ZPR Investment Report

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A NEWSLETTER FOR ZPR CLIENTS

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US Commentary

By Mark Zavanelli

US stocks rose slightly in April as market volatility continued. A positive corporate earnings season has been offset by the negatives of higher commodity prices and renewed increases in interest rates. The market now has to balance positives and negatives about the outlook, unlike a few months ago when the negatives were further in the background and optimism was more one-sided. This has produced the volatility we are seeing today. However, without an unexpected jump in inflation I don't see why it can't resolve positively and send the market higher.

Our own performance this month was mixed, with our volume-based quant strategies performing well and our fundamental strategies lagging. Our volume strategies are constructed to sidestep market volatility, and this is the type of environment where we would expect them to show outperformance. They can be left in the dust when the market is rising rapidly, but in a choppy environment the attribute of steering clear of the market's attention is a positive one. I continue to think that this is an important diversification benefit. In our SCV strategy, we've been hit by a couple of factors simultaneously that have hurt performance so far this year. First, our biggest winners from 2017 reversed sharply, as those companies are generally in cyclical industries that have seen substantial earnings gains the past few years. The businesses are unconnected, ranging from semiconductors to homebuilders and RV

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Asian and UK Results

By Vaidas Petrauskas

In April our All Asian portfolios lost 2.78%. The resurgent US dollar was the main culprit of poor performance. After a long period of underperformance, the dollar advanced strongly in April. It gained 1.2% against the Thai Baht, 1.1% against the Singapore dollar, 2.8% against the Yen, 2.1% against the British Pound, and 2% against the Euro.

The dollar strengthened as the yield on the 10-year US government bond advanced toward and then crossed 3%. Emerging market currencies like Turkey, Brazil, and Russia were especially hard hit, losing around 3%.

Where the US dollar goes next, I can only speculate. My guess is that the dollar continues to get stronger. I have said before that based on the interest rate differential, the dollar should be stronger, but there are many factors affecting currency movements and it is very hard to say if this is the beginning of a new trend of a stronger dollar or just a temporary blip. Major currency pairs tend to move in long-term trends with long periods of outperformance by one currency followed by long periods of outperformance by another, like we see with the EUR/USD exchange rate. For long-term investors these movements do not matter. For example, the EUR/USD exchange rate is now at the same level it was

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Is This Normal?

By Mark Zavanelli

It’s a confusing time to be an investor, with many cross-currents. Part of the reason is that while the economic cycle is progressing normally relative to past precedents, we are dealing with some conditions that are different from what we have seen in a very long time, if ever.

First the normal. The current cycle has plodded along slowly for most of the last 10 years, but we are finally seeing an increase in optimism and spending that looks like other past cycles. Now the market worries how long it can be sustained with potential supply constraints, since unemployment is very low and commodity prices are recovering. Overheating is clearly a risk to the cycle, and the market fears both the Fed for its rate increases and a true rise in inflation. The market reacts in a volatile way to incoming economic data since there is higher perceived risk. These aspects are completely normal, late cycle dynamics. In some cycles, this is a very good period for investment returns because good news is abundant. Hot momentum stocks, and the big gap between Growth and Value returns are typical. If left relatively to its own devices, there are historical examples of the economy making its way just fine from this starting point (but not the hot Growth stocks, sorry). We might actually not be late cycle, and might continue on for years, given the trend for recent cycles to be longer. Even if we are late cycle, there are historical precedents of soft landings or mild recessions. Even in the 2000 cycle, the massive tech overinvestment wasn’t enough to cause any real economic damage (just damage to the overvalued stocks). The bad examples have financial crises, war and commodity shocks in them. These aren’t truly random events, but they don’t happen every cycle either. Overall, I think the market does a reasonable job of discounting these normal cycle aspects, even if the “black swans” are also more normal than we might think. My take on how we should react to the normal cycle is that we should emphasize diversification, have modest expectations, and avoid greed that causes us to overextend.

Next the Non-Normal. Unfortunately, we have the legacy of the last crisis to contend with. The history is that in order to save the world from the 2008 Financial Crisis, the Fed drove market interest rates to zero and pumped the economy full of money by buying massive amounts of government bonds (which is very much akin to printing currency and having the government spend it). This seemed to work so well, without producing inflation, that it was copied by the ECB and the BOJ to help them with their own goals, collectively covering almost the entire developed world, which in financial terms is almost everyone except China. Since China manages its exchange rate to the US dollar, it effectively shares in US monetary policy. While the Euro did have its separate problems to deal with in Greece and elsewhere, the reality is that the world central banks pursued a coordinated policy of extreme manipulation of interest rates after the financial crisis was long over. The result of this was not only extra government debt but a massive increase in debt everywhere you look due to the lower rates. Public, and private. Corporate, and consumer. High quality, and high yield. This is a very one-sided risk. It doesn’t matter until it does. When the normal economic cycle is ticking along, the debt seems very benign. Defaults are very low, and positive economic times allow for continued growth in debt that fuels growth. But now the Fed is trying to reverse the process, and the other two central banks are just starting to end their stimulus. Rates are rising, and the higher interest costs will start to bite a little sooner than they would have historically. I think anyone who argues that rates are still low due to historical comparisons is not analyzing the right thing. The downside of a debt binge can take many forms, but they are all negative to economic growth. The only safe prediction is that central banks would try massive intervention again after their recent success. It’s really too early to factor this into near-term investment thinking, but it’s a reason to keep some caution in our longer-term planning.

Asian and UK Results (Continued)

in 2003, although there were very wild swings in the exchange rate during those last 15 years.

Currencies of countries dependent on commodities are different. They trade together with commodity prices, appreciating when commodities appreciate and vice versa. Such countries are Australia, New Zealand, Canada, Brazil, Norway, and others. We don't invest in any of these countries.

So, the resurgent dollar was a big headwind for us in April, but our Asian stocks did not perform well even in local currency. We had a small gain from our Thai stocks and a small loss from our Japanese stocks. We had a 1.8% loss in Singapore. I am always reluctant to single out Singapore as a separate country because we only have 2 Singapore-listed stocks. One of them has no operations in Singapore. They operate in Malaysia. We like both companies a lot.

The UK was one bright spot for us in April (another was the performance of our quant strategies). Our UK stocks rose around 4.5%. However, the dollar curbed our gains as the British Pound lost over 2% against the US dollar. Only Global portfolios hold UK stocks.

Asian markets have been very frustrating in the last three months. Definitely a very different investing environment than 2017. Stocks bounce around, not falling by much for us to buy more, but also not rising a lot for us to take profits. It seems that after a very strong performance in 2017, when the Japanese small cap indices and our Japanese stocks rose over 40%, everyone is in a wait-and-see mode. Maybe that's good. Some consolidation perhaps before the next move up.

What is especially frustrating is that large cap stocks have advanced while the small caps were completely left behind. The Japanese Nikkei 225 index recovered very strongly in April for example. The difference in performance between large capitalization and small capitalization Asian stocks in 2018 is striking:

As you can see, small capitalization stocks were completely left in the dust. We invest in small companies, of course. The performance of one group of stocks over another (large cap versus small cap) changes over time depending on foreign investor fund flows and the global economy in general. Large Cap stocks tend to be concentrated among foreign investors and these companies export a lot of their production abroad. Stock prices of large companies depend on foreign fund flows, the health of the global economy, and the currency exchange rate. Small companies, on the other hand, tend to be owned mostly by local individual investors and sell their products domestically. The three factors mentioned above should have less of an influence on the stock prices of small companies.

May will be a busy month for our companies and for us. All Asian companies will report their quarterly results in May. Thai companies have to report the first quarter's results by May 15th. This is a busy time as we look at all reporting companies and usually pick up some new stocks during that time (also sell some of our current holdings because of deteriorating results). Japanese stocks will report 4th quarter results. The fiscal year ends in March for almost all Japanese companies. This will be an especially important earnings season in Japan because all companies will issue a very specific guidance for sales and earnings for the next year. I already discussed how ridiculous the guidance practice in Japan is – the guidance is very conservative and usually done as an afterthought, only because they have to submit something.

If the last Japanese earnings season is anything to go by, we should have a very good earnings season. A handful of our Japanese companies reported in the last days of April and those results were disappointing. We hope those were just some bad apples as the Japanese economy is doing well, relatively speaking. There are some weak spots like the home building sector and a shortage of workers is a big problem for all Japanese companies. But wages have finally started rising in Japan. This is long overdue.

Indices (Excluding Dividends)	**April**	**YTD**
Thai Large Caps (Thai SET)	0.22%	1.51%
Thai Small Caps (FTSE SETSmall Cap)	-1.51%	7.08%
Japan Large Caps (Nikkei 225)	4.72%	-1.30%
Japan Small Caps (Topix 2nd Section)	-2.34%	-3.17%
Singapore Large Caps (FTSE ST All Share)	4.50%	4.63%
Singapore Small Caps (FTSE ST Small Cap)	-1.07%	-4.84%

US Commentary (Continued)

makers, but the market fears that we are at peak earnings for these types of stocks as interest rates are rising. Despite the strong price gains over the last few years, these stocks are actually among the cheapest we own since earnings have risen faster than prices. I'm certainly glad to have taken some profits in those stocks even though it resulted in higher realized gains last year. These turning points can be difficult for our system as the market tries to anticipate earnings trend changes that haven't happened yet. We'll treat each of these independently since I suspect that the market's broad fear is misplaced and that some of these stocks will move past the cyclical fears. Still, their environment has changed from last year and these stocks will be volatile at least.

The second issue that we've run into is that deeper value companies where earnings have not met expectations have continued to be marked down. The spread between how value stocks and growth stocks are priced continues to widen, and in such an environment the market wants companies where earnings expectations are rising, period. At some point that reverses, but it clearly hasn't yet. Our strategy to cope with this and get performance back on track has several elements. Primarily, we trust our process, and apply it consistently regardless of recent performance. It doesn't really make sense to chase what the market is rewarding right now because that can shift quickly. However, within our own process there are times where we need to be willing to replace stocks aggressively to respond to a changing economic environment. Also, we can adjust our risk positioning based on the opportunities that the market is giving us. Correlation within the market is low, especially between momentum and non-momentum stocks. This allows us to gain a diversification benefit by pairing cheap stocks that the market has punished due to earnings misses with value stocks that have better momentum in the current environment, such as energy and materials stocks.

Just the Numbers

	Period Ending 4/30/18			Period Ending 3/31/18			
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	-1.33%	-1.33%	-7.13%	11.53%	12.32%	15.68%	12.08%
Volume Winners	2.73%	2.73%	3.77%	11.17%	19.67%	17.24%	NA
Volume Value	1.85%	1.85%	1.17%	9.35%	20.91%	20.28%	NA
Volume Momentum	1.25%	1.25%	-1.83%	5.98%	10.28%	12.37%	NA
Russell 2000	0.81%	0.81%	0.72%	11.80%	8.39%	11.47%	9.84%
S&P 500	0.27%	0.27%	-0.49%	14.00%	10.79%	13.32%	9.50%
ZPR Global Equity	-2.07%	-2.07%	-3.20%	17.24%	9.79%	8.98%	13.85%
MSCI ACWI	-1.01%	-1.01%	0.16%	15.44%	8.72%	9.79%	6.15%
ZPR All Asian	-2.78%	-2.78%	-0.32%	22.28%	9.35%	5.61%	15.43%
MSCI EAFE	2.39%	2.39%	0.94%	15.33%	6.05%	6.98%	3.24%
ZPR All Thai Equity	-1.25%	-1.25%	-2.90%	2.92%	6.32%	3.98%	NA
Thai Set Index	0.79%	0.79%	2.93%	16.35%	9.05%	5.98%	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.