



Michael Corbett,  
Chief Investment Officer  
Portfolio Manager

### SURPRISE!

The fourth quarter and 2016 brought several surprises to investors. Fortunately, many of those surprises were *positive*. The first surprise came earlier last year when the British decided to exit the Euro (Brexit). While initial market reaction was negative, the proceeding weeks that followed was a strong rally for equity investors around the world. The next surprise occurred in the fourth quarter when Donald Trump won the Presidential election and the Republicans swept control of Congress. Once again, the initial market reaction was negative, but the stock market rebounded by more than 10% in less than two weeks from the low on election day. While it makes intuitive sense that the stock market would rally, I believe most investors were surprised by the rally, particularly the degree of the rally.

As you can see from the table below, the fourth quarter and year were very fulfilling for investors. As measured by the S&P 500 Index, large stocks rose 3.82% in the quarter and finished up nearly 12% for the year. For the first time since 2013, small stocks Trumped (sorry I couldn't resist) large stocks. As measured by the Russell 2000 and the Russell Microcap Indexes, smaller stocks rose 8.83% and 10.05% in the quarter and 21.31% and 20.37% for the year, respectively. These results were a surprise to most strategists, including yours truly! While we expected a positive return for smaller stocks and better performance relative to larger stocks, the surprise was a return greater than 20% in both indexes for the year.

### INDEX PERFORMANCE

	TOTAL RETURN 12/31/2016	
	4th Quarter 2016	2016 YTD
S&P 500 Index	3.82%	11.96%
Russell Microcap Index	8.83%	21.31%
Russell 2000 Index	10.05%	20.36%

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

The strong results last year were certainly a nice surprise, but it does concern us that we might be borrowing returns a bit from the future. The Russell 2000 Index trades at more than 20 times earnings, which is the highest level since 2001. However, **earnings growth is expected to be near 15% and could be much higher** if Trump is successful in lowering corporate taxes. Another concern is that if the Federal Reserve hikes interest rates too aggressively, it could slow economic growth. The bottom line is the strong rally in the past year might be priced in the market already.

As we have said, this past year has been full of surprises, and it wouldn't surprise us if next year was similar. For many strategists, the ritual of predicting the future is just an ego trip. As Benjamin Graham inferred, forecasting where the markets will be a year from now is nothing more than rank speculation. We prefer to focus on what we view as quality companies for our funds and review history as a guide of how the future may be formed.



The table below is the annual performance of the S&P 500 Index, the Russell 2000 Index and the delta of these indexes performance. Small stocks tend to perform in streaks. That is, once they perform well in one year, they tend to perform well for several years. Since last year was the first-year small stocks outperformed in a couple years, we believe the odds are above average for another strong year in 2017 for small stocks. We outline this small stock performance lesson in a white paper entitled *Deja vu All Over Again: Serial Correlation and Micro-Cap Equities*. Please check our website for the full report.

YEAR	S&P 500	Russell 2000	DELTA
2006	15.79	18.37	2.58
2007	5.49	-1.57	-7.06
2008	-37.00	-33.79	3.21
2009	26.46	27.17	0.71
2010	15.06	26.85	11.79
2011	2.11	-4.18	-6.29
2012	16.00	16.35	0.35
2013	32.39	38.82	6.43
2014	13.69	4.89	-8.80
2015	1.38	-4.41	-5.79
2016	11.96	21.31	9.35

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Finally, according to Investment Company Institute, we estimate that investors have pulled nearly \$1 trillion from domestic equity mutual funds and domestic ETFs since 2005. This level of investor redemptions is unprecedented. Since Trump's election though, investors have started pouring money back into domestic funds. We estimate that investors have purchased more than \$25 billion of domestic mutual funds and ETFs in the past two months. We believe the 2017 surprise could be that individual investors continue that buying frenzy of domestic equities, which could help power equity prices higher again.

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.

***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 Ultra MicroCap Fund and Low Priced Stock 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.***

**Russell 2000 Index** is an index that measures the performance of approximately 2,000 small-cap companies in the Russell 3000 Index, which is made up of 3,000 of the biggest U.S. stocks. **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. **S&P 500 Index** is an American stock market index based on the market capitalizations of 500 large companies having common stock listed on the NYSE or NASDAQ. It is not possible to invest directly in an index. **Delta** is the ratio comparing the change in the price of the underlying asset to the corresponding change in the price of a derivative

[Click here](#) for a current prospectus. Fund holdings and sector allocations are subject to change at any time and should not be considered a recommendation to buy or sell any security. Click here for the Funds' top 10 holdings: [PLOWX](#), [PREOX](#), and [PRCGX](#).

**Earnings growth is not representative of the fund's future performance.**

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