Valara
Capital Management, LLC

January 12, 2018

Dear Friend of Valara Capital Management,

The Partnership's fourth quarter results lagged the S&P 500 as growth stock's continued their dominance of recent market returns. For the three months ended December 29, 2017, Valara Partners, LP. generated a total return, net of fees, of 4.72% compared to a total return of 6.64% for the S&P 500. For the full year 2017, Valara Partners, LP. produced a return of 10.09%, net of fees, versus a total return of 21.83% for the S&P 500.

Global stock markets generally continued to move higher in the fourth quarter but not as uniformly as earlier in the year. Of the more prominent markets around the world the S&P placed third behind Japan and India which were both up almost 12% for the final three months of the year. Mexico, China (Shanghai) and France were down slightly and the German DAX was only nominally positive. The global economic picture continued to be favorable. In the US, housing and autos continue to grow modestly, unemployment is very low, at 4.1%, with the job market still indicating strength and business loan demand, while slower, is still positive. Third quarter earnings reports were favorable with an 8.1% year over year increase – solid but a slight deceleration from the first and second quarters. US domestic politics overpowered geopolitical concerns around North Korea, Iran and Saudi Arabia, et al., with universal enthusiasm regarding the earnings and consumer spending boost expected from the Trump tax cuts. The ultimate impact on future US budgets was not much dwelt upon. The major central banks all seem to be inching toward a less ebullient stance with regard to market liquidity, the latest being the European Union announcing that it will begin easing off the stimulus in 2018. While one month does not a trend make, the Bank of Japan, which has said very little about tapering, actually reported a shrinkage of its balance sheet in December.

My suggestion that the third quarter might have indicated a nascent change in preference from growth stocks toward value may yet prove out but it was not reflected in the broader indices in the three months that ended December 29th. The fourth quarter saw growth stocks up almost 8%, as measured by the Russell 1000 Growth index, versus roughly 5.5% for Value. The strongest sectors were consumer discretionary, technology and financials. The presence of the financial sector in the list did repeat a tentative nod toward value. Large capitalization stocks continued to dominate, with the Russell Large Cap index up 6.6% - twice the return of the Russell Small Cap Index. This means that the market cap weighted S&P 500 continued to be heavily driven by the largest companies. The leading US stocks in the quarter included Amazon, Microsoft, Apple, Wal-Mart, Google, BankAmerica, Home Depot and Facebook and accounted for over a third of the total S&P return. While we owned Microsoft and BankAmerica they are approaching full value in our work and were being reduced (more below). The weakest sectors in the period included utilities, REITS and healthcare.

PERFORMANCE COMMENTARY

Valara's underperformance in the fourth quarter was largely the result of our gold stocks modestly trailing the S&P 500. The rest of the story is rather eclectic. Energy as a sector essentially matched the market, led by the subset of exploration and production companies. Being fairly diversified in energy we had a similar experience. Diamond Offshore, Marathon, Murphy and Conoco were strong performers but Weatherford, Baker Hughes GE and our other drilling stocks lagged. Microsoft and Intel helped us within technology. As noted above, Microsoft, which has been a significant contributor to performance in recent periods, is no longer particularly attractive due to its appreciation and has been substantially reduced. Proceeds have been invested in IBM which I believe will prove, in its own methodical way, to be a key provider of cloud infrastructure and artificial intelligence to large enterprises. BankAmerica, Fluor, Jacobs Engineering and Mosaic rounded out the list of strong performers. Barrick Gold had the distinction of being our worst stock in the quarter in terms of its weighted impact on our results. The company reported a quarter that underwhelmed on cost of production and growth outlook. Nothing in the report cast any material doubt on the value we perceive over the remainder of the cycle. GE was the largest percentage decliner in the portfolio but we only have a tag end position that we did not quite finish selling when the stock was $30 and, as a result, it had no impact on our performance relative to the S&P. As I noted last quarter, I am evaluating the stock with the inclination toward owning more of it. Our two bio-techs, Amgen and Gilead, gave up the ground they gained in the third quarter but I still believe that they have excellent potential. Other lagging stocks included Pan American Silver, Archer Daniels and AIG. During the quarter we eliminated our position in Brighthouse Financial and reduced Microsoft, BankAmerica and Chevron. We added a new position in Nordstrom's (thanks to our intern Katherine Hetzel for her good work on this name) and increased our positions in IBM and Gilead.

The year 2017, overall, was challenging and frankly disappointing after the extremely strong 2016 that we had. Recall that in 2016 Valara produced a return of 27.84%, net of fees, versus a total return of 11.96% for the S&P 500 and 17.34% for the Russell 1000 Value. At the time, we thought 2016 might be a sea change for the equity markets. However, after a lull in 2016 growth stocks resumed their outperformance in 2017 beating value by over 17%. For 2017, the market was overwhelmingly led by technology with a particularly strong performance from the semiconductor sub-industry. While healthcare only slightly outperformed, the biotech sub-industry was up more than 40%. Financials, retail, energy and utilities – all traditional value groups - lagged.

OUTLOOK

The back and forth cycles between value and growth have an established history with neither style convincingly dominating over long stretches of time. Without implying that I can predict when it will happen, value's day is coming and Valara intends to be positioned to make the most of it. As we have discussed in past letters, the energy and select materials stocks are the most undervalued groups in our work but we have found plenty of idiosyncratic opportunities and there are other emerging sectors of interest. Despite rallying late in the year, retail stocks look attractive on a price basis. The thing that gives me pause is not Amazon or online shopping, although that is certainly an important issue. My primary concern is that most retailers took on a fair amount of debt as the "Amazon" threat emerged and now carry it late in the economic cycle with the broader industry facing excess capacity. As we have seen in oil and gold, excess capacity, a waning cycle and elevated debt can be a tough trio. I am interested in retail but intend to proceed slowly and carefully. As 2018 unfolds, there is a lot to do and to be optimistic about. By sticking to our disciplined investment process Valara expects to produce excellent returns for our partners across the cycle. Thanks for your continued interest and support.

Robert W. Simmons, CFA
Principal