Valara
Capital Management, LLC

October 12, 2018

Dear Friend of Valara Capital Management –

For the third quarter of 2018, Valara Partners, LP generated a total return, net of fees, of 2.02%, versus 7.71% for the S&P 500. For the nine months ended September 30, 2018, the partnership produced a total return net of fees of 4.69% as compared to 10.56% for the S&P 500. Clearly it was a very difficult quarter and a continuation of the back and forth results we have had over the last twelve months.

While it was another newsworthy three months, it seemed relatively dull in that there were few new trends or issues that arose. The two primary countervailing fundamental factors affecting stocks continued to be earnings on the positive side and interest rates on the negative. Second quarter earnings were very strong, driving forward estimates of revenues and earnings higher. The tailwind of tax reform will continue to be a direct positive for earnings through year end with follow on effects into 2019. After a dip into the third week of August, ten year treasury yields rose steadily through September, with the Federal Reserve raising its target range for the Federal Funds rate to 2.00% - 2.25%. The yield curve stopped flattening in the quarter but it remains to be seen where it goes from here. Global trade and geopolitics topped the headlines for the entire period with the S&P500 doing a better job of ignoring the associated angst than most global markets. Mexico had the distinction of being the strongest of the larger markets following a favorable start for the county's new President and the resolution of its trade dispute with the US. Chinese and Indian stocks were among the weakest, impacted by: (1.) increasing local borrowing costs brought on by rising US interest rates and the strong dollar and (2.) major trade uncertainty. The most vulnerable emerging markets are struggling as the Federal Reserve raises interest rates and drains dollars from the global monetary system.

Within US stocks, growth continued its relentless outperformance of value in the quarter (see attached graph), while small cap stocks gave up all of the year to date lead they had accumulated over large caps as of June 30. The best performing US market sectors were Health Care, Transportation, Industrials and Technology, with Real Estate, Energy, Materials and Utilities being the biggest laggards. Apple, Microsoft and Amazon alone accounted for over 2% of the S&P 500's 7.71% advance.

**PERFORMANCE COMMENTARY**

At the highest level, our performance continues to be impacted by the dominance of growth stocks over value. Rather than repeating what I have said in recent letters, I will simply reiterate that I am confident that this cyclical phenomenon will ultimately normalize in our favor. From a sector weighting perspective, we were heavy in the wrong places in the quarter, with large overweights in Energy and Materials. While our energy sector exposure did not help, our stock selection within Energy was quite favorable, offsetting much of the pain. Ensco, Noble, Marathon Oil and Conoco Philips all bucked the general energy trend and strongly outperformed the S&P 500. In aggregate, our energy position did not hurt us to any significant degree in the period. The big problem for Valara, LP was Materials – specifically gold mining stocks. We have been favorably disposed to the gold stocks for quite some time and have yet to see a reward. The case for gold is similar to that for oil. The industry went through a wrenching earnings washout, as gold prices surprised to the downside after 2011, and has dramatically rationalized production capacity. At this juncture, gold prices provide most players slight profits but nothing nearly good enough to justify incrementally investing to grow. As we move forward, I expect production to shrink while demand grows moderately, shifting the dynamic in favor of rising gold prices. Clearly that did not happen in the third quarter. Rather, rising interest rates and a stronger US dollar made owning gold less attractive and the gold price fell - taking the stocks with it. The five worst detractors from performance in the quarter were all gold related. Investing in industry turnarounds can try one's patience; but, they can also be extremely rewarding. I continue to believe the reward is coming.

In the third quarter, I finished selling BankAmerica from the portfolio – thank you Bill Cohen for a very successful investment holding. Also on the sell side, I reduced our position in Nordstrom after a significant jump in price on strong second quarter earnings. I initiated positions in Gap Stores and Borg Warner at what I believe to be very attractive entry points. Gap is a turnaround of sorts. The company owns Gap, Old Navy, Banana Republic and Athleta brands. The part of the company that is a turnaround is the Gap, with the other parts of the franchise growing nicely – particularly Old Navy and Athleta. The concerns over the Gap may be justified; but, at this point, they appear to have overly discounted the implied price for the rest of the business. Borg Warner is a leading supplier of drive train components to the global auto industry. Because of their end to end solutions (engines to differentials) they are taking share in the industry. At the moment, the market is worried that the auto cycle has peaked (it probably has) and all auto and related stocks have been under severe pressure. This has given us an opportunity to buy a great company at a very cheap price. Finally, I defended a handful of our gold stock positions by rounding them up into weakness.

**OUTLOOK**

As I write this at the end of the second week of October, the US stock markets have gotten volatile again. This is not necessarily surprising after the strong performance that we have seen over the last several months. Recently Chairman Powell of the US Federal Reserve unnerved investors by saying that interest rates are still well below a neutral level (implying they need to go much higher over time). As I wrote last quarter, interest rates are likely to be the key to how the rest of the current economic cycle plays out. While the coincident indicators of economic activity are doing fine and the lagging ones are still strong (employment, consumer spending…), there have been some hints that the outlook may not be as robust. Of the leading economic indicators, the markets (bond and stock) are among the best thought of, largely because they are by their nature anticipatory animals. I have already spoken repeatedly about the yield curve. In addition, several industry groups that bear watching towards the end of an expansion are waving a yellow flag – notably, autos, housing and bank stocks (all major drivers of the economy). Auto and housing stocks have been particularly weak and recently banks have stopped outperforming with rising interest rates. As the Fed raises rates there will be a level at which the drag of higher debt service starts to curtail consumption growth (auto and home…), share repurchase, capital spending, etc. The US economy is one of many that are carrying a substantially higher level of debt than they have in the past. This is not a forecast of an emerging recession because these observations are by no means definitive; but, I have started to prepare for the possibility of tougher times by shedding balance sheet risk and lower quality franchises from our holdings. None of this changes my view of Valara's outlook or prospects. The portfolio, as it stands today, has enormous outperformance potential and I am excited about the next few years regardless of the external circumstances. By sticking to our disciplined investment process we expect to produce significant outperformance across cycles. As always, I appreciate your confidence and support and welcome any questions you may have.

Sincerely,

Robert W. Simmons, CFA
Principal

**Performance of Growth versus Value**