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The Diverse Income Trust

Trust manager: Gervais Williams

Gervais Williams, manager of The Diverse Income Trust, outlines a number of traditional investment strategies and evaluates whether it is possible to position your portfolio in order to employ them in tandem.

Why quality outperforms

The scenario

There are a number of different investment strategies that can generate good client outcomes over the longer term.

- One strategy buys into the share prices of stocks that have suffered a major setback, because those selling have become too emotional and are therefore insensitive to their recovery potential. The return principally comprises forthcoming share price appreciation, as often the stocks that disappoint badly have ceased to pay dividends or cut them substantially.
- Another strategy tends to focus on stocks which aren't likely to grow rapidly, and hence the returns are principally driven by surplus cash on past investment. These kinds of stocks can fund a premium dividend yield that is anticipated to grow into the future. This strategy can deliver a return via an attractive, premium stream of cash dividend payments which is valuable at times when the stock market indices themselves might be flatlining for several years, or indeed decades.
- A third strategy is to identify individual stocks, where clients are so pleased with the customer service, that they are able to charge premium prices for the services or goods they produce. The premium profit margins on these kinds of stocks means they can reinvest the substantial cash they generate each year into the business, thereby scaling up their operations, and keeping their level of service above others on an ongoing basis. Since much of the cash generated by these kinds of businesses is reinvested in further expansion, the return on these kinds of stocks is principally derived from capital gains on the share price, rather than dividend income.

These three investment strategies are often known as recovery, income and growth respectively.

One final point - although all three strategies have their different methods of selecting stocks, in practice, some stocks can fit the criteria of more than one of the aforementioned strategies and nearly all investors are sensitive to valuation, which means that fund managers don't necessarily buy in to stocks that may have the characteristics above, as they don't believe that the prospective share price appreciation will be attractive enough.

Contextualising the fundamentals

With this background in mind, it is important to highlight that there are periods when the general market trends favour one or another of the strategies above. For much of the last decade for example, the injection of plentiful financial stimulus has tended to boost the valuation of all assets. At times of progressively rising share prices, it is usual for the valuation of stocks with plentiful future growth (i.e. the third strategy outlined above) to appreciate rapidly, and hence outperform. Stocks whose share prices are particularly sensitive to market moves (i.e. the third strategy outlined above), are known as high-Beta stocks, because when stock markets fluctuate, their share prices tend to rise faster than that of the more mainstream stocks.

In short, the statement that *markets systematically undervalue high quality growth companies and their ability to maintain high barriers to entry and continuously deliver positive earnings surprises* has been broadly correct since 2008, as investors have been pleasantly surprised by a consistent market tailwind, as long-dated bond valuations have dragged up stock markets much more substantially than fund managers had originally expected. With the current fears of renewed inflation for example, the valuation of long-dated bonds and other financial assets have peaked out over recent months. Without a rising stock market tailwind, the share prices of high-Beta growth stocks have fallen more abruptly than the mainstream stocks and underperformed. Meanwhile, with most global stock markets having a weak start to the year, this tends to favour companies that pay good and growing dividends. If their share prices decline, their dividend yields become progressively higher, and that brings in additional buyers. Overall, if equity income stocks can maintain their dividends through unsettled economic and stock market conditions, then they tend to outperform. Note how the UK stock market, that is dominated by equity income stocks has indeed slightly risen during 2022 when most others have been in retreat.

The bottom line is that whilst active fund managers can add value to all three strategies, they each tend to have their moments in the sun, and by implication periods when they tend to lag others. This begs a question about fund positioning. Should funds rotate their stock selection strategies to those favoured by the current market trend? Or is it better to become really expert in just one, and acknowledge that it might come into and go out of fashion at different times? Over recent years, all the evidence appears to point one way. Anyone who has taken profits on the growth holdings over the past ten years, has normally been wrong footed, and considers buying them back, often at a higher valuation than that when they took profits. Meanwhile, the other two strategies have been out of fashion, with investors mainly holding these stocks for diversification, that scales back portfolio volatility. With the current uncertainties about whether the inflationary pulse is transitionary or the start of a new longer term trend, what should investors do? Continue to favour growth strategies and hope for the best, or take a risk that market trends have changed, and move into recovery or income funds?

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Unlocking the underappreciated

That said, there are corners of the equity market where fund managers can find a universe of stocks with the prospect of outperformance because they meet two or even three of the strategies outlined above. In our opinion, a good example is the strategy of the Diverse Income Trust (DIVI), which invests via a multi-cap portfolio of stocks with the potential for good and growing dividends. Generally, most fund managers don't research many of the UK quoted small-caps, because they are small and the capital that can be invested tends to be below their normal portfolio unit scale. We take a different view, as some of these stocks that have potential are high-quality growth companies that are simply overlooked. Very occasionally, during the pandemic sell-off for example, some of these share prices are so low, they also have substantial recovery potential, and in effect, match all three of the criteria outlined above.

The outcome has meant that whilst the UK Equity Income sector has generally not delivered very good returns over the last ten years, for example relative to the US stock markets, the fact that many of the holdings in DIVI are mispriced growth stocks, has nevertheless meant that it has outperformed. Indeed, it has delivered premium returns, even at a time when equity income strategies have generally been out of fashion.

Calendar year %	2017	2018	2019	2020	2021	YTD
Trust share price	16.97	-7.69	6.94	8.60	19.49	-2.84
Trust NAV	17.46	-8.37	12.51	7.57	15.78	-1.25
IT UK Equity Income sector	13.42	-10.39	22.53	-7.84	18.67	-0.78

Source for performance data: Morningstar. YTD data to 31.01.2022.

The performance information presented in this trust insight relates to the past. Past performance is not a reliable indicator of future returns.

If inflation is now more of a feature, or perhaps if global growth were to become sub-normal due to issues in China, then we believe that the DIVI strategy, with a cohort of younger quoted businesses in its portfolio, might continue to be well placed to deliver premium returns.

In short, it may be that high-quality growth companies that maintain high barriers to entry and positive earnings surprises underperform as their valuations retreat from the very forward looking ratings they currently stand on. Meanwhile, the UK market, with its emphasis on slower moving stocks that often generate surplus capital, might be on the threshold of outperforming. For reference, even though the UK's FTSE All-Share Index has underperformed the S&P 500 Index for an extended period of time, it has outperformed in the past. If that pattern were to reoccur, then we believe that the DIVI strategy could have the advantage of combining two market tailwinds – first through the ability to invest in companies that have grown well over the last ten years, along with the ability to invest in companies with plentiful surplus cash in the coming ten years.

Risks

The value of investments may fluctuate which will cause trust prices to fall as well as rise and investors may not get back the original amount invested.

The level of income paid by the trust may fluctuate and is not guaranteed.

In certain market conditions companies may reduce or even suspend paying dividends until conditions improve. This will impact the level of income distributed by the Trust.

Forecasts are not reliable indicators of future returns.

IMPORTANT INFORMATION

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All data is sourced to Premier Miton unless otherwise stated. Persons who do not have professional experience in matters relating to investments should not rely on the content of this fund insight.

For your protection, calls may be monitored and recorded for training and quality assurance purposes.

A free, English language copy of the trust's full Prospectus, the Key Information Document and Pre-investment Disclosure Document are available on the Premier Miton website, or you can request copies by calling us on 01483 306090.

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