



**I**t's been 34 years since I began teaching investments and finance at the University level and nearly 23 years since I created *Investment Horizons*, an investment newsletter that focused on the analysis of small company stocks. The newsletter was an outgrowth of research conducted by a University of Chicago student working on his doctoral dissertation who "accidentally" discovered that portfolios of small firm stocks consistently outperformed portfolios of large firm stocks, even after adjusting for the greater risk in the former. This phenomenon was dubbed "the small firm effect" by academic researchers. It marked the first crack in the solidly built foundation of the efficient market theory. According to this well-accepted theory, portfolios of common stocks are not supposed to provide greater returns than can be accounted for by their underlying risk. Unlikely as it could be, small firm stock portfolios provide the equivalent of an investment free lunch. The goal of the newsletter was to allow individual investors to capture the small firm effect.

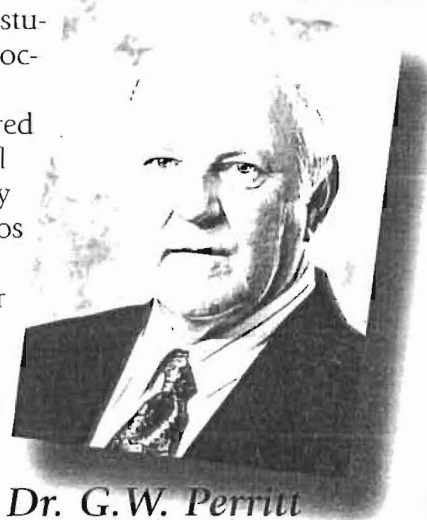
Five years after the creation of my newsletter, I established Perritt Capital Management to manage small firm stock portfolios for individual investors and for the Perritt MicroCap Opportunities Fund. As was the case with my newsletter, the

objective of this fund was to give individual investors an opportunity to capture the small firm effect. I am pleased to report that this experiment has thus far been an unqualified success.

During the three and a half decades that I have been involved in the investment world as an educator and practitioner, I have seen investment bubbles expand and ultimately burst. In 1970, investors' love affair with so-called conglomerate stocks abruptly ended during a severe bear market. In the mid-1970s, the real estate investment trust bubble burst, in the early 1980s biotech mania ended in near disaster for most investors, in the late 1990s, of course, it was the dot.com bubble

that burst the dreams of investment riches for many investors. In short, I have seen many investment fads come and go, with investors being left worse off when a group of stocks suddenly fell out of fashion.

However, since its discovery in 1978 by researcher Rolf Banz, the small firm effect has continued to provide superior returns for investors who possessed the patience to maintain their portfolios of small firm stocks over long time periods. During each of the last five years and so far during the sixth, small firm stock returns have exceeded those of large firm stocks as represented by the Standard & Poor's 500 Index. Such a



**Dr. G. W. Perritt**  
President  
Perritt Capital  
Management, Inc.

streak of over performance for small firm stocks is not unique. Small firm stock returns possess positive serial correlation and over performance streaks, nearly twice the length of this one, can be observed during the last 80 years for which reliable data exist.

Of course, if something can't go on for ever, it will eventually end. That is certainly the case for the current streak of over performance of small firm stocks relative to the performance of large firm stocks. However, when the streak will end is open to conjecture. Large firm stock aficionados have been calling for the end of the streak for nearly two years. According to these pundits, it is time to sell your small firm stocks and park your money in portfolios crammed with large firm stocks. I don't want to offend these prognosticators, so I will duck the debate.

If you want to earn the greatest possible investment returns, you should park your money in the asset class that performs best. However, you have to know which asset class will be the return leader before you make the investment, and history strongly suggests that the ability to hop from the best performing investment class year-after-year is nearly a metaphysical impossibility. However, if you want to earn all of the return that you deserve (given the underlying risk of your portfolio), you should maintain a diversified portfolio containing asset classes whose returns are less than perfectly correlated with one another. Although the reasons are beyond the scope of this brief note, statisticians tell us that

portfolios consisting of asset classes with less than perfectly correlated returns can reduce portfolio risk without sacrificing a concomitant reduction in investment return. In other words, portfolios containing both large firm and small firm stocks can provide greater returns per unit of risk than can portfolios consisting of a single asset class.

A small firm stock portfolio is not a substitute for investing in other asset classes. It would be foolish to park all of one's money in a small firm stock portfolio. It would be equally as foolish to invest one's entire nest egg in any other single asset class. Investment in small firm stocks is a compliment to and not a substitute for other asset classes contained in a well-diversified portfolio.

Investment fads will continually come and go. However, the rules of successful investing have remained constant over time. Assume no more risk than you can tolerate, diversify your portfolio across many asset classes, minimize the cost of investing, take a long-term perspective, and invest as much as you can as often as you can.



**Dr. G. W. Perritt  
President**

*Opinions expressed are those of Dr. Perritt and are not intended to be a forecast of future events, a guarantee of future results, nor investment advice.*

*Dr. Perritt received a doctorate in finance and economics from the University of Kentucky in 1974. He has taught courses in investments and finance at a number of colleges and universities and has authored several books on investing. Dr. Gerald W. Perritt shares the portfolio management duties of both the MicroCap and Emerging Opportunities Funds with Michael Corbett.*