Valara
Capital Management, LLC

July 10, 2020

Dear Friend of Valara Capital Management,

I am very happy to report that for the second quarter and six months ended June 30, 2020, Valara Partners, LP. produced returns, net of fees, of 34.89% and -0.21%, versus 20.54% and -3.08% for the S&P 500 index, respectively. While it was clearly a good quarter for the fund, we still have work to do to achieve our full cycle objectives. Perhaps most gratifying is that we managed to achieve the above results even though growth continued to vastly outperform value in the period. More on this below.

QUARTERLY REVIEW

As I sat down to write this, my first thought was that the second quarter was relatively quiet – a period where things settled down a great deal. Perhaps it was by the end of June; however, up over 20% for the S&P 500 in a single quarter is hardly quiet or settled. The economic numbers for April, May and June were nothing short of historic: unemployment of 14.7% in April, with 23 million out of work, and retail sales down almost 15%. By April, auto sales had declined by 50% from their February level and were reflected in depressed business and consumer confidence. First quarter GDP (mostly pre-Covid) came in at a weaker than anticipated -5.0% and Q2, which should be the trough, is expected to be down approximately 15%. May and June saw marked improvement in most economic measures (off the April bottom), including employment and spending, with the economy gradually opening up and Covid-19 infections easing. Amid the economic weakness, crude oil was hit particularly hard. In late April, as the futures contracts matured, the over-supply of oil was so severe and storage so short that the price of oil went materially negative. With no place to store it, holders of future contracts paid up to $38 per barrel (WTI) for someone to take the oil off their hands. The situation was highly disruptive but short lived, with WTI prices recovering to the low $40s by June 30th. Finally, I note the recent protests. While it would be easy to say that they have been about racial inequality and police brutality (they were/are), the economist in me believes that heightened levels of frustration, brought on by our "haves and have nots" society, has pushed anger to new levels. I cannot help but feel that the larger message is that the system is not serving us all. The difficult and nuanced question is how to fix it.

All of this economic turmoil was met with substantial fiscal and monetary stimulus (as noted in our Q1 letter). Certainly, in the short run, this seems to have helped greatly. Seeing the actions taken, market participants shifted to offense and purchased stocks and corporate bonds aggressively, easing the illiquidity in capital markets. As Covid-19 infections leveled out and declined, hospitalizations fell, and treatment and testing grudgingly advanced, confidence ticked up and markets soared. Most major global stock markets were up in the 18-24% range for the quarter. Laggards included the UK, Japan and China. Treasury rates vacillated in a relatively low and narrow range through the period, but corporate rates declined dramatically on easing credit concerns - mostly a function of the Federal Reserve backstop. Notably, the cumulative Federal budget deficit for the months of April, May and June totaled almost exactly $2 trillion which would account for almost 40% of GDP for the period a year ago (unaffected by Covid-19). The prior deficit high water mark for a full fiscal year was 2009 at $1.4 trillion (itself an astonishing number). We are proceeding down an unsustainable fiscal path.

PERFORMANCE COMMENTARY

While value stocks had a significant rally as the quarter came to a close, it was not enough to prevent another drubbing by growth. For the quarter, the Russell 1000 Growth Index rose by 27.4% with the Russell 1000 Value up only 13.6%. As an aside, I have been finding an increasing number of opportunities to take advantage of this disparity (see below). Our performance success in the quarter was due, in roughly equal measure, to our sector weighting and stock selection. With money printing in vogue and huge fiscal deficits, gold and precious metals miners performed exceptionally well. Pan American Silver was up 112%, Kinross Gold rose 81% and Wheaton Precious Metals and Agnico Eagle Mines were both up over 60%. Energy was the second strongest group in the market which was evident in our positions in Murphy Oil - up 125%, Marathon Oil - up 81% (to our sale price – see below) and Baker Hughes - up 47%. Consumer Discretionary was the third strongest group and, while we were roughly market weighted, we had some big winners. GAP was up 79%, BorgWarner was up 45% and Mohawk was up 33%. Our biggest laggards were mostly in the Health Care Sector, with Pfizer up less than 1%, Gilead up only 3% and Mylan up 8%.

We had one of the most active trading quarters that we have had in years. This is mostly attributable to the weakness in value, creating some great opportunities, coincident with a fairly epic rally in select precious metals stocks and the S&P 500 overall. During the quarter we initiated positions in Franklin Resources, Textron and Ralph Lauren and added to our positions in BorgWarner, Discovery, Quanta Services, Mylan, Mosaic, Mohawk, Murphy Oil, National Oilwell Varco, ConocoPhillips, Baker Hughes and Gap. We funded these purchases with a substantial decrease in our remaining position in the SPY, the elimination of our holding in Marathon Oil and meaningful trims of Newmont, Wheaton Precious Metals and Barrick Gold. In an unusual move for us, we bought some Pan American Silver early in the quarter only to trim it a month later and 45% higher. I said we were busy. Note that precious metal stocks started their recent move from an historically depressed level and, in most cases, still have substantial upside to our estimates of fair value. The sales of the SPY took our position down from 23.24% to a mere 8.6% and if recent trends persist it is possible that we exit the SPY entirely.

OUTLOOK

Despite the feel-good aspect of the major rally that occurred in the second quarter, I cannot say that the outlook has gotten that much clearer. It is certainly comforting that the immediate financial strains have eased. Additionally, despite the resurgence in Covid-19 infections, I think there is reason for incremental optimism in the more muted increases in hospitalizations and deaths. Early-on in the Covid-19 pandemic I read excerpts from an interview with Luc Montagnier the French virologist that discovered HIV. It was his conviction that the Covid-19 virus was man made (altered in a lab) and that in the intermediate and long-term that would be good news. His reason for believing so was that Nature does not typically tolerate artificial alterations for long before expelling them. In this case, he predicted that process would make Covid-19 less virulent. I am hopeful that this is now playing out. There have been hard hit locations around the world (like Spain) that have reported that they now seem to be dealing with a less threating virus.

The economy very likely saw its low in April, if only because, no matter what happens, Governments will be reluctant to close the economy again. No one really knows how quickly the economy will recover. My guess is that the modest “V” bounce we have had off the bottom will extend at a slower pace as long as virus related deaths remain controlled and the monetary and fiscal medicine does not fall short or backfire. This latter point gets to the real heart of the matter. The unprecedented scope of the recent intervention, on top of the undiminished pile of actions taken since 2008, suggests that we are merely papering over a problem that is too daunting to address politically. At some point, the system-wide ratio of debt to GDP needs to decline.

To repeat the very good news (from the Q1 letter), despite significant uncertainties in economics, politics, and markets, we are finding remarkable value opportunities in individual stocks. The clearest thinking investors I know do not focus on indices, nor try to time the markets or the economy. Instead they emphasize finding good companies/businesses, acquirable at attractive prices and patiently waiting to be rewarded while continuing to watch and evaluate. With all the uncertainty, I find myself increasingly excited and optimistic about what our current portfolio will deliver. With its SPY exposure down to less than 10%, Valara Partners, LP. is increasingly going its own way by following its disciplined investment process. As always, I appreciate your continued confidence and support and welcome your questions, comments or concerns.

Sincerely,

Robert W. Simmons, CFA
Principal