The Diverse Income Trust

Unloved small-caps offer long-term opportunities

Investment trusts

The Diverse Income Trust (DIVI) aims to generate a good and growing level of income, as well as capital gains over the long term. It is not constrained by benchmarks and has a wide opportunity set across the market capitalisation spectrum to find high-quality, resilient companies that can sustain dividend growth over the long term. The managers, Gervais Williams and Martin Turner, have a small-cap bias and over two-thirds of the portfolio is outside of the FTSE 350 index. Since its inception in April 2011, the trust has delivered an annualised NAV total return of 12% and consistent growth in its regular dividend. Performance in more recent years has lagged the FTSE All-Share index, which the managers believe reflects small-cap and value stocks being overlooked, and they are finding superior investment opportunities in this segment of the UK equity market.

12 months ending	Share price (%)	NAV (%)	FTSE All-Share (%)	FTSE 350 High Yield (%)	FTSE Small Cap Index (%)
31/03/15	1.4	3.0	6.6	3.8	1.2
31/03/16	13.8	13.3	(3.9)	(7.2)	5.9
31/03/17	1.8	7.8	22.0	26.7	19.7
31/03/18	16.0	8.9	1.2	(1.2)	2.2
31/03/19	(7.2)	(3.3)	6.4	7.9	(3.1)

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

The market opportunity

UK equities are out of favour and, according to the Bank of America Merrill Lynch survey of global fund managers, allocations are well below even the levels of 2008 and 2009 when the UK faced a banking crisis. Small-cap equities have lagged the mainstream indices and may have stronger recovery potential over the long term.

Why consider investing in DIVI?

- Unconstrained multi-cap strategy offers a wider investment opportunity set and achieves greater diversification across sectors that are not represented in mainstream indices.
- The managers favour small-cap value stocks, which they believe often have superior return potential and low correlations with mainstream markets.
- The managers are mindful of downside risk, reflected in quality holdings and a put option to help protect the portfolio from a sharp fall in the FTSE 100 index.
- In the event of a major UK equity market setback, DIVI has an unused £25m loan facility, which would enable it to invest should share prices become unjustifiably depressed, without the need to sell existing holdings.

Shares trade close to NAV

At 31 March, DIVI traded on a 2.0% discount to cum-income NAV, which is wider than its three-year average discount of 0.4%. The trust typically trades close to its NAV, and the board is committed to manage the discount, utilising an annual redemption facility and its ability to issues new shares to meet supply and demand requirements.

15 April 2019

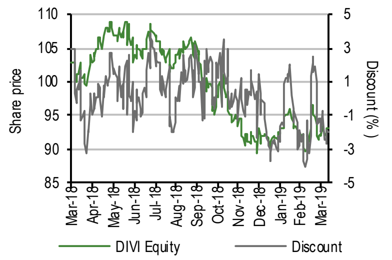
Price	**93.0p**
Market cap	**£356.9m**
AUM	**£359.3m**

NAV*	93.4p
Premium to NAV	0.4%
NAV**	94.9p
Discount to NAV	2.0%

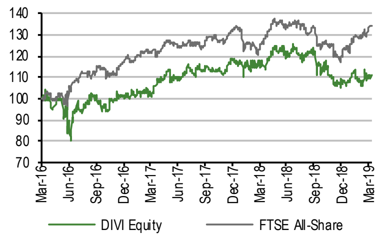
*Excluding income. **Including income. As at 11 April 2019.

Yield	3.9%
Ordinary shares in issue	383.8m
Code	DIVI
Primary exchange	LSE
AIC sector	UK Equity Income

Share price/discount performance



Three-year performance vs index



52-week high/low	109.0p	89.4p
NAV** high/low	107.2p	90.6p

**Including income.

Gearing

Gross*	0.0%
Net cash*	2.8%

*As at end-March 2019.

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Edison profile page

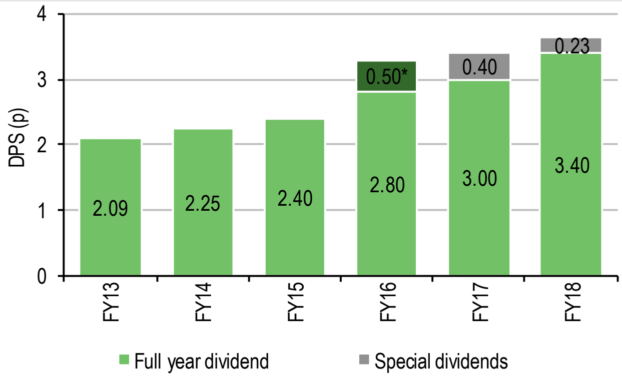
The Diverse Income Trust is a research client of Edison Investment Research Limited

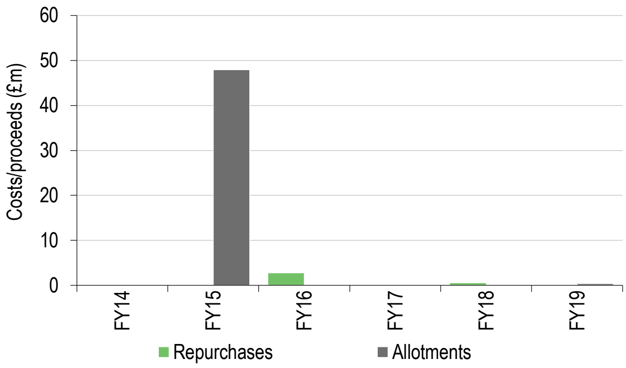
Exhibit 1: Trust at a glance

Investment objective and fund background	Recent developments
The Diverse Income Trust's objective is to provide an attractive and growing level of dividends, coupled with capital growth over the longer term. It invests in a diversified portfolio primarily of quoted or traded UK companies, with a bias to small- and mid-cap stocks. It may also invest in FTSE 100 companies where the manager believes this will increase shareholder value. As a stock-specific portfolio, there is no benchmark.	■ 8 February 2019: Interim results for six months ended 30 November 2018. NAV TR – 8.1% vs -7.7% for the FTSE All-Share index. Second interim dividend of 0.85p per share declared. ■ 14 December 2018: Announced, with effect from 1 January 2019, the retirement of Lucinda Riches, and appointment of Andrew Bell and Caroline Kemsley-Pein as non-executive directors.

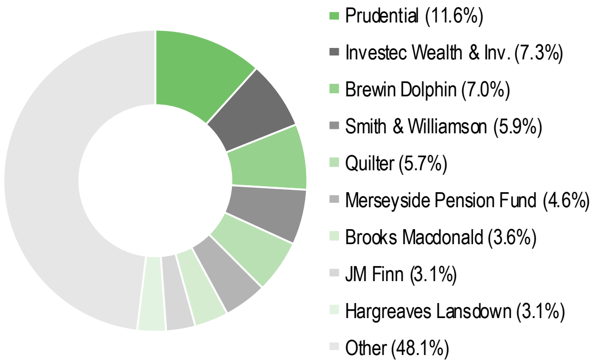
Forthcoming		Capital structure		Fund details	
AGM	October 2019	Ongoing charges	1.13%	Group	Miton Group
Annual results	August 2019	Net cash	2.8%	Manager	Gervais Williams, Martin Turner
Year end	31 May	Annual mgmt fee	1.0% of market cap (0.8% above £300m)	Address	6th floor, Paternoster House, 65 St Paul's Churchyard, London, EC4M 8AB
Dividend paid	Quarterly	Performance fee	None		
Launch date	28 April 2011	Trust life	Indefinite	Phone	+44 (0) 20 3714 1501
Continuation vote	No	Loan facilities	See page 7	Website	www.mitongroup.com

Dividend policy and history (financial years)	Share buyback policy and history (financial years)
Quarterly dividends are paid in February, May, August and November. DIVI distributes substantially all of its income, net of costs, annually. *Note in FY16 that five dividends were paid - the fifth would ordinarily have been designated as the first interim of FY17, but it was redesignated as a final dividend for FY16. Thereafter three interim and a final dividend have been paid.	Renewed annually, DIVI has authority to purchase up to 14.99% and allot up to 10% of issued share capital. Subject to directors' discretion, DIVI offers investors an annual facility to redeem all or part of their shareholding at NAV less costs.

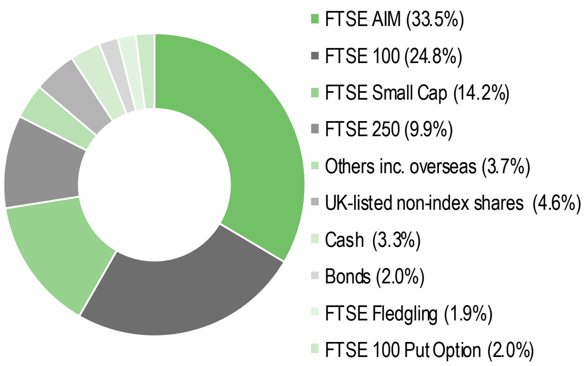




Shareholder base (as at 12 April 2019)



Portfolio exposure by market segment (as at end-March 2019)



Top 10 holdings (as at 31 March 2019)

			Portfolio weight %	
Company	**Index**	**Sector**	**31 March 2019**	**31 March 2018***
Diversified Gas & Oil	FTSE AIM	Energy	2.2	N/A
FTSE 100 Put option	FTSE100	N/A	2.0	2.4
Zotefoams	FTSE Small Cap	Chemicals	1.8	2.2
Safecharge	FTSE AIM	Support services	1.8	1.6
Phoenix Group	FTSE Small Cap	Insurance services	1.6	N/A
Randall & Quilter	FTSE AIM	Insurance services	1.5	1.3
A&J Mucklow Group	Non-index	Real estate investment trust	1.5	1.5
4imprint Group	FTSE Small Cap	Media	1.5	N/A
Morses Club	FTSE AIM	Consumer finance	1.5	N/A
Charles Taylor	FTSE Small Cap	Insurance services	1.5	2.1
Top 10 (% of holdings)			**16.9**	**17.3**

Source: The Diverse Income Trust, Edison Investment Research, Morningstar. Note: *N/A where not in top 10 at March 2018.

Market outlook: UK equities extremely out of favour

The FTSE All-Share index appreciated by c 8% in Q119 following one of the weakest fourth quarters in history in 2018, reflecting a rapidly deteriorating outlook for global growth, much exacerbated by geopolitical factors. These included an ongoing US-China trade dispute, stalemate over the US budget, which led to government shutdown, and uncertainty over Brexit outcomes. Since the start of 2019, fears for sharp economic slowdowns in major economies have receded, led by the US, where the Federal Reserve has signalled that interest rate rises are on hold for the time being. Meanwhile, investors are more optimistic that recently implemented Chinese government policies to stimulate the economy can take effect and that talks to resolve the US-China trade dispute may succeed. However, uncertainty over Brexit outcomes remains and continues to weigh on the performance of UK equities. By comparison with the FTSE All-Share's 8% rise, the MSCI World index appreciated by c 12% in Q119. UK equities are unloved and under-owned. According to the Bank of America Merrill Lynch survey of global fund managers, allocations are at the lowest point for 20 years and are at levels significantly below those of 2008 and 2009, when the banking system was facing a systemic crisis. The direction of UK equities in the near term will likely continue to be influenced by geopolitical factors.

Fund profile: Small-cap bias, downside aware

DIVI was launched in April 2011 and aims to provide shareholders with good and growing dividends through a fundamental approach to investing primarily in UK companies. It is not constrained by benchmark or market capitalisation considerations, enabling it to invest across the entire universe of listed equities. The managers, Gervais Williams and Martin Turner, are smaller company specialists and believe small-caps often have better risk/reward profiles; the portfolio typically has over two-thirds of its holdings outside the FTSE 350 index. They are mindful of downside risk and pay considerable attention to the portfolio's resilience to market downturns, with an investment process that focuses on companies with sustainable dividend growth, and strong balance sheets. The managers also use put options to help protect the portfolio from a sharp fall in equity values.

The fund managers: Gervais Williams & Martin Turner

The managers' view: Small-caps overlooked, underappreciated

Williams has a cautious outlook for global equities, which he believes face numerous headwinds. In his view, these include slower prospects for global economic growth, a gradual normalisation of liquidity conditions following a decade of extraordinarily loose monetary policy and an extended period of poor corporate productivity. He thinks UK equities, being more reasonably valued and out of favour, are better placed than many markets as these issues unfold. Williams notes that UK equity valuations have trailed those of major markets (the US in particular) following the UK's EU referendum in mid-2016, and that this disparity should narrow over the medium term, Brexit outcomes notwithstanding.

The manager observes that the most unloved segments of the UK equity market are small- and micro-cap value stocks. A period of abundant liquidity and synchronous global growth over the past several years has heavily favoured large growth stocks. In Williams's view, this has resulted in many investors' portfolios being heavily weighted in mainstream stocks that are highly correlated to one another, which is risky should equity market conditions deteriorate and earnings and/or dividends disappoint. Meanwhile, smaller stocks have been sidelined, and given investors' preference for growth, small-cap value stocks have been particularly overlooked. Williams believes these companies can offer excellent prospects for sustainable dividend growth, and often operate in sectors not represented in the large-cap indices, thus presenting genuine diversification from the mainstream market. By virtue of their size, smaller companies are often more able to adapt to changing economic conditions and those with under-utilised balance sheets are well placed to make transformative acquisitions in challenging environments. The manager notes that in the 1960s and 1970s small-caps outperformed significantly despite periods of acute economic stress, which included very high inflation, a sterling devaluation and oil price shock.

Asset allocation

Investment process: Disciplined framework

DIVI follows a rigorous bottom-up approach to find companies that can deliver sustainable productivity gains, which in turn help underpin long-term dividend growth, with attractive risk/reward ratios. The managers have an intensive schedule of meetings with companies and they do not screen out companies prior to these meetings, as they believe this implies making an investment decision without sufficient factual information. Their detailed analysis focuses on five key factors:

- **Prospects for rising turnover**. Although companies can grow profits without growing turnover, in general, durable dividend growth comes from those that can progressively expand turnover.
- **The sustainability of margins**. Declining margins cannot sustain growth. A company should be able to improve or defend its profit margins through productivity gains and outstanding customer service.
- **Managements that can build intrinsic value**. Companies that grow too quickly often carry too much risk. The managers believe attractive returns tend to come from companies that manage the rate of growth to limit risk.
- **Balance sheets with financial flexibility**. The managers look for companies with net cash or modest levels of debt relative to their capacity to borrow. These firms are better placed to sustain dividend payments over the long term, even when underlying profitability dips temporarily, and are also more able to take advantage of economic setbacks to improve their market position disproportionately.
- **Low entry valuations**: Smaller-caps are less well researched and are therefore more likely to be overlooked companies with low valuations.

A traffic light rating system is applied to each of the key factors and investments are continually monitored to determine whether an investment case remains valid or needs to be challenged.

Current portfolio positioning

As shown in Exhibit 2, the largest sector exposure is to financials at 29.7%, which has increased by 4.5pp over the 12 months to end-March 2019. This increase reflects both positive performance and the addition of new stocks. In December 2018, the trust invested in the IPO of Manolete Partners, an insolvency litigation specialist that funds and completes legal cases for clients. The company's share price has more than doubled since its listing and the stock was the largest positive contributor to DIVI's performance in Q119. The manager also invested in another litigation finance company, Litigation Capital Management, which is headquartered in Australia (UK-listed) and has an international footprint and plans for growth. Williams notes these specialised businesses have counter-cyclical qualities and should be resilient to economic downturns, as well as being highly profitable; both companies achieve very attractive internal rates of return in excess of 75%.

Sources of funds for purchases included four takeovers, which in Williams's view, highlight the intrinsically attractive value of DIVI's stocks, which has been amplified by a Brexit-induced de-rating of UK equities. Takeovers included media and telecommunications conglomerate Sky (by Comcast in the US), food manufacturer Dairy Crest (by Saputo in Canada), and recruitment company Harvey Nash (taken private).

Exhibit 2: Portfolio sector exposure vs FTSE All-Share (% unless stated)*

	Portfolio end-March 2019	Portfolio end-March 2018	Change (pp)	Index weight	Active weight vs index (pp)	Trust weight/ index weight (x)
Financials	29.7	25.2	4.5	26.3	3.4	1.1
Industrials	14.8	17.9	(3.1)	11.2	3.6	1.3
Consumer services	11.1	12.6	(1.6)	11.7	(0.6)	0.9
Basic materials	10.5	10.7	(0.2)	8.1	2.4	1.3
Oil & gas	8.2	6.6	1.6	14.0	(5.8)	0.6
Consumer goods	7.3	5.9	1.4	13.9	(6.6)	0.5
Technology	3.3	4.8	(1.6)	1.1	2.2	3.0
Telecommunications	3.3	3.4	(0.1)	2.6	0.7	1.3
Utilities	3.0	1.7	1.2	2.9	0.1	1.0
Health care	2.2	2.0	0.2	8.2	(6.1)	0.3
Funds	0.0	0.6	(0.6)	0.0	0.0	N/A
Cash, bonds & other	6.8	8.6	(1.8)	0.0	6.8	N/A
	100.0	**100.0**		**100.0**		

Source: DIVI, Edison Investment Research, FTSE Russell. Note: *All figures subject to rounding.

Relative to the FTSE All-Share index, the portfolio is most underweight the consumer goods sector (-6.6pp), which reflects Williams's negative view on the levels of household debt in the UK, at a time when interest rates are at historic lows. The manager, however, is benchmark-agnostic in his investment approach and relative sector weightings are a by-product of stock selection. Williams is focused on diversification; in particular, he favours stocks that have low correlations with the mainstream market. For example, the portfolio has a c 3% exposure to stocks listed in Iceland, where policy responses after the global financial crisis have helped return the country's and its banks' balance sheets back to good health. Williams believes these investments should have low correlation to the UK equity market: Iceland's credit cycle is at an early stage, while UK households are stretched; and as foreign investor access has only been permitted since March 2017, he thinks Icelandic companies are relatively undiscovered.

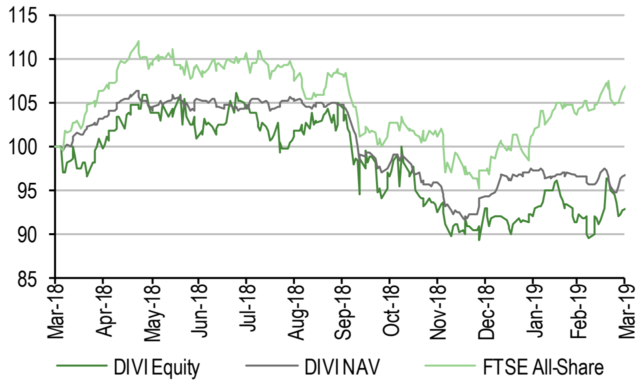
The portfolio owns a FTSE 100 put option, covering around 40% of the trust, which should help protect it against a sharp fall in the broader market. The option was recently extended from September 2019 to December 2020 and gives DIVI the right to sell the FTSE 100 index at 6,300 at any time prior to expiry. In this event, DIVI would receive cash, giving it the opportunity to make investments when share prices are at depressed levels, without the need to sell existing holdings. Furthermore, the trust has an unused £25m debt facility, which the manager holds in reserve to allow DIVI to take advantage of a major market setback.

Performance: Strong long-term track record

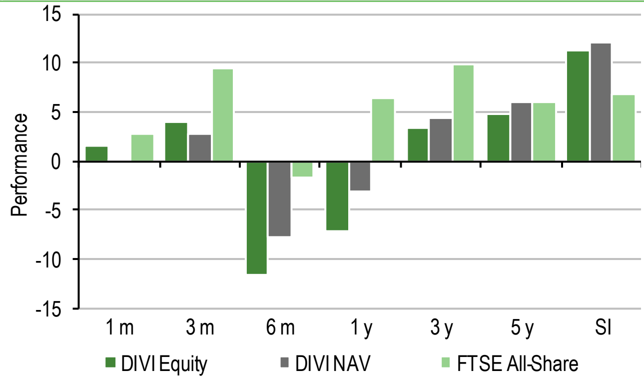
As shown in Exhibits 3 and 4, DIVI has delivered strong long-term performance. The NAV total return since its inception in April 2011 has significantly outperformed the FTSE All-Share, FTSE 350 High Yield and FTSE Small Cap indices. Over five years, DIVI's NAV has outperformed the FTSE 350 High Yield and FTSE Small Cap indices, but slightly underperformed the FTSE All-Share index. Over shorter periods, its relative performance has trailed these indices, although it has performed broadly in-line with the FTSE Small-Cap. Over the past few years, UK equities' performance has been led by large-cap names, while smaller companies have tended to be overlooked. The manager believes that, over the longer term, funds that generate better dividend growth generally deliver better returns to shareholders. However, this factor has not come through in the trust over the last three years, in his view because the Brexit uncertainty has tended to cause asset allocators to hold back from the UK, a factor which should unwind in time, and he believes DIVI may be subject to a period of catch up.

Exhibit 3: Investment trust performance to 31 March 2019

Price, NAV and FTSE All-Share total return performance, one-year rebased



Price, NAV and FTSE All-Share total return performance (%)



Source: Refinitiv, Edison Investment Research. Note: three- and five-year and since inception (SI, 28 April 2011) performance figures annualised.

Exhibit 4: Share price and NAV total return performance, relative to indices (%)

	One month	Three months	Six months	One year	Three years	Five years	SI
Price versus FTSE All-Share	(1.0)	(5.1)	(10.0)	(12.8)	(16.8)	(6.5)	39.2
NAV versus FTSE All-Share	(2.4)	(6.1)	(6.0)	(8.9)	(14.6)	(0.9)	46.3
Price versus FTSE 350 High Yield	(1.4)	(4.7)	(10.8)	(14.0)	(19.4)	(3.3)	38.2
NAV versus FTSE 350 High Yield	(2.8)	(5.8)	(6.8)	(10.2)	(17.3)	2.5	45.3
Price versus FTSE Small Cap	0.9	(2.1)	(4.4)	(4.3)	(7.3)	(1.7)	12.1
NAV versus FTSE Small Cap	(0.5)	(3.2)	(0.2)	(0.0)	(5.0)	4.1	17.8

Source: Refinitiv, Edison Investment Research. Note: data to end-March 2019. Geometric calculation.

Exhibit 5: NAV total return performance relative to FTSE All-Share index over five years

Source: Refinitiv, Edison Investment Research

Discount: Well-managed, typically close to NAV

DIVI currently trades on a 2.0% discount to its cum-income NAV, which is slightly wider than its three-year average discount of 0.4%. As shown in Exhibit 6, the trust typically trades close to its NAV and sharp falls tend to reflect surprise events, such as the result of the UK's EU referendum in June 2016. There appears to be strong appetite for DIVI's multi-cap investment strategy, as evidenced by the strong growth in assets to £1.3bn in the equivalent OEIC, Miton UK Multi-Cap Income, which was launched shortly after the trust. DIVI's board is also committed to managing the trust's discount and utilises the annual redemption facility, and its ability to issue new shares, to meet supply and demand requirements.

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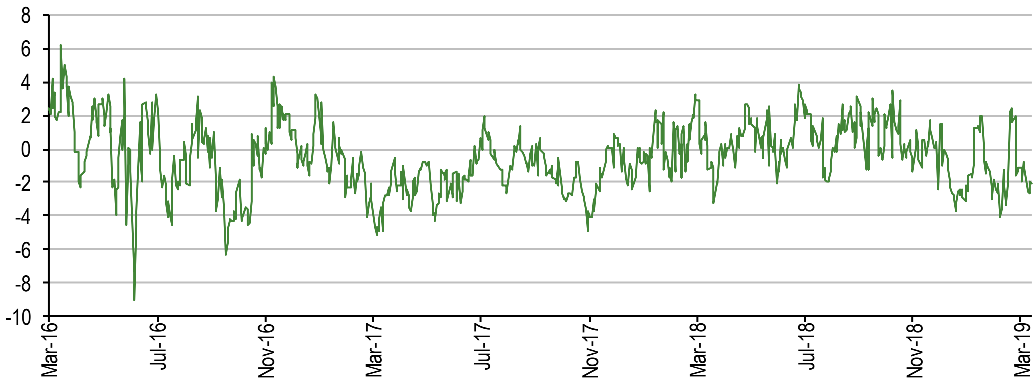
Exhibit 6: Share price premium/discount to NAV (including income) over three years (%)



Source: Refinitiv, Edison Investment Research

Capital structure and fees

DIVI is a conventional investment trust with 383.8m shares in issue. It offers shareholders the option to redeem their shares each year at NAV less costs on 31 May (redemption requests must be received by 30 April). During FY18, the company received redemption requests for 0.5m shares, representing 0.1% of the issued share capital. All these shares were matched with buyers in the market. Miton Trust Managers is paid an annual management fee of 1.0% of DIVI's market cap up to £300m, reducing to 0.8% above this level. The fee is charged to both the income and capital accounts in the proportion of 75:25. As at end-February 2019, the ongoing charge was 1.15%. Gearing is permitted up to 15% of NAV and the trust has a £25m debt facility with the Royal Bank of Scotland. As at end-March 2019, the trust was ungeared and had a net cash position of 2.8%.

Dividend policy and record

The trust aims to generate dividend growth above that of its peers and over the past five financial years, DIVI's regular dividends have increased 63%, representing over 10% annualised growth. During this time, the trust has also benefited from numerous irregular one-off dividends from its underlying holdings, which has allowed it to pay special dividends in FY17 and FY18. In the current financial year, DIVI has received fewer one-off dividends, and there may be less scope for a special dividend this year. Nevertheless, the trend of dividend growth in the underlying portfolio remains positive and is reflected in increases to the interim dividends declared to date in FY19. The board declared a first interim dividend of 0.80p per share in October 2018 (0.75p in FY18), and a second interim of 0.85p per share in February 2019 (0.80p in FY18). Dividends are paid four times a year in February, May, August and November.

Peer group comparison

Exhibit 7 shows the 12 largest trusts in the AIC UK Equity Income sector (which comprises 24 funds). DIVI's dividend growth has outpaced most of its peers over the past five financial years. The yield, ranking eighth, is consistent with the objective of providing good and growing dividends, rather than a high starting yield. DIVI's NAV total return over one, three and five years ranks 11th, 10th and eighth, respectively. These returns have been achieved without the use of gearing in rising markets. The trust ranks highest in terms of ongoing charges, which the manager believes reflects the specialist nature of its research-intensive all-cap strategy.

Exhibit 7: Selected peer group as at 12 April 2019*

% unless stated	Market cap £m	NAV TR 1 year	NAV TR 3 year	NAV TR 5 year	Discount (cum-fair)	Ongoing charge	Performance fee	Net gearing	Dividend yield (%)
Diverse Income Trust	356.9	(3.6)	13.8	33.2	(2.5)	1.1	No	100	3.9
BMO Capital & Income	329.9	5.4	39.6	52.5	(0.4)	0.6	No	102	3.5
City of London	1,578.7	6.6	26.0	39.5	1.8	0.4	No	108	4.4
Dunedin Income Growth	398.7	9.6	36.7	31.8	(7.2)	0.6	No	113	4.6
Edinburgh Investment Trust	1,253.0	2.4	12.4	39.9	(10.5)	0.6	No	109	4.3
Finsbury Growth & Income	1,599.2	14.1	50.0	86.0	0.6	0.7	No	101	1.8
JPMorgan Claverhouse	409.5	4.3	34.2	41.0	(2.8)	0.7	No	114	3.8
Lowland	372.9	(4.9)	22.6	23.5	(4.9)	0.6	Yes	112	4.0
Merchants Trust	543.4	4.2	32.2	30.8	0.8	0.6	No	117	5.2
Murray Income Trust	534.2	10.4	36.1	36.2	(6.3)	0.7	No	102	4.1
Perpetual Income & Growth	792.3	0.3	6.4	21.5	(12.3)	0.7	No	115	4.4
Temple Bar	892.1	9.3	35.9	34.3	(3.6)	0.5	No	107	3.3
Simple average (12 funds)	755.1	4.8	28.8	39.2	(3.9)	0.6		108	3.9
Rank in peer group	11	11	10	8	5	1		12	8

Source: Morningstar, Edison Investment Research. Note: *Performance to 11 April 2019 based on ex-par NAV. TR = total return. Net gearing is total assets less cash and equivalents as a percentage of net assets. 100=ungeared.

The board

DIVI's board consists of six independent non-executive directors. Chairman Michael Wrobel, senior independent director Jane Tufnell (due to resign at the October 2019 AGM) and Paul Craig have all served on the board since the trust's inception in April 2011. With effect from 1 January 2019, Lucinda Riches (also appointed April 2011) retired, and two new directors joined the board: Andrew Bell and Caroline Kemsley-Pein. Bell has significant experience as a non-executive director and chairman of investment trusts, and Kemsley-Pein is a qualified solicitor and a specialist in corporate and commercial practice.

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