Valara
Capital Management, LLC

April 12, 2019

Dear Friend of Valara Capital Management,

For the first quarter of 2019, the partnership generated a total return, net of fees of 9.84% versus 13.65% for the S&P 500. It was yet another quarter with growth stocks outperforming value by a substantial margin. For reference, the Russel 1000 Growth index outperformed the Russell 1000 Value index by 4.4%.

In my third and fourth quarter 2018 letters, I noted that signs of economic weakness were on the rise and that the Federal Reserve was likely to preemptively push back at some point. That turned out to be a fair synopsis of the first quarter of 2019, with a healthy dose of trade optimism and a resolution of the government shut down thrown in for good measure. In January, the Federal Reserve abruptly reversed its stance on interest rates, emphasized policy patience and announced that the shrinking of its balance sheet would quickly come to an end. Other global central banks took analogous actions. The result was an explosion of markets to the upside, virtually eliminating the market decline experienced in the fourth quarter. Global equity markets were strong across the board, led by China and Russia, with the S&P 500 coming in third of all the larger markets. Bonds rallied broadly with interest rates falling and credit spreads (the difference in interest rates paid by strong vs weak borrowers) contracting. The broad capital markets rally was substantially a function of central banks acknowledging a slump in economic growth and responding with reassurance and a shift in policy. While nobody particularly likes recessions, they play a critical role in long term economic health by clearing out capital investment mistakes and separating the good decision makers from the bad. In the long run they are essential for optimizing growth and reallocating wealth. The fact that central banks seem increasingly determined to micro-manage the "creative destruction" of capitalism (recessions) is somewhat worrisome and prone to create problems of its own. This is by no means a new behavior, although it has evolved, nor is it a new realization. However, central bank intervention is an increasingly discussed topic in global markets whose significance was highlighted in the quarter.

Stocks and bonds were not the only assets to experience appreciation. The price of commodities, in general, and oil, in particular, rose as well. Oil hit a low of roughly $42.50 in late December 2018 and closed the first quarter of 2019 at roughly $60.50 – an increase of 42%. While this outcome was supported by OPEC's agreement to reign in production, the recent volatility is remarkable. Our longer term expectation for oil prices has not changed. The swing producer is US shale (because of its ability to start and stop production quickly) and, based on recent industry results, most participants need a WTI price between $65-$80 to make a reasonable return on investment. While that means little for what the price of oil will be for any short term period it means a great deal in the long term.

PERFORMANCE COMMENTARY

Knowing that growth stocks once again outperformed value, it will come as little surprise that the strongest sector in the market was technology. Other leading sectors included: Real Estate, Industrials and Energy. Many of the usual suspects put in strong performances for the quarter, including mega-caps, Microsoft, Apple, Amazon, Facebook and Netflix. Lagging sectors included Health Care, Financials, Materials and Utilities. In the quarter, our under representation in what we view as expensive technology stocks was perhaps the biggest issue for performance, followed by our continued overweight in Materials. Our underweights in Financials, Health Care and Utilities were helpful. On a stock specific basis our biggest contributors were Wheaton Precious Metals, which resolved its tax dispute with the Canadian government, Goldcorp, which agreed to be acquired by Newmont and Baker Hughes GE, Murphy Oil, Marathon Oil and Transocean – all of which rallied with the oil price. Our lagging stocks included Mosaic and Pan American Silver, which had a poor fourth quarter reports, and our three health care names: Amgen, Pfizer and Gilead.

The first quarter was one of the quietest trading quarters we have had in a long time. This was in part due to the extreme reversal in the market that saw the S&P up over 8% in January alone. Chasing stocks as prices rose rapidly was not terribly appealing to us. During the period, we sold our remaining position in Jacobs Engineering and redeployed the proceeds into Fluor and Mosaic Corporation.

OUTLOOK

Judging by the performance of markets in the first quarter, the Fed (and its peers) has gotten ahead of the global economy once again. That may prove to be the case for a while but we are entering the eleventh year of what will be (this quarter) the longest expansion in US history and it is difficult to imagine that the elevated level of system debt to GDP won't eventually work to slow things down. The primary offset that has made the high debt to income manageable has been the record low interest rates being paid on it. One can reasonably infer that recent rising interest rates (although still historically low) pressured debt service costs and chipped away at economic growth.

In my ongoing review of the fundamental metrics for stocks in our opportunity set I find a rising number of "issues". Some of these companies have strong current income dynamics but surprisingly high debt levels due to aggressive share repurchase programs or acquisitions. Others have distressed business models due to technological disruption, industry overcapacity, global trade, regulatory or other matters. Given my concerns regarding late economic cycle risks, these issues make the number of "investable" stocks lower than it otherwise would be. That said, I am still finding interesting and compelling opportunities to put capital to work. During the first week of April I added Quest Diagnostics to the portfolio and there are other prospects currently under review.

I continue to believe that we have seen the dynamics of the present environment before. Every day it looks more and more like the late 1990s, with loss making technology companies being enthusiastically embraced. The late 1990s were NOT fun for value managers but the tide did turn and the returns to value investing were extraordinary for years thereafter. By staying true to our discipline I hope to deliver strong full cycle returns to our partners. Thank you for your continued confidence and support.

Sincerely,

Robert W. Simmons, CFA
Principal