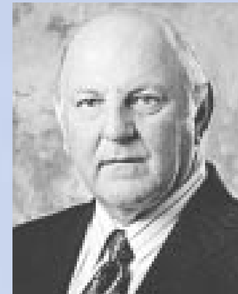
Perritt Funds
MicroCap Opportunities Fund, Inc.
Emerging Opportunities Fund, Inc.

1970s *Deja Vu*

Imagine a decade marked by feelings of disillusionment, cynicism, bitterness, and anger. Americans are increasingly disillusioned with the government and their democratic institutions. Burdened with this political disillusionment, American society is also under siege by economic decline and declining standards of living. For many Americans it's a decade of transition – marked by confusion, frustration, and an overwhelming feeling that America has lost its direction. Americans are faced with economic stagnation and recession, increasing poverty, decline in their standards of living, and fears that the "American Dream" is becoming harder to achieve.

During the decade, a number of trends can be observed, including: higher divorce rates, increase in couples living together, increased recognition of homosexual lifestyle, rise in drug use, rising crime rates, increasing energy costs, growing concern about an environmental crisis, and a declining standard of living. If you haven't already guessed, I am not talking about the current environment. I am describing the decade of the 1970s.

During a recent interview, supply side economist Arthur Laffer described the outlook for the next decade as a repeat of the financial and economic environment of the 1970s. If you remember your history, that decade was marked by hyper-inflation, above-average unemployment, skyrocketing energy costs, double digit interest rates and economic recessions. Dr. Laffer's ominous forecast probably caused plenty of investors to quake in their boots. However, a reading of financial market statistics indicates that some investors fared very well during that decade. Here's a bit of the historical record.



Dr. Gerald Perritt
CEO & Founder

The investment returns in the major categories of financial assets, when viewed from the perspective of the entire decade (January 1, 1970 through December 31, 1979) did in fact provide mediocre returns. Corporate bonds (as measured by the Citigroup Long-Term High-Grade Corporate Bond Index) returned 6.2% per year, Treasury bills 6.3%, S&P 500 Index 5.9%, international stocks 10.1% (as measured by the MSCI EAFE Index) and small company stocks (as measured by the fifth quintile of stocks on the NYSE based on market capitalization) 11.5%. On a nominal basis, these returns appear to have rewarded investors for the risks they took. However, during the decade, the rate of increase in consumer prices averaged 7.4% a year. Thus, on an inflation-adjusted basis (so-called real returns) the returns in every category were far below their long-term historical average. In fact, on an inflation-adjusted basis, corporate bond, Treasury bill, and large-cap stock investors experienced a decline in their wealth during the decade.

These return numbers do indeed look bleak. However, the decade-long compound returns for the common stock categories paint a distorted picture. Remember, stock prices around the world took a significant tumble during 1973 and 1974. For example, the Standard &

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Poor's 500 Index declined by 17.4% in 1973 and by 29.7% during 1974. If you exclude these two years, the common stock returns during the rest of the decade were significantly above their long-term averages. Ex 1973 and 1974, large-cap stocks (as measured by the S&P 500 Index) returned an average of 13.9% a year, international stocks returned an average of 18.6%, and small-cap stocks returned a whopping 23.4% a year.

Of course, if you exclude the worst annual returns from any time series, the returns during the remaining years will be much higher. Thus, it may appear to be a fool's errand to talk about investment returns during the 1970s after excluding the 1973-1974 bear market. However, I am trying to make the point that by averaging returns across a long time period, an investor can get a distorted picture of market action during individual years in that time period. In other words, when it appears that common stocks provide below-average returns over a prolonged period of time, it is usually significant declines lasting a year or two that cause the abnormally low long-term performance average.

That brings me to the point of this discussion, which is if Dr. Laffer is correct and we are currently living the decade of the 1970s, I say "bring it on." Common stocks delivered some of their best returns during the period 1975-1983. That period followed on the heels of a double dip bear market 1969-1970 and 1973-1974. Like investors in the 1970s, investors today have experienced a double dip bear market 2000-2003 and 2007-2009. In other words, I believe that the worst of the decade's returns are most likely behind us.

Returns After Ten Worst Stock Market Declines

S&P 500	Year	10-Yr Average Annual Return	10-Yr Total Return
-47.1%	1931	6.4%	86.0%
-38.6	1937	9.6	150.1
-38.5	2008	???	???
-29.7	1974	14.8	297.6
-28.5	1930	1.8	19.5
-23.4	2002	???	???
-17.9	1941	17.3	393.2
-17.4	1973	10.7	176.4
-14.3	1957	12.8	233.5
-13.0	2001	???	???

Source: Ibbotson Classic Yearbook, 2008
Past performance is not a guarantee of future results

The accompanying table illustrates what has occurred during the decade following the worst annual stock market declines in modern history. As can be seen, large-cap stocks earned positive returns during each of the 10-year periods following the abnormally large yearly stock market declines. Except for the 10-year period following the 1931 market meltdown, investors may have been well-rewarded for staying the course.

Interestingly, the big winners during the decade of the 1970s were small-cap stocks (as measured by the fifth quintile of stocks on the NYSE based on market capitalization). Not only did they return 11.5% annually during the entire decade (including 1973 and 1974), they continued to perform exceptionally well into 1983. During the nine-year period following the 1973-1974 bear market, they produced a 35.3% annual compound annual return. Furthermore, they delivered double digit returns during each of the nine years following that bear market. What makes this record even more phenomenal was the fact that that period was marked by high inflation, soaring interest rates, and above-average unemployment. If this economic environment sounds familiar to you, it should because it is exactly the environment that Arthur Laffer and numerous other economists believe will be the hallmarks of the next 10 years. Although past results do not guarantee future performance, I believe that the market pundits who are telling investors that the best places for their money is domestic giant-cap stocks and international stocks are overlooking the one segment of the market that has not only delivered the highest returns during the past century, but offer significant return potential during the near term.

It is also interesting to note that the returns of so-called value stocks trounced the returns of growth stocks during the decade of the 1970s. One research team, which examined large-cap portfolios of high price-to-book value stocks (growth portfolio) and low price-to-book value stocks (value portfolio), found that the growth portfolio returned an average of 3.4% per year during the decade

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versus a 12.2% return for the value portfolio. (Source: Ibbotson Classic Yearbook, 2008) When the years 1973 and 1974 were stripped out of the decade, growth stocks returned an above-average 12.3% annual return. However, the value portfolio produced a whopping 20.0% return.

Although past performance doesn't guarantee future results, these return statistics have given me a few clues about structuring my portfolio given the current economic environment. First, I am skeptical of the pundits who are telling me that the best places for my money today are domestic giant-cap stocks and international stocks (including emerging markets). History tells me that they may be overlooking the one segment of the market that has not only delivered the highest returns during the past century and one that has performed exceptionally well after significant bear market declines. That, of course, is the segment containing the smallest company stocks. Furthermore, the 1970s have given me a clue to the types of stocks I want in my portfolio. That is, those stocks that appear to be value-priced on such metrics as price-to-earnings, price-to-sales, and price-to-book value.

The thesis here is that common stocks have historically tended to provide superior returns during the years following severe bear markets. The implication is that common stock investors (especially small-cap stock investors) could potentially experience hefty returns during the next ten years. However, there certainly are detractors to this view. Most notably, Mohamed El-Erian and Bill Gross, co-chief investment officers of PIMCO, the large bond invest-

2009 2nd Quarter Financial Market Statistics

Commodities	
Gold	2.0%
Corn	-14.1
Cattle	-1.7
Soybeans	28.8
Silver	6.3
Wheat	-4.0
Platinum	5.5
Oil	40.7
CRB Index	13.4

Foreign Markets	
U.K. FTSE 100	8.2%
DAX	17.7
CAC 40	11.9
Japan	22.8
Hong Kong	34.4
India	49.3
China	24.7
Mexico	35.7
Brazil	41.7
Argentina	41.0

U.S. Industry Performance	
Basic Materials	16.2%
Consumer Goods	14.0
Consumer Services	12.6
Financials	35.6
Health Care	8.7
Industrials	19.2
Oil & Gas	13.2
Technology	16.6
Telecomm	11.6
Utilities	9.2

U.S. Stocks	
Dow Industrials	11.0%
Nasdaq Composite	20.0
Nasdaq 100	19.4
S & P 500	15.2
Russell 2000	20.2
Wilshire 5000	16.2

U.S. Dollar vs.	
Euro	-5.7%
British Pound	-14.7
Canadian Dollar	-7.8
Yen	-2.8

Bond Yields (quarter end)	
30-yr T-bond	4.32%
10-yr T-bond	3.53
3-mo T-bill	0.19

SOURCE: Yahoo Finance

Fund holdings and sector allocations are subject to change and should not be considered a recommendation to buy or sell any security.

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ment firm, have been highly vocal about the upcoming underperformance of common stocks. In their words, during the next 3-5 years, common stock investors will experience "a new normal." According to their view, economic growth, coming out of the current recession will be well-below trend. As a result, corporate profit growth will be anemic as will be common stock returns. They say, rather than the 10-11 percent long-term annual returns provided by common stocks during the last 150 years, investors may experience average returns of 5 to 6 percent. Their forecast is based on the notion of an economy and financial system that will be de-leveraged, de-globalized, and re-regulated.

Although their argument for anemic stock market returns well into the future is well thought out, I am a bit skeptical. First, their prescription for investors is to lighten up on stocks and increase allocations to bonds. Given that these prognosticators run the world's largest bond firm, could you expect them to write any other prescription for investors. That aside, the most dangerous phrase ever uttered on Wall Street is "It's different this time." Although El-Erian and Gross have eschewed this phrase, their replacement phrase "It's a new normal" sounds a lot like it.

I have to admit that it is different this time around. First, the United States is no longer the engine of world economic growth. It has been replaced by China, India, and to some extent Brazil. Second, the financial crisis, which arose because of excessive leverage in the financial system is already causing the government to ramp up regulation. However, the assumption of quasi-permanent de-leveraging is probably wide of the mark. It is true that the use of excessive leverage by the banking system appears to be a thing of the past. However, I believe that both business and consumers will continue to borrow as they have during the years preceding the 2000-2007 financial bubble. During the century and a-half preceding that bubble, large-cap stocks (as measured by the S&P 500 Index) provided a 6.8% average annual real (after-inflation) return.

Furthermore, the last 10 years have been marked by below-average stock market returns. In fact, the total annual return of the Standard & Poor's 500 Index has been etched in red ink during that period. A statistical concept called "gravitation toward the mean" suggests that the average annual returns during the next 10 years could easily top those of the last 10 years if the long-term average stock market return gravitates back toward its historical 10-11% rate.

Are You Better Off Than Your Parents?

I don't know about you, but I definitely am. Sixty years ago our family was living without a television, cell phone, computer, internet access, a transistor radio, a microwave oven, an icemaker, and air conditioning. The family clunker didn't have an automatic transmission, air conditioner, radio, or turn signals. And there were no superhighways to get us from one place to another. There were no heart transplants and a myriad other medical procedures.

Of course, there were a number of things we were living with that are not around today. We lived with measles, chicken pox, whopping coughs (and the red quarantine signs that were tacked to the doors of those families whose children were suffering these maladies). We lived in fear that one of our loved ones would contract polio. And there was the fear that the entire world would be consumed in a nuclear holocaust.

Back then, my dad was bringing home $50 a week as an employee of a major steel company, my mom was hanging out the wash, I helped shovel coal into the coal bin in winter, and my favorite toys were a baseball and glove. Back then necessities were food, clothing, and shelter.

Earlier this year, the Pew Research Center asked Americans what they couldn't live without. You might only be mildly surprised at their responses. Here's the top ten list (along with the percentage of responses): Car (88%), clothes dryer (66%), home air conditioning (54%), TV set (52%), home computer (50%), cell phone (49%), microwave (47%), high-speed internet (31%), cable or satellite TV (23%), and dishwasher (21%).

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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. Investments in smaller companies involve additional risks such as limited liquidity and greater volatility than larger companies. Investments in micro cap companies tend to perform poorly during times of economic stress. The funds 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 Book Value Ratio is calculated by dividing the current price of the stock by the company's book value per share. Book Value is the net asset value of a company, calculated by subtracting total liabilities from total assets. 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 smallest2,000 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. DAX 100 Index is a German price-weighted index of that country's top 100 stocks. 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. The MSCI EAFE Index (Morgan Stanley Capital International, Europe, Australia and Far East) Index is an unmanaged index of over 1000 foreign common stock prices including the reinvestment of dividends. It is widely recognized as a benchmark for measuring the performance of international value funds. The Citigroup Long-Term High-Grade Corporate Bond Index (also known as Citigroup High-Grade Corporate Bond Index) is the corporate component of the Credit Index. It includes those issues from the Credit Index that have at least 10 years to maturity (long term) but excludes asset-backed securities and non-U.S. sovereign/provincial issues. You cannot invest directly in an index.

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