ZPR Investment Report

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A NEWSLETTER FOR ZPR CLIENTS

November Contents:

US Commentary

By Mark Zavanelli

US stocks fell in October as investors took profits after a strong third quarter. Small caps, which had led on the way up, also led on the way down. The biggest factor this month was a move back up in interest rates in the US and in Europe from the record lows of this summer. The market came around to the idea that central banks might be slightly less stimulative on the margin, with the Fed likely raising rates in December, and that US inflation is ticking higher. Also the bond market is a sensitive momentum market, the type where selling begets more selling instead of bargain shopping. So 10 year Treasury rates moved up over 1.8% from 1.4% after the Brexit vote. Doesn't seem like a lot in absolute terms but it makes a big difference to the bond price. Higher US rates strengthened the dollar (even with European rates moving too), which the market sees as negative for US corporate profits. The third quarter GDP report was strong overall but confirmed that business spending was weak (which has been the trend). Did anything actually change? Not really. Earnings reports from US companies were positive overall, and the crisis in European banks has passed for the moment. One thing I did learn if I didn't know it already is that this stock market will not take higher rates quietly. So even though normalization might be a good thing for

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Asian Results

By Vaidas Petrauskas

THAILAND

The Thai stock market was on a wild ride in October. The Royal Palace released a statement in the beginning of the month that the king's health was in unstable condition. This was a very rare admission which indicated that the king's condition was really dire. Stocks and the currency went into free fall. The stock market lost more than 7% in the week from October 6th through 12th. Then on October 13th it was announced that the king had died. He was 88 and ruled for 70 years (the longest ruling monarch in the world at the time). Obviously there is shock and sadness among the Thai people. Most people spent their wholes lives with this one king and they revered him. Now his son, the Crown Prince, is to take over, but he is an unknown and not much admired among Thais. He lived in Germany until now with his third wife. Wikileaks revealed that the prince had his favorite dog Fufu promoted to the rank of Air Chief Marshal in the Royal Thai Air Force. He's wacky.

The military is in full control. There were no riots or disorder after the king's death. The military would squash any disturbance. The situation in the country is now a bit crazy. A one year mourning period was announced. People have to wear black. Those that do not wear black are attacked by angry mobs for not mourning strongly enough. Because there

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Healthcare

By Mark Zavanelli

Reversion to the mean occurs even in the most dependable growth areas of the market. A couple of years ago money was rushing into healthcare investments, especially pharma and biotech. Indeed it has been among the best areas of the market over the past 5 years, with the S&P 500 Healthcare sector beating the S&P 500 each year from 2011 through 2015. This year, the outcry over Mylan's EpiPen and other drugs with price increases has awakened fears over price regulation, sending the stocks lower. California has a voter referendum, Prop 61, to require that any state agency that buys prescription drugs, including the state run Medicaid program, not pay more than the Veterans Administration does for an individual drug. The VA has historically had a special deal where they pay the lowest price for a given drug in the marketplace, although Medicaid is not too far off (Medicare Part D is a different story however). These and similar "negotiation" efforts are just smoke and mirrors and won't have much effect on prices. The industry could easily just set the reference price high and stop giving special breaks to the VA. It's about the structure of the (non) marketplace, not the tactics.

Advocates of government run healthcare see opportunities for gains whenever there is a backlash against private companies, but at least for now the debate has been settled with the creation of Obamacare. Private companies are providing healthcare, while the government is regulating insurance and increasingly subsidizing the cost of care. It is clear that the American people are not ready to turn healthcare into a public utility, and advances in healthcare are highly valued by society. At the same time, government assistance programs have been steadily expanded by lawmakers from both political parties. This is a powerful incentive for both consumers (to not be price conscious) and providers of healthcare (to invest in new and expensive treatments) because the price linkage between demand and supply is disrupted. Insurance companies have sometimes in the past played the bad guy by restricting coverage based on cost/benefit, but these are now highly regulated to "protect" consumers from insurance profits. So they will just perform risk sharing and pass on the costs directly. The bottom line is that the system is designed to minimize budgetary constraints so both utilization and costs will go up for the foreseeable future. Add in the demographics of an aging population and it's hard to see a scenario where healthcare won't just keep growing as a percentage of GDP.

Value guys like us normally don't get to buy stocks with such favorable long term growth, because they are typically bid up to levels where you have to pay for all of that growth up front. As is typical, the transition from a pretty picture that a growth investor wants to own and a cheap price that a value investor wants is a deep valley. That's occurring now. We have a couple of healthcare stocks in the US fundamental portfolio that are beaten up, one a generic drug company and one a manufacturer of pharmaceutical ingredients (to be fair, we owned the generic drug company when it was still a momentum stock, but have added on weakness too). Both of these companies are part of the answer to problems in healthcare and should see faster than industry growth in the future.

Some Healthcare tidbits:

1. Where Did My Paycheck Go?

According to the Kaiser Foundation survey, the average health insurance premium for a family in 2016 was $18,142 per year. Employers contributed about 70% of that on average, or $12,865, while workers paid an average of $5,277. Contrast these numbers to the Median Household Income of $54,462 in 2015 (not apples to apples, but the point is that it's a significant percentage any way you look at it). You've probably seen the statistics that incomes are about flat from 2008, having went down and then recovered somewhat. Did that stop healthcare spending, even in the private sector among working age people? No. The average annual premium grew 43% from 2008 to 2016, even while the out of pocket deductible level doubled. In another effort to contain costs, the worker share of premiums has been increasing. In a slow growth economy, health care is basically eating all of the increase in worker compensation.

2. Obamacare and Subsidy Expansion

For the 2017 enrollment period, the cost of Obamacare's benchmark silver plan is increasing by 25% on average. What's happened is that the pool of applicants is a sicker and more expensive population to cover than

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Healthcare (Continued)

anticipated. Not to worry, the government says, because increased subsidies will mean it's not really more expensive (depends for whom I guess). Why is this happening? Because incentives matter. Healthier, younger people who aren't covered at work are still finding it cheaper to go without insurance and use the ER or to negotiate with providers directly when they need care. The mandate to buy insurance was never supposed to be too financially punitive. That leaves the applicants who are more likely to actually use the coverage in the market. So, Obamacare becomes not the cost saving insurance pooling of the uninsured, but just another government funded health care plan for those that don't qualify for the others (Medicare, Medicaid, CHIP). Since expansion of subsidy coverage is the main goal, Medicaid spending has also increased by over 10% per year in 2014 and 2015.

Asian Results (Continued)

is a shortage of black clothes, dyeing shops have sprung up to turn brighter garments into black. The laws against insulting the Royal family are extreme. People cannot speak openly. Some have been sent to jail for 20 years for posting negatively about the king on Facebook.

The one year mourning period is bad for business, of course. All entertainment events are cancelled for 30 days. Spending has dropped. Retail, media, and tourism sectors will be hit hard. We don't own any such companies, but the economic slowdown will be felt regardless. The Thai economy is still expected to grow over 3% this year and next.

A remarkable thing happened when the Thai stock market opened the next day after the king's death. Instead of plunging, which could be expected, the market soared by 4.5% and small caps ran up by 7%. Thai stocks managed to finish the month slightly higher which shows their resilience in the face of bad news. We spent a little bit of cash in Thailand this month when the market dropped.

JAPAN
Japanese stocks had another excellent month and our stocks especially were very strong. The Nikkei 225 index rose 5.93%. Our stocks advanced more than 13% in Yen. The Yen lost 3.60% against the US dollar. Money still flows into Japanese equities when the Yen falls. At least the magnitude of the move reflects how cheap the stocks are. It was a pleasure to watch the Japanese stocks in the last two months. No big moves, just ticking up little by little each day. That's not to say we didn't have big winners. One of our Japanese real estate companies rose 58% in October after announcing very strong results. Even after this advance the stock is trading at 1 x book value and 8 x earnings while generating 20% ROE and growing earnings at 30%. All of our Japanese holdings were up in October. That almost makes it two months in a row. In September only one stock was down.

SINGAPORE
Singapore stocks were disappointing. Our stocks lost almost 7% and the Singapore dollar lost 2% against the US dollar. We only hold 5 stocks in Singapore. Our gold stock has the biggest weight and the biggest impact on Singapore portfolio returns. It was down 10.5% in October as gold dropped by 3%. The stock jumps around. Nothing fundamentally has changed. Still very cheap and a fast growing miner which actually pays a dividend!

US Commentary (Continued)

the health of the economy down the road, in the short run it will send the market lower. I think this move up in rates is probably about done, irrespective of the December rate hike, so we're not going to have to worry about this for a while. The ECB intentionally planted this idea that they would taper their QE (who knows, maybe it was done to help Deutsche Bank), and they've already walked it back. Central banks less stimulative? Please. They will do this until inflation runs them over.

US Small Cap Value Performance

Re-reading my own commentary from last month, I feel like I should have been more prepared for our awful performance this month in our US Small Cap Value strategy (and the US portion of our Global strategy). I got a little greedy with the rising prices and held off from taking profits, when instead I should have recognized the potential for a move up in rates and a higher dollar to scare the market about just the types of stocks that we have in the portfolio. The worst hits we took were a result of earnings reports, where current earnings were fine but the market was not in a mood to accept uncertainty about next year. Still, even our companies with cyclicality and pristine earnings got hit hard this month. Well, when the going gets tough, the tough go shopping, as they say. We did spend down a good portion of our cash buying cheap stocks, since I feel confident in what the fourth quarter and beyond will bring. I continue to think it's a buy the dip market. Our stocks have a lot of economic skepticism built into their prices, which I think leaves lots of room for upside next year. Despite the poor month we're still having a good year.

The Economy and the Election

If there's one thing I'm absolutely confident in about this election cycle it's that we can identify a clear loser. The fiscally conservative, small government wing of the Republican party has tire tracks on its back and is down for the count. Truth be told, this group's political mojo has been on life support at least since Obama called John Boehner's bluff and the Grand Bargain failed. The American populace is like a kid that has already eaten two cookies from the cookie jar, with a whole bunch left in there. Resistance is futile, what's the incentive to stop now? We'll convince ourselves that these are oatmeal raisin cookies, and they really are healthy! So whoever wins a week from now, we can be prepared for the unleashing of the beast that is government spending. Every so called expert out there says that what we really need is fiscal stimulus (after all, it's worked so well in Japan over the last 25 years). The only argument now is what else we will spend the money on aside from our already planned overspending. Recession in 2017? Only possible if somehow we get actual inflation and the Fed freaks out and raises rates a bunch of times. I would put the chances of that at very low. We'll have rising inflation in the US from wage pressure in the service economy but we are still in the post-commodity bust world where we have declining goods prices. Also, in her latest speech Janet Yellen said she'd even tolerate inflation (central bank communication at its finest, right there). Why not, I suppose, if the Dollar is King, and foreign buyers will keep our rates at negative real yields? I'm guessing that next year we are going to build the inflationary pressures that will be the end of this cycle, because that seems to be what everyone wants. But who knows, maybe we'll end up exporting it somehow. This Fed-induced end of cycle pattern really does not seem to be happening anytime soon. Maybe just as likely is some other boom/bust pattern, but you need to have a boom first before a bust! This expansion is not going to just die of old age, that's not how it works. So I'm not scared of companies with economic sensitivity, and the more these are discounted when the market fears a shock the more excited I am to buy them.

Just the Numbers

	Period Ending 10/31/16			Period Ending 9/30/16				
ZPR Composites Names in Bold *Benchmarks in italics*	Month	Quarter To Date	YTD	1 Year	3 Year Annualized	5 Year Annualized	Inception (if < 5 yrs)	Incep. Date
ZPR Fundamental Small Cap Value	-9.16%	-9.16%	15.14%	36.73%	14.94%	20.67%		
Volume Winners	-0.62%	-0.62%	12.70%	21.98%	13.56%	15.12%		
Volume Value	-0.51%	-0.51%	14.73%	24.61%	14.98%	21.87%		
Volume Momentum	-1.74%	-1.74%	9.23%	14.38%	4.55%	17.29%		
Russell 2000	-4.81%	-4.81%	6.10%	15.46%	6.71%	15.82%		
S&P 500	-1.94%	-1.94%	5.75%	15.45%	11.17%	16.38%		
ZPR Global Equity	-2.26%	-2.26%	9.39%	17.38%	6.20%	14.70%		
MSCI ACWI	-1.67%	-1.67%	5.30%	12.62%	5.75%	11.24%		
ZPR All Asian	3.19%	3.19%	5.61%	4.65%	1.14%	11.32%		
MSCI EAFE	-2.04%	-2.04%	0.12%	7.04%	0.92%	7.91%		
ZPR All Thai Equity	0.13%	0.13%	16.92%	7.29%	7.46%		16.47%	1/1/12
Thai Set Index	0.88%	0.88%	19.87%	13.68%	5.79%		11.98%	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.