

From the Desk of Dr. G. W. Perritt, President Perritt Capital Management, Inc.

In late 1978, a University of Chicago doctoral student, Rolf Banz, uncovered the fact that small company stocks had outperformed large company stocks during most of the twentieth century. Of course, one might suspect a performance differential favoring smaller company stocks, because these stocks contain more risk than do large company stocks. However, when this researcher adjusted small company returns to account for their increased risk, a substantial performance differential favoring small firm stocks remained. The extra risk-adjusted returns supplied by small company stocks eventually become known as “the small firm effect.”

During the decade following the discovery of the small firm effect, a number of mutual fund companies launched a large number of funds aimed at capturing the extra returns offered by small firm stocks. These funds proved to be quite popular with investors who poured hundreds of millions of dollars into small firm mutual fund portfolios. Although quite successful in attracting assets, mutual fund portfolio managers quickly found that the limited liquidity of small company stocks precluded investment in the very tiny companies represented in Rolf Banz’ original research. To maintain nearly fully invested portfolios, these managers merely increased the size of the companies included in their portfolios. As a result, the average market capitalizations of many small company funds exceeded the threshold used by Banz in defining the small company universe.

To account for the disparity in the average size of stocks contained in smaller company fund portfolios, these funds were reclassified as either small company funds or micro-cap company funds. Generally, micro-cap funds were defined as those with portfolios with average market capitalizations below \$500 million while mutual funds with average market capitalization portfolios ranging from \$500 million to \$1.5 billion were designated as small-cap funds.

The separation of micro-cap funds from small-cap funds by portfolio tracking services was made necessary because of the wide risk and return differentials that exist between funds that invest in smaller companies versus those that invest in tiny companies. In other words, funds that invest in tiny companies were just not comparable to those that invested in significantly larger companies. Even so, most small-cap and micro-cap funds continued to compare their results to a common investment benchmark, the Russell 2000 Index.

The Research Foundation of the CFA Institute states that investment portfolio benchmarks “are paper portfolios constructed for comparison with real portfolios to see whether the latter is being managed effectively.” To perform its function properly, a benchmark should “embody the opportunity set of investments in an asset class.” In other words, if you want to know whether or not the portfolio managers of the funds you own are doing a good job, you should compare their returns with those of an appropriate benchmark. However, in recent years, this has been an impossi-

ble task for those who opted to allocate a portion of their investment portfolio to micro-cap mutual funds because there was no index that “embodied the opportunity set of investments” in this asset class. However, help is finally on its way.

In May 2003, Morgan Stanley Capital International created an index that it claims will adequately benchmark the performance of micro-cap equity portfolios. The MSCI Micro Cap Index seeks to replicate the performance of stocks contained in the bottom 1.5 percent of public companies when ranked according to market capitalization. At present this Index contains the stocks of 1,434 companies with market-caps ranging from \$10 million to \$461 million and possessing an average market-cap of approximately \$150 million. The largest sector weights include financial services, health care, technology, industrials and consumer discretionary. The Index is subject to a semi-annual index review each November and May.

Compare this benchmark with the Russell 2000 Index, which contains the stocks of approximately 2,000 companies and is revised annually each July. Companies included in this Index have market-caps that range from \$3.2 billion to \$40 million. At present the average market-cap of this Index stands at \$1.0 billion. The largest sector weights include financial services, consumer discretionary, technology, health care, and industrials.

As can be seen, there is a huge disparity in the size of companies contained in the Russell 2000 (small-cap) Index and the MSCI US Micro Cap Index. However, both indices tend to be quite similar in terms of industry concentration.

Interestingly, it appears that the Frank Russell and Company also has recognized that the Russell 2000 Index does not provide an adequate benchmark for micro-cap portfolios. Beginning in June 2005, the company will publish the Russell Microcap Index designed to reflect benchmark microcap portfolio managers. The index will consist of the smallest 2,000 companies out of the 4,000 largest public companies when ranked according to market capitalization. A preliminary report indicates that market-caps will range from approximately \$55 million to \$500 million and the index will possess an average market capitalization of about \$280 million.

Both of these new benchmarks should be of interest to shareholders of the Perritt MicroCap Opportunities Fund and the Perritt Emerging Opportunities Fund, since the former invests in companies with market capitalizations below \$400 at the time of initial purchase, while the latter limits its initial investments to companies with market-caps below \$250 million. Because of the lack of historical data for both the newly created MSCI Microcap Index and the Russell Microcap Index, we have compared the performance of the Funds in this report to those of the Russell 2000 Index. However, in future annual shareholder reports, we plan to also include a performance comparison with these two new micro-cap indices.