EDISON

Acorn Income Fund

Finding opportunities in small-cap dividend payers

Acorn Income Fund (AIF) has produced solid long-term total returns (+138% share price and +135% NAV over five years) from its portfolio of UK smaller companies (70-80% of assets) and high-yielding securities (20-30%). The first half of 2016 has been a more challenging period, but over the latter part of the summer AIF has begun to reassert its trend of outperformance versus its benchmark. The allocation to the small-cap portfolio has been increased to the maximum 80% as the managers continue to find well-financed, dividend-paying smaller companies at attractive valuations. The current wider than average discount may reflect a degree of uncertainty ahead of the forthcoming five-yearly discontinuation vote; investors are reminded to vote *against* the special resolution if they wish to back the continuation of the company.

12 months ending	Share price (%)	NAV (%)	Acorn ZDPs (%)	Numis Smaller Cos ex-IC (%)	FTSE All-Share (%)
31/08/12	14.9	24.6	--	12.4	10.2
31/08/13	79.9	47.3	7.0	36.0	18.9
31/08/14	1.7	13.3	7.1	11.3	10.3
31/08/15	18.9	15.9	2.8	9.0	(2.3)
31/08/16	(4.6)	(2.5)	3.7	3.6	11.7

Note: Twelve-month rolling discrete £-adjusted total return performance.

Investment strategy: Focus on yield and growth

AIF has two investment advisers: Unicorn Asset Management (Simon Moon and Fraser Mackersie) for the smaller companies portfolio and Premier Fund Managers (Paul Smith) for the income portfolio. Both sets of managers follow a bottom-up style. The small-cap managers are looking for well-financed, growing companies at attractive valuations, which offer both a high yield (now or in the near future) and the prospect of dividend growth. The income portfolio provides a yield enhancement as well as offsetting some of the capital risk of small-cap investment.

Market outlook: Pockets of value amid uncertainty

The surprise outcome of the UK's EU referendum caused a sharp decline in equity markets, with smaller companies slower to recover than their larger counterparts. Emergency measures from the Bank of England put further downward pressure on bond yields and exacerbated liquidity problems in the fixed income market. However, while the uncertainty is far from over, investors may still find growing companies with attractive yields, particularly if they look beyond the largest stocks.

Valuation: Wider discount with scope to narrow

At 16 September AIF's shares traded at an 11.4% discount to cum-income NAV. This is wider than both short- and longer-term averages, possibly reflecting under-performance earlier in the year and uncertainty ahead of the discontinuation vote (see above). Strong medium- to longer-term performance and an attractive yield of 4%+ have seen the shares frequently trade at a premium, and it is reasonable to expect the discount to narrow (assuming shareholders vote against discontinuation) if the early signs of a return to outperformance become more established.

Investment companies

19 September 2016

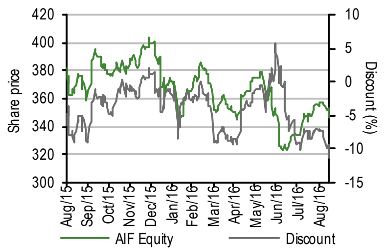
Price*	**345.5p**
Market cap*	**£55.0m**
AUM	**£90.0m**

NAV**	382.1p
Discount to NAV	9.6%
NAV***	389.7p
Discount to NAV	11.4%

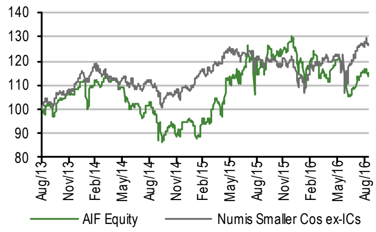
*Ords only. **Excluding income. ***Including income. Data at 16 September 2016.

Yield	4.3%
Ordinary shares in issue	15.9m
ZDPs in issue	21.4m
Code Ord/ZDP	AIF/AIFZ
Primary exchange	LSE
AIC sector	UK Equity & Bond Income

Share price/discount performance



Three-year cumulative perf. Graph



52-week high/low	403.5p	322.5p
NAV* high/low	400.2p	318.5p

*Including income.

Gearing (including ZDPs)

Gross*	47.2%
Net*	39.4%

*As at 1 September 2016.

Analysts

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Edison profile page

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

Exhibit 1: Investment company at a glance

Investment objective and fund background

AIF's objective is to provide a high level of income with the opportunity for capital growth. The portfolio is split into two pools: one (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 the Numis Smaller Companies (excluding investment companies) index.

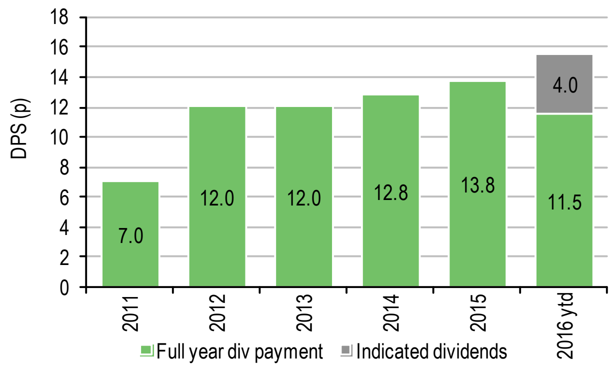
Forthcoming and recent developments

- 26 September 2016: AGM. Shareholders are reminded to vote **against** the discontinuation resolution if they wish the fund to continue.
- 30 August 2016: Results for the six months to 30 June. NAV TR -14.0% (ordinary shares); gross asset value TR -8.13% and share price TR -12.75% compared with -5.6% for NSCI ex-IC benchmark.
- 17 August 2016: Third interim dividend of 4.0p declared for FY16.

Forthcoming		Capital structure		Fund details	
AGM	September 2016	Ongoing charges	1.6%	Group	Premier Fund Managers
Annual results	March/April 2017	Net gearing	39.4% (through ZDPs)	Managers	Simon Moon, Fraser Mackersie (Unicorn), Paul Smith (Premier)
Year end	31 December	Annual mgmt fee	0.7% of total assets	Address	Eastgate Court, High Street, Guildford GU1 3DE
Dividend paid	Quarterly	Performance fee	Yes, see p7		
Launch date	11 February 1999	Trust life	Indefinite, subject to vote	Phone	+44 (0)1483 30 60 90
Continuation vote	Five-yearly, next 2016	Loan facilities	None	Website	www.premierfunds.co.uk

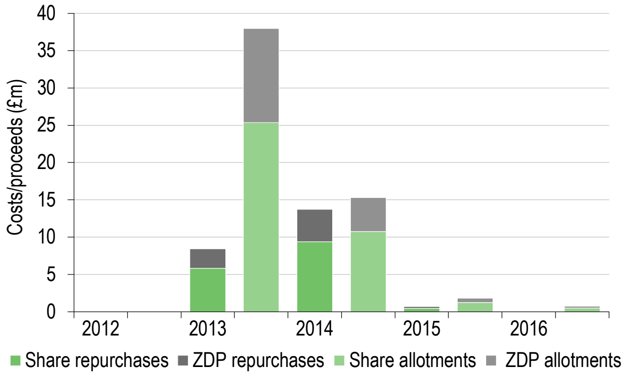
Dividend policy and history

Quarterly dividends paid in March, June, September and December. Higher dividends since 2012 facilitated by ZDP issue, which eliminated interest costs.

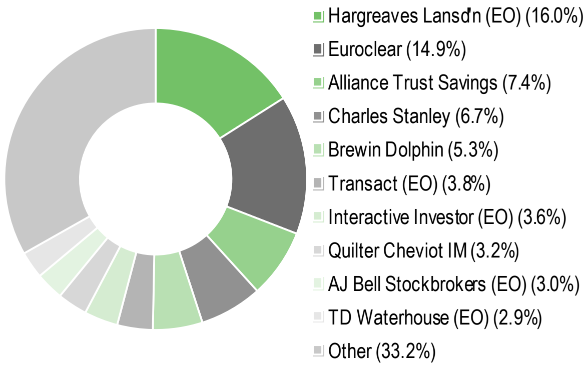


Share buyback policy and history

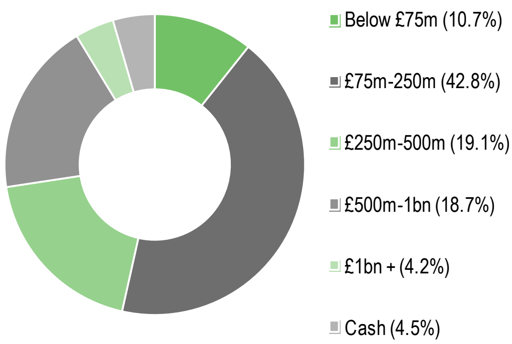
ZDPs are issued and bought back at the same time as ordinary shares in quantities such that the ratio of ZDPs to ordinary shares is maintained.



Shareholder base (as at 1 August 2016)



Portfolio exposure by market cap (as at 31 August 2016)



Top 10 holdings* (as at 31 August 2016)

Company	Market cap 9 Sept 2016	Sector	Portfolio weight % % of gross 31 Aug 2016	% of ptfl 31 Aug 2016	% of gross 31 Aug 2015**	% of ptfl 31 Aug 2015**
Conviviality Retail	£367.3	Off licences	3.3	4.1	N/A	N/A
Clipper Logistics	£297.6	Distribution	2.9	3.7	2.7	3.6
Macfarlane Group	£73.5	Packaging	2.9	3.6	3.3	4.4
Acal	£170.8	Industrial electronics	2.8	3.5	3.2	4.3
Secure Trust Bank	£414.6	Banking	2.5	3.2	2.8	3.7
Safestyle UK	£227.7	UPVC/building products	2.5	3.1	2.5	3.3
Primary Health Properties	£659.3	Real estate	2.5	3.1	2.9	3.9
Park Group	£128.6	Financial services	2.3	2.8	N/A	N/A
Castings	£195.2	Manufacturing	2.2	2.8	N/A	N/A
James Halstead	£937.1	Flooring	2.2	2.7	2.3	3.0
Smaller companies portfolio top 10			**26.1**	**32.6**	**27.5**	**36.4**
Income portfolio top 10			**6.0**	**29.7**	**6.4**	**26.2**

Source: Acorn Income Fund, Edison Investment Research, Morningstar, Thomson. Note: *All of the top 10 are constituents of the smaller companies portfolio. **N/A where not in 31 August 2015 top 10.

Market outlook: Does wall of worry lack foundation?

So far 2016 has proved a challenge for investors in both bonds and equities, with an ongoing tension between fears over the macroeconomic environment on one hand, and the need to eke out some kind of return in a continued climate of ultra-low interest rates on the other. This was exacerbated in June by the UK vote to leave the European Union, which led to an immediate sell-off in equity markets and a collapse in the value of sterling. While the first was reversed quickly (particularly for larger stocks with greater international exposure), the pound has only recently begun to recover a little. An interest rate cut by the Bank of England to a record low of 0.25%, accompanied by a new round of quantitative easing, has further delayed the anticipated normalisation of monetary conditions on this side of the Atlantic.

While share prices have risen, corporate earnings growth remains modest. This has led to falling levels of dividend cover, particularly for larger companies, leading to the possibility of dividend cuts. In light of this, a focus on well-financed, dividend-paying smaller companies with sustainable earnings could lead to a more stable and growing income stream, although with such a large, diverse and comparatively under-researched universe of UK companies (2,000+ compared with 100 in the large-cap index), investors may prefer to leave stock selection to experts in the sector.

Fund profile: Small-cap growth with added yield

Acorn Income Fund (AIF) was launched in 1999 to achieve a high income and the potential for capital growth from a portfolio that blends small- and mid-cap UK equities with high-yielding securities. It is incorporated in Guernsey and listed on the London Stock Exchange. An issue of zero dividend preference shares (ZDPs) in 2011 provided structural gearing and allowed for the repayment of debt, reducing interest costs and facilitating a material increase in the dividend, which is paid quarterly. The ZDPs are due for repayment in January 2017.

The fund has two distinct portfolios, with the smaller companies portfolio advised by Simon Moon and Fraser Mackersie at Unicorn Asset Management and the income portfolio advised by Paul Smith at Premier Fund Managers, which also acts as the overall investment manager. Benchmarked against the Numis Smaller Companies (excluding investment companies) index (NSCI), AIF has a very strong longer-term performance record; 10-year NAV total return of 211.5% is almost 100 percentage points ahead of its nearest rival in the AIC UK Equity & Bond Income sector.

AIF has a five-yearly discontinuation vote, with the next vote due at the AGM on 26 September 2016. AIF's board wishes to remind investors that in order to vote for the continuation of the fund, they must vote **against** the special resolution.

The fund managers: Moon, Mackersie and Smith

The managers' view: Business as usual after volatile summer

AIF's three investment advisers are keen to stress that it remains 'business as usual' in the aftermath of the Brexit vote, with clarity yet to emerge on how or when the process will be implemented and what its impacts will be. Smaller companies were initially hit harder than larger companies and took longer to recover, but Simon Moon and Fraser Mackersie see better earnings growth from small- and mid-caps both this year and next compared with FTSE 100 companies; combined with more favourable valuations, this should translate into superior returns and more sustainable dividends.

Where valuations have begun to look stretched, putting downward pressure on dividend yields, the managers have taken profits and reinvested into cheaper stocks with higher (average 5%+) yields.

This has led to the fund being able to increase its dividend materially (+14% from the first to the second interim). Special dividends have also boosted portfolio income, but the managers stress that these are in many cases semi-regular rather than one-off specials, and come from well-financed companies with strong balance sheets and confidence in the future.

The post-referendum correction brought some stocks on to the managers' radar that they would previously have deemed too expensive, including pub company Greene King. The firm made a significant acquisition in 2015 that is beginning to reap rewards, but was heavily sold off in the Brexit fallout amid recession fears because of its UK consumer focus. Moon and Mackersie note that in volatile environments, companies may be marked down severely for no apparent reason, adding that this is often a source of opportunity for them given their knowledge of the small-cap market.

Smith has run the income portfolio with short duration in recent years, commenting that this gives him greater liquidity and a more absolute return profile that is not reliant on central bank actions. He has added some index-linked exposure as he believes the market is underplaying inflation fears. As well as increasing holdings in closed-end funds, Smith has also added two structured notes in recent months. A J.P. Morgan-structured instrument is based on the performance of four large UK REITs versus the EPRA real estate index, and has produced good returns in the post-Brexit period as large-cap REITs outperformed the index; while a Natixis-structured investment is linked to the Euro Stoxx 50 and 10-year US swap rates. This has an 8.5% yield and 35% downside protection, meaning that it will not fall in value unless one of the comparators declines by 35% or more.

Asset allocation

Investment process: Growth and income from dual portfolio

The smaller companies portfolio of AIF normally makes up 70-80% of total assets, with the income portfolio at 20-30%; a 75/25 split is viewed as a neutral allocation. In the small-cap portfolio managers Simon Moon and Fraser Mackersie seek profitable companies with competitive advantages in growing markets. Stocks must be on a clear path to paying dividends if they do not do so already, as the managers believe the highest-quality companies should be able both to fund growth and reward investors with an income stream. The use of quantitative (profitability, income [yield and dividend cover], growth) and qualitative (analysis of end-markets and competitive advantage) screens narrows down a universe of more than 2,000 UK-listed companies to c 150-200 potential investments. The managers undertake c 500 company meetings annually so they can build a detailed understanding of existing and potential holdings. This gives them an advantage in assessing companies that may lack sell-side analyst coverage.

The managers limit themselves to a maximum of 50 holdings (currently 46 compared with a typical number nearer 40), which should be well financed, with high operating margins. Holdings come from across the small- and mid-cap bracket, with c 54% currently in companies with a market capitalisation below £250m. Some 38% of holdings are listed on AIM. Stocks in this area may be less liquid, and the managers hope to minimise any problems arising from this by doing their own dealing, which allows them to make best use of their networks and to be patient in building or selling down stakes. The most common reason for exiting a position is where strong capital performance has led to stretched valuations and caused a stock's dividend yield to fall; in these situations the managers will rotate into more attractively valued, higher-yielding stocks.

The income portfolio has a threefold aim of increasing the overall yield and providing a hedge to the extra capital volatility that may come from being structurally geared and from focusing on small-cap equities. Manager Paul Smith runs a longer stock list than in the equity portfolio (69 holdings at 31 August) in spite of having a smaller portion of the overall assets; this allows him to overcome issues with bond market liquidity and take positions in smaller bond issues (such as retail bonds) that would be impracticable for managers of larger mandates. Holdings are chosen on a bottom-up basis, though Smith takes account of the macro environment and the outlook for interest rates. The portfolio is currently a mix of fixed income securities, structured investments and closed-end funds.

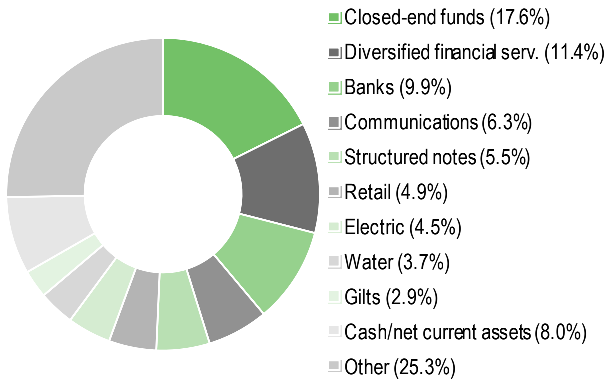
Current portfolio positioning

Following a shift in the allocation between the portfolios, AIF's smaller companies portfolio currently accounts for the maximum permitted 80% of assets, with the income portfolio at 20%. This reflects both a degree of confidence in the equity outlook and an appreciation of the difficulty of finding attractive investments for the fixed-income portfolio in the current climate. The smaller companies portfolio (Exhibit 3) has exposure to a broad range of sectors, although the managers avoid the resources and pharmaceutical sectors as a matter of policy, on the basis that they do not have the specialist technical knowledge necessary to gain an edge over other investors in these areas. There is a tilt towards industrial companies, including a c 11% weighting in industrial transportation.

While Moon and Mackersie take a longer-term approach to investing, their focus on valuation and dividend growth potential has led to several portfolio changes so far in 2016. Longstanding industrial holdings VP (plant hire and equipment) and Diploma (specialist technical products and services) were sold after strong capital performance led to yield compression, although the managers say they would happily repurchase the stocks at a lower price. The managers used the proceeds to invest in higher-yielding stocks on more favourable valuations, specifically greetings card retailer Card Factory, logistics firm Wincanton, pub company Greene King, audiovisual equipment distributor Midwich, private airport operator BBA Aviation and in-home lender Morses Club. Midwich and Morses Club were bought at IPO, while Wincanton, Greene King and BBA Aviation were already held in the managers' open-ended portfolios.

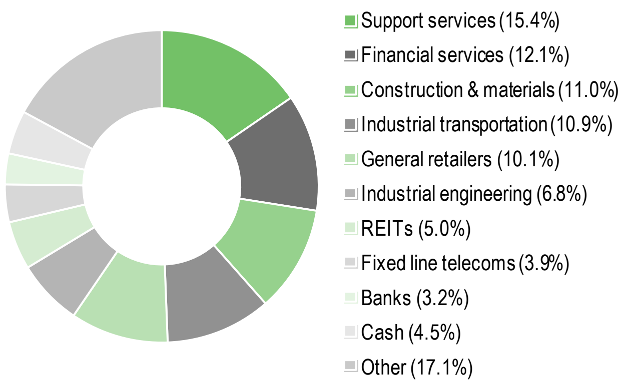
Former top 10 holding British Polythene Industries has exited the portfolio after being acquired by RPC Group, and mail operator DX Group was sold following disappointing performance.

Exhibit 2: Sector exposure of income portfolio



Source: Acorn Income Fund, as at 31 August 2016

Exhibit 3: Sector exposure of smaller companies ptfl



Source: Acorn Income Fund, as at 31 August 2016

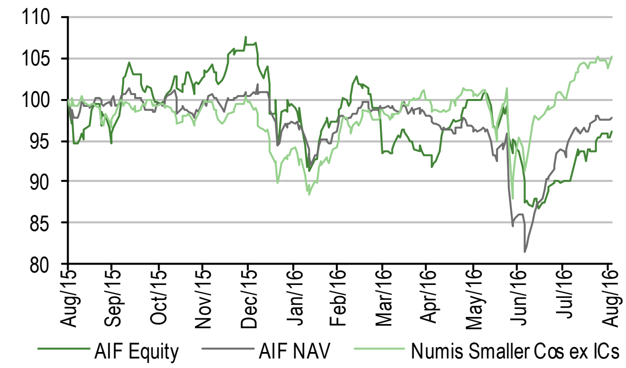
While some stocks in the small-cap portfolio were negatively affected by the Brexit vote, such as top 10 holding Secure Trust Bank, the managers point to the broad diversification of the portfolio, with two-thirds of revenues coming from the UK and one-third from abroad.

In the income portfolio (Exhibit 2), exposure to banks (18.1% at the time of our last note) has fallen after some issuers used the first opportunity to 'call' their contingent convertibles (CoCos). Closed-end fund exposure has risen, with manager Paul Smith actively trading JPMorgan Global Convertibles Income to take advantage of falling bond yields, and buying credit hedge fund DW Catalyst and alternative finance fund Hadrian's Wall. With value in conventional bonds hard to find, Smith has also been structuring investments with issuers such as J.P. Morgan and Natixis (see The managers' view), and buying inflation-linked retail bonds issued by Tesco.

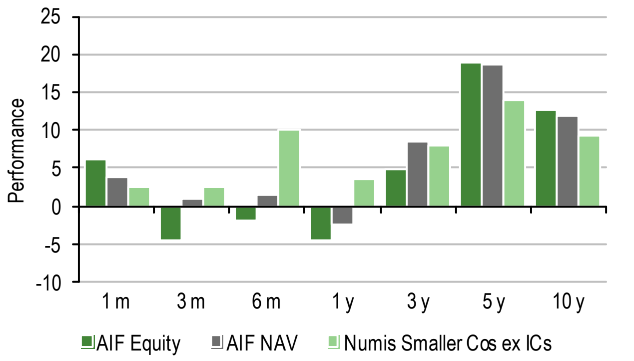
Performance: Bouncing back after Brexit blow

Exhibit 4: Investment trust performance to 31 August 2016

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



Price, NAV and benchmark total return performance (%)



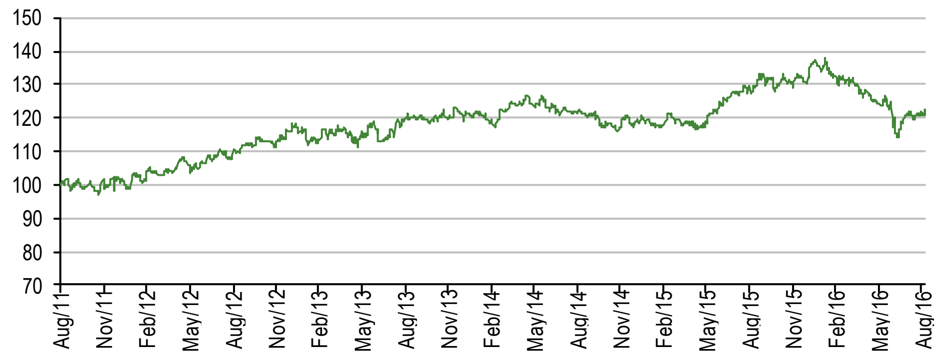
Source: Thomson Datastream, Edison Investment Research. Note: Three-, five- and 10-year performance figures annualised.

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

	One month	Three months	Six months	One year	Three years	Five years	10 years
Price relative to Numis Smaller Cos ex ICs	3.5	(6.9)	(10.9)	(7.9)	(8.2)	24.1	35.3
NAV relative to Numis Smaller Cos ex ICs	1.1	(1.6)	(7.8)	(6.0)	1.7	22.2	27.1
Price relative to FTSE All-Share	4.2	(12.3)	(13.4)	(14.6)	(4.2)	51.2	86.3
NAV relative to FTSE All-Share	1.9	(7.3)	(10.4)	(12.8)	6.2	48.8	75.1

Source: Thomson Datastream, Edison Investment Research. Note: Data to end-August 2016. Geometric calculation.

Exhibit 6: NAV performance relative to benchmark over five years



Source: Thomson Datastream, Edison Investment Research

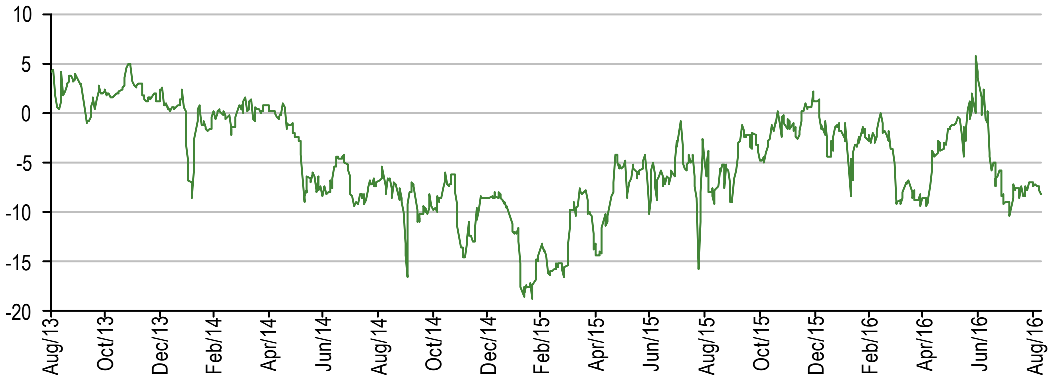
The first half of 2016 was a challenging period for AIF, with sentiment towards smaller companies hit by rising risk aversion at the start of the year, followed by a sharp fall in values in the immediate aftermath of the UK's EU referendum. While the large-cap UK index bounced back quickly, smaller companies took longer to recover and AIF's portfolio was punished more severely than the benchmark NSCI. AIF's NAV and share price performance beat the NSCI in August, but underperformance in the first half of 2016 has dented the fund's medium-term track record versus both the index and the wider UK stock market (Exhibits 4 and 5). However, longer-term performance remains very strong, with annualised share price and NAV returns approaching 20% over five years, and the recent uptick may point to a re-establishment of AIF's positive long-term record (Exhibit 6).

Strong performers in the small-cap portfolio recently include concrete screeding equipment maker Somero Enterprises (which derives most of its revenues from the US and is thus a beneficiary of sterling weakness), international IT recruitment specialist FDM and transport infrastructure play Hill & Smith. The income portfolio has benefited from holdings in bonds issued by BT and ITV.

Discount: Still within longer-term range

At 16 September, AIF's shares traded at an 11.4% discount to cum-income NAV. While this is within the longer-term range, it is wider than the average over one, three and five years. A tension between the attraction of a high dividend yield (4%+) and the swings in sentiment towards smaller companies, which are seen as more risky than large-caps, has seen the fund move between a premium and a discount over recent years. Unusually, the shares spiked to a three-year high premium of 5.9% in the immediate aftermath of the EU referendum – a period in which most investment trust discounts widened – because the prices of the underlying small-cap stocks declined more quickly than the price of AIF's own shares, leading to a steep (if swiftly reversed) fall in the NAV.

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



Source: Thomson Datastream, Edison Investment Research

Capital structure and fees

AIF currently has two classes of share, with 15.9m ordinary shares and 21.4m ZDPs in issue. The ZDPs mature in January 2017 and the board and management of AIF are considering options for replacing them, possibly with a rollover issue of ZDPs or with another form of leverage. The ZDPs have a final capital entitlement of 138p and at 9 September traded at a price of 136p with a NAV of 134.5p. Gross gearing via the ZDPs was 47.2% at 1 September.

An annual management fee of 0.7% of AIF's total assets is payable to Premier Asset Management (Guernsey), from which fees to the investment advisers are paid. A performance fee of 15% of excess returns may be payable if the NAV per share plus dividends has grown by more than 10% per annum compound since the last year-end in which a performance fee was paid. No performance fee has been paid since FY13. We calculate ongoing charges at H116 (30 June 2016) as 1.6%.

Dividend policy and record

AIF pays dividends quarterly, in March, June, September and December. In the last three financial years, the first interim dividend has been set at the same level as the fourth interim of the previous year, with a higher second interim setting the bar for the rest of the year. On this basis, with one dividend of 3.5p and two of 4.0p declared so far for FY16, it would be reasonable to assume a total for the year of at least 15.5p, a prospective yield of 4.5% based on the 16 September share price.

Dividends have been fully covered by income in each of the last five financial years and have grown at a compound annual rate of 14.5%. Based on guidance for the FY16 dividend, the payout will have more than doubled since 2011, when the introduction of the ZDPs allowed the repayment of bank borrowing, reducing interest costs and allowing a materially higher dividend to be paid.

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Peer group comparison

AIF is a member of the AIC UK Equity & Bond Income peer group. The sector contains funds that hold a mix of equity and bond investments, although the split between asset classes varies and most of the peers have a larger-cap equity focus. Strong longer-term performance means AIF is comfortably top of the group for NAV total returns over five years, while the more challenging recent conditions have seen it slip to last place over 12 months and mid-table (although still above average) over three years. Ongoing charges are in line with those of its closest peer (run by Aberdeen), and AIF is one of three funds with a performance fee structure in place. The ZDPs give AIF the highest level of gearing in the sector, while the yield and the discount are both broadly in line with the unweighted average. Risk-adjusted performance as measured by the Sharpe ratio is below average over one year, but in line over three years.

Exhibit 8: UK Equity & Bond Income peer group as at 9 September 2016

% unless stated	Market cap £m	NAV TR 1 Year	NAV TR 3 Year	NAV TR 5 Year	Ongoing charge	Perf. fee	Discount (ex-par)	Net gearing	Dividend yield (%)	Sharpe 1y (NAV)	Sharpe 3y (NAV)
Acorn Income Fund	**56.4**	**0.1**	**27.1**	**141.2**	**1.6**	**Yes**	**(6.9)**	**135**	**4.4**	**(0.8)**	**0.1**
Aberdeen Smaller Companies Inc	44.3	5.1	30.8	119.8	1.5	No	(21.9)	110	3.4	(0.6)	0.2
City Merchants High Yield	172.3	11.0	24.9	63.8	1.0	No	2.4	93	5.2	(0.5)	0.1
CQS New City High Yield	211.8	7.7	16.6	44.6	1.3	No	5.8	109	7.5	(0.7)	(0.1)
Henderson High Income	209.2	8.8	32.4	108.2	0.8	Yes	4.9	123	4.7	(0.3)	0.2
Investors Capital A Share	115.4	14.6	21.0	66.2	1.1	No	(7.9)	104	4.8	(0.1)	0.0
Investors Capital B Share	115.1	14.7	21.0	81.8	1.1	No	(8.2)	98	0.0	(0.1)	0.0
Investors Capital Units Unit	123.4	14.6	21.0	66.2		No	(7.9)	100	4.1	(0.1)	0.0
Jupiter Dividend & Growth Common	9.3	8.7	28.8	82.7	1.3	Yes	(12.9)	100	2.1	(0.4)	0.1
Simple average	**117.5**	**9.5**	**24.8**	**86.1**	**1.2**		**(5.8)**	**108**	**4.0**	**(0.4)**	**0.1**
Weighted average		**10.2**	**23.8**	**77.9**	**1.1**		**(1.5)**	**108**	**5.3**	**(0.4)**	**0.1**
AIF rank in sector	**7**	**9**	**4**	**1**	**8**		**4**	**1**	**5**	**9**	**4**

Source: Morningstar, Edison Investment Research. Note: TR=total return. Sharpe ratio is a measure of risk-adjusted return. The ratios shown are calculated by Morningstar for the past 12- and 36-month periods by dividing a fund's annualised excess returns over the risk-free rate by its annualised standard deviation. Net gearing is total assets less cash and equivalents as a percentage of net assets.

The board

There are three non-executive directors on the board of AIF. Helen Green became a director in 2007 and has served as chairman since 2012. Nigel Ward was appointed in 2011 and David Warr joined the board in 2012. The directors have professional backgrounds in accountancy and investment management and all are resident in Guernsey, where AIF is incorporated.

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