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## Why Invest In Micro-Cap?

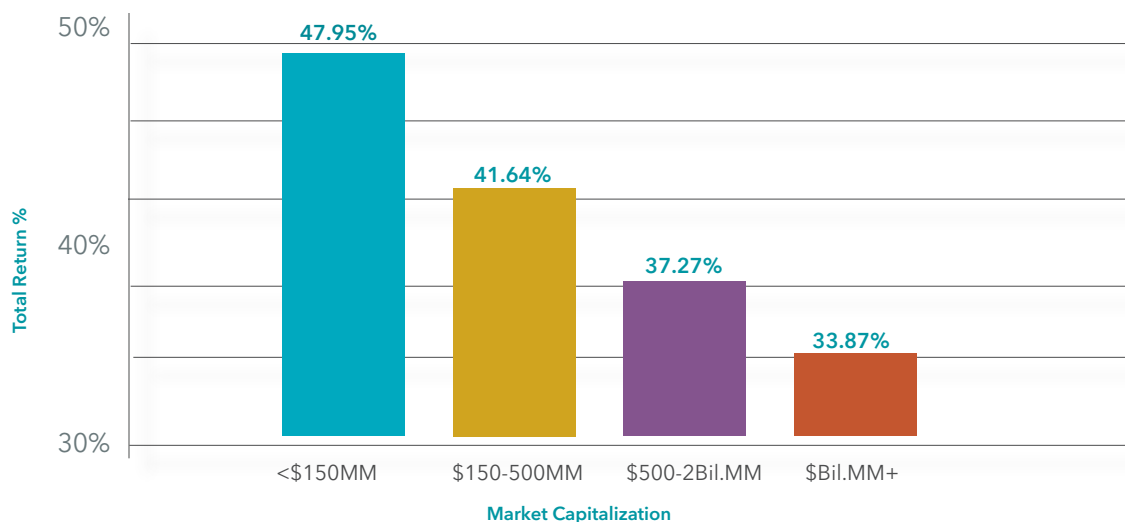
### NUMBERS SPEAK LOUDER THAN WORDS: 2013 REVIEW

"Why should I include micro-cap as part of my small-cap allocation?" It is a question we hear often from investors. The answer is that, since 1926, micro-cap investments have increased the return and reduced correlation within a diversified portfolio (as documented by Rolf Banz & Ibbotson & Associates<sup>1</sup>). Ask an investor to consider the benefits shown in 87 years of data, however, and you'll quickly see their eyes begin to glaze over. The rewards of investing in micro-cap are easier to understand when you look closely at a period when micro-caps began to perform well. Last year was certainly part of this cycle, as we will see below:

#### Smaller Was Better: Lowest Market Cap's Provided Best Returns

The chart below illustrates why we believe it makes sense to include micro-cap within a small-cap allocation.

#### SMALL/MICRO-CAP PERFORMANCE BY MARKET CAPITALIZATION 2013 RETURNS



*The Small Cap Universe is a composite index of the constituents of the Russell 2000 Index, Russell Microcap Index, and all other publicly traded companies that are 1) listed on a major US exchange, 2) is a stand-alone operating company, 3) and has a market cap between \$25mm-\$3,000mm, at the beginning of the calendar year.*

Source: Capital IQ

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## Active Management Makes A Micro-Cap Comeback

We believe that the inefficiencies that exist in the micro-cap asset class make it a good place for active management. After a few years where active management lagged, the trend shifted in 2013. With certain companies becoming too expensive in our opinion (and the Russell Microcap Index's nearly 30% weight to Financials), we believe this trend can continue.

| Performance as of 12/31/13 (Annualized %) | YTD    | 3 YR   | 5 YR   | 10 YR | 20YR   | Inception       |
|-------------------------------------------|--------|--------|--------|-------|--------|-----------------|
| MicroCap Opportunities Fund (PRCGX)       | 46.26% | 14.13% | 23.53% | 9.15% | 11.51% | 10.26% (4/1988) |
| Ultra MicroCap Fund (PREOX)               | 56.34% | 14.81% | 27.58% | -     | -      | 8.90% (8/2004)  |
| Russell 2000 Index                        | 38.82% | 15.67% | 20.08% | 9.07% | 9.27%  | 10.03% (4/1988) |
| Russell Microcap                          | 45.62% | 16.52% | 21.05% | 6.99% | -      | 8.91% (8/2004)  |

Perritt MicroCap Opportunities Fund Expense Ratio: 1.27%

Perritt Ultra MicroCap Fund Expense Ratio: 1.85%

*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.*

## 80/20 Rule: Big Winners Drive Returns

As is usually the case in micro-cap investing, the investments that worked best accounted for much of the overall return. By the end of the year, we had taken profits on all of the below names to reinvest in what we believe could be next year's winners.

### TOP 10 TOTAL RETURNS OF 2013

| PERRITT MICROCAP OPPORTUNITIES FUND    | RETURN  | PERRITT ULTRA MICROCAP FUND            | RETURN  |
|----------------------------------------|---------|----------------------------------------|---------|
| Anika Therapeutics Inc. (ANIK)         | 283.90% | Quadrant 4 Systems Corp (QFOR)         | 700.00% |
| USA Truck, Inc. (USAK)                 | 281.45  | Liberator Medical Holdings Inc. (LBMH) | 343.38  |
| Medical Action Industries, Inc. (MDCI) | 218.22  | WidePoint Corp. (WYY)                  | 343.24  |
| Addus HomeCare Corporation (ADUS)      | 214.07  | Dot Hill Systems Corp. (HILL)          | 259.47  |
| Motorcar Parts of America, Inc. (MPAA) | 193.76  | Addus HomeCare Corporation (ADUS)      | 214.07  |
| MFRI, Inc. (MFRI)                      | 153.09  | Hennessy Advisors, Inc. (HNNA)         | 171.73  |
| Aceto Corp. (ACET)                     | 152.93  | Speed Commerce, Inc. (SPDC)            | 162.36  |
| Atlas Financial Holdings, Inc. (AFH)   | 147.39  | Digital Ally, Inc. (DGLY)              | 158.33  |
| Barrett Business Services, Inc. (BBSI) | 145.76  | MFRI, Inc. (MFRI)                      | 153.09  |
| Virtusa Corp. (VRTU)                   | 131.83  | Atlas Financial Holdings, Inc. (AFH)   | 147.39  |

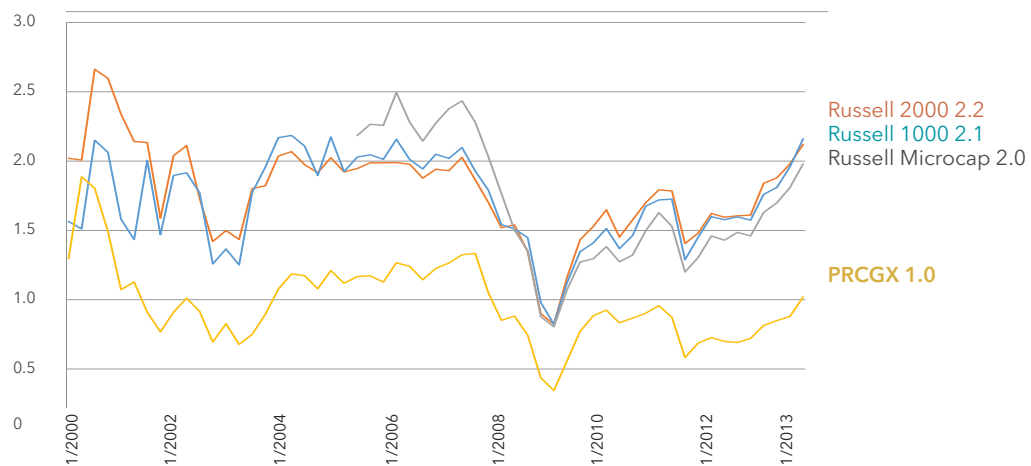
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## Valuations Still Below Recent Highs

Price-to-Sales Ratios for are still below recent highs. For a more detailed analysis of recent valuations see our recent research paper: [Are Micro-cap stock valuations high or low? Maybe both.](#)

### PRICE TO SALES STILL BELOW RECENT HIGH



Source: Capital IQ and Perritt Capital Management

## ATTRIBUTION ANALYSIS

### MICROCAP OPPORTUNITIES FUND (PRCGX)

- The MicroCap Opportunities Fund gained 46.26 for the year, outperforming both the Russell 2000 and the Russell Microcap Indexes.
- Stock selection was the key driver of outperformance. As seen in the table above, stock selection accounted for nearly 20% of relative performance. This is largely attributed to the 80/20 rule as discussed in this commentary.
- Stock selection was most pronounced in the Financials and Health Care sectors. Bank of the Internet (BOFI) and Virtus (VRTS) were financials positions which were sold due to valuations after gaining 129% and 93% for the portfolio, respectively. Two of the Fund's top five performing investments were Health Care related: Addus (ADUS, 214% return) and Anika (ANIK, 284%).
- Stock selection accounted for positive relative returns in 8 out of 9 sectors, indicating that our bottom-up investment process was certainly a success in 2013.
- While our allocation effect was negative in all but 3 sectors (Financials, Industrials, and Utilities) we believe this emphasizes the fact that we are not closet indexers and look to invest in opportunities with out regard to the Index's weighting.

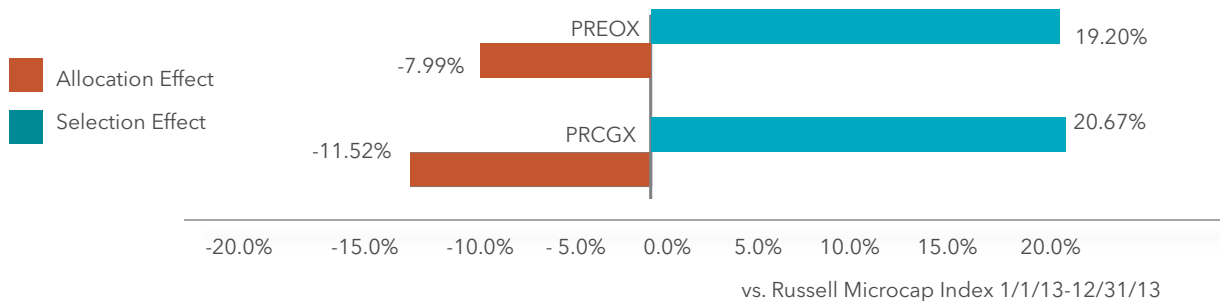
### ULTRA MICROCAP FUND (PREOX)

- The Ultra MicroCap Fund gained 56.34% in the year, versus 45.62% for the Russell MicroCap 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 \$79 Million (as of 12/31/13).
- Stock selection accounted for nearly 20% of relative outperformance. Financials and Technology were the best performing sectors.
- The top five contributors added 12.3% to the fund's return while the bottom five detracted only 3.7%. This illustrates how our diversified approach of holding 100+ names and starting positions at just 0.5% -1.0% of the portfolio can provide downside protection.
- True to our philosophy when launching this strategy, the fund has tended to behave differently than the markets this year, as seen in the beta vs. the Russell microcap of 0.71 & r-squared of 0.74.

## STOCK SELECTION DRIVES OUTPERFORMANCE



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 prospectus contain this and other important information about the investment company and may be obtained by calling 1-800-331-8936 or by visiting [www.perrittcap.com](http://www.perrittcap.com). Read carefully before investing.*

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. Please [click here](#) for a link to the Perritt MicroCap Opportunities Fund's top ten holdings. Please [click here](#) for a link to the Perritt Ultra MicroCap Fund's top ten holdings.

<sup>1</sup> Banz ranked NYSE-listed stocks by market capitalization and formed five portfolios containing the largest to smallest stocks listed on the Exchange. "The Relationship Between Market Value and Return of Common Stocks." Rolf Banz, Journal of Financial Economics, November, 1981. The study has been continued annually by Ibbotson & Associates, "Ibbotson Yearbook: Stocks, Bonds, Bills and Inflation," 2013.

Price to Sales ratio is a tool for calculating a stock's valuation relative to other companies, calculated by dividing a stock's current price by its revenue per share. Beta measures the sensitivity of rates of return on a fund to general market movements. R-Squared is a statistical measure that represents the percentage of a fund's or security's movements that are explained by movements in a benchmark index. Correlation is a statistical measure of how two securities move in relation to each other. The Russell 1000 Index is an index of approximately 1,000 of the largest companies in the U.S. equity markets. 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 Fund may invest in early stage companies which tend to be more volatile and somewhat more speculative than investments in more established companies. Diversification does not guarantee a profit or protect from loss in a declining market.**

The Perritt Funds are distributed by Quasar Distributors, LLC

**Perritt**  
CAPITAL MANAGEMENT

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