Perritt Funds

MicroCap Opportunities Fund, Inc.
Emerging Opportunities Fund, Inc.

CIO Interview: Small Cap Focus

Michael Corbett
CIO & Portfolio Manager

Q.

How should advisors benchmark the Perritt MicroCap Opportunities Fund?

A.

To give some perspective, The Perritt MicroCap Opportunities Fund currently has a median and average market cap of just over $135 million. In comparison, as of the most recent quarter end, the median market capitalization of the Russell 2000 Index was $500 million, and the median market capitalization of the Morningstar Small Cap Blend peer group was $1.2 Billion. Since the Fund's inception in 1988, we have been consistent in our investment approach, which is to focus on the bottom 20% of companies as ranked by market capitalization. After the market's recent decline, that number includes all companies with a market capitalization of under $500 million. The result is that the companies we chose to invest in tend to be much smaller than those which are traditionally believed to lie within the small cap universe. The Fund does continue to use the Russell 2000 Index as a benchmark for performance. However, this is primarily for the simple reason that the Russell 2000 Index is the only small-cap index that has been in existence for as long as we have. We continue to believe that we invest in a segment of the market that is under-followed, and where Ibbotson data shows the small firm effect is most pronounced. This segment of the market includes many challenges, including limited liquidity and limited research coverage. These challenges have certainly been on display throughout the current difficulties in the market. However, when you are investing in a segment of the market that can be distinguished by stocks reaching an extreme in terms of inefficient pricing, there does exists a significant upside potential, particularly during a market rebound.

In a bear market, the stocks of all companies tend to be affected equally.

Q.

Can you comment on the recent market performance?

A.

Last quarter was obviously very disappointing. As I discussed in the last quarter's commentary, within the Russell 2000 Index it has been the smallest companies, in terms of market cap, that have been hit the hardest. This trend has become more pronounced. In a bear market, liquidity dries up and investor confidence plummets. As investors liquidate their small cap stocks in an illiquid environment, market makers drop their bid price and micro-cap stocks usually suffer more than the more liquid small-cap stocks. Because we invest in these types of smaller, more illiquid companies, our Funds have certainly experienced a greater impact from this decline. In

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addition to company size, there are also two major differences in industry weightings between our Fund and the Russell 2000 Index which contributed to the Fund's underperformance in these two areas. First, the Perritt MicroCap Opportunities Fund is significantly underweight in financial stocks. As of September 30, financial stocks made up 22% of the Russell 2000, as opposed to just over 4% of the Perritt MicroCap Opportunities Fund. Financial stocks experienced a large recovery in the third quarter, which contributed to the Russell 2000's relative out-performance. However, we are still not convinced of the overall fundamental strength in these companies. This outlook is based on numerous meetings that we've had with management teams of small financial companies who haven't given us a high level of conviction that their businesses will be able to weather the current weakness in our overall economy. Second, there is a marked difference in energy industry weightings between our Fund and the Russell 2000 Index. As of September 30, energy stocks made up 17% of the Perritt MicroCap Opportunities Fund, as opposed to 5% on the Russell 2000 Index. As the prices of commodities fell in the recent quarter, energy stocks as a group tended to decline. We continue to be strong advocates in energy space, particularly in the energy service sector. There tends to be a higher level of predictability of company revenue and earnings in the energy service sector. As always, it is important for our investors to remember that we construct our portfolios from the bottom-up, meaning that we look for individual companies that we believe are in strong financial condition, regardless of their industry.

Portfolio Characteristics As Of 10/17/08

	PRCGX	PREOX
Median Market Cap	135 Million	28 Million
Price / Earnings	10.10	9.00
Price / Sales	0.60	0.40
Price / Book	0.90	0.80
Price / Cash Flow	3.90	3.00

Q.

How have you been positioning the portfolios recently?

A.

One thing that we have learned during our 20-year history of investing in portfolios of small companies is that, in times like these, you cannot attempt to drastically alter a portfolio in order to conform to temporary market conditions. Instead, we believe it is crucial to maintain a consistent investment strategy. In our case, this is a focus on investing in small companies that we believe have the fundamental qualities that should bring profits for our shareholders over the long-term. A question that I am often asked is, "How will the companies in your portfolio weather an economic slowdown?" The answer is that the companies that are the best positioned to endure a period of slow economic growth are those companies which offer products and services that fill a niche, those with a high level of cash, and those with recurring revenue streams. However, it is important to remember that in a bear market, the stocks of all companies tend to be affected equally. The companies with the fundamental qualities that I mentioned have had their stock prices drop by just as much as the companies that don't possess those qualities. This creates potential investment opportunity. In fact, where we have been finding the most opportunity is with a number of companies that we already hold in our portfolio. Recently, we have been trimming the number of overall portfolio holdings while increasing our positions in the names and management teams that we know best. There are many companies with business models that we know, that remain in strong financial condition, and that should continue to increase profits. At the same time, their stock prices have continued to be beaten down tremendously. Things may certainly continue to be difficult in the short term, but these are the companies in which we have the most conviction in over the next three to five years.

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Q.

Can you comment on Portfolio Valuations?

A.

With the recent pullback in stock prices, portfolio valuations have become more reasonable. Part of what has been going on in overall markets is what we call "a crisis of confidence." With concerns about the overall economy, management teams have begun to pull in their expectations of how business will grow in the near term. Companies are moving as quick as they can to re-adjust their overall businesses to reflect a weaker economy. As of October 17, our portfolios are trading at price-to-earnings multiples of about 10.1, and at 8.5 times forecasted earnings. These P/E ratios are actually not as low as I have seen during the lowest point of past cycles. What I have not seen before in my 20 years in the industry, however, are price-to-sales multiples as cheap as they are now. Currently, our portfolios are trading at 0.6 times sales. In addition, close to one-half of the companies in our portfolio are trading at below tangible book value. A large majority of these companies have high levels of cash. I think that tells you something about the severity of the most recent stock market downturn. We are obviously in a weaker economy, and suffering from what I said before was that "crisis of confidence." Once this crisis begins to subside, I believe we will see that the valuations of certain companies have become very attractive.

Q.

What are some examples of these types of companies?

A.

During our security selection process, what we look for are companies in a strong financial position that engage in a niche business with a competitive edge. One example of this type of company is Middleby (MIDD), a name that we've owned for nearly five years and with whom we have a high level of confidence in the management team. This company has continuously grown its top and bottom line in excess of 20%. They have modestly pulled in their numbers recently, but they're still looking for close to a 20% growth rate over the next few years. And yet its stock price in this market has dropped over 35%. Another example is Star Bulk Carriers (SBLK). What attracted us to this company was they're in the dry bulk business, and they have contracts that span the next several years. This company is currently trading at or just below book value, and it pays out a substantial portion of the cash flow that they generate. As it stands today, this company actually has a dividend yield of nearly 20%. Now, we don't claim that a 20% yield will be stable for a very long period of time, and we certainly don't recommend investing in individual stocks in anything but a well-diversified portfolio. The point here is that we are in the midst of a market that has brought down the prices of so many companies, and with such little regard to business fundamentals, that these types of situations do exist. Here we have a company that is generating cash, one that has contracts in place for the next two years, and it is trading below book value while paying out a 20% dividend. That to me is a clear definition of the type of opportunity that exists when you invest during a bear market.

Q.

Finally, and on a more light-hearted note, what effect can seasonality have on stock market returns?

A.

It is interesting that over the past 30 years, a large majority of market returns in both large and small cap stocks have come during the winter periods. Between the beginning of November and the end of May, the S&P 500 Index has returned an average of 10.6% per year, and the Russell 2000 Index has returned 13.6%. In comparison, over that same 30-year period, in the period between the beginning of June 1 and the end of October, the S&P 500 Index has returned 2.9% while the Russell 2000 Index has returned just 0.4%. That is certainly an anomaly worth noting. We do not expect this seasonality effect to materialize every year, and we certainly do not invest our portfolios with any mandate that it will. However, we do think that it may be something for investors to keep in mind as these winter months begin.

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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.

As of 9/30/08, The Perritt Funds held Middleby (0.80%) and Star Bulk Carriers (0.52%). 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 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.

The Perritt Funds are distributed by Quasar Distributors, LLC (10/08)

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