EDISON

The Diverse Income Trust

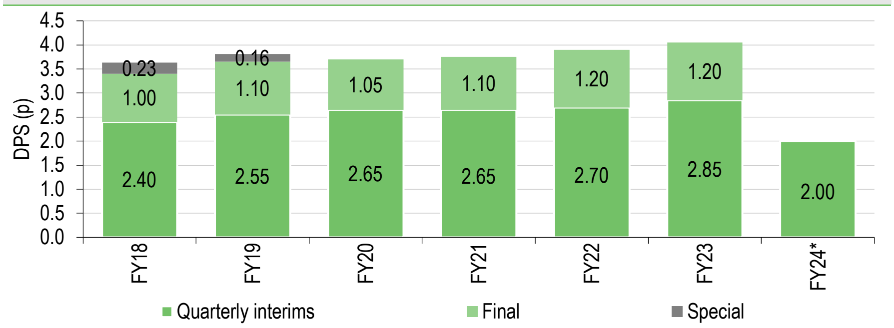
Manager anticipates a small-cap super cycle

Investment trusts
UK multi-cap equity income

14 February 2024

The Diverse Income Trust's (DIVI's) managers Gervais Williams and Martin Turner focus on generating a dividend income stream that is more resilient and has the potential to grow faster than those of the trust's peers. They believe that over time this strategy should lead to superior capital appreciation as well as income growth. Since launch in 2011, DIVI's dividend has compounded at an average annual rate of around 6%. UK stocks have been out of favour with global investors, who now make up around two-thirds of the UK shareholder base compared with 17% in 1994. As a result, the UK market looks very attractively valued in both absolute and relative terms, so there may be considerable upside potential from an improvement in sentiment towards UK stocks.

DIVI's progressive dividend policy continued during COVID-19



Source: DIVI, Edison Investment Research. Note: *FY24 is year-to-date.

Why consider DIVI?

DIVI is indeed a diversified company as it has the second-longest list of holdings (around 120 names) in the 20-strong AIC UK Equity Income sector. The trust has exposure to all 11 market sectors and is a true multi-cap portfolio split broadly: large cap (23%); mid-cap (17%); small cap (56%); and other (4%, primarily cash). DIVI has a progressive revenue and dividend record despite its capital growth being hampered in recent quarters by poor sentiment towards UK small-cap stocks.

The trust offers a low-risk way to participate in the UK equity market, which is illustrated by cumulative upside/downside analysis. With measures well below 100% in rising and falling markets, while DIVI may not fully participate when share prices rally, there should be an element of downside protection during periods of stock market weakness. However, since its launch, DIVI has added value in rising markets due to its successful stock-selection process.

DIVI's current 6.2% discount is wider than its historical averages over the last three, five and 10 years. For much of its life, the trust traded close to NAV, so there is the potential for a narrower discount if investor sentiment improves, along with the prospects of share price appreciation and a rising income stream. Based on its current share price, DIVI offers an attractive, above-market 5.1% dividend yield.

The UK chancellor has recently mooted ringfencing a part of the annual ISA allowance for UK equities to reduce local selling of domestic stocks. Williams and Turner believe that even a slight reduction in selling pressure, coupled with large-cap buybacks, could prove very supportive for the performance of the UK market.

NOT INTENDED FOR PERSONS IN THE EEA

Price	**81.0p**
Market cap	**£258m**
Total assets	**£275m**

NAV*	86.3p
Discount to NAV	6.2%

*Including income. At 12 February 2024.

Yield		5.1%
Ordinary shares in issue		318.5m
Code/ISIN		DIVI/GB00B65TLW28
Primary exchange		LSE
AIC sector		UK Equity Income
Financial year end		31 May
52-week high/low	96.2p	75.4p
NAV* high/low	99.4p	82.5p

*Including income.

Gearing

Gearing at 31 January 2024	0.0%

Fund objective

The Diverse Income Trust's investment objective is to provide an attractive and growing level of dividends, coupled with capital growth over the long term. It invests in a diversified portfolio primarily of quoted or traded UK companies across the market cap spectrum, with a bias to high-quality small- and mid-cap stocks. The stock-specific approach means the trust's portfolio does not track a benchmark index.

Bull points

- DIVI's modest large-cap exposure, means if these companies deliver disappointing results, the trust still has the potential to deliver satisfactory returns (as in 2020 for example).
- Since its launch in 2011, DIVI has built a revenue reserve that is c 1.3x the last annual dividend.
- Income diversification enabled DIVI to grow its dividend during the global pandemic.

Bear points

- DIVI's strategy based on 'the small-cap effect' has been a major headwind in recent quarters when large-cap stocks have been in favour.
- The UK market underperformed during globalisation; as global relationships fragment it may take time to be reflected in UK share prices.
- The trust's intensive research process contributes to its above-average ongoing charge within the AIC UK Equity Income sector.

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Edison profile page

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

DIVI: Potential benefits from a multi-cap approach

Williams and Turner are very upbeat about DIVI's prospects given the potential to generate good returns in different market conditions and believe that the outlook is even brighter in an unsettled economic and geopolitical environment. They are especially bullish about the trust's small-cap stocks given their inexpensive valuations. In a recent interview Williams said, 'I am more optimistic about the sector than I have been for 30 years; I think we are entering a super cycle of small-cap outperformance.'

The managers' investment approach

Williams and Turner aim to generate a robust and growing income stream by investing in a broader range of UK-listed companies than the trust's peers in the AIC UK Equity Income sector. They invest across the market-cap spectrum from larger mature firms to AIM-listed younger businesses, all of which are expected to generate excess cash that can fund meaningful and growing dividends.

DIVI's less-diversified peers are reliant on fewer companies to generate their income, which is a riskier approach, while the trust's multi-cap strategy provides a broader investible universe, which also reduces DIVI's income risk. Companies that may not currently pay a dividend, but are likely to be able to do so as they exit a capex period, are also considered. Holdings are sold if their valuations are no longer attractive, with the proceeds reinvested into less expensive companies; this process provides a yield pickup, supporting the trust's strong and rising dividend stream.

Perspectives from DIVI's managers

The benefits of an income focus in different market environments – despite the strong performance of growth strategies in recent years, this should be put into a broader context. Over the last three decades the globalisation trend has been pervasive, but throughout history there have been different macroeconomic backdrops; the managers believe that an income focus offers the prospect of good returns regardless of equity market conditions. They consider that during periods of economic uncertainty there is risk in focusing on capital appreciation, particularly on businesses that are dependent on raising additional capital. Companies with strong balance sheets can take advantage during economic malaise by acquiring their struggling competitors at advantageous valuations either in the market or debt free from a receiver.

Low interest rates have led to outsized equity returns – the globalisation theme has kept inflation in check and enabled a low interest rate environment. This resulted in outsized equity returns versus history as asset prices revalued and has encouraged narrower stock ownership with market winners attracting ever greater investor interest. Hence, there has been increased demand for larger-cap passive funds rather than actively managed smaller-cap strategies. Persistent selling of small-cap stocks, which are generally less liquid, has led to multiple compression and amplified the divergence between the performance of large- and small-cap equity returns.

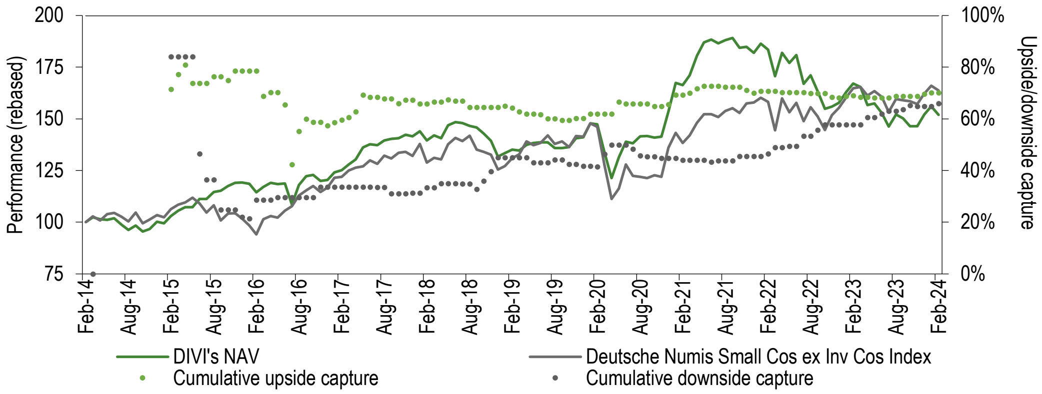
The small-cap effect – while larger-cap companies may have been favoured in recent years, over the long term, small-cap businesses have generated superior total returns for shareholders. The managers explain that this is known as the 'small-cap effect', where the returns of quoted companies are inversely related to their market caps; hence, DIVI's multi-cap approach, which aims to generate attractive returns whatever the market environment. UK stocks have performed relatively poorly over a multi-year period versus overseas markets, which in part have been supported by the strong performance of large-cap technology shares; however, this has not always been the case. According to the managers, during periods when the UK outpaced international markets, it was led by the performance of small-cap stocks.

Outlook for UK market in 2024 – higher interest rates bring risks to economic growth and if there is a recession this year, it should favour companies with excess cash. The managers say that economic weakness can disproportionately affect larger companies with strong market positions as it can be difficult for them to offset weaker demand with rapid expansion into other areas. In contrast, small-cap companies can be more agile in shifting their business emphasis. Also, in an unsettled interest rate and geopolitical environment there is typically inelastic supply in capital-intensive industries due to escalating build costs and higher required rates of return; if demand remains steady it can lead to very high margins for these corporates. The UK market has a large percentage of capital-intensive businesses so could be relatively well positioned in this type of environment. Also, within the UK, there are a relatively large number of quoted small-cap businesses, which tend to outperform during global economic weakness. Between 1965 and 1985, when there were persistent inflationary pressures and recessions, UK stocks fared far better than those listed in the United States and UK small-cap was one of the best performing global markets.

DIVI's upside/downside capture

Exhibit 1 shows DIVI's upside/downside cumulative capture over the last 10 years versus the Deutsche Numis Smaller Companies excluding Investment Companies Index. Its defensive portfolio qualities are shown by its upside capture of 66% and a downside capture of 61%. This low volatility, coupled with the trust's outperformance since inception, implies that DIVI offers investors an attractive mix of high alpha and a below-average beta.

Exhibit 1: DIVI's upside/downside capture



Source: Refinitiv, Edison Investment Research. Note: Cumulative upside/downside capture calculated as the geometric average NAV total return (TR) of the fund during months with positive/negative reference index TRs, divided by the geometric average reference index TR during these months. A 100% upside/downside indicates that the fund's TR was in line with the reference index's during months with positive/negative returns. Data points for the initial 12 months have been omitted in the exhibit due to the limited number of observations used to calculate the cumulative upside/downside capture ratios.

A genuine multi-cap UK income fund

Exhibit 2: Portfolio capitalisation exposure

	End-December 2023 (%)	End-December 2022 (%)	Change (pp)
AIM	29.3	37.6	(8.3)
Large cap	23.3	20.0	3.3
Small cap	22.1	20.9	1.2
Mid cap	16.9	13.9	3.0
UK listed non-index	2.7	2.0	0.7
Fledgling	1.4	0.6	0.8
Large-cap put option	0.0	0.5	(0.5)
Other	0.8	0.7	0.1
Overseas	0.2	0.3	(0.1)
Cash	3.3	3.5	(0.2)
Total	**100.0**	**100.0**	

Source: DIVI, Edison Investment Research

DIVI's multi-cap exposure is shown in Exhibit 2. At the end of December 2023, large and mid-cap stocks made up just 40.2% of the portfolio. The reduced AIM exposure (-8.3pp) is likely due to the poor performance of these stocks rather than a conscious desire by the managers to reduce DIVI's exposure to this market, which they expect to be a source of future large-cap winners.

DIVI's top 10 holdings

At the end of December 2023, DIVI's top 10 holdings made up 21.5% of the fund, which was a modestly higher concentration than 20.2% a year before; two positions were common to both periods. Over the year, the total number of holdings declined from 127 to 122.

Exhibit 3: Top 10 holdings (at 31 December 2023)

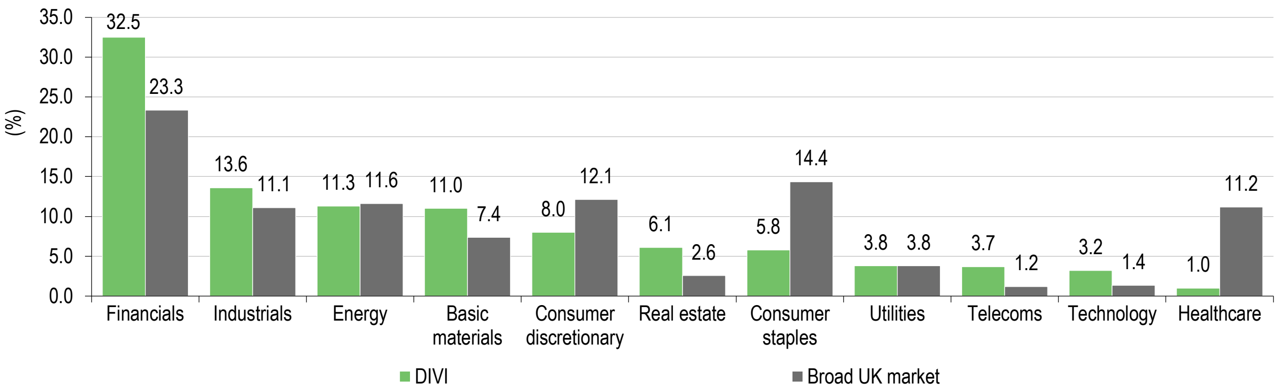
		Portfolio weight %	
Company	**Industry**	**31 December 2023**	**31 December 2022***
XPS Pensions Group	Financials	3.0	1.7
TP ICAP Group	Financials	2.6	N/A
Kenmare Resources	Basic materials	2.4	2.3
Galliford Try Holdings	Industrials	2.2	N/A
PayPoint	Industrials	2.1	N/A
Legal & General Group	Financials	1.9	N/A
Tesco	Consumer staples	1.9	N/A
Phoenix Group Holdings	Financials	1.8	N/A
Sainsbury (J)	Consumer staples	1.8	N/A
Just Group	Financials	1.8	N/A
Top 10 (% of portfolio)		**21.5**	**20.2**

Source: DIVI, Edison Investment Research. Note: *N/A where not in end-December 2022 top 10.

DIVI's sector and income exposures

Since the trust's inception in 2011, financials has always been DIVI's largest sector; it is made up of a broad range of different businesses. In Exhibit 4 we show how DIVI's sector exposure differs from that of the broad UK market. At the end of November 2023, the notable differences were below market weights in healthcare (-10.2pp) and consumer staples (-8.6pp) with a continued overweight position in financial stocks (+9.2pp).

Exhibit 4: DIVI's sector exposure versus the UK market (at 30 November 2023)



Source: DIVI, Edison Investment Research

Looking at Exhibits 5 and 6 below, it is interesting to note that DIVI receives a disproportionate amount of income from its industrial holdings (+7.1pp) and that the financial sector generates less income (-3.6pp) compared with its sector weighting. However, over the last five years, the financial sector been the largest contributor to DIVI's income, particularly the large-cap names including M&G, Intermediate Capital Group, Legal & General Group, Admiral Group and Aviva. The best performing stock over this period was XPS Pensions Group despite it being a small-cap company.

Exhibit 5: DIVI's sector exposure*

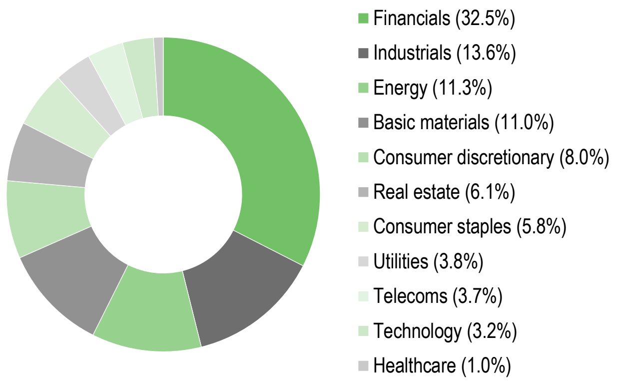
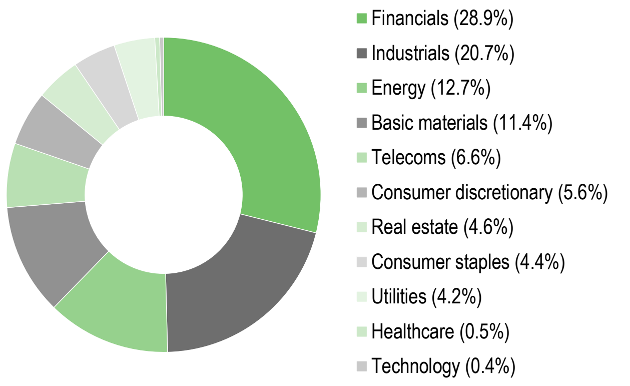


Exhibit 6: DIVI's income exposure



Source: DIVI, Edison Investment Research. Note: *Rebased without cash. Data at end-November 2023.

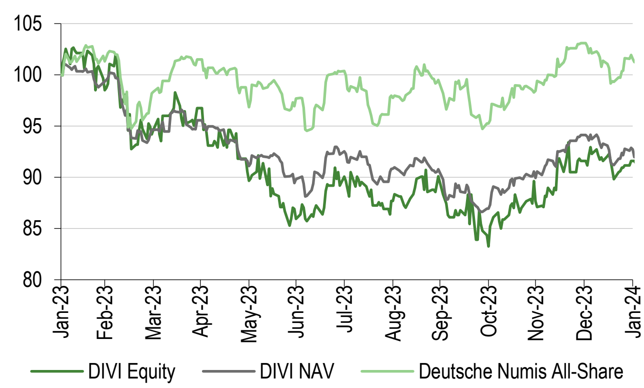
Performance: Ahead of the market since launch

While DIVI's results in recent years have been disappointing during a period of small-cap underperformance, one should not forget the trust's long-term record. Data from the company show that since DIVI's launch in April 2011 until end-H124 (30 November), its NAV and share price total returns of +171.7% and +144.0% respectively compared with the Deutsche Numis All-Share Index's +92.5% and the peer group's +147.4% total returns.

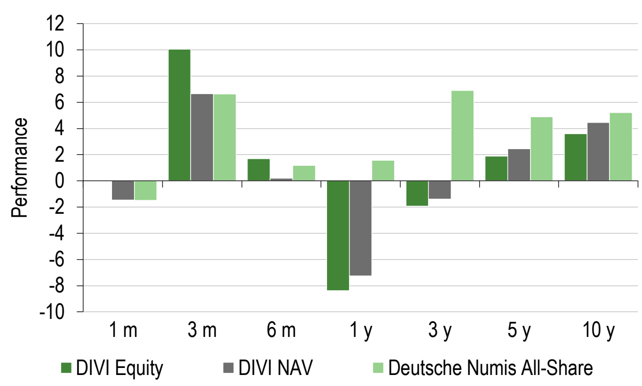
The managers highlight two periods in recent years when poor sentiment has negatively affected DIVI's returns. The first was from September 2018 to December 2019 due to concerns about political gridlock during Brexit negotiations. Secondly, sentiment towards UK small-cap stocks has been weak since April 2021, meaning good results have not been fully rewarded, while the shares of companies failing to meet expectations have been punished.

Exhibit 7: Investment company performance to 31 January 2024

Performance and NAV total return, one-year rebased



Performance and NAV total return (%)



Source: Refinitiv, Edison Investment Research. Note: Three-, five- and 10-year performance figures annualised, on a total return basis in pounds sterling terms.

In H124, DIVI's NAV and share price total returns of -1.3% and -2.2% respectively outpaced the Deutsche Numis Small Cap plus AIM (excluding investment companies) Index's -3.7% total return but were behind the Deutsche Numis All-Share Index's +1.6% total return.

Three positive contributors to the trust's performance were: DWF Group (received a takeover bid, which the managers believe was too low given the company's future prospects); XPS Pensions Group (sold its National Pensions Trust subsidiary to SEI Investments for a meaningful sum but will continue to earn administration fees from the combined company, which is now the market leader); and Galliford Try Holdings (announced another acquisition and raised revenue guidance).

The largest detractors to the trust's performance were: I3 Energy (lower commodity prices); CMC Markets (increased capex and lower profitability); and Vanquis (reduced lending activity). All three companies remain in the portfolio as the managers have positive outlooks for these companies.

Exhibit 8: 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 Deutsche Numis All-Share	1.5	3.2	0.5	(9.8)	(22.8)	(13.6)	(14.5)
NAV relative to Deutsche Numis All-Share	0.0	0.0	(0.9)	(8.7)	(21.5)	(11.1)	(7.2)
Price relative to Deutsche Numis Smaller Cos ex-ICs	2.0	(3.5)	(0.4)	(10.0)	(12.9)	(10.0)	(8.8)
NAV relative to Deutsche Numis Smaller Cos ex-ICs	0.5	(6.5)	(1.9)	(8.9)	(11.5)	(7.5)	(1.0)
Price relative to CBOE UK All Cos	1.1	3.6	0.4	(10.2)	(27.1)	(15.9)	(17.4)
NAV relative to CBOE UK All Cos	(0.3)	0.4	(1.1)	(9.1)	(25.9)	(13.5)	(10.4)

Source: Refinitiv, Edison Investment Research. Note: Data to end-January 2024. Geometric calculation.

Exhibit 9: Five-year discrete performance data

12 months ending	Total share price return (%)	Total NAV return (%)	Deutsche Numis All-Share (%)	Deutsche Numis Smaller Cos ex ICs (%)	CBOE UK All Cos (%)
31/01/20	5.2	7.4	10.2	13.7	10.5
31/01/21	10.7	9.7	(5.6)	(0.9)	(8.6)
31/01/22	16.8	13.9	16.5	15.1	19.3
31/01/23	(11.9)	(9.2)	3.3	(7.5)	6.3
31/01/24	(8.4)	(7.3)	1.6	1.8	2.0

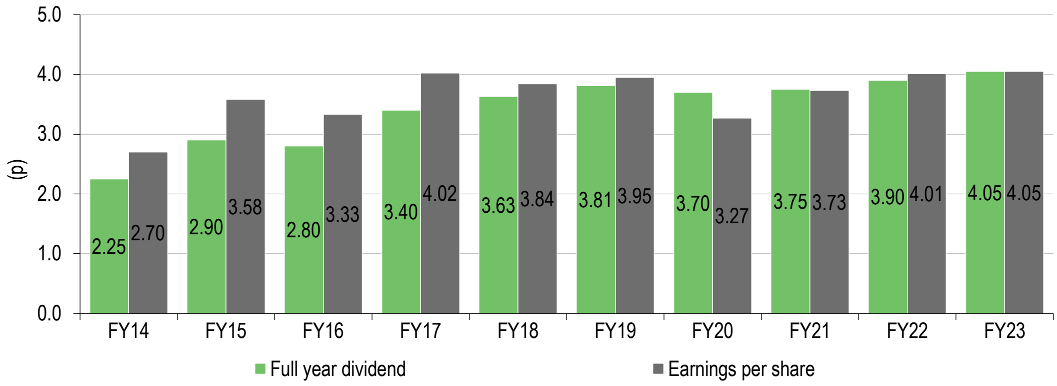
Source: Refinitiv. Note: All % on a total return basis in pounds sterling.

Dividends: Growing payments and attractive yield

DIVI's annual dividend has increased each year since the fund was launched in 2011. It should be noted that to allow shareholders to vote on the dividend, a final dividend of 0.50p per share was paid in FY15 in addition to four interim dividends, resulting in five payments for that year. Since then, there have three interim and a final dividend paid in respect of each financial year.

As shown in Exhibit 10, in normal market conditions, DIVI has a fully covered dividend. The most recent exceptions were during COVID when the FY20 annual payment was 0.9x covered and there was a small drawdown from reserves in FY21.

Exhibit 10: Last 10-year dividend and earnings per share history



Source: DIVI, Edison Investment Research. Note: Includes special dividends of 0.40p, 0.23p and 0.16p per share in FY17, FY18 and FY19, respectively.

In H124, DIVI's revenue return per share was 2.38p, which was 6.7% higher year-on-year. At the end of H124, the trust's revenue reserve was c £16.9m, which is equivalent to around 1.3x the annual dividend payment. So far, in respect of FY24, two interim dividends of 1.00p per share have been declared, which are 5.3% higher year-on-year. The board expects to at least maintain the total FY24 dividend at 4.05p per share.