EDISON

The Diverse Income Trust

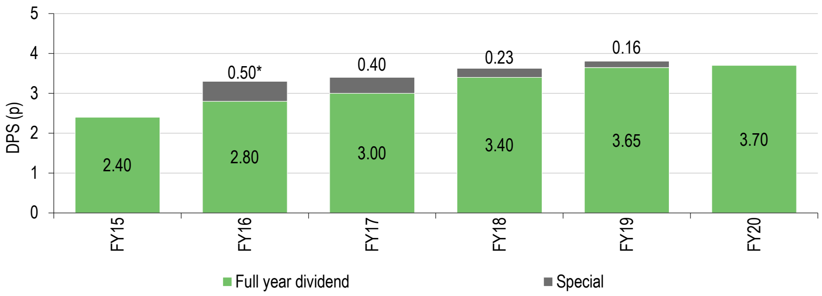
Accelerating into 2021 recovery

Investment trusts
UK multi-cap equity income

16 March 2021

The Diverse Income Trust (DIVI) continues to top the ranks of UK high dividend yield peers over the past 12 months by NAV total return (TR) and remains in the top quartile by NAV TR over the medium term. This multi-cap trust is little correlated with UK equity indices but reflects the UK market's performance trend. Williams and Turner are cautiously optimistic about the global recovery from the pandemic. Given the lag of the UK market since the 2016 Brexit vote relative to global equities, the managers expect the UK to outperform global shares within the short- to medium-term horizon. The managers also believe that income shares or what they call 'short-duration' shares will outperform growth equities.

DIVI's dividend record



Source: Bloomberg, Edison Investment Research

Why DIVI now?

Since FY15 DIVI's regular dividend has grown by an annual compound rate of 9%, exceeding the annual growth target of 5–7% pa anticipated by the team during normal market conditions. The trust has continued to deliver attractive dividend income throughout the pandemic. The board intends to at least maintain the FY21 dividend payment at the FY20 level (3.70p per share), when the ordinary dividend was increased by 1.4%. The managers only buy shares that generate a substantial cash pay back. New holdings with high dividend and growth potential constantly refresh the portfolio. One of the new notable additions to the portfolio is Avacta Group (£504m market cap), the AIM-quoted developer of a lateral flow COVID-19 test. The managers expect this technology to boost testing and speed up the return to economic normality. The managers are currently full of ideas, finding opportunities and are upbeat about implementing them in 2021 and beyond.

The analyst's view

DIVI's multi-cap strategy and the portfolio's diversification (c 130 holdings) mean the trust's portfolio stance has not needed significant change during the pandemic. The trust is well positioned for either the UK recovery or for continuing to deliver attractive returns on the current high-beta dominated markets. The cyclical value sectors within the portfolio, including financials (29.1% at end-January 2021), materials (15.4%) and energy (10.7%), are set to give an additional performance boost during an economic upturn. Given that small-, mid-caps and AIM-quoted stocks, combined, comprise over 63% of DIVI's portfolio, DIVI is likely to outperform the all-cap index and many larger-cap tilted peers in the recovery scenario.

NOT INTENDED FOR PERSONS IN THE EEA

Price	**110.0p**
Market cap	**£393.9m**
AUM	**£391.8m**

NAV*	109.5p
Premium to NAV	0.5%
NAV**	111.3p
Discount to NAV	1.1%

Excluding income. **Including income. As at 12 March 2021.

Yield	3.4%
Ordinary shares in issue	358.0m
Code	DIVI
Primary exchange	LSE
AIC sector	UK Equity Income

52-week high/low*	110.0p	54.6p
NAV** high/low	111.3p	70.3p

*A-shares. **Including income.

Gearing

Net cash at 31 January 2021	5.3%

Fund objective

The Diverse Income Trust's objective is to provide an attractive and growing level of dividends, coupled with capital growth over the longer term. It invests in a diversified portfolio primarily of quoted or traded UK companies across the market-cap spectrum, with a bias to high-quality small- and mid-cap stocks. As a stock-specific portfolio, the team does not use a benchmark.

Bull points

- Multi-cap strategy helps to diversify away from dividend concentration risk.
- Consistent growth in regular dividends since the trust's launch in April 2011.
- Revenue reserves can be used to help maintain the pattern of dividend growth.

Bear points

- The UK market could remain out of favour and retain the valuation gap with developed markets.
- A multi-cap strategy is not a clear-cut asset class to fit into an investor's portfolio.
- A labour intensive, active multi-cap mandate results in a relatively high management fee.

Analysts

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The manager's view and portfolio positioning

With the UK economic recovery emerging from the slump caused by the COVID-19 pandemic, DIVI's managers Williams and Turner still expect a 'bumpy ride', with periods of rallies and setbacks. The UK's vaccine rollout programme is likely to have some hitches, and this might delay the re-opening and easing of lockdown. They anticipate more festivities in the UK for Christmas 2021 than during Christmas 2020.

Expecting a pick-up in inflation, the managers believe that income shares, or what they call 'short-duration' shares will outperform growth equities. Although some of DIVI's holdings cut dividends in 2020 to preserve cash, the diversified nature of the portfolio, in combination with a partial use of the revenue reserve, allowed DIVI's board to continue to increase the dividend and outperform. Williams and Turner see these short duration shares outperforming in 2021. They also believe smaller companies will be winners during the recovery.

The managers positioned the portfolio (exhibit 1, at end-January 2021) for the rising market: DIVI has a lot of cyclicals, such as financial, materials and energy, in the portfolio. AIM stocks continue to represent the largest share of DIVI's portfolio (31.7% at end-January 2021, Exhibit 2).

Exhibit 1: Portfolio breakdown by sector

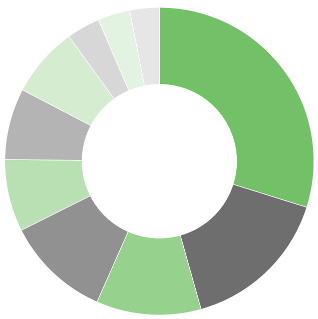
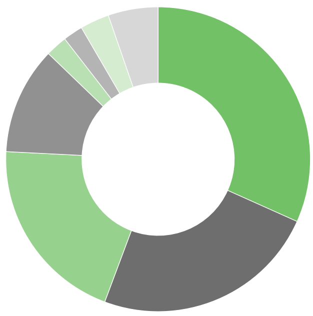


Exhibit 2: Portfolio breakdown by market cap



Source: The Diverse Income Trust, Edison Investment Research. Note: Data at end-January 2021.

Financials remains the biggest sector (29.1% at end-January 2021). The team took some profits from CMC Markets, which remains the largest holding (3.8% of the portfolio at end-January 2021). Within the sector, the managers have very limited exposure to high street banks, preferring to buy into specialist financial services companies. A 2020 acquisition, XPS Pensions Group, is a pensions advice company that came to the market at very high valuations, then suffered when insurance markets were hit in 2020 – and the managers used the favourable entry point to buy. K3Capital (top 10 holding, 2.0%), an AIM listed corporate finance business for SMEs, targets growing dividends to June 2021, 2022 and 2023 at 9.1p, 12.1p and 15.5p respectively.

Basic materials is the second largest weighting (15.4%) and Kenmare Resources (top 10 holding, 2.3% of the portfolio at end-January 2021) is the largest holding in that sector. A recent addition, Ferrexpo (c £2bn market cap), is one of the top iron ore producers in the world. Another new purchase, Tharisa (£354m market cap), a global platinum miner and manufacturer, was trading at a 'completely wrong' price, according to the managers. Over the last three months the share price has increased from 75p to 138p, and even with such a rise the stock trades at barely 4.4x the forward 12-month P/E. Four gold miners in the portfolio (Polymetal, Petropavlosk, Centamin and Pan African Resources) serve as a hedge against a possible sharp drop in the market.

Energy is the fourth largest sector in the portfolio (10.7%). As the world decarbonises, investing in energy companies remains one of the trust's key themes. The managers expect a shortage of energy within the next decade, as large oil companies have been cutting their oil exploration budgets since 2015, firstly due to the sharp fall in the oil price, then because of ESG moves during 2018–9. The oil price has almost reached US$70 per barrel and we have not yet seen the recovery from the COVID-19 crisis. The managers believe that the recovery will benefit cyclical stocks, including energy, and that onshore gas is a good area to invest in. Within the energy sector, the managers hold Touchstone Exploration (top 10 holding, 1.7%), an onshore gas exploration company in Trinidad. It is a quality company, according to managers, that pays a dividend, generates cash and hence has the ability to grow dividends.

Williams and Turner hold a number of technology stocks. These include Stirix Group (top 10 holding, 1.7%) and Amino Technologies. The latter suspended dividend payments for 12 months in 2020, but has now resumed payments, the managers expect the stock price to triple within the next few years. CML Microsystems and iEnergizer (top 20 holding, 1.4%), both pay generous dividends.

Within the consumer staples sector (the fifth largest sector), the team is happy with its supermarket holdings. These include three UK stalwarts: WM Morrison (top 20 holding, 1.5%), Sainsbury's (top 20 holding, 1.4%) and Tesco (top 20 holding, 1.3%). All three supermarkets have posted a positive TR or 8–25% over the past 12 months. Considering 'the toilet paper' crisis in 2020, another consumer staples holding, Accrol Group (£192m market cap), a household and sanitary products manufacturer and seller of kitchen and toilet tissue and other paper products in the United Kingdom, is unlikely to go out of business any time soon.

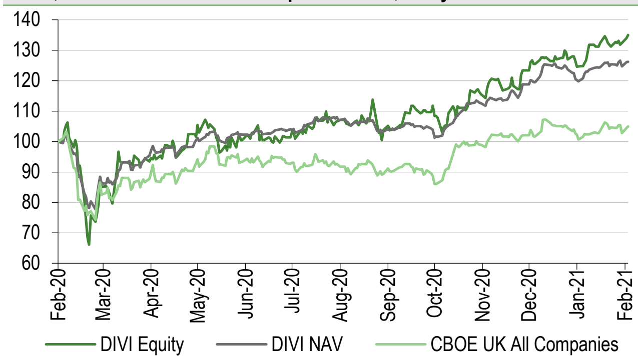
Recent complete sales included ING Group, as the shares revalued materially and the managers took profits on Hilton Food Group.

Performance

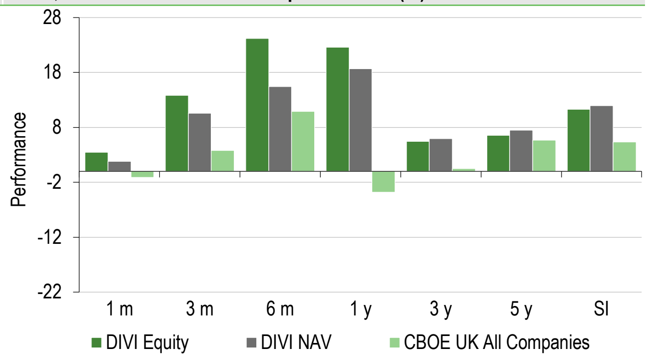
As Exhibits 3 and 4 illustrate, even during 2020 when long-duration (or growth) assets were generally outperforming, DIVI has outperformed.

Exhibit 3: Investment company performance to 28 February 2021

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



Price, NAV and index total return performance (%)



Source: Refinitiv, Edison Investment Research. Note: Three, five and SI (since launch on 28 April 2011) perf. figures annualised.

Exhibit 4: Five-year discrete performance data

12 months ending	Total share price return (%)	Total NAV return (%)	CBOE UK All Companies (%)	MSCI UK High Dividend Yield (%)	CBOE UK Small Companies (%)	Major AIM All-Share Index (%)
28/02/17	4.0	7.1	23.7	24.4	19.1	33.1
28/02/18	12.7	11.9	4.4	6.5	13.8	16.0
28/02/19	(4.8)	(3.7)	1.6	4.0	(6.6)	(11.3)
29/02/20	(5.8)	(0.7)	(2.1)	(3.1)	5.9	(4.4)
28/02/21	32.4	24.7	2.8	(3.6)	17.8	39.3

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

DIVI's discrete performance is little correlated with UK indexes, as exhibit 4 shows. DIVI's multi-cap approach allows the managers to demonstrate a less volatile performance compared to the CBOE UK Small Companies and Major AIM All-Share indices and outperform larger-cap indices during their periods of lacklustre performance.

Exhibit 5 compares DIVI's performance with 12 peers in the UK income sector. DIVI ranks in the top quartile for all the periods shown: one, three and five years and since launch on 28 April 2011, on the NAV TR basis. The short-term one-year performance to end-February 2021 places DIVI at the top of the 13-peers group ranking. Posting a 24.4% NAV TR, the trust outperformed the peer group average (3.5% NAV TR) by 20.9pp. Over the same period DIVI outperformed the next best-performing peer, Dunedin Income Growth (10.7%) by 13.7pp.

Exhibit 5: Selected peer group at 28 February 2021*

% unless stated	Market cap £m	NAV TR 1 year	NAV TR 3 year	NAV TR 5 year	NAV TR si***	Discount (cum-fair)	Ongoing charge	Performance fee	Net gearing	Dividend yield (%)**
Diverse Income Trust	381.3	24.4	19.0	41.5	204.8	(1.6)	1.1	No	100	3.4
Aberdeen Standard Eq Inc Trust	160.0	(3.0)	(14.4)	0.5	59.1	(6.9)	0.9	No	112	6.3
BMO Capital & Income	315.1	(1.3)	5.4	40.8	88.2	(2.3)	0.6	No	105	4.0
City of London	1,554.8	(2.9)	(0.7)	18.6	81.9	2.7	0.4	No	109	5.2
Dunedin Income Growth	437.1	10.7	22.4	56.6	91.9	(2.4)	0.6	No	109	4.3
Edinburgh Investment Trust	976.3	5.7	(1.8)	6.2	98.4	(7.9)	0.6	No	107	4.2
Finsbury Growth & Income	1,896.5	6.3	20.6	60.2	210.8	(1.2)	0.6	No	101	2.0
JPMorgan Claverhouse	382.2	2.8	3.1	35.1	86.3	(2.8)	0.7	No	112	4.5
Lowland	324.2	2.6	(9.1)	21.7	89.9	(7.1)	0.6	No	115	5.0
Merchants Trust	566.2	5.1	8.2	37.3	85.4	0.4	0.6	No	113	5.8
Murray Income Trust	966.8	4.3	17.4	48.2	92.9	(3.8)	0.6	No	110	4.2
Perpetual Income & Growth	159.3	(3.8)	3.2	16.4	86.0	(4.5)	0.7	No	106	4.3
Temple Bar	690.1	(6.0)	(7.5)	19.9	67.4	(7.0)	0.5	No	113	3.7
Simple average (12 funds)	**677.7**	**3.5**	**5.1**	**31.0**	**103.3**	**(3.4)**	**0.7**		**109**	**4.4**
Rank in peer group	**9**	**1**	**3**	**4**	**2**	**4**	**1**		**13**	**12**

Source: Morningstar, Edison Investment Research. Note: *Performance to 28 February 2021 based on cum-fair NAV. TR = total return. Net gearing is total assets less cash and equivalents as a percentage of net assets. 100=ungeared. **Based on historic dividends. ***si – since DIVI's launch on 28 April 2011.

Dividend policy, record and guidance

DIVI's primary objective is to provide shareholders with an attractive and growing level of income, as well as deliver capital growth over the long run. The board has a policy to build revenue reserves during the years of generous dividend payments from portfolio companies and uses them as necessary when dividend payments from portfolio companies subside, as happened during the COVID-19 pandemic.

Revenue reserves stood at £14.8m at the end of H121 (to end November 2020). This is equal to c 1.0x the ordinary annual dividend payment. The trust used some of its revenue reserves in FY20 (to end-May 2020) to smooth dividend payments to shareholders. During FY20 DIVI's net revenue return per share declined by 17% from 3.95p to 3.27p, as a number of investees reduced or cancelled dividends during the pandemic. Subsequently, during H121 the board maintained the dividend of 1.75p at the H120 level over the six-month period to November 2020. During H121 the trust's revenue per share fell again, this time by 11.1% over the corresponding period, as lockdowns bit, but the board expects it to recover in coming years so did not tap into revenue reserves for H121 dividends. Revenue earnings of 1.77p per share for this interim period fully covered the two dividends in respect of the period (1.75p per share).

The board expects to at least maintain the full year ordinary dividend for the year to May 2021 of 3.70p per share. The board does not envisage paying a special dividend in FY21.

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