)	100	3.4
Henderson High Income	244.3	10.2	32.0	86.4	107.4	0.8	Yes	(1.3)	122	4.9
Jupiter Dividend & Growth Common	11.4	12.1	34.0	79.7		1.3	Yes	(4.0)	100	5.1
Weighted average		11.1	28.2	68.8	116.3	1.1		(2.0)	108	5.0
AIF rank in sector	7	2	2	2	1	1		6	1	6

Source: Morningstar, Edison Investment Research. Note: *Performance data to 28 September 2017. TR=total return. Net gearing is total assets less cash and equivalents as a percentage of net assets (100 = ungeared).

The board

AIF has three non-executive directors, all resident in Guernsey where the fund is incorporated. The chairman, Helen Green, took on her current role in 2012, having become a director in 2007. Nigel Ward joined the board in 2011 and David Warr was appointed in 2012. The directors have backgrounds in investment management and accountancy.

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