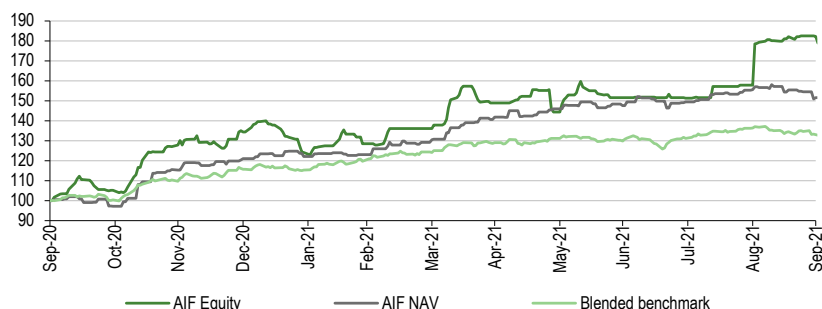


Acorn Income Fund

Time to act following wind-up proposals

Acorn Income Fund (AIF) ordinary shareholders have less than a week to decide whether to cash in their investment or roll over into the open-ended Unicorn UK Income Fund run by AIF's small-cap portfolio managers, Fraser Mackeris and Simon Moon. The proposals are subject to a vote in favour of discontinuation at the AGM and subsequent EGM approval (proxy forms to be returned by 8 October) and elections for the rollover or cash exit must be received by the registrar by 11 October. AIF's 2022 zero-dividend preference share (ZDP) holders need take no action at present. In this note, we outline the background to and substance of the proposals, as well as considering how the Unicorn fund stacks up against the AIF portfolio.

AIF's shares have re-rated since the rollover option was announced



Source: Refinitiv, Edison Investment Research. Total returns in sterling.

AIF: the story so far

Acorn Income Fund was launched in 1999 as a UK smaller companies fund with an additional income portfolio (neutral allocation 75:25). Managed by John McClure from launch until his death in 2014, the small-cap portfolio has been run since then by McClure's former deputies, Simon Moon and Fraser Mackeris at Unicorn Asset Management, with the income portfolio managed by Premier Fund Managers (now Premier Miton Investors). Performance was challenging at times for the small-cap portfolio in the period from the Brexit vote in 2016 to the COVID-19 pandemic, and [in May 2021](#), AIF's board brought forward a proposal to hand over the fund to BMO Global Asset Management, changing its mandate to a global sustainable income focus. However, a lack of support for this change led to revised proposals at the start of September, giving investors the choice of a cash exit or a degree of continuity via a rollover to Mackeris and Moon's Unicorn UK Income OEIC.

The analyst's view

Although a small fund (total assets of c £100m including the gearing from c £35m of ZDPs), it seems clear that AIF has a core of shareholders who like its small-cap UK income angle and were less than enthused by the prospect of switching to a large-cap global strategy, whatever its sustainability credentials. While those who choose (or default to) the rollover option will lose some of the features of the closed-end structure, such as the ability to gear and to hold smaller, less liquid stocks, they should benefit from transferring into the OEIC at close to NAV (and with no trading costs), thus wiping out the remaining discount at which the shares currently trade.

Investment trusts UK small-cap income

4 October 2021

Price Ord. 402.5p
Market cap £63.7m
AUM £102.2m

NAV* 425.5p

ZDP NAV 164.6p

Discount to NAV 5.4%

*Including income. At 30 September 2020.

Yield (ord shares) 6.1%

Shares in issue 15.8m

ZDPs in issue 21.2m

Code AIF/AIFZ

Primary exchange LSE

AIC sector UK Equity & Bond Income

52-week high/low 419.5p 248.5p

NAV* high/low 454.6p 293.8p

*Including income.

Gearing

Gross gearing at 30 Sept 2021 51.9%

Fund objective

Acorn Income Fund'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: 75% of the Numis Smaller Companies (excluding investment companies) Index and 25% ICE BofAML Sterling Non-Gilts Index.

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

Background to the proposals

In the FY20 annual report, AIF's board announced that it had initiated a strategic review to determine the next steps for the fund ahead of the five-yearly discontinuation vote scheduled for the August 2021 AGM (since postponed). Shareholders had overwhelmingly backed continuation at the previous vote in 2016, but the period following the referendum on European Union membership had seen UK companies (and smaller ones in particular) fall out of favour with investors, leading to a widening discount to NAV for AIF's shares even though NAV performance remained ahead of the blended benchmark (75% Numis Smaller Companies (excluding investment companies) Index and 25% ICE BofAML Sterling Non-Gilts Index). While the landslide Conservative election victory and the agreement of trade terms with the EU at the end of 2019 appeared to herald a more positive period for UK companies, the onset of the COVID-19 pandemic in early 2020 caused a severe shock in financial markets, with AIF's portfolio selling off by more than its comparator index (Exhibit 2), compounded by a hit to its income as many companies cut or suspended dividend payments.

Exhibit 1: Performance pre-EU referendum

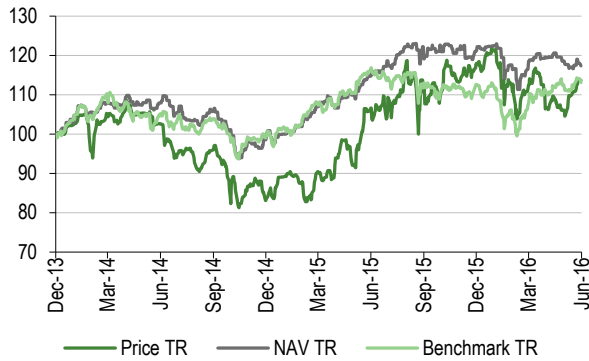
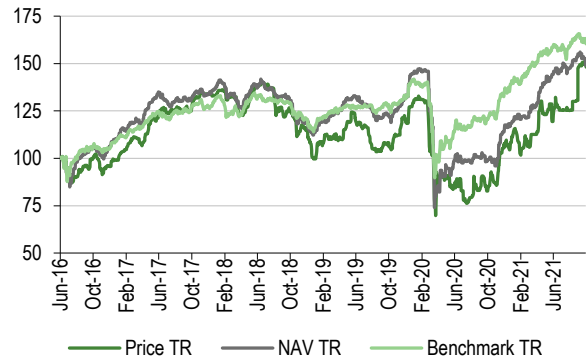


Exhibit 2: Performance post-EU referendum



Source: Refinitiv, Edison Investment Research

The strategic review sought to consider the appropriateness of the investment management structure and investment objectives, with the aim of addressing the discount, expanding the investor base and facilitating the future growth of the fund. With the previous level of dividends deemed unsustainable following COVID-related cuts, the board also sought to determine the appropriate level of sustainable yield, as well as the amount and structure of gearing and its impact on portfolio income.

Exhibit 3: Ordinary share discount to NAV over five years



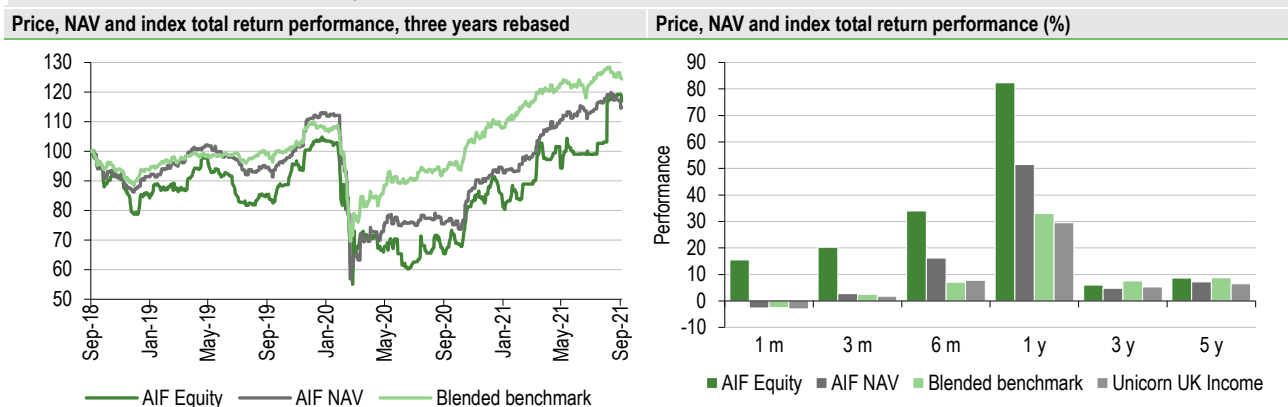
Source: Refinitiv, Edison Investment Research

In an update to the market in May 2021, AIF’s board said the strategic review had led to the conclusion that ‘the current arrangements will not deliver a product with wide appeal to investors and that maintaining the status quo will leave [AIF] facing the same problems of scale and liquidity that have challenged it in recent years’. Instead, it proposed a change in strategy and manager, with the new mandate to be a sustainable global equity income fund run by BMO Global Asset Management, ‘investing principally in a global portfolio of publicly listed companies that offer an attractive level of income and make a positive impact on society and the environment’. However, feedback from investors led the board to announce in August that ‘despite...continuing to believe that the BMO proposal is an attractive investment proposition...an alternative proposal...may represent a more suitable proposition for [AIF’s] shareholders’. This was then followed on 1 September by the announcement of a proposed scheme of liquidation with a rollover option into the Unicorn UK Income fund, set out in more detail below.

What are investors’ options?

AIF’s ordinary shareholders may choose either to roll over their investment into the open-ended Unicorn UK Income Fund (which we consider in more detail below) or to take a cash exit. Those who make no election will be deemed to have chosen the rollover option. In either case, the value of the investment will be calculated after deducting the final capital entitlement of the ZDPs (c £35.5m) as well as setting aside a liquidation pool to cover the quantifiable costs of the scheme and a retention pool for any unforeseen administration costs (not expected to exceed £10,000). In total the costs are not expected to exceed £500,000, of which Unicorn Asset Management has agreed to contribute up to £100,000 (subject to a minimum of £50,000, the final level to be determined by the take-up of the rollover option). Taking a median contribution from Unicorn of £75,000 and applying these figures to AIF’s total assets at 1 October 2021 of c £102.2m would give residual assets of c £66.3m (after deducting the final capital entitlement of the ZDPs and the estimated liquidation and retention pools), which is c 1.5% below the 1 October net assets of c £67.3m. While AIF’s ordinary share discount to NAV has narrowed appreciably since the scheme’s announcement (from 18.6% at 31 August 2021 to 5.4% at 1 October), the estimated residual NAV per share (419.3p) would still represent a c 4.2% uplift on the 1 October share price of 402.5p, with shareholders on the register at 1 October also due to receive a dividend of 7.5p per share on 8 October. Furthermore, Unicorn has agreed to waive the management fee on shares in the Unicorn UK Income Fund for a period of 12 months for AIF shareholders who choose the rollover option.

Exhibit 4: Investment company performance to 30 September 2021



Source: Refinitiv, Edison Investment Research. Note: Three- and five-year performance figures annualised.

The principal difference between AIF and the Unicorn UK Income Fund is of course that AIF has two portfolios (smaller companies and income), while the OEIC is a more straightforward equity

fund. For this reason, we will consider only AIF's smaller companies portfolio; fund manager Premier Miton has indicated that the income portfolio is currently being managed to maximise liquidity ahead of the overall mandate moving to Unicorn Asset Management on 13 October. (It is anticipated that Unicorn will oversee the portfolio as the fund is liquidated; however, the new management agreement will take effect even if the proposals are not passed by shareholders.)

The Unicorn UK Income Fund is a much larger vehicle than AIF, with more than £500m of assets under management. However, Unicorn has said that the two portfolios have roughly two-thirds of their holdings in common, which should give investors some comfort as to continuity of approach, as well as limiting the impact of dealing costs during the rollover. Looking at the two funds' performance (Exhibit 4, right-hand chart), AIF's NAV total returns have been similar to the total returns of the OEIC over three and five years, although the closed-end fund has outperformed markedly over more recent periods. While some of this may be attributable to differences between the two funds' holdings, it is more likely to reflect the effect of AIF's high level of gearing (currently c 52% of net assets, down from c 70% a year ago) in a rising market.

Exhibit 5: AIF smaller companies portfolio top 10 holdings (as at 31 August 2021)

Company	Sector	Market cap (£m)*	Portfolio weight %
Polar Capital Holdings	Financial services	799	4.4
Chesnara	Life insurance	432	3.6
Telecom Plus	Utilities	939	3.5
Somero Enterprises	Industrial engineering	309	3.4
Warpaint London	Personal care	135	3.4
Sabre Insurance Group	Non-life insurance	555	3.4
Vesuvius	Industrial engineering	1,339	3.4
Primary Health Properties	Real estate investment trusts	2,048	3.1
Severfield	Construction & materials	242	2.9
Ocean Wilsons Holdings	Industrials	347	2.8
Top 10 (% of portfolio)			33.9

Source: Acorn Income Fund, Edison Investment Research, London Stock Exchange. Note: *Market cap at 29 September 2021.

In Exhibits 5 and 6 we compare the two funds' top 10 holdings at 31 August 2021 (the latest available data). Because this is prior to the announcement of the liquidation scheme, it will exclude any potential further alignment of the AIF smaller companies portfolio with the OEIC that may have occurred since 1 September. While there are five holdings in common, it is worth noting that the five smallest companies in AIF's top 10 holdings (Warpaint London, Severfield, Somero Enterprises, Ocean Wilsons Holdings and Chesnara) do not appear in Unicorn UK Income Fund's top 10, and only one of the OEIC's top 10 holdings, Numis Corporation, has a market cap below that of any of these companies. This is understandable given the far greater size of the OEIC's portfolio; while AIF can hold a meaningful 3.4% of its small-cap assets in the tiny (£135m) Warpaint London, a similar weighting in Unicorn UK Income Fund would represent c 12.5% of the company. So while the OEIC shares AIF's bias towards smaller and mid-cap companies, the average market cap of its top 10 holdings is £1.7bn compared with £715m for AIF.

Exhibit 6: Unicorn UK Income Fund top 10 holdings (as at 31 August 2021)

Company	Sector	Market cap (£m)*	Portfolio weight %
LondonMetric Property	Real estate investment trusts	2,199	5.1
Phoenix Group Holdings	Life insurance	6,398	5.0
Brewin Dolphin Holdings	Financial services	1,143	4.9
Telecom Plus	Utilities	939	4.2
Polar Capital Holdings	Financial services	799	4.2
Sabre Insurance Group	Non-life insurance	555	3.9
Primary Health Properties	Real estate investment trusts	2,048	3.8
Vesuvius	Industrial engineering	1,339	3.7
FDM Group	Software & computer services	1,356	3.1
Numis Corporation	Financial services	413	3.0
Top 10 (% of portfolio)			40.9

Source: Acorn Income Fund, Edison Investment Research, London Stock Exchange. Note: *Market cap at 29 September 2021.

The dividend yield on Unicorn UK Income Fund is c 3.7%, with distributions made quarterly (as is the case with AIF currently). While AIF's gearing (and to an extent its income portfolio) has historically allowed it to pay a higher dividend (total distributions of 23.0p in FY20 would represent a 5.7% yield on the current share price), the board had cautioned in the 2020 annual report that following the widespread UK dividend cuts as a result of the COVID-19 pandemic, 'a return to a sustainable and covered dividend will necessitate a lower dividend payment in future years'.

The 7.5p dividend announced on 23 September is in effect a distribution of AIF's remaining revenue reserves in anticipation of the fund's liquidation, and brings total dividends for the year to 24.75p per share, a yield of 6.1% on the current share price.

Next steps for AIF shareholders

While investors who wish to roll their AIF shareholding into the Unicorn UK Income Fund can in theory do so by taking no action, it is worth noting that the proposal is still subject to two votes: first, a vote in favour of discontinuation at the AGM on 12 October, and second, a vote in favour of the proposals at the EGM immediately following the AGM. Should both votes be passed by shareholders, those wishing to take a cash exit must elect to do so in order to avoid defaulting to the rollover option. Key dates are as follows:

- **1 October:** Record date for receipt of interim dividend.
- **8 October:** Dividend paid. Proxy voting forms for the AGM and EGM must be received by 10am (EGM: 10:10am).
- **11 October:** Forms of election (for either the cash or rollover option) must be received by 1pm.
- **12 October:** Trading in shares suspended. AGM (discontinuation vote) and EGM (vote on the proposals). Assuming both votes are passed, the scheme becomes effective and the shares will be reclassified (as either the liquidation pool or the rollover pool) according to elections made or deemed to have been made.
- **10 November (on or around):** Final NAV and residual values per share published.
- **11 November:** Rollover fund transferred into Unicorn UK Income Fund.
- **15 November (on or around):** Unicorn UK Income Fund shares issued to continuing investors and/or cash paid (or cheques despatched) to those choosing a cash exit.

The full circular regarding the proposals can be accessed via AIF's [website](#).

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