ZPR Investment Report

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A NEWSLETTER FOR ZPR CLIENTS

January Contents:

US Commentary

By Mark Zavanelli

With another plunge and recovery, world stock markets continued to act in crisis mode in February. Stocks have traded in a very tight relationship with an array of other financial assets such as oil futures, government bonds, or certain currency pairs (such as Dollar/Yen), suggesting that large movements of money are behind all of them. This may seem obvious, but we need to keep in mind that financial markets represent the aggregate actions of buyers and sellers at a point in time, and not necessarily anything more predictive of reality than that. What is clear is that market participants are nervous.

Our take is still that we avoid a sharp economic downturn that hits corporate earnings and stock prices hard. This month's data did show, however, that the world economy has slowed in the near term. US corporate profits had trouble growing at all in the fourth quarter, and they are facing further headwinds in terms of higher labor and capital costs. This is troubling, but it doesn't signal the end of the economic cycle. We think that the

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Asian Results

By Vaidas Petrauskas

It was another roller coaster month for Japanese investors. Despite the best efforts of the Bank of Japan (BOJ), their attempt to devalue the Yen by adopting negative interest rates worked for only one day. The Yen strengthened 7% against the U.S. dollar in February. That is a significant move for any currency. In Japan the stocks and the currency almost always move in the opposite direction. The popular Nikkei 225 index dropped 8.51% for the month and the broader Topix index dropped 9.37%. It was even worse mid-month. The stocks recovered in the second half. In February all of our Asian companies reported. The reports in Thailand were generally good to great while some of the Japanese results were disappointing. The economic slowdown is being felt in corporate earnings. As we sold off the Japanese companies with deteriorating fundamentals, we have moved the cash to Thailand where we can find much better opportunities. But we are not only selling in Japan. We bought a new company – a manufacturer of lighting fixtures which has a 13% ROE, 3.7% dividend yield, and trades below book value. This is the type of company that we like to find.

Not all Asian markets dropped in February. Both Thailand and Singapore indices advanced similarly – around 2.40%. While we lagged the Thai SET index for the month, year-to-date our results in Thailand are very good. Our All Thai portfolios are up 5.67% this year compared to 3.44% for the Thai SET index and 0.87% for the Thai FTSE SET Small Cap index.

Our All Asian portfolios finished down 2.95% for the month in U.S. dollars while the Global portfolios finished up 0.98% thanks to strong performance from our U.S. stocks.

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Currency Wars

By Vaidas Petrauskas

On the last business day of January the Bank of Japan (BOJ) surprised the markets by adopting negative interest rates of -0.10%. They didn't invent anything new. The central banks of EU (ECB), Sweden, Switzerland, and Denmark adopted negative rates a while ago. The decision was surprising nevertheless and it barely passed by a 5-4 vote. The reason central banks like negative rates is that they have proven to be effective at weakening their currencies. A weaker currency allows central banks to meet their inflation targets because the cost of imported goods rises. At least that's the theory. It also helps the country's exports as their goods become more competitive. Another less obvious impact of negative rates is that with negative rates the central banks are forcing the commercial banks to lend money and stimulate economic growth instead of keeping that money at the central bank. So all good news for central banks except that the currency must decline relative to their trading partners. If everyone responds by weakening their currencies, like what is happening now, then the effect is only temporary and we are in a race to the bottom with no winners. That doesn't stop the central banks from trying. Admittedly the ECB and BOJ have a difficult problem to solve. Facing zero growth and zero inflation they are willing to try anything to revive their economies. But their tools are losing potency and all the bond buying programs only increase the debt.

The trend right now is for the rates to go even deeper into negative territory. If the medicine doesn't work, give more of it. Sweden's Riksbank cut its main overnight borrowing rate to -0.50% this month and both ECB and BOJ are expected to cut rates further into negative territory in March in a mad effort to weaken their currencies and generate inflation. Yet the Yen and the Euro are getting stronger! Imagine the frustration at the BOJ when the Yen strengthened considerably (from 121 to the Dollar to 113) instead of weakening in February. One reason is that other countries are striking back and are also weakening their currencies. Another reason for this was that we had another market panic in the beginning of February and there was a flight to safety. The Japanese Yen and the Japanese government bonds are considered to be a safe haven by investors. That is a strange choice for a safe haven. First of all, the Japanese 10-year government bonds yield a negative -0.06% at this time. So if held to maturity they are a sure way to lose money. Second, there is currency risk. Of course, few foreign investors plan to hold them until maturity. They will only hold them until "things calm down". In fact, there are only two ways in which these safe haven seekers will not lose money on this trade – either the rates have to go deeper into negative territory (in which case the bonds will appreciate in value) and/or the Yen has to strengthen further. The BOJ is now in a bind. Their "bold step" to devalue the Yen backfired and the currency appreciated significantly instead of weakening. They will have to do something crazy again in March because a strong currency is hitting their exports and profits.

So far the commercial banks have taken the hit for negative rates because it limits their ability to extend loans profitably. Banks borrow short and lend long. The long-term rates that banks charge for loans are being squeezed lower by a flattening yield curve. On the short end the banks have taken the hit for negative rates which they did not pass to their customers (they don't want to charge depositors negative rates on deposits). That has eroded their interest rate margins. In effect, the banks are being forced to seek out riskier lending opportunities. One side effect of this is that loans are so cheap in Europe (I pay 1.5% on a 30-year loan) that it may cause a real estate bubble. This may seem like the least of the problems on the central bankers' minds but there is already a real estate bubble in Denmark (specifically Copenhagen) and the Danish government had to tighten loan requirements by requiring a bigger initial deposit to cool down the real estate market. The U.S. banks are in better shape than their European and Japanese counterparts. They are better capitalized and the interest rate situation in the U.S. is not as dramatic (The U.S. 10-year government bond yields a fat 1.75%). The European bank stocks have been particularly hard hit this year.

An interesting fact - the value of worldwide government bonds with negative yields currently stands at $6-$7 trillion. It was zero two years ago. The Swiss and Japanese 10-year bonds have a negative yield. The German 10-year is at zero. The Swiss 30-year is likely to be the first to go into negative territory for that maturity. Not a good time to be a saver.

US Commentary (Continued)

economy is in an unusually non-synchronous state, meaning just that some areas are doing well while others are declining. The overall effect is data from some areas that look ominous and other data that look not only fine but strong. This non-synchronicity exists even in China, where residential real estate prices have been soaring due to stimulus money finding its way into prices. You end up with a muddy overall picture that defies generalization but which becomes clearer as you examine individual assets. The implication is that the market is wrong in painting all risk assets with the same negative brush and driving up the prices of so called safe havens. This creates dislocations that we can take advantage of, since small cap value assets are the type of risk that the market is fearful of in a recessionary environment.

Although the current environment comes with uncertainty and indeed real risk, it may actually end up being the catalyst for improved performance for our style of investing, both in the US and internationally. The last few years have been a period where growth assets were bid up, at least partly as a result of monetary policy which always seems to promote momentum bubbles (that's the mechanism of Fed policy, the wealth effect, at work for you). Safe haven assets are also priced at silly levels where there is clearly no profit to be made, just the idea that you will get your money back plus a small yield, if you're lucky. Highly valued stocks never offer actual safety from loss, and they are typically poor long term investments (they can work strongly under one condition – momentum). Stocks that are not in these favored categories are generally down substantially from mid-2015 and are downright cheap. Most foreign markets are also very cheap as capital has flowed from them into the US on concerns that the dollar will continue to appreciate. It makes sense that as a time of fear transitions into better confidence that these trends would begin to reverse. This is the right starting point from which as a long term investor you would expect to be paid at least in line with historical averages for owning small cap value. The old adage is that when the market is fearful you should be greedy, and vice-versa.

Of course we need to be mindful of the risk that the economic situation really does deteriorate a lot more than we currently expect. This would make the potential for short term losses too great and we would switch gear into a more protective mode (hopefully not timed while the market is plunging). If this happens I think it will be most clear from the debt market as that has been where the biggest excesses have occurred. The market knows there will be a lot of energy defaults, and that's already been priced, but we will be vigilant for a more generalized downturn in the credit cycle, which we don't expect.

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Just the Numbers

ZPR Composites **Names in Bold** *Benchmarks in italics*	Period Ending 2/29/16 Month	Period Ending 2/29/16 YTD	Period Ending 12/31/15 1 Year	3 Year Annualized	5 Year Annualized	Inception (if under 5 yrs)	Incep. Date
ZPR Fundamental Small Cap Value	6.14%	-1.76%	1.15%	14.43%	9.60%		
Volume Winners	0.53%	-1.97%	10.87%	16.75%	10.82%		
Volume Value	-0.03%	-7.61%	5.61%	19.42%	17.34%		
Volume Momentum	0.87%	-5.33%	-7.66%	15.18%	11.30%		
Russell 2000	-0.14%	-8.92%	-4.42%	11.65%	9.18%		
S&P 500	-0.41%	-5.33%	1.40%	15.14%	12.57%		
ZPR Global Equity	0.98%	-6.04%	-2.69%	8.28%	8.58%		
MSCI ACWI	-0.41%	-6.60%	-1.83%	8.26%	6.66%		
ZPR All Asian	-2.95%	-9.16%	-4.21%	5.12%	8.56%		
MSCI EAFE	-1.80%	-8.89%	-0.40%	5.46%	4.10%		
ZPR All Thai Equity	1.41%	5.67%	-9.20%	3.57%		15.29%	1/1/12
Thai Set Index	2.41%	3.44%	-11.23%	0.65%		9.56%	1/1/12

Composite returns are presented net of management fees and trading expenses, and include the reinvestment of dividends and other income. All returns are in US dollars except for the Thai Set Index, which is presented in Thai Baht.

Past performance does not guarantee future results. The table above reflects (1) performance of the ZPR Investment Management, Inc. (“ZPR”), composites named in bold in the first column, (2) performance of the benchmark which reflects the composite’s investment mandate, objective, or strategy, and (3) performance of the S&P 500 Index, which is provided for overall comparison and informational purposes. Please see the reverse for important information about composite and benchmark descriptions, how to receive more complete information about the composites, and disclosures regarding the calculation of performance, among other matters. Subsequent markets may perform better or worse than for the periods shown, which will cause the actual results of a portfolio to be better or worse than shown. ZPR does not guarantee or offer any assurance that any portfolio or account will be profitable, meet a client’s stated objectives, or prevent or reduce losses. **A client may lose money by investing in a portfolio.**

ZPR Investment Management, Inc. ("ZPR") is an SEC registered investment adviser managing separate accounts that are fully discretionary. SEC registration does not constitute an endorsement of the firm by the Commission nor does it indicate that the adviser has attained a particular level of skill or ability. ZPR claims compliance with the Global Investment Performance Standards (GIPS™). To receive a complete description of the policies and procedures for any composite, a list and description of all ZPR composites, and a presentation that complies with the GIPS standards, please contact us at 386-775-1177 or zprim@mpinet.net.

All composites include fully discretionary, management fee-paying and, beginning on January 1, 2011, non-management fee-paying accounts, including those accounts no longer with the firm. The U.S. Dollar is the currency used to express performance, except for the ZPR All Thai Equity Strategy, for which performance is expressed in the Thai Baht. Returns are presented net of management fees and include all trading expenses and the reinvestment of all income. Net of fee performance was calculated using actual management fees, except in the case of non-fee paying accounts where model fees have been imputed. Actual advisory fees and transaction fees will vary depending on, among other things, the portfolio, account size, and activity. Fees are described in ZPR's ADV Part 2A.

The benchmark and other data provided was obtained from publicly available reports, including internally derived databases and other resources available to ZPR. ZPR believes such data to be reliable but does not audit, verify, or guarantee its accuracy or completeness. When comparing the performance results to a benchmark, clients should keep in mind that: 1) Indexes are unmanaged and unavailable for direct investment. 2) Benchmark returns include reinvestment of income, but do not reflect taxes, or investment advisory or other fees that would reduce performance. 3) Performance information of benchmark indexes is included for comparison purposes only.

Composite and Benchmark Descriptions:

The S&P 500 and Russell 2000 are market cap weighted indices of large company and small company US stocks, respectively.

The Fundamental Small Cap Value Composite consists of accounts that hold U.S. small cap stocks selected by using ZPR Fundamental Analysis. This analysis identifies undervalued companies using ZPR's GRAPES valuation model and also applies other selection criteria relating to a company's business prospects, management quality, and capital structure. The benchmark for the composite is the Russell 2000 Index, presented in U.S. Dollars. In the past the composite has displayed higher volatility than its benchmark.

The Volume Winners Composite consists of accounts that hold U.S. micro cap stocks selected by using ZPR Volume Winners Analysis. This analysis is a quantitative evaluation system incorporating volume, momentum and valuation measures. The benchmark for the composite is the Russell 2000 Index, presented in U.S. Dollars. In the past the composite has displayed lower sensitivity to market returns than its benchmark, which would cause it to underperform in a strongly rising market.

The Volume Value Composite consists of accounts that hold U.S. micro cap stocks selected by using ZPR Volume Value Analysis. This analysis is a quantitative evaluation system incorporating volume and valuation measures. The benchmark for the composite is the Russell 2000 Index, presented in U.S. Dollars.

The Volume Momentum Composite consists of accounts that hold U.S. micro cap stocks selected by using ZPR Volume Momentum Analysis. This analysis combines two quantitative evaluation techniques; ZPR's price and earnings momentum measure SuperMo, and ZPR's volume, momentum and value system Volume Winners. The benchmark for the composite is the Russell 2000 Index presented in U.S. Dollars.

The Global Equity Composite consists of accounts that hold both U.S. and International stocks selected by using ZPR Fundamental Analysis. This analysis identifies undervalued companies using ZPR's GRAPES valuation model and also applies other selection criteria relating to a company's business prospects, management quality, and capital structure. The benchmark for the composite is the MSCI All Country World (Gross) Index, presented in US Dollars. MSCI ACWI is a market capitalization weighted index comprised of equities from developed and emerging markets, including the US. The composite has historically held small cap stocks from a limited set of countries while the benchmark weighting is primarily composed of larger companies spread across many countries. This is likely to cause the composite to have greater volatility than its benchmark. The composite includes the performance of accounts that may occasionally use margin; however, the use of margin is not part of the overall strategy of the composite.

ZPR All Asian Composite consists of accounts that hold Asian stocks selected by using ZPR Fundamental Analysis. This analysis identifies undervalued companies using ZPR's GRAPES valuation model and also applies other selection criteria relating to a company's business prospects, management quality, and capital structure. The benchmark for the composite is the MSCI EAFE Index, which is comprised of equities from developed markets around the world, excluding the US and Canada. MSCI EAFE is presented in U.S. Dollars. The composite has historically held small cap stocks from a limited set of countries, including emerging markets, while the benchmark weighting is primarily composed of larger companies from developed countries. This is likely to cause the composite to have greater sensitivity to the returns of countries where it invests, and overall greater volatility than its benchmark.

The ZPR All Thai Equity Strategy consists of accounts that hold Thai stocks selected using ZPR's Fundamental Analysis. This analysis identifies undervalued companies using ZPR's GRAPES valuation model and also applies other selection criteria relating to a company's business prospects, management quality, and capital structure. The benchmark for the composite is the Thai Set (TRI) Index, a market capitalization weighted index of securities listed on the Stock Exchange of Thailand and presented in Thai Baht. The composite has historically held small cap stocks while the benchmark weighting is primarily composed of large companies. This is likely to cause the composite to have greater volatility than its benchmark.