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The Diverse Income Trust

Trust managers: Gervais Williams & Martin Turner

Having written previously about the benefits of being in a compounding income strategy, fund managers Gervais Williams and Martin Turner turn their attention to another key aspect of the Diverse Income Trust – the breadth of its portfolio.

The advantages of portfolio diversification

Some of those outside the investment services industry assume that professional fund management is all about jumping aboard an investment trend just as it is leaving the station, riding it up, and then departing just before it reaches its terminus or starts its reverse journey. This concept implies that premium return is all about linking together a consecutive series of winning bets.

Whilst this notionally sounds attractive, such a strategy has a fatal flaw. In practical terms, jumping aboard a trend that has just left the station isn't possible on an institutional scale, as most of those already on a winning train aren't sellers. Effectively, it is really hard to buy into a new trend once it's become obvious. In a similar manner, taking profits on a trend that is already peaking is also prone to illiquidity. So even if a fund manager were omnipotent, and knew the future precisely, the aggregate profits delivered on a trade in/trade out strategy would be disappointing.

Weather the unknown

As it is, anyone thinking they can get both the buying and selling moments serially correct, all the time, is kidding themselves. The truth is that the future is unknown. From here, all sorts of different futures might happen. It's a bit like the weather. The forecast for the coming days can often be inferred, but thereafter it becomes increasingly problematic. Ultimately, the best that can be said is that during summer it tends to be warmer.

So rather than trying to forecast future market trends precisely, successful fund managers spend their time picking out businesses with winning prospects. If the current trends remain in place, then those with commercial advantage can normally generate plentiful cashflow in the future. But note the conditional nature of this statement. Even here, the unknowable nature of the future can still get in the way. Anyone buying into a number of businesses with winning prospects at the start of 2020 for example, was in for a shock. Their expectations were about to be derailed by the pandemic.

Clearly, a change in economic trends can lead to a business suffering a setback, or indeed an unexpected boost to its prospects. Hence, a portfolio of broadly similar businesses, all operating in a similar industry sector could fall back sharply, or potentially improve together.

This is where the magic of portfolio diversification comes into its own. The key is to welcome the fact that a change to economic trends tends to affect different stocks in different ways. A portfolio can harness diversity, in terms of the scale of different businesses (i.e. big and small), a wider range of business sectors, and even in a range of business models within specific industry sectors. Thereafter, whilst a change to economic prospects might affect some adversely, there may be others whose prospects are improved. In short, through a series of unexpected events, diversity within an investment portfolio tends to deliver a more resilient outcome, when compared with strategies that narrow the investment universe to solely the largest quoted companies paying premium dividend yields for example.

A diversified strategy in action

This welcoming of diversity explains how the Diverse Income Trust differs from other trusts in the equity income sector. In contrast to most other UK equity income strategies, the trust's strategy embraces much, much greater diversity. It includes numerous younger businesses that serve immature business sectors whose prospects are not necessarily as closely reliant on the fluctuations of the global economy, for example. Furthermore, since AIM-listed companies aren't in the FTSE All-Share Index, their share prices can be more out of line with their prospects, which leaves more potential upside if they succeed.

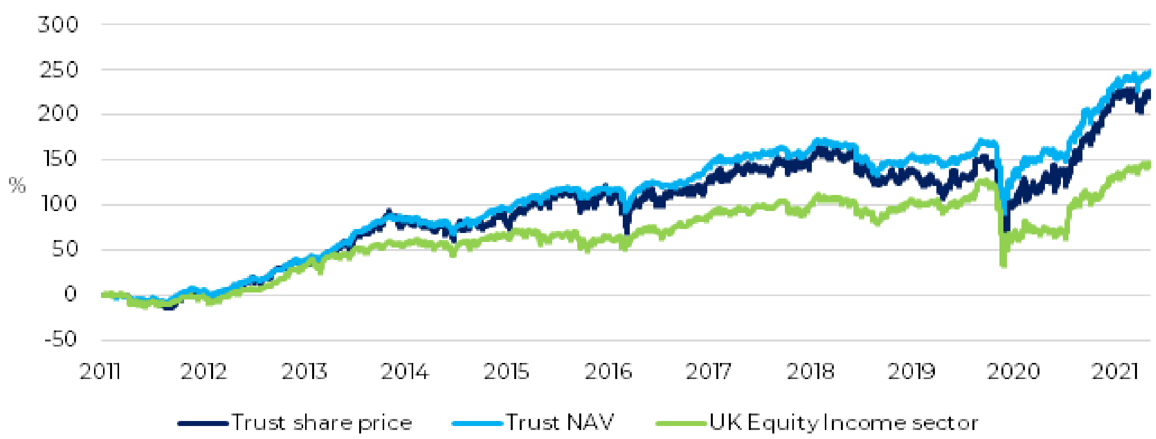
Overall, the trust includes a longer list of holdings, so the weighting of each holding tends to be much more modest than those focusing on the largest quoted companies. This factor is particularly relevant when it comes to the dividend income paid by the trust. Since its individual holdings are relatively small, the income they each generate also tends to be just a small part of the total portfolio income. Crucially, the aggregate dividend income paid out by the trust is not especially reliant on the success of a limited number of major positions, but rather reflects the general outcome of the widely diversified portfolio.

To some degree, this aspect of the strategy has been stress tested recently. Some businesses were so badly affected by the global pandemic that they were forced to cut or indeed cease paying dividends to shareholders altogether. Whilst the dividend income from a number of the trust's holdings were affected by this, there were also quite a few that continued to thrive. In the year to 31 May 2021, the trust's revenue per ordinary share grew from 3.27p to 3.73p, recovering much of the ground lost in the previous year. As a result while the total dividend of 3.75p for the year involved drawing upon retained revenue reserves, this was to a much lesser extent than in the previous year, The expectation going forward is that revenue earnings will continue to recover, restoring the normal position where annual revenue earnings fully fund the year's dividends and dividend growth.

A second aspect of a diversified strategy

In a similar manner to the trust's income, to some extent the resilience of the trust's capital return has also been tested through the investment cross-currents of the last ten years. Generally, as long-dated bond yields have declined considerably the valuation of stock markets has continued to appreciate. But alongside, there have been the challenges of the Brexit referendum as well as that of the Covid pandemic. Through this period, the amplitudes of the fluctuations of the Diverse Income Trust's share price have been rather less than the others in its peer group - reflecting the diversity of the trust's strategy. In short, the share price of the trust has been more resilient. Interestingly, the embracing of diversity hasn't held back the opportunity to add value via stock selection. In fact, we see the breadth of the trust's diverse investment universe as being a key advantage, with it delivering some of the very best returns of its peer group since it was launched in April 2011.

CHART: Performance since launch (28.04.2011)



Calendar year performance %	2016	2017	2018	2019	2020	YTD
Trust share price	-0.85	16.97	-7.69	6.94	8.60	20.82
Trust NAV	2.16	17.46	-8.37	12.51	7.57	19.62
UK Equity Income sector	7.43	13.42	-10.39	22.53	-7.84	18.56
FTSE All-Share Index	16.75	13.10	-9.47	19.17	-9.82	14.66

Source for all performance data: Morningstar, as at 31.08.2021.

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

Going forward, the decline in long-dated bond yields and the stock market tailwind that has come with it, are expected to come to an end. There are practical limits as to just how low long-dated bond yields can go. If this is correct, then we believe that the general appreciation of stock markets might be rather more limited in future, and hence this might be a time when the advantages of broad portfolio diversification could become even more important. For these reasons we continue to be very upbeat about the prospects for the Diverse Income Trust as it continues in its second decade.

Risks

Reference to any particular stock does not constitute a recommendation to buy or sell the stock. 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.