Valara
Capital Management, LLC

April 10, 2020

Dear Friend of Valara Capital Management,

For the first quarter ended March 31, 2020, Valara Partners, LP. produced total returns, net of fees, of -26.02% versus -19.60% for the S&P 500. As the Coronavirus panic set in and the prospect for recession and interest rate cuts rose, growth stocks again outperformed value – by a remarkable 13%. At this point, value has completely round-tripped to its all-time low versus the S&P 500 that occurred in March of 2000 – a level, ex-post, considered so extreme (coincided with the internet bubble) that I am surprised to see it again in my lifetime.

QUARTERLY REVIEW

Everyone knows the lead story for global markets through March, but many will have forgotten that the quarter began with euphoria over finally reaching a trade deal with China. The S&P 500 was up 4.6% by the middle of February. It seems like a different lifetime. While the Covid-19 pandemic dominated the quarter and will likely do so for the immediate future, there were two other important events: 1. a break-down in OPEC cooperation and 2. the actions by the Federal Reserve and Treasury to mitigate the virus's impact on the economy – which will be an important influence for the intermediate and long term. The OPEC collapse originated from a disagreement between Russia and Saudi Arabia that ended in emotional irrationality. Coming at a time when the Chinese economy was already in free-fall (soon to be followed by the rest of the world), the oil price declined dramatically. Since the 2008 financial crisis, Wall Street has been debating the particulars of the Federal Reserve's exit strategy from Quantitative Easing I, II, and III (specifically, whether it would be attempted and/or succeed). Any hope that the Fed was going to extract itself from its heavy-handed intervention has now been severely eroded. It's hard to list all of the programs that have been announced but among them are: the Fed launching QE IV and its own hedge fund, with $454 billion of capital from the Federal Government, through which they can buy corporate credit instruments (the Fed is not allowed to take credit risk – so the US Government will assume any losses) and the Congress passing a $2.3 trillion stimulus program. Most recently, the Federal Reserve has added junk bonds to the list of securities it will purchase – leaving everyone to speculate whether stocks are next. With 17 million new unemployment claims and the economy substantially shut down, these actions may not be enough; still, the longer-term implications of the government so strongly and persistently intervening in markets are extremely problematic. The primary function of markets is to allocate capital to its best use. The process relies on thousands of self-interested participants putting real money behind their best judgement and intellect to form a pricing consensus that, over great stretches of time, has proven to be insightful at a level that no handful of academic bureaucrats can match. The collective intelligence of markets is a force to be reckoned with not trifled with.

The market movements of the first quarter of 2020 were for the record books. While stocks always seem to get the media attention, it was what happened to Treasury yields that was most surprising (at least to me). In a matter of two weeks the ten-year treasury yield dropped over 100 basis points to an all-time low of just under 0.35%. The U.S. treasury market, considered to be the most liquid in the world, became partially dysfunctional. Not surprisingly, with the growing concerns about global recession, credit spreads widened significantly. Global stocks were hit hard with emerging markets and small caps generally performing the worst. The S&P 500 was the third best performer of the larger markets, being outdone only by China (ironically) and Japan. As alluded to above, growth massively outperformed and, at the risk of foolishly sticking my neck out, the action in value looked like capitulation (a cathartic washout of uncommitted investors) that frequently marks a bottom. You may justifiably call me an optimist; but I regard it as mathematics (valuation) and probability (extreme).

PERFORMANCE COMMENTARY

With growth stocks again topping value, it will be no surprise that Technology stocks led the overall market. They were closely followed by Health Care, Consumer Staples and Utilities. The weakest groups were Energy, Financials, Transportation and Industrials. At this point, Energy's underperformance has become pitiful – the industry just can't catch a break. Our slight overweight in the sector did not help us. On the other hand, our underweights in Financials and Industrials did. Our stock selection had elements of extreme favor and disfavor. All our Energy names were notably weak, as were many of our cyclically exposed stocks like Gap, Mosaic, BorgWarner and Fluor. On the positive side, Regeneron Pharmaceuticals was up 27%, Gilead was up 15% and Newmont was up 4%. Most of our precious metal stocks performed better than the market. The net of it all was the underperformance reported above which, in the balance, was driven by an extreme flight from cyclicals - regardless of industry position or balance sheet. The month of March was pure, indiscriminate panic and I would expect our holdings to fare better as the process of sorting the wheat from the chaff begins.

We did some active trading in the quarter as prices moved significantly, giving us a chance to both buy and sell. We sold completely out of Carnival Corporation when the first Covid-19 scare was announced, realizing just over $44 per share. While this was down from our average purchase price, it compares to $12 as I write this. I also sold all our Regeneron Pharmaceuticals (it reached our target price) and our small remaining position in Diamond Offshore and trimmed a handful of our precious metal holdings into strength. The proceeds from the sale of Diamond went into a new investment in ConocoPhillips and the rest into companies we already owned and a slightly higher cash balance.

OUTLOOK

While the economy was slowing before the impact of Covid-19, it is now the consensus that a meaningful recession lies directly ahead. The debate has shifted to how long and how severe the recession will be. Coming to a high conviction conclusion on this front is a challenge for at least two reasons: 1. no one knows the path of the global pandemic with any certainty, including whether there will be a second wave (which appears to be a real possibility) and 2. it remains to be seen what the totality of the central bank/fiscal intervention will be.

With respect to the virus itself, it could fade into the summer, it could linger and return in the fall or, best case, it could abruptly and confidently end with the arrival of a vaccine. While Covid-19 has been a tragedy and a severe wake up call, its primary role has been to highlight poor assumptions we all have made – financial and organizational. The corrective adjustments will take time but will be accomplished.

Meanwhile, the Fed and Treasury have taken dramatic and extreme actions to counter the unprecedented shut-down of the economy. Further actions are almost certainly coming. I had hoped that we had learned from the 2008 financial crisis that there are long term implications that come from altering the social contract in the face of an emergency. The wealth gap that is so much talked about is a direct result of actions taken to depress interest rates and support stock prices to revive the economy post 2008. Labor does not own much in the way of stocks. The anger, frustration and political divide should not be a surprise. The Fed picked winners and losers when, by contract, this was the role of the free market. Wall Street argued that we needed to save jobs, but they meant their jobs[1]. As unpleasant as it can be, capitalism requires that the risk of loss be borne by capital, regardless of the circumstances – short of fraud. When stockholders win but never lose, it's not surprising people get angry and that's not the half of it. The real problem will ultimately be that socializing

[1] There is a misconception perpetuated by the "bailout crowd" that bankruptcy means companies cease to exist, operate and employ. Sometimes this is the case but far more often all that happens is a financial restructuring under which stockholders lose their investment, bondholders become the new stockholders and business continues.

losses is not a free lunch. Bailouts require money and it must come from somewhere. There are two possibilities – taxes and/or inflation. Hint: it won't be taxes. Inflation is viewed by politicians as the easy way out. Simply let the Federal Reserve finance the government giveaways and in so doing expand the supply of money in the system, driving longer-term inflation. Politicians assume (mostly correctly) that they won't get blamed for inflation because: they will be long gone, few will really understand its origins, and who can fault them for "helping" the people in a crisis. As they said after 2008 – "we had no choice".

That completes a long-winded explanation that inflation is increasingly part of my outlook for the future (and a warning that our social contract needs defending). As a word of caution, I should note that I have no crystal ball as to how quickly inflation may emerge. Ironically, the economic weakness directly ahead may be immediately deflationary – certainly the price of Caribbean cruises (for example) has collapsed. That said, the more deflation threatens the more I would expect the Federal Reserve and Treasury to push back against it because, left alone, it leads to default. The good news is that inflation, should it arise, will be relatively beneficial to value stocks (versus growth stocks) because of the shorter duration of their cash flows (valuation math). Finally, I would like to remind my partners that our portfolio does not look much like the S&P 500 at the current time. That is a conscious decision and the much lower valuation parameters and stronger balance sheets should position us well for the future, no matter what it looks like. As always, Valara will navigate this volatile environment by sticking to our discipline. I appreciate your support and patience and I am available to answer any questions you may have.

Sincerely,

Robert W. Simmons, CFA
Principal