

# The Diverse Income Trust

Managed for sustained dividend growth

The Diverse Income Trust (DIVI) invests in UK listed companies across the market capitalisation spectrum. It aims to deliver good and growing dividends as well as capital returns. Over two-thirds of its investments are outside the FTSE 350 index of large and mid-cap stocks, and the managers believe the small-cap universe is still rich in opportunities. The fund also seeks to minimise the scale of downside risk, and therefore the portfolio currently includes FTSE 100 put options. DIVI's share price has risen by around 110% since launch in April 2011 to end-September 2017, outperforming the FTSE All-Share index by over 50%.

12 months ending	Share price (%)	NAV (%)	FTSE All-Share (%)	FTSE 350 High Yield (%)	FTSE Small Cap Index (%)
30/09/13	36.8	40.8	18.9	16.8	44.9
30/09/14	9.7	10.6	6.1	6.7	5.6
30/09/15	18.2	19.6	(2.3)	(9.7)	9.0
30/09/16	4.9	4.6	16.8	22.8	10.5
30/09/17	13.9	14.8	11.9	10.4	17.8

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

## Investment strategy: Small-cap bias, fundamental

DIVI is focused on sustained dividend growth. The strategy is stock-specific and market cap agnostic to allow it a very wide investment opportunity set. The managers meet 70-80 companies a month to identify those that can make productivity gains and generate good payback on invested capital; in turn these characteristics drive future cash flows and underpin sustainable dividends. The fund has a small-cap bias with more than two-thirds of its holdings outside the FTSE 350, and is well diversified with over 150 stocks across 12 industry sectors.

## Market outlook: Mindful of downside risk

The FTSE All-Share index is near all-time highs, trading on a current P/E of c 25x. The increase in dividend payouts among many large companies has often been at the expense of reduced dividend cover. With dividend cover near this century's lows and interest rates starting to edge up, equity markets may be vulnerable to increasing volatility. DIVI's managers are sensitive to the importance of finding stocks that have sustainable dividend income, with ongoing prospects for productivity improvements that would fund future dividend growth. The wider opportunity set of multi-cap portfolios provides more scope for adding value, which is particularly important during periods of economic challenge.

## Valuation: Consistently close to NAV

DIVI's shares trade at a 1.4% discount to cum-income NAV. Since inception, the trust has traded close to the NAV, often at a premium, reflecting strong demand for the multi-cap strategy and its ability to manage the supply and demand for the shares. Although DIVI's 3.0% yield is at the low end of its peers, it is generously covered and managed for sustainable growth. Ordinary dividends have increased every year since inception in 2011 and two special dividends have been declared.

## Investment trusts

16 October 2017

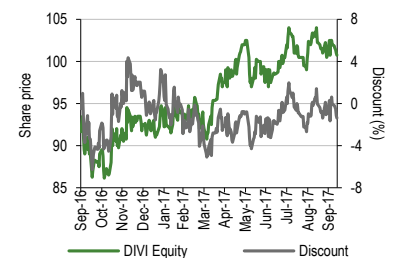
**Price** 100.8p  
**Market cap** £386.4m  
**AUM** £386.3m

NAV\* 100.6p  
 Premium to NAV 0.2%  
 NAV\*\* 102.2p  
 Discount to NAV 1.4%

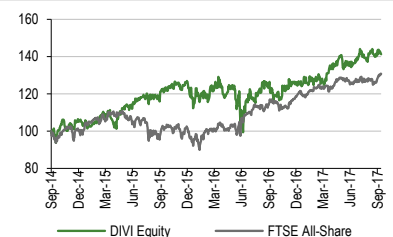
\*Excluding income. \*\*Including income. As at 12 October 2017.

Yield 3.0%  
 Ordinary shares in issue 383.5m  
 Code DIVI  
 Primary exchange LSE  
 AIC sector UK Equity Income

## Share price/discount performance



## Three-year performance vs index



52-week high/low 104.0p 86.1p  
 NAV\*\* high/low 103.4p 89.9p

\*\*Including income.

## Gearing

Gross\* 0.0%  
 Net\* 1.6%

\*As at 31 July 2017.

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### Exhibit 1: Trust at a glance

#### Investment objective and fund background

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.

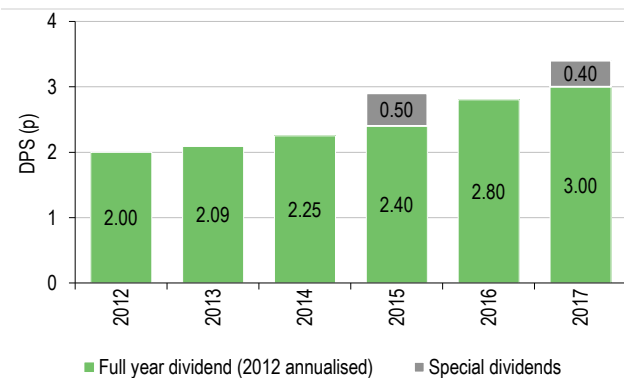
#### Recent developments

- 10 October 2017: AGM. Special dividend of 0.40p approved. Proposal to increase allotment from 10% to 20% of issued share capital was rejected.
- 7 August 2017: Annual results for the year ended 31 May 2017. NAV TR +13.6% compared with +20.0% for FTSE All-Share index. Ordinary dividends increased 7.1% plus 0.40p special dividend proposed.
- 30 June 2017: Third quarterly dividend of 0.80p per share declared for the year ending 31 May 2017.

Forthcoming		Capital structure		Fund details	
AGM	October 2018	Ongoing charges	1.15%	Group	Miton Group
Interim results	February 2018	Gearing	0%, net cash 1.6%	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	Phone	+44 (0) 20 3714 1501
Launch date	28 April 2011	Trust life	Indefinite	Website	<a href="http://www.mitongroup.com">www.mitongroup.com</a>
Continuation vote	No	Loan facilities	See page 7		

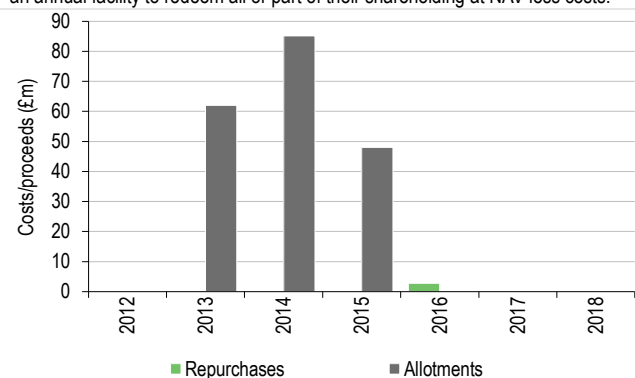
#### Dividend policy and history (financial years)

Quarterly dividends are paid in February, May, August and November. DIVI distributes substantially all of its income, net of costs, annually.

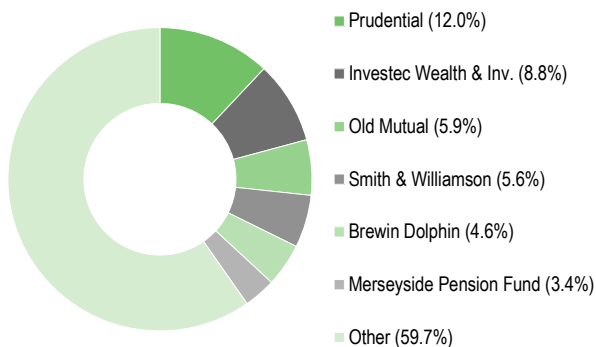


#### Share buyback policy and history (financial years)

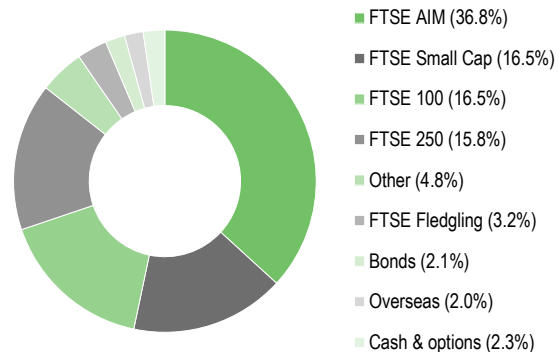
Renewed annually, DIVI has authority to purchase up to 14.99% and allot up to 10% of issued share capital. Subject to directors' discretion, DIVI offers investors an annual facility to redeem all or part of their shareholding at NAV less costs.



#### Shareholder base (as at 6 October 2017)



#### Portfolio exposure by market segment (as at 31 August 2017)



#### Top 10 holdings (as at 31 August 2017)

Company	Listing	Sector	Portfolio weight %	
			31 August 2017	31 August 2016**
Stobart Group	FTSE 250	Industrial transportation	3.2	1.95
IG Design Group	FTSE AIM	Household goods	1.9	1.62
Charles Taylor	FTSE Small Cap	Insurance services	1.8	2.35
FTSE Put Option*	FTSE 100	N/A	1.7	N/A
SafeCharge	FTSE AIM	Support services	1.4	0.84
Amino Technologies	FTSE AIM	Technology hardware & equipment	1.4	1.36
A&J Mucklow Group	Non-index	Real estate investment trust	1.3	1.16
Rio Tinto Plc	FTSE 100	Metals & mining	1.3	N/A
Zotefoams	FTSE Small Cap	Chemicals	1.3	1.1
Park Group	FTSE AIM	Financial services	1.3	1.3
<b>Top 10 (% of holdings)</b>			<b>16.3</b>	<b>16.9</b>

Source: The Diverse Income Trust, Edison Investment Research, Morningstar. Note: \*Two FTSE Put Option positions have been amalgamated to give a true position. \*\*N/A where not in top 10 at 31 August 2016.

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## Market outlook: Bright prospects for small-caps

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A long period of strong market returns in the UK has been supported by a remarkable reduction of 10 year gilt yields, falling from 10% in 1992 to just 1% currently. Lower bond yields have pushed up the value of assets and the FTSE All-Share index level is near an all-time high, commanding a current P/E of c 25x. Meanwhile, dividend cover has fallen towards this century's lows as larger companies' share prices have been rewarded for yield ahead of capital reinvestment. With central banks around the world looking for the appropriate opportunity to shrink balance sheets, equity market conditions may become less favourable.

DIVI's managers believe, going forward, smaller companies have brighter prospects than mainstream listed companies and that they can perform much better in economically challenging times. By virtue of size, they can be more nimble and, because they are less researched by institutions, are also less well-owned by institutions. This theory seems to be supported by recent performance. For the year to end September 2017, the FTSE Small Cap index has increased 17.8%, ahead of the 11.9% gain for the FTSE All-Share index.

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## Fund profile: Well diversified and unconstrained

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DIVI was launched in April 2011 to invest in UK companies across the market capitalisation spectrum, unconstrained by benchmarks. This approach allows the managers to access a much larger opportunity set compared with typical UK equity funds. The primary objective of the trust is to pay shareholders a good and growing income, principally derived from those dividends received from its portfolio companies. This, in turn, should also support attractive capital growth over time.

DIVI is managed by Gervais Williams and Martin Turner at Miton Asset Management (where Williams is also managing director). Both are smaller companies specialists who believe the better investment opportunities often lie outside of the largest stocks, which are well-researched and highly correlated with the overall market. The trust therefore has a strong smaller-cap bias and, typically, over two-thirds of its holdings are outside the large and mid-cap FTSE 350 index. The portfolio is well diversified, with over 150 holdings across 12 industry sectors.

Williams and Turner also manage an equivalent open-ended fund (OEIC), Miton Multi Cap Income. Demand for the firm's multi-cap income strategies has been strong. DIVI has grown from £50m assets under management at launch to c £390m through a combination of strong performance, share issuance and a merger with Miton Income Opportunities Trust in 2013, while the OEIC has grown to over £950m. The closed-end structure can be of benefit for a small-cap biased fund, as holdings can be illiquid. It also allows for gearing of up to 15%. DIVI has a borrowing facility in place, which is currently unused but enables the fund to be agile to invest at depressed levels when markets suffer setbacks.

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## The fund managers: Gervais Williams & Martin Turner

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### The managers' view: small-caps more resilient in downturns

Williams believes the current three-decade long credit cycle, extended by quantitative easing since 2008, has left markets too complacent about risk. He notes the expectation for FTSE 100 volatility is at the bottom of its range since 2008 in spite of elevated risks, and sees "very little cushion in the system". Personal levels of debt are high while wage growth is stagnant. At the corporate level, productivity has been declining at the same time dividends have been rising (in response to shareholder demand for income), with the resultant dividend cover near all-time lows for this

century. Central banks are looking to increase interest rates from current ultra-low levels, which would reverse the trend of abundant liquidity that has fuelled asset price rises. Meanwhile, there is little room for policymakers to manoeuvre with interest rates so low, alongside fiscal and political limitations.

The managers are attentive to downside risk and the protection of investors' capital, focusing on stocks that are conservatively financed. Williams observes that small stocks outperformed significantly during the 1960s and 1970s in spite of extreme economic challenges (including high inflation, sterling devaluation and stagflation). Small companies are better placed to invest in slow-growth and more uncertain environments as many of the most attractive opportunities will be smaller in scale and thus of less interest to large companies. Dividends are still growing amongst many small stocks. Conversely, organic dividend growth for the FTSE All-Share index declined one percentage point in 2016, with the headline increase of 4.2% reflecting currency translation gains from a sharp fall in sterling.

## **Asset allocation**

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### **Investment process: Productivity growth is key**

The managers believe companies that can grow dividends consistently over time also tend to drive a sustained increase in share price performance. In particular, they are looking for companies that can improve productivity and generate attractive payback on invested capital. Such companies are best able to underpin future cash flow which, in turn, funds future dividend growth. In assessing a company's potential prospects, the managers pay close attention to five key characteristics:

- Turnover growth. Durable dividend growth over time comes from companies that can progressively expand turnover.
- Sustained margins. Companies that generate turnover and income growth but cannot defend margins are unattractive.
- Management of risk. Companies with more modest risk appetites can help moderate the trust's portfolio risk yet still offer attractive long-term returns.
- Better balance sheets. The managers prefer investments with net cash balances or modest levels of debt relative to their capacity to borrow.
- Low entry valuations. The managers believe there are still plenty of stocks with attractive valuations, strong equity market performances notwithstanding. Many of these are outside the FTSE 350 because they are less well-researched.

The all-cap approach to investing gives the managers a very large and diverse universe of around 1,600 companies from which to select investments for a portfolio of around 150 stocks. As part of its bottom-up, stock specific investment process, the managers meet 70-80 companies a month. Each investment candidate is then subject to rigorous analysis with particular focus on how it satisfies the five key characteristics described above. Similarly, when a portfolio stock shows signs of weakening in these areas, it is flagged for potential sale.

### **Current portfolio positioning**

As at 31 August DIVI held 152 holdings. This is significantly higher than UK equity income peers and reflects the fund's bias towards smaller-cap stocks which are less liquid, necessitating smaller position sizes. Stocks outside the FTSE 350 accounted for 68% of the fund. The managers are not subject to benchmark nor sector constraints. As a result, the portfolio represents a set of stock-specific, high-conviction decisions, and can deviate significantly from the index (as shown in Exhibit 2).

The exhibit also shows sector exposures are little changed compared to a year ago. While the fund remains overweight consumer services relative to the FTSE All-Share index, much of this exposure is international stocks where the immediate challenges are less acute than those facing domestically-focused companies. The overweight positions to sectors such as industrials and technology are believed to be beneficiaries of the weakness in sterling.

The fund is underweight oil & gas, healthcare and consumer goods. The managers have been adding to the oil & gas sector more recently and hold stocks such as Shell and BP. At holding sizes of just 1% each, however, the fund remains notably underweight this sector relative to the index. Meanwhile, the managers find the current environment of high personal debt levels, stagnant wage growth and potentially higher interest rates unattractive for consumer cyclicals.

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

	Portfolio end-August 2017	Portfolio end-August 2016	Change (pp)	Index weight	Active weight vs index (pp)	Trust weight/index weight (x)
Financials	27.6	24.9	2.7	26.5	1.1	1.0
Consumer Services	19.6	17.5	2.1	10.9	8.7	1.8
Industrials	18.7	21.1	(2.4)	11.2	7.5	1.7
Consumer Goods	8.5	8.8	(0.4)	16.2	(7.7)	0.5
Basic Materials	6.6	7.6	(1.1)	7.6	(1.1)	0.9
Technology	6.5	5.0	1.5	0.9	5.7	7.5
Telecommunications	3.7	3.3	0.4	3.7	(0.1)	1.0
Oil & Gas	2.1	3.0	(0.9)	11.4	(9.3)	0.2
Healthcare	1.4	2.2	(0.8)	8.5	(7.1)	0.2
Utilities	0.9	1.4	(0.6)	3.1	(2.3)	0.3
Cash, fixed interest & other	4.5	5.2	(0.7)	0.0	4.5	N/A
	<b>100.0</b>	<b>100.0</b>		<b>100.0</b>		

Source: The Diverse Income Trust, Edison Investment Research, FTSE Russell

At the end of August, Stobart Group was the fund's largest position despite some profit-taking. Although the stock has performed very strongly, the managers still consider the investment case for this stock to be compelling from dividend growth and valuation perspectives. They are also of the view that, in the smaller-cap space, there continues to be plenty of good investment opportunities, and they note improved primary issuance opportunities. DIVI has recently participated in several IPOs, including Strix and Arena.

Strix is the world's largest kettle controls manufacturer with around 38% global market share, capitalising on changing consumer tastes in favour of teas, especially in the US. At purchase, the company traded on a single-digit PE. Arena is a global events management company operating in an immature market with good margins. Both companies are expected to generate attractive dividend yields.

## FTSE 100 put option position

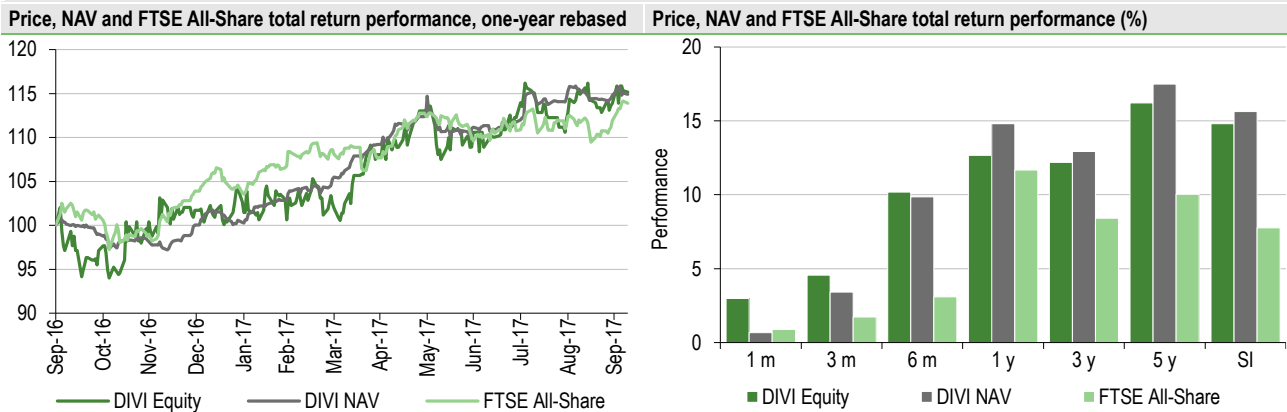
The managers are attentive to downside risk and use put options to help provide 'insurance' against a sharp setback in UK equities. The FTSE 100 put option position effectively allows DIVI to make gains if the index falls below 6,500. The gains will be proportionate to the scale of the market setback below this level and can be used to add holdings to the portfolio without the prior need to sell existing holdings at a time when stock prices are depressed. The duration of the option provides for 'insurance' to March 2019 and has an effective monthly cost of around 0.05% of the portfolio, which the managers believe is modest relative to its potential benefits.

## Performance: Solid long term track record

DIVI's NAV growth has outpaced the FTSE All-Share and FTSE 350 High Yield indices over all periods shown in Exhibit 4, and by 57.3% and 57.5% respectively since its inception in April 2011. This effectively shows outperformance against large-cap stocks as the FTSE 100 accounts for over

80% of the FTSE All-Share index. DIVI has also outperformed FTSE Small Cap Index over most periods. Williams notes that small-cap companies have traditionally been focused on growth at the expense of dividends, but this trend is in reverse and is contributing to an expansion of the trust's investable universe.

**Exhibit 3: Investment trust performance to 29 September 2017**



Source: Thomson Datastream, 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 relative to FTSE All-Share	2.1	2.8	6.9	0.9	10.9	31.5	50.3
NAV relative to FTSE All-Share	(0.2)	1.7	6.6	2.8	13.1	38.8	57.3
Price relative to FTSE 350 High Yield	1.7	3.9	9.1	2.4	16.0	38.9	50.5
NAV relative to FTSE 350 High Yield	(0.6)	2.7	8.8	4.3	18.2	46.6	57.5
Price relative to FTSE SmallCap Index	0.7	0.8	2.9	(4.1)	(0.2)	(2.3)	8.4
NAV relative to FTSE SmallCap Index	(1.6)	(0.3)	2.6	(2.3)	1.8	3.1	13.4

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

**Exhibit 5: NAV total return performance relative to FTSE All-Share Index over three years**



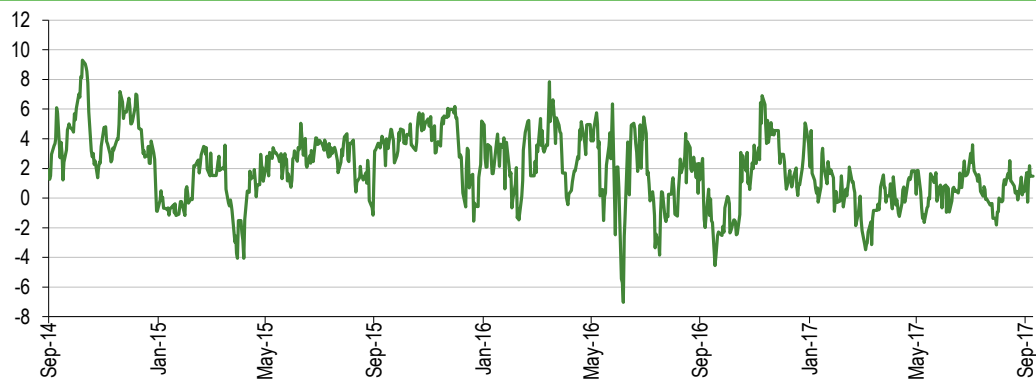
Source: Thomson Datastream, Edison Investment Research

## Discount/premium: Consistently close to NAV

DIVI currently trades at a narrow 0.2% discount to NAV (cum-income). The trust has traded close to its NAV since inception, often at premiums with the five-year and ten-year average premiums of 1.4% and 1.5% respectively. In part, this reflects strong investor appetite for the strategy, as evidenced by the strong growth in assets to over £950m for the equivalent OIEC, Miton UK Multi-Cap Income fund. The narrow discount is also a result of the fund's ability to manage supply and demand imbalances through share issuance and an annual redemption facility.



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



Source: Thomson Datastream, Edison Investment Research

## Capital structure and fees

DIVI is a conventional investment trust with 383.5m shares in issue. It listed in April 2011 with 100m shares and has grown significantly through C share issuance and a merger with Miton Income Opportunities Trust in 2013. DIVI operates a redemption facility whereby shareholders can elect to redeem their shares at NAV less costs on 31 May each year. Redemption requests must be made by 31 April. In FY17 the company received redemption requests for 1.1m shares, all of which were matched with buyers. Miton Trust Managers receives a management fee per annum calculated on the adjusted market capitalisation of the company of 1.0% for up to £300m and 0.8% above £300m. These fees are charged to both income and capital, allocated at 75% and 25% respectively. For the year ended 31 May 2017 the ongoing charges were 1.15%. The trust has an overdraft facility and is permitted to gear up to 15% of NAV. At end July 2017 the company was ungeared.

## Dividend policy and record

The primary objective of the fund is to grow dividends consistently over time. For FY17, DIVI declared ordinary dividends of 3.00p per share, an increase of 7.1% over FY2016. The board also proposed a bonus dividend of 0.40p per share reflecting the receipt of many special dividends from its portfolio companies over the year. Williams notes revenues from the portfolio over the past two years have risen faster than expected. Revenue reserves of £15.5m as at the financial year end more than covers the cost of the dividends declared (and the proposed bonus) and is available to help smooth distributions to shareholders in future years.

Dividends are paid quarterly in February, May, August and November.

## Peer group comparison

Exhibit 7 shows the 12 largest peers in the AIC UK Equity Income sector, comprising of 23 funds. DIVI ranks third in the sector for NAV total returns over both three and five years, and seventh over one year. Its yield of 3.0% is at the lower end of its peers though consistent with the fund's objective to provide good and growing dividends rather than simply high yield. DIVI's ongoing charges are above average though, unlike some peers, there is no performance fee. It is one of four funds trading on a premium to ex-par NAV, whereas the peer group average is a discount of 3.8%.

**Exhibit 7: Selected peer group as at 16 October 2017\***

% unless stated	Market cap £m	NAV TR 1 year	NAV TR 3 year	NAV TR 5 year	Discount (ex-par)	Ongoing charge	Performance fee	Net gearing	Dividend yield (%)
Diverse Income Trust	386.4	14.2	48.5	116.3	0.2	1.2	No	100	3.2
City of London	1,496.3	11.3	38.0	73.4	1.8	0.4	No	108	4.0
Dunedin Income Growth	395.1	8.4	30.3	55.4	(9.2)	0.7	No	112	4.5
Edinburgh Investment	1,387.3	8.8	39.6	85.9	(7.4)	0.6	No	112	3.6
F&C Capital & Income	324.7	18.3	52.0	76.5	2.4	0.7	No	104	3.3
Finsbury Growth & Income	1,202.5	18.2	66.0	125.4	0.8	0.7	No	102	2.0
JPMorgan Claverhouse	381.4	16.5	43.5	90.0	(7.4)	0.8	No	111	3.5
Lowland	411.2	17.3	44.2	91.3	(6.4)	0.6	Yes	106	3.5
Merchants Trust	530.7	13.6	34.5	61.9	(8.0)	0.6	No	117	5.1
Murray Income Trust	528.1	11.2	34.1	61.3	(7.2)	0.8	No	102	4.1
Perpetual Income & Growth	930.7	8.2	29.0	83.7	(8.1)	0.7	No	113	3.6
Temple Bar	879.4	16.3	34.2	71.0	(3.7)	0.5	No	98	3.1
<b>Weighted average (out of 23 funds)</b>		<b>12.9</b>	<b>41.4</b>	<b>84.6</b>	<b>(3.8)</b>	<b>0.6</b>		<b>107</b>	<b>3.5</b>
<b>Rank in sector (out of 23 funds)</b>	<b>10</b>	<b>6</b>	<b>3</b>	<b>2</b>	<b>4</b>	<b>1</b>		<b>11</b>	<b>10</b>

Source: Morningstar, Edison Investment Research. Note: \*Performance data to 12 October 2017. TR=total return. Net gearing is total assets less cash and equivalents as a percentage of net assets.

## The board

DIVI has five independent directors. Chairman Michael Wrobel, senior independent director Jane Tufnell, Paul Craig and Lucinda Riches have all served on the board since the trust's inception in April 2011. Calum Thomson was appointed in December 2016 and is chairman of the audit committee. The directors have backgrounds in audit, fund management and investment banking.

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