October 10, 2019

Dear Friend of Valara Capital Management,

For the third quarter and nine months ended September 30, 2019, Valara Partners, LP produced total returns, net of fees, of -1.58% and 9.25%, respectively, versus corresponding total returns for the S&P 500 of 1.70% and 20.55%. By the numbers it would appear to have been a disappointing yet fairly quiet quarter; however, it was anything but under the surface.

QUARTERLY REVIEW

Clearly the big story in the quarter continued to be geopolitical – namely the trade dispute between the US and China and the lesser frictions between the US and Europe. July began on a positive foot and a market rally with word out of the G20 summit that both China and the US were taking a step back from the brink. This anxious detente held for most of the third period with a meeting planned in Washington in October. Elsewhere, geopolitics were less market favorable and included: an ugly Brexit fight in the UK that remains ongoing as we enter the fourth quarter, violent riots in Hong Kong with the threat that the mainland will impose martial law, a default on Argentina's sovereign debt, rising Middle East tensions - including an attack by Iran on Saudi Oil facilities and impeachment proceedings against President Trump in the US House of Representatives. On the economic front the lead story was the Federal Reserve cutting interest rates for the first time in over a decade. While the markets liked this, the fact that it was called a mid-cycle adjustment was not up to expectations. Other top economic news included the European Central Bank cutting their benchmark rate to -0.5% and restarting balance sheet expansion, Germany officially tilting on the brink of recession and continued slowing in China. Overall the global economic back drop is soft. Corporate news was dominated by second quarter earnings reports which were up less than 4% versus a year earlier with a weakening outlook. There were a seemingly large number of alarming earnings misses as judged by stock price reactions. Aside from earnings there were a handful of noteworthy news items including GE being called a financial fraud by Harry Markopolis (Madoff's accuser), Boing's ongoing 737 debacle, a nationwide strike at GM and a DOJ investigation of big tech (Facebook, Google, Amazon…). All of the above come together in markets. With the Federal Reserve cutting rates and recession concerns on the rise, interest rates collapsed while the yield curve remained officially inverted. The drop in interest rates was driven by a speculative rush into bonds of all types in an effort to get ahead of the Fed. From the beginning of July to the end of August ten year treasury yields declined by roughly 30% in what looked like a bond buying panic. Growth stocks soared. This panic eased in the first half of September with a handful of better economic reports, triggering a backup in interest rates and a seismic shift out of growth stock leaders into value. The hint that this manic behavior may in fact be climatic is the breakdown of the repurchase market at the end of the quarter. The repurchase market is the mechanism through which trading positions are financed on Wall Street and the fact that liquidity dried up and the Fed needed to intervene suggests that market turmoil had the banks fearful of lending to one another overnight (wild markets cause accidents). Hopefully the above provides a sense of the underlying dynamics in the quarter – it was not as quiet as it may have seemed.

For the quarter, the S&P 500 was the second best performer of the major global equity indices. Japan was first, up 2.24%, and the only other one that was positive was Canada. With the US economy holding up better than most, the broad global equity markets were more cautious in the period. Despite the dramatic first half of September, which was quickly nicknamed the Momo meltdown (short for momentum =

growth stock leaders), growth did regain its footing to outperform value for the period - but by less than 1%.

PERFORMANCE COMMENTARY

Given the relatively narrow margin by which growth outperformed value, I would have hoped Valara, LP to perform better. A large part of the problem was which parts of the value universe outperformed. Utilities, REITS, and Consumer Staples, all value groups but none particularly cheap/attractive, led the markets. Gold miners performed well and continued to help our returns. The bottom three sectors were, Energy, Health Care and Transportation, in that order. We remain modestly overweight energy and continued to suffer for it. In addition to inopportune sector weighting, our results were held back by a particularly disappointing earnings and restructuring announcement out of Fluor, a significant holding of ours. While I have reduced our assumptions on Fluor to reflect the pending asset sales and write-downs, I continue to believe that this leader in the Engineering and Construction industry is very attractively valued, will regain its operational rigor and excel. Importantly the company's balance sheet and cash flow remain sound. On the positive side, our positions in Pan American Silver and Kinross Gold were up 21% and 19% respectively, followed by strong performances in our other mining stocks and by Intel, State Street and Quest Diagnostics.

It was a fairly active quarter from a trading perspective with the addition of new positions in Quanta Services, Mylan Labs and Regeneron Pharmaceuticals and the elimination of ConocoPhillips, Valaris and Transocean. We continue to think that the Energy sector is one of the most attractive in the market but the recovery of the deep water drilling industry, while underway, got pushed further out into the future on the second quarter conference calls. For the deep water drillers Valaris and Transocean, the continued cash burn will get uncomfortable and potentially dilutive. We had the opportunity in the quarter to maintain our energy exposure but reduce our risk by shifting from these drillers to better positioned players in oil service - Baker Hughes GE and National Oilwell Varco – which we did. In addition, we took advantage of price weakness in Gap, Mosaic, Borg Warner and Fluor to add to our holdings and trimmed Agnico Eagle into strength.

OUTLOOK

Recession fears have continued to edge higher despite the Federal Reserve's recent interest rate cuts. As the Fed has reduced the target short term rate (Federal Funds) longer dated rates have fallen a comparable amount, keeping the yield curve inverted. Corporate earnings have been soft and are expected to remain so in the fourth quarter. A comprehensive resolution of trade disputes would help a great deal. At this point, the consensus expects further interest rate cuts into year-end and a resumption of Fed open market activity, presumably with a continuation of the existing corporate and geopolitical backdrop. With all the uncertainty in the market, stocks remain near all-time highs. It is tempting to ask what happens if things get better: the trade war eases, Brexit becomes history (anything might be better than purgatory), the Middle East settles down and the global economy begins to respond to recent stimulus? Because of the length of the current global expansion and the fatigue I sense in consumer cyclicals, I tend to be a bit less optimistic but from an investment strategy perspective we are agnostic - with the caveat that we are closely monitoring balance sheet risk.

The Valara game plan remains the same: find valuation based opportunity in the market and take advantage of it by buying and waiting. Ultra-low interest rates have been a challenge for all value managers because they have a disproportionately positive impact on growth stock PE multiples. At some point the growth stock tailwind provided by this backdrop will be behind us - if for no other reason than it has gone too far. While recently I have harped on value versus growth, Valara seeks out <u>under</u>valued stocks which, as a group, are frequently, but not always, tightly correlated with the value indices. There have been periods when value lagged that we outperformed by such a wide margin that we well outpaced the S&P 500 (2009 was one such instance). None the less, when value struggles we often struggle too – particularly when the markets are dominated by mega cap, high PE growth stocks. I have attached a graph of the relative performance of growth stocks versus the S&P 500 (which is a blend of growth and value) below. Despite the challenges of recent years, our strategy and discipline is particularly well suited to profiting from extreme environments. By persevering I expect Valara, LP to be rewarded. As always, I appreciate your faith and confidence. Please feel free to call or email with questions or comments.

Sincerely,

Robert W. Simmons, CFA
Principal