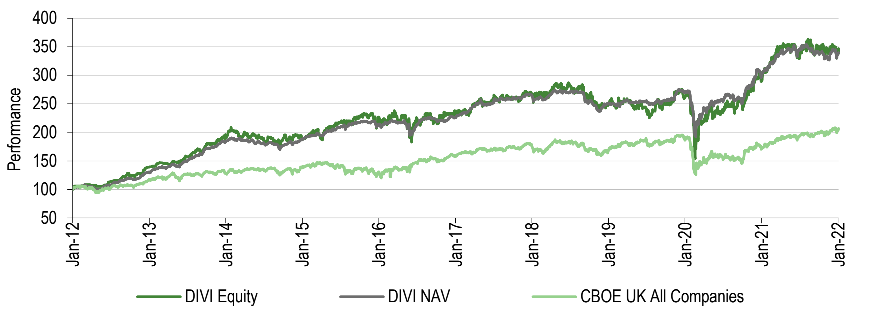
The Diverse Income Trust

Navigating a volatile 2022

Alpha generation and low correlation of Diverse Income Trust (DIVI) with major UK indices has resulted in a steady long-term total return. After celebrating its 10-year anniversary last year, multi-cap DIVI continues to be among the top-ranked UK high dividend-yield trusts over periods longer than three years, despite some setbacks in short-term performance against peers due to its relatively high AIM exposure. About a third of DIVI's portfolio is in AIM-listed stocks, while most peers are more exposed to large caps. Looking ahead, portfolio managers Williams and Turner expect their multi-cap income approach to continue to deliver over the medium to long term, and for the UK equity market to outperform the US.

DIVI's 10-year performance*



Source: Bloomberg, Edison Investment Research. Note: *Performance rebased, TR in GBP.

Why invest in DIVI now?

The trust has continued to deliver an attractive dividend income throughout the COVID-19 pandemic. The board intends to at least maintain the FY22 dividend payment at the FY21 level (3.75p per share), when the ordinary dividend was increased by 1.4%. The managers only buy shares that generate a substantial cash payback. New holdings with high dividends and growth potential constantly refresh the portfolio. When markets fall, cash-rich companies that populate DIVI's portfolio can expand and strengthen, taking advantage of acquisition opportunities at bargain prices. The managers expect this to happen with a number of UK companies and look for more opportunities in 2022 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 changed significantly either during the pandemic or throughout its life. The trust has delivered attractive returns on the still dominating high-beta markets of the past decade. In 2021, as the AIM market underperformed the broader UK market, DIVI's performance lagged peers. DIVI's 14% NAV TR over the 12 months to end-January 2022 was below the peer group average of 20%. Whether or not the UK stock market recovers, we expect DIVI to capture extra returns amid a potential market shift from growth to value as global growth slows. High equity valuations took a hit at the start of 2022. If they continue to unwind, DIVI is well positioned to outperform indices and peers, given its income-generating multi-cap strategy and diverse sources of income.

NOT INTENDED FOR PERSONS IN THE EEA

Investment trusts
UK multi-cap equity income

21 February 2022

Price	**114.0p**
Market cap	**£412m**
AUM	**£402.8m**

NAV*	111.6p
Premium to NAV	2.2%
NAV**	113.1p
Premium to NAV	0.8%

*Excluding income. **Including income. At 18 February 2022.

Yield	3.3%
Ordinary shares in issue	361.9m
Code	DIVI
Primary exchange	LSE
AIC sector	UK Equity Income

52-week high/low*	121.5p	103.5p
NAV** high/low	120.7p	107.0p

*A-shares. **Including income.

Gearing

Net cash at 31 December 2021	1.8%

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. Building 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.

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Edison profile page

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Managers’ view and portfolio positioning

As the UK emerged from 2021 Christmas festivities into a volatile January 2022, DIVI’s managers expect a ‘bumpy ride’ in UK equities during 2022, with periods of rallies and setbacks.

They believe companies with the potential to generate cash surpluses each year, such as equity income stocks, have a natural advantage during more unsettled periods. The managers estimate that about a fifth of UK private and public companies that have borrowings, are ‘zombie’ companies, unable to pay interest on their debt. When stock markets peak and decline, many such businesses become forced sellers of their assets to settle debts. During such unsettled times, portfolio managers Williams and Turner expect cash-generating companies to acquire some of the over-levered, but otherwise viable, businesses from the administrator-receiver. These acquisitions could enable cash-rich companies to generate more cash, contrary to the general trend, as others go bankrupt or struggle.

The proportion of AIM and small-cap stocks in DIVI’s portfolio increased to 37.2% and 17.1% (at end-December 2021) from 31.7% and 11.4% respectively (at end-January 2021, Exhibit 1). Together they represent the largest share of DIVI’s portfolio at 54.3%.

Exhibit 1: DIVI’s capitalisation weighting

	End December 2021	End January 2021	Change:
AIM stocks	37.2	31.7	5.5
Large caps	22.6	24.0	-1.4
Small caps	17.1	11.4	5.7
Mid caps	14.8	20.1	-5.3
UK listed non-index shares	2.0	2.3	-0.3
Overseas	1.3	2.1	-0.8
Other (fledging, bonds)	2.1	3.1	-1.0
Cash	1.8	5.3	-3.5
UK FTSE 100 put option	1.1	0.0	1.1
Total:	100.0	100.0	

Source: The Diverse Income Trust

DIVI continues to source its income from a wide range of sectors (Exhibit 2).

Exhibit 2: Portfolio breakdown by sector

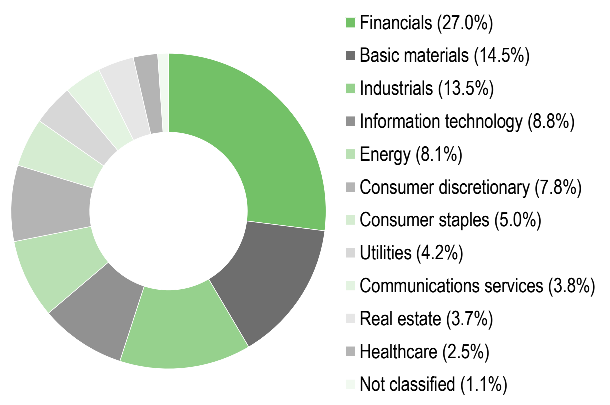
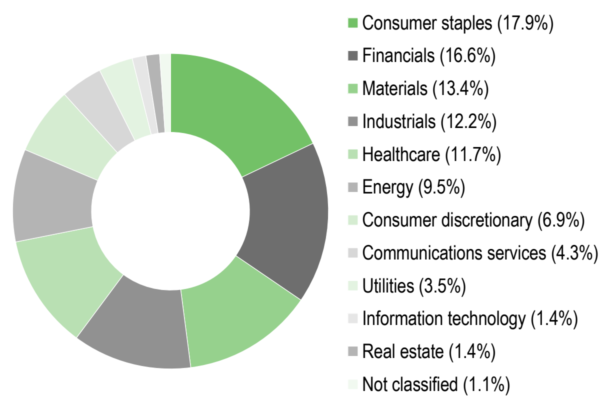


Exhibit 3: Major UK large-cap index sector breakdown



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

Although the trust has a high proportion of cyclicals, such as financial, materials and energy, in the portfolio, its sector representation differs from that of a major UK large cap index (Exhibit 3), and hence offers a differentiated source of income to investors, from selective cash-rich companies in each sector.

Financials is the biggest sector (27% at end-December 2021). This sector contains a wide range of financial businesses, big and small. The top 20 holdings include a large insurer, Legal & General (1.6% of the portfolio at end-December 2021), and Man Group (1.4%), an investment management company. The top 20 list also contains K3Capital (top holding, 2.4%), an AIM-listed corporate finance business for SMEs that targets growing dividends for the next two years, and CMC Markets (2.0%), a financial derivatives dealer.

The basic materials sector has the second largest weighting (14.5%) and Kenmare Resources (second top holding, 2.4% of the portfolio at end-December 2021) is the largest sector holding. Williams and Turner have considered mining companies to be a good value during the past few years and have built and maintained exposure to the the sector. Nevertheless, the managers' risk aversion prompted them to sell Polymetal, a Russian gold miner, and Eurasia mining, a platinum and gold projects developer in Russia. Both companies were sold at the beginning of 2022 on the escalation of geopolitical risk around potential Russian invasion of Ukraine.

The industrial sector is the third largest (13.5%) and is very diverse. Among the industrial holdings are Strix Group (top 20 holding, 1.7%), a manufacturer of kettle safety products, Smurfit Kappa, a manufacturer of paper packaging products, and Forterra, a manufacturer of masonry products, such as clay bricks and concrete blocks. A recent addition to the sector is Mears Group, a social housing repairs and maintenance service provider for local authorities and registered social landlords in the UK. Mears employs over 15,000 people and provides services to over 10% of the UK social housing stock. The managers believe this construction and services business has considerable growth potential in the UK.

Non-conventional information technology stocks form the fourth largest sector (8.8% weighting) of the portfolio. These include AIM-listed semiconductor manufacturer for the communications industry, Concurrent Technologies, which designs, manufactures and markets single board computers used in the telecommunication, telemetry, military and aerospace industries. Other companies paying generous dividends are CML Microsystems, a semiconductor manufacturer in the communications sector and iEnergizer, a business outsources services company.

iEnergizer has been in the portfolio for over two years, but is overlooked by most fund managers. Operating from India, iEnergizer provides tele-support for UK companies and has expanded in Mexico to cover the US market. The valuation was very low when DIVI purchased the shares and the share price has gone up c 700% during the time of DIVI's share ownership. The company generates cash, pays dividends and around third of its £730m market cap is represented by cash.

Performance

Exhibits 4 and 5 illustrate DIVI's outperformance of the CBOE UK All Companies index over three and five-year periods, when long-duration (or growth) assets were generally outperforming. DIVI's discrete performance is little correlated with UK indexes, as Exhibits 4 and 5 also show.

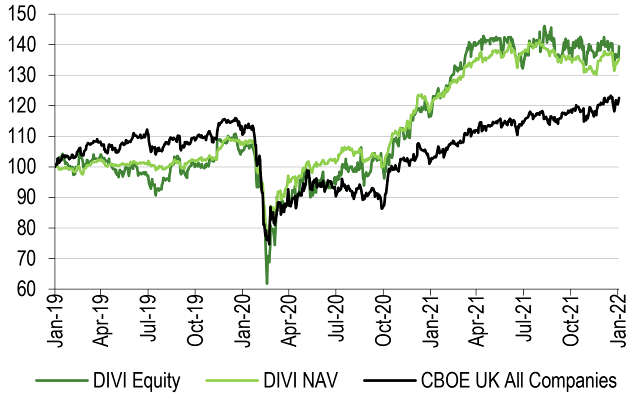
Exhibit 4: Five-year discrete performance data

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 (%)
31/01/18	15.6	17.0	11.3	15.1	19.6	22.6
31/01/19	(7.2)	(4.8)	(3.9)	(0.4)	(7.6)	(12.9)
31/01/20	5.2	7.4	10.5	11.5	13.7	5.0
31/01/21	10.7	9.8	(8.6)	(15.9)	(0.8)	23.1
31/01/22	16.8	13.9	19.3	18.9	29.4	(4.8)

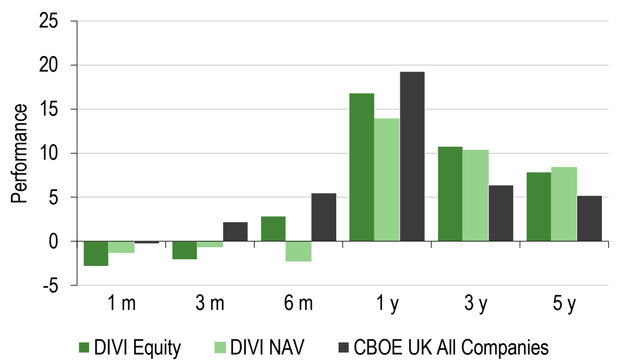
Source: Refinitiv. Note: All % on a total return basis in pounds sterling.

Exhibit 5: Investment company performance to 31 January 2022

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



Price, NAV and index total return performance (%)



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

Discrete performance over the five years to 31 January 2022 was mixed relative to the CBOE UK All Companies index (Exhibit 4), such that the trust's NAV underperformed in three periods out of five on a TR basis. However, DIVI has performed more strongly over longer periods (Exhibit 5). DIVI's multi-cap approach led to the less volatile performance compared to the CBOE UK Small Companies and Major AIM All-Share indices and outperform all-cap indices during their periods of lacklustre performance, such as in 2021 (Exhibit 4).

Exhibit 6 compares DIVI's performance with 11 peers in the UK income sector. DIVI is the second top performing fund over three and 10 years (the latter attained shortly after its launch on 28 April 2011), and third over five years, on the NAV TR basis. The short-term one-year performance to end-January 2022 ranks DIVI close to the bottom of the 12 companies in the peer group, despite its positive 14.0% NAV TR.

Major UK large-cap, all-cap, mid-cap and small-cap indices returned 19.6%, 17.8%, 9.7% and -5.7% on a TR GBP basis, for the past 12 months till end-January 2022, respectively. This explains DIVI's underperformance over one year, relative to larger-cap peers, as DIVI has over half of its portfolio in the combination of AIM-listed (37%) and small-cap stocks (17%), at end-December 2021.

Exhibit 6: Selected peer group at 31 January 2022*

% unless stated	Ticker	Market cap £m	NAV TR 1 year	NAV TR 3 year	NAV TR 5 year	NAV TR 10 year	Discount (cum-fair)	Ongoing charge	Net gearing	Dividend yield (%)**
Diverse Income Trust	DIVI	**402.6**	**14.0**	**34.2**	**48.7**	**233.2**	**(1.6)**	**1.1**	**100**	**3.4**
Aberdeen Standard Eq Inc Trust	ASEI	175.1	16.1	3.6	10.7	94.4	(2.3)	0.9	100	5.8
BMO Capital & Income	BCI	353.3	18.9	22.8	37.5	125.7	0.6	0.6	107	3.5
City of London	CTY	1,801.8	23.9	21.0	29.7	127.3	0.8	0.4	108	4.8
Dunedin Income Growth	DIG	459.3	7.8	31.4	41.5	114.2	0.5	0.6	108	4.2
Edinburgh Investment Trust	EDIN	1,099.1	23.9	15.3	17.7	129.0	(7.9)	0.4	106	3.8
Finsbury Growth & Income	FGT	1,944.5	6.7	24.5	53.8	237.5	(3.7)	0.6	100	2.0
JPMorgan Claverhouse	JCH	446.0	20.2	23.0	31.0	139.8	0.9	0.7	120	4.1
Lowland	LWI	378.3	25.7	17.6	18.8	134.7	(3.4)	0.6	115	4.3
Merchants Trust	MRCH	731.7	35.9	41.6	53.8	165.5	1.2	0.6	110	4.8
Murray Income Trust	MUT	1,028.2	15.0	32.6	44.9	127.3	(6.4)	0.5	109	3.7
Temple Bar	TMPL	799.2	30.1	11.0	17.9	109.5	(3.6)	0.5	No	107
Simple average (12 funds)		801.6	20.0	22.2	32.2	129.0	(2.1)	0.6	108	4.0
Rank in peer group		**9**	**10**	**2**	**3**	**2**	**6**	**1**		**10**

Source: Morningstar, Edison Investment Research. Note: *Performance to 31 January 2022 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. ***since DIVI's launch on 28 April 2011.

With UK markets performing strongly over recent quarters, many AIM listed companies raised additional capital during 2021, ahead of the year-end. Therefore, during November and December there were an unusually large number of small-company fund raisings that led, as the portfolio managers put it, to 'some market indigestion'. Over the 12 months to end-January 2022, the supply of small-cap shares exceeded demand and small-cap shares underperformed large caps.

UK major large-cap index put option

The managers bought a FTSE 100 Index put option during Q421. This insurance costs c 1% NAV a year, but the managers believe market volatility will continue in 2022 and prefer to insure the fund from any sharp market correction, similar to the one in March 2020. DIVI did have a put option in place then and exercised it at a profit, receiving c 13–14% of NAV surplus cash into the fund.

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.

Since FY15, DIVI's regular dividend has grown at an annual compound rate of 9%, exceeding the annual growth target of 5–7% per year anticipated by the team during normal market conditions.

Revenue reserves stood at £15.9m at the end of H121 (to end November 2021). This is equal to c 1.2x the ordinary annual dividend payment. The board used some of its revenue reserves to pay the 3.75p per share FY21 dividend (increased from 3.70p in FY20). The trust also used some of its revenue reserves in FY20 (to end-May 2020), as revenue per share fell 17%, to smooth dividend payments to shareholders. During H121 the trust's revenue per share fell again, this time by 11% over the corresponding period, as lockdowns hit the economy, lowering business activity. The situation has since improved and the board expects revenue to recover in FY22 and coming years.

On 20 October 2021, the company declared a first interim dividend of 0.9p per ordinary share for FY22. The board expects to at least maintain the full-year ordinary dividend of 3.75p per share for the year to May 2022 and does not envisage paying a special dividend in FY22.

Board: Director change

On 24 January 2022 the company announced that, after a process run via an independent recruitment consultant, Charles Crole was appointed as an independent non-executive director, with effect from 1 February 2022. Mr Crole is head of Institutional at Guinness Asset Management and the chairman of the Investment Committee of MacRobert Trust. He previously served as a non-executive director of Jupiter Green Investment Trust. Charles has over 35 years of executive experience in the asset management sector across a range of fund management responsibilities, including 19 years at Schroder Investment Management and 12 years at Jupiter Fund Management. In addition, he has held a number of non-executive and trustee roles and is an associate at the Society for Investment Professionals.

As recorded in the 2021 annual report, Paul Craig has served almost 11 years on DIVI's board and will be stepping down on 28 February 2022, in line with the recommendations of the AIC Code of Corporate Governance. This will return the board to five directors.

The managers and fund profile

DIVI was launched in April 2011 as a multi-cap UK income and growth strategy by Gervais Williams and Martin Turner, who continue to co-manage the trust. Williams is a well-known manager of UK equities within the City of London. His passion for UK equities investing, combined with experience and strong performance track record, make him an influential opinion maker within UK investment circles.

The fund remains the only pure multi-cap fund within its UK income closed-end peer group. Unconstrained by index considerations, the managers have a wide universe from which to find attractive stocks. Their investment approach is bottom-up, looking for companies that are able to generate sustainable cash flows and underpin long-term dividend growth. Williams and Turner are smaller company specialists and often find the most interesting investment opportunities in this segment of the UK equity market. Small caps can operate in sectors that are not represented by companies in the mainstream indices, thereby offering genuine diversification benefits. Furthermore, they can be overlooked by sell-side analysts, which can result in underappreciated valuations.

ESG: Active engagement with companies

The portfolio management team seeks to pick companies that deliver outstanding service levels. After the qualitative analysis, only companies whose boards know the tasks and challenges of staff at all levels, from top management to shop floor, are considered potential DIVI holdings. The team collects this information, asking companies' management a number of relevant questions. These include how often they do staff surveys, the date of the last staff survey, the key outcomes of the survey, whether the results of the staff survey are included in the board papers. The portfolio managers follow up on these metrics regularly, as any dip in staff engagement is often reflected in a dip in customer service and also profit margin. Thereafter they usually ask the management teams of the trust's holdings to report on staff engagement and service standards regularly via their presentations and annual reports. They also seek progress on the disclosed matters with many companies including some data, and the nature of that data becoming more extensive over time.

On top of this, the portfolio team engages with companies, aiming to identify and scale back the downside risks to the business. Routinely this involves asking about the safety record, about near misses, and if appropriate why this data is missing from their presentations and annual reports. In some industries such as mining, where safety is often considered as the number one agenda item in all internal meetings, DIVI's team requests to highlight this at external meetings as well. Nearly all of the trust holding companies now report safety data as the first datapoint in their communication. A recent good example is DIVI's holding Pan African Resources, where safety was discussed in the first sentence in the news release for investors.

DIVI also continues to engage on remuneration, board composition, corporate purpose in the way it has done for many years. These arrangements for most of the companies in which the trust invests are already in a position that the portfolio managers consider appropriate. As part of the monitoring process and ongoing engagement with FTSE100 and some other companies in DIVI's portfolio, if DIVI believes that the top executives' remuneration is too high, the team would vote against their remuneration reports.

Lastly, with climate change, the team engages with all the trust's holdings on how they can identify the quantum of the carbon emissions, and then over time find ways to scale it down. Some companies already have very limited carbon emissions. In some instances, DIVI invests in companies with relatively high emissions, where they believe, these emissions will be scaled back considerably over time. For example, Vesta wind turbine normally sits on a 800 tonne steel mast. Vesta might have a modest carbon footprint, but they still rely on the steel industry to get their turbines working. The team believes that the financial services sector has a responsibility to address this agenda, in part by providing capital so that steel companies and others can progressively reduce their carbon footprints over time. DIVI does not have a steel manufacturer in the portfolio currently, but this principle applies to a number of manufacturing businesses within DIVI's portfolio.

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