

The Smallest Companies Out There

Perritt Emerging Opportunities Fund was created with the idea to invest in the smallest companies to be discovered, smaller even than the companies in Perritt MicroCap Opportunities Fund. The philosophy behind microcap investing is simple – the smaller the companies, the better the potential long-term return. But because of the specific risks of this micro space, it's the research effort that makes the difference.

Q: How would you describe the investment philosophy of your fund?

A: We have two funds, the Micro Cap Opportunities Fund and the Emerging Opportunities Fund. Micro Cap has been closed to new investors, but since we had many clients still interested in that space, we launched the Emerging Opportunities Fund. This fund invests even in smaller companies than the Micro Cap fund. You could almost call it a “nano-cap” fund, but we came up with the name Emerging Opportunities.

Q: What is the average market value of the two funds?

A: Our firm was established to invest in small and micro-cap companies and we define that space as the smallest of the small-cap stocks. According to the prospectus, we invest in companies with market cap below \$250 million.

We rank all the companies and separate the part below the bottom eighth decile. Today that number is about \$500 million or less and that's where we start with our Micro Cap fund. There is some overlap between the two funds but, in general, we're trying to maintain the distinction of the eighth to ninth decile for the Micro-Cap Fund and the ninth to the tenth decile for

the Emerging Fund.

That means that the average market-cap of the Micro Cap fund is about \$250 million, while of the Emerging Fund it's usually around \$100 million or less. Today our average market cap is about \$80 million.

Q: Why do you invest in such companies? What value do you find in the smallest part of the market?

A: We truly believe that by investing in the smallest companies you get the biggest return for your money, which is obvious if you read Ibbotson long-term data. We take a very long-term approach to our investments, looking over the next three to five years. Hopefully, we'd hold the investment that long in the portfolio.

Most ranking services define us as a blend strategy, although we lean toward the value side. We're certainly looking for some deep value type of investments, but we're also investing in growth stocks. We have a GARP approach in that space and we want to make sure that we are buying at a discount.

Q: How many companies generally fall into your universe? Are there specific sectors that pop out consistently in that market-cap range?

Fund Facts

Symbol	PREOX
Website	www.perrittmutualfunds.com
	Perritt Capital Management, Inc. 300 S. Wacker Dr., Suite 2880
Address	Chicago, IL 60606
Tel. No.	800-331-8936
Inception	8/27/2004

Portfolio

Total Net Assets *	\$83.7
Avg Mkt Cap (\$ Weighted) *	\$85.5
Average Price/Earnings Ratio	20.2
Average Price/Book Ratio	2.8
Turnover Ratio	64 %

Investment Information

New Investment	Open
Min Initial Investment	\$1,000
Min Subsequent Investment	\$50
Min Initial IRA Investment	\$250

Risk (Against S&P 500 - 3 Years)

Alpha	N/A
Beta	N/A
R-Squared	N/A
Ann Std Deviation	N/A
Sharpe Ratio	N/A

Returns vs. Russell 2000 Index

	PREOX	Index
3 Mo. (Cum.)	-2.98 %	-5.02%
6 Mo. (Cum.)	9.62%	8.21%
1 Year (Cum.)	29.26%	14.58%

Returns vs. S&P 500

	PREOX	Index
6 Mo. (Cum.)	-2.98%	-1.44%
1 Year (Cum.)	9.62%	2.71%
3 Year (Ann.)	29.26%	8.63%

Fees and Expenses

Max Sales Charge - Front	0.00%
Max Sales Charge - Deferred	0.00%
Max Redemption Fee	2.00%
Total Expense Ratio	1.70%

Portfolio Manager

Michael Corbett - Lead PM	Aug-2004
---------------------------	----------

* millions **within 3 months after purchase

Source: Company Documents; Lipper

Data through: 6/30/06



TICKER's Choice

A: Not really. Maybe business service companies end up in the space often but, generally, it is a pretty broad-based universe. If you include the pink sheets, the overall universe consists of about 10,000 companies, but we don't invest in pink sheets. I'll look at a pink sheet company only if I know that the company's stock is going to be moving over to the bulletin board or the regular NASDAQ. Excluding those companies, our universe probably consists of 4,000 to 5,000 companies and our analysts are searching all the various aspects to find new investments for each of our funds.

Q: *How many names do you have in the portfolio on average at any given time?*

A: We have more than 100 names in both funds at all times. We maintain a very broadly diversified approach and that's part of the risk control. Our general rule is that the positions start between 0.5% and 1.5% of the portfolio. If we get beyond 3% in any individual name, we start selling even if we still think there is more upside potential. We just don't want to get too tied up in stock-specific risks.

The portfolios are built with a bottom-up approach. We don't pay attention to sector or industry breakdowns although we regularly look at our portfolio to see if we're getting a little heavy in a certain one. We don't have specific rules for industries or sectors but if we see a concentration of 20% or 30% in one industry, this is a red flag to examine our weight there.

Q: *What is the benchmark that you track or are aware of?*

A: For the Micro Cap fund, which we launched in 1988, we use the Russell 2000 index because it's been around the longest. But since we launched the Emerging Fund about two years ago, several micro-cap indexes have been created. We compare our numbers against two of those indexes, the Russell Microcap index and the Morgan Stanley Micro-cap index. Those indexes may not be the perfect ones for our funds, but we think that they are the closest ones and, obviously, we need a benchmark to measure our performance.

Q: *How do you handle the liquidity issue*

and the lack of coverage of these stocks? Do you view these as a problem or as an opportunity?

A: Research is a very important part of the process in the micro-cap space. It is true that liquidity isn't great and there aren't a lot of research firms following these companies, so we do a fair amount of research internally. But there are also regional brokerage firms and paid-for research firms that help us out with ideas.

Our research process starts with screening the various databases. We also go through the earnings releases, the news-wires, the SEC filings, etc., to see if any ideas pop up. We network with about two dozen regional brokerage firms and paid-for research firms to find ideas. That's how we sometimes get our better ideas because many micro-cap names don't usually appear in the traditional databases. Even if they end up there, the data may not be reliable, so we like to do our own research and dig through the numbers.



Once we get an idea, the company is put through a proprietary nine-step process. We've combined a quantitative model with fundamental analysis. The nine-factor model is based on items that you can get from the balance sheet, income statement, and the cash flow statement. If a company scores well on six out of the nine factors, then we'll do more research on this company, which includes asking the management some questions, doing channel checks, as well as assessing the valuation and the growth rate.

Q: *Could you give us a couple of examples*

of successful or unsuccessful stock picks based on your research?

A: Barrett Business Services would be a good example. The stock is no longer in the Emerging Fund as it moved up to the Micro Cap fund when its market cap grew. We purchased that company a couple of years ago when the market-cap was around \$40 million, while today it is a little over \$300 million. Obviously, we've done well with this company, which scored well during our research. If I remember correctly, its score was seven or eight out of nine factors.

There are two aspects to the business of this company. The first one is providing temporary help in the upper Californian market to small and mid sized companies. But just like any other temporary firm in the early part of the decade, its business suffered because there wasn't a need for temporary help.

They maintained some profitability and, at the same time, they created another division for managing human resource departments for their customers. And that's a business that just exploded for them. It went from zero in the early part of the decade to several hundred million dollars today. We've watched them explode in that space and they're still trying to keep up with the demand. Meanwhile, the temporary help business improved because the economy improved.

Q: *So the initial reason for getting into that stock was the score in more than six of the nine factors in your model, is that correct?*

A: Yes, that's where we start. Everything starts with the quant model and then we do the detailed analysis to assess the business, the management, and where they are going with the overall business plan.

Q: *Is your approach to these nine factors historic or forward-looking into the next two or three years?*

A: That's where our fundamental analysis comes in. If we just use the quant model, the portfolio would be very different. We have a lot of companies that pass the first tests but don't necessarily pass the fundamental test of management assessment

or valuation. In general, the companies scoring well are companies that have been doing well with their business, so the valuations might be too rich.

Q: *What happens when you do all the right work, find a stock, and then it hits a roadblock? How would you describe your sell strategy?*

A: There are several aspects to our sell strategy. Since we pay attention to market-cap, we have to move on when the market cap becomes too big. That means that sometimes you have to give up some of your favorite companies, but we have to stick to the basics of investing in the smallest of the small companies.

The other aspect has to do with valuation we sell when a company gets way too expensive based on our outlook for that company for the next 2 to 3 years. On a GARP approach, that means that if a company is trading at 1.5 or 2 times its growth rate, we need to start selling that stock or to sell it altogether.

The last aspect is when companies are bought out. We average between 5 and 7 companies bought out in our portfolio every year. I've already had 5 companies bought out this year and I wouldn't be surprised if that rate continues based on some of the conversations I've had with the management teams.

On the negative side, when we have the wrong interpretation or assessment of the business, we'll have to admit our mistake. We wouldn't sell a company if it just misses the numbers in a quarter; we tend to give them a lot of time, so there are no stop losses set.

Q: *What are the specific risks characteristic of the micro-cap space? What dangers do you try to avoid as part of your risk control?*

A: There's a lot of risk investing in this space but there's also a lot of reward. The risks are typically tied down to general things, such as companies that have very few product lines and only a few customers. We try to investigate the companies and ask all the questions to make sure that they have a more broad-based customer base and product line. Sometimes they don't and we'll still invest in them, but we'll ask a

great deal of questions of management to assess the risk.

Those are the biggest risks to be aware of but by having a lot of names in your portfolio, you're only risking 0.5% to 1.5% for an individual name as opposed to the upside. I always tell my clients that I'm investing in a space that certainly has a lot of downsides, but if I can get 20% to 30% of the stocks to become the home runs, then all that downside is nothing

"I'm investing in a space that certainly has a lot of downsides, but if I can get 20% to 30% of the stocks to become the home runs, then all that downside is nothing."



about

Michael J. Corbett

Michael J. Corbett joined Perritt Capital Management in 1990 and served initially as the Company's senior securities analyst. In 1996 he became co-manager of micro-cap equity portfolios. In 1999, he became lead portfolio manager of all small and micro-cap equity portfolios. He currently serves as Chief Investment Officer and President of the Perritt MicroCap Opportunities Fund and Perritt Emerging Opportunities Fund.

Mr. Corbett has also been a contributor to several investment newsletters and financial books, including *The Mutual Fund Encyclopedia*, *Small Stocks*, *Big Profits*, *Investment Horizons* and *The Mutual Fund Letter*. Michael received a Bachelor of Science degree in finance from DePaul University in Chicago, Illinois and is regularly quoted in the financial press.

I've had plenty of losers over the years but if you pay attention to the valuations, then your downside is only 25% to 50%. We just don't want to add stocks that could go to zero if something goes wrong. Part of the work of my team is assessing balance sheet items to make sure that the company has assets, cash, and some intrinsic value, so that we know that it isn't going to go bankrupt. That would be a very rare event for us because we make sure that we assess the company as fairly as we can. ■

Ticker.com