EDISON

# The Diverse Income Trust

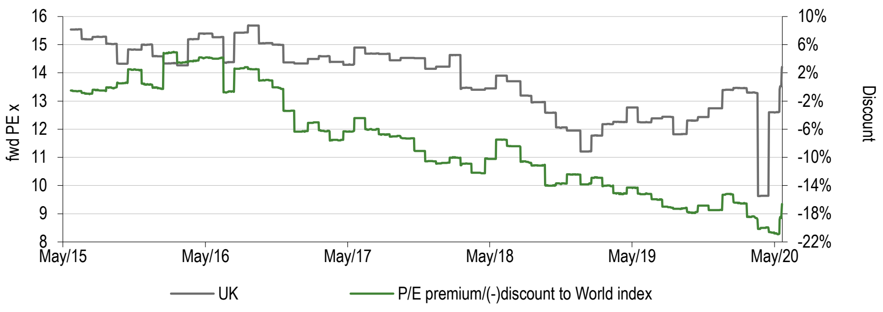
## Well placed to capitalise on weak sentiment

Investment trusts
UK multi-cap equity income

**21 May 2020**

**The Diverse Income Trust (DIVI) aims to provide shareholders with an attractive income, as well as capital growth, over the long term through a bottom-up approach to investing in UK equities across the market capitalisation spectrum. This gives the manager a wider opportunity set from which to pick stocks and dial down portfolio risk. DIVI has also profited from put options that boosted cash levels when the market was extremely weak. Although DIVI's income may decline in the short term, as many UK companies have recently cut their dividends, the board has recently maintained the third interim dividend, which suggests it expects this to be a transitory feature for the trust.**

**UK equities continue to be at a heavy discount to global equities**




Source: Refinitiv, Edison Investment Research

## The market opportunity

UK equities were heavily sold off in response to the COVID-19 pandemic (see chart above). Although there has been rebound, UK equities continue to lag most major markets, and the valuation gap with global equities, which started after the EU referendum, has widened to c 17%. This extreme disparity may suggest an attractive opportunity for the longer-term investor.

## Why consider investing in DIVI?

- DIVI's multi-cap strategy is unconstrained by index considerations, giving the managers a wide opportunity set from which to pick stocks.
- The wider opportunity set of potential dividend stocks, combined with a robust investment process, has helped deliver consistent growth in regular dividends.
- DIVI has accumulated revenue reserves and the board intends to use these to help maintain this year's dividends in line with the previous year.

## Deep discount has scope to narrow

DIVI trades at a discount of 8.1% to its cum-income NAV of 19 May 2020, which is well below the three-year average of 2.1%. The board takes a proactive approach to manage this discount to a level close to the trust's NAV, including an annual opportunity to redeem shares at NAV less costs. An improvement in sentiment towards UK equities would give considerable scope for DIVI's NAV to narrow over time.

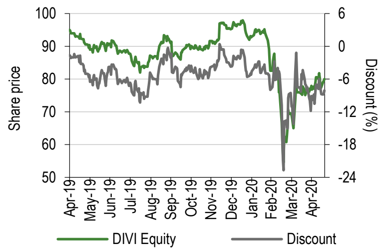
| | |
|---|---|
| **Price** | **80.0p** |
| **Market cap** | **£302.6m** |
| **AUM** | **£329.1m** |

| | |
|---|---|
| NAV* | 85.7p |
| Discount to NAV | 6.6% |
| NAV** | 87.0p |
| Discount to NAV | 8.1% |

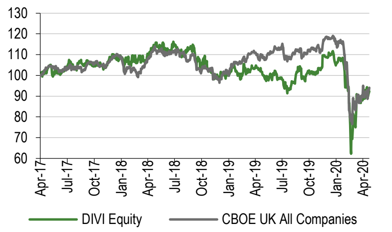
*Excluding income. **Including income. As at 19 May 2020.

| | |
|---|---|
| Yield | 4.7% |
| Ordinary shares in issue | 378.3m |
| Code | DIVI |
| Primary exchange | LSE |
| AIC sector | UK Equity Income |

**Share price/discount performance**




**Three-year performance vs index**




| | | |
|---|---|---|
| 52-week high/low | 98.0p | 54.6p |
| NAV* high/low | 99.6p | 70.3p |

*Including income.

**Gearing**

| | |
|---|---|
| Gross* | 0.0% |
| Net cash* | 8.7% |

*As at 30 April 2020.

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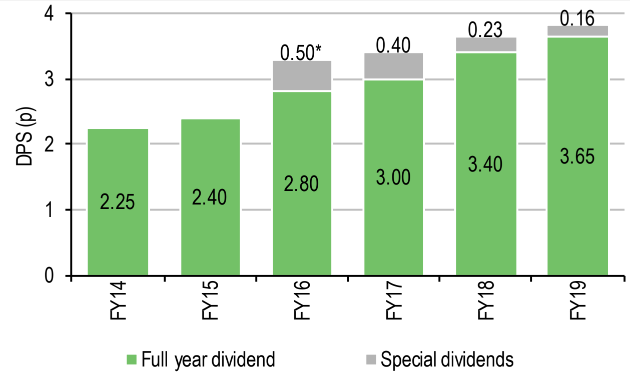
***The Diverse Income Trust is a research client of Edison Investment Research Limited***

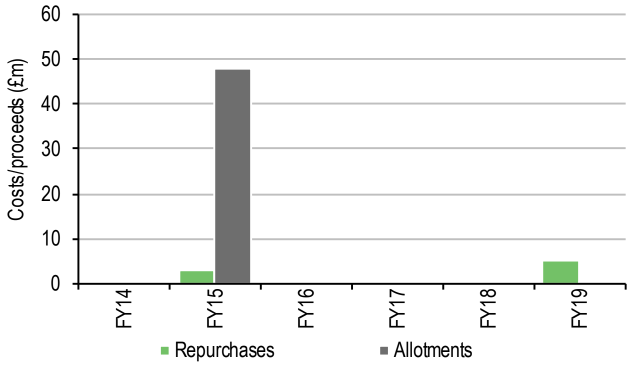
## Exhibit 1: Trust at a glance

| 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 across the market-cap spectrum, with a bias to high-quality small- and mid-cap stocks. As a stock-specific portfolio, there is no benchmark. | ■ 6 May: Declaration of third interim dividend of 0.9p per share.<br>■ 21 February 2020: Interim results for six months ended 30 November 2019. NAV TR +2.4% vs +5.8% for the broad UK stock market.<br>■ 10 October 2019: Announced the appointment of Michelle McGrade as independent non-executive director with immediate effect. |

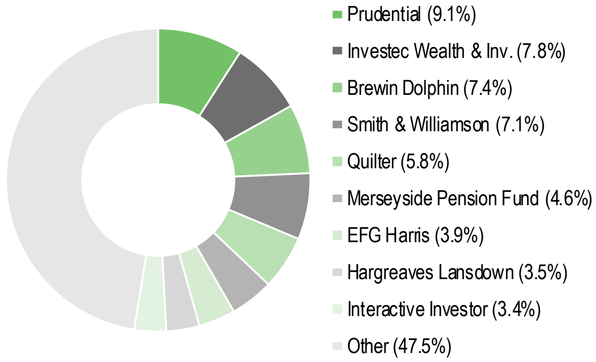
| Forthcoming | | Capital structure | | Fund details | |
|---|---|---|---|---|---|
| AGM | October 2020 | Ongoing charges | 1.16% | Group | Miton Group |
| Annual results | August 2020 | Net cash | 9.9% | Manager | Gervais Williams, Martin Turner |
| Year end | 31 May | Annual mgmt fee | Tiered structure (see page 7) | 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. *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. |

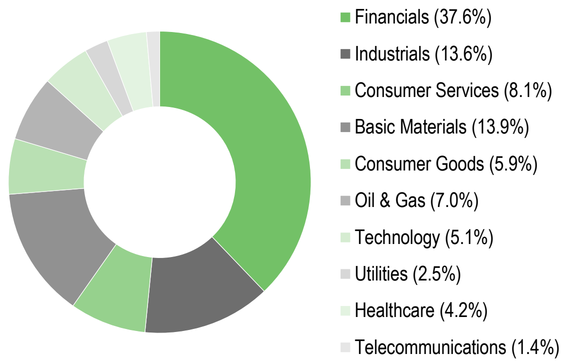



**Shareholder base (as at 25 March 2020)**




**Portfolio exposure by sector, rebased for cash, bonds & other (as at end-April 2020)**




**Top 10 holdings (as at 30 April 2020)**

| | | Portfolio weight % | |
|---|---|---|---|
| **Company** | **Sector** | **31 April 2020** | **31 April 2019*** |
| Highland Gold Mining | Mining | 2.3 | N/A |
| Centamin | Mining | 2.3 | N/A |
| CMC Markets | Financial services | 2.2 | N/A |
| Admiral | Insurance services | 1.9 | N/A |
| IG Group | Financial services | 1.8 | N/A |
| Strix | Industrials | 1.8 | N/A |
| Morrison (Wm) Supermarkets | Consumer goods | 1.8 | N/A |
| Diversified Gas & Oil | Energy | 1.7 | 2.1 |
| FRP Advisory | Financial services | 1.7 | N/A |
| Direct Line Insurance | Insurance services | 1.6 | N/A |
| **Top 10 (% of holdings)** | | **17.5** | **17.0** |

Source: The Diverse Income Trust, Edison Investment Research, Morningstar. Note: *N/A where not in top 10 at end-April 2019.

## Market outlook: Driven by COVID-19

Towards the end of 2019, the UK economy started to show signs of strengthening. A decisive election result, which cemented Boris Johnson's position as prime minister, raised hopes for progress on Brexit, and, coupled with a de-escalation in the US-China trade dispute, an improved outlook for global growth supported relatively bullish investor sentiment. This nascent optimism has been brought to an abrupt end by the coronavirus pandemic. Its wide-ranging impact represents both a severe demand-side and a supply-side shock. Although the government has responded with sizeable fiscal and monetary policies on an unprecedented scale, the UK is nevertheless facing one of its deepest recessions in history, and earnings and dividends are expected to fall sharply this year, with the shape of a recovery uncertain. The direction of equity markets will likely continue to be driven by developments relating to the disease. The UK stock market, however, remains relatively attractively valued and has been out of favour for some time, exacerbated by Brexit uncertainty since June 2016. The chart on the front page shows that, on forward P/E multiple terms, UK equities moved to a discount to global equities after the EU referendum, and the disparity has widened considerably since to a near period low of c 17%. A return to pre-Brexit levels would suggest decent upside for UK equities.

## Fund profile: Unconstrained, downside aware

DIVI was launched in April 2011 with the objective to generate an attractive level of dividends as well as capital growth over the long term, through investing mainly in UK equities across the market cap spectrum. Unconstrained by index considerations, this gives the managers, Gervais Williams and Martin Turner, a wide universe from which to find attractive companies. Their investment approach is bottom-up, looking for companies that are able to generate sustainable cash flows, which can underpin long-term dividend growth. Williams and Turner are smaller company specialists, and often find the most interesting investment opportunities in this segment of the UK equity market. Small caps can operate in sectors that are not represented by companies in the mainstream indices, thereby offering genuine diversification benefits. Furthermore, they can be overlooked by sell-side analysts, which can result in underappreciated valuations. Gearing is permitted up to 15% of the fund; however, historically it has been rarely used, reflecting the managers' propensity to protect against downside risk. The managers have used derivatives, such as put options on UK large-cap indices, to cushion the portfolio against sharp falls in equity markets.

## The fund managers: Gervais Williams & Martin Turner

### The manager's view: Stock selection and small caps to the fore

Williams believes the current coronavirus pandemic is causing major demand- and supply-side dislocations for the UK economy, with most companies negatively affected. The initial sell-off in UK equities was been broad and sharp, including companies with strong balance sheets. In his view, many companies have over-borrowed during this past decade of unprecedentedly low interest rates, and may suffer a permanent loss of capital or even go bust. Williams says DIVI has assiduously avoided companies with excessive leverage, and he expects its holdings to be able to continue their original trajectory of growth and dividend payments post the current period of dislocation. However, he is cautious that prospects for recovery from the current recession could remain muted for some time as governments, companies and consumers focus on deleveraging, and spending is constrained. In this environment, large companies may find it relatively harder to grow. Williams has also been cautious for some time that seemingly attractive dividend yields, which have helped underpin the performance of many large-cap companies for the past decade, were unsustainable. He observed that dividend cover has been falling over this period and, even prior to the current crisis, many high-yielding and widely held stocks had already cut dividends.

Williams believes the UK is relatively well positioned compared to many other major economies, with a flexible currency, and the ability to set its own policy. The depth of its capital markets is also a significant advantage, and he highlights that the UK is distinctive for its vibrant small- and micro-cap equity market. Smaller companies have underperformed large caps for some years, particularly since the Brexit vote in June 2016, yet the manager believes they can offer exposure to robust and growing businesses that represent genuine diversification from mainstream indices. In his view, good stock selection will become increasingly important in the current environment.

## Asset allocation

### Investment process: Well-established fundamental framework

DIVI follows a bottom-up investment process to find companies that generate strong cash flow payback on their capital expenditure, which helps to underpin the ability to sustain growing dividend payments over a three- to five-year period. The managers are very experienced small-cap equity specialists, and over time have met many companies to help build their confidence over managements' governance credibility and their ability to execute. Williams and Turner have an established framework for evaluating the attractiveness of a company:

- **Prospects for rising turnover**. In the managers' view, companies that progressively expand turnover are usually more able to generate durable dividend growth.
- **Sustainability of margins**. The most attractive companies are those that can expand or defend their profit margins, typically through productivity improvements or outstanding customer service.
- **Managements that can build intrinsic value**. Often, this is more likely to be found in companies that grow at a steady pace, rather than those that grow too quickly, which may carry too much risk.
- **Financial flexibility in balance sheets**. The managers look for companies with net cash or low levels of debt relative to their capacity to borrow. In their view, these firms are better placed to maintain dividends, even when underlying profits dip temporarily. Furthermore, these companies are more able to take advantage of economic setbacks to improve their market position.
- **Low expectations reflected in the share price**. Smaller companies are often less well researched and can by overlooked by the wider investment community.

### Current portfolio positioning

Exhibit 2 shows the portfolio's exposure by sector to end-April 2020. Financials account for over a third of DIVI's holdings, and increased by 4.1pp over the past year. Consistent with the managers' preference for smaller companies with niche strengths, most of the investments are in specialist financial services, and the trust has a relatively low weighting to the high-street banks. DIVI participated in the IPO of debt restructuring specialist FRP Advisory in February 2020. The managers favoured the counter-cyclical nature of its business, reflecting their cautious view on the high levels of indebtedness within UK corporates. The portfolio's financials holdings have shown good resilience during the current weak markets. Among the better performers are the online trading companies CMC Markets and Plus500, which Williams identified should do well at times of rising stock market volatility. DIVI also has exposure to insurance companies that specialise in relatively defensive domestic market segments, such as Admiral and Direct Line.

Recent purchases include Russian gold and silver mining company Polymetal. Williams noted that the price of gold would normally appreciate in response to a pandemic; however, precious metals prices fell in tandem with the market – a surprise correlation that he believed represented a buying opportunity. Pharmaceutical company GlaxoSmithKline was also introduced into the portfolio, reflecting the managers' confidence that the resilience of its underlying business should enable it to continue to pay dividends.

Significant gains have been made from the sale of a put option on the main UK large-cap index. The managers had purchased the put when they perceived market volatility to be unsustainably low, as an insurance policy to protect the portfolio in the event of a sharp fall in UK equities. A number of holdings have been sold in response to the pandemic, including transport companies easyJet and Go-Ahead, and entertainment company Rank. Healthcare-focused communications group Huntsworth was subject to an attractively valued takeover by an American private equity firm. These activities have contributed to relatively high levels of cash. As at end-April, DIVI held net cash of 8.7%, and following the sales of the put, this was as high as 14% in mid-March. This has allowed the managers to take advantage of market weakness to add selectively to existing holdings and make new purchases when opportune, without the need to sell at a time when share prices are broadly depressed. Many existing holdings have also been topped up; however, cash levels remain higher than usual as the managers take a cautious and patient approach to its reinvestment.

**Exhibit 2: Portfolio sector exposure***

| | Portfolio end-April 2020 | Portfolio end-April 2019 | Change (pp) |
|---|---|---|---|
| Financials | 34.0 | 29.9 | 4.1 |
| Basic Materials | 12.6 | 10.0 | 2.6 |
| Industrials | 12.3 | 15.1 | (2.8) |
| Consumer Services | 7.3 | 10.8 | (3.5) |
| Oil & Gas | 6.3 | 8.6 | (2.3) |
| Consumer Goods | 5.4 | 7.3 | (2.0) |
| Technology | 4.7 | 3.2 | 1.4 |
| Healthcare | 3.8 | 2.0 | 1.8 |
| Utilities | 2.3 | 2.8 | (0.5) |
| Telecommunications | 1.3 | 3.5 | (2.3) |
| Funds | 0.7 | 0.6 | 0.0 |
| Cash, bonds & other | 9.5 | 6.1 | 3.4 |
| | **100.0** | **100.0** | |

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

## Performance: Significant outperformance

As shown in Exhibits 4 and 5, DIVI's NAV total return has meaningfully outperformed the CBOE UK All Companies, MSCI UK High Dividend Yield and CBOE UK Small Companies indices across all the time periods shown. This is particularly noteworthy for the shorter-term periods of three and six months, when the equities sell-off in response to the coronavirus pandemic has been broad-based. DIVI's outperformance has been significantly boosted by its put option, which has generated large gains. The portfolio's holding of conservatively managed companies with strong balance sheets has also contributed towards its relative resilience. Since the trust's inception in April 2011, DIVI has outperformed the CBOE UK All Companies Index by 63.7%.

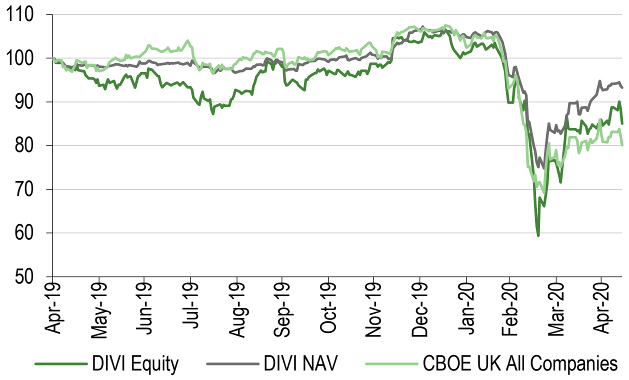
**Exhibit 3: Five-year discrete performance data**

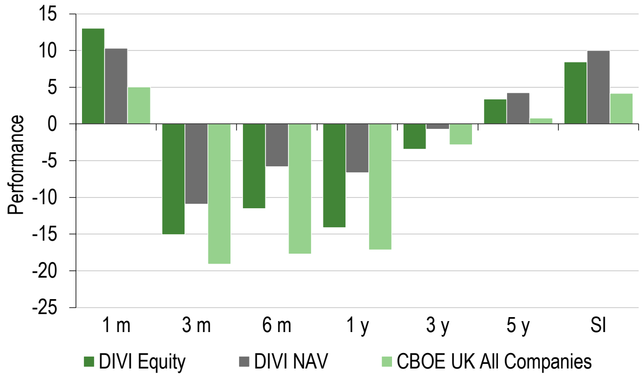
| 12 months ending | Total share price return (%) | Total NAV return (%) | CBOE UK All Companies (%) | MSCI UK High Dividend Yield (%) | CBOE UK Small Companies (%) |
|---|---|---|---|---|---|
| 30/04/16 | 17.5 | 10.9 | (5.6) | (5.8) | (5.6) |
| 30/04/17 | 11.8 | 13.6 | 20.3 | 21.8 | 20.3 |
| 30/04/18 | 9.1 | 8.4 | 8.1 | 7.2 | 8.1 |
| 30/04/19 | (4.0) | (3.4) | 2.5 | 3.8 | 2.5 |
| 30/04/20 | (14.1) | (6.6) | (17.2) | (18.2) | (17.2) |

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

**Exhibit 4: Investment trust performance to 30 April 2020**

| Price, NAV and FTSE All-Share total return performance, one-year rebased | Price, NAV and FTSE All-Share total return performance (%) |
|---|---|



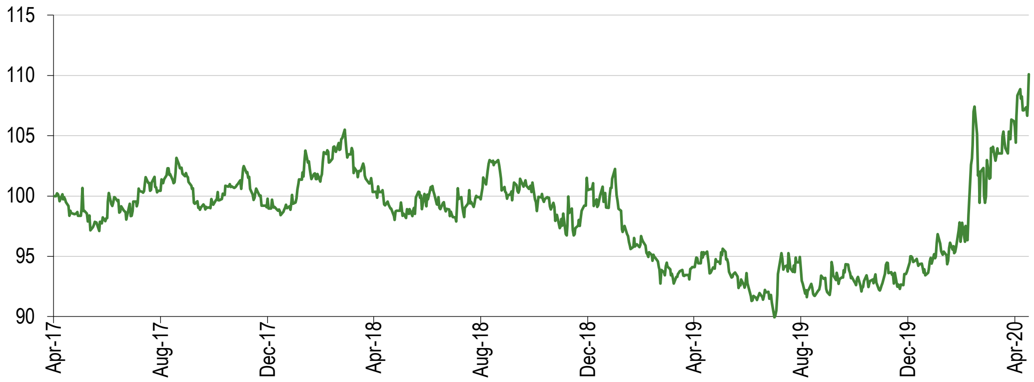

Source: Refinitiv, Edison Investment Research. Note: three- and five-year and since inception (SI, 28 April 2011) performance figures annualised.

**Exhibit 5: 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 CBOE UK All Companies | 7.6 | 5.0 | 7.5 | 3.7 | (1.9) | 13.5 | 43.6 |
| NAV relative to CBOE UK All Companies | 5.0 | 10.1 | 14.5 | 12.7 | 6.6 | 18.3 | 63.7 |
| Price relative to MSCI UK High Dividend Yield | 4.1 | 8.9 | 4.4 | 5.0 | (1.1) | 13.3 | 34.4 |
| NAV relative to MSCI UK High Dividend Yield | 1.6 | 14.2 | 11.1 | 14.1 | 7.5 | 18.1 | 53.3 |
| Price relative to CBOE UK Small Companies | 7.6 | 5.0 | 7.5 | 3.7 | (1.9) | 13.5 | 43.6 |
| NAV relative to CBOE UK Small Companies | 5.0 | 10.1 | 14.5 | 12.7 | 6.6 | 18.3 | 63.7 |

Source: Refinitiv, Edison Investment Research. Note: data to end-April 2020. Geometric calculation.

**Exhibit 6: NAV total return relative to CBOE UK All Companies Index over three years**

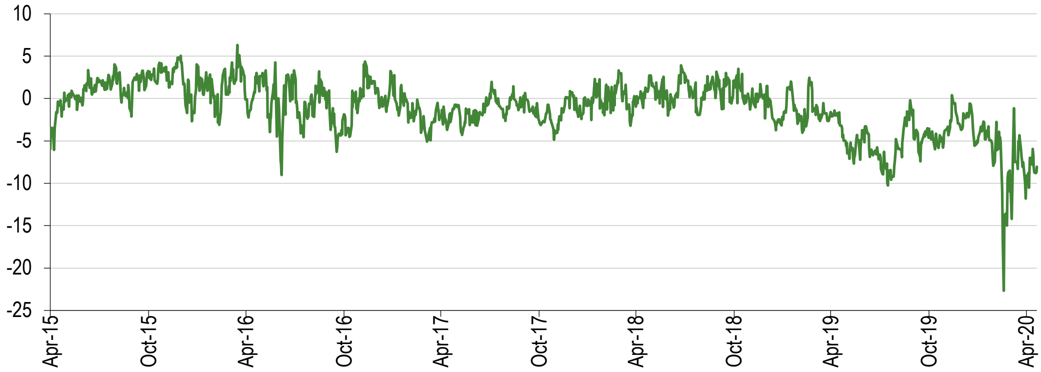



Source: Refinitiv, Edison Investment Research

## Discount: Meaningfully wider than history

At 19 May 2020, DIVI traded at an 8.1% discount to cum-income NAV, which is below the three-year average of 2.1%, but represents a sharp recovery from the 22.7% level in late March, its lowest point in history, as shown in Exhibit 7. DIVI has historically traded close to its NAV, an objective of the board. The board has the authority (renewed annually) to buy back shares if it considers it to be in the best interests of the shareholders, and also operates an annual redemption facility (see Capital structure and fees).

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




Source: Refinitiv, Edison Investment Research

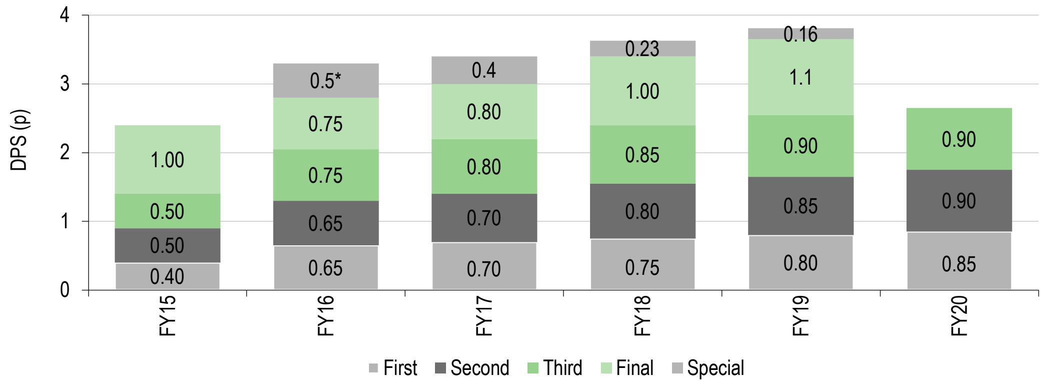
## Capital structure and fees

DIVI is a conventional investment trust; there are 378.3m ordinary shares in issue. The trust has an annual redemption facility that allows shareholders to tender their shares at NAV less costs at the end of May, and requests must be received by the end of April. For FY20, 20.2m requests have been received, representing 5.4% of issued share capital (FY19: 5.5m shares, representing 1.4%). The management fee payable to Premier Portfolio Managers has been reduced from August 2019, to 0.9% on the first £300m market capitalisation of the Trust, then 0.8% on any market capitalisation between £300 and £600m, reducing to 0.7% above £600m. Fees are charged to both the capital and income accounts, allocated at 75% and 25%, respectively. Gearing is permitted up to 15% of NAV, and the trust has a £25m loan facility with the Royal Bank of Scotland. This has not been drawn, and as at end-April 2020, DIVI had a net cash position of 8.7%.

## Dividend policy and record

DIVI's primary objective is to provide shareholders with an attractive and growing level of income, as well as deliver capital growth over the long run. As shown in Exhibit 8, since the trust was established in 2011 it has grown its regular dividends to shareholders (paid in February, May, August and November), as revenues have grown. The trust has also built up a revenue reserve that is available to smooth future dividends to shareholders. Over recent months, as numerous UK quoted companies have reduced or cancelled dividends due to the pandemic, DIVI's revenue has fallen back somewhat. Subsequently, the board has declared a maintained third interim dividend to shareholders, and stated that it is hoped that the trust's revenue shortfall wil prove to be temporary, so the four dividends for the financial year to May 2020 may be at least similar to the previous year, through utilising some the trust's revenue reserves from previous years.

**Exhibit 8: DIVI's regular dividend has grown at a compound 10.2% pa over five years**




Source: The Diverse Income Trust, Edison Investment Research. Note: *In FY16 five dividends were paid – the fifth would ordinarily have been designated as the first interim of FY17, but was redesignated as a final dividend for FY16. Thereafter three interim and a final dividend have been paid.

## Peer group comparison

Exhibit 9 shows the 12 largest funds by market capitalisation in the AIC UK Equity Income sector (which consists of 24 funds). DIVI is one of the smallest trusts within this peer group, ranking 10th. Its NAV total return ranks first over one year, fourth over three years, and second over five years. These returns have been generated without the use of gearing. DIVI has the highest ongoing charges among peers, which partly reflects its smaller size but also, in the managers' view, the labour-intensive nature of running a multi-cap fund with considerable weighting in small- and micro-cap companies. The dividend yields shown are based on historic payments, and many UK companies have cut their dividends in response to the pandemic, which may result in lower payments for the current year. At present, DIVI's yield ranks ninth, and the board has indicated its intention to utilise revenue reserves to help maintain this year's dividend at last year's level. The trust's discount to cum-fair NAV ranks ninth.

**Exhibit 9: Selected peer group at 20 May 2020***

| % 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 | 302.6 | (4.0) | (2.9) | 21.1 | (8.1) | 1.2 | No | 100 | 4.7 |
| BMO Capital & Income | 264.2 | (21.1) | (13.5) | 8.4 | 1.2 | 0.6 | No | 106 | 4.7 |
| City of London | 1,372.1 | (15.8) | (11.5) | 1.2 | (0.1) | 0.4 | No | 109 | 5.8 |
| Dunedin Income Growth | 374.9 | (6.0) | 1.5 | 15.7 | (5.6) | 0.6 | No | 109 | 5.0 |
| Edinburgh Investment Trust | 777.3 | (21.4) | (27.8) | (14.3) | (14.5) | 0.6 | No | 105 | 6.4 |
| Finsbury Growth & Income | 1,743.1 | (8.3) | 19.0 | 48.7 | (0.1) | 0.7 | No | 100 | 2.1 |
| JPMorgan Claverhouse | 322.2 | (19.0) | (13.2) | 1.0 | (1.1) | 0.7 | No | 109 | 5.2 |
| Lowland | 251.3 | (26.0) | (29.1) | (16.2) | (7.2) | 0.6 | Yes | 116 | 6.5 |
| Merchants Trust | 432.9 | (18.5) | (15.4) | (7.8) | (0.7) | 0.6 | No | 116 | 7.4 |
| Murray Income Trust | 502.4 | (6.7) | 1.0 | 18.2 | (3.9) | 0.7 | No | 107 | 4.6 |
| Perpetual Income & Growth | 455.4 | (29.6) | (35.8) | (29.8) | (14.8) | 0.7 | No | 113 | 7.1 |
| Temple Bar | 474.8 | (36.0) | (32.2) | (23.0) | (11.6) | 0.5 | No | 105 | 7.2 |
| **Simple average (12 funds)** | **606.1** | **(17.7)** | **(13.3)** | **1.9** | **(5.5)** | **0.6** | | **108** | **5.5** |
| **Rank in peer group** | **10** | **1** | **4** | **2** | **9** | **1** | | **11** | **9** |

Source: Morningstar, Edison Investment Research. Note: *Performance to 19 May 2020 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. **Based on historic dividends.

## The board

DIVI's board consist of six independent non-executive directors, chaired by Michael Wrobel, who has performed this role since the trust's inception in April 2011. He has announced that he will retire at the October 2020 AGM, following nine years of service. The board has been proactive in succession planning in view of the tenure of the original directors, and has appointed three new directors over the past three years. Andrew Bell (appointed in January 2019) serves as the senior independent director. The other members of the board, and their dates of appointment, are Paul Craig (April 2011), Calum Thomson (December 2016), Caroline Kemsley-Pein (January 2019), and Michelle McGrade (October 2019).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