

Henderson Diversified Income Trust

Dear Prudence

In the face of declining yields across its investment universe, the managers of Henderson Diversified Income Trust plc (HDIV) are taking a pragmatic and sensible approach by refusing to chase higher yielding but riskier opportunities. Instead the trust is paying the price for prudence by cutting its dividend. The managers tell us many shareholders have been consulted and are supportive of this move.

High income from a flexible fixed income portfolio

HDIV's objective is to seek income and capital growth such that, on a rolling annual basis, the total return on the NAV exceeds three-month sterling LIBOR plus 2%. It invests in a diversified portfolio of global assets including secured loans, government bonds, high yield (sub investment grade) corporate bonds, unrated corporate bonds, investment grade corporate bonds and asset backed securities. The trust may also invest in high yielding equities and derivatives. The managers use gearing to enhance returns.

Dividends, which comprise the bulk of returns for investors, are paid quarterly.

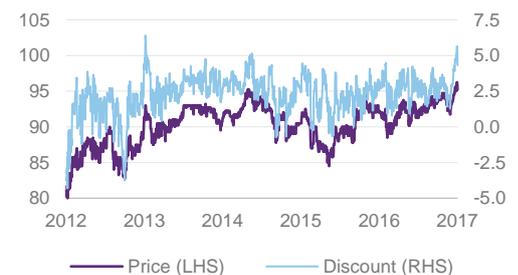
Year ended	Share price total return (%)	NAV total return (%)	Three-month LIBOR plus 2%/1.25%*(%)
30/09/13	10.4	10.4	1.8
30/09/14	12.1	9.3	1.8
30/09/15	3.1	4.4	2.5
30/09/16	7.9	9.8	2.6
30/09/17	7.4	6.3	2.4

Source: Morningstar, Marten & Co. Until 31 October 2014 Henderson Diversified Income used three-month sterling LIBOR + 1.25% as a target return. Three-month sterling LIBOR +2.0% has been used since 1 November 2014.

Sector	Global high income
Ticker	HDIV LN
Base currency	GBP
Price	95.625p
NAV	91.3p
Premium/(discount)	4.7%
Yield	4.6%

Share price and discount

Time period 31/10/12 to 31/10/17



Source: Morningstar, Marten & Co

Performance over five years

Time period 30/09/12 to 30/09/17



Source: Morningstar, Marten & Co, * 3-month sterling LIBOR + 1.25% pre 01/11/14, 3-month sterling LIBOR +2.0% since.

Domicile	United Kingdom
Inception date	18 July 2007
Manager	John Pattullo and Jenna Barnard
Market cap	180.1m
Shares outstanding	189.618m
Daily vol. (1-yr. avg.)	215,921 shares
Net gearing*	17.9%

* Note: net gearing comprises borrowings of 14% and synthetic gearing of 3.9%, both as at 30 September 2017

[Click here for our initiation note](#)

A rebased dividend, an amended fee

“Everything has rallied”

John Pattullo and Jenna Barnard (the managers) say that, across their investment universe, everything has rallied – from Treasury bills to high-yield bonds. As a consequence, it is becoming harder to identify new investments at attractive yields and there are less opportunities to raise income by selling protection through CDS. Rather than increase the risk of the portfolio in search of higher yields, the board and the managers have agreed to cut HDIV’s dividend. They tell us that the shareholders that they have talked to, since the announcement of the dividend cut, are supportive of the move.

12% dividend cut in tandem with removal of performance fee

What was a quarterly dividend of 1.25p will become a quarterly dividend of 1.1p, a decrease of 12%. They augmented this move with a change to the management fee. The board and managers agreed that the performance fee was no longer appropriate, and this will cease to apply after 31 October 2017. In compensation, the base fee rises slightly from 0.6% to 0.65% of net assets but the maximum fee payable in any one year falls from 1.2% of net assets to 0.65%.

Managers’ view

Managers are not keen to move up the risk curve

Higher yields are available in areas such as European bank CoCos and CCC rated bonds but the managers are not keen to move up the risk curve. Likewise, the managers are not keen to increase the concentration of the portfolio on the handful of issuers that they do like.

This is not to say that they think the market is overheating; they do not think we are seeing a rerun of 2007. For example, the Federal Reserve has mandated that the banks that it lends to should not make loans with more than 6x leverage. There are exceptions to this rule but generally leverage levels are not excessive.

Defaults remain at low levels

It may be true that some parts of the market are failing to price risk correctly, and they would like to see a shake out, but the managers do not think we will see a spike in defaults, which remain at low levels. This is especially true if you disregard the commodities sector, which has been hit by the collapse in oil and other commodity prices yet remains a large part of the US high-yield sector.

We have seen some weakness in the retail sector with problems at companies such as Toys R Us and J Crew in the US, and New Look in the UK, but this is a relatively small part of the overall market (around 3% of the US high-yield sector). There is more concern about auto loans (backed by the OEMs in Europe and specialist lenders in the US).

Events in Puerto Rico have exacerbated nerves in the muni bond sector, even though the territory’s extreme debt levels were a known issue before Hurricane Maria. The managers also think that Chinese debt could prove problematic at some point.

Excessive valuations not fundamentals are the problem

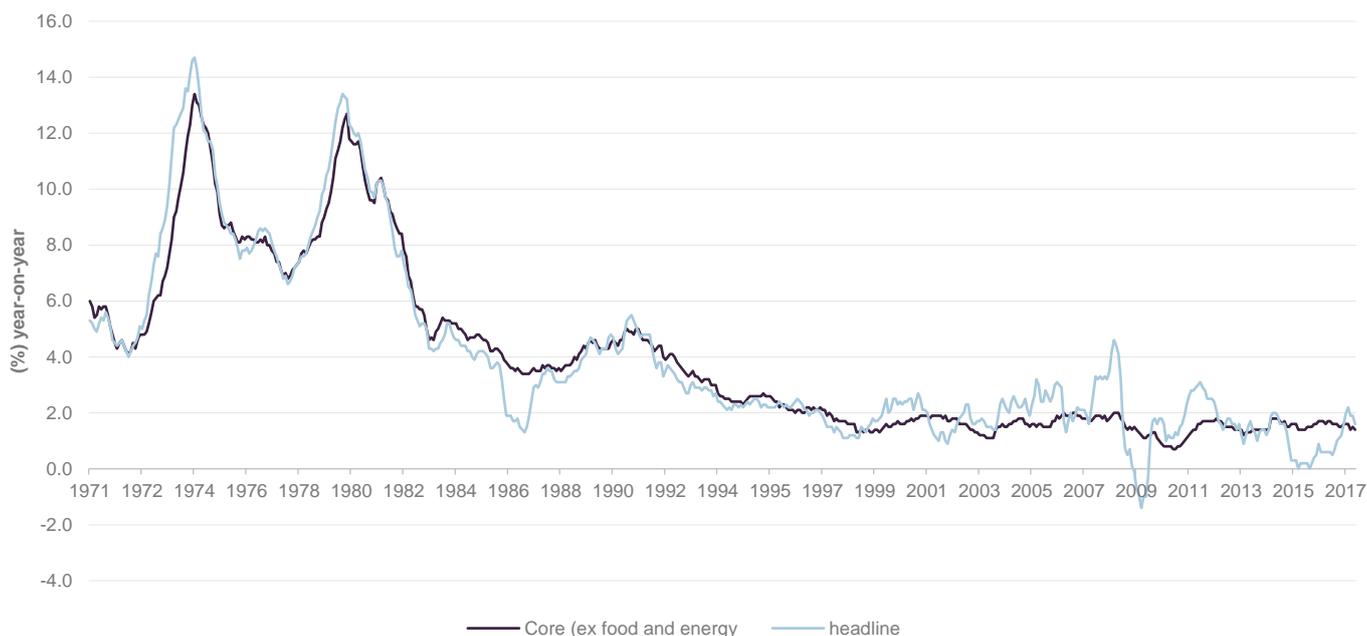
Nevertheless, the managers are adamant that it is excessive valuations rather than fundamentals that are the issue in the debt market at the moment. Money has been flooding into the asset class, especially from Asia and from retail investors in the US and Europe. The managers think UK investors are generally more bearish. However,

the conditions have supported the return of covenant-lite issues. In addition, investors in search of yield have encouraged the growth of the CLO market.

Deflationary environment will persist

The managers reiterate their belief that the reflation trade is a chimera. They are convinced that we will be stuck in a deflationary environment for some time. We articulated their reasoning behind this view in our initiation note (see page 6 of that note for more detail). However, they do not discount the possibility that efforts made by President Trump to cut taxes and inject some other fiscal stimulus into the US economy may unnerve debt markets in the short term. This would provide a good opportunity to increase the quality of the portfolio at reasonable prices.

Figure 1: G7 inflation, headline versus core



Source: OECD

Rate rises are to choke off asset-price exuberance rather than rein in inflation

The managers also point out that commentators have been misforecasting the debt market for years (with an overly negative bias).

It is true that interest rates are rising in some countries but the managers think this is more a reaction to factors such as household-debt levels and asset-price exuberance than worries about persistent inflation. They cite the example of Canada, which has increased rates even though its inflation rate is well below target.

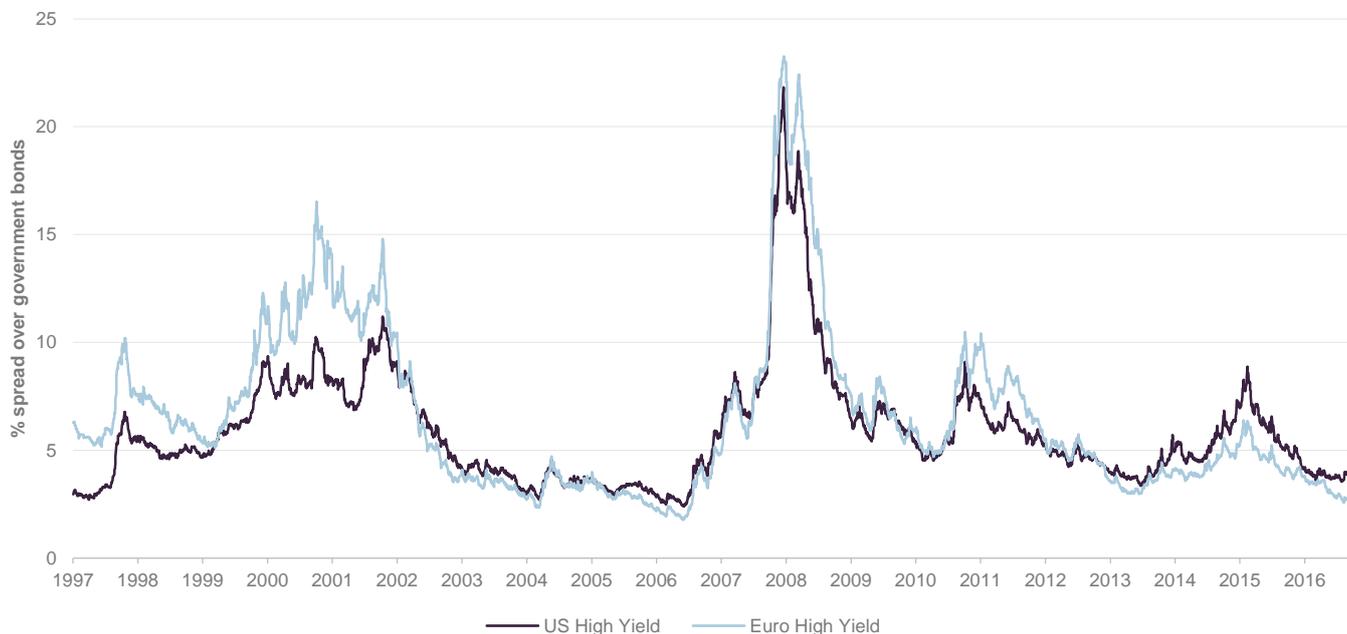
In the UK, they see Brexit as a supply-side shock and think that the Bank of England may be countenancing modest rate rises for similar reasons to those in Canada. The Bank of International Settlements has been critical of inflation targeting and is concerned about the consequences of keeping rates artificially low. One tool that central banks have been using to great effect, the managers believe, is buying investment-grade corporate bonds in their quantitative-easing programmes. They may look to unwind this if they think things are becoming overheated, which could ease pricing.

Race to the bottom on terms and conditions but Fed rules on leverage levels should curb excessive leverage

The tightening of spreads and excess liquidity has been favouring the high-yield bond market over the loan market. The managers describe a ‘race to the bottom’ between the two markets in terms of terms and conditions as well as rates. As loans have been repriced downwards, the exposure to this area within the portfolio has fallen and is now at its lowest levels since the launch of the fund. Spreads have fallen to around 225bps over much lower base rates. The managers believe that these yields are just not

attractive given the associated risk. The leverage constraints that the Fed has imposed are being replicated by the ECB, however. This should limit the danger of excessive leverage.

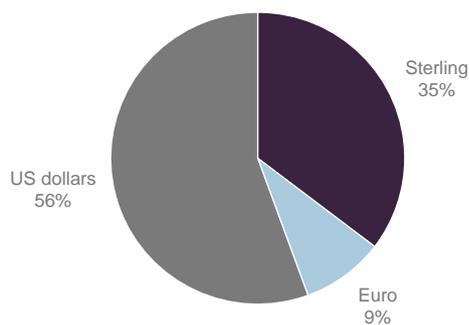
Figure 2: High yield bond spreads over equivalent government bonds in US and Europe



Source: Bank of America Merrill Lynch

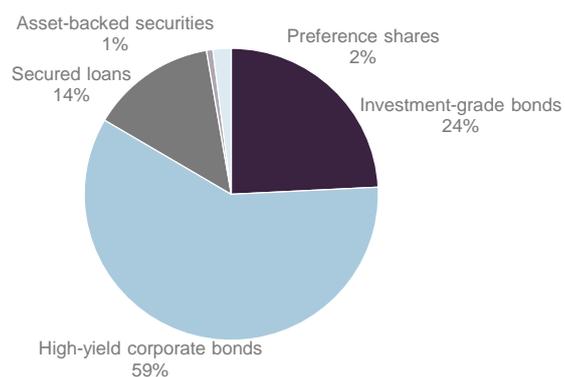
Asset allocation

Figure 3: Portfolio distribution by underlying currency at 30 September 2017



Source: Henderson Diversified Income, Marten & Co

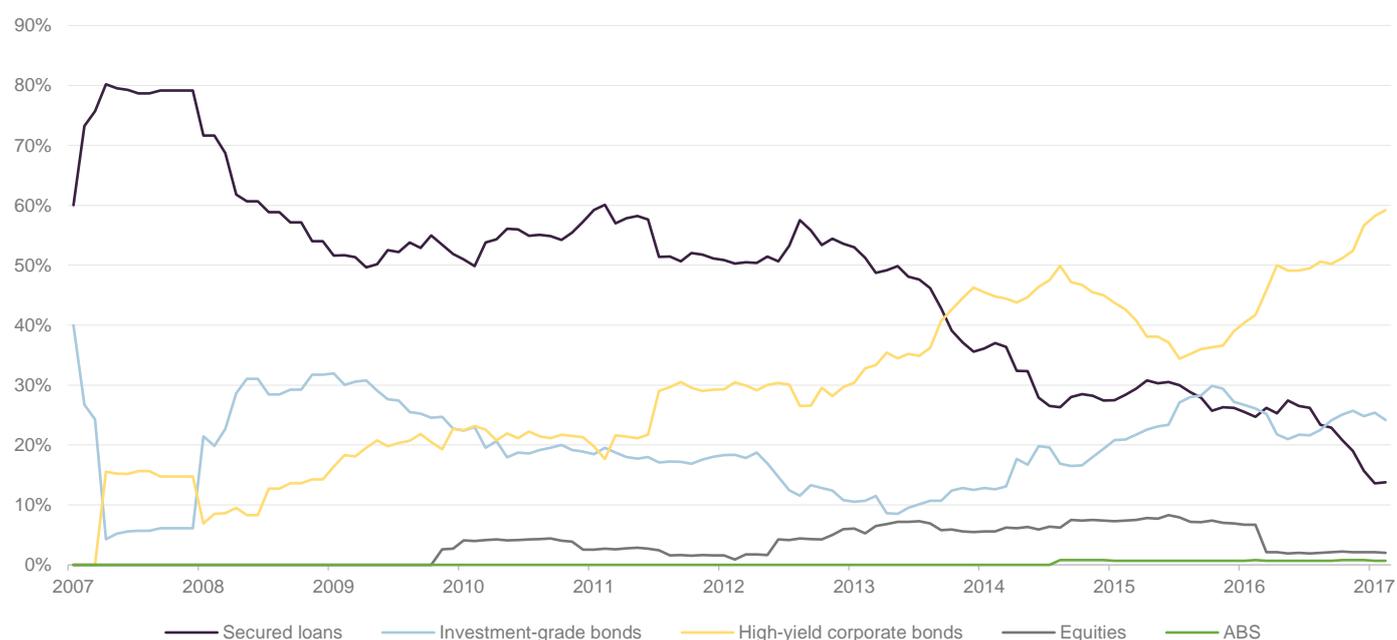
Figure 4: Portfolio distribution by type at 30 September 2017



Source: Henderson Diversified Income, Marten & Co

The proportion of the portfolio allocated to secured loans has been falling given the lack of attractive opportunities in that part of the market. This is clearly evident in Figure 5. As this part of the portfolio has declined, the emphasis on high-yield bonds has increased.

Figure 5: HDIV asset allocation over time



Source: Henderson Global Investors, BNP

10 largest holdings

Figure 6: 10 largest holdings at 30 September 2017

Holding	Industry	(%)
Nationwide Building Society	Banking	2.1
Credit Suisse Group 6.25% 2049	Banking	2.0
Cott 5.5% 2050	Beverages	2.0
Virgin Media Secured Finance 6.25% 2029	Cable TV and telecommunications	2.0
Wachovia Capital Trust III 2049	Banking	1.9
PGH Capital 6.625% 2025	Life insurance	1.9
Aramark Services 4.75% 2026	Food service, facilities and uniform services	1.8
Co-operative Group 7.5% 2026	Food retailing, funerals and insurance	1.8
Altice US Finance I 5.5% 2026	Telecommunications	1.7
ING Groep 6.5% 2049	Banking	1.7
Total		18.9

Source: BNP Paribas

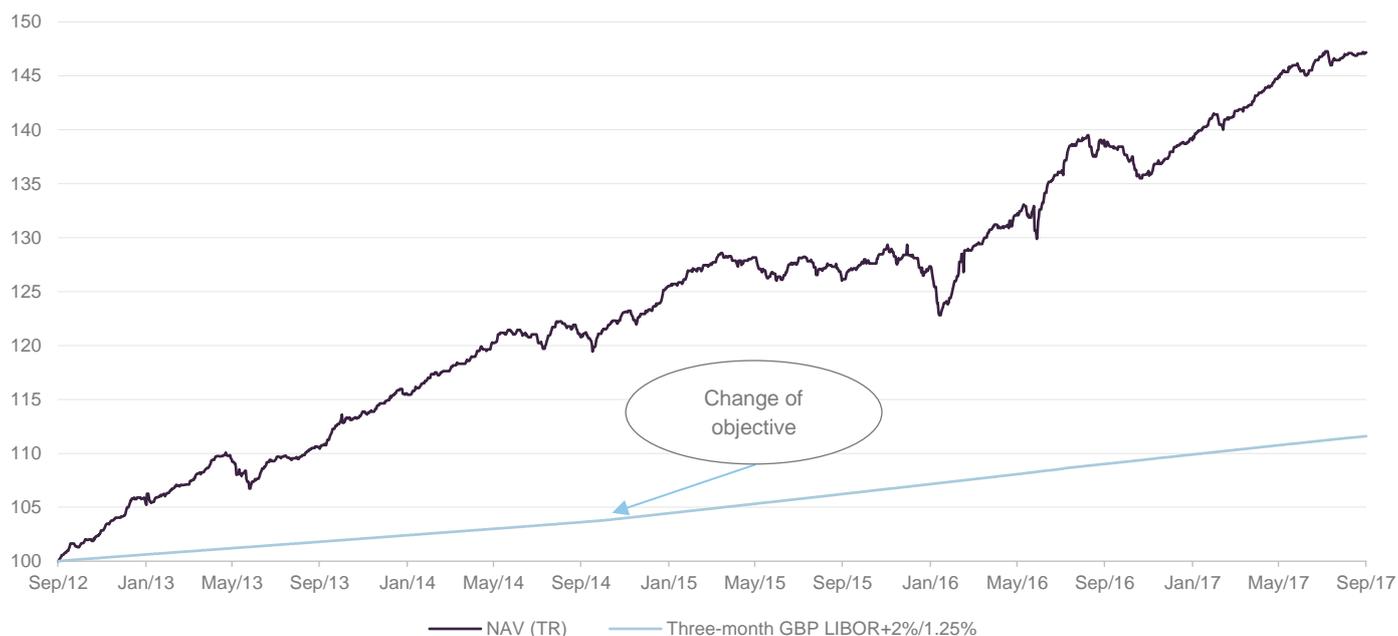
There were 141 holdings in the portfolio at the end of September 2017, which is a drop from the 150 holdings HDIV had at the end of March. This reflects the rebalancing of the portfolio in the face of falling yields and the refinancing of loans that have been taking place over that six-month period. Nevertheless, as Figure 6 demonstrates, the portfolio is still diversified (the total investment in the top 10 holdings in the fund at the end of March was 17.4%).

Performance

Up-to-date information on HDIV is available on the [QuotedData](#) website

HDIV's NAV has surpassed the average price at which HDIV raised money, which should mean that most investors in the fund will have achieved a capital profit on their investment, on top of the attractive income returns that they have had.

Figure 7: HDIV NAV total return performance versus objective



Source: Morningstar, Marten & Co

Figure 8: Total return cumulative performance over various time periods to 30 September 2017

Heading	3 months (%)	6 months (%)	1 year (%)	3 years (%)	5 years (%)
HDIV NAV	1.2	3.8	6.3	21.9	47.2
HDIV Price	0.0	3.9	7.4	19.5	47.8
Objective	0.6	1.2	2.4	7.7	11.6

Source: Morningstar, Marten & Co

HDIV's NAV returns are running at a lower annualised rate currently, reflecting the decline in yields available. Nevertheless, returns are well ahead of the objective.

Fund Profile

More information is available at the trust's website

www.hendersondiversifiedincome.com

Henderson Investment Funds Limited is HDIV's Alternative Investment Fund Manager (AIFM) and Henderson Global Investors Limited is the delegated investment manager. The Henderson Group had over £100bn of AUM at the end of December 2016. The named fund managers are John Pattullo and Jenna Barnard. They have been managing the fund since it was launched in 2007 and have been working together at Henderson since 2002. They are part of a five-strong Strategic Fixed Income team which is supported by Henderson's wider fixed income team and its seven-strong specialist secured-loan team. Responsibility for the selection of suitable secured loans

is delegated to the specialist secured-loan team led by David Millward. HDIV uses three-month LIBOR plus 2% as a benchmark.

Wide-ranging, diversified fixed-income portfolio

Investment restrictions

HDIV invests in unlimited amounts of secured loans; government bonds; and investment-grade, high-yield and unrated corporate bonds. Up to 40% of the portfolio can also be invested in asset-backed securities and up to 10% of the portfolio can be invested in high-yielding equities. No more than 10% of the fund can be invested in any one issuer. Exposure to any one counterparty with a credit rating less than a single A or equivalent is limited to 5% of the portfolio.

Derivatives

Gearing is used to arbitrage between the cost of debt and the yields available from investments. HDIV can also boost its income in exchange for taking on some default risk. In addition to gearing provided through a borrowing facility (see page 15), CDS are used to provide gearing to the portfolio. The managers can use derivatives (CDS, interest-rate futures and swaps) in the management of the portfolio – it lets them manage exposures without buying or selling the underlying securities. Exposure to credit derivatives (synthetic gearing) is capped at 40% of net assets and the combination of synthetic gearing and more traditional gearing is also capped at 40% of net assets. HDIV's interest-rate exposure is managed in a range of 0 to 8 years. Forward currency contracts are used to hedge foreign-currency exposures.

Previous research publications

Readers may be interested in our initiation note on HDIV, Onshore, on-message, on-form, on 4 May 2017. We reproduce the contents page of this note below.

On shore, on message, on form – from 4 May 2017

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