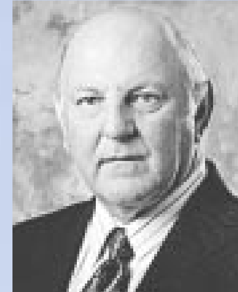
Perritt Capital Management

What a Quarter!

Presidential candidate Barack Obama promised us change, and President Obama has indeed fulfilled his campaign promise. The government has a significant ownership position in the nation's largest financial institutions; his administration is dictating company policy at Chrysler and General Motors; he, Congress, the Treasury, and the Fed have poured more than $3 trillion dollars into a sick economy and financial system; he has proposed universal health care, a high speed rail system, and elimination of the Bush tax cuts set to expire at the end of 2010; and his projected budget short-fall during the next 10 years is of epic proportions. Meanwhile, the financial markets have begun to thaw, the number of unemployed in the labor force has swelled beyond 6 million, the unemployment rate is steadily on track to hit 10%, housing starts have hit historic lows (currently an average of about 1,000 homes a month for each state in the Union), and bankruptcy filings (both personal and business) continue to spike.

During the quarter we took several calls from private clients wanting to know if they should dump all of their stocks and park the proceeds in money market funds or short-term Treasury securities. Television pundits were regularly brought on-air calling for investors to head for the exits. This sentiment reached its peak during the second week of March when the market averages breached their November lows. To us, that was the signal of an impending stock market rebound. From the November 9th low to mid-April the Standard & Poor's 500 Index rose 30%, emerging markets rose 37%, the Russell 2000 spiked 38% and the Perritt MicroCap Opportunities Fund soared 44%.

So, where does the market go from here? First, if anyone tells you they know where the stock market is headed, RUN. That being said, like the tulip bulbs we planted last year, we are beginning to see some sprouts of economic activity poking their noses upward this spring. Modest upticks in consumer confidence, automobile sales, retail sales, and a significant slowdown in the rate of expansion in new unemployment claims are giving us hope that the economy will stabilize during the third quarter and head modestly higher during the fourth quarter. Like a supertanker, the decline in GDP must first slow before it stops and begins to head in another direction.



Dr. Gerald Perritt
CEO & Founder

We don't believe that the stock market's 30% rebound between March 9th and mid-April is the beginning of a new secular bull market. Instead, the rebound was a snapback from overly an overly depressed level. At Dow 8000, the 5-week surge basically recouped the loss it sustained during the 5-week period between the end of January and March 9th. The rebound aside, the stock market itself is showing a few sprouts. We have seen a pickup in corporate buyouts, and the suitors are paying cash. We have also seen a handful of successful IPOs hit the market and trade at significant premiums in the secondary market. Finally, there is plenty of cash around to fuel a sustained bull once it begins. According to the Investment Company Institute there is currently nearly 4 trillion dollars invested in money market funds.

DR. PERRITT continued on page 4

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An Interview With Michael Corbett,

President and Portfolio Manager of the Perritt Funds

Michael Corbett
CIO &
Portfolio
Manager

Q.

Did you see any signs from small cap stocks in the first quarter '09 that lead you to believe that the market could be recovering?

A.

Over the last quarter it appeared to us that small cap stocks began trading based on fundamentals as opposed to the demand for liquidity. The types of forced selling that we saw in the 4th quarter of 2008 that was tied to hedge funds in the small cap space was much less frequent. During the market's deterioration at the end of last year, investor demands for redemptions from hedge funds led to a forced liquidation out of small and micro-cap positions on a large scale. The selling for liquidity that we saw in the first quarter of 2009, when it did exist, was much less drastic. We continue to believe that we are near the end of forced selling by hedge funds in the small cap space. This is an encouraging sign to us because we believe it means that markets are starting to trade on a more normal basis. In other words, we feel stocks are beginning to trade on a fundamental basis, which should bode well for small cap stock prices.

Q.

Are you concerned about the debt levels of small companies in the face of this credit crunch?

A.

We are always concerned about a company's level of debt. However, we believe that there is a misconception about debt in regards to smaller companies. Conventional wisdom seems to be that most small companies are loaded with debt and that they need the debt and equity markets to survive and grow their businesses. In fact, that idea couldn't be farther from the truth. The table on the following page outlines the level of debt between companies in the S&P 500 Index, the Russell 2000 Index, and our own portfolios. This data illustrates that larger companies are more leveraged than small companies. Because the first part of our investment process is finding small companies with strong balance sheets, our team spends a great deal of time seeking companies with zero leverage or only a manageable amount of debt. Because so many of our companies are currently holding large cash positions, and in many cases zero debt, we have an expectation they may avoid the types of financial difficulties associated with excess leverage.

Portfolio Characteristics as of 3/31/09

	PRCGX	PREOX
Median Market Cap	$101 Mil.	$22 Mil.
Price / Tangible Book	0.8	0.7
Price / Earnings	8.1	7.2
Price / Sales	0.3	0.3
Price / Cash Flow	2.5	2.5

Q.

To what degree have you seen smaller companies engaging in cost-cutting or restructuring due to the recession?

A.

Each bear market is different, but all bear markets give us a chance to closely examine the behavior of management teams of the companies in our portfolio. While there have certainly been some disappointments, many of the management teams of companies that we currently own or are on our watch list have been quite impressive to us because of their actions in this bear market. Small companies can be exciting in this environment because of their agility and flexibility. An analogy that we often use is that a large company is like a supertanker and a small company is like a speedboat. What this means is that we believe that smaller companies can be much more agile when maneuvering in a stormy economy. As we enter into a new economic environment, it is essential for companies to be able to adjust their businesses models in an effort to boost performance in the face of poor economic conditions. We have several companies that we feel have done a great job of changing their cost structures in this new environment. One example of this is Universal Power Group (UPG), a company which is in the battery

Q&A continued on page 3

Q&A continued from page 2

Debt Levels: Large Cap vs. Small Cap as of 3/31/09:

	S&P 500 Index	Russell 2000 Index	MicroCap Opportunities Fund (PRCGX)	Emerging Opportunities Fund (PREOX)
Zero Debt: # of companies with zero debt on balance sheet	**41 of 500** (8.2%)	**517 of 1913** (27.0%)	**65 of 128** (50.8%)	**57 of 137** (41.5%)
Cash Position: # of companies holding 10% or more of market cap. in cash	**41 of 500** (8.2%)	**1173 of 1913** (61.3%)	**58 of 128** (45.3%)	**67 of 137** (48.9%)
Median Debt to Assets Ratio	**20%**	**11%**	**3%**	**4%**

business. UPG has actually been able to reduce their cost structure in excess of 25 to 30 percent without experiencing a deterioration of their business near those levels. This shows you how a small company can move quickly in the face of new challenges in a way that can improve their bottom line. One of the advantages of investing in smaller companies is that we have a portfolio packed with companies whose management teams are able to make similar types of changes as new challenges arise.

Q.

We have discussed the portfolio's historically low levels of valuations in the past, what does this mean for investors?

A.

The assessment of valuations is a large part of our investment process. If done properly, valuations can tell you how far a stock may rise or fall, without necessarily giving a time horizon. In our opinion the opportunities today are unbelievable. I have not seen this degree of opportunities in both their range and depth over my twenty year career. Our portfolios continue to trade well below tangible book value – most companies that we own are holding low levels of debt and large cash positions. Because of the damage to the confidence in our markets and in our economy, we believe that the recovery could last for many years and the rewards could be very impressive. These rewards could be magnified in the small cap sector. This is not only because the valuations of small company stocks are the most severely depressed, but also because, as we discussed previously, smaller companies are like speedboats that can quickly adjust to take advantage of new opportunities as they present themselves during an economic rebound.

Q.

What is your greatest fear in the near term?

A.

As we have said many times before, you never know the catalyst that moves a market until after it has occurred. Instead of trying to speculate which particular event will be the one to move the markets, we believe that it is more important to focus on the fundamentals of the businesses that we own or seek to acquire. That being said, in the last several months we have had an above-average level of calls from private equity firms and other shareholder activists looking to unlock some of the value in the small cap space that has resulted due to forced selling. We do not know if the level of buyout activity increases to the point that serves as a catalyst to move the markets. However, should that occur our greatest fear is that companies we currently own will accept a buy-out offer below what we believe the company is ultimately worth. In the past several weeks about a half dozen of our companies have received buy-out offers; in some cases these offers were in excess of 100 percent of the then existing share price. For example, ICT Group (ICTG), which is in the call center business, was trading around $4 a share when it received a buy-out offer from Aegis, a business process outsourcing company, for $8 a share. Because they believed the value of the business to be greater than the offered price, management of ICT Group turned this proposal down within 24 hours of receiving the offer. We tend to agree with management of ICT and other companies in our portfolio for turning down buy-out offers because we believe that based on the value of the businesses the upside during the next two to three years could be well in excess of the offers currently being proffered.

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DR. PERRITT continued from page 1

With the expansion in the money supply, there is plenty of talk about impending inflation and a sinking dollar. We don't see either on the near-term horizon. First, despite the Fed and Treasury actions, the value of the dollar has actually gained ground against the euro, pound, and yen. That's because everyone else in the world is in worse shape than the U.S. at this point in time. Furthermore, we believe that the U.S. economy will turn upward before Europe and Japan. Thus, we look for the value of the dollar to stabilize near current levels. As for inflation, remember that there are 6.1 million people out of work in the U.S. and capacity utilization has fallen below 70%. Thus, there is plenty of slack in the economy, which needs to be siphoned off before inflation pressures become a problem. The hope is that the government can slowly reverse its expansionary course once the economy begins to head upward.

My call for a stock market bottom in November missed the mark. When I made this call last September, I didn't realize how bad the credit crisis had become. Thus, I am hesitant to call the March 9th low the ultimate bottom, though it sure feels like it. My guess is that the market will muddle along during the summer and begin a sustained rally in the fall. Our friends at *Investors Intelligence* have pointed out that since 1950, holding the Dow Jones Industrial Average between May 1 and October 31 has resulted in a loss, and that is after a 58 year period.

That being said, we are still seeing extremely attractive valuations in the smaller company segment of the market. Business is bad, but there are plenty of companies around that are still generating cash, have plenty of cash on their balance sheets, and possess minimal amounts of long-term debt. That is also true in the mid-cap and large-cap space. Remember, corporate America has cut its labor, production, and distribution costs. Once the economy turns, corporate earnings could explode as operating leverage and greater efficiencies send increased revenues straight to the bottom line.

2009 1st Quarter Financial Market Statistics

Commodities	
Gold	+6.2%
Corn	+0.3
Cattle	-9.0
Soybeans	-1.0
Silver	+21.5
Wheat	-8.0
Platinum	+25.1
Oil	+11.3
CRB Index	-5.1

Foreign Markets	
U.K. FTSE 100	-11.5%
DAX	-15.1
CAC 40	-12.8
Japan	-8.5
Hong Kong	-5.6
India	+0.6
China	+37.9
Mexico	-15.3
Brazil	+9.1
Argentina	+4.3

U.S. Industry Performance	
Basic Materials	-5.5%
Consumer Goods	-11.4
Consumer Services	-7.1
Financials	-27.7
Health Care	-8.0
Industrials	-19.5
Oil & Gas	-10.6
Technology	-4.8
Telecomm	-3.3
Utilities	-12.2

U.S. Stocks	
Dow Industrials	-13.3%
Nasdaq Composite	-3.1
Nasdaq 100	+2.1
S & P 500	-11.7
Russell 2000	-15.4
Wilshire 5000	-10.7

U.S. Dollar vs.	
Euro	+5.1%
British Pound	+1.5
Canadian Dollar	+3.8
Yen	+9.0

Bond Yields (quarter end)	
30-yr T-bond	3.56%
10-yr T-bond	2.71
3-mo T-bill	0.21

The Death of Small Firm Stocks . . . . . . Another Exaggeration

There's nothing like a severe bear stock market to spawn some of the worst advice financial pundits can offer. Given that this bear market is the worst in memory (very few of today's investors remember the great bear market of the 1930s), some of the worst advice we have ever heard is spewing from the talking heads on financial "news" programs.

With most stock market indexes sporting 10-year declines, a growing number of pundits are telling us that a buy-and-hold strategy is doomed to failure and that profit-seeking investors should opt instead for an active trading strategy. We have been told that bonds will outperform stocks during the remainder of this decade and the next. The advice: abandon equities and head instead for better yielding bonds. We have heard that exchange traded funds should be avoided because the stock market will provide suboptimal returns for the next decade. The advice here is to avoid market replicating portfolios in favor of highly concentrated portfolios whose returns are uncorrelated with market performance.

We have also been told that after such a catastrophic decline in stock markets around the world and in the ongoing economic recession (depression?) we should avoid the shares of small company stocks and the mutual funds that invest in them and opt instead for the shares of giant cap firms. The reasoning here is that small companies are undercapitalized, are burdened with debt that can't be refinanced, and lack the management sophistication to navigate a perilous economic environment. While this description is no doubt true for some companies in the small-cap and micro-cap segment of the market, the description also holds true for a number of large-cap and giant-cap companies as well. (In fact, we could argue that the current economic disaster was created by giant-cap companies painted with this descriptive brush.)

It is somewhat understandable why advisors have been telling investors to avoid small-cap stocks and to pack their portfolios with the stocks of large and giant companies. With the stock market near a 12-year bottom, investors have seen the value of their nest eggs cut in half. The reasoning behind the "avoid small company" advice is that investors need to reduce the risk of their equity portfolios in order to allow them to stay in the market longer term. However, that advice is akin to someone telling you that you should purchase homeowners insurance now that you house has burnt to the ground.

We are small-cap and micro-cap investors, and like most investment pros we are biased toward our chosen investment category. However, we believe we are also prudent financial professionals and are constantly telling anyone who will listen that an all-cap strategy is best for equity investors. That being said, we also believe that shunning small company stocks after a catastrophic stock market meltdown is one of the biggest mistakes an equity investor can make.

First, the performance record for small company stocks is not nearly as bad as conventional wisdom indicates. Check out the accompanying table. It lists the compound annual investment returns provided by small company stocks during each of the last eight decades. I am sure that you are surprised to learn that during every one of these decades (including the partial decade bounded by 2000 and 2008) small firm stock produced positive average annual returns.

Small Company Stocks Compound Annual Return by Decade

Decade	Return (%)
1930s	1.4 %
1940s	20.7
1950s	16.9
1960s	15.5
1970s	11.5
1980s	15.8
1990s	15.1
2000s*	4.1

Based on the period 2000-2008

Source: Ibbotson 2009 Classic Yearbook

We have pointed out in previous issues of this newsletter the fact that when the stock market rebounds from a severe bear market , the stocks of smaller companies perform best both in terms of absolute returns and in returns relative to those of larger company stocks. The reason has nothing to do with the quality of small firm stocks relative to the quality of large firm stocks. Instead it is

SMALL STOCKS continued on page 7

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What Now Dow?

The Dow Jones Industrial Average, the "Dow," was created by American journalist Charles Henry Dow on May 26, 1896. The Jones part was named after Dow's business partner Edward Davis Jones, a statistician. Interestingly, Jones didn't have anything to do with creating the stock index. Dow compiled the index to gauge the performance of the industrial sector of the American stock market. It is the second-oldest U.S. stock market index, after the Dow Jones Transportation Average, which Dow created 12 years earlier.

The Dow was created to help investors ' view trends in the stock market and disseminated daily in Dow's publication, *the Customers' Afternoon Letter*. Dow and Jones partnered with Charles Bergstresser in the financial news business. They opened their shop in the basement of a lower Manhattan candy store that eventually became home to the New York Stock Exchange. *The Customers' Afternoon Letter* later became the *Wall Street Journal*, the first edition of which contained 4 pages and sold for 2 cents. The first day's closing average of 12 stocks was 40.94. Two-and-a-half months later, on August 8, 1896, the average had tumbled to 28.48, which was the lowest point on record for the Dow. Of the 12 original companies included in the average, only General Electric remains today.

Over the years, the Dow Jones Industrial Average evolved into a blue chip average of the largest companies in America. The phrase "blue chip" to describe high quality stocks was coined by a Dow Jones employee (Oliver Gingold) in the 1920s. Gingold noted that the highest value poker chips were colored blue applied that color to the highest value companies whose stocks were listed on the NYSE. When Charles Dow dies in 1902, Clarence Barron, originally hired as a correspondent, purchased a controlling interest in the firm.

Originally, the Dow was computed as a simple average of the share prices of its 12 component companies. However, as time passed adjustments to the Dow were required to adjust its value to account for stock splits, stock dividends, and a changing composition. For example, when a company split its stock, its stock price would fall by an amount equivalent to the reciprocal of the split. Although the value of the company would remain after the split (a lower share price but more shares outstanding), the value of the Dow would decline because of the price decline. To adjust for these events, the divisor of the Dow would be reduced by an amount that would leave its value unchanged. To day, the Dow's divisor stands at 0.125552709. Thus, the impact of a $1 change in any of its 30 components caused the "Average" to change by 7.97 points.

Although the Dow is the most quoted market measure, very few professional investors use it as a benchmark to judge portfolio performance . First, unlike most other indexes of stock market performance (e.g., Standard & Poor's 500, Wilshire 5000, Russell 2000, etc.) that are market value weighted, the Dow is price weighted. That is, the stocks with the highest price impact the Dow the most. For example, a $1 change in the share price of IBM (currently trading around $100 a share) causes an 8 point change in the Dow as does a $1 change in the share price of General Motors (currently trading around $2 a share). Thus, a 1% move in one stock can cause the same move in the Dow as a 50% move in another stock.

Second, professional investors believe that the Dow is much too narrow to be a reliable gauge of stock market performance. Of the 5,000 or so publicly traded stocks with national exposure, it contains the stocks of 30 companies, which represents less than 1% of the nationally traded stock universe. Finally, the Dow Jones Industrial Average is not really an average of industrial stocks. Four of its components (American Express, Bank

WHAT NOW DOW continued on page 7

Dow Jones Average Milestines

Milestone	Date
First close over 100	Jan 12, 1906
First close over 1,000	November 14, 1972
First close over 5,000	November 1995
First close over 10,000	March 29, 1999
Lowest close 28.48	August 8, 1896
Record close 14,164.53	October 9, 2007
Divisor falls below 1.0 for the first time (0.956) as a result of a 2-for-1 Merck stock split on May 27, 1986	
Largest daily point loss 778 points on September 29, 2008	
Largest daily point gain 936 points on October 13, 2008	
Largest daily percentage decline 22.6% on Black Monday October 19, 1987	
Largest daily percentage gain 15.3% on March 15, 1933	

WHAT NOW DOW continued from page 6

of America, Citigroup, and JPMorgan Chase) are financial services firms and three others (Home Depot, McDonald's, and Walmart) have been drawn from the retail sector.

The keepers of the Dow are a panel of Wall Street Journal Editors who decide which companies go in and out of the Dow. Their goal is to keep the Dow representative of American industry. Interestingly, they have had a notoriously bad track record when it comes to making changes. For example, they kicked Chrysler out of the Average when its stock hit bottom in the late 1970s, only to miss its subsequent robust share price rebound. They added Intel and Microsoft in November 1999, shortly before technology stocks nosedived. They added AIG in 2004 when it was a darling of Wall Street and removed it when bankruptcy loomed in 2008. Interestingly, the Average was expanded from 20 to 30 stocks in 1928, near the height of the "roaring 20s" bull market. Although we are not sure when the next changes will occur, rumor has it the both General Motors and Citigroup will soon be departing.

The Dow Jones Industrial Average appreciated at a 5.3% compound annual rate during the 20th Century, a record Warren Buffett called "a wonderful century." According to Mr. Buffett's calculations, to achieve that return again, the index would need to reach nearly 2,000,000 by 2100. So far, the 21st century has not treated the Dow very well. The current credit crisis and resulting economic recession have exacted a heavy toll on the Average. It was trading above 14,000 shortly before the current recession began in late 2007 and nosedived 7,700 points by early March 2009. Three of its current components are in deep financial trouble (Bank of America, Citigroup, and General Motors). Interestingly, if the prices of the stocks of these three companies were to suddenly fall to zero simultaneously , the impact on today's Dow would be a decline of 134 points, a drop of a mere 1.7 percent.

SMALL STOCKS continued from page 5

liquidity that calls the tune. Smaller company stocks tend to perform worse than large cap stocks on the way down because they are less liquid. Selling of stocks across-the-board by fearful investors sends the prices of small company stocks markedly lower as market makers step away from the market. Each successive round of selling hits market makers' bids that become progressively lower. The reverse is true during a market rebound. Incremental buying pressure takes out market makers' asking prices and the lack of other willing sellers causes the share prices of smaller company stocks to soar. In short, small cap stocks perform best during stock market rebounds because they were overly depressed when the market ultimately hit its bottom.

The quality of a company has nothing to do with size. Like all stocks, quality depends on financial condition, management expertise, the ability to deliver quality goods and services, and cost containment. And these are attributes are not confined to the large-cap and giant-cap sectors of the market.

Panics, Recessions, and Depressions

Ever wonder how "The Great Depression" got its name? President Herbert Hoover, the man blamed by many for causing the Great Depression of the 1930s, also helped name it.

During this country's 233-year history, there have been many periods marked by falling commodity and financial asset prices, and plummeting economic output. The downturns were generally known as "panics," but Hoover deliberately chose the word depression because he thought it sounded less alarming, according to historian William Manchester.

Hoover even used these words in a speech in the fall of 1931: "I need not recount to you that the world is passing through a great depression." But his use of "a" instead of "the" was an indication that Hoover did not grasp the historical significance of the economic troubles. It fell to Lionel Robbins, a British economist, to write a book that would give a name to the times, *The Great Depression*, in 1934.

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Past performance does not guarantee future results. Index performance is not illustrative of fund performance. You cannot invest directly in an index. For fund performance please visit w.perrittmutualfunds.com.

Perritt Capital Management Client Newsletter, 1st Quarter 2009

- What a Quarter . . . . pg. 1
- An Interview With Michael Corbett . . pg. 2
- The Death of Small Firm Stocks . . . . . pg. 5
- What Now Dow?. . . . . pg. 6
- Panics, Recessions, and Depressions . . pg. 7

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