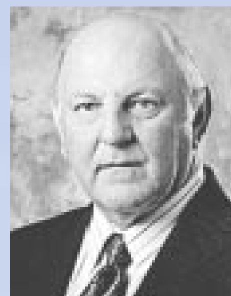
Perritt
Capital Management

1970s *Deja Vu*

Imagine a decade marked by feelings of disillusionment, cynicism, bitterness, and anger. Americans are increasingly disillusioned with the government and their democratic institutions. Burdened with this political disillusionment, American society is also under siege by economic decline and declining standards of living. For many Americans it's a decade of transition – marked by confusion, frustration, and an overwhelming feeling that America has lost its direction. Americans are faced with economic stagnation and recession, increasing poverty, decline in their standards of living, and fears that the "American Dream" is becoming harder to achieve.

During the decade, a number of trends can be observed, including: higher divorce rates, increase in couples living together, increased recognition of homosexual lifestyle, rise in drug use, rising crime rates, increasing energy costs, growing concern about an environmental crisis, and a declining standard of living. If you haven't already guessed, I am not talking about the current environment. I am describing the decade of the 1970s.

During a recent interview, supply side economist Arthur Laffer described the outlook for the next decade as a repeat of the financial and economic environment of the 1970s. If you remember your history, that decade was marked by hyper-inflation, above-average unemployment, skyrocketing energy costs, double digit interest rates and economic recessions. Dr. Laffer's ominous forecast probably caused plenty of investors to quake in their boots. However, a reading of financial market statistics indicates that some investors fared very well during that decade. Here's a bit of the historical record.



Dr. Gerald Perritt
CEO & Founder

The investment returns in the major categories of financial assets, when viewed from the perspective of the entire decade (January 1, 1970 through December 31, 1979) did in fact provide mediocre returns. Corporate bonds (as measured by the Citigroup Long-Term High-Grade Corporate Bond Index) returned 6.2% per year, Treasury bills 6.3%, S&P 500 Index 5.9%, international stocks 10.1% (as measured by the MSCI EAFE Index) and small company stocks (as measured by the fifth quintile of stocks on the NYSE based on market capitalization) 11.5%. On a nominal basis, these returns appear to have rewarded investors for the risks they took. However, during the decade, the rate of increase in consumer prices averaged 7.4% a year. Thus, on an inflation-adjusted basis (so-called real returns) the returns in every category were far below their long-term historical average. In fact, on an inflation-adjusted basis, corporate bond, Treasury bill, and large-cap stock investors experienced a decline in their wealth during the decade.

These return numbers do indeed look bleak. However, the decade-long compound returns for the common stock categories paint a distorted picture. Remember, stock prices around the world took a significant tumble during 1973 and 1974. For example, the Standard & Poor's 500 Index declined by 17.4% in 1973

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An Interview With Michael Corbett,

President and Portfolio Manager of the Perritt Funds

Michael Corbett CIO & Portfolio Manager

Q.

How have changes made to the portfolio during the worst of the market's downturn contributed to the Funds recent out-performance?

A.

Much of the Funds' recent performance was a result of our taking advantage of the extreme valuations that we saw in the microcap space at the beginning of this year. In March, the selling became so irrational that half of the companies in our portfolios were trading at levels below tangible book value. We took this opportunity to add to some of our positions. One example of this is Bioscrip, Inc (BIOS). This health care company acts as a middle man between pharmacies to provide services that help consumers get less expensive prices for the prescriptions they need. In early March, there was one particular seller with a significant position in the stock that needed to be unloaded because they were receiving redemption requests. We took advantage of this opportunity by taking a significant portion of the shares when the stock was trading at less than $2.00. The stock has since rebounded to nearly $6.00. These types of examples certainly added significant value to the portfolio and have helped the Funds' performance so far this year. According to Morningstar, for the period January 1 through June 30, 2009, both PRCGX and PREOX ranked in the top 2% among 570 funds in the small-blend funds category, based on total returns.

Q.

Now that we've experienced a significant rally, are small company stocks still undervalued?

A.

There is good news and bad news that comes with any significant rally. Obviously the good news for investors is that they have made money. The bad news is the idea

Morningstar ranked the MicroCap Opportunities Fund (PRCGX) in the top 31%, 24% and 3% out of 661, 465 and 231 small-blend funds for the one-, five- and ten-year periods ending 6/30/2009. Morningstar ranked the Emerging Opportunities Fund (PREOX) in the top 95% and 91% out of 661 and 570 small-blend funds for the one- and three-year periods ending 6/30/2009.

Performance as of 6/30/09

	YTD	1 Yr.	3 Yr.	5 Yr.	10 Yr.	15 Yr.
Perritt MicroCap Opportunities Fund (PRCGX)	27.57%	-23.35%	-9.46%	0.05%	9.81%	10.16%
Perritt Emerging Opportunities Fund (PREOX)	27.94%	-37.13%	-16.26%	NA	NA	NA

Perritt MicroCap Opportunities Fund Expense Ratio: 1.37%

Perritt Emerging Opportunities Fund Expense Ratio: 1.87%

Performance data quoted represents past performance; past performance does not guarantee future results. The 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 of the fund may be lower or higher than their original cost. Performance data current to the most recent month end may be obtained by calling 1-800-331-8936. The funds impose a 2% redemption fee for shares held less than 90 days. Performance data quoted does not reflect the redemption fee. If reflected, total return would be reduced.

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that the market may have gone too far, too fast. While this statement may be true, it is clearly a short run view. Over the long run, what ultimately determines the future level of stock prices are valuations. There are several ways to look at valuations. Given the fact that we are currently in a recession, valuation measures such as price-to-earnings ratios and price-to-cash flow ratios become less important. This is because earnings and cash flow levels are likely to become depressed during a recession. In our opinion, one of the most important tools to use when determining a company's value during a recession is the price-to-sales ratio and the quality of the balance sheet. As can be seen in the table that we've provided, The Emerging Opportunities Fund currently trades at 0.4 times sales and The Microcap Opportunities Fund trades at 0.5 times sales. In addition, the balance sheets of the companies in both Funds remain in pristine condition. For more details on the cash and debt levels of the Funds, please see the table at the end of this commentary. It is important to note that historically, in a recession, small companies have been able to move quickly to cut costs. As a result, any improvement in future sales due to a strengthening economy should lead to an even greater increase in the earnings.

Q.

Has the downturn in the economy had an effect on the number of analysts that cover small cap stocks, and if so, what does this mean for you portfolios?

A.

To answer this question it is important to understand why a company receives coverage from analysts in the first place. There are actually two types of firms that cover equities, sell-side firms and firms related to investment banking. A sell-side firm wishes to recommend a company in order to generate trading and subsequently earn commissions. On the other hand, firms related to the investment banking business engage in secondary offerings or other types of banking services. According to The Wall Street Journal, there were more than 2,200 cases of analysts formally dropping coverage of small cap stocks between last September and Mid-May of this year. It is not surprising that due to the recession the overall coverage has decreased. With less money available and less business activity, both sell-side firms and firms related to investment banking have suffered.

Analyst Coverage as of 6/30/09

	Perritt Microcap PRCGX	Perritt Emerging PREOX	Russell 2000 Index	S&P 500 500 Index
Number of stocks	127	145	2019	500
Zero analyst coverage	25	74	299	2
One analyst coverage	24	36	262	7
Average # Analyst	**2.75**	**1.00**	**4.01**	**10.03**

The table above compares the level of analyst coverage within the small-cap and large-cap space, as well as the coverage levels for companies in our portfolios. The number of small-cap companies being followed by analysts has always been less than that of large-cap companies. This is one of the key factors in the inefficiencies that we believe exist within the small-cap sector. Therefore, in our opinion, the recent drop in the level of analyst coverage is actually a positive for micro-cap investors because stocks become more inefficiently priced. In other words, the stocks become more undervalued. This is an area where we believe our in-house research has added significant value uncovering mispriced securities. Our research team believes that the entry point for small-cap and micro-cap stocks continues to be attractive right now, as an abundance of these stocks remain inefficiently priced when evaluated on a three to five year time horizon.

Q.

How do you explain the wide disparity in performance among the various micro-cap indexes?

A.

The substantial difference in the performance of the various micro-cap indexes is somewhat astounding, as seen in the table below. As of June 30, 2009 there is a difference

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of nearly 30% between the best and worst performing micro-cap indexes year-to-date, all of which are supposedly tracking the same sector of the market. A closer look reveals that a possible explanation to this irregularity is related to the number of companies being tracked by each index and how they are chosen. In its entirety, the micro-cap universe is made up of approximately 5,000 names. The Russell 2000 and the Russell Microcap Index each track 2000 companies, the Morgan Stanley MicroCap Index tracks 1,300 companies, and the Dow Jones Select Microcap Index and Zacks Microcap Index each track less than 500 companies. The lesson here is that within the micro-cap sector of the market, selecting between the right stock and the wrong stock can have large ramifications on a portfolio's ultimate performance. This is part of the reason why for twenty years we have been such strong advocates of active management within the micro-cap sector of the market. When done correctly we believe it can add a great deal of value in both the short run as well as the long run.

MicroCap Index Performance as of 6/30/09

Index	Performance
Russell 2000	2.6%
Russell Microcap	6.0%
MSCI Microcap	22.5%
Dow Jones Select Microcap	-3.2%
Zacks Microcap	-5.0%

Portfolio Characteristics as of 6/30/09

	Perritt MicroCap PRCGX	Perritt Emerging PREOX
Median Market Cap	$145 M	$31 M
Price / Tangible Book	1.0	0.8
Price / Earnings	12.8	13.0
Price / Sales	0.5	0.4
Price / Cash Flow	4.2	3.0

Large Cap vs. Small Cap: Comparison of Debt Levels as of 6/30/09:

	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%)	**575 of 2019** (28.5%)	**56 of 127** (44.1%)	**64 of 145** (44.1%)
Cash Position: # of companies holding 10% or more of market cap. in cash	**208 of 500** (41.6%)	**1194 of 2019** (59.1%)	**79 of 127** (62.2%)	**90 of 145** (62.1%)
Median Debt to Assets Ratio	21%	10%	2%	1%

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and by 29.7% during 1974. If you exclude these two years, the common stock returns during the rest of the decade were significantly above their long-term averages. Ex 1973 and 1974, large-cap stocks (as measured by the S&P 500 Index) returned an average of 13.9% a year, international stocks returned an average of 18.6%, and small-cap stocks returned a whopping 23.4% a year.

Of course, if you exclude the worst annual returns from any time series, the returns during the remaining years will be much higher. Thus, it may appear to be a fool's errand to talk about investment returns during the 1970s after excluding the 1973-1974 bear market. However, I am trying to make the point that by averaging returns across a long time period, an investor can get a distorted picture of market action during individual years in that time period. In other words, when it appears that common stocks provide below-average returns over a prolonged period of time, it is usually significant declines lasting a year or two that cause the abnormally low long-term performance average.

That brings me to the point of this discussion, which is if Dr. Laffer is correct and we are currently living the decade of the 1970s, I say "bring it on." Common stocks delivered some of their best returns during the period 1975-1983. That period followed on the heels of a double dip bear market 1969-1970 and 1973-1974. Like investors in the 1970s, investors today have experienced a double dip bear market 2000-2003 and 2007-2009. In other words, I believe that the worst of the decade's returns are most likely behind us.

The accompanying table illustrates what has occurred during the decade following the worst annual stock market declines in modern history. As can be seen, large-cap stocks earned positive returns during each of the 10-year periods following the abnormally large yearly stock market declines. Except for the 10-year period following the 1931 market meltdown, investors may have been well-rewarded for staying the course.

Returns After Ten Worst Stock Market Declines

S&P 500	Year	10-Yr Average Annual Return	10-Yr Total Return
-47.1%	1931	6.4%	86.0%
-38.6	1937	9.6	150.1
-38.5	2008	???	???
-29.7	1974	14.8	297.6
-28.5	1930	1.8	19.5
-23.4	2002	???	???
-17.9	1941	17.3	393.2
-17.4	1973	10.7	176.4
-14.3	1957	12.8	233.5
-13.0	2001	???	???

Source: Ibbotson Classic Yearbook, 2008
Past performance is not a guarantee of future results

Interestingly, the big winners during the decade of the 1970s were small-cap stocks (as measured by the fifth quintile of stocks on the NYSE based on market capitalization). Not only did they return 11.5% annually during the entire decade (including 1973 and 1974), they continued to perform exceptionally well into 1983. During the nine-year period following the 1973-1974 bear market, they produced a 35.3% annual compound annual return. Furthermore, they delivered double digit returns during each of the nine years following that bear market. What makes this record even more phenomenal was the fact that that period was marked by high inflation, soaring interest rates, and above-average unemployment. If this economic environment sounds familiar to you, it should because it is exactly the environment that Arthur Laffer and numerous other economists believe will be the hallmarks of the next 10 years. Although past results do not guarantee future performance, I believe that the market pundits who are telling investors that the best places for their money is domestic giant-cap stocks and international stocks are overlooking the one segment of the market that has not only delivered the highest returns during the past century, but offer significant return potential during the near term.

It is also interesting to note that the returns of so-called value stocks trounced the returns of growth stocks during the decade of the 1970s. One research team, which examined large-cap portfolios of high price-to-book value stocks (growth portfolio) and low price-to-book value stocks (value portfolio), found that the growth portfolio returned an average of 3.4% per year during the decade versus a 12.2% return for the value portfolio. (Source: Ibbotson Classic Yearbook, 2008) When the years 1973 and 1974 were stripped out of the decade, growth stocks

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returned an above-average 12.3% annual return. However, the value portfolio produced a whopping 20.0% return.

Although past performance doesn't guarantee future results, these return statistics have given me a few clues about structuring my portfolio given the current economic environment. First, I am skeptical of the pundits who are telling me that the best places for my money today are domestic giant-cap stocks and international stocks (including emerging markets). History tells me that they may be overlooking the one segment of the market that has not only delivered the highest returns during the past century and one that has performed exceptionally well after significant bear market declines. That, of course, is the segment containing the smallest company stocks. Furthermore, the 1970s have given me a clue to the types of stocks I want in my portfolio. That is, those stocks that appear to be value-priced on such metrics as price-to-earnings, price-to-sales, and price-to-book value.

The thesis here is that common stocks have historically tended to provide superior returns during the years following severe bear markets. The implication is that common stock investors (especially small-cap stock investors) could potentially experience hefty returns during the next ten years. However, there certainly are detractors to this view. Most notably, Mohamed El-Erian and Bill Gross, co-chief investment officers of PIMCO, the large bond investment firm, have been highly vocal about the upcoming underperformance of common stocks. In their words, during the next 3-5 years, common stock investors will experience "a new normal." According to their view, economic growth, coming out of the current recession will be

2009 2nd Quarter Financial Market Statistics

Commodities	
Gold	2.0%
Corn	-14.1
Cattle	-1.7
Soybeans	28.8
Silver	6.3
Wheat	-4.0
Platinum	5.5
Oil	40.7
CRB Index	13.4

Foreign Markets	
U.K. FTSE 100	8.2%
DAX	17.7
CAC 40	11.9
Japan	22.8
Hong Kong	34.4
India	49.3
China	24.7
Mexico	35.7
Brazil	41.7
Argentina	41.0

U.S. Industry Performance	
Basic Materials	16.2%
Consumer Goods	14.0
Consumer Services	12.6
Financials	35.6
Health Care	8.7
Industrials	19.2
Oil & Gas	13.2
Technology	16.6
Telecomm	11.6
Utilities	9.2

U.S. Stocks	
Dow Industrials	11.0%
Nasdaq Composite	20.0
Nasdaq 100	19.4
S & P 500	15.2
Russell 2000	20.2
Wilshire 5000	16.2

U.S. Dollar vs.	
Euro	-5.7%
British Pound	-14.7
Canadian Dollar	-7.8
Yen	-2.8

Bond Yields (quarter end)	
30-yr T-bond	4.32%
10-yr T-bond	3.53
3-mo T-bill	0.19

SOURCE: Yahoo Finance

Fund holdings and sector allocations are subject to change and should not be considered a recommendation to buy or sell any security.*Source: Yahoo Finance*

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well-below trend. As a result, corporate profit growth will be anemic as will be common stock returns. They say, rather than the 10-11 percent long-term annual returns provided by common stocks during the last 150 years, investors may experience average returns of 5 to 6 percent. Their forecast is based on the notion of an economy and financial system that will be de-leveraged, de-globalized, and re-regulated.

Although their argument for anemic stock market returns well into the future is well thought out, I am a bit skeptical. First, their prescription for investors is to lighten up on stocks and increase allocations to bonds. Given that these prognosticators run the world's largest bond firm, could you expect them to write any other prescription for investors. That aside, the most dangerous phrase ever uttered on Wall Street is "It's different this time." Although El-Erian and Gross have eschewed this phrase, their replacement phrase "It's a new normal" sounds a lot like it.

I have to admit that it is different this time around. First, the United States is no longer the engine of world economic growth. It has been replaced by China, India, and to some extent Brazil. Second, the financial crisis, which arose because of excessive leverage in the financial system is already causing the government to ramp up regulation. However, the assumption of quasi-permanent de-leveraging is probably wide of the mark. It is true that the use of excessive leverage by the banking system appears to be a thing of the past. However, I believe that both business and consumers will continue to borrow as they have during the years preceding the 2000-2007 financial bubble. During the century and a-half preceding that bubble, large-cap stocks (as measured by the S&P 500 Index) provided a 6.8% average annual real (after-inflation) return.

Furthermore, the last 10 years have been marked by below-average stock market returns. In fact, the total annual return of the Standard & Poor's 500 Index has been etched in red ink during that period. A statistical concept called "gravitation toward the mean" suggests that the average annual returns during the next 10 years could easily top those of the last 10 years if the long-term average stock market return gravitates back toward its historical 10-11% rate.

Are You Better Off Than Your Parents?

I don't know about you, but I definitely am. Sixty years ago our family was living without a television, cell phone, computer, internet access, a transistor radio, a microwave oven, an icemaker, and air conditioning. The family clunker didn't have an automatic transmission, air conditioner, radio, or turn signals. And there were no superhighways to get us from one place to another. There were no heart transplants and a myriad other medical procedures.

Of course, there were a number of things we were living with that are not around today. We lived with measles, chicken pox, whopping coughs (and the red quarantine signs that were tacked to the doors of those families whose children were suffering these maladies). We lived in fear that one of our loved ones would contract polio. And there was the fear that the entire world would be consumed in a nuclear holocaust.

Back then, my dad was bringing home $50 a week as an employee of a major steel company, my mom was hanging out the wash, I helped shovel coal into the coal bin in winter, and my favorite toys were a baseball and glove. Back then necessities were food, clothing, and shelter.

Earlier this year, the Pew Research Center asked Americans what they couldn't live without. You might only be mildly surprised at their responses. Here's the top ten list (along with the percentage of responses): Car (88%), clothes dryer (66%), home air conditioning (54%), TV set (52%), home computer (50%), cell phone (49%), microwave (47%), high-speed internet (31%), cable or satellite TV (23%), and dishwasher (21%).

The information provided herein represents the opinion of Perritt Capital Management and is not intended to be a forecast of future events, a guarantee of future results, nor investment advice.

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.

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