



Michael Corbett
Chief Investment Officer
Portfolio Manager



Where's the Breadth? A Closer Analysis of a Strong Year for MicroCap

The year 2012 is now in the history books, and while returns in the small/micro-cap space were certainly a pleasurable read, we are also reminded of the old advice “don’t judge a book by its cover.” Despite our strong returns over the past year for both of The Perritt Funds, we believe that more opportunity may exist in our space. Valuations appear attractive, small businesses are growing, and an analysis of underlying index returns reveals how the small/micro-cap universe has not had the kind of broad-based run that has historically provided the best return environment for active managers.

The 2012 return of the Russell Microcap Index was concentrated in a small number of sectors and securities, as we detailed in our last commentary. At year end, more than 35% of the Index’s return was due to the contribution of just two sectors: Biotechnology and Commercial Banks/Thrifs. The trend that a relatively small number of companies are driving the returns of the small/microcap space is more pronounced as you go down the market-cap scale. As shown in the table below, when

we look beyond the Index and take a close analysis of our proprietary small cap universe, the advance/decline ratio was 1.5 or lower among companies with a market capitalization of \$500 million and under. Historically, during a robust and healthy advance for micro-cap equities, this number has generally been much higher.

If we are to see the kind of improved breadth among micro-cap companies associated with a healthy advance, what will spark the investor confidence needed to get us there? One potential answer is the continued improvement of Cash Attitudes among management teams. We saw very healthy use of cash by companies in our portfolios at the end of 2012, although not in the way we predicted. More than 10% of companies in each of our Funds paid a special dividend at the end of last year.

SMALL/MICRO-CAP UNIVERSE* RETURN BY MARKET CAPITALIZATION

Market Cap Range	#Positive Return	#Negative Return	Advance/Decline	Average Return
\$2B+	128	92	1.4	4.16%
\$500-2B	715	382	1.9	13.11%
\$150-500M	589	408	1.4	11.39%
\$<150M	694	475	1.5	18.24%

{ Perritt Universe

1/1/12- 12/31/12

*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.

"...the small/micro-cap universe has yet to have the kind of broad-based run that has historically provided the best return environment for active managers"



In fact, the Perritt MicroCap Opportunities Fund received 150% more dividend income during the last two months of the year than during the first ten months, primarily due to special dividends. Management teams decided to pay special dividends in large part because of the imminent tax increase on dividends (most of the companies we invest in have high insider ownership). Dividend payouts were also related to high levels of cash on balance sheets, which is a result of our process of investing in financially sound small companies.

The unparalleled payout of special dividends we saw last year is a shareholder-friendly action that we believe should bring positives to the capital structure of many micro-cap companies we invest in. First and foremost, small companies continue to improve their top and bottom lines. However, the excess cash held by many of the companies in our portfolio has driven down returns on equity, negatively affecting the P/E ratio investors are willing to pay. For example, RCM Technologies (RCM) is a company we own which has been in the \$5.00-6.00 range while having \$2.50 in cash per share. In December, RCM paid a special dividend of \$1.00 per share, equal to one-sixth of its stock price, which will also increase the company's ROE by a similar amount. With a lower shareholder equity number, the company's future growth will show a greater improvement in ROE with less cash on hand. In the case of many micro-cap companies which fly so far under the traditional Wall Street radar, these kinds of actions can be the catalyst which sparks interest in the underlying business quality which has in fact been there all along.

We can't finish without a mention that the Russell 2000 Index has reached a new all time high and a discussion of what this might mean for small/micro-cap investors. In our view this is again related to the issue of breadth. That the Russell 2000 Index has reached new highs despite the fact that returns have been concentrated in a small number of names indicates that there may be opportunity for a more broad-based advance. Having avoided the 'fiscal cliff' and with tax changes now settled, many management teams that we have met with are saying that uncertainty is declining, allowing them to better plan and execute their growth strategy. Smaller company stocks tend to demonstrate serial correlation, meaning that strong performance has historically been followed by periods of similarly strong performance. We will outline serial correlation in a new research paper later in the first quarter.

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**"CASH ATTITUDES"
OF HOLDINGS PAYING DIVIDENDS**

	PRCGX	PREOX
# of Holdings Paying Dividends	107 28 of 107 (26.2%)	101 23 of 101 (22.8%)
# Paid Special Dividends	12 of 107 (11.2%)	11 of 101 (10.9%)
		As of 12/31/12

COMPANY BUY-OUTS AS A PERCENTAGE OF PORTFOLIO**

	2012	2011	2010	2009	2008	2007
PRCGX	10 of 111 (9.0%)	6 of 125 (4.8%)	12 of 132 (9.2%)	9 of 122 (7.4%)	8 of 135 (5.9%)	14 of 165 (8.5%)
PREOX	8 of 103 (7.8%)	9 of 125 (7.2%)	10/148 (6.8%)	2 of 151 (1.3%)	8 of 143 (5.6%)	8 of 181 (4.4%)

**Based on the average number of portfolio holdings during the calendar year



ATTRIBUTION ANALYSIS

Performance as of 12/31/12 (Annualized %)	1 YR	3YR	5YR	10YR	15YR	Since Inception
MicroCap Opportunities Fund (PRCGX)	16.87%	8.75%	0.86%	10.37%	8.46%	9.01% (4/11/88)
Ultra MicroCap Fund (PREOX)	11.79%	10.40%	2.27%	-	-	4.27% (8/27/04)
Russell 2000 Index	16.35%	12.25%	3.56%	9.72%	5.89%	9.00% (4/11/88)
Russell Microcap	19.74%	11.88%	1.46%	8.42%	-	4.41% (8/27/04)

Perritt MicroCap Opportunities Fund Expense Ratio: 1.23%

Perritt Ultra MicroCap Fund Expense Ratio: 1.66%

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 1-800-331-8936. The funds impose a 2% redemption fee for shares held less than 90 days. Performance data quoted does not reflect the redemption fee. If reflected, total return would be reduced.

MICROCAP OPPORTUNITIES FUND (PRCGX)

- The MicroCap Opportunities Fund gained 2.78% versus 1.85% for Russell 2000 Index and 0.04% for the Russell MicroCap Index during the fourth quarter. For the year the Fund returned 16.87% versus 16.35% and 19.74% for the Indexes, respectively.
- Stock selection was strong for the year, contributing 5.82% to relative returns versus the Russell 2000 Index and 4.12% versus the Russell MicroCap Index. Six of the Fund's nine equity sectors added to relative performance (one sector, Telecom, had no impact).
- Stock selection was most pronounced in the Health Care and Financials sectors. Returns in the Health Care sector were driven by a nearly 100% return in top 5 holding BioScrip (BIOS). Financials returns were strong across the board, with over 75% of Financials holdings contributing to absolute returns.
- Despite the fact that Financials names we did invest in worked well, overall strength in the Financial sector overall detracted from our relative performance due to our significant underweight relative to the Index. Nearly 30% of the Russell MicroCap Index is now allocated to Financials. As discussed previously, more than 35% of the return of the Russell Microcap Index was concentrated in a small number of Biotech, Regional and Thrift Banking and stocks.

ULTRA MICROCAP FUND (PREOX)

- The Ultra MicroCap Fund gained 1.91% versus 0.04% for the Russell MicroCap Index during the second quarter. The Fund returned 11.79% for the year versus 19.70% for the Index.
- We always stress the difficulty of comparing this fund to a benchmark as it invests in companies far below the traditional radar, as demonstrated by its median market capitalization of just \$50 Million (the lowest of all 8,163 equity Funds, according to Morningstar as of 1/28/12).
- Overall stock selection was positive, contributing 3.45% to relative performance for the year. The best performing investment was John B Sanfilippo & Son's (JBSS), maker of Fisher Nuts. After trading at 0.1 times sales and 0.5 times book value earlier in the year JBSS began to gain traction after price increases took hold and margins expanded. We continue to be long term investors in JBSS and remain confident in this management team.
- Stock selection gains were outweighed by negative contribution from holdings in the Technology and Materials sectors, both in terms of stock selection and sector allocation. Our relative overweight in Technology companies demonstrates our conviction in the strong upside opportunities currently found in more cyclical industries, especially in the sub-\$50 million market cap range.

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 12/31/12, The Perritt MicroCap Opportunities Fund held a 0.81% position in RCM, a 1.94% position in BIOS and a 1.74% position in JBSS. The Perritt Ultra MicroCap Fund held a 0.93% position in RCM, a 1.61% in JBSS, and no position in BIOS. Fund holdings and sector allocations are subject to change and are not recommendations to buy or sell any security.

ROE is the amount of net income returned as a percentage of shareholders equity. Price to Earnings Ratio is a valuation ratio of a company's current share price compared to its per-share earnings. Correlation is a statistical measure of how two securities move in relation to each other. 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. It is not possible to invest directly in an index.

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.

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