ZPR Investment Report

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A NEWSLETTER FOR ZPR CLIENTS

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US Commentary

By Mark Zavanelli

The US market fought off declines and ended little changed in March. International stocks rose. Despite the flat return there was actually a lot that happened this month. The market shook it all off and chose to focus on the one positive element, a clear positive economic uptick in Europe.

In my thinking the most important development was that the Fed hiked rates ahead of where the market thought it would previously. Although this was the third hike, it was the first where the timetable was accelerated instead of pushed back. The Fed now seems committed to a much faster pace of rate increases than was imagined just a couple of months ago, which is a more important development than the single hike. In earlier meetings, they predicted higher rates but never seemed willing to actually do it. So, something obviously changed. I think there were several factors that came together at once which gave the Fed the rationale and opportunity to signal that it wants to get back to normal faster. First, the inflation data so far this year has been higher (but volatile). The headline numbers are mostly about energy prices, but there's still a clear shift higher in core inflation too. Second, economic growth has inflected higher both in the US and internationally. Third, the market presented a very favorable moment, in that

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Asian and UK Results

By Vaidas Petrauskas

All Asian portfolios rose 2.05% in March in US Dollars and are up 8.08% year to date. Our stocks rose in all three markets while the U.S. dollar continued to depreciate against all Asian currencies, which further improved dollar-based returns. In March we added 5 new Thai stocks to the portfolio and greatly reduced (cut in half) the cash position in All Thai accounts. We also added 4 new Japanese stocks and 1 new Singapore stock. The All Asian accounts now are almost fully invested.

Since the beginning of the year the Thai Baht is already up 4% against the U.S. Dollar as capital flowed to that country. The Thai Baht is considered a safe currency because of Thailand's massive foreign reserves and the current account balance of 8% of GDP. The Japanese Yen also appreciated against the U.S. Dollar by more than 4% this year. The Singapore Dollar is up 3.4%. The U.S. Dollar is experiencing some weakness because investors perceived the recent Fed statement as being less hawkish. Also the new administration's inability to push through the healthcare reform signaled that the tax reform may also hit roadblocks. Dollar weakness is temporary I think. Interest rate increases are coming which should lead to stronger dollar,

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ZPR INVESTMENT MANAGEMENT
1642 N.Volusia Avenue
Orange City, Florida 32763

Phone: (386) 775-1177
Fax: (386) 775-7749

E-mail: info@zprim.com
Web: www.zprim.com

Fighting the Last War

By Mark Zavanelli

There has been a massive push into passive equities (Indexing) over the past year, both from institutional and individual investors. Why is this happening now? The news reports say that it's all about the lower fees for passive vs. active, and the increasing utilization of ETFs. That is true, but it misses a deeper reason. Whenever there's a bull market, beta, or market exposure, is king. By definition, in a bull market past performance of the major indices is strong and looks attractive. Passive investments are simply delivering beta at a cheap price, so in these times they look like the best deal around, outperforming other options with low fees to boot. However, this is not a complete view. While they are highly diversified, index funds don't give a whit about risk, only delivering one thing – beta. Active managers as a group will often lag a big market move such as we've had, not because they are bad at delivering return but because they hold cash and are almost by definition more risk averse than passive indexes. Value managers in particular often lag market moves late in bull markets when valuations are high because there's less blue sky upside in boring, mundane industries, and exciting new technologies can be priced without regard to anything tangible about the businesses.

Passive investments do of course serve a valuable role for investors. However, the way they are being used does not. The issue that I have right now is the big increase in positioning, which we see from the flows data. They are being used specifically to add exposure to large cap US stocks, which have outperformed other asset classes, eight years into a bull market. Chasing beta, I believe, is a very foolish thing. Yet it's exactly the pattern that we see historically in the data in past cycles looking at stock ownership (which mostly comes from institutional data). Remember when hedge funds were all the rage? It was because investors wanted an alternative to beta. Why was that so popular early in the post crisis period? Because returns for the market were bad and times seemed riskier (as they always do when the market is low). Granted, hedge funds have not delivered the magic they promised and are also suffering because of their own failures. But the timing of this active to passive switch has everything to do with investors seeing the good market returns and feeling more confident about getting them in the future. I think this is a behavioral misunderstanding of risk rooted in our psychology, where the positive feedback of a good market and the distance from painful events makes us more confident and willing to take risk. This "gut feeling" unfortunately does not work well in describing actual market risk. Since market valuations mean revert over long periods, bull markets actually increase the risk of poor future returns as the market gets more expensive.

Unfortunately, this shift in market sentiment towards passive investments is just another indicator that makes the longer-term outlook for large cap US stocks incrementally worse. Maybe not right now, but there will be a point where beta will act as an anchor and not a tailwind. Investors can prepare by emphasizing diversification, not necessarily within a stock portfolio but across asset classes that are not perfectly correlated. Even within ZPR's strategies, which are all oriented around a small cap value style, there are significant differences in beta. Our Volume Winners strategy, for example, was designed specifically to have a low beta. Also, our international stocks have been much more attuned to local market conditions in recent years and have not been very correlated with the US market.

Volume Value Strategy Recognized

By Vaidas Petrauskas

The performance of our Volume Value quant strategy has really been something to be proud of. Pensions and Investments ranked our Volume Value strategy as #1 in their "Domestic Equity" category for the 5 years ending 12/31/2016, out of 1967 strategies! We are very proud to be #1 and want to thank our team for their dedication and hard work in researching and managing all of our investment strategies.*

**Note: Pensions & Investments Top Performing Manager ratings are provided by Morningstar and derived from their separate account database for specific categories and time periods. Recognition as a Top Performing Manager is not indicative of future performance. Recognition as a Pension and Investments Top Performing Manager is not indicative of future investment success, and working with a highly rated advisor does not ensure a higher level of performance. This award is not based on client evaluations, nor is it an endorsement of the firm by any past or present client. The firm did not pay any fee in order to be included in the rankings.*

US Results (Continued)

stocks have been up, bonds are already worrying about higher inflation, and the dollar has been weak. Despite talking about all sorts of esoteric things, the Fed actually cares about these real factors, and it makes sense that it would use this opportunity to catch up. Interestingly, the market seemed to agree with the move, and stocks, bonds, and the dollar all shrugged off the hike and guidance of more to come. It's as though the market was feeling things were a little too hot, in Goldilocks terms, and is relieved that the Fed won't be behind the curve. You can see this in the 10 year bond yield, which hit 2.6% during the month (Bill Gross's bond bear market number), but settled back down to 2.4%, the low end of its recent range. I also agree that normalization is a good thing, and well past due. So are we out of the woods, and the Fed isn't a danger to the market? Not so fast. This month we learned that we are in a real tightening cycle. These often end badly for stocks, although to be fair history also tells us it will depend on the outcome to the real economy. But that's hardest to predict at inflection points when it matters most. So, we're left with the indicator that we have. While history never repeats exactly, this is a big risk factor for the market as we head down the path of higher rates. I don't think it's a problem right now, but the further along we get the riskier it becomes.

Second, we saw the difficulty in enacting a pro-growth agenda in the inconclusive debate over healthcare legislation. The bottom line is that it is going to be harder than the market was hoping to get anything done that improves the environment for business investment in the US. Optimism on this agenda is part of why business confidence shot to a record and why business investment spending immediately took off after the election. Healthcare was never particularly important to the market, although it actually is for small businesses. The Obamacare rules enforce a rigidity that makes offering employee healthcare an all or nothing proposition. There's also the matter of the Obamacare surcharge on capital gains, which now looks like it will stay. Tax reform is a much more popular subject, although still by no means easy. At the very least the timetable is pushed back, which is not the end of the world but in practical terms means that market is not likely to bake that into 2018 earnings until a bill is actually signed. Although the recent data has been strong, I think this throws cold water onto optimism that the US can grow faster, and that businesses likely will go back to planning for slow growth. It's a little tricky to predict because there is a lot of positive momentum both at home and abroad, and that tends to continue.

To sum it all up, my fear is that we've already experienced most of the positives that drove the market higher since last fall but that further improvement will be hard to come by. We're still in a bull market so the path of least resistance is up, but I think a meaningful pullback this year has become more likely.

Asian and UK Results (Continued)

especially against the Euro. The Dollar already gained back some lost ground in the last week of March.

Our official All Thai return, which is expressed in U.S. dollars, was 3.44% in March. The benchmark Thai SET Total Return index (in Thai Baht) was up 1.60% and a stronger Baht added 1.30%. Our Thai stocks are having a very good year so far.

The Japanese Nikkei 225 index lost -1.1% while the Yen gained 0.4% against the US Dollar. Our Japanese stocks gained around 1% in local currency. We have a portfolio of very good Japanese businesses which are growing nicely while many of them trade for less than book value.

Our Singapore stocks rose more than 2% in March thanks to a very strong performance from most of our stocks, but our biggest weighted Singapore holding (gold stock) slipped by 2% and held us back in March. The Singapore stocks have been disappointing in the last couple of years, but they are finally on an upswing this year.

On March 29th the UK finally triggered the divorce process with the European Union. Negotiations about exit terms and a possible new trade deal will last at least 2 years. The EU requests Britain to agree to pay a 60 billion Euro “divorce bill” for future commitments to the EU before they even start talking exit and a new trade deal. Britain won’t pay. They have been a net contributor to the European Union for many years. It will be a bitter separation. There will be 2 years of acrimonious debate and no results. Meanwhile the UK has a huge opportunity to become a land of minimum taxes and minimum regulation and can once again become a great trading and financial center of the world.

There is a possibility of another Scottish independence referendum. In the last one, which took place a couple of years ago, Scots voted to remain in the UK. The UK Prime Minister Theresa May said she would not allow a second referendum until the Brexit process is finished as they need to be fully focused on that. It is unclear if the second referendum would provide different results to the first. The majority would still vote to stay in the UK according to the polls. Scotland has no central bank. Hence would have no currency. 80% of all commerce is with England. There is no guarantee that Scotland would ever be accepted into the EU if it becomes independent. Imposing border controls and passports when Scots and Brits have been commingled for 300 years? Northern Ireland is a bigger problem with its open border with Ireland.

For now there has been little impact from Brexit on the British economy. It is still growing and even the home builders do not see any slowdown on the horizon. The Pound is holding steady. Our UK stocks, which are part of Global portfolios only, advanced around 0.40% in Pounds in March. The UK FTSE All Share index rose 0.93%. The British Pound gained 1.05% against the US Dollar.

Just the Numbers

ZPR Composites **Names in Bold** *Benchmarks in italics*	Period Ending 3/31/17 Month	Quarter To Date	YTD	Period Ending 12/31/16 1 Year	3 Year Annualized	5 Year Annualized	10 Year Annualized
ZPR Fundamental Small Cap Value	1.77%	5.81%	5.81%	30.22%	11.08%	16.63%	8.24%
Volume Winners	0.83%	3.09%	3.09%	31.97%	17.34%	17.47%	NA
Volume Value	1.79%	5.60%	5.60%	42.37%	19.57%	25.79%	NA
Volume Momentum	1.47%	7.59%	7.59%	24.75%	6.94%	17.41%	NA
Russell 2000	-0.05%	2.27%	2.27%	21.31%	6.74%	14.46%	7.06%
S&P 500	-0.04%	5.90%	5.90%	11.98%	8.88%	14.67%	6.95%
ZPR Global Equity	1.97%	7.14%	7.14%	14.49%	5.56%	13.00%	10.92%
MSCI ACWI	1.29%	7.05%	7.05%	8.50%	3.70%	9.96%	4.12%
ZPR All Asian	2.05%	8.08%	8.08%	5.16%	2.48%	11.27%	14.48%
MSCI EAFE	2.87%	7.39%	7.39%	1.50%	-1.16%	7.05%	1.23%
ZPR All Thai Equity	3.44%	10.48%	10.48%	19.94%	11.09%	16.21%	NA
Thai Set Index	1.60%	2.96%	2.96%	23.85%	9.41%	12.28%	NA

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 compliance@zprim.com.

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 dependcing 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.