ZPR Investment Report

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A NEWSLETTER FOR ZPR CLIENTS

Contents:

US Commentary

By Mark Zavanelli

US and international stocks finished a strong year with gains in December despite minor losses for small caps. In addition, correlations between stocks were low as the market rotated from one group of stocks to another. Energy stocks, 2017's worst performers by far, were the leaders in December due to rising oil prices. For the overall year though, Technology stocks ended with the highest return. Demand for US equities was strong in 2017 because corporate earnings resumed growing, tax cuts became increasingly likely, and overall global economic confidence improved. Large flows of money into index ETF's were the biggest driver of performance, and this was part of the reason Large Cap Growth more than tripled the performance of Small Cap Value for the year (according to the Russell Indices). I am pleased that we could deliver outperformance in a year with such strong style headwinds.

I will discuss 2018 predictions to a greater extent in another article, but I will briefly summarize by saying that I do not see the next year playing out the same way as the last, despite the global economic backdrop's stability. In reality, we continue to exit from the post-financial crisis environment into a new phase with unique characteristics. This is not necessarily negative, but there will be surprises.

In the near term, the tax bill will be very important for corporate earnings and activity. The final bill kept the most important provisions for corporations, including the lower tax rate, a special rate for repatriation of foreign held assets, and expensing of capital spending. Taken together, these will have a meaningful

(Continued on page 3)

Asian and UK Results

By Vaidas Petrauskas

2017 was a good year for Asian stock markets. The export-dependent region benefitted from the global recovery. This also lifted Asian currencies which boosted our returns when expressed in US Dollars. The following table shows the performance of currencies relevant to us against the US Dollar in 2017.

Thai Baht	+9.86%
Singapore Dollar	+8.11%
Japanese Yen	+3.82%
British Pound	+9.72%
Euro	+14.11%

(Continued on page 3)

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Outlook for 2018

By Mark Zavanelli

"Prediction is very difficult,
especially if it's about the future."
-Niels Bohr

A wise investor carries a healthy dose of skepticism about future predictions, focusing instead on potential return versus risk. Considering a range of possibilities guards against overconfidence, even if those ranges are approximate. In our investment strategy, the anti-prediction, or betting against the market's conventional wisdom as expressed in relative values, is emphasized much more than our own attempts to speculate on the future. Instead, I focus on economic and market conditions that are reflected in current prices but might be subject to change, especially when those conditions differ from the historical norm.

The period from mid-2016 to the end of 2017 ushered in important changes for the market, resulting in an abnormally positive return. We experienced a resumption of corporate earnings growth in the US, a revitalized economic picture outside the US, and a tax cut that served as the culmination of a business-friendly policy. These factors dominated risk as the driving factor of market performance. In 2018, however, all of these occurrences are already priced in to some degree. This does not mean that more gains will not come with continued good news, but it does dictate that the abnormally high positive returns are mostly in the past.

In 2018, I expect risk and volatility to play a much higher role in establishing market prices. The current perception that risk is very low is, in my opinion, a result of constantly rising prices and not a reflection of reality. This will be a headwind to market performance compared to what we have recently seen. This should not be too shocking, as risk and volatility both serve as reversion to the mean "anti-predictions".

Furthermore, I believe that we have exited the economic environment of the post-crisis period. I do not think the current growth is "normalization" any more, but instead is a jump to a new mid-late economic cycle (at least in the US). The post-crisis period has been highly unusual, with unprecedented central bank policy. But now the economy is entering a new phase, which might be more similar to past economic cycles than the period we have just experienced. This was a tough period for many in the economy, and such a jump is good news. For US equity investors, however, this was a very good period for returns. This time was marked by abnormally low rates, and P/E multiples rose to reflect that. Even without any signs of inflation, rising short term rates in 2018 will likely put the brakes on continued P/E expansion, which means that market gains will have to come from earnings. This is not a problem though, since earnings will likely rise over 10%. On the other hand, risk is clearly rising too, since bad economic events have a higher probability of occurring as you get further into a Fed tightening cycle.

Finally, I believe that the valuation gap between US and foreign shares, where the US market is valued at significantly higher earnings multiples, is likely to further shrink in 2018. This will likely happen through foreign markets realizing a higher return (at least in local currency) than US stocks. Foreign stock values, outside of trendy markets such as India, generally still reflect the poor earnings environment that existed in 2016 after the crash in oil prices. While they might not catch up with US multiples, there's a favorable combination of a cycle that is still early and valuations that still have room to rise, both of which are in contrast to the US market. Correlation to the US was high in 2017 as everything rose together, but that will not necessarily be the case in 2018.

Returning to the concept of considering potential returns alongside potential risks, these negative factors for US stocks should be considered together with the fact that we are still firmly in a bull market alongside an economic expansion. Looking at history, the null hypothesis for that condition is equity market gains. The presence of risk does not mean that positive surprises will not occur to produce a good outcome. Instead, it means that we should have balance in our stock allocation that reflects the possibility of both gains and losses. With the market relying more on earnings growth than investor flows to drive returns, I think it will be a less friendly environment for passive investing, instead favoring value strategies and stock selection overall.

Review of Quant Strategies

By Vaidas Petrauskas

At the end of each year I will review the performance of our quant strategies. It was another good year for our quant strategies. Not on the same level as previous years when the strategies surpassed the benchmark by a wide margin, but considering the environment, they performed slightly better than our research indicates. We compare the performance of our quant strategies to the Russell 2000 index because the stocks we buy for the quant strategies come from our Micro Cap 1000 universe, which is roughly the same as the smallest 1000 companies in the Russell 2000 index.

Volume Winners was the only quant strategy which lagged the Russell 2000 index (13.45% versus 14.47%). Volume Winners is our most defensive strategy with a lower risk objective intended to reduce drawdowns during a market sell-off. So this year's result is quite good considering that stocks advanced strongly in 2017.

Volume Value continues to perform well, outperforming the Russell 2000 index by almost 2%. The strategy is also intended to be lower volatility than the market, but higher volatility (and higher return) than Volume Winners. It is commendable that the Volume Value strategy continues its track record of outperforming the benchmark during a rising market. The market environment this year was especially challenging for Volume Value: large cap stocks beat small cap stocks and growth stocks beat value stocks. So our Volume strategies were in the most unfavorable style box. Still, Volume Value managed to outperform the Russell 2000 index, although it could not match the S&P 500 as large cap tech stocks were unbeatable this year in the US market.

Volume Momentum finally had a good year. It had a difficult couple of years prior to 2017, but this year it was our best performing quant strategy. Volume Momentum is 50% Volume Winners strategy (very conservative) and 50% Super Mocon strategy (very aggressive). Because it was the year of momentum and growth, the combination of Super Mocon with Volume Winners worked out well.

US Results (Continued)

positive effect on corporate income and investment. The drop in the corporate rate will show up relatively quickly in earnings forecasts, while the incentives around capital deployment will take a little longer to play out as corporate planning is revised. It's a safe bet, however, that we will see a surge in corporate spending as those plans take hold.

Asian and UK Results (Continued)

Our All Asian portfolios rose 28.90% in 2017. Global portfolios rose 27.07%.

Japanese stocks were the biggest winners for us, helped by strong earnings growth. The Nikkei 225 index rose 19.10% in 2017 while the Small Cap Topix 2nd Section index rose 39.12%. Our Japanese stocks rose more than 40% in 2017 in local currency. We also benefitted from a stronger Yen.

The Thai stock market finished the year with a modest sell-off. Our official All Thai return, which is expressed in U.S. dollars, was 15.64% for the year. Considering that the Thai Baht rose 9.86%, the return from our Thai investments in local currency was less than we would like and behind the main Thai benchmark. The Thai SET Total Return index (in Thai Baht) posted a gain of 17.30% for the year. But the performance among Thai stocks was very uneven. The index of small capitalization Thai stocks - FTSE SET Small Cap, was barely up for the year.

There are several reasons for our lackluster performance in Thailand in 2017:

1. In November - December we lost money in Thailand because of a market sell-off and some of our stocks were especially hard hit after their earnings release in November.

(Continued on page 4)

Asian and UK Results (Continued)

2. We held a large amount of cash. At some times during the year we held a third of the portfolio allocated to Thai stocks in cash. The reason was that stock prices were running ahead of fundamentals and we could not find new bargains. Cash was held in US Dollars (we cannot hold cash in Thai Baht), so the portfolios did not fully benefit from the Baht appreciation during the year.

We view the current weakness in Thai stocks as temporary. The Thai economy is expected to grow strongly next year. We continue to look for bargains in Thailand and add on weakness.

Our Singapore stocks had another difficult year. We had a couple of big losers in the beginning of the year and that made it difficult to recover. We only have 2 Singapore stocks left at this point and we do not plan to have many more in the future. We lost around 5% in Singapore for the year and finished far behind the local indices. Only a stronger Singapore Dollar helped reverse our losses in Singapore. The main Singapore index FTSE ST All-Share rose 17.67%. Big banks have a large weight in that index. So it is not a good benchmark for us. A more appropriate FTSE ST Small Cap index rose 7.43% for the year.

Our Global portfolios got a nice boost from UK stocks and the currency in 2017. We made over 18% on UK stocks in 2017 in Pounds. For comparison the UK FTSE All-Share index rose 9.00%. In addition to that, the British Pound appreciated by 9.72% against the US Dollar, making it a very solid first year for us in the UK. Unfortunately, our allocation to the UK is small because of a shortage of stocks that meet our criteria.

Going into 2018 our All Asian portfolios continue to have a very large allocation to Japanese stocks. That market is the only stock market where we can still find bargains, although less so now than a year or two ago. We currently own 23 Japanese stocks. We never know what the currency will do, but I think Japanese stocks will continue to do well going forward. Earnings are growing strongly and there are also visible improvements in corporate governance. Being exporters, Japanese companies are benefiting from improved global growth and relatively weak yen.

Markets move in cycles. Japanese equities had been in a prolonged bear market from 1989 until 2012. That’s a painfully long time. One of the reasons for such prolonged bear market is that at the peak in 1989 the valuations of Japanese stocks were crazy. Stocks became so overvalued that Japan accounted for 45% of the global stock market in 1989. Real estate was even crazier. I read that by the end of 1989 total real estate values in the city of Tokyo exceeded the cost of all real estate in the United States, and by 1990 the total Japanese land values reached levels that were 50% higher than all land in the rest of the world.

It takes a long time to work through such excesses. The Japanese economy went in a prolonged period of stagnation after 1989 as real estate prices crashed and took the economy with it. The mood changed from extreme optimism to the opposite. Japanese are still reluctant to spend money. The mood will improve if people start seeing better prospects. The current bull market in Japanese equities started in 2012 when Shinzo Abe became the Prime Minister. If this is a new secular bull market in Japanese equities, it could last for some time.

Just the Numbers

	Period Ending 12/31/17			Period Ending 9/30/17			
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	-0.50%	5.31%	25.38%	22.32%	15.79%	17.82%	8.92%
Volume Winners	1.74%	0.09%	13.45%	31.91%	19.49%	18.83%	NA
Volume Value	0.23%	2.33%	16.24%	40.23%	23.86%	22.73%	NA
Volume Momentum	0.00%	0.49%	17.61%	31.34%	12.16%	17.59%	NA
Russell 2000	-0.56%	3.17%	14.47%	20.75%	12.18%	13.79%	7.85%
S&P 500	0.98%	6.51%	21.69%	18.63%	10.83%	14.23%	7.44%
ZPR Global Equity	0.65%	4.86%	27.07%	23.96%	7.81%	12.72%	11.50%
MSCI ACWI	1.65%	5.84%	24.62%	19.30%	8.03%	10.80%	4.45%
ZPR All Asian	1.25%	4.89%	28.90%	26.27%	3.70%	10.21%	15.11%
MSCI EAFE	1.62%	4.27%	25.62%	19.68%	5.52%	8.90%	1.83%
ZPR All Thai Equity	-1.02%	-4.01%	15.64%	23.74%	6.38%	12.30%	NA
Thai Set Index	3.41%	5.02%	17.30%	16.43%	5.12%	8.77%	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 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.