

Don't Mistake Speculation for Strength: The Mirage of Small-Cap "Junk" Outperformance

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Key Takeaways

- In 2025, speculative small-cap stocks with no earnings or dividends have sharply outperformed quality peers, driven by a surge in risk appetite and retail investor flows.
- Despite short-term momentum, valuation gaps between high- and low-quality small caps have widened significantly, creating a potential setup for mean reversion.
- Investors seeking to capitalize on a shift back to fundamentals may consider the [WisdomTree U.S. SmallCap Quality Dividend Growth Fund \(DGRS\)](#), which offers higher-quality metrics at discounted valuations relative to broader benchmarks like IWM.

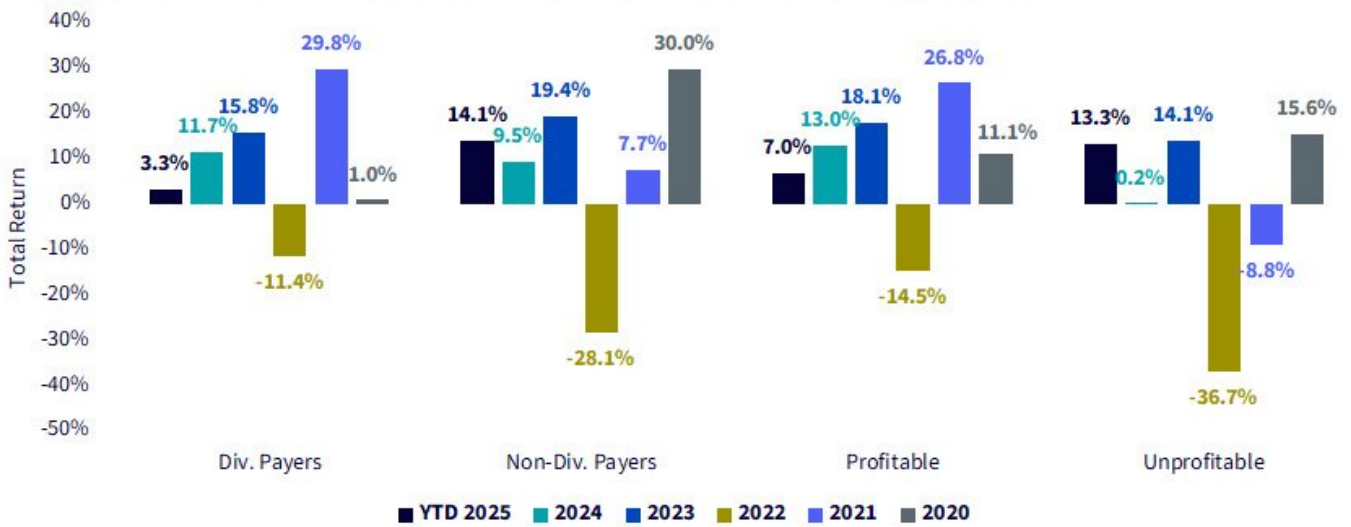
U.S. small-cap equities have defied traditional logic in 2025. The companies investors have typically prized for their prudence, those with steady earnings and consistent dividends, have lagged behind the more speculative corners of the market. Instead, firms with no profits and no payouts have been leading performance charts, marking a striking reversal of the patterns that dominated much of the post-global financial crisis era.

- **Risk Appetite Revival:** Speculative small caps are benefiting from renewed enthusiasm for growth optionality rather than cash flow discipline.
- **Liquidity and Leverage Effects:** Easy financial conditions and the return of retail flows have amplified momentum in unprofitable names.¹
- **Valuation Divergence:** Dividend payers and profitable small-cap firms now trade at unusually wide valuation discounts, potentially setting up a mean-reversion opportunity.

Figure 1 captures a rare market inversion: In 2025, unprofitable and non-dividend-paying small caps are sharply outperforming their higher-quality peers. After years when fundamentals drove returns, investor sentiment has pivoted toward speculative growth. The data underscores a risk-on rotation, liquidity-driven exuberance and a potential setup for future mean reversion.

Figure 1: Something New under the Sun?

2025 Is the First Year in Recent Memory Where 'Junk' Outperforms Quality among Small Caps

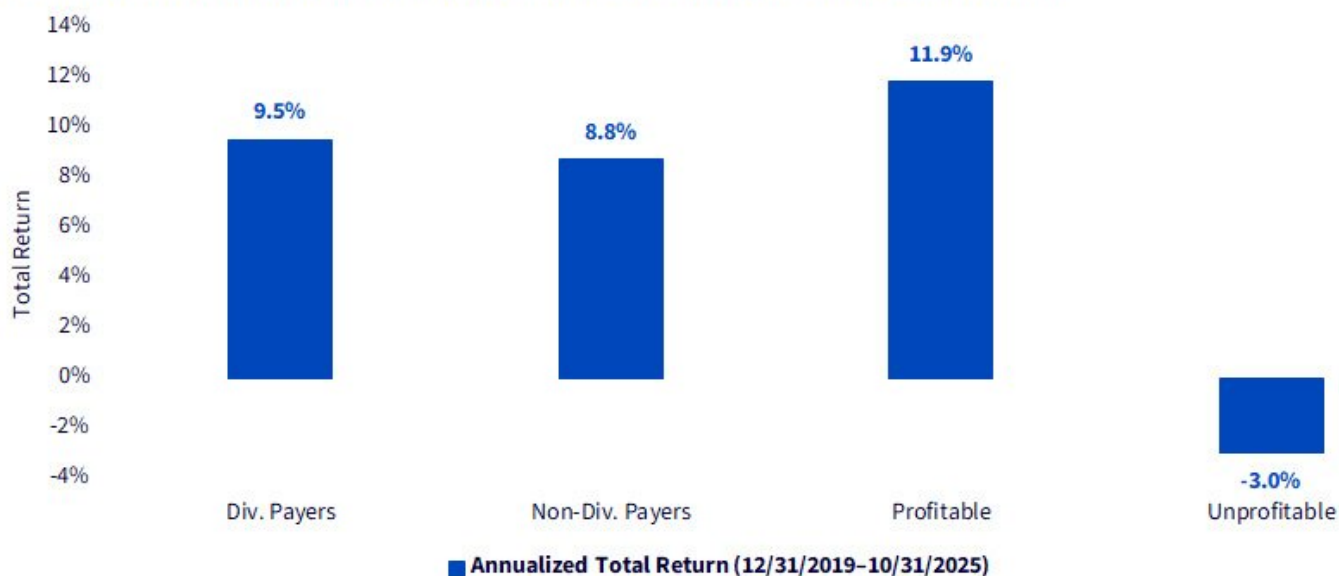


Sources: WisdomTree, MSCI, FactSet, as of 11/3/25. **Past performance is not indicative of future results. You cannot invest directly in an index.** Profitable (unprofitable) small caps are defined as constituents of the [MSCI USA Small Cap Index](#) that had positive (negative) trailing 12-month earnings as of the most recent calendar year-end. Returns represent the weighted average year-to-date and calendar year returns among constituents using index weights as of the beginning of the return period. Annualized returns are calculated based upon calendar year and year-to-date 2025 returns, which individually use beginning-of-evaluation period weights.

Despite 2025's surge in "junk" small caps, longer-term results, shown in figure 2, reaffirm the value of fundamentals. Over the past six years, profitable and dividend-paying companies have delivered the strongest compounded gains, while unprofitable firms remain in negative territory. The data highlights that short-term speculation fades, but quality compounds over time.

Figure 2: Longer Horizons May Look Different from Shorter Periods in Small-Cap Performance

2025's Junk Rally in Small Caps Shouldn't Dissuade Investors from Strong Fundamentals



Sources: WisdomTree, MSCI, FactSet, as of 11/3/25. **Past performance is not indicative of future results. You cannot invest directly in an index.** Profitable (unprofitable) small caps are defined as constituents of the MSCI USA Small Cap Index that had positive (negative) trailing 12-month earnings as of the most recent calendar year-end. Returns represent the weighted average year-to-date and calendar year returns among constituents using index weights as of the beginning of the return period. Annualized returns are calculated based upon calendar year and year-to-date 2025 returns, which individually use beginning-of-evaluation period weights.

Conclusion: A Look at Two Exchange-Traded Funds Focused on U.S. Small Caps

The most widely referenced benchmark for U.S. small-cap equity performance is the Russell 2000 Index. The iShares Russell 2000 ETF (IWM) is designed to track the total return performance, before fees, of this benchmark. As of September 30, 2025, it had roughly 28% of its weight in companies that had negative earnings over the prior 12 months.²

The [WisdomTree U.S. SmallCap Quality Dividend Growth Fund \(DGRS\)](#) is designed to track the total return performance of an index focused on higher-quality small-cap companies that all pay dividends.³ They also have relatively higher return on equity and return on assets measures.

Therefore, we can look at:

- IWM as a broad-market benchmark with significant exposure to more speculative small-cap stocks.
- [DGRS](#) as a more focused strategy on U.S. small caps that emphasizes the higher-quality angle.

For those investors considering that the speculative rally may end, we wanted to focus on two of the following figures. Figure 3a indicates the valuation discount, on multiple metrics, of [DGRS](#) relative to IWM.

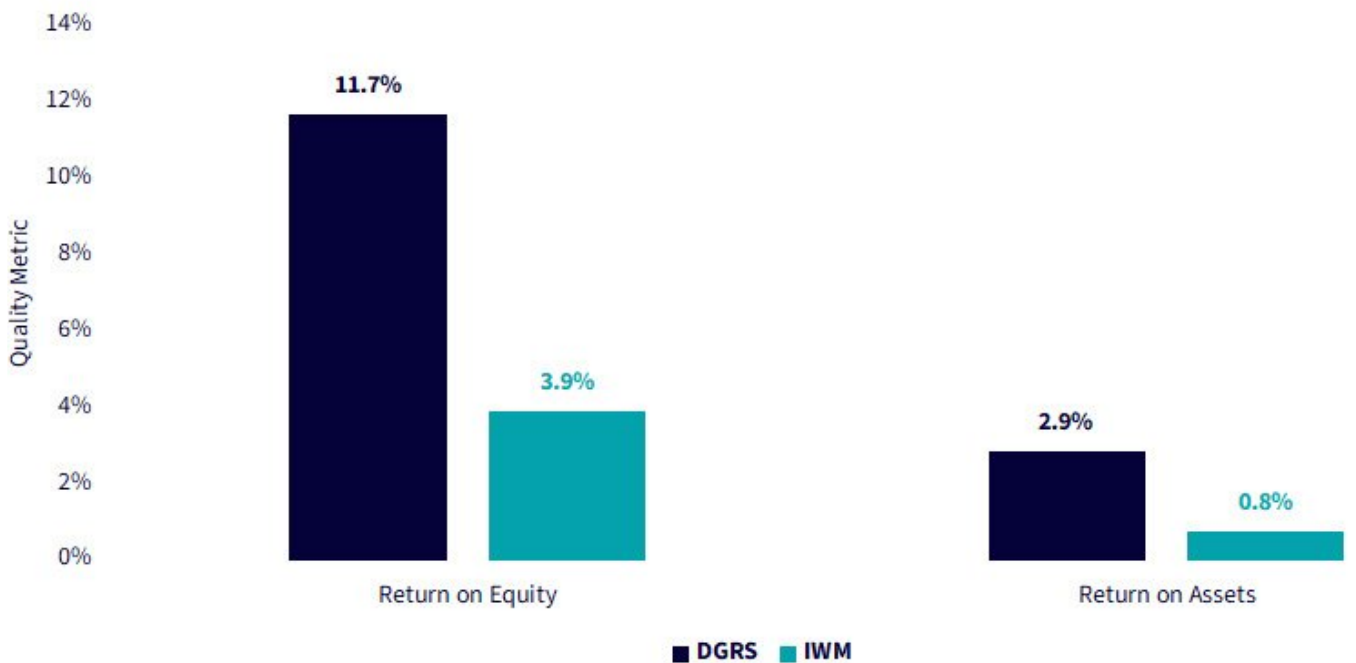
Figure 3b indicates the return on equity and return on assets of DGRS versus IWM.

Figure 3a: DGRS Shows a Valuation Discount on Multiple Measures against IWM



Sources: WisdomTree, FactSet, Morningstar, with data as of 9/30/25.

Figure 3b: DGRS Shows Significantly Higher Quality Metrics than IWM



Sources: WisdomTree, FactSet, Morningstar, with data as of 9/30/25

If the trend shifts back to rewarding higher-quality small caps, we think that [DGRS](#) may be particularly well positioned.

Figure 4: Additional Information

Fundamentals	WisdomTree U.S. SmallCap Quality Dividend Growth Fund	iShares Russell 2000 ETF
Objective	The WisdomTree U.S. SmallCap Quality Dividend Growth Fund is designed to track the total return performance of, before fees and expenses, the WisdomTree U.S. SmallCap Quality Dividend Growth Index. The Index is comprised of small cap dividend-paying companies with strong return on equity, return on assets and forward-looking earnings growth characteristics. The index is dividend weighted annually to reflect the proportionate share of the aggregate cash dividends each component company is projected to pay in the coming year, based on the most recently declared dividend per share.	The iShares Russell 2000 ETF is designed to track the total return performance of, before fees and expenses, the Russell 2000 Index. The Russell 2000® Index measures the performance of the small cap segment of the US equity universe.
Risks	There are risks associated with investing, including possible loss of principal. Funds focusing their investments on certain sectors increase their vulnerability to any single economic or regulatory development. This may result in greater share price volatility. Please read the Fund's prospectus for specific details regarding the Fund's risk profile. Dividends are not guaranteed, and a company currently paying dividends may cease paying dividends at any time.	There are risks involved with investing in ETFs, including possible loss of money. Shares are not actively managed and are subject to risks similar to those of stocks, including those regarding short selling and margin maintenance requirements. Ordinary brokerage commissions apply. The Fund's return may not match the return of the Underlying Index. The Fund is subject to certain other risks. Please see the current prospectus for more information regarding the risk associated with an investment in the Fund. Investments focused in a particular sector, such as technology, are subject to greater risk, and are more greatly impacted by market volatility, than more diversified investments.
Total Expense Ratio	0.38%	0.19%
Total Assets Under Management (millions, \$)	348	68,858

Sources: Specific Fund pages on the WisdomTree and iShares website, with AUM figures as of 11/5/25.

1 Source: "Small-cap stocks gain momentum: A new era of retail-driven growth and earnings optimism," Alinvest, 10/25/25.

2 Sources: WisdomTree, FactSet, Morningstar, with data accessed as of 11/6/25 within WisdomTree's Fund Comparison tool.

3 This index is the [WisdomTree U.S. SmallCap Quality Dividend Growth Index](#).

Important Risks Related to this Article

There are risks associated with investing, including possible loss of principal. Funds focusing their investments on certain sectors and/or smaller companies increase their vulnerability to any single economic or regulatory development. This may result in greater share price volatility. Dividends are not guaranteed, and a company currently paying dividends may cease paying dividends at any time. Please read the Fund's prospectus for specific details regarding the Fund's risk profile.

