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and Portfolio Manager**



Perritt MicroCap Opportunities
Perritt Ultra MicroCap

In times like today, it is sometimes too easy to become swallowed by negative news and prevailing pessimism about the economy. Yet we consider ourselves fortunate to have the ability to meet with 3-5 management teams of small companies every week inside our offices. The perspectives we have gained from these on-the-ground entrepreneurs is often much different from what you read in the headlines. Here we pass along some of the opportunities we are uncovering during our analysis and meetings with company management. If you read closely you will find that in the Small/Micro-cap universe the facts counter many common misperceptions.

Q Opportunity Now: Reasons For Small Company Optimism

Our clients understand that micro-cap equity is an asset class where active managers can provide great value. The lack of traditional Wall Street Analyst coverage leads to price inefficiencies and potential trading advantages that don't always exist in the more closely-followed sectors. **Yet as of the end of June, from what we have seen, active management in the micro-cap space appears to have lagged.** As seen, micro-cap benchmark returns have been concentrated in a small number of Biotech and Regional Banking firms where many active managers (including ourselves) don't observe compelling trade-off between risk and reward.

Fast Facts: Russell Microcap Index YTD Performance 13.01%

Sector Contribution		Security Contribution	
Biotechnology	2.66%	Parmacyclics Inc.	0.73%
Commercial Banks	1.82%	Arena Pharmaceuticals, Inc.	0.53%
		Inhibitex, Inc.	0.46%
Total:	4.48%	Total:	1.72%
	(34.4% of return)		(13.2% of return)

Source: Capital IQ

As of 6/30/12

"Micro-cap benchmark returns have been concentrated in a small number of Biotech and Regional Banking firms where many active managers (including ourselves) don't observe a compelling trade-off between risk and reward"

Lack of Confidence in the Economy

Opportunity: Capital Allocation Moving In Right Direction

The changing “Cash Attitudes” of small company management teams that we have discussed in the past is ongoing, and management teams have been utilizing their cash and balance sheets to expand businesses and enhance shareholder value. **As seen in the table below, the median debt/asset ratio of companies in our MicroCap Opportunities Fund has steadily increased over the past year.** This is the proper action in most cases because the cost of capital is at record lows and tactical opportunities for growth exist. Note that an 8.4% median debt/asset ratio is not an excessive level for a portfolio– the low amount of leverage is a result of our focus on companies with fundamentally sound balance sheets. What is important to observe here is the trend. We applaud the many companies in our portfolio who are driving capital allocation in the right direction.

With New Confidence Small Companies Now Allocating Capital

	1Q2011	2Q2011	3Q2011	4Q2011	1Q2012
PRCGX Median Debt/Asset Ratio	1.1%	2.7%	3.3%	4.7%	8.4%

High Margin Levels Unsustainable

Opportunity: Pricing Power Lets Many Small Companies Continue Margin Expansion

It seems to be a common belief that margin expansion is at its peak. However, this is not always true in the types of small, niche businesses that possess more nimble pricing power than their larger, more diversified peers. The decline of input costs related to falling commodity prices is another often overlooked part of the peak margin story. For example, John B. San Filippo & Son (JBSS) (maker of Fisher Nuts) consistently raised prices during a recent cycle where raw nut prices were steadily increasing. Roughly speaking, in a typical period where JBSS’s revenue was growing at 5%, prices were increasing by 10% while sales were down 5%. Knowing that this is a cyclical business, we were pleased when our investment thesis was proven correct and positive sales growth returned. Today, JBSS’s business is growing and nut prices are beginning to come down. Yet those higher prices the company set will be sticky, helping to potentially increase margins. Despite increasing over 100% this year, we continue to believe JBSS has upside potential; even after the substantial increase in share price JBSS is still trading below book value.

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Small Company Equities Bound to General Market Trends

Opportunity: Event Driven Stories Historically Provide Uncorrelated, Hockey Stick Opportunities

Lower correlation to the general market can be one of the major benefits of investing in micro-cap companies. With fewer analysts covering micro-cap names, a natural result is that price movements don't always move in lockstep with the market. A second reason why micro-cap equities are uncorrelated is related to event-driven movements, or what we like to call hockey-stick opportunities. Micro-cap companies often have a concentrated list of customers or business lines (a key reason why we hold 100+ companies in our portfolios). As a result, when a micro-cap company wins a new business contract or a new customer it can have large and immediate implications for the share price, regardless of current market trends. For example, Iteris, Inc. (ITI), a company that builds intelligent traffic systems, is a likely beneficiary of the recently signed Highway Transportation Bill. After nearly three years of temporary extensions, the bill provides \$105 billion of funding over the next two years for transportation projects such as Iteris' technology. ITI jumped 25% in a short period following the run-up to the announcement. Long term, we remain confident in ITI, which has a market capitalization of 50 million, trades at less than 1.0 x sales and has a clean balance sheet with \$19 million in cash.

Attribution Analysis

As discussed earlier, much of the micro-cap Index performance this year has been driven by concentrated returns in a small number of Biotech and Regional Banking firms. In our MicroCap Opportunities Fund, Healthcare (which includes Biotechnology) was the largest sector detractor from performance, contributing -1.50% to relative performance. In addition, our portfolios are currently invested with a cyclical bias in energy, technology, and industrial companies. This is wholly a result of our bottom-up analysis and our conviction that the greatest upside opportunity in micro-cap space can currently be found in cyclical companies.

However, more cyclical investments have suffered due to a general flight to liquidity most of this year. Along with the aforementioned Healthcare sector, three of the top four sector detractors to performance were in fact Energy, Technology, and Industrials.

Stock selection has had a greater positive impact on the Ultra MicroCap Funds' performance than seen in the MicroCap Opportunities Fund this year. This is not surprisingly considering we are investing in companies which are so far off the traditional radar; the current median market capitalization is approximately \$50 million. One of our top performing holdings, U.S. Home Systems (USHS), provides customized kitchen and bathroom remodeling for Home Depot customers. USHS increased nearly threefold in a matter of two months on what was essentially market speculation about the recovery in U.S. housing. This type of "irrational buying" demonstrates the potential upside of investing in less liquid securities that many investors may overlook when focusing only on the risk to the downside of investing in micro-cap companies. Having experienced this type of short-term investor behavior many times before, we reduced our position by half before the stock returned to more normalized prices. USHS's business is still growing and at today's more modest price we believe that future earnings could equal a P/E in the mid single-digits.

Small/Micro-Cap Universe* Performance By Market Capitalization

Market Cap Range	Number of Stocks	Median Return
\$2B+	218	-0.1%
\$500-2B	1053	6.7%
\$150-500M	955	6.3%
<\$150M	1126	8.5%

*Small/Micro-cap universe includes all equities listed in the Russell 2000 & Russell Microcap Indexes plus an approximate 1,000 U.S. listed micro-cap equities not listed in the Indexes.

12/31/11-6/30/12 Source Capital IQ



The information provided herein represents the opinion of Perritt Capital Management and is not intended to be a forecast of future events, a guarantee of future results, nor investment advice.

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.perrittmutualfunds.com. Read carefully before investing.

As of 6/30/12, The Perritt MicroCap Opportunities Fund nor the Perritt Ultra MicroCap fund held a position in Pharmacyclics Inc. (PCYC), Arena Pharmaceuticals, Inc. (ARNA), Home Depot (HD) or Inhibitex, Inc. (INHX). The Perritt MicroCap Opportunities Fund held a 1.7% position in JBSS and no position in ITI or USHS. The Perritt Ultra MicroCap Fund held a 1.7% position in JBSS, a 1.06% position in USHS and a 1.0% position in ITI. Fund holdings and sector allocations are subject to change and are not recommendations to buy or sell any security.

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 than larger companies. The Funds invest in micro cap companies which tend to perform poorly during times of economic stress. The Ultra MicroCap may invest in early stage companies which tend to be more volatile and somewhat more speculative than investments in more established companies.

Past performance is not a guarantee of future results. Index performance is not illustrative of fund performance. One cannot invest directly in an index. Please call 1-800-331-8936 for fund performance.

Total Debt to Total Asset Ratio is a metric used to measure a company's financial risk by determining how much of the company's net assets have been financed by debt book value is the total value of the company's assets that shareholders would theoretically receive if a company were liquidated. Correlation is a statistical measure of how two securities move in relation to each other. Price to Earnings Ratio is a valuation ratio of a company's current share price compared to its per-share earnings.

The Perritt Funds are distributed by Quasar Distributors, LLC



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