// ZPR Investment Report
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A NEWSLETTER FOR ZPR CLIENTS

ZPR Investment Report

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US Commentary

By Mark Zavanelli

US stocks continued to rise in July. Large cap tech stocks were again making strong gains after their pullback last month. Value stocks continue to struggle in this market while the darlings make new highs. This only encourages more momentum seeking among market participants. As I said last month, we've seen this movie before and I don't think it is a good time to join them. Instead, based on this one indicator alone, it's the right time to reduce risk and look to unloved assets. As a value manager, we're not having trouble finding those.

The economic backdrop for stocks at the moment is probably too good. Two important positive things have happened this year that were not expected by the market (nor us). First, a cyclical recovery has finally taken hold in major non-US economies. Japan and Europe have almost zero real growth over the longer term, but that doesn't mean there isn't a cycle, and it's happening now. This has led to a change in interest rate expectations and has moved the US dollar sharply lower. With a weaker dollar and decent economic growth at home, US public companies are

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Asian and UK Results

By Vaidas Petrauskas

We had another good month in Asia thanks to a strong performance by our Japanese stocks and a weaker US dollar. The All Asian portfolios rose 2.81% in July.

Mark already mentioned in his article some of the drivers behind the dollar's weakness this year (The Dollar Index is down around 10% this year against a basket of currencies). First of all, the Trump trade is over – policy developments have been bad for the dollar. Nothing has been done about infrastructure and the failure to reform healthcare raises the risk that tax cuts will also not be easy to agree on. In addition to that we have much better than expected economic and political developments in Europe and Japan. The European economy is now growing, albeit slowly. On the political front in Europe there was a very real fear in the beginning of the year that far-right anti-EU populist parties will gain power in the Netherlands and in France, but pro-EU parties won in both counties. And the election of Emmanuel Macron as French president especially was a boon for the Euro. Money is pouring into Europe.

Fundamentally however, the dollar should be strong because of the yield differential and stronger growth in the US than in Europe. The current weakness in the US dollar is a result of two factors - a loss of confidence in Mr. Trump and talk of potential tapering of QE by the European and other central banks. The success or failure of a tax cut will be very important

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Improving Corporate Governance in Japan

By Vaidas Petrauskas

Investing in Japanese equities can be frustrating because the managements of many Japanese companies don't seem to care about their shareholders. They do not bother communicating to their shareholders about the current business environment or what they see for the company ahead. It is all in the culture. As our Japanese analyst noted, the top management of a Japanese company have usually worked at the same company all their lives and have slowly risen through the ranks to the top by strictly following the rules. They are not entrepreneurs. When such a person becomes a President of a company, his/her main objective is not to do anything stupid to endanger the existence of the company (avoid shame) and to strengthen the company the best they can so that they can pass it on to the next generation in good condition. The shareholders of the company or the stock price are not their priorities. They have an interest in preserving a long-term corporate value. If this includes conservative management, piling up capital for a rainy day, and various other poor capital allocation decisions that annoy investors, so be it. This description certainly seems accurate from our experience.

The corporate governance problems in Japan are well known - Japanese companies have notoriously low returns on capital, there's a lifetime employment system with people working at the same job all their lives, and protectionist cross-shareholdings are widespread. Nikkei 225 companies have the lowest median proportion of independent directors (26%) and female directors (0%) and the oldest average age (63.2 years) among developed-market peers. So the boards of directors are packed with yes-men who just want to serve out their term quietly and not cause any trouble. That's partly the reason why we had such big Japanese corporate implosions recently like Olympus and Toshiba. Nobody questioned the CEOs decisions.

Partly because of low returns on equity, the Nikkei 225 index is still nearly one-half of its 1989 peak, although currently the index hovers close to its 2-year high. Japanese companies' ROE stands at around 7-8% while the global standard is above 15%. In a recent interview Seth Fischer, who is the founder of Hong Kong-based hedge fund Oasis Management which invests in Japan, said "With better governance, I believe comes increased margins, much more efficient use of balance sheets, which would dramatically increase ROEs (return on equity), which would, I believe, more than double the Nikkei over the next three to five years". Potential changes in culture could unleash a sea change in valuation of Japanese equities.

There has already been some improvement in recent years. The corporate governance reform is being pushed from above – by the government. The reform – pushing companies to increase outside board members and encouraging more dialogue between shareholders and company management – has been a key part of Japanese Prime Minister Shinzo Abe's drive to revive the economy, along with monetary and fiscal stimulus. This is Abe's third arrow. The government also encourages investors to be more forceful in prodding companies to increase returns. There has been an increase in activist campaigns and acquisitions in Japan. There has also been a pickup in share buybacks by companies. Considering that shares of many Japanese companies trade at or below book value, share buybacks are an attractive and underutilized way to deploy cash that many corporations prefer to simply hoard. Shareholder proposals and votes signaling disapproval of management or of external directors are becoming more common. The Tokyo Stock Exchange, too, is pushing for better governance by introducing new corporate governance rules for public companies and has launched a JPX-Nikkei index of 400 companies, chosen for their higher returns on equity and strong governance. These are all only baby steps but in the right direction.

One aspect of Japanese corporate culture which we have found especially troubling, and which isn't talked about at all, is the way management issues earnings guidance for the present year. True to their nature of being ultra-conservative stewards of a company for future generations, the management does not try to issue an accurate earnings guidance. Instead they issue a low-ball number that they can definitely beat (avoid shame). This behavior is true everywhere but in Japan takes on an extreme nature, almost as though they are providing a worst case scenario. We discover and research these companies thinking they are a good investment and the company indeed does very well operationally, but then at the end of the fiscal year they give an awful forecast for next year sending the stock down instead of up on recent good results. And then they carry that awful forecast for a long time, the stock goes nowhere and what should have been a good investment languishes with no gain and all credibility of the company is lost.

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Improving Corporate Governance in Japan (Continued)

Again and again, year after year they do this, and finally as a shareholder we cannot take it anymore. In many cases we had failed to make any money for our investors when the company has actually been very successful, but not its stock price. One would imagine that the market would see through these biased forecasts, but in practice we have found that instead it places a cloud over the company's prospects and management credibility that impacts valuation.

For two of our recent holdings, we took the step of writing them (in Japanese) to raise the issue and got no response. While we eventually did get offered a meeting, it's pretty clear that these managements aren't too interested in responding even to professional foreign investors. Without confidence in a pathway to a higher stock price, these are no longer stocks we want to own.

Since we got no reply to our letter we are now sending them directly to Shinzo Abe's cabinet and the government officials and agencies responsible for improving the corporate governance in Japan to make them aware of what is important to us – the foreign investors. The change in corporate mind-sets will take time, but government officials acknowledge the problem and are taking steps to address it. Although at a very slow pace, things are moving in the right direction in corporate Japan.

US Results (Continued)

seeing growth in both sales and earnings. They are surprised by the positive inflection too, and had planned for the previous environment where costs were rising without sales and margins were being squeezed. They are responding in the natural way, becoming more confident and switching to pursuing growth. This is positive for the corporate earnings cycle, and we're not close to the point yet where overinvestment becomes a problem.

For the market, there's a Yin and a Yang to good news. Remember that high returns come from fear and low valuations while low returns come from exuberance and high valuations, both conditioned on the actual outcome of economic events. So, we're certainly happy that good economic conditions are occurring because stock prices are tied to that economic value. However, if the market starts losing its natural fear of things going wrong and jumps prices up too much too fast, at some point those gains will have to be given back. Of course, it's not easy to separate the two because they go hand in hand. Lately, the fall in the dollar and the resurgence of overseas economies has taken the pressure off of two major risk factors in the world financial system: China's currency and the Euro. The fear here was similar, that the huge stimulus efforts to prop up bad debt problems would result in a currency meltdown. The pressure release is partly a "real" impact, because the risk of an imminent problem actually has diminished with a better economy. But I would argue that the bigger impact is that the market's fear has gone away, at least temporarily. Does that mean these problems are really solved? No. It isn't a problem of low growth really in either case, but of bad incentives and bad structure. However, there's a big difference in impact between a crisis and a long term structural problem, and maybe with luck this has transformed into the latter.

In their reaction to the market movements, we're going to learn something about what central bankers really believe over the next few months. For the Fed at least, they have a clear green light to normalize further because the market is up, the dollar is down, and credit spreads are tight. They give lip service to inflation targeting and the market believes them, but I think they will soon signal more tightening because the environment allows it. US stocks might not like that, and we could see some traditional August-September weakness. If momentum stocks falter again it might turn into a real pullback. Despite this, the medium term looks to be a continuation of good times with the path of least resistance higher for stocks. I remain very concerned about longer term returns from this starting point however, and I think consideration of risk should come before consideration of return.

Asian and UK Results (Continued)

for the future direction of the dollar. Central banks will also play a key role in the direction of currencies in the coming years. If the Federal Reserve starts reducing its balance sheet while its counterparts in Europe and Japan do not, this will be a positive for the dollar. For now US corporations are big beneficiaries of a weaker dollar and this makes US exports more competitive.

Thailand

Our Thai stocks took a breather after a strong performance in the first half of the year as investors took profits in some of our biggest winners. The official All Thai return, which is expressed in U.S. dollars, was -1.65% in July. The Thai Baht strongly appreciated by 2.01% against the US Dollar. We lagged the benchmark Thai SET Total Return index (in Thai Baht) which was up 0.10%.

Japan

Japan was the bright spot. Our basket of Japanese stocks rose more than 5% in local currency in July. The Nikkei 225 index actually was down -0.54% although small cap Japanese stocks performed better – the Topix Small Cap index was up 1.64%. The Yen advanced by 1.28% against the US Dollar.

UK

The UK FTSE All Share index rose 1.10% in July. Our stocks lagged with a return of around 50 basis points as one of our illiquid micro caps dropped 16% for no apparent reason. The British Pound finished the month stronger, gaining 1.29% against the Dollar.

Singapore

We only have four stocks in Singapore at the moment. They rose around 1% in local currency and a stronger Singapore Dollar added another 1.42% to the dollar-denominated return. The Singapore stock market, as measured by the FTSE ST All Share index, rose 2.49%.

Just the Numbers

	Period Ending 7/31/17			Period Ending 6/30/17			
ZPR Composites Names in Bold *Benchmarks in italics*	Month	Quarter To Date	YTD	1 Year	3 Year Annualized	5 Year Annualized	10 Year Annualized
ZPR Fundamental Small Cap Value	2.57%	2.57%	11.07%	20.35%	10.03%	16.54%	7.50%
Volume Winners	-0.47%	-0.47%	10.63%	37.21%	18.27%	18.56%	NA
Volume Value	-0.59%	-0.59%	10.58%	53.26%	22.57%	22.99%	NA
Volume Momentum	-0.85%	-0.85%	12.40%	41.07%	8.84%	17.32%	NA
Russell 2000	0.69%	0.69%	5.72%	24.61%	7.36%	13.70%	6.92%
S&P 500	1.93%	1.93%	11.47%	17.91%	9.63%	14.64%	7.18%
ZPR Global Equity	2.51%	2.51%	14.75%	22.67%	5.16%	12.47%	10.11%
MSCI ACWI	2.83%	2.83%	14.98%	19.45%	5.40%	11.15%	4.27%
ZPR All Asian	2.81%	2.81%	17.05%	24.66%	2.25%	10.52%	13.39%
MSCI EAFE	2.89%	2.89%	17.53%	20.84%	1.61%	9.21%	1.51%
ZPR All Thai Equity	-1.65%	-1.65%	17.06%	26.34%	7.29%	15.17%	NA
Thai Set Index	0.10%	0.10%	4.21%	12.54%	5.27%	9.74%	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.