

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,

Performance as of 9/30/09

	<u>YTD</u>	<u>1 Yr.</u>	<u>3 Yr.</u>	<u>5 Yr.</u>	<u>10 Yr.</u>	<u>Since Inception</u>
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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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 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 deter-

mine 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 <u>PRCGX</u>	Perritt Emerging <u>PREOX</u>
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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Investing In Smaller Companies Since 1987



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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. Implications 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:

	<u>S&P 500 Index</u> (Large Cap)	<u>Russell 2000 Index</u>	<u>Perritt MicroCap Opportunities Fund (PRCGX)</u>	<u>Perritt Emerging Opportunities Fund (PREOX)</u>
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%

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.

The fund's investment objectives, risks, charges and expenses must be considered carefully before investing. The prospectus contains this and other important information about the investment company, and it may be obtained by calling 800-331-8936 or by visiting www.perrittmutualfunds.com. Read it carefully before investing.

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.

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 Earnings ratio is calculated by dividing current price of the stock by the company's trailing 12 months' earnings per share. Price to Tangible Book Ratio is calculated by dividing the current price of the stock by the company's book value per share. Price to Cash Flow is calculated by dividing the current price of the stock by the company's cash flow per share. Cash flow measures the cash generating capability of a company by adding non-cash charges (e.g. depreciation) and interest expense to pretax income. Median Debt to Assets Ratio is calculated by dividing a company's total liabilities by total assets. It is used to indicate the proportion of a company's assets that is being financed through debt. The S&P 500 is an unmanaged broad based universe of 500 stocks which is widely recognized as the US equity market. The Russell 2000 Index consists of the smallest 2000 companies in a group of 3000 companies in the Russell 3000 as ranked by market cap. It is not possible to invest directly in an index.

As of 9/30/09, ICT Group comprised of 1.09% and 0.00% of The Perritt MicroCap Opportunities Fund and Emerging Opportunities Fund, respectively. Both the Perritt MicroCap Opportunities Fund and the Emerging Opportunities Fund held no position in either Aegis or Sykes Enterprises. Fund holdings and sector allocations are subject to change at any time and are not recommendations to buy or sell any security.

The Perritt Funds are distributed by Quasar Distributors, LLC



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