Valara
Capital Management, LLC

April 10, 2018

Dear Friend of Valara Capital Management,

For the first quarter of 2018, the partnership generated a return, net of fees, of -3.25% versus -0.76% for the S&P 500. Our results mostly reflect the fact that the value component of the overall equity market continues to lag growth. For reference, the Russell Large Cap Value index returned -2.83% while the Russell Large Cap Growth index was +1.42%. Through decades of history this phenomena has always been cyclical and, in light of the current, extreme valuation spreads, we expect that to repeat in the periods ahead.

The first quarter was noteworthy for a handful of reasons. President Trump's tax plan passage in late December propelled an extremely strong stock rally in January. The view in the markets was that the tax plan would add to the already increasing strength in the underlying economy while fourth quarter earnings came in favorably. For the month, the S&P 500 was up 5.73% while the ten year Treasury bond yield rose roughly 40 basis points. Rising rates were always going to be a concern for the economy and stock prices and that anxiety asserted itself with a vengeance on February 2nd. In the following eight days the S&P 500 sold off 8.5%. Elevated price volatility has been the norm ever since, even as the focus shifted from rising interest rates to trade disputes and protectionism. While anxiety (long absent) has entered the picture, the economic backdrop has not really changed very much – labor markets are producing jobs, economic confidence remains high and consumers continue to spend on cars and houses. Of all the leading economic indicators, the most reliable remain the various bond and stock markets (globally) and they are suggesting that it's time to pay attention. In addition to the obvious – the stock market correction and increased volatility - there has been a notable widening in investment grade corporate bond spreads which means that lenders to good credits are demanding to get more compensation for risk. This is typically a late cycle phenomenon. While widening credit spreads are something that we are watching, at this point it is one of very few cautionary data points – the flattening yield curve we have spoken about in past letters remains another.

Global equity market outcomes were more variable in the first quarter than they have been lately with the S&P 500 producing a middle of the road result. On the positive side were Brazil and Russia which were up 11.2% and 9.3%, respectively. The prominent laggards were Japan (-5.8%), Germany (-6.4%) and India (-7.3%). While one might take this increased dispersion of returns as a cautionary sign, the fact that traditionally riskier markets like Russia and Brazil led the list would refute that conclusion. Within the US market the leading sectors were Consumer Discretionary and Technology – not surprising given that growth outperformed. The worst performers were Staples, Energy and Materials. Small cap stocks slightly outperformed large caps, for a change, but only by a very slim margin. Noteworthy in the quarter were the sell offs of some of the large cap growth "Aristocracy". Facebook came under pressure for its management of subscriber data which set off a "soul searching" throughout the data driven internet model stocks – Google, Instagram, Twitter, et.al. Tesla, also a large cap growth darling, underperformed as cash flow remains extremely negative while the company struggles to produce cars on schedule.

PERFORMANCE COMMENTARY

Despite our clear over weights in Energy and Materials, Valara's quarterly performance was substantially influenced by individual stock selection. To illustrate this point, Goldcorp and Newmont Mining were

among our top five positive contributors to performance while Barrick Gold and Agnico Eagle Mines were among the bigger detractors. Conoco Philips was a leading stock in the portfolio while the deep water drillers, in aggregate, gave up part of their strong fourth quarter performance. Away from energy and materials, Intel was our strongest single contributor driven by a positive fourth quarter earnings surprise and improving outlook. Arconic was a significant underperformer despite solid fourth quarter earnings because management tempered their expectations for the year (2018).

During the quarter we eliminated our position in Microsoft (as it reached our target price), adding to IBM and continued to reduce BankAmerica while adding to MetLife. Perhaps most notably, after the company announced a truly shocking $15 billion reserve charge for a long term care insurance operation that had been discontinued more than ten years earlier, I concluded that GE was neither on top of its turn-around nor truly had the balance sheet we had assumed. While the realized sales price was a disappointment at the time I eliminated it from the portfolio in mid-January, by the end of the quarter it had fallen an additional 18%. Although GE was not a meaningful position for us, until the recent events I had hoped it could be something we added to. I remain open to revisiting the stock as the situation clarifies. It's also worth noting that we eliminated our position in Weatherford in late-January after the stock price had rebounded from the news that it had failed to close its OneStim JV with Schlumberger. Weatherford's balance sheet had gotten too stretched and its turnaround was floundering.

OUTLOOK

I continue to think that the outlook for our portfolio is favorable. The driving factor for this view is the observation that valuation spreads between our holdings and the rest of the market are unsustainably wide. The implication is that over time they should narrow, driving portfolio outperformance. There are any number of valuation spread examples to point to but perhaps the most striking to me at the moment is Tesla (which we don't own because of its high valuation) versus GM. Tesla has the same market cap as General Motors, but it makes no money and it's unclear when it will, it has 1/8 the revenue of GM, is hemorrhaging cash from its operations and may need to raise capital this year. There are burgeoning reliability and quality issues and the company has persistently failed to make production targets. Even with all that, the market has bid the stock up nine fold in the last five years on the hope that it will be the "Apple" of the auto industry. Having visited the annual New York auto show last week, it is clear that Mercedes, BMW and Porsche (not to mention GM) aren't going to stand back and casually let Tesla dominate in electric vehicles. Ultimately, Tesla may in fact prove to be a great investment but history suggests that the majority of the many analogous "new paradigm" stories that have led this market will not be able to live up to current, over-hyped, expectations. That, in essence, is what we are waiting for. In the meantime, the economy is doing fine, with the caveats noted earlier, and earnings are growing. The geopolitical environment is clearly a wildcard but so far the markets have mostly shrugged it off. We will stick to our strategy of finding companies that are trading at a discount to their long term value, invest, watch and wait. With process and discipline, we expect to do well over a full investment cycle. Thank you for your continued support.

Sincerely,

Robert W. Simmons, CFA
Principal