ZPR Investment Report

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A NEWSLETTER FOR ZPR CLIENTS

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US Commentary

By Mark Zavanelli

US stocks plunged again in December despite a post-Christmas bounce. What a tough year. This time the market leading Tech stocks also participated in the decline. Most foreign markets (except Japan) held up a little better due to a weak dollar. My forecast last month of a rally was completely wrong despite positive news on China tariffs and a shift from the Fed.

Beginning with the trade war news, this month showed tremendous progress on two key issues bothering the market. Trump and Xi are now personally engaged and are capable of making any deal they want to. I think the likelihood of removal of the current 10% tariffs is much greater than a 25% tariff being put in place. Certainty on the tariff question will unleash a lot of pent up capital spending, especially in China. Next, the Fed clearly blinked in December as they reduced their forecast for future rate hikes and took pains to indicate that they could halt at any time. This was another very significant change.

So why did the market ignore these and continue falling anyway? I think for two reasons. First, they were overcome by the selloff itself. At the moment when investors decide collectively to de-risk, everything else stops mattering and it has a life of its own. The extreme optimism this year in expensive growth stocks finally reversed this month, and this was the last shoe to drop. These stocks were the last bull market

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Asian and UK Results

By Vaidas Petrauskas

What Happened?

December capped off an incredibly difficult and frustrating year for ZPR; one of the worst. The foreign stock markets peaked around January 26, 2018. So, for us investing in Asian stocks, the whole year has been one big struggle. U.S. stocks kept rising until September, then, what started out as a minor downturn in October and November turned into a major sell-off in December. Global stocks sank into a bear market.

The reasons for the weakness of Asian stocks in 2018 are now obvious and many are stemming from the U.S.:

- A strong dollar because of the Fed tightening and capital flows;
- Trade war fears and tariffs implemented by the Trump administration on foreign imports;
- A global economic slow-down which is related to the trade war. A slowdown in local economies of Japan and Thailand. A slowing of China's economy has ripple effects through other economies, especially in Asia.

These factors have dragged down Asian stocks the whole year as money was pulled out of Asian assets in favor of U.S. assets. Then, a big sell-off, which started in the U.S. in the 4th quarter, dragged down Asian stocks further. In the 4th quarter the volatility was incredible as the market was

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Quant Strategies' Results

By Vaidas Petrauskas

At the end of each year I briefly review the results of our quant strategies. Our Volume Winners and Volume Value portfolios contain illiquid stocks with low correlation to daily market moves. As a result, we expect them to provide some downside protection when markets are falling (by falling less). Volume Winners is especially conservative (and will lose in strong up markets) so we are counting on better performance during market declines for that strategy to be successful. Volume Value is more balanced between risk and return so modest outperformance in down markets is what we would expect.

How did they fare in 2018? Overall, I am happy with the performance of Volume strategies in 2018, especially Volume Winners. Both strategies lost money, but less than the benchmark – the Russell 2000 index. Net of fees Volume Winners finished down -4.09% for the year, Volume Value was down -10.55%, the Russell 2000 index was down -11.19%.

I expected a better showing by Volume Value, but I have to point out that our Volume strategies faced a huge headwind in 2018. The biggest-weighted industry in the Volume portfolios is banks. This is mostly due to the population of small local banks who become publicly traded companies through the demutualization process, bypassing Wall Street and institutional investors. Bank stocks were one of the worst-performing industry groups in 2018, against the consensus view in the beginning of the year that bank stocks would do well. Large cap US bank ETFs finished the year down close to 20%, and small cap banks also did poorly. This was the environment where these strategies might have seen unusual underperformance just due to that industry effect. Despite this, the strategies still performed within expectations.

US Commentary (Continued)

in equities anywhere this year. When that finally failed, after massive outperformance, the rush to preserve profits was not going to stop with a mild pullback. Second, economic slowdown fears began to show up in the bond market. Treasury bond yields fell sharply during the month, causing a partial inversion of the middle of the yield curve. It's thought that any inversion in the yield curve precedes a full inversion which then predicts recession (but with a lag). High yield spreads, which are disproportionally affected by energy companies, also rose as oil prices fell. This spooked the market since high yield spreads historically rise ahead of negative economic events. This month the markets in different asset classes reinforced the bearish economic forecast as stocks, bonds, and commodities all moved in a way that indicates slowing growth. All of that being said, the bond market has not exactly been acting in any consistent way lately. Just two months ago the 10 yr and 30 yr bonds were making new recent highs in yield terms only to fall back now to levels last seen in January. It's too caught up in financial flows to be an independent indicator.

It's no question that we're at a moment of high uncertainty in the market. The history in the US is that significant market declines where a recession doesn't follow typically lead to rebounds with positive returns. If this decline is preceding a recession, then the overall market will probably see additional weakness as that unfolds. So, in the end it's the real economy that matters. Of course this is unknown too, but it is at least something concrete as opposed to the daily drama of the market. Our stocks have been beaten up enough that they are already discounting a bad event. Last month I wrote that a slowdown was already here but that I didn't think it would amount to much. I still believe that. This month there was more data on China's current economic weakness, but I think that this will only move them to be more aggressive with stimulus. Economic data in the US is still strong and does not show typical pre-recessionary signs at this point.

Happy New Year!

We at ZPR Investment Management wish you a happy, healthy and prosperous 2019.

Asian and UK Results (Continued)

wrestling with a wide range of different inputs. The December 20-25th sell off of Japanese small caps (following losses on Wall Street) clearly had signs of panic selling or forced end-of-year selling. On Christmas day the Japanese market was open and it finished that day down more than 6%. Then it recovered all of that loss in the next two trading sessions following an advance of U.S. stocks.

There was no hiding in value stocks as neither valuations nor fundamentals matter in such an environment. It has been a political event driven market, as opposed to a fundamental one. Markets were driven by macro news, tariff talk, Trump's tweets, and the Fed's nuanced hints about the speed of interest rate hikes. This made it an especially difficult investing environment.

All of this was going on while companies continue growing and generating strong profits. We are bottoms-up stock pickers. If we saw any signs of a slow-down in company results or management's projections then we would know what to do. There are no signs of that yet (granted, we may start seeing troubling signs in upcoming earnings releases as it takes time for macro issues to show up in actual business results.) Yet stocks are crashing in anticipation of an economic slow-down or a recession down the road. The markets seem to be moving to discount an imminent recession in a far more extreme way than anything in the data currently supports.

Two events happened in the beginning of December that were supposed to nurture gains: a dovish speech by Fed Chairman Jerome Powell and a 90-day truce in the U.S.-China trade confrontation. To me this seemed to resolve or postpone two of the greatest market worries: The Fed tightening too fast and an intensifying trade war between the U.S. and China. Instead, the market chose to create a monster of its own imagining: quantitative tightening. The sell-off intensified after the Fed meeting of December 18-19th. The Fed hiked the rate by 25 basis point and promised two more hikes in 2019 instead of the three that were planned before. The Fed will also continue unwinding its balance sheet. This sparked a massive sell-off in global equities. Nothing the Fed did or said should have come as a great surprise. Everything they have done this year is consistent with what they've been saying they would do all year long. The difference is in the market's perception of the news. Right now, the markets are very sensitive to any information that confirms the current narrative (slowing global growth, the Fed tightening too aggressively).

There's nothing wrong with the U.S. economy. Unemployment is near historic lows. Interest rates are still very low and inflation is under control. With the slowing global growth, inflation should not be a problem. For this reason, I believe the Fed will curtail its future rate hikes which are still too aggressive.

I think the market realized that the Fed will not necessarily come to the rescue of a falling stock market. There is a worry that the Fed will make a mistake and push the US economy into a recession. But it also seems as likely to me that the markets could talk themselves into a recession as a negative feedback loop comes into play. Being overly concerned about an economic recession could actually cause one. As of now, most of the warning signs are coming from the financial markets rather than the real economy.

<u>Could We Have Known?</u>

Could we have predicted that 2018 would turn out to be such a bad year for global markets? It seems simple with hindsight but it wasn't obvious in the beginning of the year.

Some factors, like a strong dollar were not known at the time (in 2017 the dollar was weak). Some factors (trade war and Fed tightening) were known, but the market did not focus on them as much as it does now.

I do not believe in market timing or that short-term market moves can be successfully anticipated. Markets are driven by so many complex factors that they are completely unpredictable. Markets do not operate based on what is known. They operate based on the best guess of millions of market participants about what lies one year ahead. Sometimes markets don't make sense at all.

2018 has been a humbling year for almost everyone in the investment world – asset managers and market forecasters. The consensus among forecasters in the beginning of the year was that bank stocks will do well in 2018 because of rising interest rates, energy stocks will do well because of a rising price of oil, and the 10-year Treasury bond yield will rise well above 3%. All of these projections turned out to be wrong.

The best market timing strategy I know is to go against the consensus view. The consensus view is usually just a simple extrapolation of the current trend. So, if one buys what has underperformed in the last year and reduces what has done well, this should work out more often than not. It works because markets are so cyclical and

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Asian and UK Results (Continued)

investors tend to move in herds, punishing underperformers and crowding into the best performers. We made 40% on Japanese stocks last year. With hindsight, this was probably a sign to reduce our exposure to Japan after a good run. Of course, you never know. The U.S. stock market kept rising for almost 10 straight years.

We choose to invest where we can find value. If one market becomes so overvalued that we cannot find enough stocks that meet out strict criteria, allocation to that market will naturally be reduced. That is our market timing tool.

What's Next?

I hope my writing up to this point proved that I am not good at making short-term market predictions.

I do know this, however:

- Markets do not fall forever – like all trends, this one too will end;
- The worst time to sell is after a market crash;
- Market corrections happen in a short period of time while market advances take a long time;
- The market will rebound when investors least expect it, in fact, when things look the worst;
- As painful as they are, market sell-offs provide a good set up for future gains. We need the market to go down sometimes so that it can sustain the ups.

Having said all that, I do believe we are in for a rebound. The December sell-off seems clearly overdone to me. We may experience a strong January effect rally. History is also on our side. An analysis of historical market returns by awealthofcommonsense.com showed that declines like the one we've seen in the 4th quarter have seen the market rally by about 25% in the following year, by 50% over the next three years and come very close to doubling over the next five years. Outside of the Great Depression, market returns have never been negative over the twelve months following a quarter as weak as the 4th quarter of 2018. Of course, no two time periods in history are identical, but we can recognize that historically market returns have been much stronger than average after periods like the one we are in.

I certainly expect there will be more volatility in 2019. The challenges of China-US trade tension, central banks retreating from easy money policy, European political uncertainty, and recession fears will not go away soon. Trump is not helping markets by discussing the firing of the Fed chairman and shutting down the government. This makes markets even more nervous and adds additional risks when we have plenty already.

We enter 2019 with the global economic slow-down, and particularly Chinese economy's slow-down, first on investors' minds. I am sure these will be replaced by new worries as the year progresses.

Although right now valuations are irrelevant, I do believe they matter greatly for long-term stock returns. Valuation of Asian stocks compressed dramatically in 2018 as corporate earnings have been good but prices crumbled. In a downdraft, even the good companies are hit. It created bargains all around as prices have completely divorced from fundamentals.

The valuation of Japanese stocks has become very attractive. The valuations are back to where they were many years ago. Honestly, I didn't think I would ever see our Japanese companies at these prices. It just shows how indiscriminate the sell-off was. What difference a year makes! Last year our Japanese stocks rose month after month. This year the companies could do no right.

I calculated the average valuation and profitability statistics for our Japanese holdings as of December 31st, 2018 and I present them in the table below.

Trailing P/E	7.5
Price/Book Value	1.05
Dividend Yield	2.7%
Return on Equity	14.3%
Expected EPS growth this fiscal year	7.7%

I am stunned at how many high quality businesses trade at mid-single digit multiples, despite strong balance sheets. I think we will have very strong gains in Japan again once the sentiment reverses. Right now, this seems unlikely, but when it does, the gains will come quickly. A weak dollar would be enough of a catalyst to make investors start looking at foreign markets.

Just the Numbers

	Period Ending 12/31/18			Period Ending 9/30/18			
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	-10.56%	-21.69%	-29.95%	-5.78%	16.37%	11.84%	11.37%
Volume Winners	-7.28%	-13.57%	-4.09%	11.08%	21.35%	16.50%	NA
Volume Value	-8.50%	-13.57%	-10.55%	5.90%	22.77%	17.68%	NA
Volume Momentum	-10.80%	-22.20%	-18.84%	4.83%	16.35%	9.49%	NA
Russell 2000	-12.05%	-20.35%	-11.19%	15.22%	17.12%	11.07%	11.11%
S&P 500	-9.18%	-13.66%	-4.54%	17.91%	17.32%	13.96%	11.97%
ZPR Global Equity	-8.37%	-18.56%	-26.40%	-5.23%	11.31%	7.07%	14.32%
MSCI ACWI	-7.00%	-12.65%	-8.93%	10.36%	14.03%	9.26%	8.78%
ZPR All Asian	-8.03%	-17.92%	-25.00%	-4.16%	8.19%	4.60%	17.57%
MSCI EAFE	-4.83%	-12.49%	-13.36%	3.25%	9.77%	4.90%	5.89%
ZPR All Thai Equity	-5.76%	-16.95%	-20.27%	-7.84%	6.96%	7.19%	NA
Thai Set Index	-4.62%	-10.63%	-8.08%	8.01%	12.65%	8.29%	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.