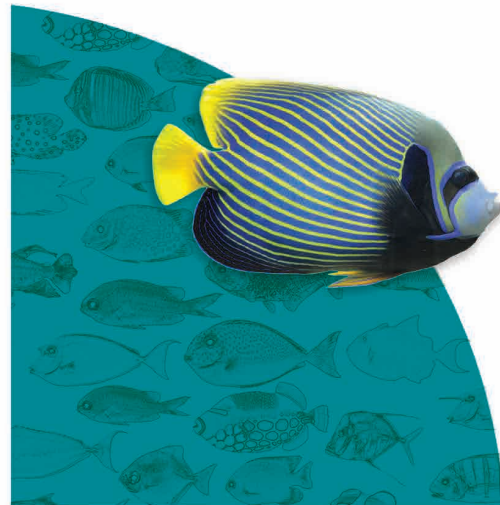


## Adding Micro-Caps to Small-Caps:

Unlock the potential to enhance return and lower risk while differentiating your practice.

### *A Guide for Advisors*

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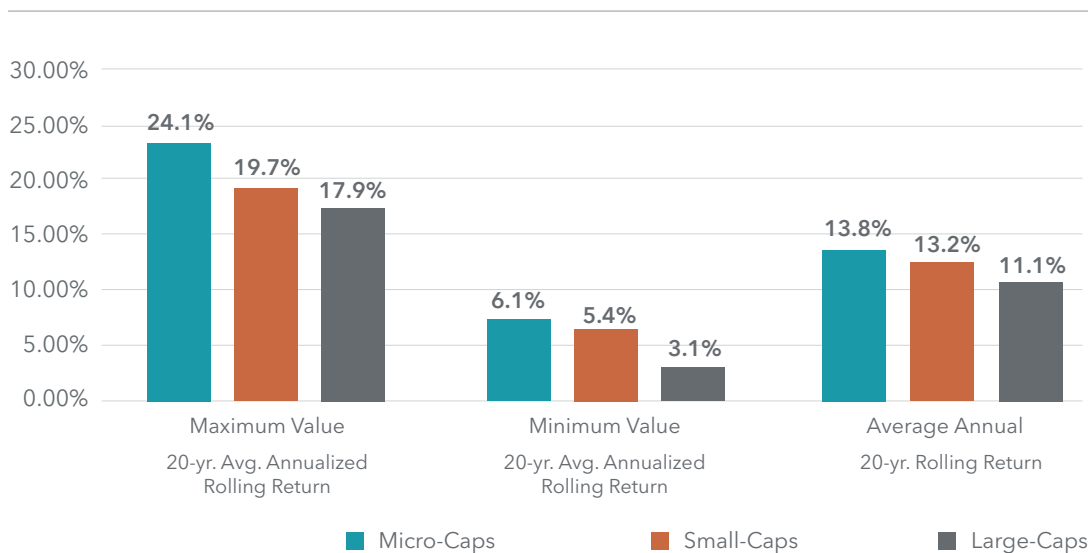
**Financial advisors** have long recognized the benefits of adding small-cap stocks to diversified portfolios. An allocation to small-cap stocks can increase return potential, add to diversification, and enable active managers to add value in a relatively inefficient market. Yet many have not yet recognized the potential additional upside that comes from adding micro-cap stocks to their clients' asset allocations. Exposure to micro-caps can further boost potential returns, augment diversification through non-correlated performance, and deliver many of the benefits of private equity and venture capital within a liquid vehicle. The strong benefits of micro-caps, combined with advisors' relative lack of attention to this dynamic asset class creates an opportunity. We believe exposure to micro-caps can further boost potential returns to your clients' small-cap allocations: you can enhance returns while modestly reducing volatility, and in doing so, differentiate yourself from other advisory firms.

## What can micro-caps offer your clients?

**The small firm effect:** Both small- and micro-cap equities have historically offered higher returns than larger company stocks, as well documented by Ibbotson & Associates\*. It is especially noteworthy that micro-caps have provided investors with both higher highs and higher lows. Our analysis of all seventy-one 20-year rolling return periods from 1926-2015 shows that for investors with a 20-year time horizon, micro-caps provided the higher maximum annualized return (24.1%) as well as the higher minimum annualized return (6.1%) when compared to small- and large-caps as the chart below illustrates.

### MICRO-CAPS PROVIDE HIGHER HIGHS AND HIGHER LOWS 20-Year Rolling Return Periods

Jan. 1, 1926 - Dec. 31, 2015



Source: Ibbotson & Associates Stocks, Bonds, Bills and Inflation Yearbook, 2015 + FRP and FactSet.  
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**Low correlations to other assets:** Micro-cap equities have historically had low performance correlation to both large- and small-cap stocks, providing significant diversification benefits to client portfolios. As an example, over the past 25 years, The Perritt MicroCap Opportunities Fund (one of three funds offered) has provided a correlation of 0.57 versus the S&P 500 Index, as well as a correlation of 0.84 to the Russell 2000 Index of small-cap equities.

**A liquid option to invest in smaller companies:** Perritt Capital Management's MicroCap Opportunities Fund managers buy companies and management teams based on strong conviction and invest in them for the long haul. As a result, similar to venture capital and private equity, the potential for gains can be great. It is possible for the top performing stocks in a micro- or small-cap portfolio to double or even triple in value in a single year. In 2015, the Perritt Ultra MicroCap Fund had 3 stocks double in value, and 11 gained more than 50%. The downside on single micro-cap stocks can be just as significant, however a disciplined selling process can help mitigate the effect one poor investment has on an entire portfolio. Micro-cap funds like the Perritt MicroCap Opportunities Fund and the Perritt Ultra MicroCap Fund also have daily liquidity, unlike private equity funds which may lock up capital for months or years.

**Merger & Acquisition (M&A) opportunities:** Healthy, growing small- and micro-cap companies

are often targets for acquisition by larger companies. In fact, since 1993, more than half of all public M&A transactions involved micro-cap equities.\*\* As a result, we believe there are far more unrecognized opportunities in this asset class. Typically, these sales drive share prices, creating a potential windfall for investors. Specifically, over the past five years between 5% - 9% of the micro-cap companies we held in The Perritt MicroCap Opportunities Fund were acquired — in many cases at a substantial premium.

**Discovering Growth Potential:** The small- and micro-cap universe is vast, comprised of thousands of companies, many of them too small to be followed by Wall Street analysts. As a result, there are far more unrecognized opportunities in this part of the market — and potential to reap the benefit once other investors start to understand the value of these uncovered companies.



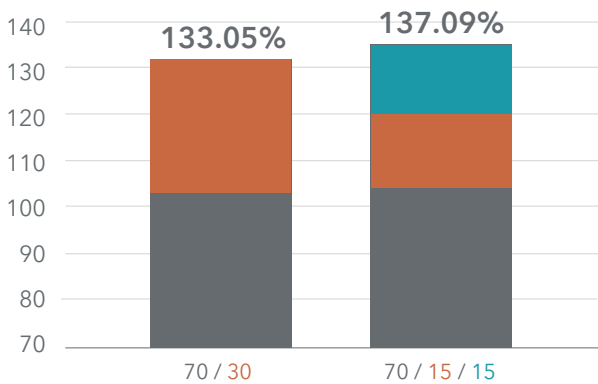
# Portfolio strategies for adding small- and micro-caps

Small- and micro-cap equities are inherently more volatile than large caps, so the higher your clients' allocation to these two sub-asset classes, the more variation in short-term performance can be anticipated. As you might expect, portfolio returns are higher when you substitute micro-cap equities for a portion of the small-cap allocation in a hypothetical portfolio. However, our research shows that as more micro-cap is added to the small-cap allocation, we also see a slight decline in volatility.

The table measures the changes in performance and volatility of a portfolio consisting of 80% large-cap / 20% small-cap when a 10% micro-cap allocation is added. In each of these examples, large-cap is represented by the S&P 500 Index, small-caps by the Russell 2000 Index and micro-caps by the Russell Microcap Index. Return and risk are calculated from 2001 through 2015, which encompasses the entire period in which the Russell Microcap Index has been in existence.

## CHANGES IN PERFORMANCE AND VOLATILITY WHEN ADDING MICRO-CAP 70/30 MIX

1/1/2001 - 12/31/2015



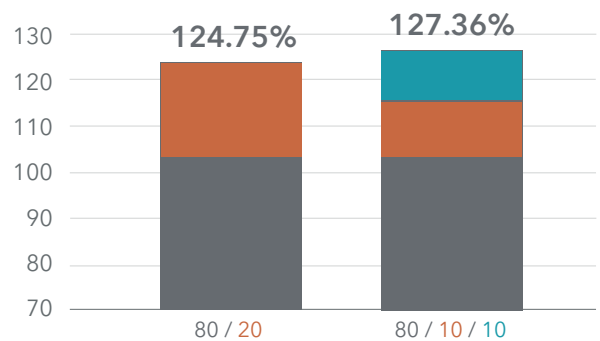
Annualized Returns	6.23%	6.36%
Average Volatility	19.19%	18.89%
Return / Risk	0.325	0.337

■ Large-Cap ■ Small-Cap ■ Micro-Cap

PAST PERFORMANCE DOES NOT GUARANTEE FUTURE RESULTS

## CHANGES IN PERFORMANCE AND VOLATILITY WHEN ADDING MICRO-CAP 80/20 MIX

1/1/2001 - 12/31/2015



Annualized Returns	5.96%	6.04%
Average Volatility	18.80%	18.59%
Return / Risk	0.317	0.325

■ Large-Cap ■ Small-Cap ■ Micro-Cap

PAST PERFORMANCE DOES NOT GUARANTEE FUTURE RESULTS

The same is true for a portfolio that begins with a slightly more aggressive allocation of 70% large-cap stocks and 30% small-cap equities. Returns are enhanced and volatility reduced when a small-cap allocation is complemented with a micro-cap allocation. As seen in the chart, when micro-caps are added to a portion of the small-cap allocation, annual returns increase from 6.23% to 6.36% (as might be expected) and average volatility actually *decreases* modestly from 19.19% to 18.89%.

### Adding Micro-Caps to Small-Caps:

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# Using small- and micro-caps for clients with three different risk profiles

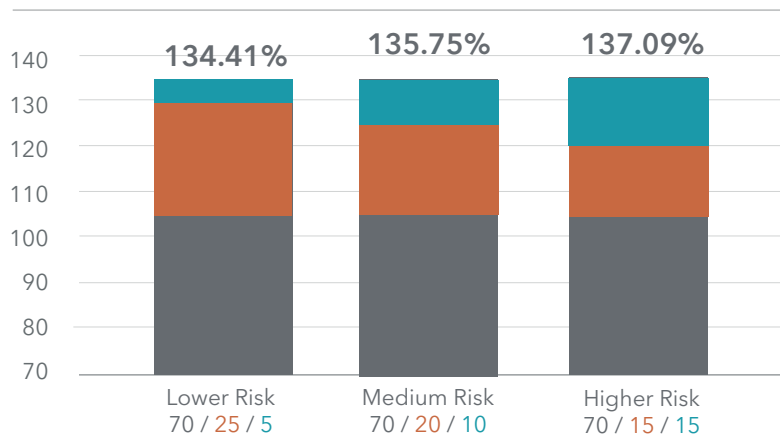
You may think of micro-cap equities as primarily an asset class for investors with a higher tolerance for risk, but in reality, prudent allocations to these investments can potentially enhance returns for even investors with a lower tolerance for risk.

Here are examples of how adding micro-caps can add to returns while modestly reducing volatility in portfolios designed for low risk, medium risk and higher risk.

As these examples show, adding micro-cap equities to the small-cap portion of diversified portfolios can enhance returns while modestly reducing volatility.

## CHANGES IN PERFORMANCE AND VOLATILITY LOWER, MEDIUM AND HIGHER RISK

1/1/2001 - 12/31/2015



Annualized Returns	6.27%	6.32%	6.36%
Average Volatility	19.09%	18.99%	19.24%
Return / Risk	0.329	0.333	0.346

■ Large-Cap ■ Small-Cap ■ Micro-Cap

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### Adding Micro-Caps to Small-Caps:

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# There are a number of factors for you to consider when incorporating micro-caps

## #1. Return

Advisors considering complementing their small-cap allocation with micro-cap equities should understand that while these assets have historically added to returns over the long-term, they have also had variable performance over shorter periods. In the chart you can see the year-by-year performance of each of our three portfolios. Note that the portfolios lost money in five out of 15 years and had double-digit gains in 8 out of 15 years.

### ANNUAL VOLATILITY Large / Small / Micro

Year	70 / 25 / 5	70 / 20 / 10	70 / 15 / 15
2001	21.17%	20.97%	20.77%
2002	24.87%	24.58%	24.28%
2003	16.86%	16.68%	16.49%
2004	12.65%	12.56%	12.47%
2005	11.62%	11.50%	11.37%
2006	11.82%	11.72%	11.61%
2007	16.88%	16.76%	16.64%
2008	41.74%	41.53%	41.29%
2009	29.58%	29.54%	29.50%
2010	19.88%	19.82%	19.91%
2011	25.91%	25.85%	25.80%
2012	13.69%	13.68%	13.66%
2013	11.87%	11.85%	11.83%
2014	12.37%	12.39%	12.41%
2015	15.42%	15.38%	15.34%
Average Volatility	19.09%	18.99%	18.89%
Return / Risk	0.329	0.333	0.337

### ANNUAL RETURNS Large / Small / Micro

Year	70 / 25 / 5	70 / 20 / 10	70 / 15 / 15
2001	-7.04%	-6.40%	-5.75%
2002	-21.28%	-21.06%	-20.83%
2003	34.96%	35.79%	36.63%
2004	12.98%	12.77%	12.57%
2005	4.78%	4.67%	4.57%
2006	16.57%	16.48%	16.39%
2007	3.05%	2.70%	2.35%
2008	-36.15%	-36.45%	-36.75%
2009	26.94%	26.97%	27.00%
2010	18.72%	18.82%	18.92%
2011	0.08%	-0.19%	-0.46%
2012	16.35%	16.52%	16.69%
2013	34.68%	35.00%	35.33%
2014	11.02%	10.96%	10.91%
2015	-0.36%	-0.39%	-0.42%
Total Return	134.41%	135.75%	137.09%
Annualized Return	6.27%	6.327%	6.36%

## #2. Volatility

Volatility is also a concern for advisors considering complementing their small-cap allocation with an investment in micro-cap equities. In the next chart you can see the annual volatility of each of our three portfolios. Note that in every year except two (2010, 2014) annual volatility was actually reduced as micro-cap allocation was increased in the small-cap portion of a portfolio.

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### Adding Micro-Caps to Small-Caps:

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## #3. Return/Risk or potential bang for buck

Our final investment measure shows how well investors are compensated for taking on the additional risks of small- and micro-cap investing. To calculate Return/Risk we simply divided the 15-year annualized returns by the average volatility over the 15 years. That tells us how much return an investor got per unit of risk.

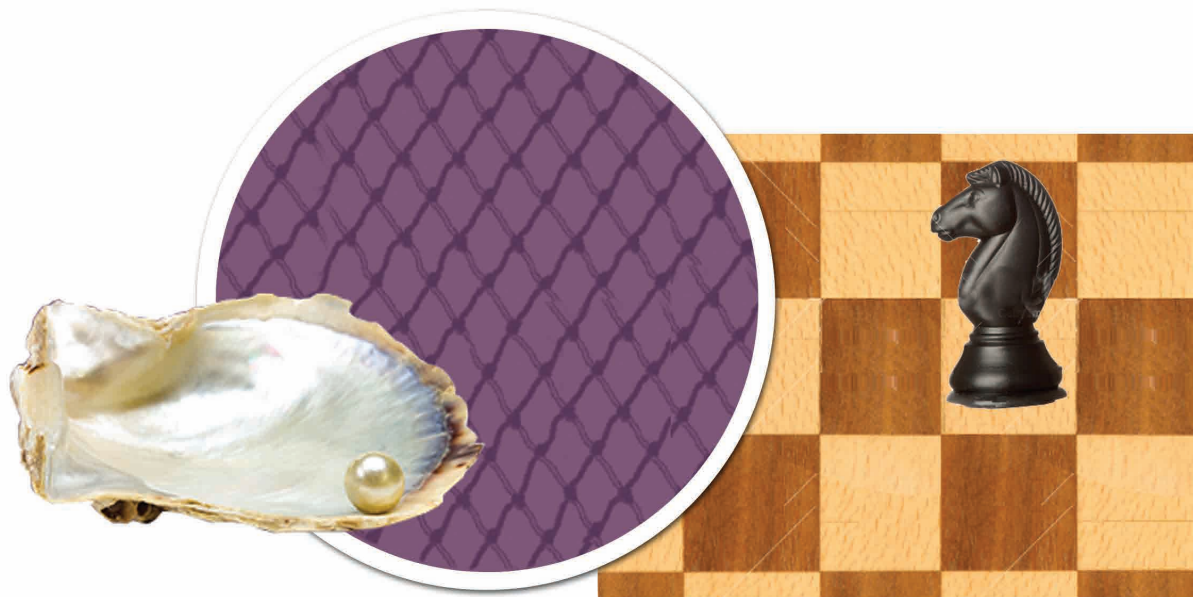
As the chart clearly illustrates, just adding small-caps to an all-large-cap portfolio increases return/risk.

	Large / Small				
	100 / 0	90 / 10	80 / 20	70 / 30	60 / 40
Return / Risk	0.296	0.307	0.317	0.325	0.331

Return/Risk rises slightly further when you add micro-caps to the small-cap allocation.

	Large / Small / Micro				
	100 / 0 / 0	90 / 5 / 5	80 / 10 / 10	70 / 15 / 15	60 / 20 / 20
Return / Risk	0.296	0.311	0.325	0.337	0.346

PAST PERFORMANCE DOES NOT GUARANTEE FUTURE RESULTS



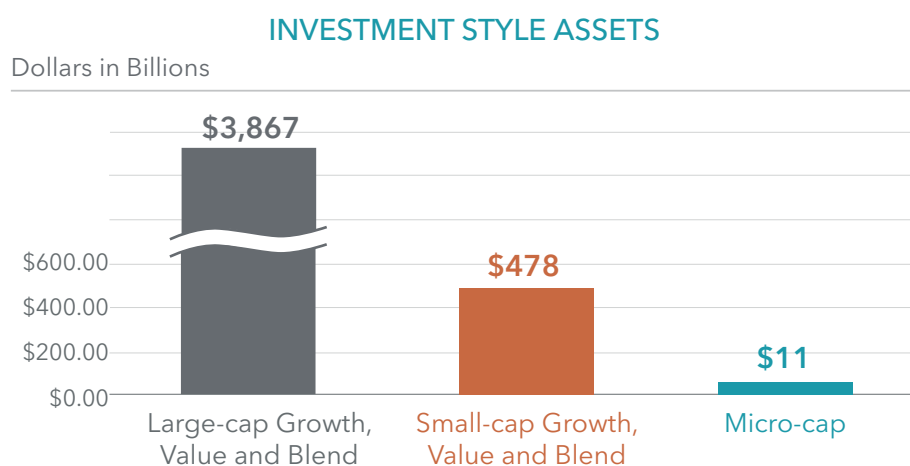
### Adding Micro-Caps to Small-Caps:

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# Differentiate your practice with micro-caps

We believe micro-cap stocks are one of the investment industry's best kept secrets. Many of these companies are not followed by Wall Street analysts. They are generally overlooked by the financial press. Their index, the Russell Microcap, isn't widely tracked or reported. And even more importantly, very few financial advisors offer micro-caps within their core equity asset allocation. Think about it. How many financial advisors in your area include micro-cap funds for their clients?

That means that showing your prospects and clients the benefits of micro-caps – their extraordinary performance potential, their low correlation to other assets, their similarity to less liquid assets – can differentiate you from your peers.



Source: Perritt Capital Management/Morningstar as of 3/31/16  
PAST PERFORMANCE DOES NOT GUARANTEE FUTURE RESULTS

We believe you can set yourself apart by introducing your prospects and clients to micro-caps – and you can take it one step further by choosing Perritt Capital Management's Funds. We have been one of the industry's leading micro-cap investors for over 25 years, offering specialized micro-cap focus and expertise, deep research and a long-term competitive

track record. Adding micro-cap stocks managed by Perritt Capital may provide a strategic advantage in attracting and retaining business. The dynamic asset class has historically provided stronger long-term performance, potentially benefiting the returns for both your clients and your practice.

**Differentiation** can be achieved by advisors that invest the time to understand and implement less mainstream asset classes for their clients' advantage. As with all investments, a long track record with clearly documented empirical evidence of performance and risk are the measures that create the confidence to act.

**Capacity:** Investing in small- and micro-caps successfully requires intensive research into thousands of little-known stocks, so the issue of capacity is an important one. Investment teams have to be cognizant of the maximum

## Adding Micro-Caps to Small-Caps:

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## Answering objections to micro-cap stocks

Despite the benefits outlined on the previous pages, many investors are still hesitant of micro-cap stocks. Here are two common objections we hear from potential investors and how we answer them.

**Lack of liquidity:** It is true that many micro- and small-cap stocks are more thinly traded than S&P 500 stocks. However, they are also far more liquid than some of the asset classes they most closely resemble with no lock-up periods and daily pricing and trading. Moreover recent studies show that illiquidity is, if anything, an added source of return. In a 2008 paper called “Liquidity as an Investment Style\*\*\*,” Zhiwu Chen and Roger Ibbotson found that an investment strategy based on undervalued stocks that were relatively illiquid outperformed all other strategies, including equal weighted and volume weighted index performance. For investors with a long time horizon, we believe illiquidity should be embraced as an opportunity.

The “liquidity premium” earned on micro-cap investments is a cornerstone of our investment philosophy and strategy. We have built trading relationships in the micro-cap space for over two decades allowing us to find unadvertised liquidity when needed. In addition, our process seeks to minimize liquidity risk. We limit single position size to approximately 3% of the portfolio and have an annual turnover ratio that historically has averaged below 50%. While at any given time, single names in the portfolio may be thinly traded, the portfolio as a whole is liquid.

Perritt Capital Management’s funds all have daily pricing and trading.

amount of assets they can invest while still maintaining a strict focus on micro-cap companies. Micro-cap managers who grow too large in assets can be forced to “creep” up the market cap scale and quickly find that their portfolio looks more like a small-cap fund. At Perritt Capital

Management, we place strict limits on fund size – and close funds to new investors when they reach our ceiling for capacity. Although our funds have been closed in the past, they remain open to new investments from select existing investors.

# Choose a Specialist Who Understands the Opportunity



At Perritt Capital Management, we have over 25 years' experience investing in small company stocks.

Our intensive, research-based process begins with a nine-point evaluation — based on balance sheets, cash flow statements and income statements — that determines if a company is acting in the best interests of its shareholders. Top performing companies have strong balance sheets, positive cash flows and expanding profitability. They also typically have a track record for above-average growth in revenue and/or earnings, a relatively low or declining level of long-term debt, a significant percentage of their shares owned by company management, and reasonable price-to-sales ratios, price-to-earnings ratios, and price-to cash flow ratios.

For companies whose fundamentals look favorable based on our evaluation, the next step is to assess broader business prospects. We look for growing, niche companies with innovative products and/or services, and the potential to build brands. During this phase of our analysis, we visit companies and meet with management to gain hands-on knowledge of their business models and growth strategies.

Companies that meet our criteria are then assessed based on valuations, and are considered for purchase if they fall under a range of valuation determinations, including GARP or Deep Value. We use conservative growth estimates to determine valuations. We understand that even the most dynamic companies cannot maintain high double-digit growth indefinitely.

Our funds invest in a diversified portfolio of 100 to 150 small companies, with individual holdings generally restricted to 3% of the fund's assets. Like venture capitalists, we are willing to hold investments over multiple market cycles so that they can reach their full potential. We have a highly disciplined approach to selling companies which includes a market capitalization target of approximately \$3 billion. This helps us to trim profits from our winners and reinvest in smaller, undiscovered companies, keeping the characteristics of our portfolios true to the micro-cap asset class and all of its benefits illustrated here.

For information about Perritt Capital Management's Mutual Funds— including fund prospectuses, performance information and additional white papers— please visit <http://www.perrittcap.com/literature/>.



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## Adding Micro-Caps to Small-Caps:

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## DISCLOSURES

### ANNUALIZED QUARTERLY TOTAL RETURNS (%) AS OF MARCH 31, 2016

	1-YR	3-YR	5-YR	10-YR	20-YR	Since Inception <sup>1</sup>
<b>PLOWX</b> - 16/30/2012	-1.98	9.76	-	-	-	12.99
<b>PRCGX</b> - 14/11/1988	-2.97	5.39	5.03	3.85	9.83	9.05
<b>PREOX</b> - 18/27/2004	-3.08	9.76	4.39	3.16	-	6.22
Russell 2000	-1.52	6.84	7.20	5.26	7.68	
Russell Microcap	-5.44	6.34	6.61	3.18	-	
S&P 500	1.35	11.82	11.58	7.01	7.98	

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 the performance quoted. Performance data current to the most recent month end may be obtained by calling 800-331-8936. The funds impose a 2% exchange and redemption fee for shares held 90 days or less. Performance data quoted does not reflect the redemption or exchange fee. If reflected, total return would be reduced.

Perritt MicroCap Opportunities Fund Expense Ratio: 1.22%

Perritt Ultra MicroCap Fund Expense Ratio: 1.76%

Perritt Low Priced Stock Fund Expense Ratio: gross expense ratio 4.36% and net expense ratio 1.41%

The investment adviser has contractually agreed to waive fees and/or reimburse operating expenses (other than interest, brokerage commissions, dividend expense on short sales, taxes, extraordinary expenses and acquired fund fees and expenses) so that total annual operating expenses are not expected to exceed 1.39% through February 2017.

Performance data quoted of the Low Priced Stock Fund for periods on or prior to 2/28/14 represents past performance of the fund's predecessor, a separately managed account. The fund is the successor to a separately managed account. The investment policies, objectives, guidelines, and restrictions of the fund are in all material respects equivalent to those of the predecessor, and the predecessor's portfolio managers are the current portfolio managers of the fund. However, the predecessor was not a registered investment company. Had the predecessor been registered under the Investment Company Act and been subject to the provisions of the Investment Company Act and the Internal Revenue Code to which the fund is subject, its investment performance may have been adversely affected. The performance information reflects the gross expenses of the predecessor adjusted to reflect the higher fees and expenses of the fund. The performance is shown net of the annual management fee of 1.00% and other expenses. The performance was achieved by the predecessor when assets were relatively small; the same strategies may not be available, and similar performance may not be achieved, when the fund's assets are larger.

Before you invest in the Perritt MicroCap Opportunities Fund, Perritt Ultra MicroCap Fund, or Perritt Low Priced Stock Fund please refer to the prospectus for important information about the investment company, including investment objectives, risks, charges, and expenses. You may also obtain a hard copy of the prospectus by calling (800) 331-8936. The prospectus should be read carefully before you invest.

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 Fund may invest in early stage companies which tend to be more volatile and somewhat more speculative than investments in more established companies. Low Priced stocks are generally more volatile than higher priced securities.

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\*According to Ibbotson & Associates Classic Yearbook 2015 + FRP and FactSet, \$1 invested in micro-cap stocks on January 1, 1926 grew to \$28,831 by December 31, 2015. \$1 invested in small-cap and large-cap stocks grew to \$17,146 and \$5,376 over the same time period. Micro-cap stocks defined as the bottom two deciles of securities ranked by market capitalization from 1926-2015. Small-cap stocks defined as deciles 6-8. Large company stocks are represented by the S&P 500 Index. S&P 500 is an unmanaged index which is widely regarded as the standard for measuring large-cap U.S. stock market performance. An investment cannot be made directly in an index. Past performance does not guarantee future results.

\*\*Source: Furey Research Partners.

\*\*\*Source: "Liquidity As An Investment Style," *Financial Analysts Journal*, Roger G. Ibbotson, Zhiwu Chen, Daniel Y.-J. Kim, and Wendy Y. Hu, Volume 69, Number 3, 2013 October/November 2012. For more information [click here](#).

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 Russell 2000 Index consists of the smallest 2,000 companies in a group of 3,000 U.S. companies in the Russell 3000 Index, as ranked by market capitalization. The Russell Microcap index is a capitalization weighted index of 2,000 small-cap and micro-cap stocks that captures the smallest 1,000 companies in the Russell 2000, plus 1,000 smaller U.S.-based listed stocks. You cannot invest directly in an index.

**Private Equity** is capital that is not quoted on a public exchange. Private equity consists of investors and funds that make investments directly into private companies or conduct buyouts of public companies that result in a delisting of public equity. The majority of private equity consists of institutional investors and accredited investors who can commit large sums of money for long periods of time. Private equity investments often demand long holding periods to allow for a turnaround of a distressed company or a liquidity event, such as an IPO or sale to a public company. Active micro-cap portfolios invest in companies that are often targeted by private equity investors due to their business characteristics and small market capitalizations. However active micro-cap portfolios only invests in companies that are listed on public exchanges.

**Volatility** is defined as Standard Deviation, which is a statistical measure of the historical volatility of price or portfolio using 12 monthly returns.

**Average Volatility** is defined as the average annual volatility from 2001-2013 for the large-cap, small-cap and micro-cap allocations.

#### **Differentiating Private Equity and Venture Capital**

Private Equity typically invests a large sum in an existing company with existing products and cash flows, then restructures that company to optimize its financial performance. When private equity works, it can turn around a poorly-performing company and turn it back into a profitable, and even growing enterprise.

Venture Capital typically invests in a start-up firm, or a growing, but still very small company that is seeking capital for both survival and growth. Many venture investments require follow-up on investments for these early life-cycle stages of growing firms. These investments are assigned letters, such as series A, B, and so on.

**Diversification does not assure a profit nor protect against loss in a declining market.**

The Perritt Funds are distributed by Quasar Distributors, LLC.

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