Valara
Capital Management, LLC

July 9, 2021

Dear Friend of Valara Capital Management,

For the second quarter and six months ended June 30, 2021, Valara Partners, LP. produced returns, net of fees, of 3.38% and 18.40%, versus 8.55% and 15.25% for the S&P 500, respectively. While value stocks performed well through May, June saw a significant, if not completely surprising, correction relative to growth, which may have implications for the immediate term outlook.

QUARTERLY REVIEW

The US economy, and those of the developed world, continued to recover strongly in the quarter. With roughly half of the population having completed the vaccination process, the US ranks in the top 10 countries for vaccination penetration and Covid infections have declined commensurately. As infections have declined, businesses have reopened and employment has substantially recovered. Interestingly, there seems to be a segment of the workforce that, making more by not working, is reluctant to reengage, leaving many low paying jobs unfilled. The resultant pressure on wages, in addition to cost pressures from raw materials and shipping, pushed inflation up to 5% in May. The cost of housing has been noteworthy as well, with the Case Shiller Home Price Index making new highs and dragging rental rates with it. With all this very much on the public's mind, the Federal Reserve maintains that the recent burst of inflation will be transitory. This may prove correct as high prices and rising interest rates have already appeared to dampen the bond market's view of the near future. The transitory inflation argument rests on the assertion that current price increases reflect temporary supply constraints rather than a permanent shortness of supply. As constraints ease, prices will fall back to trend line. Alternatively, the economy may slow under the "tax" of higher prices and interest rates, undermining demand. As I wrote in my last outlook, this would not be surprising but, unless politicians change their stripes, any slump will be met with renewed fiscal and monetary support because inflation is the new policy goal.

Anyone that has spent much time investing in stocks knows the signaling value of the bond market. Bond investors typically react quickly to any hints of a change in fundamentals. After almost tripling over eight months, 10-year treasury yields peaked at 1.75% on March 30, 2021. Up until this week, the equites market has been willing to treat the subsequent decline in yields to 1.40% as a normal consolidation. With a break below 1.40%, the stock market acted as if it is taking notice. Cyclical value stocks, which have been lagging, traded like the recovery is flagging and disinflation is returning. One observation does not a conclusion make but bond yields and cyclical stocks are now suggesting that the Fed may have had a point about maintaining an accommodative stance.

Other noteworthy items in the quarter include the negotiation of President Biden's infrastructure plan and its companion tax increase. Generally speaking, the plan has shrunk as time and debate has gone on. Its final form remains to be determined. Lastly, I would observe that the first half of 2021 was remarkable for the abundance of "Duke and King" sightings. This is a reference to the two con-artists in the Mark Twain classic <u>The Adventures of Huckleberry Finn</u>. It may prove unfair, but the proliferation of SPACs, stonks, memes, NFTs, Doge (coins), etc., suggest that the Duke and King are about, as will happen when investors suspend their disbelief. It is worth taking note.

PERFORMANCE COMMENTARY

Growth stocks roared back with a vengeance, mostly in the month of June, beating value by over 7% in the quarter. Given the magnitude of the lead value had established over the preceding two quarters, it is not surprising that we experienced a significant pullback. I realize that "not surprising" is not the same as not disappointing. Small cap underperformed large cap which implies a preference for safety coming back to the fore. The top sectors were Technology, Real Estate, Communication Services (traditional and social media) and Energy. The laggards were Utilities, Transportation, Consumer Staples and Industrials. Facebook, Alphabet (Google) and NVIDIA, all top ten weights in the S&P 500, were up 18%, 21% and 50%, respectively. Our sector underweights in Technology and Real Estate were significant detractors to our results, our Energy overweight helped, and the remainder were fairly neutral. The top five stocks in Valara's portfolio were Murphy Oil, Textron, Wheaton Precious Metals, ConocoPhillips and GAP, while the laggards were Discovery (recall that we had almost no shares left so the impact was minimal), Fluor, Pan American Silver, Kinross Gold and Ralph Lauren. On balance, our stock weighting hurt us as Fluor and Pan American detracted more than Murphy and Textron contributed with the rest of the portfolio modestly lagging, on average.

Our trading in the quarter was fairly targeted. Responding to large rallies (over the first and second quarters), I reduced our positions in Mohawk, Textron, and Quanta Services as the remaining upside diminished. I reinvested the funds, so generated, in Discovery (after its sell off), Gilead, Viatris, Pfizer, NOV and Barrick Gold. While Valara does not explicitly pursue a macro investment strategy, the net effect of these actions would be a slight reduction in economic sensitivity and an increase in exposure to a weaker US dollar.

OUTLOOK

The only change to the outlook relates to the recent hint that we may be farther along in the economic recovery than one might normally think. That said, with the unusually heavy hand of the Fed and Treasury most economists would be hard pressed to think that this is truly a normal recovery. As alluded to above, the bond and stock markets are expressing concern about the economy/reflation trade. Recall that when Covid started we were at the end of one of the longest expansions in US history. The downturn caused by the virus and the lockdowns was short, forcibly met by the financial authorities and it is unclear how much of the normal corrective process of recession was completed. In theory, a recession is needed to clear away past capital investment mistakes and open the path for new ideas and competitors. I see little evidence that any of that happened off of Main Street. With aggregate debt levels still increasing, inflation (even the temporary type) on the rise, and new taxes in the works, it would not be surprising to see the economy underwhelm. If that were to happen, I would expect the Federal Reserve to extend its support rather than withdraw it. I continue to believe that moderate inflation is the goal with real interest rates likely remaining negative.

Regardless of the economic environment, Valara will stick to its discipline of buying stocks that are materially undervalued relative to the general market with the expectation of significant outperformance over a full cycle. The portfolio is invested in strong companies, currently has a price to earnings multiple below 10x, and is well positioned for whatever lies ahead. Please feel free to call or email with any questions or comments you may have. Thank your continued confidence.

Sincerely,

Robert W. Simmons, CFA
Principal