ZPR Investment Report

February 2018 Volume 24, Issue 2

A NEWSLETTER FOR ZPR CLIENTS

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US Commentary

By Mark Zavanelli

Large cap US stocks sprinted higher in January, led by Tech shares, while smaller stocks lagged (especially our own SCV strategy). Sizable inflows into equities drove prices higher, which at least partially explains the better relative performance of stocks with a big weight in the major indices. Surprisingly, this also showed that there was still money on the sidelines to fuel market gains. I wouldn't count on this situation continuing, however, since measures of investor sentiment are already very high. This is also occurring as volatility is rising. I think that this combination sets us up for a correction in the near term. This would be healthy for the market, while further parabolic increases would be a bad sign. It's time to be fearful when others are greedy, although I don't think we're quite to that point yet.

It's not uncommon to see big moves in a variety of markets in January as there is a lot of rebalancing activity. In addition to the move in stocks, we saw bonds drop sharply (sending interest rates higher) and the dollar weaken. The fall in the dollar was the major contributor to foreign stock returns when translated back to the US.

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Asian and UK Results

By Vaidas Petrauskas

Weakness of the US Dollar continued to be the prevailing market theme in the beginning of 2018. This Dollar weakness continues to benefit our Asian investments as the US currency depreciated strongly against not only Asian, but almost all currencies in January.

I again present the table showing the change of foreign currency rates against the US Dollar, because currency changes are a very important component of total returns achieved by investors in foreign markets, sometimes even more important than the return from stocks. The following table shows the performance of selected foreign currencies against the US Dollar in January '18.

Thai Baht	+4.0%
Singapore Dollar	+2.2%
Japanese Yen	+3.5%
British Pound	+5.0%
Euro	+4.0%

These are big changes for one month and that's on top of the big Dollar depreciation in 2017.

Our All Asian accounts rose 5.30% in January. This was achieved because of continued solid performance of our Japanese stocks, a very strong rebound in Singapore (we only have two stocks

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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

The 5% vs the 95%

By Mark Zavanelli

There always comes a point in a bull market where the market indices start to look so good in terms of historical performance that they become the default option for most investors. If it's easy, cheap, and good, the question becomes, why bother doing anything else? There's also the comfort of buying well-known companies whose products we use every day, or the excitement of buying companies that seem to represent the future of a particular industry or technology. There have always been such companies, and the reaction of investors is predictably the same in each cycle. As businesses, these companies do represent something new each time the cycle turns, but as investments they are just the same, because the same psychological forces are at work to set their prices. This is investing with the heart, not the mind. There are times when such companies are in a favorable environment and the returns are great. They are particularly susceptible to momentum markets. That's where we have been for the last year, and it might continue. But historically on average you have to accept a lower return to own Mega Cap stocks (the biggest of the big), which is somewhat offset by their lower volatility.

In this particular bull market, we also have a new investment structure, the ETF (Exchange Traded Fund). While this vehicle has a lot of advantages, it has also served to accelerate the shift in money flows to the market index itself. Within the ETF world, flows and assets are dominated by a small number of funds representing major indices. The problem now is that the positive benefits of ETFs are co-joined with performance chasing. Since the volatility of returns dominates the smaller effects of fees or tax benefits, even over multi-year periods, the outcome of the rush towards ETFs is likely to hinge on how that performance chasing works out. I believe that momentum, as it is practiced by the average invested dollar, is a Weapon of Return Destruction. Investors think they see it working by looking at what has just happened, but in reality momentum is tuned to a very particular trading horizon which almost no investor (basically just pure quants) is prepared to utilize. Instead, at the longer horizon that most investors actually use to make decisions, what matters is that valuation (the price you are paying) and returns are inversely related. At that horizon contrarian behavior works, which almost no one will actually do, because it feels too risky. This is a Cassandra-like story, but it's why markets act the way they do and seem so irrational.

There is an antidote to the situation we are in today. It's not true that all equities are expensive and there's nowhere to invest sensibly. The key is to put more weight where the indices aren't, which can be accomplished in multiple ways. At the highest macro level, this means investing more in smaller foreign markets, and less in the US, which is by far the largest market. Next, even if your portfolio has effectively the same stocks as the index, holding them in non-market cap weights is likely to yield results that are different from the index. Finally, you can go where the indices aren't, to the 5% of market cap that is left out because it's illiquid and uneconomic for the index business. This is where ZPR primarily invests. Our motivation to be there actually is independent of the market environment, because we want to be relevant across different points of the market cycle. We invest there primarily because our research shows that market inefficiency is greater there, not surprisingly, and we can use our models and tools to get an edge in this pool of stocks. But I also believe that what we do has additional value at times like this when the 5% is out of step with the 95% due to all of the excitement over the biggest stocks. The diversification value of what we do goes up as the correlation with the rest of the market goes down.

US Commentary (Continued)

The rise in interest rates, even though absolute levels are still low and likely to stay low, is a big deal for the entire financial system. As I've said before, we are transitioning to a new environment. For now, the jump in world economic growth we are seeing is dominating, and equities have effectively had to catch up with the good news. That doesn't mean that the rise in rates is going to be harmless to stock prices over time, however. The denominator in the equation for valuing companies, which is interest rates, is almost always more powerful than the numerator, which is earnings or cash flows. US stock investors are reaching the point where what's good for the overall economy is not necessarily good for stock prices. Usually inflation must be rising for that to be true, but we have been in an environment of unusually depressed real yields (where the inflation rate is removed) as well as nominal yields. So those real yields can rebound, sending interest rates higher, without any extra inflation. This is happening as a byproduct of the end of QE and the prospect of ongoing US fiscal deficits. It's also likely that inflation will rise somewhat, which will also contribute to the overall rise in rates. This is not a conducive environment for ongoing strong returns for the stock market averages in the US, despite what we've seen so far in January. This doesn't mean, however, that there won't be stocks that can perform well despite the environment. Correlation within the market is not high, and there are cheap stocks.

The impact of rising rates is also not the same across world markets. For most foreign markets, the faster growth has been an unexpected positive shock, changing the trajectory of their economic cycle and corporate earnings, with a lot of room to run. While my denominator comment still generally applies, the super low rates overseas were never reflected in stock price values the way they have been in the US. I attribute this to a resistance to bake in artificial QE levels into long term prices. We saw the same thing in the US earlier in the post-crisis period. So I think foreign stock P/E levels, which are significantly cheaper than US stocks, can continue to rise along with earnings. The bottom line is that the faster pace of growth and the rise in rates is much better news for non-US markets, and as a result the outlook there for stocks is much brighter.

Asian and UK Results (Continued)

there), and the already discussed Dollar weakness.

Our Japanese stocks rose around 3% in January in local currency. A stronger Yen added another 3.5%. So January was another solid month in Japan. The Japanese stock market has been very good to us since mid-2016. How long this lasts I do not know. But I do know that we have a collection of some of the cheapest stocks in the world of companies which are growing strongly. I read an article in the Nikkei Asian Review that foreign fund managers are only now starting to discover Japanese small cap stocks. So I have a feeling that the bull market in Japanese equities is far from over.

We still treat Singapore as a separate market although we only have two Singaporean stocks. Last year our returns in Singapore stocks were dismal. This January the Singapore part of the portfolio rose 18%. But one of our two stocks is responsible for the whole gain – the heavily weighted industrial automation company's stock rose 26%. This Singaporean stock had the biggest positive impact on our All Asian results in January.

Our Thai stocks were almost unchanged for the month, but the Thai Baht continued to strengthen, resulting in a gain of 3.56% for All Thai accounts. We finished the month far behind the main benchmark - the Thai SET Total Return index rose 4.19% in baht. Thai large capitalization stocks clearly led the way in January. The FTSE SET Small Cap index rose only 1.45%.

UK stocks sold off in January. The UK FTSE All Share index closed down -1.99%. Our stocks lost -2.8%. However, similarly to the situation in Thailand, we were saved by the strong currency. The British Pound appreciated very strongly, gaining 5% against the US Dollar in January. So, because of the currency, we had a positive month in the UK when expressed in US Dollars.

We updated the following table showing the weighted average valuation, profitability, and growth statistics of our portfolio companies by country and comparing them to the S&P 500 index. This will give you some understanding about what kind of companies we currently hold in the portfolio. We are usually looking for profitable and growing companies which are

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Asian and UK Results (Continued)

undervalued. Of course everyone is looking for stocks like that. A great company is rarely cheap and a cheap company is rarely great. Most cheap stocks are cheap for a good reason. Markets are mostly efficient, especially the US stock market. The trick is to find those very rare out of favor or misunderstood companies which are temporarily mispriced.

	Thailand	Singapore	Japan	UK	US	S&P 500
Price / Earnings TTM	11.6	12.2	9.3	14.4	18.4	25.6
Price / Book Value	1.8	1.0	1.1	3.9	3.1	3.6
Return on Equity (Median)	16.4%	6.0%	12.6%	22.4%	15.5%	15.2%
Net Income Growth – TTM (Median)	9.2%	52.1%	23.1%	1.3%	16.7%	7.0%
GRAPES Upside (Median)	54%	96%	87%	95%	77%	0%
Market Cap (USD) Mill. (Average)	$338	$324	$496	$2,479	$2,120	$52,721
Dividend Yield (Average)	4.5%	1.7%	1.8%	3.8%	0.9%	1.8%

Source: ZPR calculations based on data from Thomson Reuters

Just the Numbers

	Period Ending 1/31/18			Period Ending 12/31/17			
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	-1.21%	-1.21%	-1.21%	25.38%	18.20%	19.59%	10.35%
Volume Winners	1.26%	1.26%	1.26%	13.45%	18.40%	18.96%	NA
Volume Value	-0.20%	-0.20%	-0.20%	16.24%	20.45%	23.02%	NA
Volume Momentum	-0.87%	-0.87%	-0.87%	17.61%	10.65%	17.52%	NA
Russell 2000	2.57%	2.57%	2.57%	14.65%	9.96%	14.12%	8.71%
S&P 500	5.62%	5.62%	5.62%	21.84%	11.43%	15.80%	8.50%
ZPR Global Equity	2.46%	2.46%	2.46%	27.07%	12.28%	13.05%	12.61%
MSCI ACWI	5.66%	5.66%	5.66%	24.63%	9.90%	11.40%	5.22%
ZPR All Asian	5.30%	5.30%	5.30%	28.90%	9.10%	9.50%	15.57%
MSCI EAFE	5.02%	5.02%	5.02%	25.63%	8.30%	8.38%	2.43%
ZPR All Thai Equity	3.56%	3.56%	3.56%	15.64%	7.99%	9.03%	NA
Thai Set Index	4.19%	4.19%	4.19%	17.30%	8.85%	8.18%	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.