



PERRITT CAPITAL MANAGEMENT



2011 Year In Review

By **Dr. Gerald W. Perritt**

The Standard & Poor's 500 Index stood at 1,257.64 at the end of 2010. One year later it stood at 1,257.60, a decline of 0.002% for the year. If you didn't know better, you would think that 2011 was an uneventful year as far as the financial markets were concerned. But that notion could not be further from the truth.

In the 43 years that I have been following the financial markets as a professional, I have never seen the level of volatility that was experienced during 2011. For example, the Dow Jones Industrial Average experienced a triple digit swing between its daily high and low more than 50% of the time. In addition, the Dow gained or lost more than 100 points during nearly 25% of the year's trading days. It's of little wonder that individual investors continued to reduce their equity investments all year long.

Here are a few of the year's events that sent the stock market on its wild ride.

- Congressional bickering over the U.S. debt ceiling led to a downgrade of the national debt from AAA to AA+. As a result, consumer confidence plummeted.
- Greece, Italy, Spain and Portugal teetered on the edge financial collapse due to slowing economic growth, rising interest rates, and a mountain of sovereign debt.
- In the U.S., house prices continued to decline, foreclosures edged higher, the unemployment rate stubbornly refused to decline from recessionary levels, and the price of gasoline rose to a new record average annual price of \$3.53 a gallon.
- The price of an ounce of gold soared to over \$1900 from \$1400 during the year, a gain of over a 500% from a decade earlier.
- An earthquake and resulting tsunami in Japan disrupted the flow of electrical and auto components which resulted in a slowdown in the U.S. manufacturing sector.
- Add to all of this, the failure of MF Global, which revealed that more than \$1.2 billion of client assets were missing. That, in turn, reinforced investor mistrust in the country's financial services sector.....(Continued on Page 3)

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YEAR IN REVIEW

Gerald W. Perritt reflects on a volatile year.

CASH ATTITUDES

Michael Corbett discusses what CEO's of small business are doing now to enhance shareholder value.

PORTFOLIO UPDATES

Analysis of 2011 results and outlook for the All Weather, Global Growth and Blue Chip Portfolios.

If you have any questions or comments, or if you know of any friends or family that might benefit from our services, please give us a call at 800-331-8936.

We look forward to continuing the Perritt Capital Management tradition of helping our clients reach their financial goals.

**Michael Corbett CIO
and Portfolio Manager**



Perritt MicroCap Opportunities
Perritt Emerging Opportunities

"Cash Attitudes"

What CEO's of Small Businesses Are Doing Now to Enhance Shareholder Value

Don't let headline market returns fool you; in the small and micro-cap space, shareholder value is being enhanced. Increased uncertainty and a rush to liquidity led to a disappointing year for micro-cap investors in 2011. However, the noise that is driving investor behavior such as political inaction and partisan bickering is short-term in nature. We are much more interested in analyzing the attitudes of the CEO's of small businesses that we speak to in our offices every day. We believe these attitudes reflect the true nature of long-term trends in our economy.

The number one difference that we detect in the management teams between now and 2008-09 is what we describe as their "Cash Attitude." Simply put, management teams are no longer trying to survive, they are creating new ways to thrive. A few years ago, the top concern for most management teams was ensuring that they had enough cash in the bank to survive a difficult recession. Today, management teams are utilizing their cash and balance sheets to expand their businesses and enhance shareholder value in a variety of ways.

As you know, shareholder value comes in many forms. In addition to bottom-line growth, companies can increase shareholder value by initiating or increasing cash dividends. **As can be seen in the accompanying table, nearly one-third of the holdings in the MicroCap Opportunities Fund pay a dividend and nearly 14% increased or initiated a dividend in 2011.**

Another way companies can enhance shareholder value is by buying back their own company's stock. Although you're not as likely to hear about it in the media, *small-cap companies are often better positioned than their large-cap peers to buy-back their own shares.* There are several companies within our portfolios that continue to buy back their own shares at levels they consider undervalued. For example, AEP Industries (AEPI) repurchased approximately \$20 million worth of its shares in a privately negotiated deal in June of last year (nearly 15% of the company's market cap at that time). We were pleased that management acted on their conviction that the company's share-price did not accurately reflect shareholder value.

Finally, shareholder value can be enhanced by acquiring other companies. With ultra-low interest rates and depressed stock prices, it can make greater economic sense to buy a company rather than build it. Lately, we have seen management teams acquire companies that are not only synergistic but are also immediately accretive to their current business. For example, Globecomm System (GCOM) acquired Comm Source, Inc. in April 2011. Using cash to buy a profitable company that is delivering current earnings was immediately accretive to Globecomm's financials.

"Cash Attitudes" # of Holdings Paying Dividends

	PRCGX	PREOX
# Of Holdings	115	117
# Paying Dividends	32 of 115 (27.8%)	25 of 117 (21.4%)
# Increased or Initiated Dividends	16 of 115 (13.9%)	16 of 117 (13.7%)

As of 12/31/11

"Simply put, management teams are no longer just trying to survive, they are creating new ways to thrive"

Regarding valuations, the small/microcap universe is attractively priced based on several characteristics, as seen in the accompanying table. The most talked-about measure, the price-to-earnings ratio, appears the least attractive. However, we encourage investors to take a closer look at price-to-sales and price-to-book value, which are very compelling. We believe these two characteristics indicate that there is substantial cash flow and/or earnings power that can soon reach the bottom line.

**Small/Micro-Cap Universe*
Valuations
By Market Capitalization**

Market Cap Range	P/S	P/B	P/E
\$2B+	1.7	2.5	18.6
\$2,000-500M	1.4	1.9	17.4
\$500M-150M	1.2	1.5	16.7
\$<150M	0.9	1.0	13.3



**Small/Micro-Cap Universe*
Performance
By Market Capitalization**

Market Cap Range	Number of Companies	Advance/ Decline Ratio	Average 2011 Performance
\$2B+	261	0.78	-4.89%
\$500-2B	999	0.59	-8.59%
\$150-500M	916	0.41	-18.15%
\$<150M	1,114	0.46	-16.25%
Total:	3,290	0.50	-13.55%

*Small/Micro-cap universe includes all equities listed in the Russell 2000 & Russell Microcap Indexes plus an approximate 1,000 U.S. listed micro-cap equities not listed in the Indexes.

All data as of 12/31/11

Despite a contraction in valuation multiples, micro-cap equities have been growing cash flows, book values and overall shareholder values over the past few years. Perhaps more importantly, the “cash attitudes” of management teams indicate that there is a robust period of growth underway for well-run micro-cap companies currently being unrecognized by the market. As is often the case, micro-cap stock prices have been slow to respond due in part to their under-followed and under-researched nature. We believe this is a short term phenomenon and that shareholder value will ultimately be recognized with higher stock prices.

(Continued from Page 1)

2011 Year In Review, By Dr. Gerald Perritt

The most interesting aspect of last year’s financial markets was the failure of markets to follow conventional wisdom. Pimco’s Bill Gross (CIO of the country’s large bond fund manager) forecasted interest rates to rise and bond prices to fall. At year end, long-term treasury bonds returned a total of 29.9%, thanks to declining interest rates. Emerging economies were supposed to dodge the economic malaise in the U.S. and Europe and stock markets there were expected to post robust returns. Instead, the EEM (an emerging markets index ETF) declined by 20.4%. Bank stocks (a favorite sector of legendary investor Bill Milller) failed to rebound in 2011 as was expected, declining 25% in 2011.

So where do we go from here? Given the dismal record of financial forecasts made a year ago and the looming problems facing the world’s economies, you have to view any forecast for 2012 with skepticism. (One pundit recently remarked that financial forecasters exist to make fortune tellers look good).

"In the 43 years that I have been following the financial markets as a professional, I have never seen the level of volatility that was experienced during 2011"

What I do know is that recent statistics indicate that the U.S. economy is improving. To be sure, the recovery in the U.S. is quite fragile and could be derailed by an economic and financial collapse in Europe, a hard landing in China, or increased hostilities in the Middle East. However, given all the pessimism, I suspect that the U.S. stock market will climb the wall of worry and finish the year with a double-digit percentage gain.

2011 Global Growth Portfolio

For the year ended 2011, the return of the Global Growth model portfolio was -3.53%. This compared favorably to the total return for the Russell Global Growth Index of -7.67%, but unfavorably to the total return of the S&P 500 Index at +2.11%. The portfolio underperformed the S&P 500 Index this year almost exclusively because of our international equity exposure. While we are disappointed with the negative return posted in 2011, we are pleased with the relative outperformance of a broad global index by a margin of over 4%. Most importantly, we are pleased with the fact that the portfolio has generated positive long-term returns for investors over the past three- five- and ten-year periods.

The Global Growth model portfolio is an asset allocation model focusing on growth and international opportunities. Because of the uncertain market conditions prevalent during 2011, specifically, persistent levels of high unemployment in the U.S. and below trend GDP growth, ongoing deterioration in the credit quality of European countries, and threats to a continued global recovery caused by a slowdown in China, we maintained levels of risk and volatility below normal levels for the Global Growth model.

Although the Global Growth model maintains allocations to international developed and emerging markets, we continue to maintain a significant amount of exposure to the domestic U.S. equity markets. We were pleased with the diversification our U.S. exposure gave us during 2011 as the U.S. equity markets were some of the top performing markets globally in 2011. Many emerging markets and even developed international markets, particularly those found in Europe, experienced negative double-digit returns.

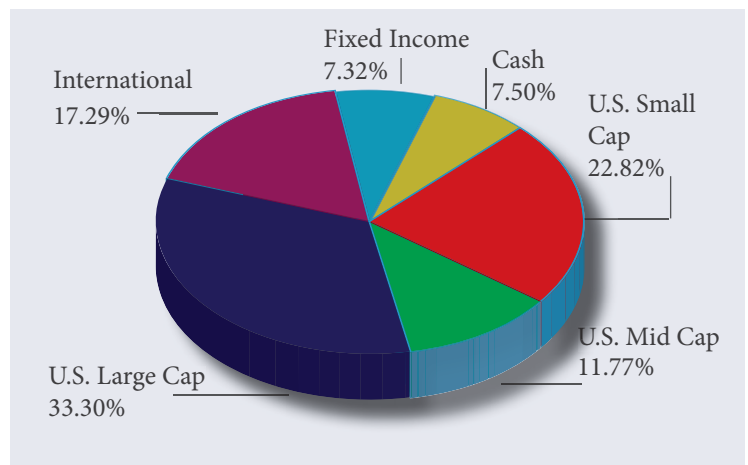
Our top contributor to performance in 2011 was The Vanguard Health Care Exchange Traded Fund (ETF) (Ticker - VHT) with a +10.7% return. This was followed by positive returns of 6.8% from our high yield bond holdings and 4.4% from the S&P 500 Growth Index ETF (IVW). Clearly America was the place to invest in 2011.

As a group, our international exposures were our largest detractors of performance. Holdings in the Emerging Markets ETF (EEM), EAFE (EFA) for UK, Japanese and European exposure, and Latin American 40 Index (ILF) each suffered double digit declines.

Early in 2012 we anticipate making changes to the positioning of the portfolio. We currently expect to continue scaling up both the international exposure and risk profile of the portfolio as the risk aversion during 2011 has significantly altered the relative valuation between international and domestic equities. As an example, we continue to evaluate pairing back U.S. small caps in favor of international small cap exposure. Lastly, and as always, we will look to take on additional incremental risk through increased equity exposure and sector rotation, as markets present opportunities to do so.

"Although the Global Growth model maintains allocations to international developed and emerging markets, we continue to maintain a significant amount of exposure to the domestic U.S. equity markets."

Global Growth Portfolio* 12/31/11



*Asset allocation models invest primarily in ETFs and mutual funds.

2011 All Weather Portfolio

For the year 2011, the All Weather portfolio returned 0.54% versus the 2.11% for the S&P 500. We are pleased that the portfolio was able to meet its first objective of conservative wealth preservation despite the volatile nature of the market environment. The All Weather portfolio is designed to provide investors with a return that matches the S&P 500 Index with less exposure to risk. The fact that we were able to accomplish this goal in 2011 is demonstrated by analyzing the performance over the course of the year. For example, during the volatile summer of 2011, the S&P 500 index plummeted 19.49% from its peak of 1365 on 4/29/11 to its bottom of 1099 on 10/3/11. During that period, the All Weather Portfolio declined 14.21%, outperforming the S&P 500 Index by 5.18%.

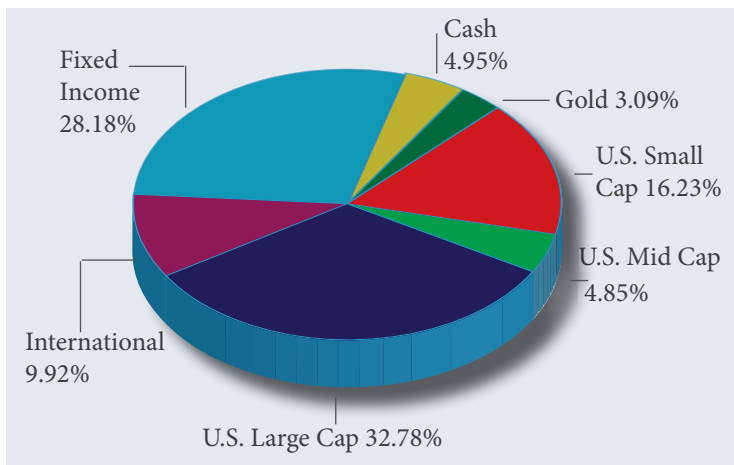
The All Weather Portfolio is a balanced portfolio that will keep at least some investment in each asset class irrespective of economic assumptions. Keeping a strict discipline of diversification can reduce unnecessary risks by spreading assets across a number of investments and industries. The protection offered by the conservative approach of this portfolio can offer a compelling return for investors. Over the last ten years, the All Weather Portfolio model has returned 77.26%, or 5.89% annualized, compared to the S&P 500 return of 33.35%, or 2.92% annualized. In addition, the All Weather Portfolio has provided clients with positive returns over the past one-, three-, five- and ten-year periods.

The Model's top performer for the year was our position in the SPDR Gold Shares ETF. This fund holds the physical bullion and contributed significantly to our performance. The performance was so strong that we chose to cut the position to keep it in line with our target allocation. We still maintain a small allocation to the metal and will continue to do so for the purpose of diversification. As a reminder, portfolio assets are rebalanced periodically back to target allocations to ensure that allocations are kept suitable to the market environment. Investors benefit from periodic rebalancing because it leads to trimming of asset classes that may have done well, and buying more of those asset classes that have fallen behind (selling high and buying low).

"Keeping a strict discipline of diversification can reduce unnecessary risks by spreading assets across a number of investments and industries."

Our asset allocation decisions also placed more of our assets in income-yielding investments such as U.S. Government Bonds, Corporate Bonds and U.S. Equities. We accomplished this by increasing our allocation to The Wisdom Tree Large-cap Dividend Fund, The iShares S&P Growth Portfolio, and The Vanguard Intermediate Term Bond Fund, which were strong performers during the year. These investments not only serve to achieve our purpose of diversification but also earn a regular dividend. The international and U.S. microcap space exposures in the model were the main detractors to performance over the course of 2011, however we will maintain these positions both to take advantage of what we see as attractive valuations as well as for the purpose of diversification.

All Weather Portfolio* 12/31/11



*Asset allocation models invest primarily in ETFs and mutual funds.

We will continue to utilize a passive asset allocation approach to position the portfolio over for long term capital protection and conservative growth. Our plan is to continue to monitor the market environment and make adjustments to the All Weather Portfolio as we see fit. That being said, the passive nature of our strategy indicates that a large number of investment changes should not be expected in any given year. We remain confident that the long term track record of the All Weather Portfolio speaks for itself and we will continue to pursue this strategy in the face of current market volatility.

2011 Blue Chip Portfolio

The Blue Chip portfolio held up well during the volatile calendar year, finishing with a total return of 2.00% as compared to the S&P 500 total return of 2.11%. This return compares favorably with the average return seen in the large cap mutual fund category for 2011. According to Morningstar, Inc. the average total return of a mutual fund in the Large Cap category was negative for the year. The average total return in the large cap value category (1,234 funds) was -0.76%. The average total return in the large cap blend category (1,732 funds) was -1.31%. The large cap growth fund (1,657 funds) category average total return was -2.45% during 2011.

During the first three months of 2011, the market was able to shake off the effects of the unrest in the Middle East as well as the Earthquake in Japan. By the end of April both The S&P 500 index and The Blue Chip portfolio were up over 8%.

Volatility soon took hold, as The S&P 500 index plummeted 19.39% from its peak on 4/29/11 to its bottom on 10/3/11. Volatility as measured by the VIX index spiked during this period. The Vix is the ticker symbol for the Chicago Board Options Exchange (CBOE) Volatility Index. The index is often referred to as the "Fear Gauge" and is widely used as a measure of market risk. VIX values above 30 are generally associated with high volatility as a result of investor fear or uncertainty. VIX values below 20 generally reflect less stressful times in the market.

Top Ten Holdings 12/31/11

IBM (IBM)	3.42%
Intuit Inc. (INTU)	2.93%
Yum! Brands, Inc. (YUM)	2.63%
The Home Depot, Inc. (HD)	2.50%
The TJX Companies, Inc. (TJX)	2.40%
Macy's, Inc. (M)	2.39%
Chevron Corporation (CVX)	2.37%
CSX Corp (CSX)	2.35%
Intel Corporation (INTC)	2.34%
eBay Inc. (EBAY)	2.26%

The VIX closed at the end of June at 16.52 and reached a peak of 48.00 on August 8th, the day the index lost 6.66%. The August 8th reading was the highest level since the VIX closed at 49.68 on March 9, 2009.

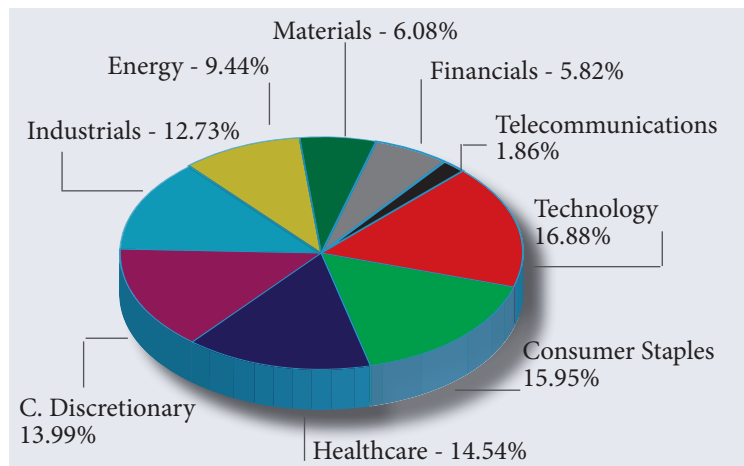
The Blue Chip portfolio declined 16.62% during the period described above, as compared to the 19.39% decline in The S&P 500 Index. Our relative out performance during this steep decline was due to our risk adverse stance. We are "bottoms-up" investors meaning we focus on the individual company valuations instead of attempting to forecast short-term market swings or cycles. We focus on companies with strong cash flow, high return on equity, and a strong balance sheet. **Our approach is designed to protect us during periods when the S&P 500 experiences large declines, such as during the 4/29/11 to 10/3/11 period.**

Investor optimism on the back of positive earnings returned in Q4 as the S&P 500 rallied 11.82% vs. the Blue Chip gain of 10.28%. The Q4 gain for the index was the best since it gained 14.54% in Q4'99. The Q4 gain was led by the October gain for the S&P 500 of 10.93%. This was the first double-digit positive month for the index since December 1991 when the index was up +11.16%.

The best performing stock in our portfolio for the year was The TJX Companies Inc. (TJX), which was up 45.42%. Macy's Inc. (M) 33.64%, International Business Machines Corp. (IBM) 25.29%, Pfizer Inc. (PFE) 23.59%, and Yum! Brands, Inc. (YUM) 20.31% round out the top 5 performing issues in the portfolio. The year's bottom performers in the portfolios include Hess Corporation (HES) -25.79%, Fluor Corporation (FLR) -24.16%, Apache Corp (APA) -24.03%, Emerson Electric Co (EMR) -18.51%, and Schlumberger Limited (SLB) -18.19%.

Overall we are pleased we were able to generate a positive total return for the year when many in the large cap universe generated negative total returns. We are confident in our holdings due to the quality of the companies and attractive valuations. We will continue to work hard in the upcoming year to examine the positions and make any adjustments we believe will help to preserve capital as well as generate returns for our clients.

Sector Allocations 12/31/11



2011 Financial Market Statistics

Commodities

Gold	10.23%
Corn	2.74%
Cattle	12.09%
Soybeans.	-13.94%
Silver	-9.77%
Wheat	-17.85%
Platinum	-21.07%
Oil	-8.15%
Copper	-22.73%
CRB Index	-8.26%

U.S. Industry Performance

Basic Materials	-10.92%
Con Discretionary	5.99%
Consumer Staples	14.09%
Financials	-17.14%
Health Care	12.40%
Industrials	-1.10%
Energy	2.84%
Technology	2.61%
Telecom	-7.42%
Utilities	19.64%

Foreign Markets

U.K	-5.55%
Germany	-14.69%
France	-16.95%
Canada	-14.36%
Japan	-17.34%
Hong Kong	-19.97%
India	-24.64%
Russia	-20.95%
China	-21.68%
Mexico	-3.82%
Brazil	-18.11%
Argentina	-30.11%

Bonds Yield (Change)

	Change bps*	Ending Yield
30-Yr T Bond	-144	2.90%
10-Yr T Bond	-139	1.91%
3-Yr T Bond	-100	0.02%

*bps: a basis point is a unit equal to 1/100th of a percentage point

USD vs...

Euro	3.22%
British Pound	0.31%
Canadian Dollar	2.21%
Yen	-5.17%

U.S. Stocks

Dow Industrials	8.38%
Nasdaq Composite	-0.79%
S & P 500	2.11%
Russell 2000	-4.18%
Wilshire 5000	0.21%

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.

Price to Earnings ratio is calculated by dividing current price of the stock by the company's trailing 12 months' earnings per share. Price to Sales ratio is a tool for calculating a stock's valuation relative to other companies, calculated by dividing a stock's current price by its revenue per share. Price to Book Value Ratio is calculated by dividing the current price of the stock by the company's book value per share. R-Squared is a statistical measure that represents the percentage of a fund's or security's movements that are explained by movements in a benchmark index. The advance/decline ratio is the ratio of advancing issues over declining issues. The Russell 2000 Index consists of the smallest 2,000 companies in a group of 3,000 U.S. companies in the Russell 3000 Index, as ranked by market capitalization. The Russell Microcap index is a capitalization weighted index of 2,000 small cap and micro cap stocks that captures the smallest 1,000 companies in the Russell 2000, plus 1,000 smaller U.S.-based listed stocks. The S&P 500 Index is a broad based unmanaged index of 500 stocks, which is widely recognized as representative of the equity market in general. The Dow Jones Industrial Average is an unmanaged index of common stocks comprised of major industrial companies and assumes reinvestment of dividend. The NASDAQ Composite Index is a market capitalization-weighted index that is designed to represent the performance of the National Market System which includes over 5,000 stocks traded only over-the-counter and not on an exchange. The Wilshire 5000 Stock index consists of more than 5000 companies, representing virtually all of the capitalization of the entire U.S. stock market. You cannot invest directly in an index

As of 12/30/11, The Perritt MicroCap Opportunities Fund held a 0.89% position in AEPI, a 1.75% position in NR, a 1.235 position in CGOM and a 1.18% position in TGE. The Perritt Emerging Opportunities Fund held no position in AEPI, GCOM, NR, or TGE. Fund holdings and sector allocations are subject to change and are not recommendations to buy or sell any security.

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.

The Perritt Funds are distributed by Quasar Distributors, LLC.



Family Wealth Advisors Since 1988



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