2nd Quarter 2011 Commentary

Give Me Illiquidity

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The "small firm effect" is known to most seasoned investors. It is the additional returns provided by portfolios of small firm stocks that cannot be explained by the portfolios' beta risk. The discovery of the small firm effect in the late 1970's by a University of Chicago researcher is the reason why I founded Investment Information Services and Perritt Capital Management nearly three decades ago. The mission of both of these enterprises was (and still is) to provide individual investors with vehicles that would help them to capture the small firm effect and the potential returns that the stocks of small equity market value firms may deliver.

Shortly after the discovery of the small firm effect, a large number of researchers set out to explain why small firm stocks have provided excess returns. Some researchers even postulated that once knowledge of the effect became widespread, actions by investors seeking these additional returns could cause market prices to adjust to the extent that all excess returns would disappear. However, after more than three decades since its discovery, the excess returns delivered by small firm stocks have remained.

Over the years, researchers have pointed to a number of causes for the existence of the effect. Most of the causes have been linked to differences between the characteristics of small firms and small firm stocks and those of larger publicly traded companies. These characteristics include the large percentage of management ownership of small companies versus their larger cousins, the absence of widespread analyst coverage of companies in the small firm universe, the lack of significant ownership of small firm shares by well-heeled institutional investors, and the relatively low degree of liquidity that exists in the small firm public marketplace.

Of all these explanations, the one that has the strongest support is the liquidity thesis. Because of the limited number of shares outstanding for most small firms, the absence of institutional investor interest (which accounts for a majority of the trading volume of larger company stocks), and the lack of knowledge about small companies due to the absence of analyst attention, the volume of trading of small firm stocks tends to be miniscule relative to the trading volume of mid-size and large-size companies. If an investor wishes to obtain a relatively large number of shares of a small firm's stock, that investor must pay a price that is higher than the quoted market price to entice other investors to sell. Conversely, if an investor wishes to dispose of a significant small firm stock investment, that investor must offer shares at below market prices to attract sufficient buyers of those shares. As a consequence of the increased liquidity risk inherent in the small firm sector of the market, small firm stock investors require a liquidity premium to compensate them for the additional risk they are assuming.

These days most people understand liquidity risk. The meltdown in the housing market has taught us that concept well. In order to sell a house during the last three years, owners either had to reduce their asking price significantly or face the prospect of having their house on the market for a very long period of time.

In other words, most of us now know that home ownership has more risk than we previously were led to believe. Although the housing market may ultimately overcome its current severe bout of illiquidity, home buyers in the future will not approach this decision with the near reckless abandon that they did so in the past. Like small firm stock investors, future home buyers will wish to be compensated for the lack of liquidity they assume when investing in their homes.

"Rather than shun stocks with low liquidity, patient investors should embrace them."

To illustrate the consequences of limited liquidity on share prices, I examined stock price behavior during several periods of severe stock market declines. These were periods in which the large company index, the Standard & Poor's 500 Index, declined by 30 percent or more. Generally, these periods were marked by investor panic and the attempt by many to liquidate their stock holdings at any price. Table 1 illustrates five such periods along with the percentage declines in large firm and small firm stocks.

TABLE ONE

Severe Bear Markets and Stock Returns

	Large Cap Stocks	Small Cap Stocks
Sept. 1929-June 1932	-86.0%	-88.9%
March 1937-March 1938	-53.0%	-61.9%
Dec. 1968-June 1970	-32.9%	-51.9%
Sept. 1987-Nov 1987	-30.2%	-32.6%
Nov. 2007 -Feb. 2009	-52.6%	-55.7%
Average	**-48.9%**	**-58.0%**

TABLE TWO

3-Month Returns After Severe Bear Market

	Large Cap Stocks	Small Cap Stocks
June 1932	82.4%	104.0%
March 1938	36.0%	57.9%
June 1970	15.8%	28.1%
Nov 1987	16.3%	19.5%
February 2009	35.1%	48.5%
Average	**25.0%**	**33.0%**

Source: Ibbotson & Associates

During each and every period, small firm (less liquid) stocks declined by a larger percentage than large firm (more liquid) stocks. On average, the prices of large firm stocks fell by 48.9% versus an average decline of 58.0% for less liquid small firm stocks. These are the negative consequences of owning less liquid stocks.

To understand why less liquid stocks decline by a greater percentage than more liquid stocks, consider the following example. Suppose that a large number of people attempt to exit a building through a single door. Because only a few people can exit at one time, a queue forms and those further back in the queue move at a very slow pace. Now suppose that the door suddenly widens. More people can exit at the same time and the building's occupants can exit in a much shorter period of time. That is exactly what happens when investors attempt to dump a large number of shares of stocks with low liquidity. In order to accommodate all that are willing to sell, market makers widen the bid ask spread by dropping their bids. As orders are executed bids continue to fall until buy and sell orders can be matched.

Remember that all market makers are individuals charged with the responsibility of being buyers when there are more shares offered for sale than buyers are willing to purchase. However, if market makers purchase large blocks of stock that they cannot immediately sell, they expose themselves to increased risk of loss if prices fall further. Thus, they attempt to mitigate that risk by lowering their acquisition cost (i.e., dropping their bid prices).

However, constrained liquidity has an upside as well. Table 2 on page six, illustrates the gain in share prices of large firm (more liquid) stocks and small firm (less liquid) stocks during the three month periods following severe bear markets. Note that in each and every case, small firm stock prices rose by a greater percentage than did large firm stocks. On average, small firm stocks rose 48.5% versus a gain of 35.1% for large firm stocks. To use our previous analogy, if many people are trying to enter a building with a narrow door, those in the rear of the pack move at a very slow pace. If the door were suddenly widened these individuals could enter the building at a much faster pace. In this case the widening door is analogous to market maker spreads being increased as offering prices rise to accommodate all who want to buy.

A large number of investors (especially large institutional investors) avoid small firm stocks because of their limited liquidity. These investors fear that they will not be able to liquidate their holdings of small firm stocks in relatively short periods of time without accepting large discounts from the going market prices. There is no doubt that when liquidating a large block of stock, investors must either accept a discount to the going price or they must spread their sales over a long period of time. However, that should not deter long-term oriented investors from investing in small firm stocks. Remember that a portion of the extra returns that small firm stocks provide exist because investors demand (and get) a liquidity premium. Rather than shun stocks with low liquidity, patient investors should embrace them. In other words, investors who do not need instant liquidity get to pocket the liquidity premium and potentially increase their long-term investment returns as a result.

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Past performance does not guarantee future results. Index performance is not illustrative of fund performance and an investment cannot be made directly in an index. For fund performance please call 1-800-331-8936.

Small company stocks defined as the bottom quintile of securities ranked by market capitalization from 1926-2009. Large company stocks are represented by the S&P 500 index. 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. You cannot invest directly in an index. Beta measures the sensitivity of rates of return on a fund to general market movements.

The fund's investment objectives, risks, charges and expenses must be considered carefully before investing. The statutory and summary prospectuses contain this and other important information about the investment company, and may be obtained by calling 1-800-331-8936 or by visiting www.perrittmutalfunds.com. Read 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.

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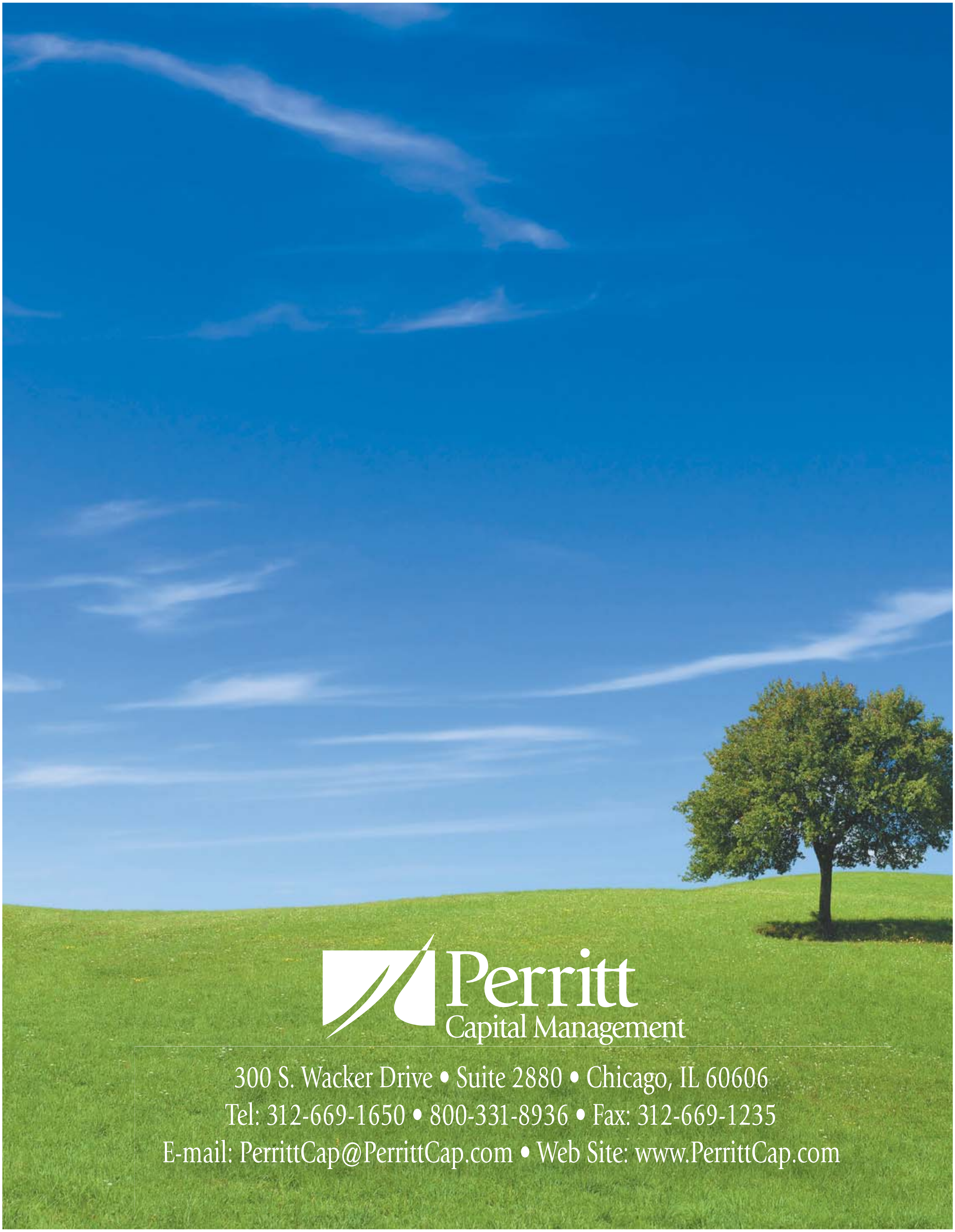

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