EDISON

Acorn Income Fund

High-yielding fund with recovery potential

Investment companies

Acorn Income Fund (AIF) is one of the best-performing funds in the AIC universe over the past 10 years. However, it suffered a period of poor performance in 2018, as its high level of structural gearing compounded the ill effects of a sell-off in UK small-cap equities, in which c 75% of its portfolio is invested. The managers of the small-cap portfolio, Simon Moon and Fraser Mackersie at Unicorn Asset Management, remain very positive on the outlook, citing highly attractive valuations for the kinds of profitable, cash-generative, dividend-paying companies they seek. Meanwhile, the managers of AIF's income portfolio (Paul Smith and team at Premier Fund Managers) are focused on generating absolute returns from a diversified selection of short-dated bonds, investment companies and structured notes.

12 months ending	Share price (%)	NAV (%)	Acorn ZDPs (%)	Blended benchmark*	Numis Smaller Cos ex-ICs (%)	FTSE All-Share (%)
31/03/15	(14.5)	(1.3)	7.7	(0.3)	(0.3)	6.6
31/03/16	17.8	12.2	1.8	4.2	4.2	(3.9)
31/03/17	13.8	16.7	8.0	18.8	18.8	22.0
31/03/18	15.7	6.9	5.2	5.2	5.2	1.2
31/03/19	(11.1)	(1.3)	1.0	1.6	(1.2)	6.4

Source: Refinitiv. Note: All % on a total return basis in pounds sterling. *See page 7.

The market opportunity

UK smaller companies have underperformed their larger brethren in recent years, as they tend to have a greater proportion of domestic earnings, and are perceived to be more at risk from an unfavourable Brexit scenario. However, the universe contains many well-managed, well-financed, cash-generative companies paying attractive dividends and, with valuations at low levels following the global equity market sell-off in Q418, there is scope for a rally if a Brexit cliff edge is avoided.

Why consider investing in Acorn Income Fund?

- Attractive valuation of underlying asset class versus long-term growth potential.
- Wider-than-average discount has scope to narrow on any improvement in investor sentiment towards UK smaller companies.
- Focus on well-managed, well-financed companies paying attractive dividends.
- Dividend yield of more than 5% is an important support for total returns.
- Income portfolio adds diversification of capital and income returns.
- Structural gearing via ZDPs has boosted returns in the long term, although recently its impact has been less positive amid market volatility.

Wider-than-average discount presents opportunity

AIF's shares have traded on average at a c 6–7% discount to cum-income NAV over the past one, three and five years, although within this time frame there have been occasions when the shares have traded at a premium. At 24 April 2019, AIF's ordinary shares traded at a 12.6% discount, suggesting there is scope for a re-rating if sentiment towards UK smaller companies improves. In the meantime, the shares offer an attractive dividend yield of 5.3%, backed up by a portfolio yield of c 5%. The high level of structural gearing has weighed on performance in recent months, but has the potential to boost returns if UK small-cap equities rally.

25 April 2019

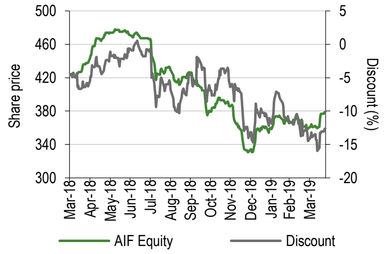
Price	**379.0p**
Market cap	**£60.0m**
AUM	**£99.4m**

NAV*	433.7p
Discount to NAV	12.6%
NAV**	433.7p
Discount to NAV	12.6%

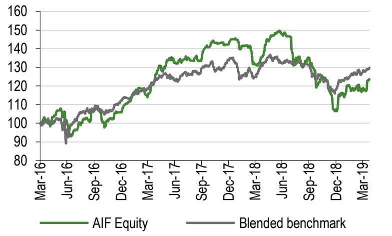
*Excluding income. **Including income (shares are currently ex-dividend). As at 18 April 2019.

Yield	5.3%
Ordinary shares in issue	15.8m
ZDPs in issue	21.2m
Code	AIF
Primary exchange	LSE
AIC sector	UK Equity & Bond Income

Share price/discount performance



Three-year performance vs index



52-week high/low	478.0p	331.0p
NAV** high/low	491.1p	380.1p

**Including income.

Gearing

Gross*	48.5%
Net of cash*	44.7%

*As at 28 February 2019

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Edison profile page

Acorn Income Fund is a research client of Edison Investment Research Limited

Exhibit 1: Company at a glance

Investment objective and fund background

AIF's objective is to provide shareholders with a high income and the opportunity for capital growth. The portfolio is split into two pools: one (c 70–80% of assets) is invested in UK small-cap equities; the other is an income portfolio containing fixed income instruments, convertibles and high-yielding shares in other investment companies. Performance is measured against a composite benchmark made up 75% of the Numis Smaller Companies (excl. investment companies) index and 25% of the ICE BofAML Sterling Non-Gilts index.

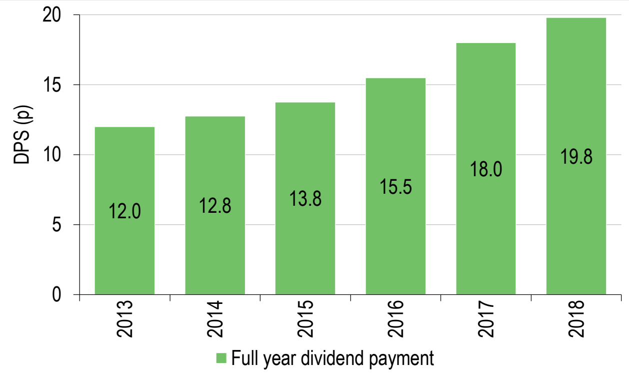
Recent developments

- 11 April 2019: Results for the year ended 31 December 2018. Total return on gross assets (including ZDPs) of -11.3% compared with -15.4% for the Numis Smaller Companies (ex-ICs) index. Ordinary share NAV TR -21.0% and share price TR -27.9%. ZDP NAV TR +3.9% and share price TR +0.2%. Total dividends for year of 19.80p, a 10% increase on FY17.
- 5 February 2019: First interim dividend declared for FY19 of 5.2p per share, an increase of 5.1% on Q118's 4.95p.
- 5 February 2019: Nigel Sidebottom appointed as a non-executive director.

Forthcoming		Capital structure		Fund details	
AGM	August 2019	Ongoing charges	1.57%	Group	Premier Asset Management
Annual results	April 2019	Gross gearing	48.5% (via ZDPs)	Managers	Simon Moon, Fraser Mackersie (Unicorn), Paul Smith & team (Premier)
Year end	31 December	Annual mgmt fee	0.7% of total assets	Address	Eastgate Court, High Street, Guildford, GU1 3DE
Dividend paid	Quarterly	Performance fee	Yes (see page 9)		
Launch date	11 February 1999	Company life	Indefinite, subject to vote	Phone	+44 (0) 1483 30 60 90
Continuation vote	Five-yearly, next 2021	Loan facilities	None	Website	www.premierfunds.co.uk

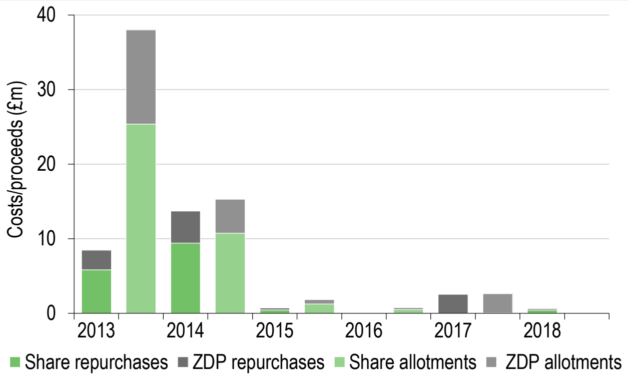
Dividend policy and history (financial years)

Quarterly dividends are paid in March, June, September and December.

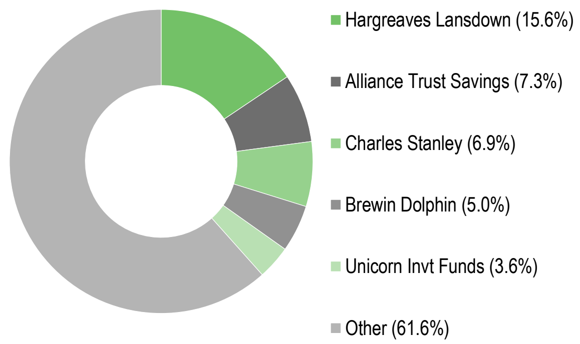


Share buyback policy and history (financial years)

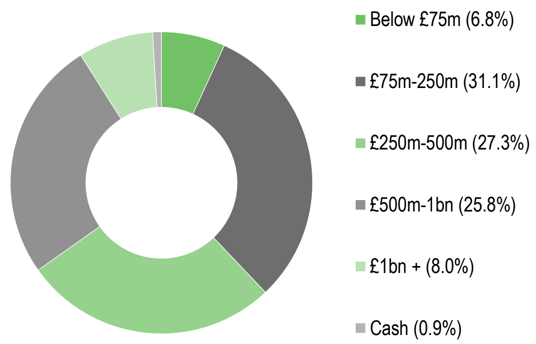
ZDPs are issued and bought back at the same time as ordinary shares, in quantities such that the ratio of ZDPs to ordinary shares is maintained.



Shareholder base (as at 2 April 2019)



Portfolio exposure by market capitalisation (as at 31 December 2018)



Top 10 holdings* (as at 28 February 2019)

Company	Sector	Market cap (£m)	% of gross 28 Feb 2019	% of portfolio 28 Feb 2019	% of gross 28 Feb 2018**	% of portfolio 28 Feb 2018**
Ocean Wilsons Holdings	Industrials	403.0	2.8	3.7	N/A	N/A
Somero Enterprises	Industrial engineering	213.5	2.4	3.2	3.2	3.9
Telecom Plus	Utilities	1,160.9	2.4	3.2	N/A	N/A
James Halstead	Building materials	957.2	2.2	2.9	N/A	N/A
4imprint	Media	674.1	2.1	2.8	N/A	N/A
Dairy Crest	Food producers	973.6	2.1	2.8	N/A	N/A
Primary Health Properties	Real estate investment trusts	1,459.58	2.1	2.8	N/A	N/A
Macfarlane Group	General industrials	151.2	2.1	2.6	3.0	3.7
Mucklow A&J Group	Real estate investment trusts	321.5	2.0	2.6	2.0	2.4
Polar Capital Holdings	Financial services	488.2	2.1	2.5	N/A	N/A
Top 10 (% of holdings)			**22.2**	**29.1**	**23.5**	**28.7**

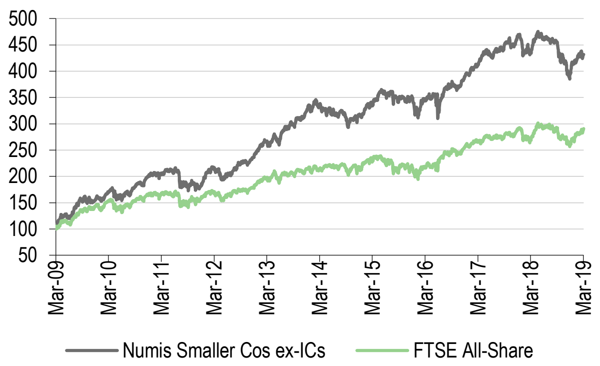
Source: Acorn Income Fund, Edison Investment Research, Bloomberg, Morningstar. Note: *All of the top 10 at 28 February 2019 are in the smaller companies portfolio. **N/A where not in end-February 2018 top 10. Market cap data as at 25 March 2019.

Market outlook: Scope for small-caps to rally

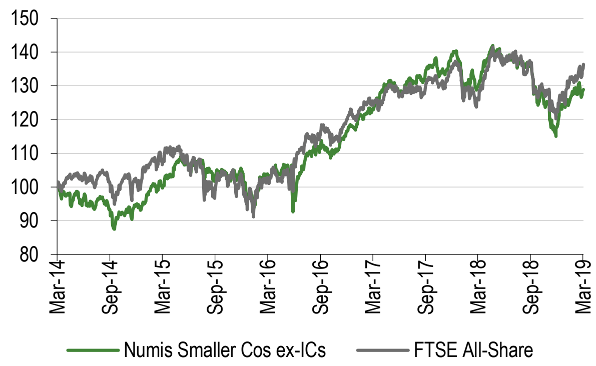
Over the long term (Exhibit 2, left-hand chart), investors in UK smaller companies have been well rewarded for the extra risk of investing in businesses that may be at an earlier stage of development, with total returns of c 330% from the Numis Smaller Companies (excluding investment companies) index (NSCIX), compared with c 190% for the broad FTSE All-Share index over the 10 years to 31 March 2019. However, as shown in the right-hand chart, the second half of this period has produced sharply contrasting results, with the NSCIX returning c 28% versus the FTSE All-Share's c 34%. Two factors are arguably behind this phenomenon, both of them in some way related to the UK's vote in 2016 to leave the European Union. Firstly, larger stocks tend to derive much more of their earnings from overseas, and the value of these earnings has been boosted for UK-based investors by the weakness of sterling since the Brexit vote. Secondly, smaller companies – because on average they are more domestically focused – are more geared to the fortunes of the UK economy, which has experienced sluggish growth and lacklustre consumer spending, both of which could worsen substantially in the event of an unfavourable Brexit outcome. However, looking only at the indices masks the broad variety of opportunities available at an individual company level. The UK smaller companies universe contains many well-financed, profitable companies with market-leading positions in attractive niches, and the global equity market sell-off in the last quarter of 2018 – combined with the lingering Brexit uncertainty – has meant forward P/E valuations have fallen to a level that may look more compelling for long-term investors. A favourable resolution to the current political chaos could spark a sharp rally in UK assets; meanwhile, dividends should prove a key contributor to total returns in the event of further market volatility.

Exhibit 2: Market performance

Numis Smaller Companies (ex-ICs) and FTSE All-Share index over 10 years



Numis Smaller Companies (ex-ICs) and FTSE All-Share index over 5 years



Source: Refinitiv, Edison Investment Research. Note: Shows total returns in pounds sterling.

Fund profile: Small-cap growth with income discipline

Acorn Income Fund (AIF) is celebrating its 20th anniversary this year, having been launched in 1999 as a Guernsey-domiciled, closed-end fund aiming to achieve income and capital growth by investing mainly in UK smaller companies, with an income portfolio (c 20–30% of assets) to diversify sources of income and limit volatility. It has two classes of share – ordinary shares and zero-dividend preference shares (ZDPs), which act as a source of gearing. The fund is managed in two parts, with the small-cap portfolio (c 70–80% of assets) under investment adviser Unicorn Asset Management (with Simon Moon and Fraser Mackersie as portfolio managers), and the income portfolio advised by Paul Smith and his team at Premier Fund Managers, a subsidiary of AIF's manager, Premier Asset Management.

Until recently, the fund had formally measured its performance versus the Numis Smaller Companies (excluding investment companies) index (NSCIX), while also taking account of the performance of the FTSE All-Share, FTSE Small Cap and ICE BofAML Sterling Non-Gilts indices. Since H218 it has formally adopted a blended benchmark, made up of 75% NSCIX and 25% ICE BofAML Sterling Non-Gilts, in line with a neutral allocation between the two portfolios. Portfolio construction is unconstrained, and the benchmarks are used solely as a performance measure. AIF is a member of the Association of Investment Companies' UK Equity & Bond Income sector.

AIF's ZDPs mature in 2022 and have a gross redemption yield of 3.5% (as at 28 February 2019), based on their final capital entitlement of 167.2p. They currently provide gross gearing of c 48.5%. Structuring its gearing in this way means AIF does not have to pay interest costs during the life of the ZDPs, which in turn facilitates the payment of a higher dividend to the ordinary shareholders.

The fund managers: Unicorn and Premier

The managers' view: Finding attractive value opportunities

Moon and Mackersie say they are currently happy with the shape of AIF's smaller companies portfolio, and that while FY18 was a period of relatively low turnover, they made use of the market volatility in the second half of the year, adding to favoured names on share price weakness. The market pullback has brought forward P/E valuations to their lowest level in several years (measured by the relevant Datastream index, the UK stock market is currently at a 12-month forward P/E of 12.9x, compared with a five-year average of 14.1x). The portfolio dividend yield is c 5%, and dividend growth in underlying portfolio companies remains robust at c 8% a year, which the managers say is in line with the long-term trend. Special dividends – which Moon and Mackersie exclude from their income forecasts – are also expected to remain a feature of the portfolio; for example, Somero Enterprises (which reports in US dollars) recently announced an ordinary dividend of 19.0c and a special dividend of 11.7c for FY18, up from 15.5c and 3.6c in FY17, a 60.7% year-on-year increase in total dividends.

The managers have not positioned the portfolio for any particular Brexit outcome, although they remain mindful of the uncertainty and the potential impacts of any resolution – for example, in a positive scenario for the UK, sterling would be likely to strengthen, which would be a headwind for companies whose earnings are largely derived from abroad. (This would have a bigger impact on large-cap UK stocks, which are more internationally exposed; smaller companies' earnings on average are more domestically sourced.) 'We just try to back the best companies we can,' they add.

In the income portfolio, Smith and his team (predominantly Chun Lee on bonds) retain an absolute return bias, with plenty of non-bond holdings in areas such as closed-end funds and structured notes. Lee says that while the bond market sell-off in November and December 2018 meant certain assets looked 'quite exciting', the recent softening of rhetoric from central banks including the US Federal Reserve has 'driven another indiscriminate yield grab', pushing absolute yields to low levels, and tightening spreads to the extent that investors may not be properly compensated for investing in riskier credits. Within bonds, the managers continue to prefer shorter-dated paper, where potential price volatility is limited by the low duration, there is greater liquidity, and in the event of a market sell-off, proceeds from maturing short-dated issues can be reinvested at higher yields. As an example of this, in December the team bought a small position in a Lloyds Bank bond with less than a year to run, offering a yield of c 2%, which compares favourably with 10-year gilt yields, yet has very little duration risk.

Brexit uncertainty has also presented opportunities, particularly in areas such as short-dated convertible bonds. Lee cites a British Land convertible with a yield of 2.5–3.0% and around a year left to run. The bond is trading well above the value of the shares (which are depressed in part because of the company's significant exposure to the troubled retail sector), meaning it is unattractive to equity investors, and would be outside the scope of most bond investors, so the team was able to buy it at a good price and get an attractive yield as a result.

Asset allocation

Investment process: Dual portfolio structure with income focus

The allocation between AIF's two portfolios broadly ranges between 70% and 80% in the smaller companies portfolio and 20–30% in the income portfolio, although the exact split will depend on the opportunities available in each segment. For much of 2017 and the first half of 2018, the smaller companies portfolio accounted for more than 80% of total assets. The allocation is agreed between the board, the manager (Premier Asset Management), and the investment advisers at Unicorn Asset Management and Premier Fund Managers. There is a strong income discipline to the small-cap portfolio, which is expected to provide the majority of both capital growth and income, while the income portfolio aims to provide diversification of capital and income returns, manage the level of structural gearing that exists via the ZDPs, and potentially limit the impact of equity market volatility.

At Unicorn, Moon and Mackersie – who also manage a range of open-ended funds investing in small- and large-cap UK equities for growth and/or income – begin the process of stock selection by using quantitative screens to filter the investment universe of more than 800 companies (broadly the smallest 10% of UK stocks by market capitalisation). As well as income factors such as yield, dividend growth and dividend cover, they also use the filters to assess profitability, valuation and growth potential. From a qualitative perspective, Moon and Mackersie look for well-managed, well-financed, profitable companies, with strong competitive positions in growing end-markets. The managers undertake c 400 meetings and site visits each year with both current and potential investee companies, and their other funds are also an important source of ideas for AIF: among the recent purchases have been longstanding smaller holdings in Unicorn's growth funds that have matured to the point that their dividend yields have become attractive to AIF.

There is a strict 50-stock limit for the small-cap portfolio, which the managers say keeps them focused on companies with the best combination of yield and growth potential. While Moon and Mackersie prefer stocks that offer a compelling dividend yield, they may also invest in companies that do not currently pay dividends, as long as there is a clear path to their doing so. Yield also forms a key component of the sell discipline; the most common reason for the managers to exit a position is where its share price has risen to the extent that the yield no longer looks compelling. Where this is the case, Moon and Mackersie will rotate into better-value, higher-yielding alternatives.

In the income portfolio, Paul Smith and his team look for assets with attractive yields relative to bond market averages. Their unconstrained approach leads them to invest in a variety of areas, including government and corporate debt, closed-ended investment companies and structured notes. Although smaller in terms of assets, the income portfolio tends to have a longer stock list than the small-cap portfolio. This means individual positions may be quite modest (the largest holding in the income portfolio at 28 February was only c £1.0m), allowing the managers to access small issues of securities such as retail bonds, which often pay attractive yields but would be difficult for managers of larger funds to invest in to any meaningful extent. The portfolio is managed with an absolute return focus, and the managers continue to prefer shorter-dated bonds given the slow pace of unwinding of unconventional monetary policy.

Current portfolio positioning

The current split between AIF's two portfolios is c 75% small-cap equities and c 25% income (74% and 26% at end-FY18). At 28 February 2019, there were 50 holdings (the managers' self-imposed maximum) in the smaller companies portfolio and 73 holdings in the income portfolio. The top 10 stocks are all in the small-cap portfolio, and accounted for 22.2% of AIF's gross assets and 29.1% of the smaller companies portfolio. This outwardly looks like a slight decrease in concentration from 23.5% of gross assets a year earlier, but is actually a slight increase from 28.7% of the small-cap portfolio; the discrepancy is because the allocation to the small-cap portfolio has fallen from c 82% to c 75% of gross assets over the period.

As shown in Exhibits 3 and 4, there is a bias towards financial and industrial companies (either as equity holdings or as issuers of debt) in both portfolios. Two of the four new stocks added to the small-cap portfolio in FY18 are from these two sectors: Integrafin, a financial services company that operates the investment platform Transact; and Marshalls, a supplier of building materials. Integrafin was bought at IPO, but subsequently sold after strong performance meant its yield no longer looked attractive. Moon and Mackersie say that while hard landscaping specialist Marshalls might outwardly look unattractive – as a domestically focused UK company with exposure to the consumer – it is genuinely the biggest and best company in its niche, with a very strong balance sheet, and is benefiting from a slower pace of housing market activity, as homeowners focus on improving their existing properties rather than moving. The stock made a positive contribution of 34bp in FY18, and the managers have trimmed the position slightly on the back of strong performance.

Exhibit 3: Sector exposure of small-cap portfolio

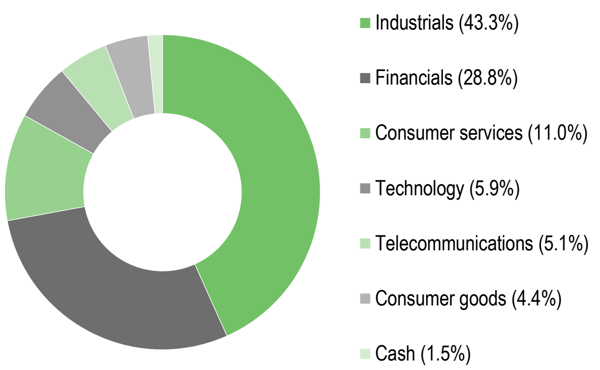
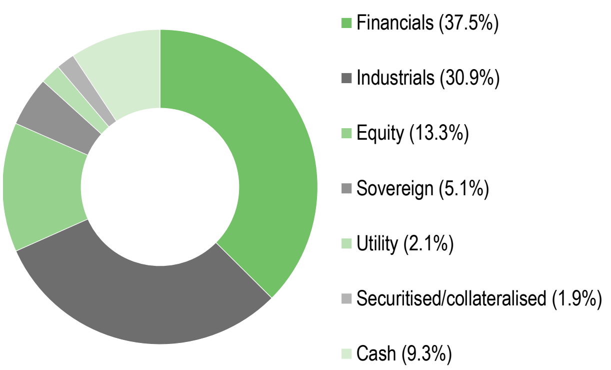


Exhibit 4: Sector exposure of income portfolio



Source: Acorn Income Fund, Edison Investment Research. Note: Data at 28 February 2019.

The other two new holdings in FY18 were over-50s focused travel and insurance company Saga, and iomart, a managed data firm that hosts websites and provides cloud computing services. iomart is a UK technology stock and has been a longstanding holding in the Unicorn UK Growth fund. Moon and Mackersie bought it for AIF after short-term share price weakness and continued dividend growth created an attractive entry point for the fund. Since the turn of the year, the managers have also added a position in cybersecurity company NCC Group. The market reacted badly to the company's half-year results in January, and the subsequent share price fall pushed its dividend yield up to 3.8%. The share price has subsequently bounced back, rising by more than 40% (effectively recouping almost all of the earlier fall) since the team bought the position in February.

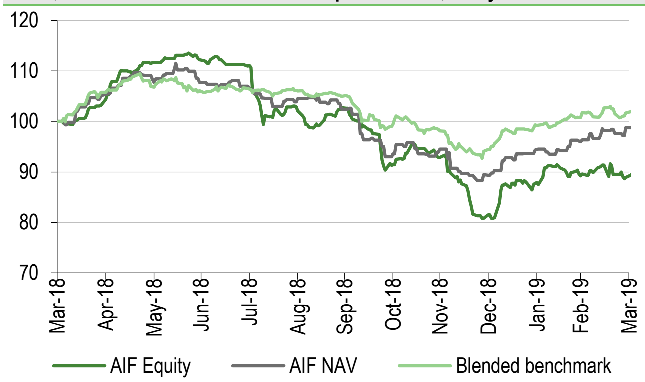
Seven stocks left the portfolio during FY18: Conviviality, after entering administration; Integrafin and specialist audio-visual equipment firm Midwich, which had both performed strongly and suffered yield compression; BBA Aviation, a long-term holding whose strong performance meant it had become too large for AIF at a c £3bn market cap; specialist piling firm Van Elle, whose performance had been flat and which subsequently suffered a profit warning; Low & Bonar, an industrial polymer company with good products but a worsening debt picture; and carpet manufacturer Headlam, where end-market conditions were felt to be too challenging. The managers have also trimmed positions in some strongly performing holdings, such as concrete screeding firm Somero Enterprises, electronics company discoverIE and corporate broker Numis Corporation. In the cases of Somero and Numis, the managers subsequently bought back some shares at more attractive valuations. They have also added to the positions in Dairy Crest and floor-covering specialist James Halstead.

In the income portfolio, the managers continue to focus on limiting interest rate exposure (by holding mainly short-duration bonds) and maintaining an absolute return bias. The largest holding in the portfolio at 28 February 2019 was an 'auto call' structured note linked to an equity index, which returns investors' capital plus an annually increasing percentage return dependent on the index level. The notes have a maturity date of August 2022, but mature early (the 'auto call') if the index level is higher than a predetermined level at the anniversary of the notes' issue. Other major holdings include index-linked UK and US government bonds, and the debt and equity securities of various closed-ended investment funds, including real estate investment trust (REIT) St Modwen Properties, investment trust Value & Income, US activist fund Pershing Square Holdings (where the underlying holdings are hedged by the team), and legal finance specialist Burford Capital.

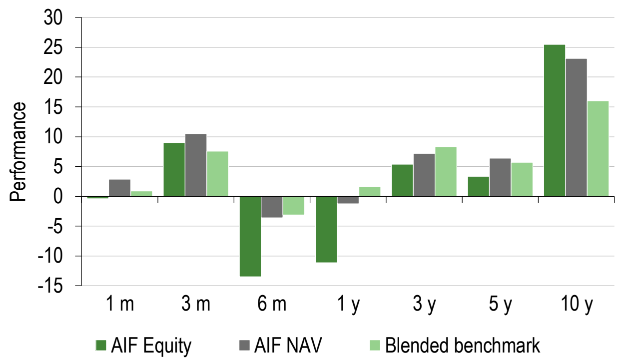
Performance: Bouncing back from negative FY18

Exhibit 5: Investment company performance to 31 March 2019

Price, NAV and benchmark total return performance, one-year rebased



Price, NAV and benchmark total return performance (%)



Source: Refinitiv, Edison Investment Research. Note: Three-, five- and 10-year performance figures annualised. Note: Blended benchmark is the Numis Smaller Companies ex-ICs index (NSCIX) until 31 July 2018 and thereafter is 75% NSCIX and 25% ICE BofAML Sterling Non-Gilts index.

Exhibit 6: 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 Numis Smaller Cos ex-ICs	(0.7)	0.3	(8.4)	(10.0)	(5.1)	(8.0)	125.3
NAV relative to Numis Smaller Cos ex-ICs	2.5	1.7	2.1	(0.0)	(0.2)	6.4	86.6
Price relative to FTSE All-Share	(3.0)	(0.4)	(11.9)	(16.4)	(10.8)	(12.3)	237.2
NAV relative to FTSE All-Share	0.2	1.0	(1.8)	(7.2)	(6.2)	1.5	179.3
Price relative to ICE BofAML £ non-gilts	(2.8)	4.6	(17.0)	(14.3)	1.9	(9.7)	365.3
NAV relative to ICE BofAML £ non-gilts	0.4	6.1	(7.5)	(4.8)	7.3	4.4	285.4

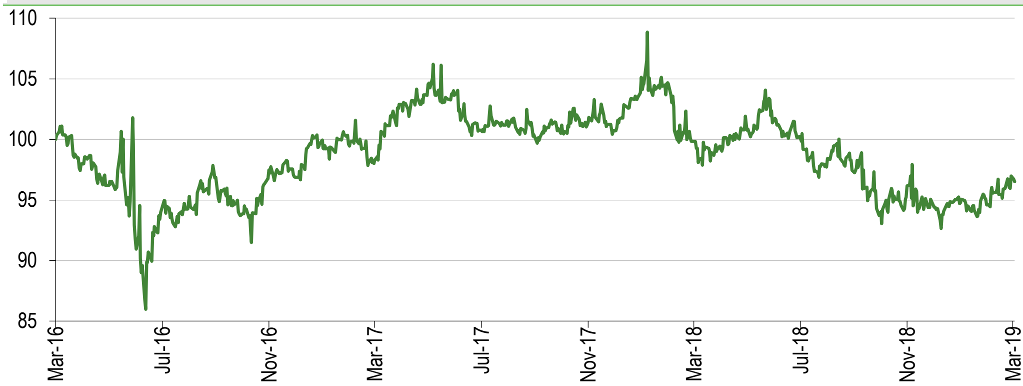
Source: Refinitiv, Edison Investment Research. Note: Data to end-March 2019. Geometric calculation.

AIF posted negative total returns for FY18 (to 31 December), with the share price down 24.5% and the cum-income NAV down 17.5%, compared with a 12.0% decline in the blended benchmark and a 15.4% drop for the Numis Smaller Companies (excluding investment companies) index (NSCIX). This can be attributed to a combination of a general decline in share prices (particularly in the fourth quarter of the year), the effect of gearing in a falling market, and stock-specific issues. The biggest of these was the collapse of drinks distributor Conviviality in April 2018, which had a negative impact of 379bp on the full-year return for the smaller companies portfolio, although the stock contributed positively to performance over the life of the holding. Cosmetics company Warpaint gave up the gains it generated in FY17 (-164bp in FY18 versus +164bp the year before), while Clipper Logistics also detracted, with a negative contribution of 128bp. However, many holdings did contribute positively during the year, with positive contributions of c 40–60bp coming from Telecom Plus, Somero Enterprises, Integrafin (sold during the year), Macfarlane, Midwich (also sold) and Hollywood Bowl. The managers of the income portfolio continued to try to protect investors' capital during a negative period for corporate bond markets, favouring short-duration bonds and more absolute return-focused holdings in investment companies and structured products.

The negative returns in 2018 have also had an impact on medium-term returns for AIF's shareholders (Exhibit 5), with annualised NAV and share price total returns of between 3.4% and 7.2% over three and five years to 31 March 2019, compared with c 9–14% over the same periods to 30 June 2018. The 10-year record remains strong, with NAV and share price total returns of more than 20% a year, compared with 16.0% for the blended benchmark. Share price total returns have underperformed the two components of the blended benchmark (the NSCIX and the ICE BofAML Sterling Non-Gilts index), as well as the broader FTSE All-Share index, over most periods shorter than 10 years shown in Exhibit 6, while the NAV total return has outperformed over five and 10 years but has underperformed over one and three years. Both the share price and NAV have outperformed over the first quarter of 2019, however.

Since the turn of the year, many of AIF's larger positions have performed strongly, which should translate into more positive figures for Q119. Between 1 January and 25 March 2019, of the top 10 holdings, only Ocean Wilsons Holdings saw a fall in its share price (-3.8%), while five of the remaining nine posted double-digit gains, led by Dairy Crest (+48.0% year to date after a takeover bid in February), Macfarlane (+33.3%) and 4imprint (+27.9%).

Exhibit 7: NAV total return performance relative to blended benchmark over three years

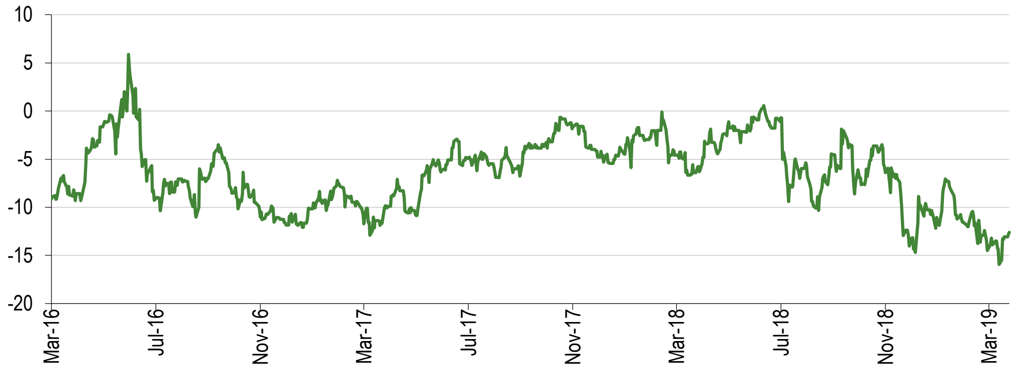


Source: Refinitiv, Edison Investment Research

Discount: Wider than average with scope to narrow

AIF's discount to cum-income NAV widened during the stock market volatility of the second half of 2018, reaching a three-year widest point of 14.7% on 4 January 2019. It subsequently narrowed to c 7% in early February, but has since widened again (reaching a new three-year high of 16.0% on 12 April) as the NAV outperformed the share price, and stood at 12.6% at 24 April. This compares with a one-year average discount of 6.9%; the shares briefly reached a premium to NAV in July 2018. Longer term, the average discounts over three and five years are similar to the one-year average, at 6.5% for both periods, suggesting there is scope for the discount to revert to single digits in all but the most unfavourable Brexit scenarios.

Exhibit 8: Share price premium/discount to NAV (including income) over three years (%)



Source: Refinitiv, Edison Investment Research

Capital structure and fees

Incorporated in Guernsey and listed on the London Stock Exchange, AIF is a closed-ended investment company with two classes of share. At 24 April 2019, there were 15.8m ordinary shares and 21.2m zero-dividend preference shares (ZDPs) in issue. The ZDPs provide AIF's gearing (48.5% gross at 28 February 2019), and mature in 2022 with a gross redemption yield of 3.5% (as at 28 February 2019). The ZDPs had a hurdle rate of -27.5% at 28 February, meaning AIF's total assets would need to decline by more than 27.5% a year over the remaining term of the ZDPs in order for their final capital entitlement not to be met in full. Shares may be allotted or repurchased to manage a premium or a discount; where this occurs, ordinary shares and ZDPs will be issued or bought back in amounts such that the gearing ratio is maintained. No shares have been repurchased since August 2018.

AIF pays a management fee of 0.70% to Premier Asset Management (charged 75% to income and 25% to capital). Premier in turn pays fees to AIF's smaller companies and income portfolio investment advisers, respectively, at Unicorn and Premier. A performance fee of 15% of excess returns may be paid if AIF's NAV per share plus dividends has increased at a compound rate of more than 10% pa since the last year-end at which a performance fee was paid. A performance fee of £559,967 was paid in respect of FY17, meaning the end-FY17 NAV per share of 486.8p becomes the new high water mark. No performance fee was paid in FY18, and ongoing charges for the year were 1.57% (FY17: 1.53% excluding the performance fee).

Dividend policy and record

Dividends on AIF's ordinary shares are paid quarterly, in March, June, September and December. Historically, the dividend was increased at the second interim stage (with the first interim having been paid at the same level as the previous year's fourth interim), but since FY17 the increase has occurred at the first interim stage, meaning four equal dividends have been paid. Total dividends of 19.8p in FY18 were 10% higher than 18.0p in FY17, and dividends have been at least 1.1x covered by income in each of the last five financial years. The dividend grew at a compound annual rate of 10.5% for the five years to FY18. AIF's revenue reserve at end-FY18 was 20.0p per share (1.0x the FY18 total dividend), giving the board the flexibility to continue to increase the dividend even if less favourable market conditions mean revenue returns per share in future years fall short of declared dividends.

So far in FY19, one quarterly dividend of 5.2p per share has been declared. Working on the pattern established since FY17, it would be reasonable to assume all four dividends will be paid at this level, suggesting a total dividend for FY19 of 20.8p, a 5.1% increase on FY18. Based on the current share price and the last four quarterly dividends, AIF's shares have a yield of 5.3%.

Peer group comparison

AIF is a member of the Association of Investment Companies' UK Equity & Bond Income sector, a peer group of funds that seek to generate an income by investing at least 80% of their assets in the UK, in a mixture of equities and bonds. Although small, the sector is diverse, as constituents may invest up to 100% in either asset class (for example, Henderson High Income is c 90% invested in equities, while City Merchants High Yield is c 99% invested in fixed income securities). AIF's closest peer in the sector is the Aberdeen Smaller Companies Income fund (ASCI), which also blends UK small-cap equities with fixed income-type securities, although at c 92% it is more biased towards equities than AIF's neutral 75/25 small-cap/income portfolio allocation.

The fund's NAV total return performance has underperformed the sector average over one and three years, ranking fifth and third of five respectively. It is marginally above average (ranking third) over five years, and comfortably leads the sector (283pp ahead of the average, and 166pp ahead of its closest rival) over 10 years. AIF's high level of gearing (31pp above the average) via its ZDPs may have contributed to its underperformance in recent market falls, although the collapse of Conviviality in April 2018 will also have had a significant impact on the one-year figure. Ongoing charges are the highest in the group, and a performance fee may also be paid. AIF's discount to NAV is currently the second-widest in the group; the fact that ASCI is the only peer with a wider discount suggests that investors continue to be wary of small-cap UK equities amid the ongoing Brexit uncertainty. AIF's dividend yield is in line with the average for the sector, but is more than 2.5pp higher than ASCI's.

Exhibit 9: UK Equity & Bond Income peer group as at 17 April 2019*

% unless stated	Market cap £m	NAV TR 1 year	NAV TR 3 year	NAV TR 5 year	NAV TR 10 year	Ongoing charge	Perf. fee	Discount (cum-fair)	Net gearing	Dividend yield
Acorn Income Fund	**59.5**	**(0.9)**	**26.1**	**43.5**	**675.3**	**1.6**	**Yes**	**(13.0)**	**149**	**5.3**
Aberdeen Smaller Companies Inc	60.9	0.2	46.7	59.0	508.9	1.3	No	(15.8)	107	2.7
City Merchants High Yield	179.4	3.5	24.4	32.2	298.4	1.0	No	(2.1)	100	5.4
CQS New City High Yield	246.9	5.1	26.7	30.3	192.3	1.2	No	6.7	109	7.5
Henderson High Income	224.1	7.7	24.1	43.9	289.0	0.8	Yes	(4.2)	125	5.6
Sector average (5 funds)	**154.2**	**3.1**	**29.6**	**41.8**	**392.8**	**1.2**		**(5.7)**	**118**	**5.3**
AIF rank in sector	**5**	**5**	**3**	**3**	**1**	**1**		**4**	**1**	**4**

Source: Morningstar, Edison Investment Research. Note: *Performance to 16 April 2019. TR = total return. Net gearing is total assets less cash and equivalents as a percentage of net assets (100 = ungeared).

The board

AIF has four non-executive directors, three of whom are deemed independent of the manager. Helen Green (appointed to the board in 2007 and chairman since 2012), Nigel Ward (appointed in 2011) and David Warr (appointed in 2012) are all resident in Guernsey, where the fund is incorporated. In February 2019 they were joined by UK resident Nigel Sidebottom, who until his retirement at the end of 2018 was deputy chief investment officer and head of closed-end funds at Premier Asset Management, AIF's investment manager. Because of his recent involvement with Premier, Sidebottom is deemed non-independent. The other directors' professional backgrounds are in investment management and accountancy. Green has announced her intention to stand down from the board at AIF's August 2019 AGM; a search is under way for a further director to replace her.

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