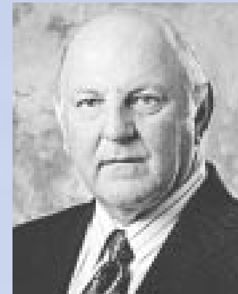
Perritt
Capital Management

It Is Different This Time

I'm getting a bit tired of hearing financial pundits compare the economic meltdown of 2007-2009 with the Great Depression. Yes, both followed economic bubbles. Yes, both were accompanied by surging unemployment rates. Yes, both were preceded by a stock market meltdown. Yes, both were accompanied by a soaring number of bank failures. However, the severity of the current economic crisis pales in comparison to that of the 1930s. Here are but a few comparative economic statistics.

During the depths of the Great Depression in 1932, one out of every four Americans was unemployed. Today, less than one of ten is unemployed. By 1932, manufacturing output had fallen to 54 percent of its 1929 level. Between 1929 and 1933, real output decreased by 30 percent versus a 7.5 percent decline in real Gross Domestic Product between November 2007 and June 2009. (The preliminary estimate of GDP growth for this year's third quarter recently came in at 3.5 percent, which just about cut the recession's real output decline in half.) During the current recession, 133 banks have failed and some economists estimate that the number will reach nearly 800 before banking stability is finally restored. However, by 1932, 11,000 of the nation's 25,000 banks failed. Furthermore, there was no FDIC around in the 1930s to protect bank depositors. When a bank closed back then, a depositor's money simply disappeared.



Dr. Gerald Perritt
CEO & Founder

That brings me to the most striking differences between the Great Depression and today's economic recession. During the Great Depression, the nation's central bank actions and inactions increased both the magnitude of the decline in economic activity and forestalled the economy's ultimate recovery.

In their now-classic book, *A Monetary History of the United States*, Milton Friedman and Anna Schwartz identified four major errors made by monetary policymakers during the period shortly before the great stock market crash of 1929 and during the economic collapse that followed. First, the Fed raised interest rates between the spring of 1928 and October 1929 to curb speculative uses of credit, especially in real estate and the stock market. Second, in September and October 1931, the Fed once again raised interest rates to stop the loss of gold reserves (remember, the U.S. and many other countries were on the gold standard at that time) and protect the value of the dollar. Although that tactic stabilized the dollar, it also deepened the economic decline. Third, with nominal interest rates near zero, the Fed mistakenly believed that it was following an easy money

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An Interview With Michael Corbett,

President and Portfolio Manager of the Perritt Funds

**Michael Corbett
CIO &
Portfolio
Manager**

Q.

Low priced stocks have led the markets recovery. Does this mean it has been a low quality rally?

A.

Many investors have pointed out that the stock market's rally since the March lows has been the strongest among so-called low quality stocks. Low quality stocks are typically defined as companies with stock prices below $5.00, which is a range that includes the majority of small company stocks. We prefer to define low quality stocks as companies with poor business fundamentals and poor capital structures. It is true that many lower priced stocks have been among the best performing investments this year. However, we disagree with the perception that low price equals low quality. There are many low priced, small companies in our portfolios that we feel meet the definition of a high quality investment: primarily, well-run businesses with low debt and clean balance sheets. For example, we have previously mentioned ICT Group (ICTG), which is a company in the call center business. This stock was trading at under $4.00 a share in March when it received a buyout offer from Aegis at $8.00 a share. Management turned down this proposal within 24 hours because they believed that the value of the business was greater than the offered price. In the first week of October, the company received a second buyout offer, in this instance from Sykes Enterprises at $15.38. In our opinion, ICT Group is a high quality stock with a strong business model and a clean balance sheet. This is demonstrated by the fact that two companies have made offers to buy the business within the past six months. And yet the stock was recently priced well

Performance as of 9/30/09

	YTD	1 Yr.	3 Yr.	5 Yr.	10 Yr.	Since Inception
Perritt MicroCap Opportunities Fund (PRCGX)	46.61%	-2.07%	-4.47%	3.66%	12.69%	8.94% (4/11/88)
Perritt Emerging Opportunities Fund (PREOX)	52.57%	-4.49%	-10.93%	-0.25%	NA	-0.01% (8/27/04)

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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under $5.00 a share, a level that would cause many investors to define it as a low quality company. We continue to see low priced small stocks such as ICT Group that we consider to be high quality investments.

Q.

With last year's financial crisis, there is even less analyst coverage of the small cap sector than before. How do you get ideas?

A.

Over the past twenty years we have developed a network of external relationships that enhances our ability to uncover some of the best small cap gems in the market place. Our research process starts with nearly two dozen individuals that bring us ideas. These relationships include small company research boutiques, regional brokerage firms, and public relations firms. The microcap space is unique because it contains thousands of companies and data is not always accurate or even available. You simply can't cover 5,000 companies unless some ideas are coming to you. As an example, the idea for ICT Group mentioned above originally came from Bill Sutherland, an analyst that we've been working with for nearly 15 years. This type of long-term relationship with a specific individual is typical to Perritt Capital Management. Due to our relationship with Bill, we've made money on ICT Group twice in the past decade.

Because we are often one of the first institutions to invest in a company, executives are eager to reach us through one of our many external channels. Once a company hits our radar, our internal process is stringent. We use a nine factor evaluation tool to determine if a company meets our capital structure requirements. We then evaluate company management, business plans and stock valuations. However, during the idea generation phase, we are much less rigid. Three to five companies come through our offices each week, and as I like to say, we don't turn down many meetings.

Q.

Have you seen any improvement in small company earnings?

A.

Most of the positive earnings news reported by small companies has been due to cost cutting. The fact that so many small companies have preserved their earnings power in this environment is a positive sign. When a company is able to maintain earnings power during a poor economic environment, we believe it demonstrates that it is a high quality company. However, the item missing from most small company earnings reports is revenue growth. It is difficult to say how soon it will be before we see this growth return. As can be seen in the table below, valuations have certainly expanded. Yet looking out into 2011 or 2012 on a normalized basis, even with a moderate recovery in mind, valuations are more attractive. We are confident that management teams will find ways to bring revenue growth back over the long term.

Portfolio Characteristics as of 9/30/09

	Perritt MicroCap PRCGX	Perritt Emerging PREOX
Median Market Cap	$167 M	$41 M
Price / Tangible Book	1.2	1.0
Price / Earnings	16.4	14.7
Price / Sales	0.8	0.6
Price / Cash Flow	5.3	4.0

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Q.

What keeps you up at night?

A.

Investing with a three to five year time horizon helps reduce the anxiety associated with short term moves in the market. The thing that does worry me is the possibility that we return to the type of demand for liquidity that we saw late last year and earlier this year. In order to defend our portfolios against this, we have started adding a new behavioral analysis element to our investment process. The goal of this analysis is to help us avoid crowded investments. Examples of a crowded investment include a stock with too much analyst coverage, a stock with large numbers of growth or momentum type investors involved, or instances of well above average trading within a particular stock. By avoiding crowded investments, we believe that we can lessen some of the losses that can occur as everyone runs for the exits at once. We are on pace to have this new behavioral element fully integrated into our process within the coming quarters.

DISTRIBUTION INFORMATION

The Perritt Funds do not anticipate any taxable distributions for 2009. Impications for future tax distributions are as follows:

Tax Characteristics as of 9/30/09
($ millions)

	Perritt MicroCap PRCGX	Perritt Emerging PREOX
Assets Under Management	$332.4	$64.4
2008 Carry Forward Losses	14.6	2.6
2009 Realized Losses	15.9	9.2
Total Realized Losses	30.5	11.8

Large Cap vs. Small Cap: Comparison of Debt Levels as of 9/30/09:

	S&P 500 Index (Large Cap)	Russell 2000 Index	Perritt MicroCap Opportunities Fund (PRCGX)	Perritt Emerging Opportunities Fund (PREOX)
Zero Debt: # of companies with zero debt on balance sheet	39 of 500 (7.8%)	570 of 2000 (28.4%)	57 of 129 (44.2%)	71 of 148 (48.0%)
Cash Position: # of companies holding 10% or more of market cap. in cash	186 of 500 (37.2%)	1100 of 2000 (55.0%)	77 of 129 (59.7%)	92 of 148 (62.2%)
Median Debt to Assets Ratio	20%	10%	2%	1%

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course and that no more should be done. Finally, the Fed decided not to intervene in the banking crisis, which once again contributed to the precipitous fall in the money supply.

Economic historians have recently identified additional factors that contributed to the economic decline that plagued most industrial nations during the 1930s. The gold standard as reconstituted after the end of World War I proved to be both unstable and destabilizing for two reasons. First, the war caused enormous economic destruction, large government debts, battered banking systems and hyperinflation in a number of countries. Second, the Bank of England could no longer maintain its leadership among other central bankers to manage the international monetary system. That job, by default, was left up to the Fed. Given the Fed's decentralized structure, inexperience, and domestically focused leadership, it was not up to the task of fostering international cooperation on monetary matters. As a result, the overall stability of the international system was ignored as central bankers focused instead on conditions within their own borders.

The actions taken by the U.S. Federal Reserve, the U.S. Treasury, and the central bankers around the world during the current financial and economic crisis are far different than those taken nearly eight decades ago. First, and foremost, central banks around the world have adopted easy money policies. They have literally flooded the world with money. Second, without the noose of the gold standard hanging around their necks, central banks have cooperated in an attempt to stabilize the world financial system. This is in complete contrast to the myopic views of central bankers during the 1930s. Finally, most industrialized nations have used fiscal policies to stimulate their local economies.

Today's economic backdrop is much different than it was 75 years ago. Because of the experience of the 1930s, a number of government agencies and programs have been created including: social security, unemployment insurance, federal deposit insurance, and the establishment of the Securities and Exchange Commission.

Although the fiscal and monetary actions taken by governments worldwide do not assure a quick resolution to the financial and economic problems facing industrialized nations, the mistakes made during the Great Depression have been avoided this time around. Make no mistake about it, the effects of the financial crisis in the United States and elsewhere are still lingering. Here at home nearly 20 million people are out of work. The nation's unemployment rate is hovering just below 10 percent and most economists believe that the 10 percent threshold will be breached before it will ebb. A large number of American families will lose their homes in the months ahead and hundreds of banks will disappear during the next 12 months. Because of a large and growing federal budget deficit, the U.S. dollar will continue to decline against most of the world's major currencies. Finally, the Federal Reserve and the U.S. Treasury will eventually be forced to walk a tightrope while reining in the nation's money supply once the crisis has passed. Tighten too fast and the economy could slip back into a recession. Tighten too slowly and a growing economy awash in money could ignite an inflationary spiral.

The most dangerous phrase ever muttered on Wall Street is "It's different this time." Pundits have dodged this phrase and have replaced it with "a new normal." The new normal has been used to describe an economy marked by higher joblessness and lower standards of living for many Americans, an economy that struggles with anemic growth for years, an economic and social landscape painted in constant change, and a stock market that produces long-term annual returns closer to 5 percent than to the long run 10 percent it has experienced for more than a century.

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In a recent editorial, the St. Louis Post-Dispatch opined: "Something is terribly wrong if the new normal means accepting 10,000 Americans a day losing their homes or one out of ten Americans being out of work or the possibility that as many as half of the 7.2 million Americans who have lost their jobs in the recession never will find steady work." I whole heartedly agree!

Things are certainly different today from the way they were during the Great Depression. However, as the saying goes "the more things change the more they stay the same." I believe that the resourcefulness, productive capacity, innovativeness of Americans and their ability to face and solve problems is undiminished. Although I don't believe that the current economic malaise will disappear overnight, I also don't believe that America and its citizens will continue to suffer for decades to come. Call me optimistic if you will, but I believe that the American dream is still alive. The economy will recover, Americans will be called back to work, standards of living will begin to rise, the financial markets will deliver solid long-term returns, and the host of social and economic problems facing us today will be resolved for the better. To me, the "new normal" is the "old normal" that Americans have been experiencing since 1776.

2009 3rd Quarter Financial Market Statistics

Commodities	
Gold	8.5%
Corn	-6.3
Cattle	-5.0
Soybeans	-5.5
Silver	22.1
Wheat	-19.1
Platinum	9.3
Oil	-2.2
Copper	23.4
CRB Index	3.8

Foreign Markets	
U.K.	20.8%
Germany	18.0
France	20.9
Japan	1.8
Hong Kong	14.0
India	18.2
China	-6.1
Mexico	18.5
Brazil	27.7
Argentina	30.7

U.S. Sector Performance	
Basic Materials	22.5%
Con. Discretionary	21.2
Consumer Services	11.3
Financials	24.5
Health Care	10.2
Industrials	21.5
Energy	12.0
Technology	17.6
Telecomm	6.7
Utilities	6.7

U.S. Stocks	
Dow Industrials	15.0%
Nasdaq Composite	15.7
Nasdaq 100	16.4
S&P 500	15.0
Russell 2000	18.9
Wilshire 5000	15.8

Currency - Dollar vs.	
Euro	-4.3%
British Pound	2.8
Canadian Dollar	-8.1
Yen	-7.0

Fixed Income Bond Yields (quarter end)	
30-yr T-bond	4.0%
10-yr T-bond	3.3
3-mo T-bill	0.1

Source: Yahoo Finance

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 www.perrittmutualfunds.com.

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