

# The Diverse Income Trust

UK equities present interesting opportunities

The Diverse Income Trust (DIVI) aims to generate a good and increasing level of income, as well as capital gains over the long term. It primarily invests in UK equities, across the market capitalisation spectrum, seeking companies that are underappreciated by the market and able to generate productivity gains, which in turn underpin future dividends growth. The trust has around two-thirds of its holdings in companies outside of the FTSE 350 index, and is relatively lowly correlated with mainstream UK indices. DIVI has a solid medium- and long-term performance track record with a total return of c 14% pa when both the NAV and dividend income are included, over the period since inception in April 2011 to end-September 2018. UK equities remain out of favour ahead of Brexit and volatility has increased. This combination is presenting greater opportunity to add value, according to the managers Gervais Williams and Martin Turner.

12 months ending	Share price (%)	NAV (%)	FTSE All-Share (%)	FTSE 350 High Yield (%)	FTSE Small Cap Index (%)
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
30/09/18	9.0	4.8	5.9	5.8	0.6

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

## Investment strategy: Disciplined and risk-aware

DIVI is not constrained by benchmarks and has a wide investment opportunity set from which to select stocks. It has a bottom-up approach and a disciplined investment process to build a diversified portfolio of around 150 stocks. The managers are sensitive to the preservation of shareholders' capital. A FTSE 100 put option covering around 40% of the portfolio should help protect against a sharp fall in mainstream UK equities and, in that event, allow DIVI the agility to take advantage of investment opportunities.

## Market outlook: UK equities unloved

As quantitative easing is phased out across the world, market liquidity is falling back to the norms that existed prior to 2008. This presents particular challenges to companies looking to generate sustained earnings growth, especially when they are on elevated valuations, or have stretched balance sheets. Investors have become less willing to support stocks that disappoint, almost irrespective of the share price. The managers believe that the more unsettled market environment will present opportunities with greater upside potential than normal.

## Valuation: Consistently close to NAV

At 15 October 2018, DIVI traded on a 1.1% discount to cum-income NAV, which is a little below its three-year average premium of 0.1%. Historically, the trust has traded close to its NAV. This reflects the success of the investment strategy, the annual redemption mechanism, as well as the board's ability to manage the supply and demand for its shares.

## Investment trusts

29 October 2018

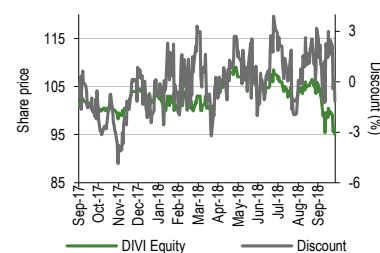
**Price** 95.0p  
**Market cap** £364.6m  
**AUM** £359.9m

NAV\* 94.5p  
 Premium to NAV 0.5%  
 NAV\*\* 96.1p  
 Discount to NAV 1.1%

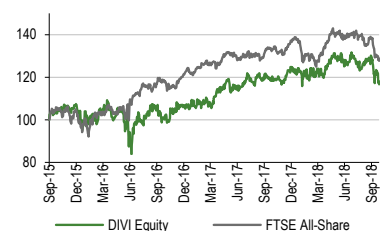
\*Excluding income. \*\*Including income. As at 25 October 2018.

Yield 3.6%  
 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 95.0p  
 NAV\*\* high/low 107.2p 96.0p

\*\*Including income.

## Gearing

Gross\* 0.0%  
 Net cash\* 1.9%

\*As at 30 September 2018.

## Analysts

Helena Coles +44 (0)20 3077 5700  
 Sarah Godfrey +44 (0)20 3681 2519

[investmenttrusts@edisongroup.com](mailto:investmenttrusts@edisongroup.com)

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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

- 3 August 2018: annual results for 12 months ended 31 May 2018. NAV TR +5.2% vs +6.5% for the FTSE All-Share index. Board declared a final dividend of 1.00p and a special dividend of 0.23p.
- 2 May 2018: third interim dividend of 0.85p per share declared.
- 31 January 2018: interim results for six months ended 30 November 2017. NAV TR was flat vs -2.0% for the FTSE All-Share index. Second quarterly dividend of 0.80p per share declared.

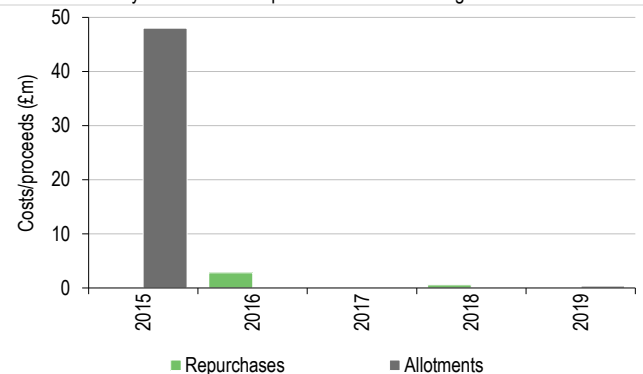
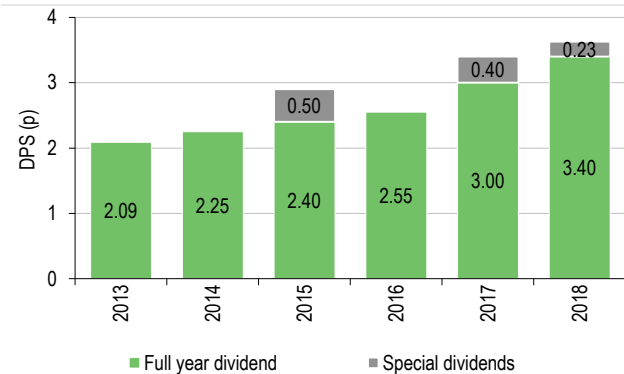
Forthcoming		Capital structure		Fund details	
AGM	October 2019	Ongoing charges	1.13%	Group	Miton Group
Interim results	January 2019	Gearing	0%, net cash 2.3%	Manager	Gervais Williams, Martin Turner
Year end	31 May	Annual mgmt fee	1.0% of market cap (0.8% above £300m)	Address	6th floor, Paternoster House, 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)

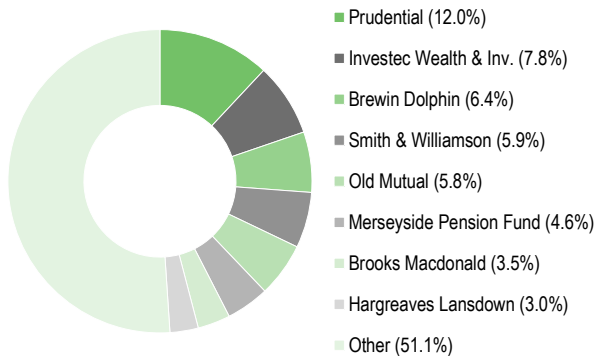
Quarterly dividends are paid in February, May, August and November. DIVI distributes substantially all of its income, net of costs, annually.

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

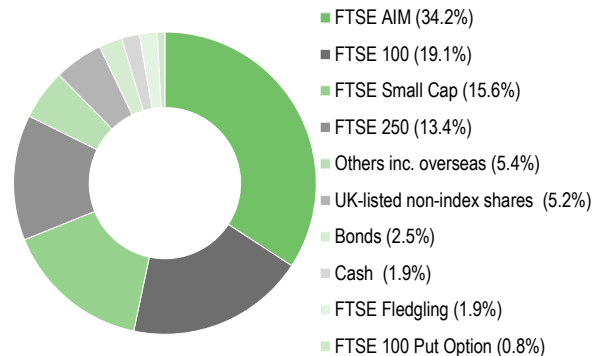
Renewed annually, DIVI has authority to purchase up to 14.99% and allot up to 10% of issued share capital. Subject to directors' discretion, DIVI offers investors an annual facility to redeem all or part of their shareholding at NAV less costs.



#### Shareholder base (as at 17 October 2018)



#### Portfolio exposure by market segment (as at 30 September 2018)



#### Top 10 holdings (as at 30 September 2018)

Company	Index	Sector	Portfolio weight %	
			30 September 2018	30 September 2017*
Diversified Gas & Oil	FTSE AIM	Energy	2.1	N/A
Stobart Group	FTSE 250	Industrial transportation	2.1	2.3
Zotefoams	FTSE Small Cap	Chemicals	2.0	1.4
Charles Taylor	FTSE Small Cap	Insurance services	1.7	2.2
Randall & Quilter	FTSE AIM	Insurance services	1.7	N/A
SafeCharge	FTSE AIM	Support services	1.7	1.6
Amino Technologies	FTSE AIM	Technology hardware & equipment	1.5	1.5
A&J Mucklow Group	Non-index	Real estate investment trust	1.4	1.4
Phoenix Group	FTSE 250	Insurance services	1.4	N/A
Royal Dutch Shell	FTSE 100	Oil & Gas	1.3	N/A
<b>Top 10 (% of holdings)</b>			<b>16.5</b>	<b>16.3</b>

Source: The Diverse Income Trust, Edison Investment Research, Morningstar. Note: \*N/A where not in top 10 at September 2017.

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## Market outlook: UK equities unloved

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The broad UK equity market has enjoyed a near-decade of growth from early 2009 to its peak (an all-time high of 4,337 points for the FTSE All-Share index) in May 2018. This has been fuelled by an exceptionally prolonged period of low interest rates, abundant liquidity and, more recently, synchronous global growth. Earnings momentum over the past two years has also been stronger than expected. Market conditions have started to change, however, as major central banks have started to unwind quantitative easing, resulting in the scaling back of liquidity and rising interest rates. This environment is more challenging for corporate profitability and limits the scope for valuation reratings. Meanwhile, investors globally have also become more sensitive to risk, as measured by an increase in the volatility index (VIX). This has been most evident in the sharp falls in the stock markets and currencies of a number of emerging markets. Although geopolitical risks are always present, issues such as tensions in the Middle East, and an escalating trade dispute between the US and China in an environment where investors are more risk-aware and valuations less forgiving, are headwinds for equities. The FTSE All-Share index has fallen around 8% since its peak, which may appear relatively modest in the context of its performance (+138.5%) over the past decade. UK equities, however, are very out of favour with international investors, who have reduced holdings since 2013, a trend that accelerated after the EU referendum in June 2016. According to the Bank of America Merrill Lynch survey of global fund managers, allocations to UK equities are back to the levels last seen during 2008, when the banking system was in crisis.

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## Fund profile: Stock picking from wide opportunity set

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DIVI was launched in April 2011 with the primary objective of paying shareholders a good and growing dividend. It aims to achieve this through investing mainly in UK companies that can improve productivity and, in turn, sustain strong cash flow to underpin growth in future dividends. DIVI is not constrained by benchmark considerations, and its ability to invest across the market capitalisation spectrum gives the managers, Gervais Williams and Martin Turner at Miton Asset Management, a wide opportunity set. The managers are smaller company specialists who believe small-caps often offer superior investment opportunities compared to larger companies; therefore, the portfolio has a bias towards companies outside of the FTSE 350 index. The trust can also invest, to a limited extent, in companies listed overseas. As at end-August 2018, around two-thirds of the portfolio was invested outside of the FTSE350. As small-caps can be illiquid, the strategy is well suited to a closed-ended vehicle. The trust is permitted to use gearing up to 15% of its NAV, although as at end-September 2018, this was not utilised.

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## Fund managers: Gervais Williams and Martin Turner

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### The manager's view: Plenty of opportunity in small companies

Williams believes the phasing out of quantitative easing in major economies is withdrawing liquidity from markets and causing a de-rating of equities from relatively demanding valuation levels. Many corporates in the mainstream indices, however, are vulnerable to changing market conditions. Over the past few years, Williams has observed that earnings have outpaced cash flows, productivity gains have been stagnant, yet dividends have been increased at the expense of dividend cover. The FTSE All-Share index dividend cover is currently around 1.8x compared to a 20-year average somewhat above 2.0x. Williams believes these factors mean mainstream stocks may be vulnerable if profitability deteriorates, and dividends may need to be cut. The manager also cautions, given relatively high valuations, that when companies disappoint, the downside potential is often underestimated by investors.

Williams believes DIVI's strategy to invest in quality companies that can improve productivity – which in turn helps sustain dividend growth – is more relevant than ever. The ability to invest across the market capitalisation spectrum of UK equities provides the manager with a wider and more diverse universe from which to pick stocks. The portfolio differs meaningfully from the FTSE All-Share index, with an active share of around 86%, and therefore is less correlated with mainstream UK indices. The manager observes that smaller companies tend to steer through adverse market conditions better than large companies. Small-caps outperformed significantly during the 1960s and 1970s despite high inflation, a sterling devaluation and oil price shock. In his view, smaller companies are more able to adapt to changing conditions; many have strong balance sheets and their acquisitions are sometimes more transformational to their prospects, when compared with larger companies. Williams observes that this segment of the market continues to increase corporate investment, with some excellent cash paybacks, and he is finding plenty of interesting opportunities.

## Asset allocation

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### Investment process: Bottom-up and risk-aware

DIVI's investment approach is bottom-up and rigorous. Visiting companies and meeting management is an important part of the investment process. The managers are looking for companies that can generate productivity gains, with attractive risk/reward ratios, and that are well placed to perform over the long term. Their fundamental analysis focuses on five key factors:

- **Turnover growth.** Few companies can generate sustainable long-term growth without the ability to grow turnover. This can be via innovation or introduction of a premium product and, even during periods of economic stagnation, these types of improvement can help underpin growth.
- **Sustained margins.** Turnover does not sustain growth if margins are in decline. Productivity improvements should help reduce costs, as well as justify higher price points. Excellent quality of customer service is particularly important to help maintain margins.
- **Management of risk.** Companies that grow too quickly carry significant risk. Attractive returns tend to come from companies that grow at a more measured pace.
- **Better balance sheets.** Exceptionally low interest rates over the past decade have resulted in many companies taking on debt, which may become a constraint on growth in the future. The managers prefer companies with net cash or under-gearred balance sheets that can take advantage of economic setbacks to improve their market positions disproportionately.
- **Low entry valuations.** Small-caps are less well researched and the managers find many overlooked companies with low valuations. They prefer stocks that may have suffered derating arising from recent problems, to those already reflecting some excitement about future prospects.

A traffic-light rating system is applied to each of the key factors, and investments are continually monitored to help assess whether an investment case remains intact or should be challenged.

The managers are mindful of downside risk and pay considerable attention to the portfolio's resilience to market downturns. An in-depth understanding of investee companies' fundamentals and risk sensitivities plays a key part in risk management. The portfolio is also well diversified across sectors and, with c 150 holdings, is not overly exposed to single names and themes.

### Current portfolio positioning

As shown in Exhibit 2, the portfolio is most exposed to the financials sector (29.5%), where the weighting has seen a significant 5.3pp increase over the past year to end-September 2018. This partly reflects strong performance from some of DIVI's holdings, including Burford Capital and

Randall & Quilter; however, it also reflects new purchases such as Lloyds Bank and Royal Bank of Scotland (RBS). Williams believes the worst of UK banks' problems, which stymied growth for a decade, are now behind them. The underlying domestic businesses are doing well, their balance sheets are now much stronger, and they have started to pay dividends again. The oil & gas exposure has also increased materially, by 6.7pp over the past year. Significant holdings include Diversified Gas & Oil, BP and Royal Dutch Shell. The manager observes oil surpluses to be lower than long-term norms following multiple years of investment cutbacks. He also believes geopolitical risks to be elevated as developments in Venezuela and Middle East have the potential to disrupt supply. These risks have also been reflected in a 1.5pp increase in the basic materials exposure. This is mainly through increased position sizes in gold stocks, which have been overlooked for some time and are attractively valued, thereby providing a defensive quality to the portfolio.

Over the past year, DIVI has notably reduced exposure to consumer services (-4.6pp) and consumer goods (-2.4pp). Williams believes UK household debt levels are relatively high at a time when interest rates are poised to rise further, and he also expects fuel prices to increase. In his view, these factors will outweigh the positives of low levels of unemployment and a modest recovery in wages. However, the managers look at each stock on its own merits and recent purchases include two consumer-related companies. Photo-Me International is best known for its instant photo booths franchise. The company also has laundry and kiosks businesses, and is expanding overseas. The manager expects the growth profile to be moderate, but Photo-Me generates good cash flows, which supports dividend growth. A share price correction after negative news on potential regulation change in Japan (which did not materialise) gave the managers an attractive entry point. Retailer Game Digital's share price had also suffered alongside many high-street names. Its new strategy to develop experience stores, Belong, in shopping malls is gaining traction. The company has a co-operation agreement with Sports Direct and is growing locations inside its stores. Williams believes prospects look promising at this relatively early stage, while risks are reasonably contained as, should a location be unsuccessful, Game is able to return the space to Sports Direct after three months. The manager believes the company to be undervalued, with cash balances of around £55m against a market capitalisation of less than £50m.

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

	Portfolio end- September 2018	Portfolio end- September 2017	Change (pp)	Index weight	Active weight vs index (pp)	Trust weight/ index weight (x)
Financials	29.5	24.2	5.3	25.3	4.1	1.2
Industrials	18.6	20.0	(1.5)	11.3	7.2	1.6
Consumer services	11.4	16.0	(4.6)	12.1	(0.7)	0.9
Oil & gas	10.0	3.3	6.7	14.5	(4.5)	0.7
Basic materials	9.0	7.6	1.5	7.5	1.6	1.2
Consumer goods	6.3	8.7	(2.4)	13.8	(7.5)	0.5
Technology	4.6	4.9	(0.3)	0.9	3.7	5.2
Telecommunications	3.2	3.2	(0.0)	2.8	0.4	1.1
Healthcare	2.1	3.2	(1.1)	9.3	(7.2)	0.2
Utilities	1.5	1.8	(0.4)	2.5	(1.1)	0.6
Funds	0.5	0.5	0.0	0.0	0.5	N/A
Cash, bonds & other	3.5	6.6	(3.0)			
	<b>100.0</b>	<b>100.0</b>		<b>100.0</b>		

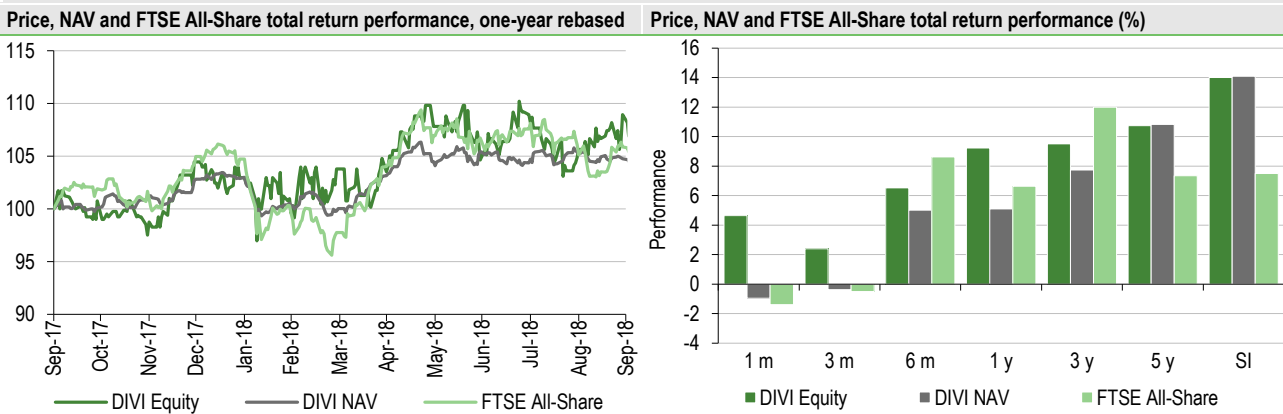
Source: DIVI, Edison Investment Research, FTSE Russell. Note: \*All figures subject to rounding.

The portfolio owns a FTSE 100 put option, covering around 40% of the trust, which should help protect it against a sharp fall in mainstream market values. The option brings the right to sell the FTSE 100 index at 6,500 at any time prior to September 2019; in this event, the cash received can be used to make additional purchases at a time when the UK equity market would have fallen. Furthermore, DIVI has an unused debt facility of £25m, which is held in reserve so that should markets suffer a major setback, and should they then enter a period when they were well set for recovery, the trust would be able to scale up its holdings and participate in greater size in the wider market recovery.

## Performance: Long-term outperformance

As shown in Exhibit 4, DIVI has a strong medium- and long-term performance track record. Over five years and since its inception (28 April 2011), the fund's NAV and share price total returns have substantially outperformed the FTSE All-Share, FTSE 350 High Yield and FTSE Small-Cap indices. The three-year performance has lagged, reflecting the relative strength of the FTSE 100 in the period following the UK's EU referendum. At that time, sterling fell sharply, benefiting multinational companies and those that pay dividends in overseas currencies, while several large FTSE 100 stocks also benefited from a strong recovery in commodity prices. In the shorter term, markets have become more volatile – and DIVI's differentiated portfolio, which is invested across the market-cap spectrum – means performance can diverge from that of mainstream indices.

**Exhibit 3: Investment trust performance to 30 September 2018**



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 versus FTSE All-Share	6.1	2.9	(1.9)	2.4	(6.5)	16.9	54.7
NAV versus FTSE All-Share	0.4	0.1	(3.3)	(1.4)	(11.0)	17.4	55.7
Price versus FTSE 350 High Yield	5.8	3.3	(2.4)	2.5	(10.3)	21.4	55.0
NAV versus FTSE 350 High Yield	0.1	0.5	(3.8)	(1.4)	(14.6)	21.9	56.0
Price versus FTSE Small-Cap	5.6	5.1	1.9	8.0	0.2	10.7	17.3
NAV versus FTSE Small-Cap	(0.1)	2.2	0.5	3.9	(4.6)	11.1	18.0

Source: Thomson Datastream, Edison Investment Research. Note: data to end-September 2018. Geometric calculation.

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



Source: Thomson Datastream, Edison Investment Research

## Discount: Historically close to NAV

At 15 October 2018, DIVI traded on a 1.1% discount to cum-income NAV, which is a little below than its three-year average premium of 0.1%. As shown in Exhibit 6, the trust has historically traded close to its NAV, with brief exceptions, such as in the immediate aftermath of the UK's EU referendum result. There is strong investor appetite for DIVI's investment strategy, as evidenced by the growth in assets of the equivalent OEIC, Miton UK Multi-Cap Income fund, to £1.3bn. DIVI's board is also committed to managing the trust's discount and can utilise an annual redemption facility and issue new shares to meet supply and demand requirements.

**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 383.8m ordinary shares in issue. It operates a redemption facility allowing shareholders to elect to redeem their shares at NAV less costs on 31 May each year. Redemption requests must be made by 31 April. In FY18, the company received redemption requests for 0.5m shares, representing 0.1% of the share capital, all of which were matched with buyers. Miton Trust Managers receives a management fee of 1.0% of the market cap of the company up to £300m, reducing to 0.8% above this level. These fees are charged to both the income and capital accounts, allocated at 75% and 25%, respectively. For FY18, the ongoing charges were 1.13% (1.15% in FY17). Gearing is permitted up to 15% of NAV and the trust has a £25m debt facility with Royal Bank of Scotland, with the scope in certain circumstances to raise this to £50m. As at end-August 2018, the facility was unused and the trust had a net cash position of 2.3%.

## Dividend policy and record

DIVI has consistently grown its regular dividends since launch. DIVI has also benefitted from numerous special dividends over the period, with many accrued in revenue reserves. These have grown considerably over the seven years since launch, and were £16.6m at end-May 2018, equivalent to more than a year's dividend payment. This reserve means the board has flexibility to smooth future payments to shareholders in the event of a temporary fall in portfolio income. Over recent years, DIVI has also paid special dividends when the trust itself has received abnormal one-off dividend receipts during the financial year. As shown in Exhibit 1, for FY18, DIVI paid a regular dividend of 3.40p per share (3.0p in FY17) and announced a special dividend of 0.23p per share (0.4p in FY17). The special dividend is lower this year, reflecting fewer one-off dividends received by the fund during the recent period.

## Peer group comparison

Exhibit 7 shows the 12 largest peers in the AIC UK Equity Income sector, which comprises 23 funds. DIVI is the ninth-largest fund by market capitalisation. Its NAV total return over one, three and five years ranks second, ninth and second, respectively. Over the three-year period, the FTSE 100 index performed relatively strongly, as many of its constituents benefited from a sharp fall in sterling and/or recovery in commodity prices. It is noteworthy that the returns generated by DIVI have been achieved without the use of gearing. The trust ranks highest in terms of ongoing charges, which in part reflects its relatively smaller size, and also, says Williams, the labour-intensive nature of running a multi-cap fund with a high weighting in under-researched small and micro-caps. It is one of four trusts to trade close to its cum-fair NAV, ranking fourth.

**Exhibit 7: Selected peer group as at 26 October 2018\***

% 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	364.6	(2.1)	14.6	46.3	(0.3)	1.1	No	100	3.6
City of London	1,390.2	(3.3)	14.3	30.2	1.0	0.4	No	112	4.6
Dunedin Income Growth	348.5	(4.5)	18.3	17.8	(10.6)	0.6	No	116	5.5
Edinburgh Investment	1,231.5	(5.0)	8.3	39.3	(9.4)	0.6	No	109	4.2
F&C Capital & Income	297.8	(4.8)	25.8	36.6	0.0	0.6	No	104	3.7
Finsbury Growth & Income	1,307.1	3.4	37.8	71.2	0.3	0.7	No	102	2.1
JPMorgan Claverhouse	380.9	(5.6)	18.8	30.9	(0.5)	0.8	No	107	4.1
Lowland	362.0	(7.5)	17.0	24.5	(8.0)	0.6	Yes	114	4.0
Merchants Trust	496.9	(3.2)	17.6	18.8	(2.8)	0.6	No	119	5.6
Murray Income Trust	462.9	(3.5)	20.3	23.0	(10.5)	0.7	No	107	4.8
Perpetual Income & Growth	790.7	(7.6)	0.5	23.8	(10.7)	0.7	No	114	4.2
Temple Bar	779.7	(5.2)	21.0	22.5	(7.7)	0.5	No	105	3.6
<b>Weighted average</b>	<b>684.4</b>	<b>(4.1)</b>	<b>17.9</b>	<b>32.1</b>	<b>(4.9)</b>	<b>0.7</b>		<b>109</b>	<b>4.2</b>
<b>Rank in sector</b>	<b>9</b>	<b>2</b>	<b>9</b>	<b>2</b>	<b>4</b>	<b>1</b>		<b>12</b>	<b>10</b>

Source: Morningstar, Edison Investment Research. Note: \*performance data to 25 October 2018. 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 board is looking at succession planning ahead of the ninth year of the trust and is in the process of seeking a new director so that board refreshment occurs on a gradual basis.

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