Perritt
CAPITAL MANAGEMENT

2Q14
Manager Commentary

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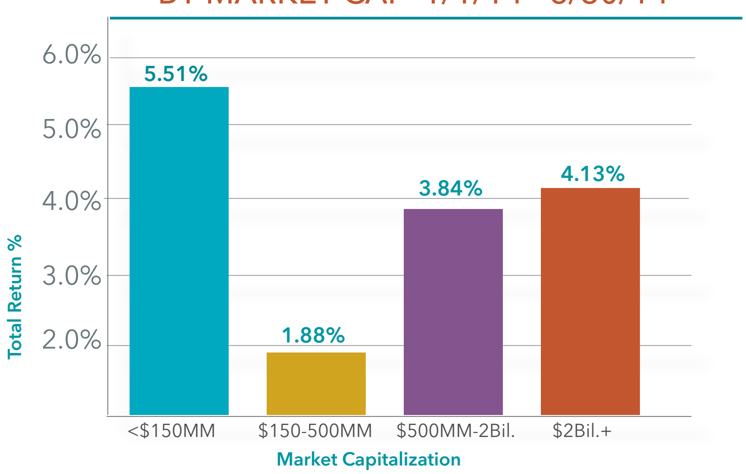
THE GREATEST STORY *NEVER* TOLD

EXAMINING THE 'STEALTH BEAR MARKET' WITHIN SMALL COMPANY INDEXES

Small and large company equity performance has continued to diverge in the first half of 2014. Small companies significantly outperformed large-cap equities in 2013. This year we have seen a reversal, as smaller company equities have lagged large-cap stocks through June 30. Recent trends have led to sweeping claims that small-cap valuations have become “stretched.” Is this true? This quarter we will attempt to show how investors can determine the answer for them selves by digging through the actual companies listed in the indexes.

SMALL COMPANY UNIVERSE* RETURNS BY MARKET CAP 1/1/14 - 6/30/14



Advance /Decline	1.38	0.88	1.04	1.37

*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.

Source: Capital IQ

The stock market is not a market of indexes, it is a market of companies. When you actually examine the individual names that form the small company indexes, what we see is that we have experienced a “stealth bear market” in smaller company stocks: the average stock in the Russell Microcap Index has fallen -23.97% from its 52-week high. Significant declines are broad-based, as 791 companies have fallen 20% or more from their 52-week high. What this means is that while ***certain*** small/micro-cap industries or individual companies are indeed expensive (in our view), there are certainly pockets of opportunity to be found.

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RUSSELL MICROCAP INDEX ANALYSIS 6/30/2014

Avg. Company Return Since 52 Week High	# Companies -20% From 52 Week High
-23.97%	791

Past performance does not guarantee future results

Small company indexes are at or near all-time highs, yet the near-majority of individual names have fallen 20% below their 52-week high. How can we explain this condition? Performance analysis shows that Index returns are being driven by a smaller number of high-flying biotech and internet software stocks. As fundamental, value-oriented managers, we believe these investments carry significant risk. Names such as Open Table (OPEN), Yelp (YELP), and Zillow (Z) may benefit from consumer recognition and investor excitement, but their current market valuations may not be justified in the future. We believe that true smaller company opportunities – names with strong potential earnings power and valuations that aren't "stretched" but "compressed" – lie elsewhere.

Performance within the small cap universe has also diverged in the first half of 2014, as seen in our table on first page. Excluding the group of companies with a market cap under $150 million (which includes many penny stocks susceptible to volatile performance swings), the larger the company the greater the return. Investors can sketch a rough chart ranking 2014 performance by asset class and see a linear climb: large-caps performed best, followed by mid-cap, then small-cap, and finally within small-cap where the smaller companies have the least return.

We hesitate to draw any conclusions about such short term returns signifying a new trend. It is possible that this is the start of a period of large-cap outperformance. Equally likely is that we are seeing a natural reversion following 2013's significant outperformance by smaller companies, and we are still in a market where smaller companies are in favor. What does appear material to us is the decreasing level of correlation between the large- and small/micro-cap asset classes.

Low correlation is one of the key reasons why we believe so passionately that investors should allocate to micro-cap equity. According to Ibbotson & Associates**, between 1926 and 2013 smaller company returns have had a correlation of 0.80 to larger company returns. Micro-cap returns should provide investors with even lower correlation than small companies, as micro-cap companies are generally far off the radar screens of traditional Wall Street analysts. Following the financial crisis, returns of all asset classes, including micro-cap equity, began moving in sync and correlation increased. As seen below, over the past year and a half this trend has started to reverse. The r-squared of the Perritt Ultra MicroCap Fund, having tracked generally near 0.75 for the past five years, has begun to decline to pre-2008 levels.

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The effect of lower correlation on investor portfolios can be significant. As we will outline in an upcoming research paper *Adding Micro-cap to Small-cap*, our research shows that complementing your small-cap allocation with an investment in micro-cap has lowered correlation and has helped reduce volatility. Part of the reason that this benefit has proved possible is the lower correlation historically delivered by an investment in micro-cap.

PREOX R-SQUARED VS. S&P 500
36-MONTH TIMEFRAME - 8/31/07-6/30/14

Past performance does not guarantee future results.

Dig through the individual names in an index and you can see widely varying returns and valuation characteristics. Our final chart below compares valuation metrics according to company size within the small company universe. As can be seen, the smaller the company, the lower the valuation. This holds true for P/E, P/B and Total Enterprise Value/Revenue (TEV/Rev).

Perhaps we have been in this business for too long, but the below chart made us reflect on the "good old days" of the 1970's and 80's, when growing small companies were rewarded with higher valuation multiples. In the era when our firm was founded, investors paid a premium to own fast-growing, dynamic small companies. Today, it seems normal for large, consumer staple-type companies to be rewarded with lofty multiples, despite internal growth rates of just a few percentage points per year. Conversely, many small companies growing at 15-20% per year are valued at a discounted multiple Perhaps this is another example of the famous "new normal", but it seems backwards in our view.

MEDIAN VALUATIONS BY MARKET CAP RANGE

Market Cap	ttm P/E	P/B	TEV/Rev
$2-$3Bil	22.48	2.47	2.30
$500MM-2Bil	22.81	2.29	2.14
$150-500MM	19.84	1.72	1.73
$25-150MM	16.48	1.26	1.56

*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. Source: Capital IQ

Annualized returns as of 6/30/14	YTD	1 YR	3 YR	5 YR	10YR	Inception
MicroCap Opportunities Fund (PRCGX)	0.95%	23.52%	14.50%	17.88%	8.60%	10.10% (4/11/1988)
Ultra MicroCap Fund (PREOX)	-1.23%	30.00%	12.25%	21.14%	-	8.29% (8/27/2004)
Low Priced Stock Fund (PLOWX)	0.70%	25.87%	-	-	-	25.49% (6/30/12)

Perritt MicroCap Opportunities Fund Expense Ratio: 1.24%
Perritt Ultra MicroCap Fund Expense Ratio: 1.76%
Perritt Low Priced Stock Gross Expense Ratio: 1.50% and net expense ratio 2.50%

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 1.50% through February 2015. 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.

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. Read carefully before investing.

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.
R-Squared R-Squared is defined as a statistical measure that represents the percentage of a fund or security's movements that can be explained by movements in a benchmark index. The S&P 500 is designed to be a leading indicator of U.S. equities and is meant to reflect the risk/return characteristics of the large cap universe.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.

*Micro-cap and small capitalization companies typically have relatively lower revenues, limited product lines, lack of management depth, higher risk of insolvency and a smaller share of the market for their products or services than larger capitalization companies. Generally, the share price of stocks of micro-cap and small capitalization companies are more volatile than those of larger capitalization companies. Also, the returns of micro-cap and small capitalization company stocks may vary, sometimes significantly, from the returns of the overall market. In addition, micro-cap and small capitalization company stocks tend to perform poorly during times of economic stress. Relative to large capitalization company stocks, the stocks of micro-cap and small capitalization companies are thinly traded, and purchases and sales may result in higher transactions costs. A mid-cap company may be more vulnerable to adverse business or economic events than stocks of larger companies.

As of 6/30/2014, the Funds held no position in Open Table (OPEN), Yelp (YELP), or Zillow (Z). Correlation is a statistical measure of how two securities move in relation to each other. A correlation of 1.00 equals perfect correlation, 0.00 equals no correlation, -1.00 equals perfect negative correlation. 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. Price to Earnings (P/E) ratio is calculated by dividing current price of the stock by the company's trailing 12 months' earnings per share. Price to Book Value Ratio (P/B) is calculated by dividing the current price of the stock by the company's book value per share. Total Enterprise Value is a valuation measurement used to compare companies with varying levels of debt. This is calculated as: TEV = Market Capitalization + Interest Bearing Debt + Preferred Stock - Excess Cash.

**Source: Ibbotson & Associates Stocks, Bonds, Bills and Inflation Yearbook, 2014. Small company stocks defined as the bottom quintile of securities ranked by market capitalization from 1926-1981. For January 1982 to March 2001, the series is represented by the DFA U.S. 9-10 Small company portfolio and the DFA U.S. Micro Cap Portfolio thereafter.

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 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.

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The Perritt Funds are distributed by Quasar Distributors, LLC

Small is specialized.