The Diverse Income Trust

Weak sentiment presents exciting opportunities

Investment trusts
UK multi-cap equity

18 October 2019

Price	**88.2p**
Market cap	**£333.7m**
AUM	**£352.6m**

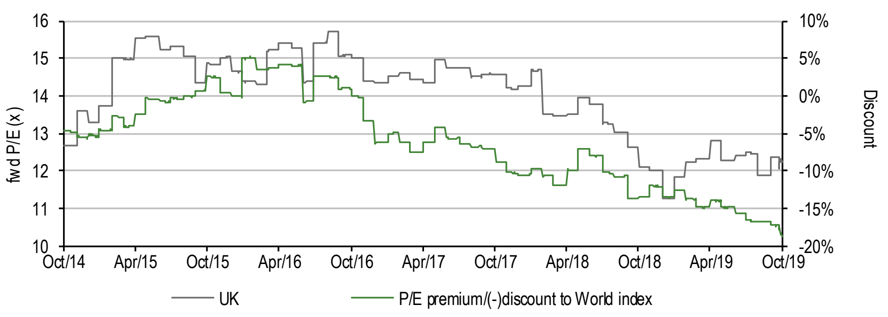
NAV*	91.4p
Discount to NAV	3.5%
NAV**	93.0p
Discount to NAV	5.2%

*Excluding income. **Including income. As at 16 October 2019.

Yield	4.2%
Ordinary shares in issue	378.3m
Code	DIVI
Primary exchange	LSE
AIC sector	UK Equity Income

The Diverse Income Trust (DIVI) aims to provide shareholders with an attractive and growing level of income, as well as capital growth, over the long term. Unconstrained by index considerations, the managers (Gervais Williams and Martin Turner) have a wide investment universe from which to select companies that are well managed and able to deliver sustainable and growing dividends. The portfolio is well diversified, with a bias towards small-cap companies; since DIVI's inception in April 2011 to end-September 2019, the trust has delivered an annualised NAV total return of 11.5% and consistent growth of its regular dividend.

UK equities at a substantial forward P/E discount to global equities



Source: Refinitiv, Edison Investment Research

The market opportunity

UK equities have been increasingly out of favour since the referendum on EU membership in June 2016. They have moved from trading at a premium to a discount to global equities, which has widened since that time, reflecting the geopolitical and economic uncertainties presented by Brexit. At the current forward P/E discount of 18% there may be considerable upside potential for UK equities post a Brexit agreement, should relative valuations normalise (see chart above).

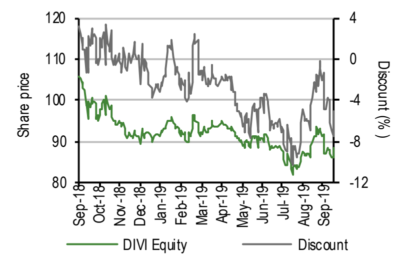
Why consider investing in DIVI?

- Managed by two highly regarded and experienced portfolio managers who employ a long-established and disciplined bottom-up investment process.
- The portfolio is significantly differentiated from mainstream indices and may offer investors genuine diversification benefit.
- The managers are mindful of downside risk, investing in high-quality companies, while a put option on the FTSE 100 helps protect the trust from a sharp fall in the index.

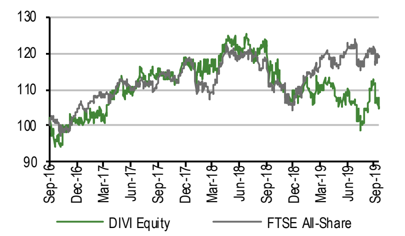
Unusually wide discount

DIVI currently trades at a 5.2% discount to its cum-income NAV, which is wider than its three-year average discount of 1.3%. The board is committed to maintaining the share price close to the NAV and there is an annual redemption opportunity for shareholders. There is scope for the discount to narrow should the current very weak investor appetite for UK equities, and small-caps in particular, improve.

Share price/discount performance



Three-year performance vs index



52-week high/low	101.0p	82.0p
NAV** high/low	97.8p	90.6p

**Including income.

Gearing

Gross*	0.0%
Net cash*	6.9%

*As at 30 September 2019.

Analysts

Helena Coles +44 (0)20 3681 2522
Sarah Godfrey +44 (0)20 3681 2519
investmenttrusts@edisongroup.com
Edison profile page

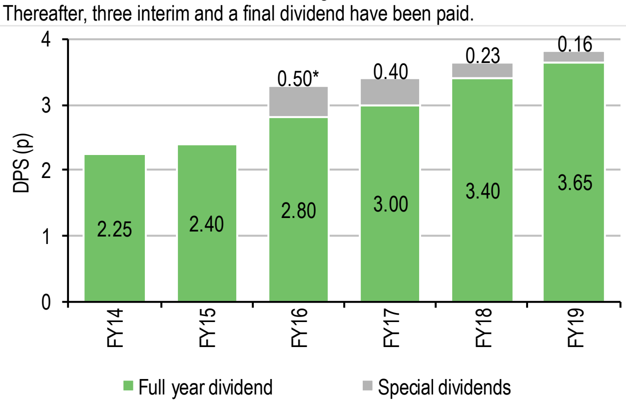
The Diverse Income Trust is a research client of Edison Investment Research Limited

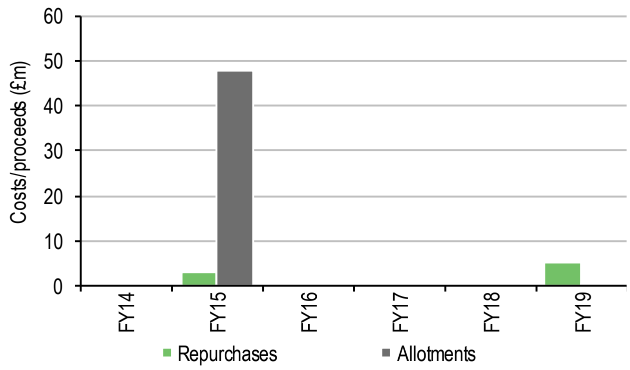
Exhibit 1: Trust at a glance

Investment objective and fund background	Recent developments
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, there is no benchmark.	■ 10 October 2019: Announced the appointment of Michelle McGrade as independent non-executive director with immediate effect. ■ 9 October 2019: Result of AGM. All resolutions passed. Declaration of first interim dividend of 0.85p per share. ■ 2 August 2019: Annual results for 12 months ended 31 May 2019. NAV TR -9.4% vs -7.1% for the FTSE All-Share index.

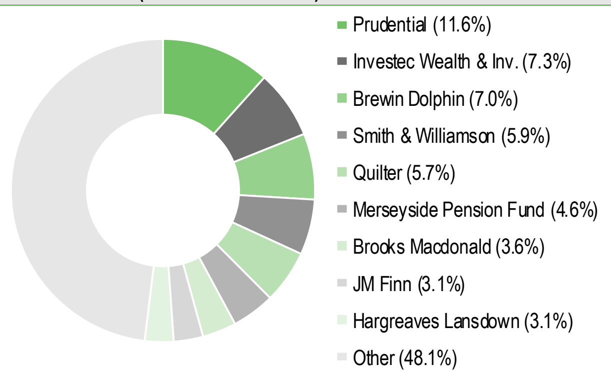
Forthcoming		Capital structure		Fund details	
AGM	October 2020	Ongoing charges	1.16%	Group	Miton Group
Interim results	February 2020	Net cash	6.9%	Manager	Gervais Williams, Martin Turner
Year end	31 May	Annual mgmt fee	Tiered structure (see page 7)	Address	6th floor, Paternoster House, 65 St Paul's Churchyard, London, EC4M 8AB
Dividend paid	Quarterly	Performance fee	None		
Launch date	28 April 2011	Trust life	Indefinite	Phone	+44 (0) 20 3714 1501
Continuation vote	No	Loan facilities	See page 7	Website	www.mitongroup.com

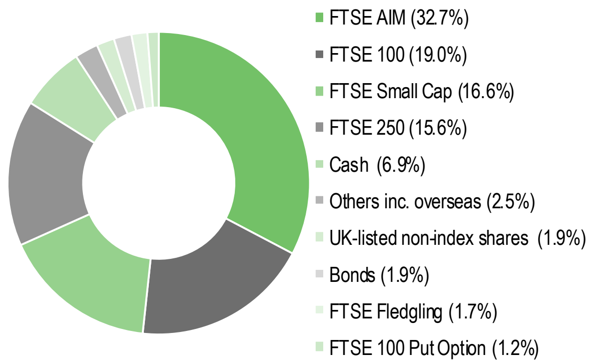
Dividend policy and history (financial years)	Share buyback policy and history (financial years)
Quarterly dividends are paid in February, May, August and November. DIVI distributes substantially all of its income, net of costs, annually. *Note in FY16 that five dividends were paid – the fifth would ordinarily have been designated as the first interim of FY17, but it was redesignated as a final dividend for FY16. Thereafter, three interim and a final dividend have been paid.	Renewed annually, DIVI has authority to purchase up to 14.99% and allot up to 10% of issued share capital. Subject to directors' discretion, DIVI offers investors an annual facility to redeem all or part of their shareholding at NAV less costs.





Shareholder base (as at 1 October 2019)	Portfolio exposure by market segment (as at end-September 2019)





Top 10 holdings (as at 30 September 2019)

			Portfolio weight %	
Company	**Index**	**Sector**	**30 September 2019**	**30 September 2018***
Charles Taylor	FTSE Small Cap	Insurance services	1.9	1.9
Highland Gold Mining	FTSE AIM	Mining	1.9	N/A
Diversified Gas & Oil	FTSE AIM	Energy	1.8	1.9
Randall & Quilter	FTSE AIM	Insurance services	1.7	1.4
FTSE 100 put option	FTSE100	N/A	1.7	N/A
Centamin	FTSE 250	Mining	1.7	N/A
Kenmare Resources	FTSE Small Cap	Mining	1.7	N/A
Strix Group	FTSE AIM	Industrials	1.6	N/A
4Imprint Group	FTSE Small Cap	Media	1.5	N/A
Zotefoams	FTSE Small Cap	Chemicals	1.4	1.9
Top 10 (% of holdings)			**16.9**	**17.3**

Source: The Diverse Income Trust, Edison Investment Research, Morningstar. Note: *N/A where not in top 10 at September 2018.

Market outlook: Brexit weighs on UK equities

The UK's economic growth is slowing and leading economic indicators are trending downwards. Following a decade of economic expansion propelled by unprecedentedly low interest rates and abundant liquidity, a cyclical slowdown has been widely anticipated. However, geopolitical events, including Brexit and the ongoing US-China trade dispute, have exacerbated the magnitude and pace of the slowdown. The lack of certainty surrounding the terms of the UK's future relationship with the EU has stymied investment and manufacturing activity has been contracting. In September, new export orders fell for the sixth consecutive month as European customers searched for alternative suppliers. Although policy responses may be deployed to manage the economic downturn, the impact of such measures may be limited given interest rates are still close to historic lows, and the government remains fiscally constrained. Geopolitical developments are likely to continue to influence the direction of markets for the time being. However, global asset managers' allocations to UK equities are already at very low levels, significantly below that of 2008 and 2009 when the banking system was facing a systemic crisis. Furthermore, UK equities appear attractively valued relative to global equities. The chart on the front page shows that UK equities are trading on an 18% forward P/E discount to world market, and this discount has widened consistently and considerably since the EU referendum in June 2016. A reduction in Brexit-related uncertainties may help improve sentiment towards UK equities.

Fund profile: Bias towards smaller companies

DIVI was launched in April 2011 and aims to provide shareholders with an attractive level of dividends as well as capital growth over the long term, through investing mainly in UK equities. The trust is not constrained by index considerations and is able to invest across the market cap size spectrum, giving the managers a very wide opportunity set from which to select stocks. The managers, Gervais Williams and Martin Turner, are smaller company specialists who focus on firms that are able to sustain strong cash flow, which in turn can underpin long-term dividend growth. They often find attractive investments among smaller firms, less well-researched firms with niche market positions, which the managers believe offer genuine diversification from the sectors that dominate mainstream indices. As at end-September 2019, the portfolio held 138 stocks, of which over two-thirds of the portfolio was invested outside of the FTSE 350. The remainder of the portfolio is invested in mid- and large-cap stocks that tend to be very liquid. The managers are also mindful of downside risk and have invested in a FTSE 100 put option, which effectively acts as an insurance policy covering the portfolio against a sharp fall in UK equities.

The fund managers: Gervais Williams & Martin Turner

The manager's view: DIVI can deliver returns and diversification

Williams observes that the environment for UK equities is weak. Slowing growth, less favourable liquidity conditions and very poor investor sentiment caused by Brexit have weighed on UK stocks. Against this backdrop, he believes that DIVI is well placed to deliver premium returns over the long run. The fund's prospects are assisted by its wider investment universe, giving the managers more choice to seek quality companies that are less well discovered. Williams highlights that small-cap companies are disproportionately out of favour; however, there is room for valuations to normalise, especially post a Brexit agreement. Furthermore, he is focused on companies that generate a good and growing yield at a time when large-cap companies listed on mainstream indices are showing declining levels of dividend cover, and he notes that several widely held high-yield stocks have already cut dividends (for example Vodafone, BT and Marks & Spencer). Williams believes that the abundant liquidity and synchronous global growth that provided the backdrop for equities for most of the past decade, has been most favourable for large growth stocks. In his view, many sectors within the mainstream indices are often duplicated across the developed markets, and investors' portfolios are highly correlated to one another, which leaves them at risk of earnings and dividends disappointments. He believes that DIVI's active share of c 88% relative to the FTSE All-Share Index, and its multi-cap approach, offer investors genuine diversification benefits.

Asset allocation

Investment process: Disciplined bottom-up framework

DIVI employs a disciplined, bottom-up approach to selecting companies, typically based on their cash flow payback on their capital expenditure and the potential to pay an attractive and growing dividend over three to five years. Meeting companies and gaining confidence in their governance and management is important, especially as the managers often find the most interesting opportunities among firms that widely overlooked and require proprietary research. The managers have a long-established framework for evaluating the attractiveness of a company:

- **Prospects for rising turnover**. The managers observe that companies that progressively expand turnover are more likely to be able to generate durable dividend growth.
- **Sustainability of margins**. Declining margins cannot sustain growth. The most attractive companies are those with the ability to expand or defend their profit margins, typically through productivity gains or outstanding customer service.
- **Management teams that can build intrinsic value**. This is often not found in companies that grow too quickly, which may carry too much risk, and may not be able to sustain growth.
- **Financial flexibility in balance sheets**. The managers look for companies that have net cash or low levels of debt relative to their capacity to borrow, which makes them better placed to sustain dividends, even when underlying profits dip temporarily. Furthermore, these firms are more able to take advantage of economic setbacks to improve their market position.
- **Low expectations reflected in the share price**. Smaller companies tend to be less well researched and are more likely to be overlooked by the wider investment community.

Current portfolio positioning

Exhibit 2 shows DIVI's portfolio exposures by sector as at end-September 2019. The most significant change over the past year has been a significant increase in cash, which has risen to 6.9% of the fund from 1.9% a year ago. This has mainly reflected a high number of portfolio companies being taken over, which Williams believes highlights the undervaluation of many UK mid- and small-cap firms. Furthermore, he notes these takeovers have enhanced the liquidity of the small-cap element of the portfolio. Holdings that have been acquired include payments technology company Safecharge, communications services provider KCOM, and most recently in September 2019, insurance services firm Charles Taylor. The increased level of cash also reflects the divestment of some holdings where the investment case has matured and, in the manager's view, their share prices presented attractive selling opportunities. Gift stationery supplier IG Holdings and litigation finance company Burford Capital are examples of this category. DIVI has been gradually reducing its stake in Burford over the past three years and had fully sold the position ahead of its share price collapse in August. The generous cash position as at end-September 2019 does not reflect a bearish stance; rather, the managers say they are finding plenty of attractive companies, which they think are currently trading on depressed valuations and present long-term investment opportunities.

DIVI has been in reinvestment mode, reflected in a number of new purchases and additions in recent months. These include a new position in mineral sands mining company Kenmare Resources. The company operates three mines in Mozambique and its main product is merchant ilmenite, a feedstock of titanium dioxide, of which it the world's largest producer. Titanium feedstocks are used as pigment to impart whiteness and opacity in paints, plastics and paper. Global consumption for pigment is growing, driven by emerging markets as rising incomes and urbanisation fuel demand for higher-quality consumer products. Williams believes the company is nearing the end of a capital expenditure cycle, which will upgrade capacity and production efficiency, reduce unit costs and expand margins. He expects Kenmare to move into the cash payback period for its investments and to start paying dividends by the end of 2019.

The manager has also invested in three online financial trading companies, IG Group, CMC Markets and Plus500. Williams identified that these stocks tend to do well at times of rising stock market volatility. Furthermore, DIVI was able to purchase these companies at low valuations, at a time when their trading was adversely affected by new regulations required for their private clients. This disruption has now stabilised, meanwhile Williams notes that these firms' hedging costs have fallen as their clients' positions are less geared than they were in the past, which he believes should be positive for profitability.

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

	Portfolio end-September 2019	Portfolio end-September 2018	Change (pp)	Index weight	Active weight vs index (pp)	Trust weight/ index weight (x)
Financials	31.1	28.7	2.4	24.9	6.2	1.3
Industrials	16.1	18.3	(2.2)	11.8	4.3	1.4
Consumer services	10.7	11.2	(0.4)	7.4	3.3	1.5
Basic materials	9.3	8.9	0.4	12.0	(2.7)	0.8
Oil and gas	9.1	10.6	(1.4)	13.1	(4.0)	0.7
Consumer goods	5.6	7.0	(1.4)	14.9	(9.2)	0.4
Technology	3.2	4.5	(1.3)	1.0	2.2	3.2
Utilities	2.2	1.4	0.7	2.7	(0.5)	0.8
Healthcare	2.0	2.0	0.0	9.6	(7.6)	0.2
Telecommunications	0.8	3.1	(2.3)	2.7	(1.8)	0.3
Funds	0.7	0.5	0.1	0.0	0.7	N/A
Cash, bonds and other	9.2	3.8	5.4			
	100.0	**100.0**		**100.0**		

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

The managers have also introduced another AIM stock, iEnergizer, into the portfolio. The company is a global business process outsourcing (BPO) solutions company based in India. It offers a broad range of outsourcing services across many industries, including banking, healthcare and legal. Williams thinks the company has a strong market position and management, noting the firm's high customer retention and robust balance sheet. iEnergizer has been reducing and refinancing its debt, which combined with good operating cash flow generation, should support growing dividends. At the time of purchase, the stock offered an attractive 6% yield.

DIVI has also purchased claims management and specialist accident services company Redde (also AIM-listed). The stock was one of the top 20 companies held in Woodford Equity Income Fund. The suspension of this fund resulted in a sharp fall in share prices of its underlying holdings and in Williams's view, Redde's valuation became unjustifiably and artificially depressed. The manager believes Redde has a solid business model, generating strong cash flows and returns, which he thinks can sustain its generous dividend yield. At the time of purchase, Redde traded at a dividend yield of over 10%.

Performance: Strong performance since inception

As shown in Exhibits 4 and 5, DIVI's NAV total return has outperformed the FTSE All-Share, FTSE 350 High Yield and FTSE Small Cap indices over five years and by a considerable margin since its inception in April 2011. Since inception, the trust has delivered an annualised NAV return of 11.5%. Nearer-term DIVI's NAV performance has generally lagged although it has outperformed the FTSE Small Cap Index in all periods shown. Over the past three years, a narrow set of large-cap FTSE 100 multinational stocks have outperformed, benefiting from a sharp fall in sterling after the UK's EU referendum and a recovery in commodity prices. Conversely, smaller companies have been increasingly out of favour. As shown in Exhibit 4 (LHS), DIVI's NAV performance year to date has been relatively stable against a more volatile UK equity environment. The multi-cap strategy is significantly differentiated from the mainstream indices, which means relative performance can diverge meaningfully.

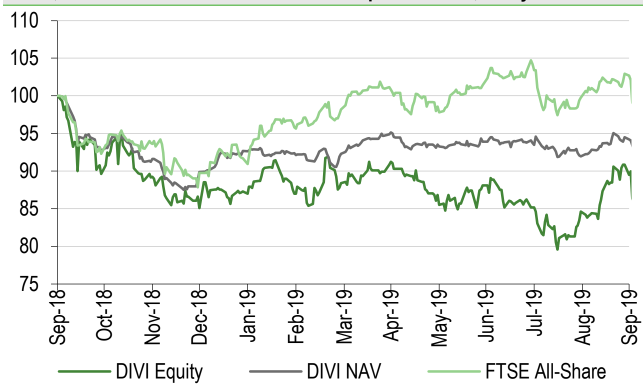
Exhibit 3: Five-year discrete performance data

12 months ending	Total share price return (%)	Total NAV return (%)	FTSE All-Share (%)	FTSE 350 High Yield (%)	FTSE SmallCap Index (%)
30/09/15	18.2	19.6	(2.3)	(9.7)	9.0
30/09/16	4.9	4.6	16.8	22.8	10.5
30/09/17	13.9	14.8	11.9	10.4	17.8
30/09/18	9.0	4.8	5.9	5.8	0.6
30/09/19	(10.5)	(5.8)	2.7	0.3	(7.8)

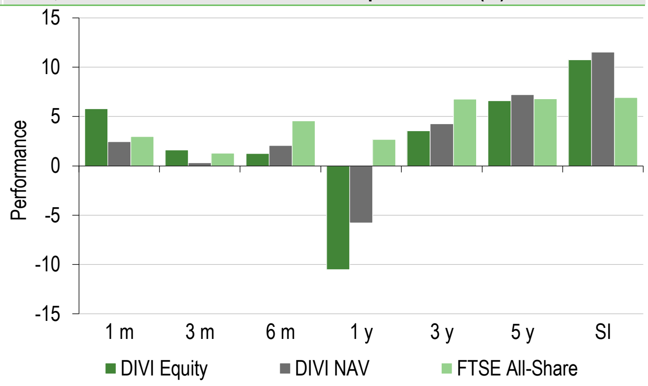
Source: Refinitiv. Note: All % on a total return basis in pounds sterling.

Exhibit 4: Investment trust performance to 30 September 2019

Price, NAV and FTSE All-Share total return performance, one-year rebased



Price, NAV and FTSE All-Share total return performance (%)



Source: Refinitiv, Edison Investment Research. Note: three- and five-year and since inception (SI, 28 April 2011) performance figures annualised.

Exhibit 5: Share price and NAV total return performance, relative to indices (%)

	One month	Three months	Six months	One year	Three years	Five years	SI
Price versus FTSE All-Share	2.7	0.3	(3.2)	(12.9)	(8.7)	(0.9)	34.8
NAV versus FTSE All-Share	(0.5)	(0.9)	(2.4)	(8.2)	(6.9)	2.1	42.8
Price versus FTSE 350 High Yield	1.0	1.8	0.0	(10.8)	(5.2)	6.0	38.3
NAV versus FTSE 350 High Yield	(2.1)	0.5	0.8	(6.0)	(3.3)	9.1	46.5
Price versus FTSE Small Cap	2.8	2.8	1.5	(3.0)	1.6	4.6	13.8
NAV versus FTSE Small Cap	(0.4)	1.5	2.3	2.2	3.7	7.6	20.6

Source: Refinitiv, Edison Investment Research. Note: data to end-September 2019. Geometric calculation.

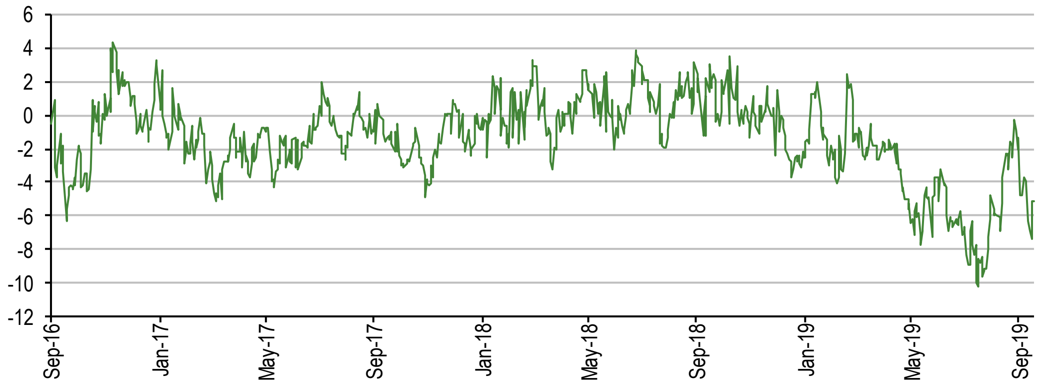
Exhibit 6: NAV total return performance relative to FTSE All-Share index over five years

Source: Refinitiv, Edison Investment Research

Discount: Deeper than usual

The board aims to keep DIVI's discount to cum-income NAV at a sustained, low level, subject to market conditions and historically, the trust has traded close to its NAV with brief exceptions. During FY19, the trust had an average discount to NAV of 0.3% and the board is aware that this has widened more recently and that DIVI has traded below NAV for some months. This partly reflects the significant outflows from UK equities against a challenging geopolitical and economic backdrop, with small- and micro-cap stocks being particularly out of favour. There is scope for the discount to return to its historic norms on improved sentiment for UK equities. The board has the authority (renewed annually) to buy back shares if it considers it to be in the best interests of the shareholders.

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



Source: Refinitiv, Edison Investment Research

Capital structure and fees

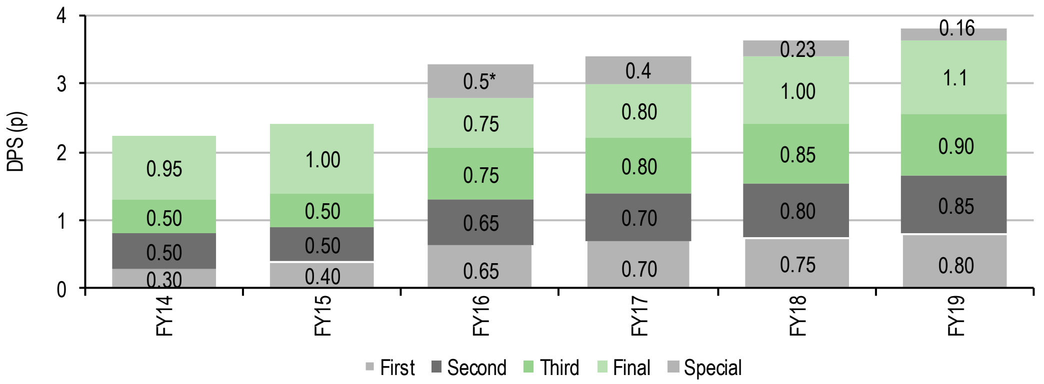
DIVI is a conventional investment trust with 378.3m shares in issue. The trust has an annual redemption facility that allows shareholders to voluntarily tender their shares at NAV less costs on 31 May each year. Redemption requests must be received by 30 April. For FY19, 5.5m shares, representing 1.4% of issued share capital, were repurchased and cancelled at a price of 95.39p per share (FY18: 0.5m shares were repurchased representing 0.1% of issued share capital). The board has recently agreed a reduction in the management fee payable to Miton Trust Managers. With effect from 1 August 2019, an annual fee of 0.9% is payable on the average market cap of the company up to £300m; then 0.8% on the average market cap between £300m and £600m;

reducing to 0.7% above £600m. Previously, the first tier was applied at 1.0% and 0.8% was applied on all assets above £300m; the third tier was introduced on 1 August 2019. These fees are charged to both the income and capital accounts, allocated at 75% and 25% respectively. For FY19 the ongoing charges were 1.16% (FY18: 1.13%). Gearing is permitted up to 15% of NAV and the trust has a £25m loan facility with the Royal Bank of Scotland. As at 30 September 2019, this facility was unused and the trust held net cash of 6.9%.

Dividend policy and record

DIVI's primary objective is to pay shareholders a good and growing dividend income. The trust has consistently grown its regular dividends since launch and has also paid special dividends when it has had abnormal one-off receipts during the financial year. Over the past eight years since listing to end-May 2019, the dividend paid to shareholders has grown by a compound 8.8% pa. For FY19 DIVI's ordinary dividend of 3.65p per share represents a 7.4% increase over the previous year. The board has also recommended a special dividend of 0.16p per share (FY18: 0.23p). Revenue reserves continued to increase by £0.8m to £17.5m as at end-May 2019, which allows the board flexibility to smooth future payments in the event of a temporary fall in portfolio income.

Exhibit 8: DIVI's regular dividend has grown at a compound 10.2% pa over five years



Source: The Diverse Income Trust, Edison Investment Research. *Note in FY16 five dividends were paid – the fifth would ordinarily have been designated as the first interim of FY17, but was redesignated as a final dividend for FY16. Thereafter three interim and a final dividend have been paid.

Peer group comparison

DIVI is a constituent of the AIC UK Equity Income sector, which consists of 24 funds. Exhibit 9 shows the 12 largest funds in the sector, among which DIVI is the smallest by market capitalisation. Many of the peer group funds are large-cap focused, whereas DIVI is biased towards small-caps which have performed less well over the past three years. The trust's NAV total return ranks ninth over one and three years and fourth over five years. Over these periods, its returns have been generated without the use of gearing. DIVI's dividend yield of 4.2% is close to the peer average; however, it ranks eighth in this group of income-focused funds. The trust has the highest ongoing charge, which partly reflects its smaller size but also, in the manager's view, the labour-intensive nature of running a multi-cap fund with considerable weighting in small- and micro-cap companies.

Exhibit 9: Selected peer group as at 18 October 2019*

% unless stated	Market cap £m	NAV TR 1 year	NAV TR 3 year	NAV TR 5 year	Discount (cum-fair)	Ongoing charge	Performance fee	Net gearing	Dividend yield (%)
Diverse Income Trust	333.7	(0.8)	12.2	48.6	(5.2)	1.2	No	100	4.1
BMO Capital & Income	334.6	10.7	25.9	64.7	1.1	0.6	No	102	3.4
City of London	1,614.7	9.0	15.4	45.6	2.9	0.4	No	109	4.5
Dunedin Income Growth	389.7	13.0	15.7	42.5	(8.2)	0.6	No	108	4.7
Edinburgh Investment Trust	1,109.2	(1.2)	1.0	33.4	(10.9)	0.6	No	103	4.6
Finsbury Growth & Income	1,783.4	19.6	42.2	104.5	0.7	0.7	No	100	1.9
JPMorgan Claverhouse	397.0	5.1	18.3	48.1	(3.0)	0.7	No	119	4.0
Lowland	349.9	(3.9)	7.3	34.6	(7.8)	0.6	Yes	113	4.6
Merchants Trust	533.2	4.7	15.8	39.3	(0.3)	0.6	No	117	5.5
Murray Income Trust	560.6	13.5	21.6	49.6	(3.4)	0.7	No	103	4.0
Perpetual Income & Growth	702.4	(0.5)	(1.6)	20.3	(13.1)	0.7	No	114	4.6
Temple Bar	893.4	12.4	24.2	47.2	(6.3)	0.5	No	109	4.0
Simple average (12 funds)	**750.1**	**6.8**	**16.5**	**48.2**	**(4.5)**	**0.6**		**108**	**4.2**
Rank in peer group	**12**	**10**	**9**	**4**	**7**	**1**		**11**	**7**

Source: Morningstar, Edison Investment Research. Note: *Performance to 16 October 2019 based on ex-par NAV. TR = total return. Net gearing is total assets less cash and equivalents as a percentage of net assets. 100=ungeared.

The board

DIVI's board currently consists of five independent non-executive directors. It recently announced the appointment of Michelle McGrade with effect from 10 October 2019. McGrade has broad experience across the investment management industry, including asset management and private wealth. She is also a non-executive director of M&G Securities and an adviser to the investment committee of the Sainsbury's Pension Scheme. DIVI's current chairman, Michael Wrobel, has announced his intention to retire at the 2020 AGM, having served on the board since its inception in April 2011. The other directors and their dates of appointment are Paul Craig (April 2011), Calum Thomson (December 2016), Andrew Bell (January 2019) and Caroline Kemsley-Pein (January 2019).

Frankfurt +49 (0)69 78 8076 960
Schumannstrasse 34b
60325 Frankfurt
Germany

London +44 (0)20 3077 5700
280 High Holborn
London, WC1V 7EE
United Kingdom

New York +1 646 653 7026
1,185 Avenue of the Americas
3rd Floor, New York, NY 10036
United States of America

Sydney +61 (0)2 8249 8342
Level 4, Office 1205
95 Pitt Street, Sydney
NSW 2000, Australia