Acorn Income Fund

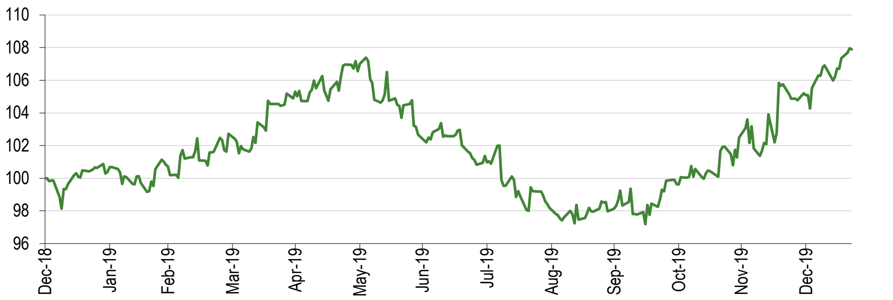
Small-cap growth backed by c 5% yield

Investment trusts
UK equity & bond income

24 January 2020

Acorn Income Fund (AIF) saw a significant bounce back in performance during 2019, boosted by greater clarity on Brexit following December's general election. In what was also a good year for the operational performance of companies in AIF's small-cap portfolio (c 77% of assets), the fund ended the year with an NAV total return of 27.4%. This was ahead of the benchmark and more than made up for losses in 2018, meaning the fund has also regained its medium- and longer-term record of outperformance. While the smaller companies managers (Simon Moon and Fraser Mackersie at Unicorn Asset Management) are very positive on the prospects for both capital and income in the year ahead, the income portfolio managers (Chun Lee and Robin Willis at Premier Miton) are less sanguine, and remain focused on absolute returns as a result.

Beyond the Boris bounce: AIF outperformed in 2019



Source: Refinitiv, Edison Investment Research. Performance relative to blended benchmark.

The market opportunity

UK small-cap equities have been out of favour with both domestic and international investors since before the UK's referendum on EU membership in 2016, yet this broad universe of c 800 companies contains many well-financed, cash-generative companies with significant re-rating potential. While the December election result had an immediate impact on valuations, smaller companies are still playing catch-up versus mid-caps, despite arguably superior growth prospects.

Why consider investing in Acorn Income Fund?

- Dual portfolio structure offers small-cap growth and income alongside absolute return-focused yield diversification.
- Strong record of long-term performance with potential to benefit further from re-rating of UK small caps.
- Dividend yield of c 5%, paid quarterly and growing at c 10% a year.

High dividend yield and scope for discount to narrow

At 23 January 2020, AIF's ordinary shares were trading at a 12.5% discount to cum-income NAV. While this was in line with the one-year average discount, it is well above longer-term averages (c 7–9%), suggesting significant potential to narrow. Meanwhile, the 5.0% dividend yield is significantly higher than the 1.5% average for UK smaller company investment trusts.

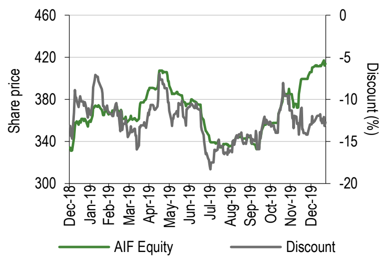
Price	**414.0p**
Market cap	**£65.5m**
AUM	**£105.0m**

NAV*	470.9p
Discount to NAV	12.1%
NAV**	473.1p
Discount to NAV	12.5%

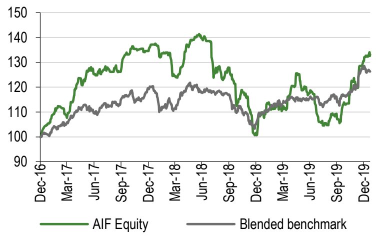
*Excluding income. **Including income. As at 23 January 2020.

Yield	5.0%
Ordinary shares in issue	15.8m
ZDPs in issue	21.2m
Code	AIF
Primary exchange	LSE
AIC sector	UK Equity & Bond Income
Benchmark	Composite (see fund profile)

Share price/discount performance



Three-year performance vs index



52-week high/low	417.0p	332.5p
NAV* high/low	474.4p	387.9p

*Including income.

Gearing

Gross*	48.1%
Net of cash*	35.6%

*As at 30 November 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

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 made up 75% of the Numis Smaller Companies (excluding investment companies) Index and 25% of the ICE BofAML Sterling Non-Gilts Index.

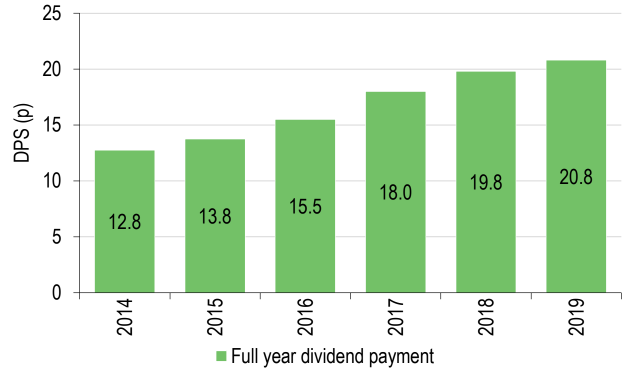
Recent developments

- 8 November 2019: Fourth interim dividend of 5.2p per ordinary share declared, bringing FY19 total dividend to 20.8p, a 5.1% increase on FY18.
- 19 August 2019: Results for the six months ended 30 June. Ordinary share NAV TR +12.43% and share price TR +15.55% versus +10.49% for the Numis Smaller Companies ex-ICs index. Total return on gross assets (including ZDPs) +8.83%. Third interim dividend of 5.2p declared.
- 16 August 2019: Helen Green has retired from the board and been replaced as chairman by Nigel Ward. Sharon Parr has been appointed to the board.

Forthcoming		Capital structure		Fund details	
AGM	August 2020	Ongoing charges	1.59%	Group	Premier Miton Asset Management
Annual results	April 2020	Gross gearing	48.1% (via ZDPs)	Managers	Simon Moon & Fraser Mackersie (Unicorn); Chun Lee and Robin Willis (Premier Miton)
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

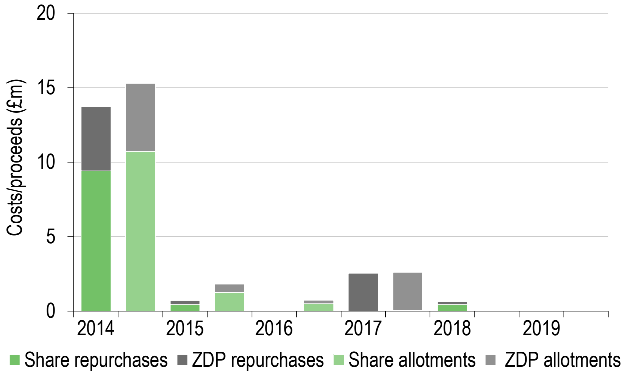
Dividend policy and history (financial years)

Dividends are paid quarterly, in March, June, September and December.

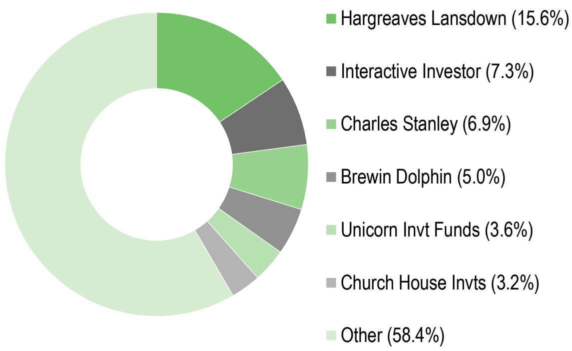


Share buyback policy and history (financial years)

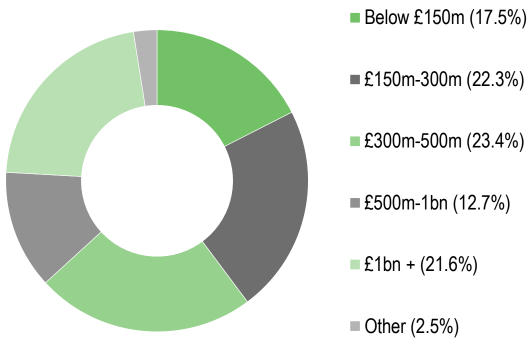
ZDPs are issued and bought back at the same time as ordinary shares, in quantities such that the ratio of ZDPs to ordinary shares is maintained.



Shareholder base (as at 1 January 2020)



Portfolio exposure by market capitalisation (as at 13 December 2019)



Top 10 holdings* (as at 30 November 2019)

Company	Sector	Market cap (£m)	% of gross 30 Nov 2019	% of portfolio 30 Nov 2019	% of gross 30 Nov 2018**	% of portfolio 30 Nov 2018**
Telecom Plus	Utilities	1,193.5	2.7	3.5	2.5	3.1
Goodwin	Industrial metals & mining	248.9	2.3	3.0	N/A	N/A
Polar Capital Holdings	Financial services	550.7	2.2	2.9	2.2	2.7
Severfield	Construction & materials	263.1	2.2	2.8	N/A	N/A
Regional REIT	Real estate investment trusts	495.4	2.2	2.8	N/A	N/A
FDM Group	Software & computer services	1,087.5	2.3	2.8	N/A	N/A
Secure Trust Bank	Banks	303.0	2.2	2.8	N/A	N/A
4imprint	Media	940.9	2.1	2.7	2.3	2.9
Clipper Logistics	Distribution	280.6	2.2	2.7	N/A	N/A
Ocean Wilsons Holdings	Industrials	353.6	2.1	2.6	2.8	3.5
Top 10 (% of holdings)			**22.4**	**28.6**	**23.4**	**29.2**

Source: Acorn Income Fund, Edison Investment Research, Bloomberg, Morningstar, LSE. Note: *All of the top 10 at 30 November 2019 are in the smaller companies portfolio. **N/A where not in end-November 2018 top 10. Market cap data as at 15 January 2020.

Fund profile: Dual structure for income and growth

Launched in 1999, Acorn Income Fund (AIF) is a Guernsey-domiciled closed-end fund that aims to achieve income and capital growth through a dual portfolio structure. The majority (c 70–80%) is invested in a portfolio of dividend-paying UK smaller companies, while the balance (c 20–30%) is held in an income portfolio of bonds and other securities, in order to limit volatility and diversify sources of income. AIF has two classes of share: ordinary shares, on which dividends are payable (current yield of 5.0%), and zero-dividend preference shares (ZDPs), which act as a source of gearing (gross gearing was 48.1% at 30 November 2019).

The smaller companies portfolio is managed by Simon Moon and Fraser Mackersie at Unicorn Asset Management. They have worked on the fund since 2013 and have had sole charge of the portfolio since mid-2014. The income portfolio is managed by Chun Lee and Robin Willis at Premier Miton, who worked together with former team head Paul Smith until his departure during 2019. Premier Miton was formed in November 2019 from the merger of Premier Asset Management Group and Miton Group, and manages asset of c £11bn on behalf of a wide range of individual investors and institutions. Premier Asset Management (Guernsey), a subsidiary of Premier Miton, acts as AIF's investment manager.

AIF measures its performance against a blended benchmark, made up 75% of the Numis Smaller Companies (excluding investment companies) Index (NSCIX), and 25% of the ICE BofAML Sterling Non-Gilts Index, to reflect the neutral 75:25 allocation between the two portfolios. The benchmark acts purely as a performance measure, with portfolio construction being unconstrained and bottom-up. AIF is a member of the Association of Investment Companies' UK Equity & Bond Income sector.

The ZDP shares mature in 2022 and have a final capital entitlement of 167.2p; they currently offer a gross redemption yield of 3.3% (30 November 2019). Using ZDPs to provide gearing means AIF does not have to pay interest costs during the life of the ZDPs, which in turn means the ordinary shareholders are able to receive a higher annual dividend.

The fund managers: Moon, Mackersie, Lee and Willis

The managers' view: Faith in small caps will be rewarded

We met with smaller companies managers Simon Moon and Fraser Mackersie, and income portfolio managers Chun Lee and Robin Willis, on 16 December in the immediate aftermath of the 12 December UK general election. After a rocky couple of years for UK small caps following the Brexit vote in June 2016, Moon and Mackersie welcome the end to uncertainty signalled by the Conservative Party's convincing win.

'Investors in small and mid-caps have been crying out for clarity,' they say, adding that the size of Boris Johnson's majority is also positive, as it lessens the party's reliance on votes from hard-line eurosceptics, and therefore makes it more likely that there will be a more business-friendly Brexit outcome. The managers argue that UK small and mid-caps have been 'a ropey place to be' since about six months before the referendum, and from that perspective they are very pleased with AIF's performance in 2019. They add that despite the more positive outlook and the scope for sterling to strengthen further, valuations are still attractive. 'Smaller companies have been at a significant discount for a long time now. The big move on the day after the election was insufficient to close that c 20% discount, but we think conditions are clearly supportive of a re-rating,' the managers say.

Notwithstanding the political noise, Moon and Mackersie have also been pleased with the operational performance of the companies they hold, and they suggest that the end of the long period of uncertainty should spur investors to increase their allocations to the UK, and will probably increase the amount of merger & acquisition (M&A) activity. This had already ramped up in 2019, leading to four exits from the 48-stock small-cap portfolio. 'We had been expecting some bid activity for a couple of years, but it hadn't occurred,' the managers say. 'We saw a fair amount in the 12 months after the Brexit referendum, where it also tended to be overseas companies taking advantage of the sterling and valuation discounts compounding; then it came back again in 2019 as we reached the point of maximum pessimism about Brexit.'

While the managers remain fairly cautious in how they run the small-cap portfolio, they describe their outlook as being 'as positive as we have been in a long time'. In particular, they say, domestic stocks still look very good value, and there is clearly capacity for valuations to improve, although 'it might take time to filter down to the small stuff'. Moon and Mackersie add that while sterling strength will be a headwind for many FTSE 100 companies, it is less of a problem for 'a domestically focused portfolio of good value stocks like this one'. They explain that the revenue split of AIF's small-cap portfolio is currently about two-thirds domestic earnings to one-third overseas and the income profile still looks strong: 'we have had another good year of income growth supporting our yield, and the outlook for dividends looks robust.'

There is arguably less unreservedly good news in the bond markets, and Lee says he and Willis are 'still really concerned on the economic cycle', given that credit spreads are 'priced for perfection' by investors who are seeking any kind of yield. 'There is no margin for error and any further slowdown in growth will lead to earnings not meeting expectations, and make it harder for companies to pay down debt,' argues Lee. 'Ratings agencies have displayed a lot of goodwill based on earnings projections, but if that doesn't come to fruition and margins are squeezed, there is pressure on the top and bottom line, and the debt comes back into focus.'

For this reason, the managers remain focused on capital preservation and keeping the income portfolio diversified. 'We have a broad, unconstrained universe with plenty of opportunities for managing a relatively small pot of money; we are just being wary of over-exuberance on price, and taking a bit off the top where things get ahead of themselves,' says Willis.

Asset allocation

Investment process: Small-cap focus with income diversification

While the exact proportions invested in AIF's two portfolios will vary depending on the investment opportunities available in each segment, the small-cap portfolio will always account for the majority (working range of c 70–80%), and is expected to supply the lion's share of both capital and income returns. Moon and Mackersie are UK equity specialists and run a range of mandates for Unicorn Asset Management investing across the market cap spectrum, with the aim of achieving growth and/or income. Their focus for the AIF small-cap portfolio is broadly the bottom 10% of UK stocks by market capitalisation, a potential opportunity set of c 800 companies. They begin by filtering this investment universe using quantitative screens, looking at profitability, valuation and growth potential, as well as income factors such as yield, dividend growth and dividend cover. While there is no hard and fast rule on dividend yields, the managers would normally see a c 4% yield as indicating a potentially attractive opportunity. Moon and Mackersie seek well-managed, well-financed, profitable companies with strong competitive positions in growing end markets. Company meetings and site visits (c 400 a year) with both existing and potential investee companies are a key element of the process, although the managers' other funds can also be an important source of investment ideas for AIF.

In order to remain focused on identifying companies with the best combination of yield and growth potential, Moon and Mackersie enforce a strict 50-stock limit on the smaller companies portfolio. This tends to translate into a broadly equal number of new holdings and complete exits each year;

the most common reason for a sale is that a company's share price has risen to the extent that it no longer offers a compelling yield; the managers usually have little difficulty finding better-value, higher-yielding alternatives.

In the income portfolio, the managers aim to provide diversification of capital and income returns, manage the level of structural gearing provided by the ZDPs, and potentially limit the impact of market volatility. Chun Lee (bonds) and Robin Willis (alternatives) look for investments with attractive yields relative to bond market averages. They may invest across a range of assets, including government and corporate debt, structured notes, derivatives and closed-end investment companies. The managers have an absolute return focus in the current environment (an important discipline with many bonds currently offering what Lee describes as 'return-free risk'), and continue to prefer shorter-dated securities given the historically low level of real (inflation adjusted) yields on benchmark assets such as the 10-year gilt.

Current portfolio positioning

At 30 November 2019, AIF had a total of 112 holdings, with 48 stocks in the small-cap portfolio making up 76.9% of total assets, and 64 holdings in the income portfolio accounting for the balance of 23.1%. While the number of smaller company holdings was unchanged from 30 November 2018, the income portfolio fell from 76 holdings over the 12 months.

Exhibit 2: Sector exposure of small-cap portfolio

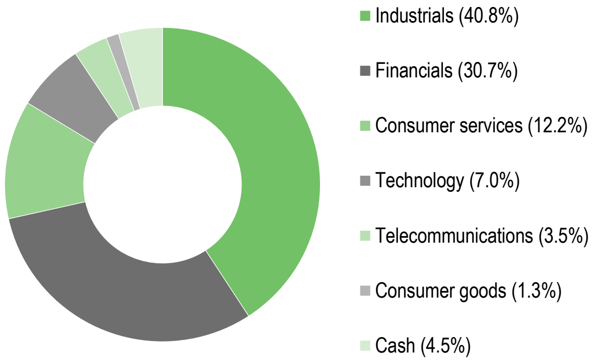
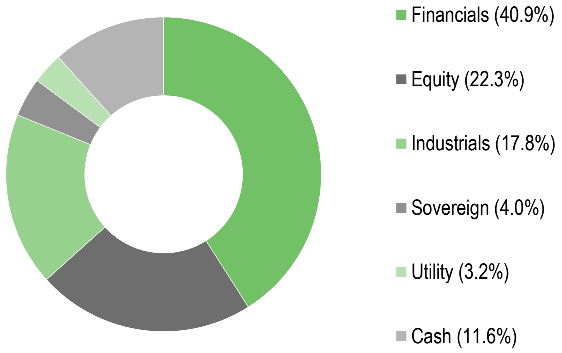


Exhibit 3: Sector exposure of income portfolio



Source: Acorn Income Fund, Edison Investment Research. Note: Data at 30 November 2019.

Sector weightings in the small-cap portfolio (Exhibit 2) remained broadly stable over the 12 months to end-November, with the biggest changes being a 2.8pp decrease in consumer goods, and a 2.4pp increase in cash (this was subsequently put to work in the immediate post-election period, so cash was effectively zero at 13 December 2019). In the income portfolio (Exhibit 3), the biggest changes were a 15.2pp reduction in industrials, and a 7.2pp increase in equity holdings, a category that broadly represents closed-end fund exposure. Again, the high cash weighting of 11.6% fell in early December as funds were transferred to the small-cap portfolio in response to a high level of investment opportunities.

In the small-cap portfolio there was a higher than anticipated level of activity in 2019, with six new holdings and six complete exits. This was driven largely by M&A activity, as four of the sales were as the result of takeover bids (A&J Mucklow, Dairy Crest, Greene King and Manx Telecom), requiring new investments to be made in their place. All of the takeover bids were accretive to performance, adding a total of 415bp to returns. The other exits were Saga (which had suffered a prolonged period of disappointing performance), and set-top box maker Amino Technologies. Moon and Mackersie say that while they like Amino's management team, the market for pay TV is evolving from a hardware- to a software-based model (eg Netflix), and 'being a small player in a rapidly changing market can be a tough place to be'.

The six new holdings are diverse, including companies involved in IT, engineering, real estate, aviation, leisure and broadcasting. NCC Group is a spinoff from the government-owned National Computing Centre, and is owned by the managers in some of their open-ended funds. They note that following some short-term issues in January 2019, it reached a 4% dividend yield for only the first or second time in its history. ‘We took a position, viewing the issues as short term, and have been rewarded well (+79bp of performance),’ they explain.

Engineering firm Goodwin is also held in another Unicorn fund. Moon and Mackersie say the company is a very specialist, high-quality engineer whose core business is slurry pumps for mining, and also dredging.

As with NCC Group, the managers took the rare opportunity to add real estate specialist Henry Boot at an attractive yield. Rather than being exposed to a large amount of development risk (although it has a small housebuilding business), Henry Boot’s core activity is acquiring land, getting planning permission and then selling it on. ‘We have looked at it for years but it has never been quite there on yield,’ say Moon and Mackersie, adding that they were able to buy the stock during a period of heightened pessimism surrounding UK domestic activity.

Two of the new holdings have previously featured in AIF’s portfolio. Signature Aviation (formerly BBA Aviation) was sold in 2018 having outgrown the small-cap designation; it has since divested a major division to focus on its core business of operating private airports in the US, and is now smaller again. ‘We are comfortable to hold it; we know it very well,’ the managers say. Meanwhile, Cineworld was added back to the portfolio in December on share price weakness. The company had fallen from favour in the market after several debt-funded acquisitions; however, Moon and Mackersie argue that the company has a very favourable income profile and generates enough cash to pay down the debt. ‘We don’t usually like companies with a lot of debt, but we are very comfortable with Cineworld’s ability to pay it,’ they say.

The final new small-cap holding is Scottish broadcaster STV. ‘People in Scotland watch a lot of TV,’ jokes Mackersie. Under a relatively new CEO, ex-ITV Digital chief Simon Pitts, the managers say there is a great opportunity to grow the business and make more original content. ‘It has a strong yield and should benefit from a more sensible political backdrop – advertising spend is always better in a more stable political environment,’ they add.

In the income portfolio, Lee and Willis note that little has changed in terms of the continuing move towards more absolute-return strategies. Willis has taken positions in alternative strategies such as Hipgnosis Songs Fund and SDCL Energy Efficiency Income Trust to supplement the yield on the bond portfolio. He has also recently taken positions in the ZDP shares of specialist financials fund EJF Investments and the global value fund UIL, both with gross redemption yields above 3.5%. Willis bought JPMorgan Global Core Real Assets on its initial public offering (IPO) in September 2019 but exited a few weeks later after the shares had appreciated by c 8% on the 100p issue price; they have since fallen back somewhat to c 103p and the manager is considering reinvesting at this lower level. Another exit was from long-term holding JPMorgan Global Convertibles Income, which wound up in October 2019. ‘We got out at NAV, so that was an uplift,’ says Willis. He notes that a number of funds are trading on wide discounts and have forthcoming continuation votes that could prove a catalyst to unlocking value. ‘If we saw something where the underlying strategy fits the mandate and there is a reason to see the discount narrow, that is the kind of strategy we like,’ he says.

Performance: Back to winning ways after Q419 surge

Exhibit 4: Five-year discrete performance data

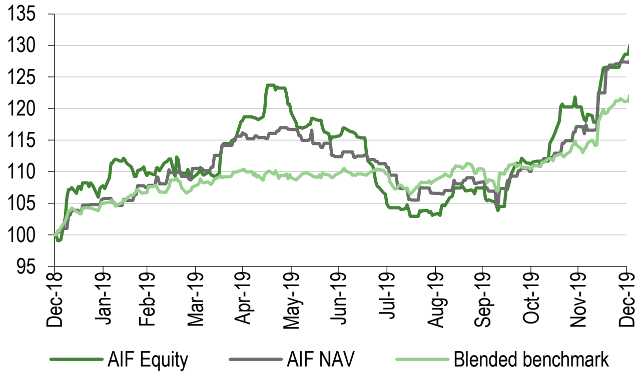
12 months ending	Share price (%)	NAV (%)	Acorn ZDPs (%)	Blended benchmark* (%)	Numis Smaller Cos ex-ICs (%)	FTSE All-Share (%)
31/12/15	36.0	22.5	1.9	10.6	10.6	1.0
31/12/16	(7.2)	6.2	5.8	11.1	11.1	16.8
31/12/17	34.5	24.2	8.5	19.5	19.5	13.1
31/12/18	(24.5)	(17.5)	0.2	(12.0)	(15.3)	(9.5)
31/12/19	28.6	27.4	2.6	21.2	25.2	19.2

Source: Refinitiv. Note: All % on a total return basis in pounds sterling. *See Exhibit 5.

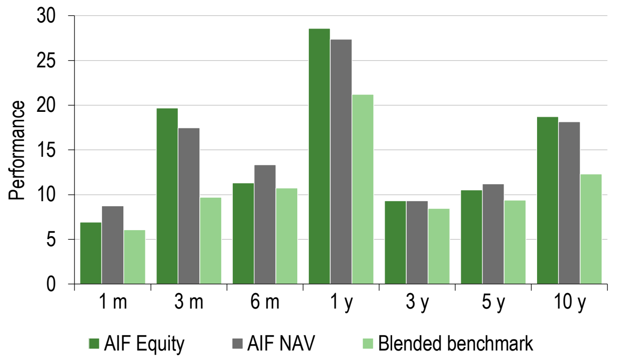
AIF's performance rebounded strongly in 2019, following a disappointing 2018 when market volatility late in the year, as well as the failure of major holding Conviviality, led to negative returns in both absolute and relative terms. FY19 performance was particularly good towards the end of the year, with the UK general election result removing some of the political and Brexit-related uncertainty that had depressed sentiment towards small UK companies, particularly those with mainly domestic operations. AIF's 27.4% NAV total return for the year was ahead of the blended benchmark (see front page chart) and the NSCIX, and also outperformed the FTSE All-Share Index, in spite of particularly strong returns from the mid-cap FTSE 250 element of the broad UK index (+28.9%).

Exhibit 5: Investment company performance to 31 December 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.

The rebound was sufficient to re-establish AIF's medium-term record of outperformance (Exhibits 5 and 6), with returns ahead of the blended benchmark over all periods shown. While the 10-year performance still partly reflects the small-cap portfolio's performance under founding manager John McClure, who passed away in 2014, Moon and Mackersie have now been in charge for more than five years, and can thus take credit for most of AIF's 11.2% pa NAV total return over this period.

In terms of contributors to performance in FY19 to date (all as at 13 December 2019), seven small-cap holdings added more than 100bp each to small-cap portfolio returns. The top contributor was 4imprint (+167bp), which makes branded promotional goods such as caps and fleeces, predominantly in the US. A successful TV advertising campaign led to strong sales growth and a re-rating; the managers took profits as a result, trimming the position by around one-third during the year, although it remains a top 10 position.

Paving company Marshalls added 119bp to returns, but has also been trimmed as strong capital performance in quite a short period compressed the yield. Packaging firm Macfarlane Group and Secure Trust Bank both contributed 108bp; Moon and Mackersie say Macfarlane continues to deliver on its strategy and has a good record of bolt-on acquisitions, while specialist UK lender Secure Trust Bank is well placed in a more settled political backdrop because of its domestic focus.

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	(1.1)	5.6	(1.8)	2.7	3.1	6.0	75.4
NAV relative to Numis Smaller Cos ex-ICs	0.6	3.7	0.0	1.8	3.1	9.2	67.0
Price relative to FTSE All-Share	3.5	14.9	5.5	7.9	7.0	14.6	154.8
NAV relative to FTSE All-Share	5.2	12.8	7.4	6.9	7.0	18.1	142.8
Price relative to ICE BofAML £ non-gilts	7.0	20.5	8.1	17.5	16.1	31.7	198.1
NAV relative to ICE BofAML £ non-gilts	8.8	18.3	10.0	16.4	16.1	35.7	184.0

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

The position in healthcare-focused REIT Primary Health Properties (+106bp) was reduced by c 25% on share price strength; the managers note it has had 'quite an active year', including the takeover of peer fund MedicX, but 'has a very sensible strategy'.

Long-term holding discoverIE (+103bp) saw more corporate activity over the year, making what Moon and Mackersie describe as 'sensible acquisitions in line with its strategy, buying specialist electronics companies and helping them to cross-sell'.

Alpha FX (+100bp), bought at IPO in April 2017, was the lowest-yielding stock in the AIF portfolio at 13 December 2019, having seen a year-to-date share price increase of 86%; it has since risen another 24% (as at 19 January 2020). The managers note it has done 'unbelievably well' in capital terms and the dividend has not kept up, so they halved the position during FY19. 'We thought we would exit completely, but we are reaching a point in its growth where it might accelerate the dividend growth,' they explain.

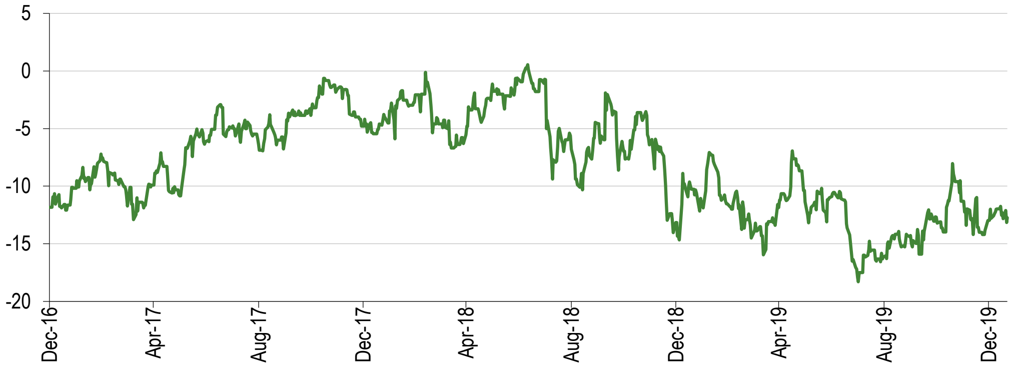
In a very positive year-to-date overall, there were no detractors above 100bp in the small-cap portfolio. The biggest negative was Park Group/Appreciate (-76bp), which has a new management team; Moon and Mackersie note that while an element of investment is required by the multi-retailer gift card specialist, 'there is no reason for it to have done as badly as it did'. The next-largest detractor (-72bp) was budget accommodation booker Hostelworld, in which the managers doubled their position during the period. It also has a new management team, which is 'very sharply aware of the failings of the past', and while it has suffered a period of underinvestment in its platform, Moon and Mackersie believe it is still a good business, and are content to wait for proof that the new CEO's strategy is working. Meanwhile, Ocean Wilsons Holdings (-63bp) had a disappointing outcome to its strategic review, and Saga (a position that has now been sold) detracted by -62bp, another lacklustre performance in 2019, after the share price declined by c 18% in 2018.

In the income portfolio, recent drivers of performance included exposure to bank debt, which Lee says offered relatively attractive yields compared with the market, while 'the new regulatory regime has meant that they are more conservatively run and well-capitalised compared to before the financial crisis'. Following the UK election result, domestic bank bonds rallied sharply as the Brexit premium was eroded.

On the alternative income funds side, Willis notes good performance from holdings including Romanian privatisation fund Fondul Proprietatea (trimmed during the year), Supermarket REIT, and SDCL Energy Efficiency Income Trust. Pershing Square Holdings detracted owing to the fact that AIF's holding hedges out the underlying portfolio risk and is effectively only exposed to the fund's discount. While the share price rose c 40% over the year, the NAV was up c 60% and the discount to NAV at 13 December was c 30%; since then it has narrowed to c 24%, and the manager expects this trend to continue. Also on the negative side, Hadrian's Wall Secured Investments declined by c 36% during the year. Willis notes this was a relatively recent investment, made after the discount to NAV widened to an attractive level, although there was a further leg down for both the NAV and share price following the write-down of a biomass investment in November.

Discount: Higher than average with potential to narrow

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



Source: Refinitiv, Edison Investment Research

At 23 January 2020, AIF's ordinary shares traded at a 12.5% discount to cum-income NAV. This is exactly in line with the 12-month average discount, and well below the three-year widest point of 18.3%, reached on 1 August 2019 shortly after the election of Boris Johnson as leader of the Conservative Party, which was seen as dramatically increasing the likelihood of a no-deal Brexit. However, the current discount is noticeably wider than the longer-term averages of 8.0%, 7.4% and 8.7% respectively over three, five and 10 years. Before the UK's EU referendum in 2016, AIF's shares often traded at a premium to NAV, and there is potential for the discount to narrow if sentiment towards UK smaller companies continues to improve.

Capital structure and fees

AIF is a closed-end investment company, incorporated in Guernsey and listed on the London Stock Exchange, with two classes of share. At 23 January 2020, there were 15.8m ordinary shares and 21.2m ZDPs in issue. The ZDPs, which provide AIF's gearing, mature in 2022 and had a gross redemption yield of 3.3% as at 30 November 2019. At the same date, the ZDPs had a hurdle rate of -63.8%, meaning that AIF's total assets would have to decline in value by more than 63.8% a year over the remaining life of the ZDPs in order for their final capital entitlement not to be met in full. Gross gearing was 48.1% at end-November 2019. The board may buy back or allot shares in order to manage a discount or a premium to NAV; where this occurs, both ordinary shares and ZDPs are repurchased or issued, in amounts such that the ratio of ZDPs to ordinary shares is maintained. No shares have been bought back or allotted since August 2018.

The fund pays an annual management fee of 0.7% of gross assets (charged 75:25 to the capital and income accounts respectively) to Premier Asset Management (Guernsey), a wholly owned subsidiary of Premier Miton. The investment manager in turn pays fees to the advisers of the smaller company and income portfolios, respectively at Unicorn Asset Management and Premier Miton. Furthermore, a performance fee (15% of excess returns) may be paid if AIF's NAV per share plus dividends has grown at a compound annual rate of more than 10% since the last year-end at which a performance fee was paid (the high-water mark). Currently the end-FY17 NAV of 486.8p is the high-water mark; since then dividends of 40.6p per share have been paid, and the end-FY19 NAV per share was 466.4p; this represents compound annual growth of c 2.1% since end-FY17 and therefore we do not expect a performance fee to be payable in respect of FY19, in spite of NAV total returns of 27.4% and a respectable c 5% outperformance of the benchmark. Ongoing charges for the year ended 31 December 2018 were 1.57%.

Dividend policy and record

Dividends are paid quarterly on AIF's ordinary shares, in March, June, September and December. While the income portfolio helps to support the revenue account, AIF's small-cap portfolio generates the majority of the yield (portfolio yield of c 4.6–4.7% versus c 3% for the income portfolio), and Moon and Mackersie report that FY19 income has grown in the high single-digits range, supported by special dividends from some portfolio companies. The ZDPs boost the value of the gross portfolio and therefore facilitate the payment of a higher dividend on the ordinary shares. For FY19, AIF has declared four dividends of 5.2p per ordinary share, bringing the total for the year to 20.8p, a 5.1% increase on 19.8p in FY18, and well above the rate of UK inflation. Dividends have tended to be fully covered by income, and the fund had revenue reserves of c £3.3m (20.9p per ordinary share) at 30 June 2019 (end-H119), 1.0x the FY19 annual dividend. Dividends have grown at a compound annual rate of 10.2% over the past five financial years. Based on the FY19 total dividend and the current share price, AIF's ordinary shares have a yield of 5.0%.

Peer group comparison

AIF is a member of the Association of Investment Companies' UK Equity & Bond Income sector. Following a review of the AIC sectors in 2018 and 2019, three of the fund's former peers have moved sectors (with two bond-orientated funds moving to the new Debt – Loans and Bonds peer group), leaving only AIF and Henderson High Income (HHI) in the original group. In Exhibit 8, we include the other former peer, Aberdeen Smaller Companies Income (now in the UK Smaller Companies sector), as, while it now invests almost entirely in equities (99% at 30 November 2019), it shares a focus on income-generating smaller UK companies with AIF. HHI also has a higher equity weighting than AIF (c 86% versus 77% at 30 November 2019) and tends to invest further up the market cap scale – for example, all its top 10 holdings are FTSE 100 companies.

In performance terms, AIF (the smallest of the three funds by market cap) ranks second over one, three and five years, and first by a considerable margin (c 78pp) over 10 years. Looking only at its performance versus its official peer, HHI, AIF ranks first over all periods. Ongoing charges are the highest in the group, partly reflecting the impact of fixed costs on a relatively small pool of assets, and the fund may also charge a performance fee. Gearing is well above average owing to the ZDPs, but will have contributed positively to performance in recent months as political uncertainty has receded and small-caps have begun to re-rate. Despite the strong recent performance, and the fact that its 5.0% dividend yield ranks a close second to HHI, AIF's discount to NAV is the widest in the group, and remains above the long-term average of c 8–9%.

Exhibit 8: Selected peer group at 22 January 2020*

% 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	**65.5**	**21.8**	**26.7**	**74.2**	**417.9**	**1.6**	**Yes**	**(12.7)**	**149**	**5.0**
Aberdeen Smaller Companies Inc	76.8	30.3	51.5	88.7	340.0	1.3	No	(8.3)	107	2.4
Henderson High Income	243.0	19.7	24.3	42.7	191.7	0.8	Yes	(0.5)	125	5.2
Simple average (3 funds)	**128.5**	**23.9**	**34.2**	**68.5**	**316.5**	**1.2**		**(7.2)**	**127**	**4.2**
AIF rank in peer group	**3**	**2**	**2**	**2**	**1**	**1**		**3**	**1**	**2**

Source: Morningstar, Edison Investment Research. Note: *Performance to 21 January 2020. TR=total return. Net gearing is total assets less cash and equivalents as a percentage of net assets (100 = ungeared).

The board

There are four non-executive directors on AIF's board, three of whom are deemed independent of the manager. Following the retirement at the 2019 AGM of Helen Green (who had served on the board since 2007 and was chairman from 2012), Nigel Ward (a director since 2011) has been appointed chairman. David Warr has served on the board since 2012, while Nigel Sidebottom (who was head of closed-end funds at Premier Asset Management until 2018, and is thus deemed non-independent) was appointed in February 2019. The newest director, Sharon Parr, joined AIF's board in August 2019. Ward, Warr and Parr are all resident in Guernsey, where AIF is incorporated. The directors have professional backgrounds in investment management, accountancy and fund administration.

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