When Small-Cap Junk Leads

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Key Takeaways

- In 2025, unprofitable companies and a concentrated group of speculative names drove much of the small-cap rally, while profitable small caps lagged.
- Past periods of small-cap quality and value underperformance have often been followed by stronger relative results, though history cannot predict when or guarantee a reversal.
- Earnings-based approaches can shape small-cap valuations and performance differently across market cycles.

A Field Guide to Small-Cap Earnings Discipline

Ask small-cap investors what stood out about 2025, and most will start with the same word:

speculative.

After a volatile spring dominated by tariff headlines that bottomed on April 8, 2025, the Russell 2000 Index clawed its way to a nearly 42% cumulative gain through the end of October, small caps' best stretch since 2021, and enough to produce the index's first all-time high since November 2021.[1] On the surface, that sounds like unambiguously good news for anyone with small-cap exposure. Look underneath the index level, though, and the composition of that rally is what might give investors pause.

The companies doing the leading by way of performance were, disproportionately, the ones without earnings. Companies with negative net income comprised roughly 40% of the Russell 2000, and it was precisely this cohort that pushed the index to fresh highs, concentrated in a handful of themes.[2]

- Quantum computing
- Cryptocurrencies
- Artificial intelligence
- Metals and mining
- Speculative biotechnology

The ten largest contributors to the Russell 2000's 2025 return accounted for more than a quarter of the index's entire gain, and the top 20 names contributed well over half, a level of concentration with little historical precedent outside the post-COVID era.[3] Meanwhile, high-quality, profitable companies, the ones

with strong balance sheets, consistent returns on equity, and more reasonable valuations, turned in one of their worst relative stretches in three decades. Rolling seven-month “quality” and “value” factor payoffs from April through October 2025 were each the second-worst such stretch in the Russell 2000 going back to 1996.[4]

None of this happened in a vacuum. In miniature, it is a story small-cap investors have lived through before.

Is This the New Normal, or a Familiar Chapter?

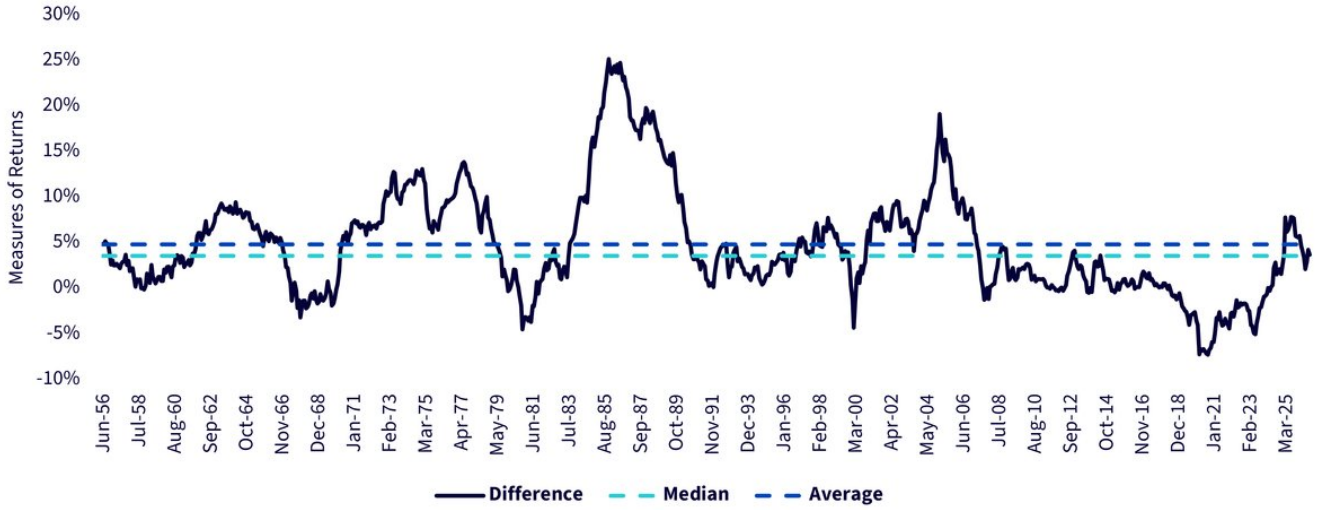
The temptation after a stretch like the one just described is to conclude that “small cap quality doesn’t matter anymore,” or that earnings-based investing has been overrun by a market increasingly driven by passive flows, retail trading, and thematic momentum. History argues against that conclusion, not by denying that the last several months were genuinely painful for earnings-oriented investors, but by putting the pain in context.

Two things stand out.

- First, dispersion like this has happened before, and it has reliably been followed by reversion rather than permanent regime change. Looking back to 1995, the annual payoff to owning the highest-quality quintile of the Russell 2000 over the lowest quintile has been positive in roughly 83% of rolling 12-month periods; the payoff to value over growth has been positive in about 79% of periods. Both factors have also shown a repeated pattern after their worst nine-month stretches. Small-cap managers who lagged badly over such a window have, on average, gone on to generate meaningfully positive alpha over the following one and three years.[5] None of that guarantees the same outcome this time, but it is the long-run base rate, and it is a very different base rate than “this factor is dead.”
- Second, a broader body of research on value investing, not confined to small caps, has made a related point about the parallel “value is dead” narrative that circulated for years following the 2007–2020 large-cap value drawdown. The bulk of that underperformance traced not to a collapse in the underlying economics of cheap, high-quality companies, but to valuations becoming steadily cheaper relative to expensive, speculative ones, a squeeze that cannot continue indefinitely without prices becoming completely unmoored from fundamentals. When that valuation gap has reached extremes historically, after the Nifty Fifty unwind, the dot-com bust, and the depths of the financial crisis, it has tended to precede above-average, not below-average, forward performance for the cheaper, higher-quality side of the market.[6]

A version of the same pattern shows up directly in small-cap earnings data. Figure 1 tracks a simple, long-running measure, specifically, the five-year annualized return of small, cheap (high earnings-yield) companies minus small, expensive (low earnings-yield) companies, using data stretching back over decades.

Figure 1: Five-Year Annualized Return of High Minus Low Earnings Yield Companies, June 1956–August 2026



Source: Kenneth French Data Library. The "Difference" is the return of small-cap companies with an earnings yield above the 70th percentile minus small-cap companies with an earnings yield below the 30th percentile, both below the NYSE median market cap. Data are five-year annualized returns, June 30, 1956–August 31, 2026. Data does not represent an index or backtest. **Past performance is not indicative of future results**.

The relationship has moved through repeated multi-year cycles above and below its long-term average. High-earnings-yield small caps delivered sharp annualized return advantages in the 1970s, the mid-1980s, and the early 2000s; extended stretches of underperformance in the late 1960s, the late 1970s, and again over the past several years. What it has not done, across seven decades and several "this time is different" narratives, is settle into a permanent negative regime. As of the most recent data, the trend had already begun climbing back toward, and briefly above, its long-run average and median.

None of this is a promise. A persuasive case can be made that today's market structure, in which passive small-cap assets have grown from under 8% of the market in 2000 to more than 30% today, and retail investors now account for roughly 36% of daily trading volume, more than double historical norms, genuinely changes the game at the margin.[7] It is also worth taking seriously the broader set of arguments for why earnings-oriented investing might be structurally impaired rather than merely cyclically out of favor.

- That today's most speculative businesses are better capitalized and more genuinely transformative than the speculative names of prior cycles
- That persistently low rates for much of the last two decades disproportionately lifted long-duration, unprofitable businesses
- That the shrinking universe of public companies has left fewer cheap opportunities behind for value-oriented strategies to find

Each of these narratives has been raised, in one form or another, at nearly every prior juncture when earnings-oriented or value-oriented investing has struggled for an extended period, and when tested against the data, each has tended to explain far less of the underperformance than a simpler culprit.[8]

Inexpensive stocks became more inexpensive still, relative to expensive ones, for a period of time.

That is a valuation dynamic, not a permanent verdict on whether earnings matter.

Why Compare EES, IWM, and IJR

That backdrop is exactly why it is useful to compare WisdomTree's U.S. SmallCap Earnings Fund (EES) against two of the largest and most widely followed small-cap ETFs.

- iShares Russell 2000 ETF (IWM)
- iShares Core S&P Small-Cap ETF (IJR)

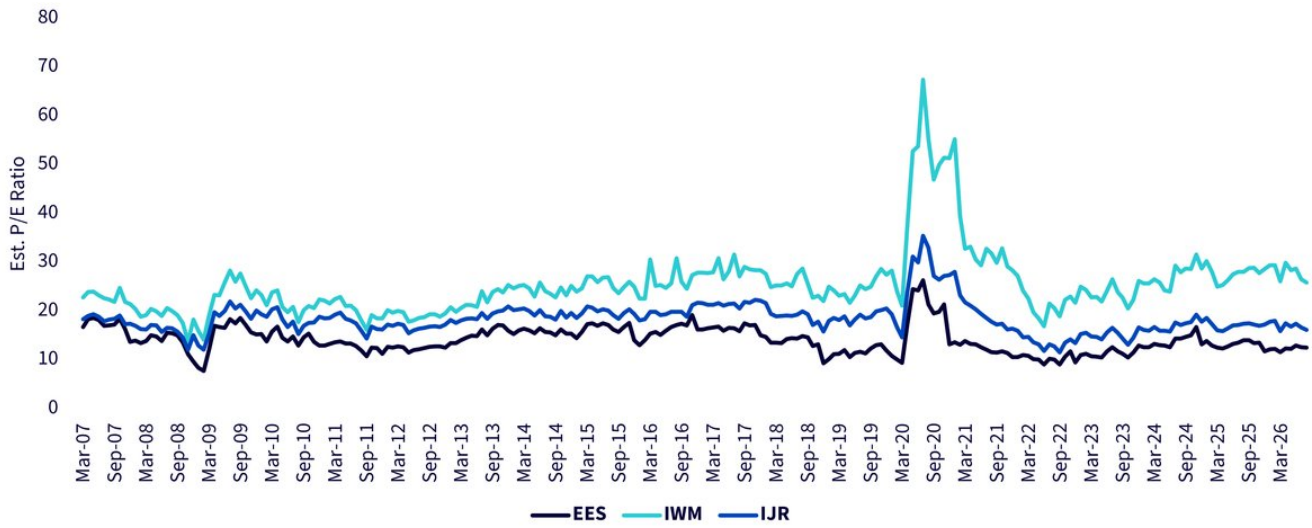
Each represents a genuinely different philosophy about what "small cap" should mean, and the differences map directly onto the debate above.

IWM tracks the Russell 2000, an index built almost entirely on market capitalization. It does not require constituents to demonstrate profitability to enter, and it does not explicitly target either a higher or lower earnings yield. In practice, that makes IWM the closest thing on this list to "all small caps," profitable and unprofitable alike, weighted by market cap size.[9] That is precisely the exposure that led the market in 2025, and it is a structural reason IWM's valuation relative to earnings has typically run well above its peers.

IJR tracks the S&P SmallCap 600 Index, which does require positive GAAP[10] net income, in both the most recent quarter and the sum of the trailing four quarters, for a company to be added to the index. That screen filters out the weakest, least-established non-earners at the point of entry, and it is one reason IJR has historically carried a lower valuation than IWM. But it is an entry test, not a standing requirement. A constituent that turns unprofitable after joining is not automatically removed on that basis alone, so profitability can and does erode within the portfolio between reconstitutions.[12]

EES takes the profitability screen a step further. Constituents in the WisdomTree U.S. SmallCap Index are weighted by earnings, and the index rebalances annually, which means each company effectively has to re-prove its profitability every year to retain its full weight.[12] That structural discipline is not free. It tends to produce a portfolio that looks and behaves differently from the broader market, most visibly in valuation. Since the fund's 2007 inception, EES's estimated P/E ratio has run persistently below both IWM's and IJR's, including through the speculative 2020–2021 period, when IWM's forward P/E briefly spiked above 65 while EES's stayed in the mid-teens, as is visible in Figure 2.

Figure 2: Estimated P/E Ratio: EES vs. IWM vs. IJR, March 2007–August 2026



Sources: Morningstar, FactSet and WisdomTree; data from the PATH Fund Comparison Tool, accessed September 26, 2026, covering March 2007–August 2026. **Past performance is not indicative of future results**.

What the Record Shows, and What It Doesn't

None of these three approaches is designed to lead, performance-wise, in every environment, and the data bear that out. Over the trailing three years, a period that captures much of the 2022–2023 recovery and the speculative 2025 rally, IWM's broader, unscreened exposure to the full spectrum of small caps outperformed both EES and IJR, since periods dominated by non-earners and high-beta names are, almost by construction, a headwind for any earnings-oriented strategy.

Figure 3a: Small-Cap Returns Across Time Horizons: EES vs. IWM vs. IJR

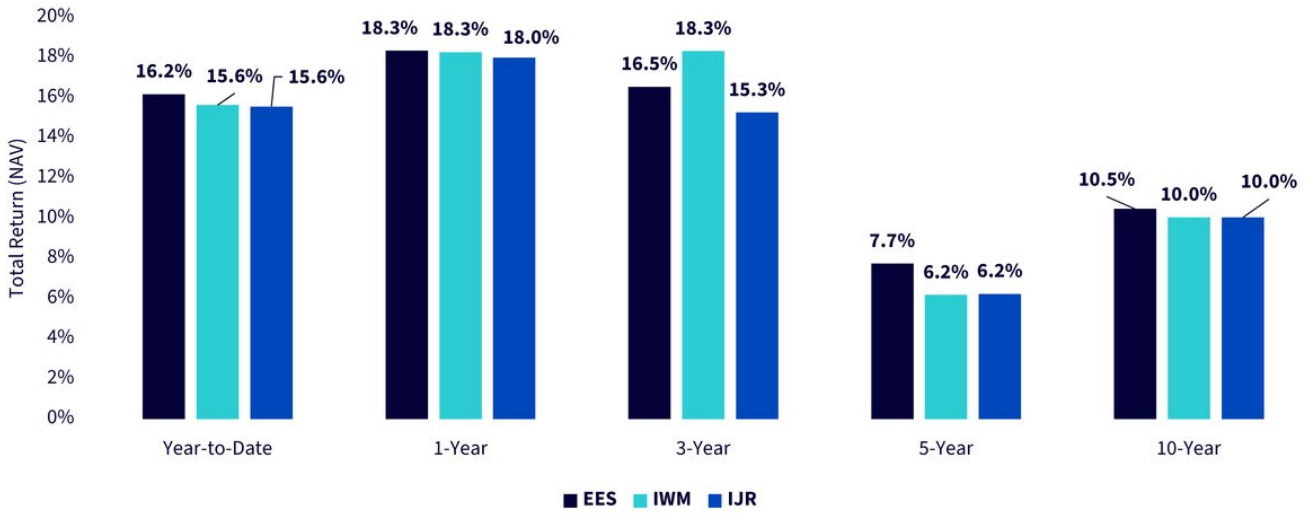


Figure 3b: Standardized Performance

Fund Name	Fund Ticker Symbol	Fund Inception Date	Fund Expense Ratio	Fund SEC 30-Day Yield	Year-to-Date	1-Year	3-Year	5-Year	10-Year	Since Fund Inception
WisdomTree U.S. SmallCap Fund (NAV)	EES	2/23/2007	0.38%	1.10%	20.40%	34.97%	16.41%	8.17%	11.50%	8.97%
WisdomTree U.S. SmallCap Fund (MP)	EES	2/23/2007	0.38%	1.10%	20.30%	35.01%	16.43%	8.11%	11.49%	8.95%
iShares Russell 2000 ETF (NAV)	IWM	5/22/2000	0.19%	0.91%	23.36%	41.60%	18.72%	7.01%	11.61%	8.74%
iShares Russell 2000 ETF (MP)	IWM	5/22/2000	0.19%	0.91%	23.50%	41.75%	18.76%	7.04%	11.62%	8.75%
iShares Core S&P Small-Cap ETF (NAV)	IJR	5/22/2000	0.06%	1.41%	21.92%	35.22%	15.36%	6.95%	11.29%	10.18%
iShares Core S&P Small-Cap ETF (MP)	IJR	5/22/2000	0.06%	1.41%	22.05%	35.34%	15.40%	6.96%	11.29%	10.18%

Sources: Morningstar, FactSet and WisdomTree, specifically, data are from the PATH Fund Comparison Tool, accessed as of September 26, 2026, but showing returns for the period ended September 24, 2026 for Figure 3a and June 30, 2026 for Figure 3b. NAV denotes total return performance at net asset value. MP denotes market price performance. **Past performance is not indicative of future results. Investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than the performance data quoted. For the most recent month-end and standardized performance, click the relevant ticker: EES, IWM, IJR.**

But widen the lens, and the profitability discipline embedded in EES has more often paid off than not. Over five- and ten-year periods, EES has outperformed both IWM and IJR, and it has also led over the trailing year and year-to-date.

A Mental Model Going Forward

Rather than asking which of these three funds is "right," it may be more useful to think of EES, IWM, and IJR as three points along a single spectrum of profitability discipline.

No positive earnings requirement (IWM)

An entry-level positive earnings requirement (IJR)

An annually re-tested positive earnings requirement (EES)

Moving along that spectrum has reliably bought investors a lower average valuation multiple and, over periods long enough to span a full market cycle, a tendency toward better absolute and risk-adjusted outcomes. It has also reliably meant lagging during the specific windows, like April through October 2025, when the market rewards exactly the companies an earnings screen is designed to filter out.

It is worth being precise about what this framework can and cannot tell an investor. It cannot time the turn. Quality and value factors have gone through multi-year stretches of underperformance before finding their footing, and nothing about the historical record rules out a similarly extended wait this time. It cannot guarantee that EES specifically outperforms IWM or IJR over any given holding period; the trailing three-year data make plain that broad, unscreened small-cap exposure can and does win for extended stretches, particularly early in a recovery. What the framework can do is reframe the question. Rather than asking whether an earnings-weighted approach to small caps has stopped working, the more productive question is where in the cycle the market currently sits, and whether the valuation gap between profitable

and unprofitable small caps has reached a point from which, historically, reversion has been more likely than not. On the evidence assembled here, a reasonable case says it has.

Figure 4: Additional Information

Fundamentals	WisdomTree U.S. SmallCap Fund (EES)	iShares Russell 2000 ETF (IWM)	iShares Core S&P Small-Cap ETF (IJR)
Objective	The WisdomTree U.S. SmallCap Fund seeks to track the price and yield performance, before fees and expenses, of the WisdomTree U.S. SmallCap Index.	The iShares Russell 2000 ETF seeks to track the investment results of an index composed of small-capitalization U.S. equities	The iShares Core S&P Small-Cap ETF (the "Fund") seeks to track the investment results of an index composed of small-capitalization U.S. equities.
SEC 30-Day Yield	1.10%	0.91%	1.41%
Total Expense Ratio	0.38%	0.19%	0.06%
Total Assets Under Management (millions)	$724.32	$82,970.35	$111,317.17

Sources: Relevant fund websites and factsheets, all data as of June 30, 2026. Subject to change.

[1] Source: Hillier, C. (2025, December). *Small caps: Unprofitables lead, active managers lag, but can it last?* Marquette Associates.

[2] Source: Hillier, C. (2025, December). *Small caps: Unprofitables lead, active managers lag, but can it last?* Marquette Associates.

[3] Sources: Aristotle Capital Boston. (2025, December 31). *Small cap observations*; Hillier, C. (2025, December). *Small caps: Unprofitables lead, active managers lag, but can it last?* Marquette Associates.

[4] Source: Aristotle Capital Boston. (2025, December 31). *Small cap observations*.

[5] Source: Aristotle Capital Boston. (2025, December 31). *Small cap observations*.

[6] Source: Arnott, R. D., Harvey, C. R., Kalesnik, V., & Linnainmaa, J. T. (2021). Reports of value's death may be greatly exaggerated. *Financial Analysts Journal, 77*(1), 44–67.

[7] Source: Hillier, C. (2025, December). *Small caps: Unprofitables lead, active managers lag, but can it last?* Marquette Associates.

[8] Source: Arnott, R. D., Harvey, C. R., Kalesnik, V., & Linnainmaa, J. T. (2021). Reports of value's death may be greatly exaggerated. *Financial Analysts Journal, 77*(1), 44–67.

[9] Source: FTSE Russell. (2026, August). *Russell U.S. equity indexes: Construction and methodology* (v7.2). London Stock Exchange Group.

[10] Generally accepted accounting principles.

[11] Source: S&P Dow Jones Indices. (2026, July). *S&P U.S. indices methodology*.

[12] Source: WisdomTree, Inc. (2026, August). *WisdomTree rules-based methodology*.

Important Risks Related to this Article

All funds are managed differently and do not react the same to economic or market events. The investment objectives, strategies, policies or restrictions of other funds may differ and more information can be found in their respective prospectuses. Therefore, we generally do not believe it is possible to make direct fund to fund comparisons in an effort to highlight the benefits of a fund versus another similarly managed fund.

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. The securities of small-capitalization companies generally trade in lower volumes and are subject to greater and more unpredictable price changes than larger capitalization stocks or the stock market as a whole. Small-capitalization companies may be particularly sensitive to adverse economic developments as well as changes in interest rates, government regulation, borrowing costs and earnings. The Fund invests in the securities included in, or representative of, its Index regardless of their investment merit and the Fund does not attempt to outperform its Index. The composition of the Index is governed by an Index Committee and the Index may not perform as intended. Please read the Fund's prospectus for specific details regarding the Fund's risk profile.

For additional disclosures, click the respective fund ticker: **IWM**, **IJR**.