ZPR Investment Report

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A NEWSLETTER FOR ZPR CLIENTS

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US Commentary

By Mark Zavanelli

Major US stock market averages made new highs in August even as foreign markets fell. The new highs are an important signal reaffirming the health of the bull market and the economic expansion. The market narrative has changed markedly since the beginning of the year when the prior new highs were set. Back then stocks were seeing large inflows and riding a wave of optimism over strong earnings and synchronized global growth. What happened next was partly the natural hangover from excess optimism, but also the other side of the coin from strong current growth and government stimulus. This was a rise in energy prices and inflation expectations, leading to a spike in interest rates and to world central banks quickly moving into tightening mode. That change, along with the fears around trade policy, threw a major monkey wrench into the global synchronized growth thesis. The US was reacting to the powerful stimulus from tax cuts and spending, but the rest of the world instead felt the negatives of a stronger US dollar alongside declining central bank liquidity (so a double whammy for local credit conditions), and of course uncertainty around trade. It's no accident that weak currencies like Argentina's and Turkey's went into crisis mode during this episode. Although the stronger dollar will eventually help exports for non-US economies (depending also on the tariff situation), in the short run it's the liquidity and money flows that are more important to

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Asian and UK Results

By Vaidas Petrauskas

It was another month of weakness in Asian equity markets. The dollar gave back some of its gains against other currencies in August. This is likely temporary. The dollar rallied significantly in the first half of the month, but then got knocked down by Trump's comments that the Fed shouldn't be in a hurry to raise interest rates because that hurts economic growth.

In August all our Asian companies reported quarterly results. It is a month in which we do a lot of portfolio reshuffling and trading, depending on how companies report. And after the earnings season is over, we search for new stocks.

The Japanese earnings season for us started at the end of July. It got off to a good start but the later reports were mixed – there were good reports and also disappointments. We completely sold out of 3 Japanese positions because of poor business performance. Later we replaced these with 3 new stocks.

Our Japanese stocks lost around 4% in August primarily as a result of the three disappointing reports I mentioned. These stocks fell sharply following their reports. This year returns in Japan are asymmetric. Bad news gets punished but good news does not get rewarded (with some exceptions).

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Small Cap Value Performance Review

By Mark Zavanelli

This year we've been left out of the party as our Small Cap Value strategy is down while the rest of the market is up. SCV is used for the US portion of our Global strategy as well so it has been dragging down performance there too. This isn't the first time we've underperformed and it won't be the last, but this episode has been worse than usual and it's always worthwhile in moments like these to assess what happened and how we will recover.

The largest impact came from our stock valuation model, GRAPES, which is the starting point of our process. The attributes that it looks for have been heavily out of favor this year. Value investing has underperformed for some time, but this year in particular companies that are cheap on the basis of their forecasted operating results for the next year have done much worse than more expensive stocks. In one sense this isn't that unusual. We're used to typical growth markets where the most expensive stocks have eye-popping returns for short periods– these markets to varying degrees are a regular part of the investing landscape. This is happening now, and one barometer is the performance of non-dividend paying stocks versus the rest of the market. When non-dividend payers are far outpacing the rest, as they have been this year, it's a reliable sign that speculative forces are driving the market. When the largest companies are also growth stocks, the popular market indices are heavily influenced by them. We've seen all of that this year. There's also an aspect to this episode of value underperformance that has been unusual, and this is what's really caused difficulty for our models. The cheapest stocks have significantly underperformed not just the growth stocks but the average stock. That normally happens during recessions as economically sensitive stocks get hit the most (a classic example of this was financial stocks during the 2008 downturn), but presently we are in a strong economic environment. A clue to why this is occurring now can be seen in the performance of the quality metric built into GRAPES, Return on Equity (ROE), which is normally a counterbalancing factor to pure cheapness. ROE is also failing this year, and the answer to why is that a greater proportion than normal of cyclical companies have high ROEs. In lay terms, the economy is doing great and the most economically sensitive companies have seen their earnings explode, making them look very cheap with high returns on capital. That was fine for 2017 when economic growth expectations were still rising, but in 2018 the market believes that this is as good as it gets, so therefore these companies are overearning and are likely to see worse results ahead. Some of these cyclicals have seen actual signs of business deterioration (big ticket, interest rate sensitive items like autos and housing come to mind), so for these the peak earnings case is based on current data. The bottom line is that in this period we have an underperformance for value stocks operating in both tails of the distribution, which is why the spread is so wide. It's a fairly rare event, but not unprecedented.

Looking at how our SCV portfolio has been affected by this, I can say with hindsight that too much of the portfolio's weight was positioned at the extreme end of our model rankings, which in this environment meant that those stocks would all act the same despite being in different businesses. Our usual risk control efforts were overcome by this effect. We never would have owned the expensive stocks because our system rejects them, but we didn't have to own only the cheapest stocks either. For us, there is a learning opportunity here and we have already begun to revamp our risk control system. For our investors, the important question is when this unfavorable period for our model will reverse. The very fact that I'm writing this article is an indicator itself. It means that we've reached a noticeable extreme, with a lot of short term momentum behind it but also a high probability of reversal. Fundamentally, just as the positive global growth story became priced in 2017 with the market's rise, I think the 2019 slowdown story has become priced in now with the severe gap between growth and value. I think we see rotation back towards cheap stocks that will benefit the most from a continued economic expansion, even with slower growth.

This discussion wouldn't be complete without an admission of some errors this year in the execution of our strategy as well. In our process there is always some percentage of stocks where we have badly mis-estimated value because company results are set to deteriorate (that's why the stock is cheap, and we missed the negative risk). As this occurs, our process calls for us to reduce or exit those positions, almost always at a loss. This year, probably due to the market's fixation on economic risks, the punishment for companies with any negative results, even due to normal business fluctuation, has been extreme. The market wants results now, because there are

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Small Cap Value Performance Review (Continued)

other stocks that are performing well. This environment has meant that any delay in selling losers was an error, and that getting what we thought was a reasonable price was unlikely. This year I have been way too stubborn in believing that the good economy would bail out companies with current issues to overcome, and as a result we held onto too many mistakes for too long. In some years you can get away with doing this without a major effect, but not this year. Based on other research I've seen into value strategies (and our own history, to be honest), I think that less patience with problem situations is better for the success of our process on average. It's unfortunate that it took this year's underperformance to drive a meaningful change to how we accomplish this, but I do think that our long-term results will benefit from it.

US Commentary (Continued)

economic conditions. With global supply chains in doubt, multinational companies are in a rush to invest more in the US and less elsewhere. This unusual environment has led to a breakdown in the correlation between the US and world stock markets. Very few markets outside the US are in positive territory this year. Money has flowed out of foreign currencies and into the US dollar in search of a safe haven, further boosting the price of US stocks and bonds. Thankfully, the foreign markets that we primarily invest in (Japan, Thailand, and the UK) have been a little better insulated from these trends than other foreign markets.

So, what happens next in this story? There certainly is some risk that it intensifies, getting worse before it gets better. This would take the form of steeper currency losses in other emerging markets seen as being potentially vulnerable, such as Indonesia or Brazil. However, in the decade since the financial crisis, these sorts of market fears have represented buying opportunities for stocks in general. That's not to say that Turkey's problems aren't for real (as Greece's also were), but the power of central banks has not allowed a vicious cycle of fear to spread generally across risk assets. Similarly, there is also the fear around China, that they have only managed to prop up growth through excessive and corrupt lending and are vulnerable to any economic shock. While this is true, it's also been a mistake to bet against the power that they have to control things in the short term within their system. China's problems will certainly bite them, but it's more likely to show up gradually than to take the form of a crisis, which they have the tools to defeat. When the fear passes and with it the money flows into the dollar, the market will be left with a very wide valuation disparity between US and non-US stocks that will begin to close. The catalyst could very well be a positive surprise on trade, such as we saw with the tentative agreements with Europe and Mexico.

Across worldwide markets, this international situation has also led to a very strong preference for growth stocks over value stocks. This has significantly hurt the performance of our strategies relative to benchmarks. More on this in a separate piece this month. Since the origin of both performance trends is similar, I also think this disparity is likely to reverse direction in the months to come. With moderately higher inflation I think that nominal growth will stay at a high level, and the market will rotate back to rewarding value stocks with strong earnings performance.

Asian and UK Results (Continued)

So we did not have enough big winners to offset the losers even though we had plenty of good quarterly reports. The loss from stocks was partially mitigated by a stronger Yen which appreciated by 0.70% against the dollar in August. Japanese large capitalization companies, as measured by the Nikkei 225 index, rose 1.38% in August while small cap stocks, as measured by the Topix Small Cap index, lost 2.04%.

We have a portfolio of wonderful Japanese businesses which are trading at truly cheap valuations. Almost all Japanese companies we own trade at a fraction of book value while being profitable and growing those profits. They also have decent, although not great, returns on capital. Efficiency could be improved greatly in Japan but efficiency is not something that Japanese managers mainly focus on.

As I mentioned before, returns in Japanese equities are lumpy, with periods of rapid appreciation, like last year, followed by periods of consolidations or drawdowns. With a great portfolio of stocks like we have today, the only thing we can do is be patient and wait until the sentiment toward Japanese stocks changes. I am a believer that if earnings are improving, stock prices will have to rise eventually.

The sentiment toward Japanese equities at the moment is negative. The reasons are the same as before – tariffs and trade war fears, especially as it relates to China. Also, with rising interest rates in the US, capital is flowing into US assets. What was new in August was the financial crisis in Turkey and Argentina and the collapse of their currencies – lira and peso. Both lost around half of their value against the dollar this year! Argentina raised interest rates to 60% to arrest the peso's slide! Although Turkey and Argentina are not significant players in the global economy, Asian markets were affected by the turmoil in those two countries. Higher US rates are intensifying the pressure on developing economies, especially those dependent on dollar-denominated debt. We do not invest in any such countries. Thailand is different.

The Thai economy is growing strongly (4.5%) and the Baht is a safe currency because of the country's current account surplus, high foreign account reserves, low foreign-denominated debt, and solid financial institutions. So, Thailand is opposite to Turkey which is in a big mess because of high foreign-denominated debt issued by corporations. It is a big problem repaying those debts, or even paying interest, when your currency collapses by 50%.

Our Thai stocks were flat in August. A big boost came from the Thai Baht which appreciated significantly against the US dollar, rising 1.6%. This helped the performance of our Asian and All Thai portfolios. We added a couple of very good new Thai investments after the earnings season and we are fully invested in Thailand.

Our UK stocks rose around 0.50% in August. The UK FTSE All Share index dropped 3.46%. The Pound depreciated by 1.31% against the US Dollar. I expect the Pound to remain volatile with Brexit negotiations between the EU and UK nearing culmination. The original deadline for the divorce agreement was set for October. It has now been moved to November and so far there is little progress. There are many thorny issues, like the Irish border. Even the UK politicians themselves cannot agree what they want. The pro-Brexit lawmakers want a clean break from the EU (hard Brexit) and the Remainers want a soft Brexit. The Prime Minister Theresa May voted against leaving the EU in the referendum and she wants to stay as close to the EU as possible. Basically the UK wants to remain close to the European Union markets, but outside its institutions. The Brexit is in two parts: first the divorce agreement to make sure the exit is orderly, and then the future trade deal will be negotiated after the UK leaves. "No deal' would be really bad for the Pound short-term and likely for the stock market also. "No deal" is a possibility, but I think the EU and UK will agree on something or kick the can down the road on the thorniest issues. The EU tends to strike last minute deals when needed and "No deal" is not in UK's interest. So, some kind of deal will be struck.

Just the Numbers

	Period Ending 8/31/18			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	-0.44%	-1.55%	-7.41%	8.89%	13.62%	14.68%	11.74%
Volume Winners	0.61%	0.84%	13.93%	15.31%	22.60%	18.87%	NA
Volume Value	0.20%	-0.75%	5.66%	11.24%	21.71%	20.59%	NA
Volume Momentum	2.94%	1.78%	8.53%	10.62%	14.58%	12.72%	NA
Russell 2000	4.19%	6.00%	14.12%	17.56%	10.96%	12.46%	10.60%
S&P 500	3.03%	6.86%	9.69%	14.38%	11.95%	13.43%	10.17%
ZPR Global Equity	-0.83%	-0.55%	-8.41%	4.55%	6.99%	8.28%	13.36%
MSCI ACWI	0.83%	3.91%	3.77%	11.31%	8.79%	10.00%	6.37%
ZPR All Asian	-1.14%	0.64%	-8.45%	3.00%	3.58%	4.82%	14.92%
MSCI EAFE	-1.92%	0.50%	-1.87%	7.38%	5.41%	6.93%	3.34%
ZPR All Thai Equity	1.28%	6.98%	-5.11%	-13.82%	2.97%	4.14%	NA
Thai Set Index	1.74%	8.56%	0.60%	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.