

2008: A Year For The History Books

It's a sure bet that your children, grandchildren, and great grandchildren will get a hefty dose of 2008 in their history books. Although more than a handful of mavens liken the current economic meltdown to that of the Great Depression, the truth is that this economic debacle is history in the making.

Yes, the stock market tanked in 2008 as it did in 1931. It is also true that commodity prices have deflated as they did in the 1930's. It is also "odds on" that the unemployment rate will be etched in double digit percentages as it was during the Great Depression. However, the government's response to today's economic cataclysm is nothing like that of the 1930's. Furthermore, the \$6-plus trillion lost in the U.S. stock market and the number of participants that saw a lifetime of savings melt away dwarfs similar statistics of the 1930's.

Here is a chronological list of what we believe were the biggest stories of 2008.

January

- Bank of America agrees to buy Countrywide Financial for \$4 billion.
- Rogue Trader at Societe General cost the bank more than \$7 billion.
- Standard & Poor's downgrades more than 8,000 collateralized debt obligations and forecasts that financial firms will lose more than \$265 billion.

February

- Congress approves a \$168 billion stimulus plan.

March

- Eliot Spitzer resigns in disgrace as New York's attorney general.
- Bear Stearns is acquired by JP Morgan at a fire sale price.

- The price of an ounce of gold closes above \$1,000 an ounce for the first time ever.
- Visa's \$19.65 billion initial public offering is the largest in history.



Dr. Gerald Perritt
 CEO & Founder

April

- Mars and Berkshire Hathaway acquire William Wrigley for \$23 billion.
- Delta and Northwest Airlines agree to merge.

May

- Linens N Things files for Chapter 11 bankruptcy protection. Later it would begin to close all of its retail outlets.
- Tropicana files for Chapter 11 bankruptcy protection.

June

- Barack Obama secures enough delegates to win the democratic party's Presidential nomination.
- Gasoline hits \$4 a gallon for the first time.
- In Bev launches a successful bid for Anheuser-Busch.

July

- Indy Mac is seized by Federal Regulators.

August

- Swimmer Michael Phelps becomes the most successful Olympian of all time.

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An Interview With Michael Corbett, President and Portfolio Manager of the Perritt Funds



Michael
Corbett
CIO &
Portfolio
Manager

Q.

2008 was obviously a horrendous year for the financial markets. Did you underestimate the economic impact on the U.S. stock market and the micro cap segment of the market in particular?

A.

There were two significant items that we underestimated in 2008: (1) the amount of leverage in the financial system, and (2) the failure of tangible asset values to serve as a floor for stock prices. We, along with most investors, are now aware of the problems that excess leverage caused in the housing market, the derivative securities market, and the banking system. However, we failed to detect the high level of leverage tied to some of the stocks held in our portfolios. We subsequently found that 10 hedge funds had a significant investment within the micro-cap space, including investments in approximately 25 stocks that were also held in our portfolio. These hedge funds, using borrowed money, held significant positions in micro cap stocks. Investor demands for redemptions from hedge funds during the market's deterioration led to a forced liquidation out of these positions on a large scale. As stock prices declined, these funds experienced margin calls, which forced even more selling. As a result, we saw a large drop in the prices of several of our holdings, along with an added downward pressure to the microcap space as a whole. To give some additional insight into the hedge fund universe, according to TrimTabs investment research, the hedge fund industry has lost approximately half of its assets over the past year. Hedge fund assets under management decreased from nearly \$2 trillion in January to \$1 trillion at the end of 2008. The level of hedge fund assets still invested in the microcap space is unclear. Monitoring the level of investment by hedge funds in our space and how this investment could affect some of our holdings is part of our ongoing homework. The drastic reduction in the size of the hedge fund industry, however, combined with the general decrease in access to leverage, does make us believe that the market has become more normalized. Because of this, we think that we are close to the end of

forced selling by hedge funds in the microcap space. As a result, we believe that the abnormal downward pressure on micro cap stock prices should abate soon.

The second item is related to the failure of tangible asset values to serve as a floor for stock prices. During our stock selection process, we spend a great deal of time trying to determine the value of tangible assets of each company. We then use this knowledge to assign a value that we believe should serve as a downside to the stock price. In effect, we continually ask: "what is the company's liquidation value?" It is that value that serves as our estimate of a stock's investment floor. However, many stocks in our portfolio, along with hundreds of others in the microcap segment of the market, plummeted far below their liquidation values. This was the result of forced and indiscriminate selling. In other words, selling regardless of investment fundamentals.

Q.

Do you see any signs that the microcap segment of the market may improve?

A.

We don't see a catalyst at this point in time, but unfortunately with catalysts you are never aware of them until after they occur. What I can say is that valuations haven't been this attractive since Perritt Capital Management's inception more than 20 years ago. Of the 136 names that we own in the MicroCap Opportunities portfolio, the average company is trading at about 0.4 times sales, 0.8 times tangible book, 3.1 times cash flow and 9.1 times trailing earnings. I would not be surprised if revenues, earnings, and cash flow decline further in 2009 as the economic recession lengthens. However, even based on what we consider to be more normalized earnings num-

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bers, our portfolios could still be trading at single-digit price-earnings ratios. In addition, most of the companies that we own in the portfolio have cash as opposed to debt on the balance sheets. Currently, the average company that we own has 10% of its market cap held in cash. Eighty of those companies, more than half of the names in our portfolio, trade below tangible book value.

Whether or not these values will become realized in the near term is unclear, but we do have a high level of conviction that the extreme values will ultimately be recognized. That would be very positive for micro cap stock prices.

Q.

Why do you think there will be a realization of value in your portfolios?

A.

Markets work in the long run, but they don't always work in the short run. In other words, while stocks can surely be mispriced at a point in time, they cannot (and do not) stay mispriced for an extended period of time. When stocks remain undervalued for long periods of time, certain types of investors will eventually step in and unlock that value. These types of investors are what we call shareholder activists, and they can include current shareholders, management teams, and private equity firms. In the last several months we have had an above-average number of telephone conversations with shareholder activists who are interested in some of the companies in our portfolios that appear to be significantly undervalued. A related example of this type of activity is a situation with a company we own, White Electronic Designs (WEDC). This company recently received a buyout offer from a private equity firm at a nearly 100% premium from where the stock was trading. Management decided that the premium was not high enough, and subsequently turned down the offer. Whether management was correct or not in their decision, only time can tell. However, we can clearly see a level of interest by shareholder

activists for microcap companies with depressed stock prices. What that ultimately could mean is that the level of buyout activity increases. We are not completely sure any buyouts will result, but we certainly like the idea that there is growing interest in the microcap space, which bodes well for their stock prices.

Q.

As a result of the bear market, how has the microcap universe changed?

A.

We define a micro cap stock as any company with an equity market value (market cap) below that of the company that separates the bottom 20 percent of companies listed on the New York Stock Exchange when ranked from largest to smallest on the basis of market cap. During the past two years, this defined micro cap stocks as those of companies with a market capitalization below \$750 million. Given the fact that we've experienced a 50% drop in stock prices within the micro cap universe, it should be expected that the upper threshold limit in the micro cap universe would decline. As now stated in our 2009 prospectus, The Perritt MicroCap Opportunities Fund will invest in companies with a market capitalization of \$500 million or less at the time of initial purchase. The Perritt Emerging Opportunities Fund, which focuses on the smallest segment of the micro cap market, will invest in companies with a market capitalization of under \$350 million. We believe that it is important to re-rank the market by capitalization at the beginning of each year to ensure that our definition of microcap is consistent with current reality. This way, we know that our investable universe contains only the smallest of small companies, where we have been investing since 1987 and where data show that the so-called "small firm effect" is most pronounced.

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September

- The government seizes Fannie Mae and Freddie Mac.
- The Federal Reserve agrees to convert Morgan Stanley and Goldman Sachs into traditional bank holding companies.
- Warren Buffett invests \$5 billion in Goldman Sachs.
- President Bush signs \$700 billion financial services rescue bill.

November

- Barack Obama elected President of the United States.
- China announces a \$586 billion stimulus package.
- Circuit City Stores files for chapter 11 bankruptcy protection. After failing to find financing, the company then decides to liquidate.

December

- The NBER announces that an economic recession in the U.S. began December 2007.
- Pilgrim's Pride files for bankruptcy protection.
- The U.S. loses 500,000 jobs, the largest monthly drop in 34 years.
- Bank of America and Merrill Lynch shareholders approve a merger agreement.
- The Tribune Company files for Chapter 11 bankruptcy protection.
- The U.S. Treasury sells four-week notes at zero percent interest.
- Bernard Madoff is arrested for carrying out a \$50 billion Ponzi scheme.
- The Bush administration agrees to lend General Motors and Chrysler \$17.4 billion.
- The government commits \$6 billion to GMAC.

2008 Financial Market Statistics

Commodities		Foreign Markets		U.S. Industry Performance	
Gold	5.8%	U.K. FTSE 100	-31.3%	Basic Materials	-51.7%
Corn	-10.6	DAX	-40.4	Consumer Goods	-28.4
Cattle	-12.2	CAC 40	-42.7	Consumer Services	-32.6
Soybeans	-18.9	Japan	-42.1	Financials	-50.1
Silver	-23.8	Hong Kong	-48.3	Health Care	-24.8
Wheat	-31.0	India	-52.4	Industrials	-40.9
Platinum	-38.7	China	-63.6	Oil & Gas	-37.4
Oil	-53.5	Mexico	-24.2	Technology	-43.6
CRB Index	-36.0	Brazil	-41.2	Telecomm	-36.2
		Argentina	-49.8	Utilities	-32.1
U.S. Stocks		U.S. Dollar		Bond Yields (year end)	
Dow Industrials	-33.8%	up	4.5%	Euro	
Nasdaq Composite	-40.9	up	36.2	British Pound	
Nasdaq 100	-41.9			Canadian Dollar	
S & P 500	-38.5	up	22.5	Japanese Yen	
Russell 2000	-34.8				
Wilshire 5000	-38.7	down	18.6	30-yr T-bond	2.69%
				1-yr T-note	2.22
				3-mo T-bill	0.04



Be Weary Of The So-Called “January Effect” Barometer

According to stock market lore, the stock market’s direction in January is a barometer of the stock market’s direction during the entire year. In other words, a stock market gain in January signals a gain for the entire year while a market decline in January signals a decline in stock prices for the year.

Recently, we checked the record for this bit of stock market wisdom. Beginning with the year 1926, we calculated the change in the Standard & Poor’s 500 Index during the month of January and the change in the Index during the entire year. Here is what we found.

During the last 83 years, the stock market’s direction during January was accompanied by a similar change in the stock market for the year 60 times. In other words, the January barometer correctly forecast the direction of change in the stock market 72.3 percent of the time. However, remember that January’s return is included in the market’s annual return. Thus, the January effect is biased toward correct forecasts. To truly measure the accuracy of the January Barometer, one should compare the direction of the stock market’s change in January with the market’s return *during the remaining 11 months of the year*. When we removed the bias in the January effect, we

found that the direction of the move in stock prices during the month of January correctly predicted the direction of the market during the next 11 months during 55 of 83 years. That is, the forecasting accuracy of the January effect declines from 72.3 percent to 63.9 percent.

There are those who would argue that, even after adjusting for the bias, the January barometer is still a good indicator of the market’s direction during the remaining months of the year. (After all it still rings true about two-thirds of the time.) However, if you ignore the stock market’s direction during the month of January and simply guess that the stock market will rise during the remaining 11 months of the year, you would have been correct in your prediction 67.5 percent of the time.

Given that it sure looks like the stock market is going to finish January 2009 with a loss, look for pundits to paint a dim picture for stock returns during the entire year. Given the state of the global economy, chances are that the stock market could have another difficult year. However, an examination of stock market returns during the last 83 years tell us to pay no attention to January 2009 returns when making our prediction for the remainder of the year.

We Are Going To Miss George Bush 43

I, for one, am going to miss President George W. Bush, if for no other reasons than his ability to butcher the English language and to say what he doesn’t mean. Here is a small sample of some of my favorite “Bush-isms.”

“Families is where our nation finds hope, where wings take dream”

“I know how hard it is to put food on your family.”

“I know the human being and fish can coexist peacefully.”

To a divorced mother of three in Omaha, Nebraska. “You

work three jobs? Uniquely American, isn’t it? I mean, that is fantastic that you’re doing that.”

“Too many good docs are getting out of the business. Too many OB-GYNs aren’t able to practice their love with women all across this country.”

“They underestimated me.”

“Rarely is the question asked: Is our children learning?”

“Our enemies are innovative and resourceful, and so are we. They never stop thinking about new ways to harm our country and our people, and neither do we.”

It's A Wacky World Out There

The "Big Three" auto executives jumped in their company jet planes and headed to Washington to cry poverty and to ask the government for a \$30 billion handout to save their troubled companies. (Just what were these guys thinking?)

Bernie Madoff (as in made off), the former Chairman of Nasdaq, admitted to stealing a mere \$50 billion of client's money in a record-breaking Ponzi scheme. Despite efforts to have him jailed, the court ruled that he should be confined to his luxurious New York apartment, where he immediately began sending millions of dollars of trinkets to friends and relatives. (If convicted, perhaps the government will let him continue to reside there and save the money that would be spent during a prison term.)

Barack Obama upset an overconfident Hillary Clinton to win the democratic nomination and then trounced an economically confused John McCain in the Presidential election.

The entire country of Iceland sank into bankruptcy because of an overleveraged banking system. (Hummm)

The Treasury let Lehman Brothers go bankrupt but later changed its policy and handed its competitors, Goldman Sachs and Morgan Stanley, billions of dollars to insure their survival.

The Bush administration enacted a mid-year economic stimulus plan that called for the distribution of \$130 billion to low- and middle-income families. The result was

a spike in consumer spending (including a huge jump in

Internet pornography site revenues) that lasted all of one month.

Former Federal Reserve Chairman Alan Greenspan, a champion of deregulation in the financial service markets, when asked by Congress why he was so certain that a lack of government regulations would be beneficial to the American economy, he replied "oops."

Eliot Spitzer, a steadfast champion of ma and pa investors and the surge of Wall Street's institutional investment community, admitted to buying sexual favors from ladies of the night, abruptly resigned as New York's attorney general. (We're willing to bet that champagne sales soared in the neighborhood of Wall and Broad.)

Michael Phelps won a record eight Olympic gold medals in the only eight events he entered in Beijing. (Could another comic book superhero, Gillman, be in the offing for 2009?)

In December, the U.S. Treasury (proving it knows a good deal when it sees one) sells billion of dollars of four-week notes and agrees to pay zero percent interest on them.

The Tampa Bay Rays (after dropping the "Devil" in their name) soared from worst to first in the American league before losing the World Series to the Philadelphia Phillies.

Not so wacky was the 53 percent, 13-month plunge in the Standard Poor's 500 Index. When the market closed December 31, 2008, it marked the worst year for stocks since 1931.

Looking Ahead

In the September issue of Perritt Capital Management's Client Letter, I outlined my reasons for believing that the stock market would find a bottom in November 2008.

That belief was based on the notion that the U.S. economy would begin to improve by mid-summer 2009. So far the prediction of a market bottom last November has held true. However, when I made that prediction, I had no idea that the credit markets were in the dire straits they proved to be in during last year's final three months. In addition, I underestimated the size of both monetary and fiscal stimulus that would be needed to thaw the freeze in the financial markets and reverse the trend in economic growth.

I am going to hold to my earlier predictions of a late 2008 stock market bottom and a 2009 second half economic

recovery. However, the probabilities associated with these calls, in my eyes, has been markedly reduced.

Why am I having a change of heart? First, the Bush administration's handling of a rescue package (the so-called TARP), was sloppy at best and totally mismanaged at worst. The Treasury changed direction in mid-stream. It backed away from toxic asset purchases and pursued injections of capital into the financial system. I am not sure which course of action would have been the best. But it appears that the Treasury was also not sure of the correct course of action, and that is quite disturbing. In short, it now appears that it is going to take some experimenting by both the Treasury and the Federal Reserve

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before a “correct” course of action is identified. That prospect will most likely lead to a longer economic recession than I anticipated back in September 2008.

Despite all of the negative news recently, (a plunge in fourth quarter GDP, tumbling corporate profits, expanding unemployment, large corporate bankruptcies, and continued credit issues) the financial markets are a bit

improved over what they were in October and November.

Believe it or not, banks are lending again. It’s not a flood; it’s more of a trickle. In addition, the yields on short term Treasury securities are beginning to rise. This indicates a modest up-tick in the willingness of

investors to assume a bit of risk. The last time I looked, the rate of three-month T-bills had risen from 0.03% to 0.22%. In other words, investors who were willing to earn a zero percent return on short-term Treasury securities because of the protection they provided have begun to divert some of their investments to marginally more risky assets. For example, after months of outflows, equity mutual funds actually posted net purchases of \$25 billion in December. This is a far cry from the monthly injections in 2007 and early 2008, but it indicates that investors are willing to dip their toes into risky asset waters.

When will the stock market head for higher ground? The answer is: “somewhere between three and six months before the economy begins an upward journey. I know that this answer is far short of definitive, but it’s the best I can muster at this time. Where is the buying going to come from that will cause stock prices to rise? My best guess is from private equity funds and other corporate investors who recognize the extremely low valuations that currently exist in the equities market. This is especially true in the micro cap sector of the market, where selling in late 2008 caused stock prices to plunge well below tangible book values. (See Michael Corbett’s comments in this

newsletter for some details.)

Even though I believe that the stock market is in the bottoming process and that the lows may have already been seen, I am not calling for the onset of a bull market. The damage to the economy and to investor’s confidence has been so severe that it is going to take time for both to

heal. The accompanying table lists the lengthiest economic recessions on record. This one is 14 months long and we are still counting. Economists don’t expect an economic upturn until at least July 2009. If these expectations are correct, the current economic recession will last a total of 19 months at a minimum. That would make the current economic

slump the seventh longest on record.

Barring some jolting and completely unexpected event, look for the stock market to gyrate in a range of 7500 to 9200 on the Dow Jones Industrial Average during the next three to six months. Should signs of economic healing begin to appear in the second half of the year, I believe the market will be set to make a run to much higher ground.

Longest Economic Recessions on Record

Peak	Trough	Months
April 1865	December 1867	32
June 1869	December 1870	18
October 1873	March 1879	65
March 1882	May 1885	38
December 1895	June 1897	18
June 1899	December 1900	18
September 1902	August 1904	23
January 1913	December 1914	23
January 1920	July 1921	18
August 1929	March 1933	43
December 2007	Present	14 & counting

Farewell

During 2008, we said goodbye to some new and some long-time friends. I, for one, will surely miss them all.

- William Buckley, Jr. (age 82)
- Heath Ledger (age 28)
- Paul Newman (age 83)
- Suzanne Pleshette (age 70)
- Tim Russert (age 58)
- Margaret Truman (age 83)
- Gene Upshaw (age 58)



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