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Flying south for the winter

The ancients saw the will of the gods in the flight of birds; our analysts think mergers may offer similar augurs for investor sentiment.

Alan Ray

alan@keplerpartners.com

In early October, [Brown Advisory US Smaller Companies \(BASC\)](#) announced its decision to merge with [JPMorgan US Smaller Companies \(JUSC\)](#) and within a couple of hours we probably had half a dozen bits of analysis in our inbox that, with a shrug of the shoulders, said *'yes, well, it was inevitable really. Nothing to see here, move on'*. We'll come back to why that's the consensus view in a moment, but our instinct is different, and we think something more interesting is happening. Rather than just another merger, this looks like a genuine case of an investment trust transaction coming at a point where investors are starting to lose faith in an asset class. Spend enough time around investment trusts, and one is bound to develop a bit of a contrary streak, as part of the fun is buying the out-of-favour, discounted trusts. Any contrarian investor should find events such as this merger extremely interesting. Why is our instinct telling us this?

First, though, a brief technical diversion, which is as much aimed at setting up our punchline at the end as it is at explaining the jargon. Investment trust mergers these days are coyly referred to as 'combinations' for reasons that matter to the Takeover Panel, HMRC, lawyers and accountants, but might be lost on the rest of us. From the perspective of an investor, a 'combination' walks, quacks and swims like a merger, and we are confident that this is the term all the advisers to such transactions use in all the conversations leading up to the official announcement of a 'combination'. For that reason, we're just going to use the word 'merger' in what follows.

With that out of the way, let's walk through the main points of the conventional analysis of this particular merger. Point one is that BASC's current market capitalisation is less than £200m. Investors want greater scale than this for two main reasons: better liquidity in the shares and the potential for lower costs. These are both good reasons to consider a merger. As the old compliance phrase, 'past performance is no guide to the future', tells us, an investment trust board cannot guarantee that a new manager will lead to better

performance, but a merger allows it to negotiate more concrete improvements like reducing the costs of buying, selling and owning an investment trust.

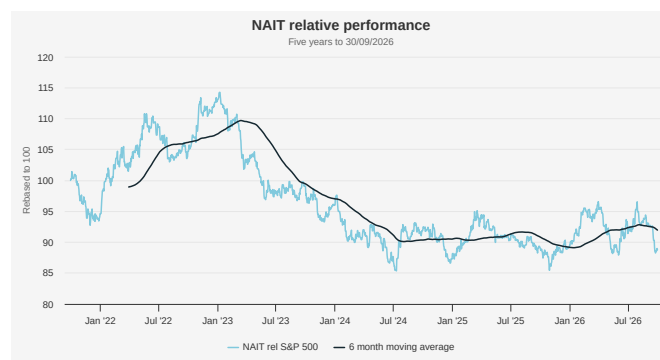
Point two is that BASC has an activist on the share register. This isn't the moment to disappear down the 'Saba' rabbit hole, but suffice it to say that if there is an activist on a share register, then, rightly or wrongly, it sharpens everyone's focus on an investment trust's future direction. Combine this with the fact that BASC has a regular continuation vote and it's not hard to see how the analysis stops right here.

Let's briefly look at the backstory. BASC's manager was appointed in 2021 with a long and successful track record of investing in US smaller companies with a 'quality growth' label. BASC's new manager, Brown Advisory, was, and still is, well known to the professional fund-buying community, and many wealth managers were already investors in similar strategies managed by Brown. As a result, the appointment received a warm welcome.

Readers probably already know the next chapter. One of the toughest places to be over the last five years has been in the 'quality growth' sphere. Stock markets have placed high valuations on companies with explosive growth, whether they are currently profitable or not, and at times have rewarded 'value' investors too, but the steady 'quality growth' companies in the middle have been a difficult place for a fund manager to make money. This is true across many regions, but nowhere is it more extreme than in the US. Everyone is familiar with the huge influence that the hyper-scalers have on the US stock market, but one could be forgiven for not spotting that a similar pattern has developed in small caps. The Russell 2000 small-cap index has performed well this year, but much of the performance can be attributed to a few stocks. Sound familiar? Companies with, to coin a phrase, a high 'AI adjacency' score have done well; those with a lower score have not.

One very interesting trend we've observed recently is recorded in the chart below. The [North American Income Trust \(NAIT\)](#) has a really good long-term performance record, but against an established narrative that says that the S&P 500's exceptional performance is being driven by just a few stocks, it's perhaps surprising to see how NAIT, which is, as the name firmly implies, an actively managed equity income strategy focused on the larger end of the US stock market, is holding its own in relative terms against that same index. The chart below looks at NAIT's NAV total return divided by the S&P 500. That means a descending line indicates NAIT is underperforming and an ascending one indicates that it is outperforming. To help see the trend, we've added the six-month moving average. Yes, NAIT's equity income strategy, focused on cash-generative, reasonably valued companies, did underperform in that first wave of AI euphoria, but as the trend has matured, NAIT has held its own. For the record, NAIT isn't benchmarked against the S&P 500 but against the broader and more appropriate Russell 1000 Value index; that doesn't change the fact that this chart tells a different story from what we might think is going on. What this chart says is that active managers, and NAIT is a great example of where the strategy is steering it away from those hyper-scalers, are starting to make really good returns from other parts of the market. The established narrative says 'own the hyper-scalers or underperform'. The evidence says this has been changing for quite a while now. Further, NAIT's returns aren't just coming from overly cheap shares reverting to the mean, but from underlying earnings growth. So just as it seemed, as it did in 2024, that large-cap active managers had a bit of a problem on their hands, fundamentals quietly started to reassert themselves. But you would hardly know it by reading the financial press. Active managers in large-cap US equities are starting to find opportunities outside that narrow group of hyper-scalers that can perform as well as, or better than, the index. And this is more than just a reversion to the mean for some undervalued stocks, with strong earnings growth starting to come through across a broad range of large-cap stocks.

NAIT Relative Performance



Source: Morningstar, Kepler. Note: the S&P 500 is represented by the Vanguard S&P 500 in this chart

Past performance is not a reliable indicator of future results

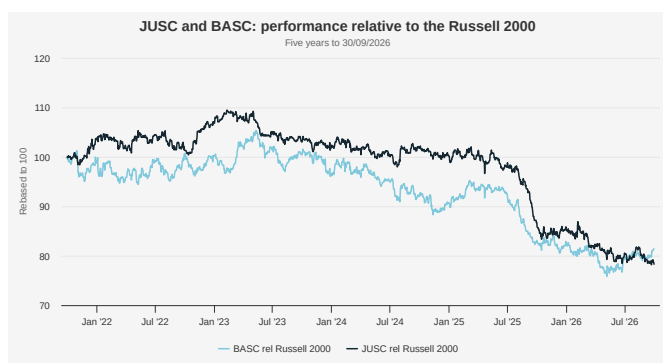
With that pattern established, let's look at how BASC and JUSC have performed relative to the small-cap benchmark, the Russell 2000. This is charted below, and it clearly illustrates the narrative established by both trusts: the index has performed extremely well recently because of just a few names which, in straightforward terms, are either unprofitable or too highly valued for either trust to own. This has an incredibly familiar ring to it from the large-cap sphere. It's really striking how small caps have just been through the same thing that large caps experienced in 2023 and 2024.

This is acknowledged in JUSC's commentary accompanying its announcement of the merger. This notes that high quality companies have 'lagged the market's enthusiasm for stocks aligned with a variety of themes, such as AI, cryptocurrency, and quantum computing, and a strong relative outperformance of high beta and high volatility stocks relative to those with higher profitability.'

The same statement goes on to say 'earnings momentum is showing signs of broadening across cyclical industries, with strengthening fundamentals in areas such as banks, industrial real estate, transportation, capital equipment and analogue semiconductors. Small-cap earnings are also expected to grow slightly faster than those of large-cap companies, which, together with attractive valuations for high quality small caps and depressed long term relative performance versus large caps, supports the investment case.' Again, it's striking how this matches up with commentary from large-cap managers from a year or eighteen months ago, and the pattern of earnings

growth broadening out across the S&P 500 is one of the reasons why NAIT, above, as well as peers such as [JPMorgan American \(JAM\)](#) and [BlackRock American Income \(BRAI\)](#), are performing well, even without going all-in on the 'AI adjacency' trade. The first of these two, JAM, runs with a relatively focused portfolio that straddles 'value' and 'growth' and, while, yes, it owns some of those hyper-scaler names, its strong performance has been derived from a variety of sources, and its 'value' investments have been an important part of that. BRAI, by contrast, takes a broader, incremental approach to active management using a mixture of human and machine intelligence, and its return analysis again shows that good returns are not just coming from the hyper-scalers.

BASC and JUSC relative performance



Source: Morningstar. Note: the Russell 2000 is represented by the State Street Russell 2000 ETF

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Conclusion

Mainly just for fun, we asked a couple of large language models (LLMs) what their instincts about the BASC and JUSC merger were. We were relieved that they both gave the established narrative about scale and costs. So, AI models might be good at gathering consensus opinion, but our instincts live to fight another day. Because this is all about instinct, we've deliberately kept the analysis quite light, but we do find those two charts, and all the associated commentary from the trusts concerned, to be more striking than we expected. And if it seems trivial to talk about instinct rather than analysis, we'd just ask readers to think how much of what has occurred in the small-cap index recently has been driven by instinct. Quite a bit, we'd surmise.

The US is, of course, a particularly tough market to read for many reasons right now. Energy prices, AI capex, politics, war, bond markets—the list goes on. Those are all things one must mix in with instinct. But we keep coming back to the fact that, yes, on the face of it, the transaction between BASC and JUSC walks, quacks and swims just like any other merger from the last few years, bringing scale and lower costs. But as some readers will know, there are well over a hundred different kinds of 'duck', which, it turns out, doesn't have a formal scientific definition anyway. Our equally unscientific instinct is that there is, from a contrarian investor's point of view, something more interesting going on here. Large-cap active managers are already showing the way, and the same thing could very well happen in small caps. Our instinct also tells us that a BASC shareholder would be wise to carefully consider keeping faith with the asset class, which a holding in JUSC will allow them to do.

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