Perritt Funds
MicroCap Opportunities Fund, Inc.
Emerging Opportunities Fund, Inc.

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

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.

Michael Corbett
CIO &
Portfolio
Manager

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.

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Q&A continued from page 1

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 we have not seen valuations 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 numbers, 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.

Portfolio Characteristics as of 12/31/08

	PRCGX	PREOX
Zero Debt: # of companies with zero debt on balance sheet	**64 of 134**	**56 of 137**
Cash Position: # of companies holding 10% or more of market cap. in cash	57 of 134	67 of 137
Median Debt to Assets Ratio	2.9%	3.9%

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, in our experience 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 may 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.

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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.

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 does not guarantee future results. Index performance is not illustrative of fund performance. You cannot invest directly in an index. For fund performance please visit www.perrittmutualfunds.com.

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. 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.

Top Ten Holdings as of 12/31/08: PRCGX - Baker Michael Corp. (2.48%), Comfort Systems USA (2.00%), Vaalco Energy (1.93%), Star Gas Partners (1.80%), Actel Corp. (1.78%), Flanders Corp. (1.77%), Kimball Intl. (1.66%), Universal Electronics (1.64%), Barrett Business Services (1.60%), Aceto Corp. (1.56%); PREOX - North American Galvanizing & Coatings (2.12%), NovaMed (2.10%), Espey Mfg. & Electronics (1.98%), Rentak Corp. (1.76%), Universal Power Group (1.64%), Versant Corp. (1.63%), Birner Dental Mgmt. Services (1.55%), KSW (1.53%), Perma-Fix Environmental Services (1.52%), Astro-Med (1.51%). Fund holdings and sector allocations are subject to change at any time and are not recommendations to buy or sell any security.

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 Book Value 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. Book Value is the net asset value of a company, calculated by subtracting total liabilities from total assets. Cash Flow measures the cash generating capability of a company by adding non-cash charges (e.g. depreciation) and interest expense to pretax income. 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. Nasdaq 100 Index an index composed of the 100 largest, most actively traded US companies listed on the Nasdaq stock exchange 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 Wilshire 5000 Stock index consists of more than 5000 companies, representing virtually all of the capitalization of the entire U.S. stock market. FTSE 100 is an index of the share prices of the 100 largest companies in the UK. The CAC-40 Index is a narrow-based, modified capitalization-weighted index of 40 companies listed on the Paris Bourse. You cannot invest directly in an index.

The Perritt Funds are distributed by Quasar Distributors, LLC (2/09)

Perritt
Capital Management

300 S. Wacker Drive • Suite 2880 • Chicago, IL 60606
Tel: 312-669-1650 • 800-331-8936 • Fax: 312-669-1235
E-mail: PerrittCap@PerrittCap.com • Web Site: www.PerrittCap.com