January 11, 2019

Dear Friend of Valara Capital Management,

For the fourth quarter, Valara Partners, LP generated a total return, net of fees, of -15.80% versus -13.52% for the S&P 500. For the twelve months ended December 31, 2018, the partnership produced a total return, net of fees, of -11.85% as compared to -4.38% for the S&P 500. The fourth quarter proved to be an extremely volatile end to a challenging year.

The final three months of 2018 were surprisingly tumultuous, reflecting the collision of rising interest rates, disruptive news flow and hypersensitive, computer driven, trading. The resulting volatility across markets and geographies was noteworthy in an historical context. While global economic growth was positive, many indicators edged lower in the quarter which surprised an optimistic consensus. Much of the economic angst was focused on a slowdown in China, whose trade rhetoric and posture seemed to hint that Trump negotiations were hitting an exposed nerve. Commerce Secretary Wilbur Ross' multiple references to China's vulnerability reinforced this concern and stoked tension - which is a fitting segue to a few comments on the raw geopolitical backdrop. I cannot remember a more chaotic time in global affairs: fractious trade wars, Brexit impasse, European protests, Saudi royal instability, OPEC disarray, toxic US politics, government shutdown, petrodollar challenge, China/Russia/US sabre rattling, a tug of war in Syria (Russia, Turkey, Saudi Arabia, Israel, US, Iran), Iran sanctions controversy, never ending investigations, cabinet revolving door, etc. It makes one nostalgic for 2017's now seemingly simpler North Korean crisis. The point being: it's not surprising that markets and economies struggle to manage all this uncertainty. Tough fourth quarter aside, the good news is that so far they have managed it. If uncertainty climaxes and begins to recede it could provide a tailwind.

For the quarter, global stocks struggled. The Brazilian market was the standout performer on a rally following the election of a right wing President dubbed the "Trump of the tropics". India was the only other major market that posted a positive return with Mexico being the biggest loser, declining 19.6% for the period. Germany fell 15.5%, Japan fell 14.4% and China fell 10.8%, closing at a five year low. The performance of the various global bond markets depended on whether they were viewed as safety or not, with US treasury bonds remaining the preeminent haven. While commodities in general were weak, the decline in the price of oil was breathtaking. From the beginning of October through mid- December the oil price fell 43% - a startling decline even for a traditionally volatile commodity. While moderating demand and rising production from US shale were important factors in this decline, it is hard not to note the surge in Saudi production as the relatively new crown prince courted the US for support. Since mid-December, the oil price has bounced back by approximately 20% on optimism that OPEC production cuts may help balance the market.

From a US sector perspective, the strongest performer in the quarter was Utilities. Other sectors that performed better than the market were consumer staples, real estate investment trusts, health care and materials (largely on the back of gold stocks). The weakest sectors were energy, transportation, industrials and technology.

The themes for the full year 2018 were the same as those for the fourth quarter, even though the sell-off in the final three months ultimately dominated the year's return. Through September 30 the S&P 500 was up over 10% with many of the issues that upset the market in the fourth quarter already visible if not fully crystalized. The year's positive influences were: modestly accelerating economic growth, strong earnings and lower taxes. Headwinds were: rising interest rates, a flattening yield curve, trade friction, and troublesome geopolitics. The perception that the Federal Reserve was oblivious to the repercussions of rising interest rates seemed to be the tipping point in the fourth quarter

PERFORMANCE COMMENTARY

Amidst the broad fourth quarter sell-off, value stocks did manage to modestly outperform growth. It is not uncommon for a direction change in the market to reverse recent internal trends which was manifest with heretofore popular technology shares underperforming. Those taking significant hits included Apple and Netflix declining almost 30%, with Facebook, Amazon and Alphabet (Google) all declining over 20%. What would otherwise have been a favorable backdrop for Valara was overwhelmed by our exposure to energy as oil prices collapsed. This negative impact was mitigated somewhat by sales that we made of energy positions very early in the quarter. On the positive side, our gold stocks performed very well with the increase in global anxiety and speculation that market turmoil would force the Federal Reserve to pause, if not reverse, recent rate hikes. If gold miners were a sector they would have been the top performer in the market with the GDX (exchange traded fund) up 13.9% in the quarter. Our individual stock selection was, on average, favorable. AIG and IBM were notable poor performers while Barrick Gold, Intel, Pfizer and Amgen all outperformed their sectors.

As indicated above, I reduced our oil positions early in the quarter, making significant sales of ConocoPhillips and Murphy Oil at multi year highs. I also trimmed our exposure to the deep water drillers – not on valuation but on the rising risk that we are late in the economic cycle. Were a recession to emerge in the near future, the normalization of oil prices that was evident through the first nine months of 2018, would likely be delayed. I sold our entire IBM position after the company announced the acquisition of Red Hat. While the combination could be defended, the undermining of IBM's balance sheet suggested a "bet the ranch" decision. With this move, IBM headed directly down the path that put General Electric in its current position. I also eliminated our modest position in Arconic. The company has been a rumored acquisition target for months but nothing has materialized. Meanwhile, the bond market has become extremely discriminating, making a deal more challenging and Arconic's balance sheet is marginal. Elsewhere, I opportunistically reduced our Mosaic and Jacobs Engineering positions as their stock prices rose. Aside from modest redeployment into existing holdings, I invested net proceeds in the SPY while looking for attractive alternatives.

OUTLOOK

Despite Value's modest victory in the fourth quarter, for the year, Growth remained dominant. As long and exhausting as this cycle has been, it appears that patience continues to be required. In my third quarter letter, I noted some observable cautionary signals about the economy and proposed that we were late in the expansionary phase. While I still believe that to be the case, it often takes a number of quarters for the waning cycle to become tangible. Although recent global economic growth has been favorable, the US Federal Reserve and other global central banks have been watchful for signs of emerging weakness with every apparent intention of resisting it. Even with that implied backstop, I continue to believe it prudent to reduce exposure to credit risk which I have methodically undertaken. The portfolio remains laden with valuation based outperformance potential that positions us well for 2019 and beyond. Valara's investment process and discipline is well suited to the capture of outperformance across the investment cycle. By staying true to our investment strategy while continuing to rigorously question all of our assumptions, we expect to produce attractive returns for our partners. I would like to reiterate my appreciation for your confidence and support. I am available to answer any questions you may have.

Sincerely,

Robert W. Simmons, CFA
Principal