

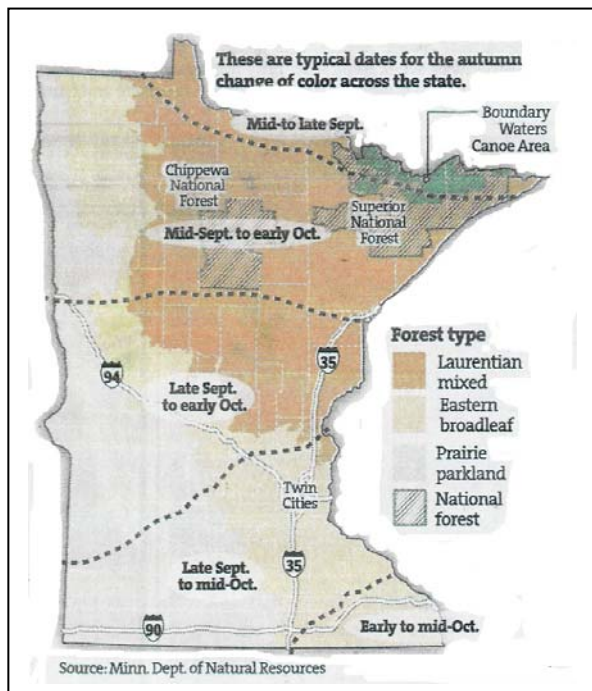


PERKINS
CAPITAL
MANAGEMENT, INC.

October 20, 2011

Dear PCM Clients and Friends:

According to a spokesman for the Minnesota Department of Natural Resources, "This will be the best fall (for colors) in the last ten years." After enduring eight years of drought



conditions, Minnesota trees have rebounded strongly with the ample rain of the past two years, rebuilding crowns and sending moisture to their foliage. When nights turn cool the green pigment in the leaves break down, which allows other pigments to stand out, as drought-ridden trees have few pigment producing chemicals, which of course, is why some drier areas have not had good color. This year the range of colors has resulted in viewing pleasure.

While the map shows the areas of the state with forest type, and dates of prime viewing, those dates will have come and gone by the time you read this. Nevertheless, many of you will have been in these areas of Minnesota and will have seen the beauty of nature which this fall is producing. Here in Wayzata, it is one of the best in our memory.

All this color is one of the treats of the hunting season for us, as we get to see the changing colors as each week progresses. While we wish we could be out in the duck marsh or in the forest pursuing grouse each and every day in the autumn, unfortunately, we are weekend warriors.

A MESSAGE FROM PERK

A recent *New York Times* article titled "The Hidden Dangers In Safe Havens" reminded me of an article I wrote 25 years ago (September 1987) titled "Finding The Hidden Risks," in which I defined three investment risks.

The first, of course, is the risk of loss of principal, the possibility that the investment you have made will decline in value and, therefore, will be worth less than what you paid for it. In fact, the dictionary defines risk as "the possibility of loss," which implies a decline in

730 East Lake Street
Wayzata, MN 55391-1769
Telephone (952) 473-8367
Facsimile (952) 473-4702
www.perkinscap.com

INVESTMENT MANAGEMENT

value. It is impossible to control price fluctuations, and therefore, the risk of any investment, but we can have some control by choosing what we buy and sell, and when we elect to sell or not to sell what we own. Often selling out of fear of risk of loss during a broad market decline may be wrong, as is the case today, for even if the timing decision to sell was right, you need to be right again about when to reinvest. And that is not an easy thing to do. Reminds me a little of the saying that "If you buy on Sam's tip, then you must sell on Sam's tip." However, that tip on when to sell never comes from Sam.

Second, there is the risk of loss of purchasing power, commonly referred to as the inflation risk. This risk is the possibility that your money will have less real value as time passes, and that you will therefore have less purchasing power. In order to preserve the purchasing power of our dollars, the rate of return must exceed the inflation rate. And if we are to receive any "rent" for our money, the rate of return must exceed the inflation rate by the amount of rent that we desire. Sidney Homer, in his book "A History of Interest Rates," showed that the true rent for money over many years (starting as far back as the money changers in the temples of biblical years) has averaged 3 1/2% to 4% per year. This is why the prime rate over years will usually be the result of the anticipated rate of inflation, plus the rent for money. There are times, however, when people are so fearful of the risk of loss of principal that they will invest in T-Bills or Government Bonds with a very low rate of return as has been the case during the recent market decline. When inflation rates are high, it follows that interest rates are even higher, which was true 25 years ago, but since bond prices move inversely to interest rates, the nearly record low in interest rates today will doubtless result in a loss of both capital and purchasing power for bondholders as interest rates rise over time from these lows. This is, of course, the argument for investing in equities, for while they fluctuate in price, it has been shown that over time equities appreciate in value in an amount at least equal to the rate of inflation plus money rent or about 8% per annum. So when we look at putting our money to work, such as in a government bond, or a corporate bond, we need to always remember that there is a risk of principal loss as well as the risk of purchasing power loss.

Finally, there is the risk of loss of opportunity, which can simply be defined as a failed opportunity to get the best return on your invested assets. Every day many businesses suffer loss of opportunity; such as the airline with unused seats (not today so much) and the hotel with unrented rooms. For investors, the loss of opportunity is less obvious. Whether you have your money invested in a savings account while it could be invested in a higher yielding investment, or whether you fail to take advantage of an opportunity to make low cost borrowed funds available to you for a more rewarding investment; it still goes under the category of a "loss of opportunity." And of course, a much more significant loss of opportunity arises for investors when they are unwilling, through fear of the unknown or neglect of their financial affairs, to invest funds in well chosen equities rather than fixed income investments. And so, when an investor puts money in a "no risk" security such as a certificate of deposit, or money market fund or some other asset which provides a fixed yield and which returns the principal with very little "risk of loss," there are two other significant risks that have been forgotten about, namely the risk of loss of purchasing power and the risk of loss of opportunity.

Today we are clearly in a classic time when the fear of loss has prompted the sale of equities in favor of the purchase of gold or low yielding bonds just at a time when both should be sold or avoided, and equities should be purchased because as over time inflation will return, equities will be back in favor, and once again many people will have done the wrong thing at exactly the wrong time. History does repeat itself.

THIRD QUARTER REPORT CARD

Well, what can we say other than OUCH! While we thought the market would be lower in the 3rd quarter following our prediction of an August top, it turned out the actual top was in April and a secondary top again in July. The 3rd quarter decline was obviously very bad,

Ranked by Q3 Return Indexes	% Return Q3 2011	% Return Q2 2011	% Return Q1 2011	% Return YTD 2011
Dow Jones Industrial Average	-12.09	.77	6.41	-5.74
NASDAQ Composite	-12.91	-.27	4.83	-8.95
S&P 500 Composite	-13.87	-.10	5.92	-8.68
Russell 1000 Total Return	-14.68	.12	6.24	-9.25
Russell 3000 Total Return	-15.28	-.03	6.38	-9.90
Wilshire 5000	-15.55	-.55	5.55	-11.36
NYSE Composite	-18.36	-1.02	5.54	-14.72
S&P Small-Cap 600 Total Return	-19.83	-.16	7.71	-13.79
Russell 2000 Total Return	-21.87	-1.61	7.94	-17.02
Value Line Composite	-22.43	-1.25	6.68	-20.05

but worse by far in small-cap stocks. For our small-cap portfolios we compare our performance with the Russell 2000, which was down 21.9%, finishing just near the bottom of both the 3rd quarter and year-to-date numbers. When you examine the tables you will see that

Ranked by YTD Return Indexes	% Return YTD 2011	% Return Q1 2011	% Return Q2 2011	% Return Q3 2011
Dow Jones Industrial Average	-5.74	6.41	.77	-12.09
S&P 500 Composite	-8.68	5.92	-.10	-13.87
NASDAQ Composite	-8.95	4.83	-.27	-12.91
Russell 1000 Total Return	-9.25	6.24	.12	-14.68
Russell 3000 Total Return	-9.90	6.38	-.03	-15.28
Wilshire 5000	-11.36	5.55	-.55	-15.55
S&P Small-Cap 600 Total Return	-13.79	7.71	-.16	-19.83
NYSE Composite	-14.72	5.54	-1.02	-18.36
Russell 2000 Total Return	-17.02	7.94	-1.61	-21.87
Value Line Composite	-20.05	6.68	-1.25	-22.43

actually the 3rd quarter rankings are nearly the same as YTD, with the Dow, S&P 500 and NASDAQ at the top, and the Russell 2000 near the bottom along with the NYSE Composite and the Value Line Composite. The message here then, is that it is primarily the

stocks of smaller companies that got hammered both in the 3rd quarter and in the YTD. To emphasize that point this time we are showing the results ranked by both 3rd quarter performance and YTD performance. The results are typical of a declining market; the small stocks suffer the most, the exact opposite of what happens in a rising market.

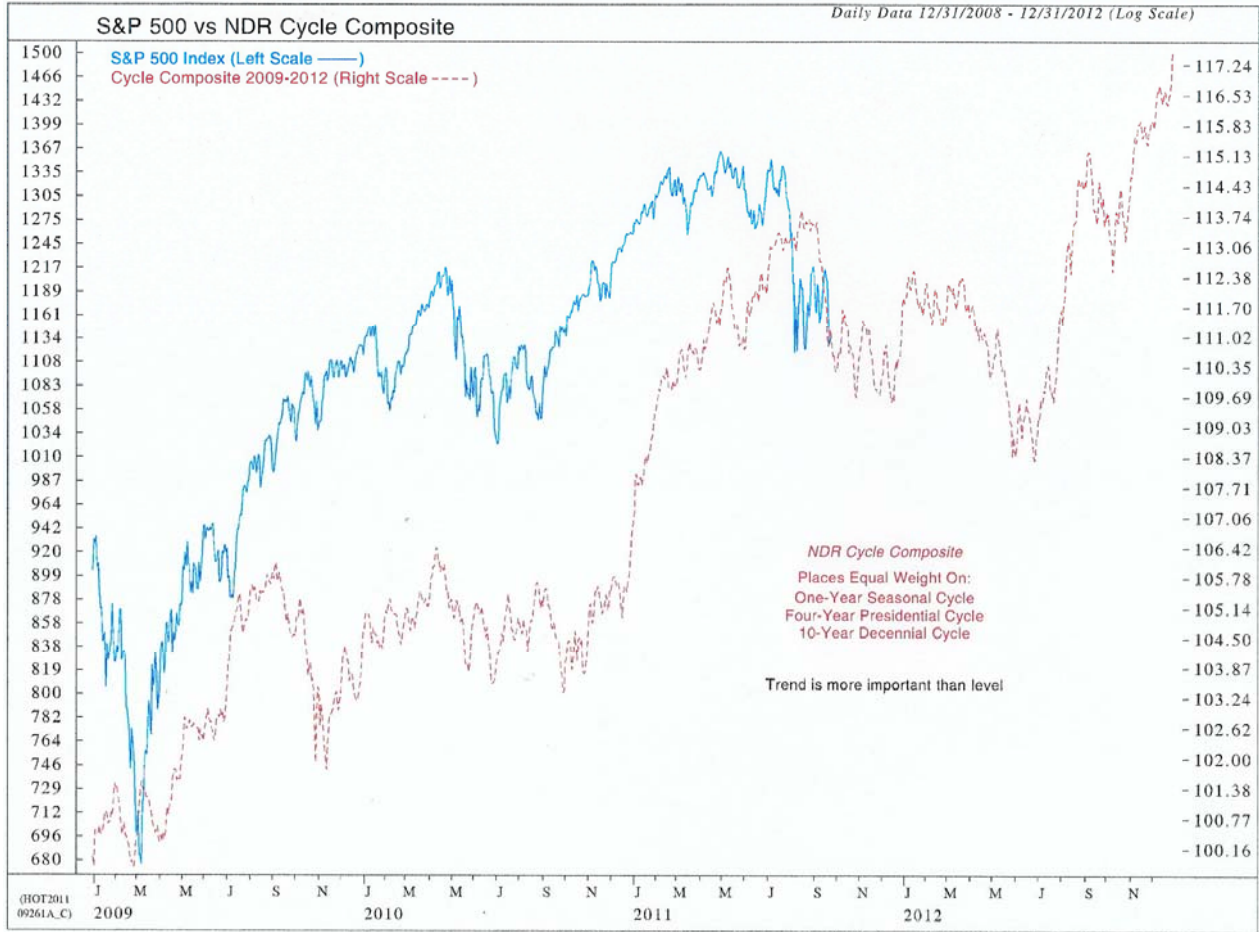
LOOKING BACK – AND AHEAD

In our January letter we discussed the market phenomenon of making a bottom in the “0” year of the decade after declining an average of 26% from the previous high. As we said then, it is likely that the next high will be in 2011, but that we would not know the date of that high until later in the year. It is now quite apparent that the high for 2011 was May 2 at an S&P 500 closing price of 1370.50. This table, now completed, is shown below, and so once again the next high after the “0” year bottom was in the “1” year as it has been on 9 of the 13 occasions in the table (1890 - 2010) with a rise of 33.3% versus the average of 34%.

DECLINES INTO 10 TH YEARS & FOLLOWING RISES				
<u>Start Of Decline</u>	<u>% Decline</u>	<u>End Of Decline</u>	<u>Next High</u>	<u>% Rise</u>
5/17/1890	-22.6%	12/8/1890	3/4/1892	+30.3%
9/5/1899	-31.8%	9/24/1900	6/17/1901	+47.8%
11/19/1909	-26.8%	7/26/1910	6/19/1911	+18.3%
11/3/1919	-44.2%	12/21/1920	5/5/1921	+19.9%
9/3/1929	-58.7%	12/16/1930	2/24/1931	+23.4%
9/12/1939	-28.3%	6/10/1940	11/9/1940	+23.5%
6/12/1950	-13.5%	7/13/1950	1/5/1953	+48.8%
1/5/1960	-17.4%	10/25/1960	12/13/1961	+29.8%
7/3/1969	-28.8%	5/26/1970	4/28/1971	+50.6%
2/13/1980	-16.0%	4/21/1980	4/27/1981	+34.9%
7/17/1990	-21.2%	10/11/1990	1/31/1994	+68.2%
1/14/2000	-14.9%	10/18/2000	5/21/2001	+13.6%
4/26/2010	-13.5%	7/2/2010	4/29/2011	+33.3%
Average	-26.0%		13.6 Mos.	+34.0%

Source: Growth Fund Research, Inc.

This leads us to reproduce the chart (shown on page 5) from our January letter which shows the predictive Ned Davis Cycle Composite made up of the One-Year Seasonal Cycle, the Four-Year Presidential Cycle, and the Ten-Year Decennial Cycle. The chart in the January letter, of course, didn't show what the S&P 500 had done during 2011 as it obviously couldn't, but now you can see that the S&P 500 peaked in May, earlier than the projected August top, but had a secondary top at the end of July, not far off the projection of an August top. And the severity of the decline is about as forecast by the chart. Since that peak was earlier than the forecast, we would postulate that the market could bottom earlier than the forecast of a bottom in the late October or early November time frame. Now in mid-October we still do not know if a bottom has been reached; obviously, time will tell. And, as noted in our January letter following that bottom in the fall of 2011, the market should rise into 2012, then decline again to a final significant bottom in 2012, which will prepare us for a rise for several years before another bottom in 2016 in preparation for the usual 7th year rise. As we have noted many times, just as there is a “0” year bottom there likewise is usually a bottom in the second year in each decade as we saw in 1932, 1942, 1952, 1962, 1982, and 2002; missing were 1972 and 1992, flat market years with no discernable pattern. Thus, while we have been chagrined at the severity of the decline these past few months, we will be prepared to take advantage of the coming bottom so as to fully participate in the rise into 2012.

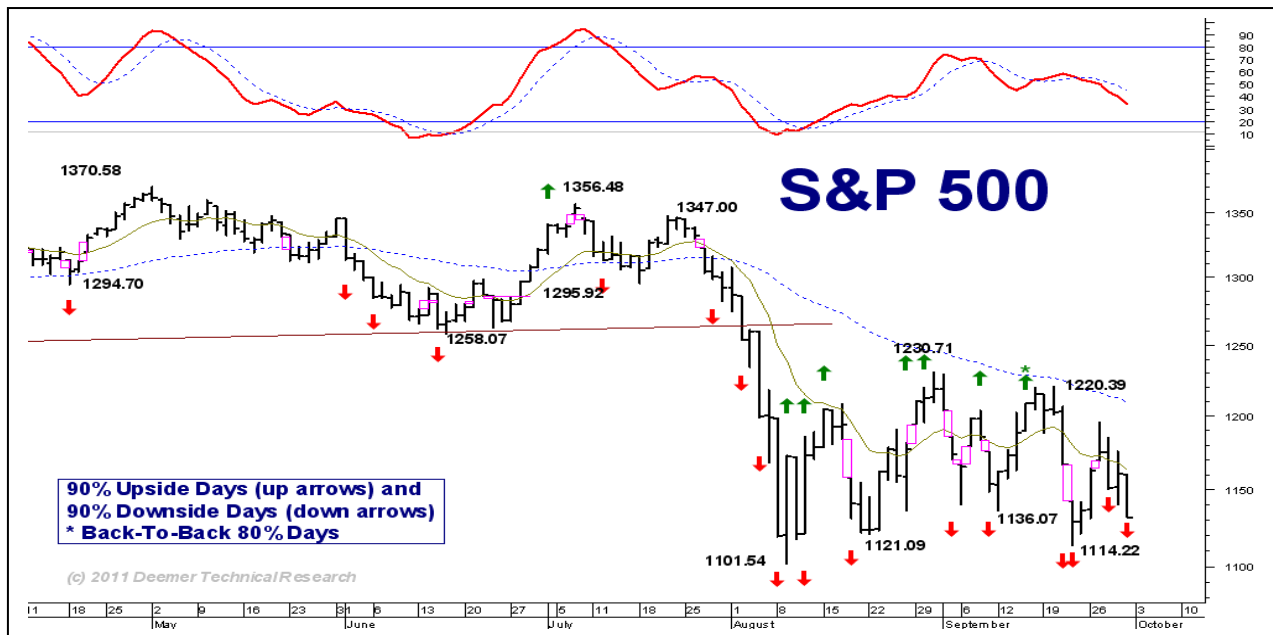


THE MARKETS' WILD RIDE

This past quarter has been one of the more volatile periods in recent history with wide wild swings in the various indices. The question becomes then whether or not there are new forces at work in the market that make trading permanently more erratic as big price moves are more common than in the past. *The New York Times* did a study, revealed in the September 12, 2011 issue, which found that price fluctuations in the indices of 4% or more during intraday trading have occurred 6 times more frequently in the years since 2000 when compared to the previous 40 years; in the '70s and '80s, price fluctuations of 1% during intraday trading were more common.

While not strictly a measure of intraday trading, days when more than 90% of the stocks are up or down gives another measure of volatility of the market day. One of our sources of market information, "Lowry's Research," is the ultimate judge of whether a day fits this categorical description and our friend Walter Deemer in his "Market Strategies and Insights" displays such days on a chart, which he has kindly given us permission to reprint.

From inspection it is clear that this current quarter ended September 30 has seen 20 up or down days of 90% or more compared to 5 in the June quarter and 4 in the March quarter.



Source: DTR, Inc.

So it seems clear that increased market volatility, both intraday and daily, is greater today than in the past. Both *The New York Times* and *Lowry's* have offered reasons for this:

- The advent of HFT, or High Frequency Trading
- The rapid growth in ETFs or Exchanged Traded Funds
- The faster availability of news today as a result of the internet and improved communications
- The elimination of the Uptick Rule in 2007
- The shift of trading away from the NYSE to electronic trading networks and other smaller exchanges
- The near demise of the exchange specialist who provided liquidity

Taken in total it is no wonder there is increased volatility. At the top of the list, properly we think, is HFT where powerful computers trade at exceptionally high speeds, often owning a stock or being short for only a few seconds or even less. HFT now accounts for as much as 60% of daily volume and on occasion even more.

Likewise, ETFs or Exchanged Traded Funds, which are really closed end funds which tie their values to indexes or bundles of stocks, have become a huge factor in trading as they need to constantly balance themselves to the index or the bundle of stocks which they represent.

News (worldwide news, in fact) is available instantaneously and can be acted upon immediately, almost certainly a cause of volatility. News has always moved stocks with

some delayed action as it is made available over time to different groups, but today there is little or no delay and with everyone wanting in or out at once the consequence is bound to be a dramatic price movement.

The uptick rule, which prohibited shorting stocks unless there was an “uptick” in the stock price or at least a zero uptick (which meant no change from the previous price) was put into place in 1938 to stabilize the market and was left there until 2007 when the SEC arbitrarily removed it. The result? More volatility, of course. We saw that during the bank meltdown when Morgan, Bear Stearns, Lehman, Citigroup, etc. were sold short unmercifully, something that could not have happened under the old uptick rule.

Today, the historic guarantor of liquidity, the specialist, the buyer or seller of last resort whose job is to maintain an orderly market is pretty much gone other than on the New York Stock Exchange, where even now each order must be filled in twelve seconds. Over the years more and more trades have been shifted to electronic exchanges. The purpose was to have orderly trading, since under electronic trading millions of investors would come together with both bids and offers under all market conditions. But it did not work that way as prices could not be maintained when bids disappeared as in the “flash crash” of May 2010. There were no buyers of last resort to maintain an orderly market as the specialist would have on the New York Stock Exchange.

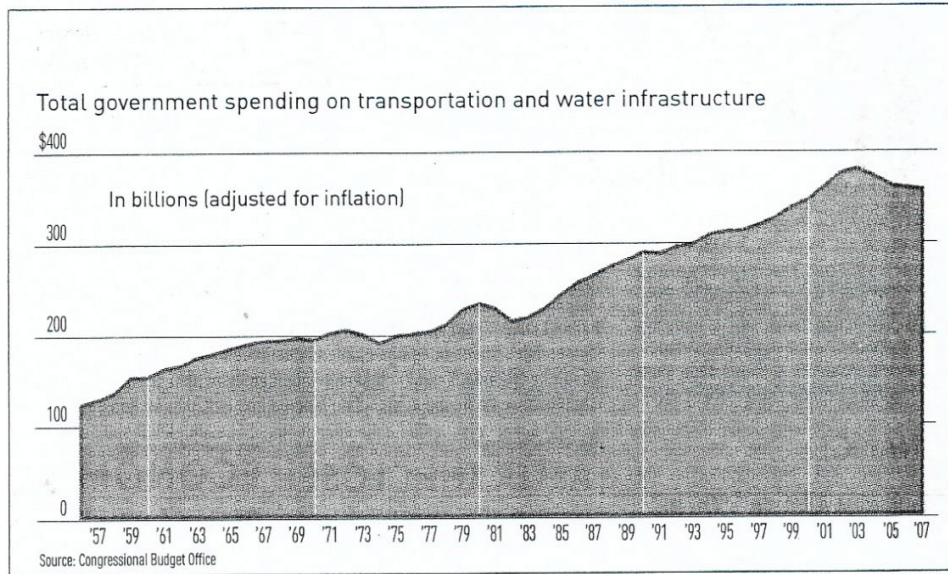
The question is, then: what is an investor to do? One option, taken by many we fear, is to simply be scared away as confidence washes away, perhaps to never return, because it is so disconcerting to see stock prices so volatile. And this carries over, of course, even into mutual funds and closed end funds as well. The big concern is that this volatility will drive the small investor away from the market all together, make it much more institutionalized and in the hands of an increasingly smaller number of banks, hedge funds, mutual fund management companies, and the like. However, we are of the opinion that the value inherent in a company, as represented by the price of its shares cannot be always obtained by trading, which can often disturb a good long-term position, but only by good analysis and sale when there are fundamental reasons to do so. Otherwise, it remains a holding for fulfillment of our investment goals. In other words, when we have what we consider to be a good investment that will reward us over our time horizon, we simply ignore the extreme fluctuations that result from market volatility in this new world of HFT, ETFs, ECNs, and all the rest. Disconcerting? Yes. It bothers us as well and is especially painful when stocks that we know are appropriately valued get kicked around the way they do because of some of these new shortcomings. Our advice is to stay the course and do what we’ve always done—smart analytical and technical investing.

A FEW BILLION HERE, A FEW BILLION THERE

After enactment of the \$830 billion stimulus bill in 2009, President Obama was quoted as saying “More than 90% of these jobs will be in the private sector - jobs rebuilding our roads and bridges; constructing wind turbines and solar panels; laying broadband and expanding mass transit.” The problem is that each of the private sector jobs being called for would be

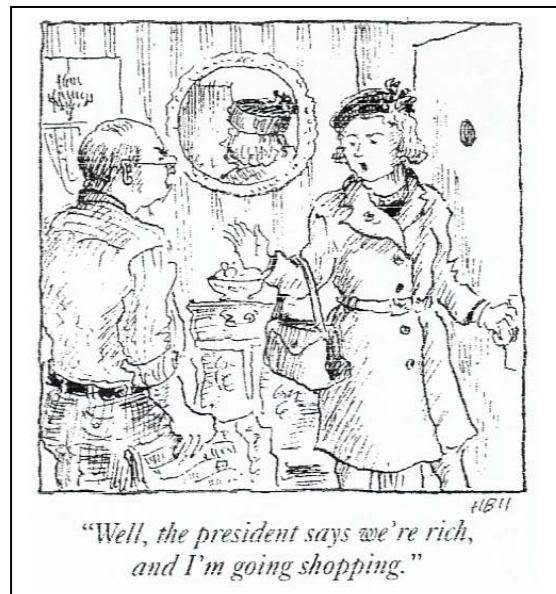
dependent upon government money. Then again, on January 27, 2010 in the State of the Union Address the statement was the same. A year later, in the January 25, 2011 State of the Union Address

he said, "We will need to put more Americans to work repairing crumbling roads and bridges. We will make sure that this is fully paid for, attract private investment, and pick projects based on what's best for the economy." Once again, these are primarily government jobs, although there were three words,



namely attract private investment that was a bit different. And then, finally, in early September of 2011 endorsing his \$50 billion American Jobs Act, he said, "The purpose of the American Jobs Act is simple: to put more people back to work and more money in the pockets of those who are working." Hopefully, some of these jobs that the president had in mind were not in the public sector and not dependent on government.

The question, of course, is where will the dollars come from? In theory he has said by closing tax loopholes used by oil and gas companies, or some other sleight of hand, if indeed this is to be new money, separate from the \$787 billion Recovery Act. Looking at the diagram reprinted here from *Investor's Business Daily*, infrastructure spending has declined for roughly the last ten years, coinciding with all the spending on foreign wars, from Iraq to Afghanistan as well as money spent by giving it outright to our enemies in Pakistan. Pretty hard, as we have learned over the years, to have both "guns and butter." So the question is whose ox will get gored? For sure, all of the expenditures over the years ranging from bailing out banks and housing to the stimulus bill will need to be paid. The politicians spend the money THEN figure out where to get it. Obviously, it means increased taxes of one kind or another. The current White House pitch is to tax the "rich" under the so-called Buffett rule. The fact, is however, that the rich already pay more than their fair share.



Internal Revenue Service data for 2008, the latest year for which the numbers are available, show that those who earned more than \$1 million in adjusted gross income paid an average federal income rate of 23.3%, while those earning from \$100,000 - \$200,000

Who Pays Our Taxes			
Income Category	2008 AGI	% of All Income	% Income Tax Paid
Top 1%	Over \$280,354	20%	38%
Top 10%	Over \$113,799	46%	70%

Source: IRS

the average federal income tax rate paid was about half or 12.7% and for those with adjusted gross incomes from \$30,000 - \$50,000 the average federal income tax

was 7.2%, less than a third of the rate paid by those earning \$1 million and over. Take a peek at the table, which shows how Americans pay taxes.

Ignored by our administration is the fact that President Kennedy's cut in the top marginal income tax rate resulted in an increase in federal revenues and that the same thing happened under President Reagan, which in his term was followed by a drop in the unemployment rate in the 1980s from nearly 10% to 5%. We need to repeat that history.

The cartoon is appropriate for the hunting season, which is just getting started.

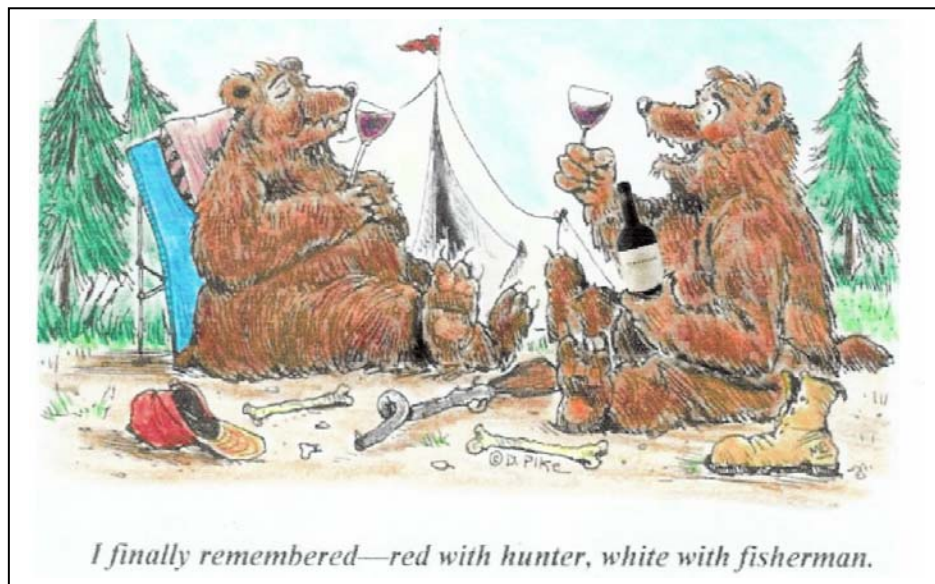
Sincerely,

RW Perkins
 Richard W. Perkins, C.F.A.
 President
 Senior Portfolio Manager

Richard C Perkins
 Richard C. Perkins, C.F.A.
 Executive Vice President
 Portfolio Manager

Daniel S Perkins
 Daniel S. Perkins, C.F.A.
 Executive Vice President
 Portfolio Manager

RWP:RCP:DSP/jah



The intriguing message that follows should not be construed as political, but some of our readers may interpret it that way.

STUFF

The folks who are getting the free stuff, don't like the folks who are paying for the free stuff, because the folks who are paying for the free stuff can no longer afford to pay for both the free stuff and their own stuff.

The folks who are paying for the free stuff want the free stuff to stop, and the folks who are getting the free stuff want even more free stuff on top of the free stuff they are already getting!

Now... The people who are forcing the people who pay for the free stuff have told the people who are RECEIVING the free stuff, that the people who are PAYING for the free stuff, are being mean, prejudiced, and racist.

So... The people who are GETTING the free stuff have been convinced they need to hate the people who are paying for the free stuff by the people who are forcing some people to pay for their free stuff, and giving them the free stuff in the first place.

We have let the free stuff giving go on for so long that there are now more people getting free stuff than paying for the free stuff.

Now understand this. All great democracies have committed financial suicide somewhere between 200 and 250 years after being founded. The reason? The voters figured out they could vote themselves money from the treasury by electing people who promised to give them money from the treasury in exchange for electing them.

The United States officially became a Republic in 1776, 235 years ago. The number of people now getting free stuff outnumbers the people paying for the free stuff. We have to change that, in 2012.

NEW ELEMENT IN CHEMISTRY'S PERIODIC TABLE

Research has led to the discovery of the heaviest element yet known to science. The new element, "Governmentium" (Gv), has one neutron, 25 assistant neutrons, 88 deputy neutrons, and 198 assistant deputy neutrons, giving it an atomic mass of 312.

These 312 particles are held together by forces called "morons," which are surrounded by vast quantities of lepton-like particles called "peons." Since "Governmentium" has no electrons, it is inert; however, it can be detected, because it impedes every action with which it comes into contact.

A minute amount of "Governmentium" can cause a reaction that would normally take less than a second, to take from four days to four years to complete. "Governmentium" has a normal half-life of 2-6 years; it does not decay, but instead undergoes a reorganization in which a portion of the assistant neutrons and deputy neutrons exchange places.

In fact, "Governmentium's" mass will actually increase over time, since each reorganization will cause more morons to become neutrons, forming "isodopes." This characteristic of moron promotion leads some scientists to believe that "Governmentium" is formed whenever morons reach a critical concentration. This hypothetical quantity is referred to as critical morass. When catalyzed with money, "Governmentium" becomes "Administratium," an element that radiates just as much energy as "Governmentium" since it has half as many "peons" but twice as many "morons."

THE CANNIBAL RESTAURANT

A cannibal was walking through the jungle and came upon a restaurant operated by a fellow cannibal. Feeling somewhat hungry, he sat down and looked over the menu.

Tourist:	\$5.00
Broiled Missionary:	\$10.00
Fried Explorer:	\$15.00
Baked Democrat or Grilled Republican:	\$100.00

The cannibal called the waiter over and asked, "Why such a high price for the Politicians?" The cook replied, "Have you ever tried to clean one? They're so full of crap, it takes all morning."

MISUNDERSTANDING

This guy was sitting at home alone when he heard a knock on the front door. There were two sheriffs there. He asked them "Is there a problem?" One of the sheriffs asked if he was married and the man says "yes." The sheriff asks if he could see a picture of his wife. The guy says "sure" and shows him a picture of his wife. The sheriff says, "I'm sorry sir, but it looks like your wife's been hit by a truck." The guy says, "I know, but she has a great personality, and she's a good cook too."

IT IS BETTER TO THINK BEFORE YOU SPEAK

A man was sitting quietly reading the paper one morning when his wife walked up behind him and hit him on the back of his head with a frying pan.

"What was that for?" he yelled. "Tell me about that piece of paper in your pocket with the name Heather written on it," his wife exclaimed angrily. "Oh, honey," he said. "Heather was the name of one of the horses I bet on when I went to the races two weeks ago." Satisfied with his answer, the wife apologized and left him alone.

Three days later the man was sitting in his chair reading when his wife again walked up and hit him on the head with a frying pan. "Now what the hell was that for?" he demanded indignantly. "Your horse called," she replied.

FALLEN

An old priest got sick of everyone in his parish confessing adultery. During one Sunday's sermon he told them, "If one more person confesses to adultery, I'll quit!"

Since everyone liked him they decided to use a code word: "fallen." From then on, anyone who had committed adultery said they had "fallen." This satisfied the old priest and the parishioners, and everything was fine for years, until finally the old priest passed away at the ripe old age of 93.

Shortly after the new young priest settled in, he paid a call on the mayor. The priest was quite concerned. "You have to do something about the sidewalks in this town, Mayor. You can't believe how many people come into the confessional talking about having fallen!"

The mayor started to laugh, realizing that no one had explained their code word to the new priest. But before the mayor could explain, the priest shook his finger at the mayor and said, "I don't know why you're laughing; your wife fell three times last week."

WELL THEN IT'S MEDICAL

A nice, calm and respectable lady went into the pharmacy, walked up to the pharmacist, looked straight into his eyes, and said, "I'd like to buy some cyanide."

The pharmacist asked, "Why in the world do you need cyanide?"

The lady replied, "I need it to poison my husband."

The pharmacist's eyes got big and he explained, "Lord have mercy! I can't give you cyanide to kill your husband, that's against the law? I'll lose my license! They'll throw both of us in jail! All kinds of bad things will happen. Absolutely not! You CANNOT have any cyanide!"

The lady reached into her purse and pulled out a picture of her husband in bed with the pharmacist's wife.

The pharmacist looked at the picture and said, "You didn't tell me you had a prescription."