ZPR Investment Report

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A NEWSLETTER FOR ZPR CLIENTS

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US Commentary

By Mark Zavanelli

It was another tough month for us as the average stock in the US declined. September is historically the market's weakest month. Large cap growth stocks continued to roll on however, pulling most of the major market averages up with them. As has been the case this whole year, divergences within equity markets were very large. The market is in a speculative mood. Marijuana stocks with no current sales see huge gains a la 1999 while at the same time companies that are awash in profits trade flat or down.

The obvious factor dragging most stocks down was the tariff drama with China. The 10% US tariff on $200 billion of Chinese goods isn't extreme, but the market is concerned that it could still get a lot worse as the trade war escalates. I think the Chinese have miscalculated so far, and we'll see if they come to their senses. The Mexico and South Korea deals show that the US is willing to accept limited improvements that don't alter the status quo in a major way. Instead, the Chinese fear that the US wants very far reaching changes in how business is done in China (i.e. less micro-management by different government entities) in order to make US imports there easier and exports to the US less favored. I think the US will accept some minor progress along this path and claim victory. In the deals so far, the US negotiators seem to want bilateral agreements in place that can be used to either protect selected industries or chip

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Asian and UK Results

By Vaidas Petrauskas

It was a calm month in Asian markets. The earnings season ended in August and fears of contagion from financial crises in Turkey and Argentina subsided. The United Kingdom continues to be embroiled in the Brexit mess which continues to act as a headwind for the Pound and UK businesses. Our Thai and Japanese stocks finished in positive territory but the Yen depreciated by 2.3% against the US Dollar, which acted as a big drag on our performance.

Our UK stocks lost around 1% in local currency. The British Pound was very volatile, but finished the month stronger by 0.80%.

Developments in Japan

The Japanese stock market started showing signs of life in September after being in a prolonged downturn since February. Foreign investors started bailing out of Japan some time in 2015 and this year it seems Japan was completely out of favor and forgotten. If foreign investors are attracted to Japan again, it can be a powerful force for stocks.

The rise of Japanese stocks in September was concentrated in the largest companies. The main Nikkei 225 index was up 5.49% for the month while the Topix 2nd Section index of small companies was up only

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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

Lessons from the Past

By Vaidas Petrauskas

I'd like to share some historical data which we collected when thinking about what other Asian markets we could potentially invest in after the emerging market fears subside.

We collected annual stock market index and currency returns from 1999 to August '18 for different Asian countries. We wanted to see how different markets and especially currencies performed historically, what was their volatility, and the correlation between stocks and currencies. Currency is a very important consideration when deciding which country to invest in because it is a very important part of returns for foreign investors. As we found out, stocks and currencies are highly correlated for most emerging markets. In the case of Japan, stocks move in opposite direction to the currency – when the currency appreciates, stocks drop. It is not always the case but that is the general tendency. The last three years was an exception to this rule because both Japanese stocks and currency got stronger. The explanation given for a negative correlation between Japanese stocks and the currency is that Japan is an export-oriented economy and a strong currency is bad for businesses. That is certainly true. But some emerging markets are also export-oriented. However, their currencies lack the status of reserve currency and safe-haven which the Yen has.

All Emerging markets' currencies should not be treated as one. As can be seen in the table on the next page; the Thai Baht is an excellent example of a very strong emerging market currency while Indonesia's Rupiah loses value over time. Thailand learned the painful lesson from the Asian Financial Crisis of 1997 which started in Thailand.

Some observations from the table:

- Anemic returns from Singaporean and Japanese stocks since 1999. Indonesia and India produced the strongest returns, but their currencies lost almost half of their value. Even with currency declines taken into account, Indonesia and India produced the best returns for foreign investors.
- Thailand is a different animal. Its currency is stable (actually appreciating against the Dollar slightly). Thailand produced very respectable returns for foreign investors. Thai companies pay out around half of their earnings in dividends. So we could add around 3% in annual returns from dividends.
- Malaysia has the least volatile stock market for local investors. But Japan is the least volatile for foreign investors because the Yen is negatively correlated with Japanese stocks.
- Emerging markets stocks and currencies are highly correlated. This can be terrible in times of panic, but a big boost to returns in recovery.
- We can clearly see which currencies are stable and which tend to lose value over time. So, even though all currencies are volatile, the Thai Baht, South Korean Won, Taiwanese Dollar, Singaporean Dollar, and Japanese Yen did not lose value over time during the chosen period. For long-term investors it is not worth hedging these currencies. On the other hand, we have currencies which tend to lose value over time – the Philippine Peso, Indonesian Rupiah, and India's Rupee.

All this data is very interesting and informative, but we should be careful not to extrapolate past trends into the future. Long-term returns have a strong habit of reversing. For example, U.S. stocks have been outperforming all other markets for a very long time now. Reversion is very likely although no one can say when it will occur.

It is clear, however, that we have to think about currencies very carefully when deciding where to invest. Some investors may think it is OK to take currency risk because the local market can rise contemporaneously to compensate. The correlation data shows that is not typically the case. When Emerging Market currencies fall, their stocks tend to fall also causing big losses for foreign investors.

Asian Markets

From 1-Jan-1999 to 31-Aug-2018 (Singapore data available from 1-Jan-2000) excluding dividends

	TOTAL (1999 - 2018.08)			ANNUALIZED			ANNUAL STANDARD DEVIATION			CORRELATION
	Index Change Local currency	Currency Change vs US Dollar	Index Change in USD	Index Change Local currency	Currency Change vs US Dollar	Index Change in USD	Index Local currency	Currency vs US Dollar	Index in USD	Country's stocks and Currency
Thailand	383.85%	10.53%	434.82%	8.35%	0.51%	8.90%	35.21%	7.01%	40.60%	52.68%
Philippines	299.01%	-27.53%	189.17%	7.29%	-1.62%	5.55%	26.71%	7.98%	32.05%	67.06%
Indonesia	1412.03%	-47.03%	700.94%	14.81%	-3.18%	11.16%	34.70%	10.97%	44.15%	72.82%
Malaysia	210.45%	-7.50%	187.17%	5.93%	-0.40%	5.51%	18.96%	6.42%	22.54%	40.99%
South Korea	312.99%	7.58%	344.29%	7.48%	0.37%	7.88%	30.36%	9.14%	35.25%	51.19%
Taiwan	72.38%	4.88%	80.79%	2.81%	0.24%	3.06%	26.40%	4.50%	28.30%	33.02%
Singapore	18.60%	21.29%	43.86%	0.92%	1.04%	1.97%	26.04%	4.99%	28.94%	40.14%
India	1164.81%	-40.25%	655.68%	13.77%	-2.58%	10.83%	33.41%	7.52%	38.47%	68.77%
Japan	65.18%	1.96%	68.43%	2.58%	0.10%	2.69%	24.03%	10.59%	22.00%	-39.71%

Please note:

- The above data below is for the period 1-Jan-1999 through 31-Aug-2018. But Singapore data is only available from 1-Jan-2000 because of index construction methodology changes.
- We show only final statistics – total and annualized returns, volatility (standard deviation), and correlation between stocks and currencies.
- We chose the main index for each stock market. So, for example Nikkei 225 index to represent Japan.
- Dividends are not included. So actual returns to investors have been greater because of dividends.

Performance Divergence: What Does it Mean for Future Returns?

By Mark Zavanelli

As I've commented on repeatedly, 2018 has seen a very large divergence in returns between growth stocks, particularly in the US, and every other type of equity investment worldwide. Since growth also outperformed in 2017, this difference is now large enough that it starts to be predictive of future returns. In past articles I've discussed other aspects of the same issue, particularly the valuation differential for growth stocks, but this is another, more immediate indicator. None of these episodes is exactly alike, but the drivers share commonalities. Usually they occur after an extended period of economic growth, where risk taking has been rewarded and market returns have been good. The market usually looks expensive, but the economy is also good and there is some real basis to be excited about the prospects of these companies. The point where you can see a wide difference between growth and value in the recent past as well as very strong returns to market exposure itself is an environment that occurs typically only once per market cycle. In this cycle, for instance, we've seen plenty of growth outperformance overall, but only now have we seen a really wide divergence coupled with strong recent market returns. These episodes typically don't end happily for the outperforming growth stocks. The reason is that investor psychology, under the right conditions, will flip from normal risk aversion to risk seeking behavior. Once the investment boom is over it flips back.

None of this means that we are on the cusp of a decline, however. In my opinion, the best way to think of it is that the clock is ticking for this period of growth outperformance. In the dot-com period, which was much more extreme than where we are today, we did see about a year of continued gains (which were large) before growth reversed direction. High volatility will be a good indicator of trouble, and for now it's subdued. The outlook for the non-growth, lower beta part of the market is less clear. If the whole event presages a real economic downturn, value stocks are going to see declines also, commensurate with the economic damage. On the other hand, if the economy holds up decently the system can reset itself with a mirror image divergence where growth simply underperforms value. That's happened before even when there was a mild recession. A reversal in favor of value where the market is ok is my base case, but it's important to understand the risk of worse outcomes too.

So, what's the correct approach to stocks if this analysis has predictive value? One way to manage thinking about risk in this environment is to divide assets into categories by time horizon. I think that today's exciting stocks should be considered as short-term speculative vehicles and not long-term investments. With a short-term view, successful speculation during a boom period has the theoretical capability to earn high returns because the skewness of returns is usually very positive in such periods. But that's only ok for money where you can accept higher than normal equity losses! Whether it's a good idea or not depends on how good of a speculator you are, and most of us will fail at this. Just like with bitcoin, if you think you are "investing" in it you are fooling yourself. It makes no sense historically to extrapolate the good returns to growth stocks from such periods into a longer time horizon, as in the following logic: "returns have been 15-20% per year, I'd be happy with 10%, so if I buy these good performing investments I'm likely to meet my goals". That's not how it works. Instead, buying expensive, high past return assets leads to negative long-term future returns that take a long time to get back to even, if ever. The sad reality is that many investors see good past returns and perceive low risk, when in fact the opposite is true. I think that a long-term investor today should look to diversify equity investments away from the expensive portion of the market and certainly not do the reverse. If a buy and hold asset allocation plan is really well balanced, it probably won't matter that a portion of it will perform poorly. Popular indices become "infected" with the disease of becoming too heavily weighted in the expensive stocks, so those are typically less well diversified than might be true on average. The good news is that there are a lot of less correlated investments to choose from since the market is so narrow, including ours. The low correlation (read – opposite direction) now is a good predictor that forward correlation will also be low until the dynamic that's driving it burns out. The less correlated investments just happen to look like dogs by comparison at the moment, almost by definition. In this market environment I think long term investors should do the opposite of the crowd – instead of seeking excitement we should seek boring.

US Commentary (Continued)

away at the overall deficit. This would be easy to do with China. The goal of reducing intellectual property theft is a lot harder because it impinges on the Chinese government's control. If they promised to listen to complaints it would probably be enough for a deal. The miscalculation here is that a deal is relatively painless while no deal will hurt more than they think. With the ability to export to the US in doubt, global companies are likely canceling Chinese expansion and actively looking to make contingency plans. This has to be hurting capital investment across China in a significant way, and represents a real risk to their economy (although it might help the rest of Asia). China absolutely has the power to make an acceptable deal, they just have to see the need for it and to find a face-saving way to go about it. They may wait until after the mid-term elections, but I think a deal gets done. Outside of China, the trade picture is actually brightening. Canada just agreed to join Nafta 2.0 as I write this. Japan is eager to get their own bilateral deal. The Europeans are hung up on protecting their farmers (like the Canadians), but the bilateral framework will allow for a deal where both sides can claim a win.

Asian and UK Results (Continued)

1.33%. Our Japanese stocks rose around 1.5%. If this positive momentum continues, it is only a matter of time until buying spreads to Japanese small caps.

There were some positive developments in Japan to wet investor appetite. The current Prime Minister Shinzo Abe triumphed in a vote for the leadership of the ruling Liberal Democratic party, giving us 3 more years of Shinzo Abe. Since he is considered to be pro-business and trying to make Japanese companies more shareholder-friendly, this is good news for stocks. This reduces political risk. There should be no surprises in Japanese fiscal and monetary policy for the next few years. One negative is that Abe is still planning to go ahead with the Value Added Tax (VAT) increase next year which would be bad for the economy.

Another positive development is an announcement that the U.S. and Japan would begin bilateral trade negotiations. Abe was advocating for a regional, Pacific-wide, trade deal, but he gave in to Trump and there will be some kind of bilateral trade deal between the U.S. and Japan. The imposition of tariffs by the U.S. on Japanese steel and aluminum had little effect, but the threat of tariffs on Japanese car imports would have real costs for the Japanese industry. This is a big deal for Japan because autos are Japan’s biggest U.S.-bound export. Now U.S. and Japan can work together in challenging China’s dominance in the Pacific. Abe got the relief from the threat of auto tariffs. This agreement, although there are no specifics yet, greatly lowers the risk for Japanese businesses exporting to the U.S. After all, the sell-off in Asian shares started because of trade war fears. Even if Japan and the U.S. strike a favorable trade deal with minimal tariffs, the risk still exists that Japan (and other Asian) nations could suffer collateral damage because of the trade spat between the U.S. and China. Many countries export to China and a slowdown in China would be felt across the region.

Finally, there is a real improvement in the profitability of Japanese companies. This is very important. There was always untapped potential to improve profitability and efficiency at Japanese companies because they are not managed nearly as efficiently as Western corporations. Some of these improvements are now becoming visible.

According to the Financial Times, pre-tax margins at both listed and un-listed Japanese companies are now their highest in six decades! There is no data before then so we can say the margins are at the highest level ever, even higher than the 1980s bubble era. Since 1954 pre-tax margins in Japan varied in the range of 2-4%. Over the past five years those margins have risen from around 4.5% to 7.7%. That’s a huge improvement. This means that even with terrible demographics in Japan and a stagnant economy, companies can increase profits, and there is a way to win for foreign investors by buying Japanese stocks.

Just the Numbers

	Period Ending 9/30/18			Period Ending 6/30/18			
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	-3.38%	-4.87%	-10.54%	8.89%	13.62%	14.68%	11.74%
Volume Winners	-2.59%	-1.77%	10.97%	15.31%	22.60%	18.87%	NA
Volume Value	-2.05%	-2.79%	3.49%	11.24%	21.71%	20.59%	NA
Volume Momentum	-3.88%	-2.17%	4.32%	10.62%	14.58%	12.72%	NA
Russell 2000	-2.54%	3.43%	11.35%	17.56%	10.96%	12.46%	10.60%
S&P 500	0.43%	7.56%	10.41%	14.38%	11.95%	13.43%	10.17%
ZPR Global Equity	-1.33%	-1.87%	-9.63%	4.55%	6.99%	8.28%	13.36%
MSCI ACWI	0.48%	4.40%	4.26%	11.31%	8.79%	10.00%	6.37%
ZPR All Asian	-0.20%	0.44%	-8.63%	3.00%	3.58%	4.82%	14.92%
MSCI EAFE	0.91%	1.42%	-0.98%	7.38%	5.41%	6.93%	3.34%
ZPR All Thai Equity	1.17%	8.23%	-4.00%	-13.82%	2.97%	4.14%	NA
Thai Set Index	2.24%	10.99%	2.85%	4.40%	5.31%	5.25%	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.