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Preparing for the coming small-cap rotation to quality

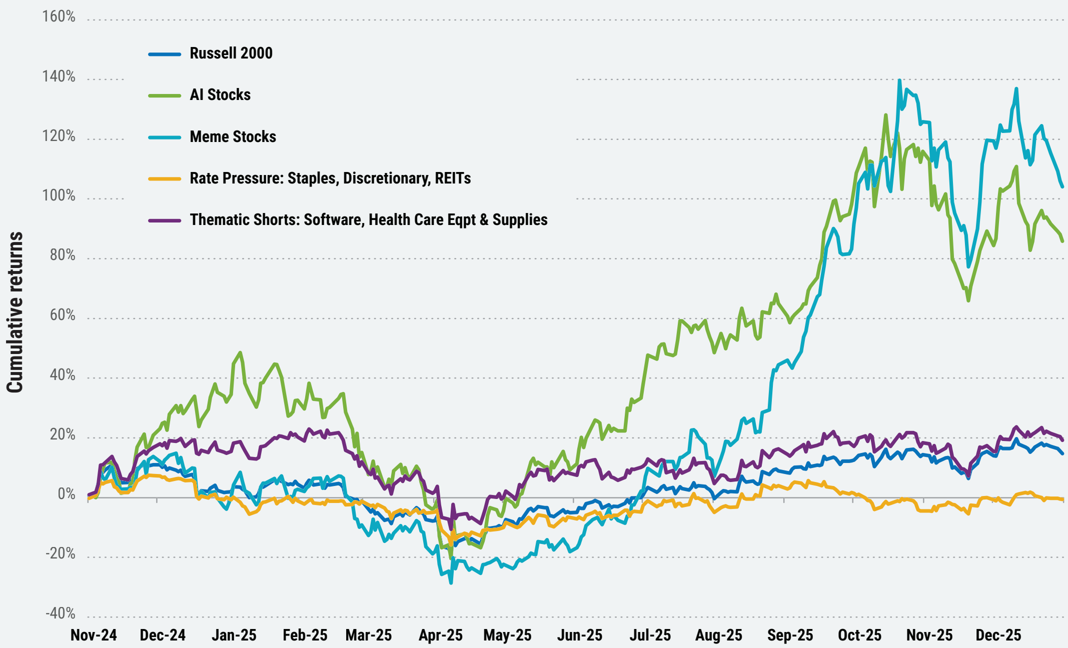
Since early 2025, the rally in small caps has been dominated by highly volatile and unprofitable names. We unpack the evidence that the leaders in 2026 will be of an entirely different caliber.

What turned out to be a good year for stocks didn't begin that way. U.S. equities of all stripes were already repricing off of their February highs when President Trump unveiled his "Liberation Day" tariff program on April 2—and the general consensus from investors was that the net effects economically would fall somewhere between merely detrimental and outright disastrous. The selloff accelerated and the result was an official bear market for small caps between February and April, with a more-than 20% draw down in just seven weeks.

Since then, small caps have recovered handily, but the solid headline performance masks a more complicated picture when parsing the market leaders and laggards. The best performing stocks since April have been, by any of a number of reasonable measures, those of some of the lowest-quality companies. There are exceptions, as two classes of companies have performed well this year for justifiable reasons: those linked to the burgeoning build-out of artificial intelligence (AI) capabilities and those companies involved in the growing adoption of GLP-1 therapeutics. But among 2025's leading performers are what we'd broadly classify as "meme stocks"—securities of companies that generate no profits (and occasionally little to no revenue) that nonetheless traded higher based almost solely on the basis of hoped-for future growth.

So-called meme stocks have been some of 2025's top performers

Russell 2000 Index and sub-themes cumulative returns: 10/31/24 to 12/31/25



Source: WPG Partners, Russell, as of December 31, 2025. Past performance does not guarantee future results. You cannot invest directly in an index. See last page for important definitions.

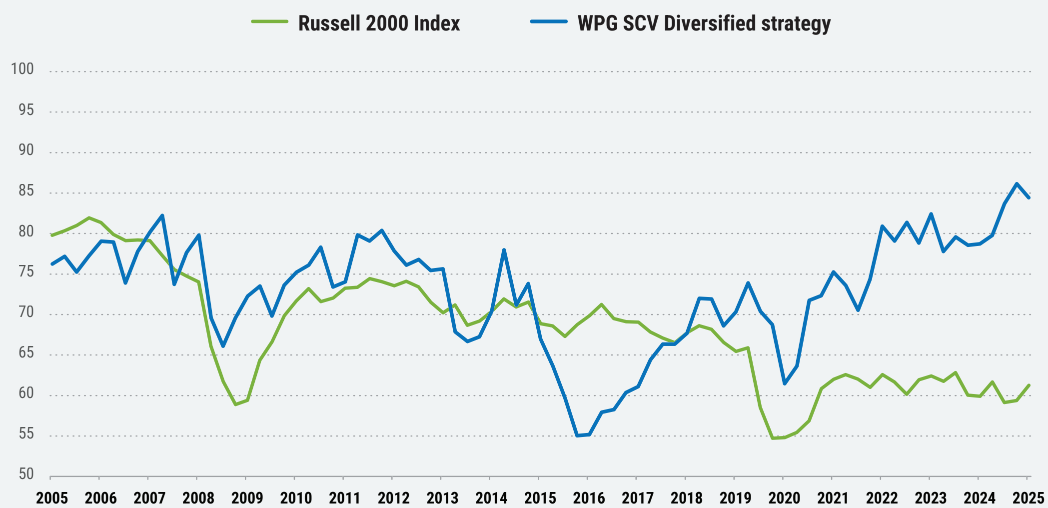
Meanwhile, real companies with real earnings have lagged. Traditional value sectors—including autos, homebuilders, food producers, retailers, staffing services, gaming, and media—have been largely overlooked. Though often dismissed as boring, these businesses consistently generate most of the index's free cash flow, not to mention perform some vital economic functions, including supporting employment in general and fueling economic growth. The market valuations for these companies remain deeply discounted: With forward P/E and enterprise value-to-EBITDA multiples in the low single digits, these stocks are priced for a recession. We believe this deep undervaluation presents an extraordinary opportunity. When market leadership broadens, these resilient companies are poised to be the primary drivers of the next phase of the market cycle.

Tapping into next year's market leaders may require a more active approach

Over time, the composition of indexes changes, and some of the moves we've seen in 2025 have already left a mark on the market. Putting aside the long-term prospects for the recent speculative winners, the reality is that they've become sizable positions for the Russell 2000 Index and therefore for passive investors as well.

The proportion of profitable companies in the index has steadily declined for 20 years

Percentage of names with positive earnings: 12/31/05 to 12/31/25



Source: WPG Partners, as of December 31, 2025.

This phenomenon has created a challenge for active managers, particularly in environments like 2025, and navigating it presents two broad options. The first is to try to adhere relatively closely to the benchmark, which lately requires owning stocks that are fundamentally weak, in order to hedge relative risk. The problem with such a tactic—beyond the inherent compromising of investment principles—is that there's no telling when the bottom will fall out on those momentum-based holdings; a move designed to mitigate risk could in actuality court more of it.

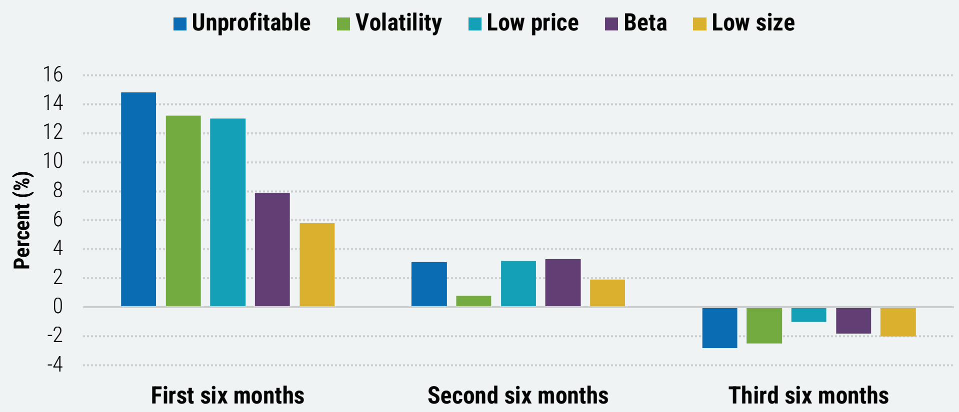
The second option is for active managers to stick with their investment philosophies, knowing that doing so might result in short-term underperformance, but believing that proactively positioning for a market rotation to higher-quality names is the better move over the long term.

Given those two choices, it's not much of a contest, in our view. We believe that as the current market concentration evaporates, companies with improving capital structures, cyclical tailwinds, and positive fundamental catalysts will be better positioned to generate long-term alpha.

There's no telling when the bottom will fall out on momentum-based holdings; owning them in an attempt to mitigate risk could in actuality court more of it.

The first six months after a bear market tend to favor lower-quality stocks

Median relative returns of various investment factors vs. the Russell 2000 Index: 2002–2024



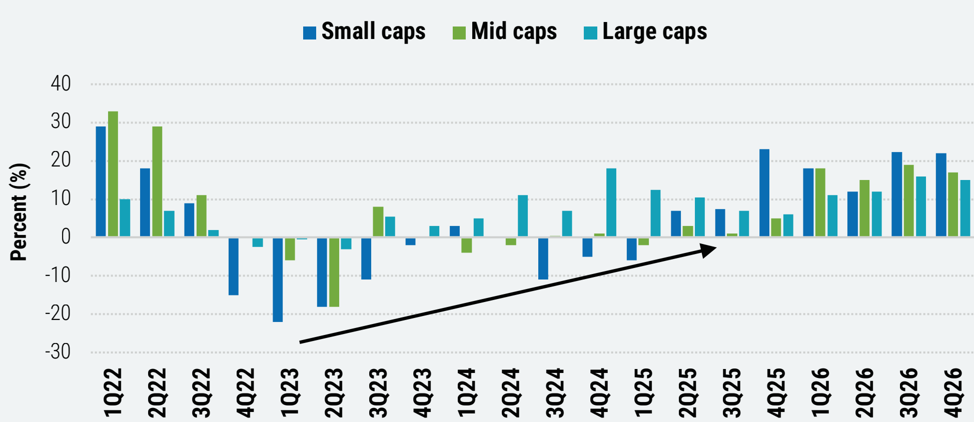
Source: FRP, FactSet, as of 9/30/25. Past performance does not guarantee future results. You cannot invest directly in an index. See last page for important definitions.

Small caps currently offer a compelling entry point for a long-term allocation

When examining the small-cap value segment, several notable trends emerge. First, small-cap equities as a group are positioned to outperform the broader market on an earnings growth basis over the coming quarters, with the Financials sector leading this acceleration. Moreover, we believe that these improved earnings trajectories may prove durable, supported by both structural and cyclical tailwinds across multiple sectors. For investors with cash to deploy headed into 2026, here are some considerations over the near and mid term:

Small caps' earnings look to be at an inflection point

Historical and projected earnings growth for small-, mid-, and large-cap stocks: 2022–2026



Source: FactSet, BofA US Equity & US Quant Strategy, as of December 2, 2025. Small-, mid- and large-cap earnings shown represent year-over-year quarterly earnings-per-share growth for the S&P 600, S&P 400, and S&P 500, respectively. Figures for Q4 2025 and after are consensus estimates. Past performance does not guarantee future results. It is not possible to invest directly in an index. See last page for important definitions.

Tactical opportunities: Short-term inflection points

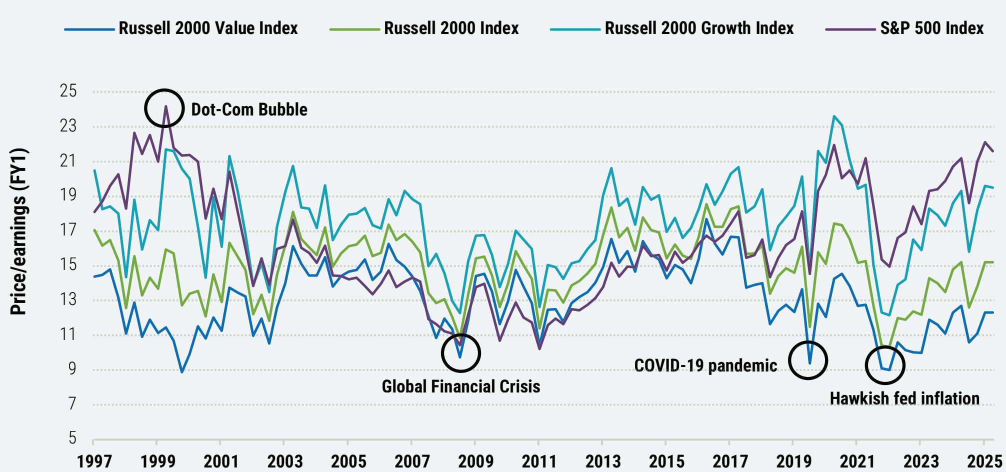
- **More rate cuts in 2026.** Fed Funds futures are currently pricing in a roughly 75% chance of at least two more rate cuts from the Fed in 2026. While the neutral policy rate appears likely to settle around 3%, the ease in policy should continue to bolster economic activity.
- **An uptick in housing.** Existing home sales are at cycle lows, similar to levels not seen since the financial crisis. An increase in inventory and/or a drop in prevailing mortgage rates may boost industrial activity while also supporting consumer sentiment.
- **Increase in durable goods purchases.** A fundamental recovery could be accompanied by a recovery in consumer sentiment. This would support spending, particularly from lower income cohorts.

Strategic opportunities: Longer-term durable trends

- **Attractive relative valuation.** By almost any measure, small caps look cheap and are hovering near cycle lows. The valuations are even more compelling when compared to other market segments like the S&P 500.
- **Positive real rates:** While short-term rates appear poised to fall somewhat further, we believe the floor will be meaningfully higher than in past cutting cycle. In other words, we're unlikely to return to a zero interest rate environment. That is significant because growth stocks won't have the same valuation buoy as they did in the wake of the Global Financial Crisis—negative real interest rates pushed investors into other asset classes, including stocks. We believe the market will pay more attention to fundamental measures like earnings and cash flow.

Small-cap value stocks' relative discount is historically wide

Historical price/earnings ratios for small cap growth and value relative to small- and large-cap market overall: 1997–2025



Source: WPG Partners, as of December 31, 2025. Past performance does not guarantee future results. It is not possible to invest directly in an index. See last page for important definitions.

Cyclical sectors are poised to benefit from these dynamics

Looking at small caps from a sector-level perspective, while Financials look particularly well-positioned to benefit from current market dynamics, we see evidence that higher returns on equity can be sustained through the next leg of the small-cap recovery cycle, as the era of zero interest rate policy (ZIRP) continues to recede into the past. That reality should act as a tailwind for multiple areas of the market.

- Banks stand to continue to benefit from higher lending margins
- Industrials are experiencing productivity gains through domestic reindustrialization and the integration of artificial intelligence
- Materials are poised to recover amid China's policy shift away from involution
- Consumer sectors stand to gain from anticipated reductions in short-term interest rates.

Wall Street forecasts call for a significant upturn for small-cap earnings in 2026—and for the segment to outpace large-cap stocks

	Earnings growth (%)		
Quarter/Year	Small	Mid	Large
1Q25A	-4.9	-2.9	14.5
2Q25A	6.2	2.8	12.0
3Q25P	3.8	4.5	8.8
4Q25P	4.5	4.3	4.3
2025P	**3.6**	**4.3**	**10.9**
2026P	**18.1**	**15.7**	**12.6**

	Sales growth (%)		
Quarter/Year	Small	Mid	Large
1Q25A	1.8	1.2	4.9
2Q25A	1.6	3.6	6.1
3Q25P	1.6	4.7	6.9
4Q25P	3.1	4.5	6.3
2025P	**2.3**	**3.7**	**6.5**
2026P	**4.8**	**5.2**	**6.7**

Sector	Profit weight (%)	2026 earnings growth (%)	Earnings contribution (%)
Financials	27.1	16.8	4.6
Discretionary	15.4	18.0	2.8
Industrials	13.9	19.0	2.6
Materials	6.5	33.9	1.9
Health Care	7.7	21.5	1.6
Info Tech	10.0	13.5	1.4
Energy	5.0	25.9	1.2
Real Estate	8.4	9.3	0.8
Comm Services	1.6	62.5	0.7
Staples	2.8	7.8	0.2
Utilities	1.6	6.0	0.1
Small Caps	**100**	**18.1**	**18.1**

Source: FactSet; Standard & Poor's, Jefferies, as of October 24, 2025, for quarterly data and November 7, 2025, for annual data. "P" denotes future projections. Past performance does not guarantee future results.

Conclusion

We do not believe that these market imbalances will persist, where unprofitable companies continue to outpace stable, revenue-generating names. History tells us that fundamentals eventually win out, and as we enter 2026, the conditions for that shift are already in place. Small-cap value stocks, trading at deep discounts yet supported by improving earnings and structural tailwinds, represent a compelling opportunity set for active investors. While passive strategies have grown increasingly concentrated and risky, active management offers the flexibility to focus on quality and capitalize on a coming rotation. Our view is clear: The next phase of market leadership will be defined by quality fundamentals and robust cash flow. We believe that in such an environment, those investors able to apply disciplined stock selection to portfolio construction will find themselves well-positioned to benefit.

About Boston Partners

Boston Partners is a value equity manager with a distinctive approach to investing—one that combines attractive valuation characteristics with strong business fundamentals and positive business momentum in every portfolio. The consistent application of this approach over more than 30 years by an experienced and long-tenured team has created a proven record of performance across economic cycles, market capitalizations, and geographies.

WPG Partners takes a unique research-driven approach to the small- and micro-cap markets: The team targets undervalued companies with improving capital structures that are near an inflection point in the business cycle with a catalyst for positive change.

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Mr. Gandhi is Lead Portfolio Manager of the WPG Partners suite of strategies. He joined WPG Partners in July 2012 as a research analyst with a concentration in the technology, media, telecom, and consumer sectors. Prior to joining the firm, Mr. Gandhi was an Associate in the investment banking division at Needham & Company. He graduated with a B.S. from the University of Maryland and received an M.B.A. from Columbia Business School, where he currently teaches Applied Value Investing as an adjunct professor. Mr. Gandhi holds the Chartered Financial Analyst designation. He began his career in the investment industry in 2007.

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Terms and definitions

AI Stocks are represented by companies in the Russell 2000 Semiconductors & Semiconductor Equipment industries and by the following AI-related companies: Applied Digital Corp., Bit Digital Inc., Chaince Digital Holdings, Cerence Inc. Palladyne AI Corp, Core Scientific, BiGBear.ai, and Fluence Energy. **Meme Stocks** are represented by companies in the Russell 2000 Bitcoin mining, nuclear energy, satellite, and quantum computing fields, specifically by the following companies: EchoStar Corp., Oklo Inc., Coeur Mining Inc., Hecla Mining Co., Viasat Inc., Cipher Mining, SSR Mining Inc., Hut 8 Corp., and Cleanspark Inc. **Rate Pressure stock**s are represented by companies in the Russell 2000 Consumer Discretionary, Consumer Staples, and REITs sectors. **Thematic Shorts** are represented by companies in the Russell 2000 Software and Health Care Equipment & Supplies industries. All weights for sectors, industries, and individual stocks are proportional to their representation in the Russell 2000 Index.

Alpha measures the excess risk-adjusted return of a portfolio relative to a benchmark index. **EBITDA** stands for earnings before interest, taxes, depreciation, and amortization. It is used to evaluate a company's profitability from core business operations, excluding the effects of any accounting practices. Enterprise value is a measure of a company's total value, including its market capitalization, total debt, and preferred equity, minus any cash and cash equivalents. **Investment factors** can refer to any number of measurable characteristics that may explain differences in securities' risk and return over time. Common factors include size, price, profitability, value, momentum, quality, and volatility (e.g., beta). **Price/earnings (P/E) ratio** measures a company's current share price compared to its per-share earnings. The **Russell 2000 Index** tracks the performance of 2,000 of the smallest companies traded in the United States. The **Russell 2000 Growth and Value Indexes** track the performance of those small-cap U.S. equities in the Russell 2000 Index with growth and value style characteristics, respectively. The **S&P 500 Index** tracks the performance of the 500 largest companies traded in the United States. The **S&P 400 and 600 Indexes** track the performance of the 400 mid-cap and 600 small-cap companies, respectively, traded in the United States. You cannot invest directly in an index.

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