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The Diverse Income Trust plc – 10 year anniversary

Fund managers: Gervais Williams & Martin Turner

The Diverse Income Trust has grown to become a 10 year old. Fund managers Gervais Williams and Martin Turner discuss why they remain upbeat about the trust's long term potential.

The advantages of being in a compounding income strategy on The Diverse Income Trust's 10 year birthday

In investment circles, we use the shorthand terms "Growth" and "Value" to distinguish between fund strategies. But as with all generalisations, the convenience of simplicity carries with it the disadvantage of overlooking some of the detail. There are successful fund strategies that invest in immature businesses with very high growth expectations whose share prices rise as they grow, and others that buy into recovering "fallen angels", whose share price moves can be even greater. Alongside, there are the many equity income stocks that may grow slowly in capital terms, but boost their modest share price appreciation via cash dividend payments, whilst other income strategies seek out stocks with lower starting yields in anticipation that the growth of their dividend income may be more rapid.

In other words, there is another way of categorising investment strategies. Those that aim to deliver a return through maximising share price appreciation can be distinguished from those where the return is more closely linked with the compounding of regular cash dividends. For the purposes of discussion, perhaps we can name these Capital Gain or Compounding Income strategies. Importantly, both of these groups can include Growth and Value approaches.

During periods when stock market liquidity is plentiful, strategies that participate in rapidly rising share prices often outperform, because they don't just go up with the growth/recovery, but because their valuations move up as well. Certainly, market liquidity has been plentiful over recent years, and asset valuations have risen considerably as demonstrated by the appreciation of long-dated fixed income paper. Many Capital Gain funds currently have the strongest performance records as a result.

In this context, over the last ten years since issue, the Diverse Income Trust strategy has been somewhat out of favour. It has been successful in terms of paying regular and growing cash

dividends to shareholders that have compounded better than many others. The valuation of the Trust's portfolio has also appreciated, so its total return is also one of the best in its peer group – the UK Equity Income Investment Trust sector. But in essence, strategies such as ours that deliver returns by compounding regular cash dividends, have been outpaced by those that maximise capital appreciation over the last ten years.

As with the fable of the hare and the tortoise, market trends aren't consistent – they do change. Furthermore, academic reviews of past stock market data often conclude that the best long-term returns are generated via Compounding Income strategies rather than the Capital Gain method. In this context, it is worth noting that some of the factors that have boosted the returns of the Capital Gain strategies over recent years are currently running out of steam. There is an absolute limit as to how far long-dated bond yields can fall. Alongside, if inflationary pressures were to rise, then the valuations of the most volatile high-Beta stocks would tend to be the most adversely affected by a reduction in the discount rate.

One of the major advantages of a Compounding Income strategy is that a large part of those returns is not reliant on the trajectory of the mainstream stock exchange indices. Even if the share price of a basket of equity income stocks were to remain unchanged for some years, investors would still receive an absolute return via the ongoing dividend payments. Better still, if the dividend payments gradually increased each year, this return would also steadily increase.

The differences between the Capital Gain and Compounding Income strategies are even starker in more challenging stock market conditions. Unfortunately, the long-term potential upside to companies with persistently negative cash flows disappears if they are obliged to keep issuing new shares to fund their businesses at very disappointing valuations. And if those that are unable to raise new capital go bust, then the original shareholders are effectively forced sellers at a near zero valuation. In contrast, whilst challenging economic conditions are also difficult for Compounding Income stocks, those with surplus cash are more likely to be in a position where their returns actually improve, because they can buy businesses with the prospect of generating a future surplus cash at incredibly distressed valuations. Perhaps this explains why the academic evidence implies that Equity Income strategies tend to outperform most others over the long-term.

We believe these advantages are even more significant in the case of the Diverse Income Trust strategy, given its multi cap approach. Small caps are often younger businesses, with greater potential to grow, even at times of economic challenge. Furthermore, an acquisition at a distressed valuation can make a transformational improvement to the returns of a quoted small cap.

Overall, as fund managers of the Diverse Income Trust we are very upbeat about its potential. It has delivered premium returns relative to its peer group over the last ten years, when the strategy was out of fashion. If these headwinds fall away, or are replaced by tailwinds that are

beneficial to equity income strategies, then there is a real opportunity for the Diverse Income Trust to deliver returns which are superior not only to those of other Compounding Income funds, but also Capital Gain strategies.

For more information about the trust, visit diverseincometrust.com

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