Valara
Capital Management, LLC

January 10, 2020

Dear Friend of Valara Capital Management,

For the fourth quarter and twelve months ended December 31, 2019, Valara Partners, LP. produced total returns, net of fees, of 11.99% and 22.36%, respectively, versus corresponding total returns for the S&P 500 of 9.07% and 31.49%. While we are extremely pleased with our quarter, even more so than one might think on the surface (for reasons explained below), we recognize that the overall year was still disappointing.

QUARTERLY REVIEW

The economic slowdown that has been at the forefront of discussion for the last few quarters and prompted the Fed to begin cutting rates last July, eased somewhat in the fourth quarter. While there was modest improvement in the underlying statistics, including jobs and consumer spending, there was a greater improvement in overall optimism. That optimism was driven by a handful of discreet events including progress on the ongoing US/China trade deal (yet to be finalized and signed), elections in the UK that should pave the way for Brexit to move forward, and, most importantly, a step-up in accommodation by the global central banks. Recall that, as the third quarter came to an end, Germany was on the verge of recession, China's growth was as slow as it has been in decades and the US was decelerating. In the fourth quarter, the ECB and the Federal Reserve rejoined the Bank of Japan in purchasing securities and expanding their balance sheets (thus injecting cash into the securities markets). For the Fed this was not an announcement but an evolution of their end of Q3 emergency liquidity injections – they just never stopped "injecting". As the fourth quarter wore on the market came to regard this as a new round of quantitative easing and interpreted that as bullish for stocks. I doubt that the Federal Reserve was disappointed. The S&P achieved its long-term average annual return in the fourth quarter and had only a handful of down days in the month of December. By the middle of the month the financial media had taken to describing market activity as a melt-up. Much of the other major news, including impeachment proceedings and the tensions with Iran that led to the early January eruption of hostilities, was quickly brushed off as so much kabuki theater.

As strong as it was in the fourth quarter, the S&P 500 was eclipsed by most of its global rivals which were playing catch up from earlier in the year. Argentina led everyone on a rebound from its severe Q3 sell-off. Russia was up 15%, followed closely by China, Brazil and Korea. The weakest returns were realized by Canada, India and Mexico. US bond yields bounced around a bit but stayed within recent ranges, while credit spreads on corporate debt tightened. Commodities, taking their cue from improved economic optimism, central bank's inflationary actions and above average political uncertainly, posted strong increases.

PERFORMANCE COMMENTARY

In the quarter, growth stocks continued their dominance of the overall market. The Russell 1000 Growth Index outperformed the S&P 500 (which is a blend of growth and value) by 1.55% and the Russell 1000 Value Index by 3.21%. The top performing sectors of the market were Technology, Health Care and Financials and the worst performing were Real Estate, Utilities and Energy. Given this, one might have expected Valara to lag. There were two factors that, combined, more than offset this relatively challenging backdrop.

The most important was simple stock selection. Valara had a significant number of stocks across sectors that performed exceptionally well. While precious metals stocks narrowly beat the S&P 500, Valara owned several that produced outstanding returns. The leader was Pan American Silver which, on the back of surprisingly strong Q3 earnings and rising silver prices, rose 51%. Other strong precious metal stocks included Agnico Eagle, Newmont Mining and Wheaton Precious Metals. Trillion dollar annual US budget deficits (in an expanding economy) and Federal Reserve balance sheet expansion generally provide a gold and silver friendly

backdrop. In Energy, which was a lagging sector, we had Murphy Oil, Diamond Offshore and National Oilwell Varco strongly outperform. In Financials we had State Street up 34%. In Consumer Discretionary, BorgWarner was up 18% and Carnival was up 16%. Finally, in Health Care, Regeneron was up 35% and Amgen was up 25%. There were other contributors and, as always, some laggards but on average our stock selection in the quarter was extremely positive.

The second factor that helped us outperform was our lack of exposure to the more expensive value groups: Real Estate, Utilities, Staples and Industrials. All of these sectors lagged significantly. Hopefully this quarter puts an exclamation point on my note in our last letter that, while Valara's returns tend to correlate with the value index in any given period, there are times when we will differ greatly (on average to the upside).

It was a relatively quiet quarter in terms of portfolio repositioning. Despite the large percentage move in Pan American Silver I did not trim the position. Normally I would have done so, but the stock started the quarter at an extremely depressed valuation and, even up 50%, it did not quite reach the price which, by our discipline, would have prompted a reduction in exposure. I added a new position in Discovery Inc. – a producer of content for television and internet platforms. Discovery is a master in the production of low cost, high value programming that is particularly popular with female audiences (an advertiser favorite). While, like most media companies, Discovery has a leveraged balance sheet, its cash flow is impressive. Finally, I added incrementally to Mylan Labs and trimmed our exposure to Gap Stores on the surprise departure of their CEO.

OUTLOOK

Regardless of the last quarter's reprieve or what the Federal Reserve is doing, we are over 10 years into the current expansion and I continue to suspect it is long in the tooth. However, that remains an observation as opposed to a prediction. Politics are strained and for obvious reason – growth is not strong enough nor broadly distributed enough to keep everyone happy. Meanwhile the costs of health care, housing and education keep rising. As a result, differences are accentuated and frictions are building. Strong stock markets have eased the situation (helped the economy) and/or made it worse (widened wealth disparity) depending on your perspective. Whether it's because of the trade war or something more basic, corporate earnings have flattened out or drifted lower. For the near term, I don't see any of this changing very much.

The last few years I have found that this section of the letter keeps getting more difficult to write. It has occurred to me that this is because the outlook for the economy, geopolitics and broad markets have been diverging from my outlook for our portfolio. While the uncertainty, noted above, has risen, the market has made new highs. As the valuation parameters for the overall market keep going up its hard to say that they look particularly inexpensive. In contrast, when I look at our portfolio, I see a group of stocks that are trading at very attractive multiples - in many cases single digit (P/E). To illustrate, our two most recent portfolio additions (Mylan and Discovery Inc.) are trading at 6.0x and 8.1x earnings estimates, respectively, that I believe are representative of sustainable earnings power. Mylan does have a management/PR issue that still needs to be resolved but I believe the stars for that are aligning. The valuation composition of the market is truly a tale of two worlds – one of haves and have nots. We have seen disparities like this before, in the late 1990's. With the caveat that the past is not always prologue, that period resolved itself with carefully selected value stocks rising while the market itself declined. Despite the challenges outlined above, I believe the opportunities to invest capital, for an attractive long-term return, remain very good – if perhaps not in the overall index. One will need to select individual positions carefully. By sticking to our disciplined investment process, we will continue to do just that. Thank you for your confidence.

Sincerely,

Robert W Simmons, CFA
Principal