Valara
Capital Management, LLC

July 12, 2018

Dear Friend of Valara Capital Management,

For the second quarter of 2018, the partnership generated a total return, net of fees of 6.07% versus 3.43% for the S&P 500, bringing the year to date return back in line with the broader market. The most satisfying part of this performance is that the partnership was able to accomplish it despite the fact that growth stocks continued to outperform value by a substantial margin. We remain confident that the growth/value tide will shift in the future providing Valara with an extra tailwind versus the S&P 500.

It was another eventful quarter in the world of economics, finance and geopolitics. The global economic picture remains fairly healthy, led by strength in the United States. Europe, Asia and Latin America are all growing but with less vigor and a few more areas of uncertainty. In an expression of confidence in Europe, the ECB recently introduced a plan to cut back on the stimulus that it has been providing through its bond buying program. It will be interesting to see the central bank undertake this as business confidence in Germany and Western Europe has ebbed. Expect the pace to be extremely slow. Japan has been more cautious with ending their program of support and, in light of continued muted economic data, recently chose to defer any decision to reign it in. China has seen growth edge lower and recent trade bluster won't help the outlook. While US stocks continue to perform well, that experience is not universal. In the second quarter, stocks in Brazil and Argentina were down over 20% (respective, MSCI indices), while China was down 10% and Russia, Mexico and Korea were all down high single digits. The apparent message is one of risk aversion related to country specific issues but also of declining global dollar liquidity as the Federal Reserve slowly shrinks its balance sheet. Bolstering this observation is widening corporate bond yield spreads to Treasuries. The yield curve, mentioned in the last few letters, has continued to flatten. While there may be technical arguments for this phenomenon, it's hard to ignore its traditional significance as a forecast of weaker growth ahead. Of particular interest is the fact that through the Federal Reserve's latest 25 basis point increase in the Fed Funds rate, ten, twenty and thirty year treasury yields actually fell by a roughly equal amount despite rising supply which would tend to pressure bond prices lower and rates higher. Geopolitics have not quieted down one bit since the first quarter but not all the news is bad. While trade disputes may turn into serious economic issues going forward, the progress that appears to have been made with North Korea is favorable. It will be interesting to see if the nascent cooperation lasts. Finally, S&P 500 earnings estimates for 2018 and 2019 received an early windfall from President Trump's tax plan and have continued to be revised higher as corporate results have come in. Second quarter earnings reports are expected to be strong.

Within the US markets growth stocks continued to outperform value while small cap stocks convincingly outperformed large cap. The sectors that led the market advance were: Energy, Real Estate (REITs), Consumer Discretionary and Technology. It is a bit unusual for growth to have outperformed value while Energy (a value group) was the leading sector but that is what happened. The lagging sectors were Industrials, Financials, Consumer Staples and Transportation. From examining the returns of individual S&P 500 stocks it is apparent that the outperformance of growth was again a function of the dominance of a handful of very large cap tech darlings: Netflix +33%, Facebook +22%, Amazon +17% and Apple +11%. The strong appreciation of a large number of small and mid-sized Energy companies was a meaningful contributor to the overall performance smaller cap stocks. Some of these energy stocks were up over 100%.

PERFORMANCE COMMENTARY

Those with good memories will recall that the performance of the energy sector in recent quarters, our holdings included, has been an on again, off again affair. While this can be frustrating, the positive slant is that frequently there is a period of ups and downs without much net progress in advance of a larger change in direction. It would seem that we have been going through such a period with the latest quarter being a more significant move up. This is not meant to be a prediction – merely an observation. The longer term case for oil remains that there has been a dramatic underinvestment in new sources of production over the last four years and global supply has been rationalized – finance speak for oil prices should be biased to the upside. Meanwhile, our energy names did spectacularly well in the quarter led by the deep water drillers. Noble Corp was up 71%, Ensco was up 66%, Diamond Offshore was up 42% and Transocean was up 36%. Our exploration and production names were close behind with Murphy Oil up 32%, Marathon Oil up 30% followed by Baker Hughes up 20%, National Oilwell up 18% and Conoco Philips up 18%. The reason the portfolio did not fare even better, in light of these big moves in energy, was because we had the usual handful of stocks with "issues". Arconic topped the list, reporting a disappointing quarter that highlighted the company's struggles to sort out its operational issues. The stock was down 26%. I am watching the company's progress carefully but have maintained our position. Fluor continues to struggle with the profitability of underpriced legacy business. The stock was down 14% in the quarter. Finally, there continues to be angst about IBM's transition to an emphasis on cloud computing, artificial intelligence and blockchain. While growth has been slow to emerge the company's strategy is sound. The stock was down 8% for the period.

During the quarter we reduced Conoco into strength as its discount to our estimated fair value price eroded and invested the proceeds in Ensco and National Oil Well. We also continued to opportunistically reduce our positions in BankAmerica and Intel on valuation. We have yet to reduce any of our deep water drillers despite the strong moves that they had. The stocks were so depressed to begin with they continue to have significant upside to our target prices. We would rather ride out the inevitable pullbacks than to trade a big move and find ourselves out of position in a group of very cheap stocks.

OUTLOOK

Our outlook remains favorable – not because we have a crystal ball that tells us what will happen next but because we have a great deal of opportunity already embedded in the portfolio. Regardless of what happens next we expect to prosper over time. The trade war threat that is constantly in the headlines is hard to judge. It seems that President Trump's negotiating strategy is to hit hard and then walk it back. With that approach you don't know how any particular opponent will respond. The market appears to have figured Trump out and now treats the headlines with increased skepticism. Otherwise, the global economy and corporate profits/earnings are doing fine with the familiar caveat that we are well into a rather lengthy expansion. In today's world an expansion is best measured by broad credit extension and debt carrying capacity rather than the older/traditional measures of production capacity and inventory. The current expansion is likely to end when economic participants run out of the appetite to borrow and spend/invest. That limit gets closer every time the Fed raises rates but it has not yet been reached. I continually look for new ideas to add to the portfolio and expect to have more to report on this in the months ahead. Our mantra remains that by sticking to our discipline we expect to create significant value over time. Thank you for your continued faith and support.

Sincerely,

Robert W. Simmons, CFA
Principal