

## Michael Corbett's 4Q '09 Commentary

President and Portfolio Manager of the Perritt Funds

**Q.**

*What worked for the Perritt Funds in 2009?*

**A.**

Last year was rewarding to many investors across most equity and asset classes. As seen in the table below, our shareholders likely benefited from the Fund's performance last year: The MicroCap Opportunities Fund (PRCGX) was up 52.89% and The Emerging Opportunities Fund (PREOX) returned 60.66% for the one year period ending 12/31/2009. We didn't change our behavior much in 2009 despite such a rising market.

In fact, we added 29 new names to PRCGX and sold 25 names, while adding 23 new names to PREOX and selling 14 names. These changes were very much in line with our typical turnover ratio, which we aim to keep below 50% annually. A few of our larger holdings did appreciate significantly, including Bioscrip (up over



**Michael Corbett**  
CIO &  
Portfolio  
Manager

### Performance as of 12/31/09

	2009	3 Yr.	5 Yr.	10 Yr.	15 Yr.	Since Inception
Perritt MicroCap Opportunities Fund (PRCGX)	52.89%	-5.77%	1.72%	11.59%	11.24% (4/11/88)	9.04%
Perritt Emerging Opportunities Fund (PREOX)	60.66%	-11.39%	-1.41%	NA	NA (8/27/04)	0.98%

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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270% in 2009), and ICT Group, a company that was bought out during the year (up over 250% during the period). The bottom line is that to us 2009 felt like a recovery from the panic of 2008. We did not witness the types of investor behavior that is typically associated with a euphoric or bubble type of mentality, which many people looking at 2009 performance might expect.

**Q.**

*Following such a strong year for small caps, do you still see much upside?*

**A.**

The recovery off of 2009's panic-driven lows was certainly drastic, as I discussed previously. As some of our largest holdings have grown significantly, we have started the process of reducing our exposure and investing in new ideas. Looking at small cap valuations today, I think that we are experiencing a return to evaluations based on business fundamentals as opposed to an environment where investors are trading securities based on greed or fear.

In terms of future upside, companies today do seem to have some remaining ability to boost earnings by cutting costs further. What many investors don't realize, however, is that there may also be significant room for top line growth. One example is American Service Group (ASGR), a company that provides health care services to prisons. Currently, over half of the prisons in the U.S. are operated by local governments.

American Service Group has shown that they can save these municipalities 20-30% in health care costs, something that we believe may be attractive to local governments considering their dire financial circumstances.

American Service Group (ASGR) has a clean balance sheet with zero debt and almost no analyst coverage (more on the debt levels and analyst coverage of companies in our portfolios can be seen in the following table). The idea was brought to us by a four person firm that we have a long relationship with; they typically don't even write research reports because their focus is to just search for and find niche businesses like this

one. ASGR is currently trading below \$16.00 and earns between \$1.10-1.20; this gives it a P/E ratio of 16, right in line with our overall portfolio. After speaking recently with management who indicated that several states were considering procuring their services, we believe that even if a few of these states decide to step up and outsource to them the company's 2012 and 2013 earnings could potentially reach \$3.00 or \$4.00, and possibly as high as \$5.00 within five years. If we were to base our estimation on just the low number of \$3.00, we estimate a P/E ratio of five times earnings, a level that we believe is very undervalued. This is just one example of how we evaluate upside potential, we see several other companies with this type of potential capability in our portfolios.

**Q.**

*Why did you launch PREOX and what type of investor is it suited for?*

**A.**

We launched the Emerging Opportunities Fund to give investors the opportunity to own the smallest of the small companies in terms of market capitalization. Our firm's investment philosophy is built on the "small firm effect," which is the fact that historically, the smallest companies have performed best over long periods of time (as demonstrated by Ibbotson & Associates' *Stocks, Bonds, Bills and Inflation Yearbook*, which looks at annualized equity returns over the period 1926-2008). More than 90% of the companies in the Emerging Opportunities Fund have a market capitalization below \$100 million. This is a segment of the market where we believe that the "small firm effect" has the potential to be most pronounced. We are determined to hold the Fund to its guideline to be invested in the smallest decile of the market (those companies in the bottom 10th percent based on equity market value).

Many of our investors have chosen to use The Perritt Emerging Opportunities Fund as a supplement to our flagship Perritt MicroCap Opportunities Fund in order to achieve a more accurate exposure to the microcap segment of the market. For example, a client with a

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# Investing In Smaller Companies Since 1988



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high risk profile might use a mix of 90% PRCGX / 10% PREOX, while a higher risk profile investor might use a 70%/30% mix. Other investors who may be interested in the Fund are those searching for characteristics including:

- **Lowest Average Market Capitalization.** According to Morningstar's database, The Emerging Opportunities Fund's average market capitalization (\$53 million) is the smallest among the over 10,000 mutual funds listed as of 1/29/10 (includes all funds with over \$100,000 under management).
- **Low Correlation.** The Fund's R-squared to the Russell 2000 is 0.69.
- **Domestic Exposure.** Despite the occasional confusion caused by its name, the Emerging

Opportunities Fund is primarily a domestic investment vehicle. Approximately 93% of the Fund is invested in U.S. companies.

An April 2009 study published by the Brandes Institute, "Is U.S. Small Cap a Viable Alternative to U.S. Private Equity?" suggests that the value-add demonstrated in selection of U.S. private equity has the potential *to closely attain that of top managers of small-cap equities*. We seek to provide that "value add" in our process by focusing on what we believe are undiscovered companies in the smallest of the small segment of the market as based on market capitalization.

(Please cut and paste this link into your internet browser to read the full report:  
<http://www.brandes.com/Institute/Documents/Private%20Equity%200409.pdf>)

## Small Cap vs. Large Cap: Comparison of Debt Levels as of 12/31/09:

	<u>Perritt MicroCap Opportunities Fund (PRCGX)</u>	<u>Perritt Emerging Opportunities Fund (PREOX)</u>	<u>Russell 2000 Index</u>	<u>S&amp;P 500 Index</u>
Zero Debt: # of companies with zero Debt on balance sheet	64 of 134 (47.8%)	68 of 149 (45.6%)	562 of 2000 (28.1%)	35 of 500 (7.0%)
Cash Position: # of companies holding 10% or more of market cap. in cash	84 of 134 (62.7%)	92 of 149 (61.7%)	1134 of 2000 (56.7%)	185 of 500 (37.0%)
Median Debt to Assets Ratio	0.1%	0.9%	9.2%	19.8%

Source: Capital IQ

## Analyst Coverage as of 12/31/09:

	<u>Perritt MicroCap Opportunities Fund (PRCGX)</u>	<u>Perritt Emerging Opportunities Fund (PREOX)</u>	<u>Russell 2000 Index</u>	<u>S&amp;P 500 Index</u>
Number of Stocks	134	147	2000	500
Zero analyst coverage	29	79	312	2
One analyst coverage	29	39	256	7
Average # Analyst	2.5	0.9	3.9	10.2

Source: Capital IQ

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](http://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 Earnings (P/E) ratio is calculated by dividing current price of the stock by the company's trailing 12 months' earnings per share. 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. A correlation coefficient is a measure of the interdependence of two random variables that ranges in value from -1 to +1, indicating perfect negative correlation at -1, absence of correlation at zero, and perfect positive correlation at +1. R-Squared is a statistical measure of how much a fund's past returns can be explained by the returned from the overall market (or benchmark index). If the fund's total returns were precisely synchronized with the overall market's return, it's R-Squared would be 1.00.

As of 12/31/09, American Service Group comprised of 0.93%, BioScrip comprised of 1.83% of The Perritt MicroCap Opportunities Fund. The Fund did not hold a position in ICT Group. Fund holdings and sector allocations are subject to change at any time and are not recommendations to buy or sell any security.

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