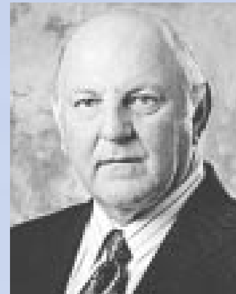
Perritt
Capital Management

The Worst Decade

Forbes magazine dubbed the last decade as the worst ever, and I heartily agree. In December 1999, investors were hailing a decade-long bull stock market, dot-com firms were raising record amounts of cash, the unemployment rate was hovering around 3.8%, and people across the country were about to welcome the onset of the twenty-first century. By decade end, natural disasters, terrorism, a banking system and a stock market collapse left Americans feeling exposed and vulnerable.

Nearly 25% of the last decade was spent in economic recession. The first recession was relatively mild and lasted eight months. The second, aside from the Great Depression, was the worst in more than a century. As is always the case, the stock market mirrored the misery in the economy. In January 2000, the Dow Jones Industrial Average peaked at 11,723 and continued in a downward spiral that ended in early October 2002 when the Dow closed at 7286. Five years later, in October 2007, the Dow peaked at 14,164 and ultimately reached bottom on March 6, 2009, when it closed at 6443, a whopping decline of 7,721 points. On a total return basis, large-cap stocks returned an average of -1.0 percent per year during the entire decade. That compares to the -0.1 percent average return of the 1930's, the only other decade during which large-cap stocks provided negative average annual returns.



Dr. Gerald Perritt
CEO & Founder

The economy entered the twentieth century at full employment (a 3.8% unemployment rate). By the end of the century's first decade, the unemployment rate stood at 10.0%. By decade-end, the number of unemployed reached a dismal 15.3 million. If one combines the unemployed with those who gave up looking for work and part-time workers who would rather be working full-time, the underemployment rate soars to 17.3%, the highest such rate since the Great Depression.

As the number of unemployed grew so did the hardship on families who were facing the loss of their homes. At the end of the decade, 7 million households were behind on mortgage payments or in foreclosure. One in ten mortgage holders were at least one payment behind on their mortgages and 1 in 22 were in foreclosure. During the final months of the decade 300,000 people a month were losing their homes to foreclosure.

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www.PerrittCap.com

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An Interview with Michael Corbett

President and Portfolio Manager of the Perritt Funds

Michael Corbett CIO & Portfolio Manager

Q.

What worked for the Perritt Funds in 2009?

A.

Last year was rewarding to many investors across most equity and asset classes. As seen in the table below, our shareholders likely benefited from the Fund's performance last year: The MicroCap Opportunities Fund (PRCGX) was up 52.89% and The Emerging Opportunities Fund (PREOX) returned 60.66% for the one year period ending 12/31/2009. We didn't change our behavior much in 2009 despite such a rising market. In fact, we added 29 new names to PRCGX and sold 25 names, while adding 23 new names to PREOX and selling 14 names. These changes were very much in line with our typical turnover ratio, which we aim to keep below 50% annually. A few of our larger holdings did appreciate significantly, including Bioscrip (up over 270% in 2009), and ICT Group, a company that was bought out during the year (up over 250% during the period). The bottom line is that to us 2009 felt like a recovery from the panic of 2008. We did not witness the types of investor behavior that is typically associated with a euphoric or bubble type of mentality, which many people looking at 2009 performance might expect.

Performance as of 12/31/09

	2009	3 Yr.	5 Yr.	10 Yr.	15 Yr.	Since Inception
Perritt MicroCap Opportunities Fund (PRCGX)	52.89%	-5.77%	1.72%	11.59%	11.24%	9.04% (4/11/88)
Perritt Emerging Opportunities Fund (PREOX)	60.66%	-11.39%	-1.41%	NA	NA	0.98% (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.

Mutual fund investing involves risk. Principal loss is possible. The Funds invest in smaller companies, which involve additional risks such as limited liquidity and greater volatility than larger companies. The Funds invest in micro cap companies which tend to perform poorly during times of economic stress. The Emerging Opportunities Fund may invest in early stage companies which tend to be more volatile and somewhat more speculative than investments in more established companies.

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Q.

Following such a strong year for small caps, do you still see much upside?

A.

The recovery off of 2009's panic-driven lows was certainly drastic, as I discussed previously. As some of our largest holdings have grown significantly, we have started the process of reducing our exposure and investing in new ideas. Looking at small cap valuations today, I think that we are experiencing a return to evaluations based on business fundamentals as opposed to an environment where investors are trading securities based on greed or fear.

In terms of future upside, companies today do seem to have some remaining ability to boost earnings by cutting costs further. What many investors don't realize, however, is that there may also be significant room for top line growth. One example is American Service Group (ASGR), a company that provides health care services to prisons. Currently, over half of the prisons in the U.S. are operated by local governments. American Service Group has shown that they can save these municipalities 20-30% in health care costs, something that we believe may be attractive to local governments considering their dire financial circumstances.

American Service Group (ASGR) has a clean balance sheet with zero debt and almost no analyst coverage (more on the debt levels and analyst coverage of companies in our portfolios can be seen in the following table). The idea was brought to us by a four person firm that we have a long relationship with; they typically don't even write research reports because their focus is to just search for and find niche businesses like this one. ASGR is currently trading below $16.00 and earns between $1.10-1.20; this gives it a P/E ratio of 16, right in line with our overall portfolio. After speaking recently with management who indicated that several states were considering procuring their services, we believe that even if a few of these states decide to step up and outsource to them the company's 2012 and 2013 earnings could potentially reach $3.00 or $4.00, and possibly as high as $5.00 within five years. If we were to base our estimation on just the low number of $3.00, we estimate a P/E ratio of five times earnings, a level that we believe is very undervalued. This is just one example of how we evaluate upside potential, we see several other companies with this type of potential capability in our portfolios.

Q.

Why did you launch PREOX and what type of investor is it suited for?

A.

We launched the Emerging Opportunities Fund to give investors the opportunity to own the smallest of the small companies in terms of market capitalization. Our firm's investment philosophy is built on the "small firm effect," which is the fact that historically, the smallest companies have performed best over long periods of time (as demonstrated by Ibbotson & Associates' *Stocks, Bonds, Bills and Inflation Yearbook*, which looks at annualized equity returns over the period 1926-2008). More than 90% of the companies in the Emerging Opportunities Fund have a market capitalization below $100 million. This is a segment of the market where we believe that the "small firm effect" has the potential to be most pronounced. We are determined to hold the Fund to its guideline to be invested in the smallest decile of the market (those companies in the bottom 10th percent based on equity market value).

Many of our investors have chosen to use The Perritt Emerging Opportunities Fund as a supplement to our flagship Perritt MicroCap Opportunities Fund in order to achieve a more accurate exposure to the microcap segment of the market. For example, a client with a high risk profile might use a mix of 90% PRCGX / 10% PREOX, while a higher risk profile investor might use a 70%/30% mix. Other investors who may be interested in the Fund are those searching for characteristics including:

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- **Lowest Average Market Capitalization.** According to Morningstar's database, The Emerging Opportunities Fund's average market capitalization ($53 million) is the smallest among the over 10,000 mutual funds listed as of 1/29/10 (includes all funds with over $100,000 under management).

- **Low Correlation.** The Fund's R-Squared to the Russell 2000 is 0.69, a relatively low correlation.

- **Domestic Exposure.** Despite the occasional confusion caused by its name, the Emerging Opportunities Fund is primarily a domestic investment vehicle. Approximately 93% of the Fund is invested in U.S. companies.

An April 2009 study published by the Brandes Institute, "Is U.S. Small Cap a Viable Alternative to U.S. Private Equity?" suggests that the value-add demonstrated in selection of U.S. private equity has the potential ***to closely attain that of top managers of small-cap equities.*** We seek to provide that "value add" in our process by focusing on what we believe are undiscovered companies in the smallest of the small segment of the market as based on market capitalization.

(Please copy this link into your internet browser to read the full report:
http://www.brandes.com/Institute/Documents/Private%20Equity%200409.pdf)

Small Cap vs. Large Cap: Comparison of Debt Levels as of 12/31/09:

	Perritt MicroCap Opportunities Fund (PRCGX)	Perritt Emerging Opportunities Fund (PREOX)	Russell 2000 Index	S&P 500 Index
Zero Debt: # of companies with zero Debt on balance sheet	64 of 134 (47.8%)	68 of 149 (45.6%)	562 of 2000 (28.1%)	35 of 500 (7.0%)
Cash Position: # of companies holding 10% or more of market cap. in cash	84 of 134 (62.7%)	92 of 149 (61.7%)	1134 of 2000 (56.7%)	185 of 500 (37.0%)
Median Debt to Assets Ratio	0.1%	0.9%	9.2%	19.8%

Source: Capital IQ

Analyst Coverage as of 12/31/09:

	Perritt MicroCap Opportunities Fund (PRCGX)	Perritt Emerging Opportunities Fund (PREOX)	Russell 2000 Index	S&P 500 Index
Number of Stocks	134	147	2000	500
Zero analyst coverage	29	79	312	2
One analyst coverage	29	39	256	7
Average # Analyst	2.5	0.9	3.9	10.2

Source: Capital IQ

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Although the stock market recouped about half of its losses between March 2009 and December 2009, market weary investors continued to abandon the stock market in favor of investments perceived to be far less risky. Inflows into fixed-income mutual funds during 2009 smashed the previous record. Investments in money market funds continued to grow despite interest yields that hovered around zero.

Although large cap stocks experienced their worst decade on record, there were a few investment bright spots in the decade. The big winner was gold bullion, which rose from $300 an ounce at the beginning of the decade to $1100 an ounce in December 2009, a compound annual return of 13.9 percent. Long-term government bonds provided a 9.9 percent average annual return and small-cap stocks rose at a 6.2 percent average annual rate. Treasury bills returned 2.8 percent annually, which topped the 2.2 percent average annual rate of inflation. A hypothetical portfolio equally balanced among these five asset classes would have provided a 6.4 percent average annual return during the decade, once again underscoring the benefit of portfolio diversification.

A Decade of Misery

March 2000: The dot-com bubble bursts with the Nasdaq peak of 5048. This Index would finish the decade at 2269, a whopping 55% decline.

December 2000: A U.S. Supreme Court decision ultimately settles the contested presidential election in favor of George W. Bush.

September 2001: On September 11 the country experiences the worst terrorist attacks ever.

October 2001: The U.S. invades Afghanistan.

July 2002: WorldCom files for bankruptcy, the largest filing in U.S. history at the time.

February 2003: The space shuttle Columbia breaks up upon re-entry, killing all seven astronauts.

March 2003: The invasion of Iraq begins with a series of air attacks.

August 2003: The largest electrical blackout in U.S. history leaves 50 million people in 8 states and Canada without power.

November 2004: An Indian Ocean earthquake and the resulting tsunami kill more than 230,000 people.

August 2005: Hurricane Katrina, the costliest hurricane in U.S. history, kills thousands of people across seven states.

April 2006: A gunman at Virginia Tech kills 32 people and wounds 25 others.

January 2008: The price of oil hits $100 per barrel for the first time ever.

September 2008: Lehman Brothers files for chapter 11 bankruptcy, far surpassing WorldCom as the largest such filing in U.S. history. The Dow Jones Industrial Average sets a single day record with a decline of 777.68 points.

December 2008: Bernie Madoff is arrested for perpetrating a giant Ponzi scheme in which thousands of investors lost almost $65 billion, including fabricated gains.

March 2009: The decline in the Dow Jones Industrial Average, which began in October 2007, finally hits bottom at 6443, a stunning decline of 7,721 points.

October 2009: The U.S. unemployment rate tops 10% for the first time in 26 years.

Perritt Capital Management

Financial Market Performance: Quarter IV and Full Year 2009

Commodities

	Q4	2009
Gold	8.7%	24.0%
Corn	20.5	1.8
Cattle	4.6	-0.1
Soybeans	12.2	6.9
Silver	1.1	49.3
Wheat	18.4	-11.3
Platinum	12.7	56.0
Oil	7.3	81.1
Copper	18.5	138.5
CRB Index	9.4	15.0

U.S. Sector Performance

	Q4	2009
Basic Materials	6.6%	45.1%
Consumer Goods	8.4	38.0
Consumer Services	4.0	10.0
Financials	-3.6	15.0
Health Care	8.4	17.0
Industrials	5.5	18.7
Energy	5.7	19.3
Technology	9.9	48.8
Telecomm	6.2	21.5
Utilities	5.8	6.9

Bond Yields (year end)

	Q4
30-yr T-bond	4.63%
10-yr T-bond	3.85
3-mo T-bill	0.06

Foreign Markets*

	Q4	2009
U.K.	5.4%	22.1%
Germany	5.0	23.9
France	3.7	22.3
Japan	4.1	19.0
Hong Kong	4.4	52.0
India	2.0	81.0
China	17.9	80.0
Mexico**	13.1	53.9
Brazil	13.9	122.0
Argentina	11.8	115.0

U.S. Stocks

	Q4	2009
Dow Industrials	7.4%	18.8%
Nasdaq Composite	6.9	43.9
Nasdaq 100	8.2	53.5
S&P 500	5.5	23.5
Russell 2000	3.5	25.2
Wilshire 5000	5.4	26.5

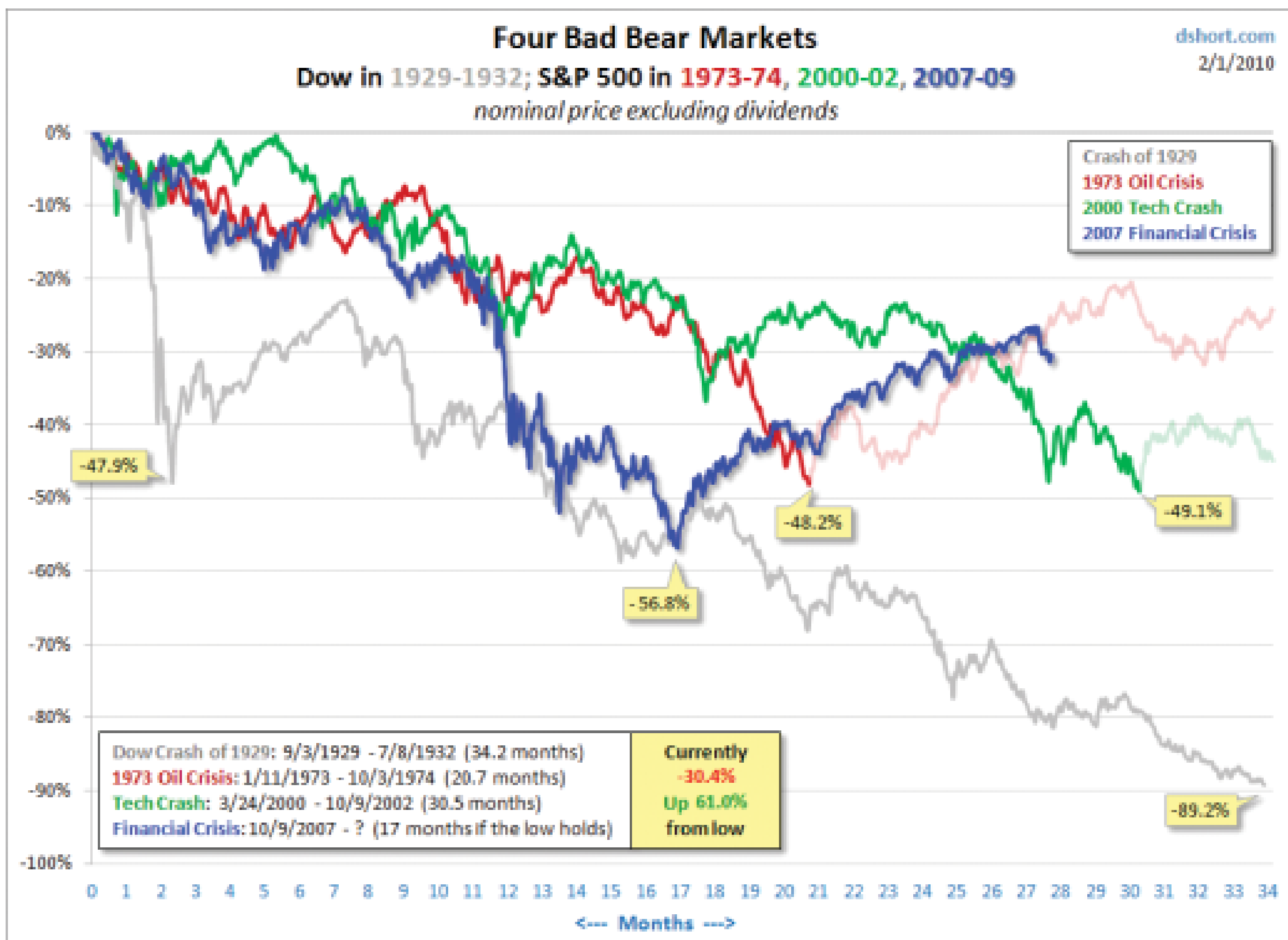
USD vs.

	Q4	2009
Euro	2.2%	-2.6%
British Pound	-0.9	-9.9
Canadian Dollar	-2.0	-13.8
Yen	3.8	2.4

Source: Yahoo Finance

The Four Bad Bears

Couresty of dshort.com, the following is a comparison of the " Four Bad Bears:" The Dow Crash of 1929 (9/3/1929) - 7/8/1932), the 1973-74 Oil Crisis (1/11/1973 - 10/3/1974), the 2000 Tech Crash (3/24/2000 - 10/9/2002), and the 2007 Financial Crisis (10/9/2007 - ?).



Bear Market Decline

Dow Crash of 1929	-89.2%
1973 Oil Crisis	-48.2
Tech Crash	-49.1
Financial Crisis	-56.8

Bear Market Duration

Dow Crash of 1929	34.2 Months
1973 Oil Crisis	20.7 Months
Tech Crash	30.5 Months
Financial Crisis	17.0 Months (if the low holds)

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 is not a guarantee of future results. Index performance is used for illustrative purposes and not indicative of fund performance. You cannot invest directly in an index.

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