

# KALO CAPITAL MANAGEMENT, LP

July 6, 2015

## Monthly Report - Kalo Emerging Growth with Reduced Volatility Strategy

Dear Investor:

For the month ended June 30, 2015, the Kalo Capital Management, LP fund lost 1.8% net, versus a gain of 0.6% for the Russell 2000.

	June 2015	YTD
Kalo Capital Mangement, LP	-1.8%	0.9%
Russell 2000	0.6%	4.1%
S&P 500	-2.1%	0.2%

### June Performance Commentary

For the month of June, the Fund lost approximately 239 gross bps from long positions and gained 31 gross bps from short exposed positions. Gains were led by index related shorts, as well as eGain (EGAN) and Covisint (COVS). Losses were led by a couple of our larger investments that we remain excited about: USA Technologies (USAT) and Coupons.com (COUP).

**Covisint (COVS):** Covisint helps companies provide cloud access to legacy systems in a controlled and secure manner. We had been following the company for quite some time and had been concerned with customer concentration and a change in strategic vision. In early 2015 we established a position as the stock fell to its lows and the risk/reward opportunity became more favorable, investor expectations were low, and the company was showing signs of improving business and lowering its cost structure. At the time we began building our position, Covisint had begun making positive comments about its pipeline, customers, and cost control, yet the stock was underfollowed, unappreciated and well capitalized. In May, the company issued positive guidance along with the announcement of new deals. Interest in the stock improved and over several weeks the price appreciated roughly 40% from our cost. More recently, our view of the risk/reward is less interesting as investor expectations have grown and the stock is far off its lows, at the same time as the stock market environment is getting weaker. Thus, we have exited the position.

As can be seen on the chart below, the Fund's longs underperformed vs. the Russell 2000, losing 2.8% on average vs. the Russell's 0.6% gain. While, the shorts performed similar to the Russell. This combination resulted in -1.9% of total gross alpha generation during the month.

	Bps Gain/Loss	Avg Exposure	Average Performance
Longs	(239)	86%	-2.8%
Shorts	31	-49%	-0.6%
Russell 2000			0.6%

Alpha (Gross performance from stock selection)	-1.9%
Beta (Gross performance from exposure)	-0.3%

### Big Picture Market Commentary

We continue to grow increasingly concerned about the stock market. Despite relative calm in the market cap weighted indices (SPY, IWM), the underlying performance of smaller cap companies (\$200 million – 2 billion) continues to deteriorate. We believe the market continues to be supported by a large cap ETF buying phenomenon. Essentially, we believe that a significant amount of investors' capital needs to be invested somewhere (not in cash), and the managers of this capital continue to invest incremental new capital in large, liquid companies or large cap index ETFs like SPY, regardless of valuation or risk. Meanwhile, the risks to the market

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continue to grow. As smaller market cap names are sold, there is little interest in new buying, resulting in significant stock price depreciations. This phenomenon has resulted in significant sell-offs in many of our smaller market cap long positions, despite attractive valuations and strong fundamentals.

While it is difficult to predict when this scenario will end, we remained concerned that the market could have a significant downturn. At the same time, we recognize that the indices could also continue to move to new highs due to a variety of factors including asset allocators continuing to put money into liquid large cap stocks/indices, a longer timeline before the Federal Reserve rate hikes, a Greek deal, etc... Consequently, we have been reducing our gross long levels (currently 73%) and bringing our net exposure to the lower end of our typical band (typically 20-60% net long). In addition, we have purchased several put options in an effort to further protect our performance in the event of a significant market selloff.

As we've discussed before, we strongly recognize the importance of preserving and protecting capital. Given our heightened concern about downside risk, we feel it is prudent to spend a small amount of performance for protection (via reduced exposure and put options) in the event of a significant downturn. In the event that our market concerns are addressed and optimism returns to the market, we feel we will benefit as many of our longs rebound from their recent losses (even if our exposure is less than it was).

## **Why Are We Concerned about the Market?**

**Greece:** Greece is running out of cash, and has become unable to pay its European creditors' bond payments. Further, its leaders seem unwilling/unable to negotiate a new deal with its creditors as it feels austerity measures put in place are too stringent. The last time this situation became a heightened concern, back in Summer 2011, it led to a significant market correction. We find it difficult to see a resolution that will come forward given the current game of chicken being played in recent negotiations. This time, the broader index market has shown little impact to date..... but the problem has not yet been resolved and we remained concerned.

**China:** Shanghai and Shenzhen markets combined are roughly \$10 trillion in market capitalization versus the NYSE at \$17 trillion and Nasdaq at \$7 trillion. Extreme volatility has been making its way into the Chinese markets since the start of the year as the government opened the financial system to foreign investors and electronic and margin trading have been gaining in popularity. The Shanghai Composite was up 60% Year to Date at one point and has since pulled back 30% since June 12<sup>th</sup>. The government has been very active in trying to stabilize the market with limited success. We are concerned with the ripple effects in the other global financial markets.

**Puerto Rico:** A debt crisis in Puerto Rico has crept into the spotlight over the last few weeks. The governor declared that the nation's \$72 billion of debt was too much to handle and in order to avoid a "death spiral" the commonwealth would have to break its promise to pay back some of the money owed.

**The Fed:** The Federal Reserve is also planning to begin raising interest rates in September or December of this year. While we don't expect this to have a significant quick market impact, it is a change that could reduce some of the broader market optimism.

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We maintain our belief that the fundamental growth of our investments will result in significant stock gains over time. We thank you once again for your belief in our process and performance.

Please feel free to call to discuss anything.

Sincerely,



Steven D. Friedman, CFA  
Founder and Chief Investment Officer

Please note that Kalo's expectations and strategy can change regularly and the views expressed here may change.

## **Historical Kalo Performance - Emerging Growth with Reduced Volatility \***

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Year	Incep.
<b>2011</b>			0.4%	0.8%	-2.2%	-0.2%	-1.7%	-2.7%	-5.1%	2.1%	-2.2%	-0.9%	<b>-11.3%</b>	<b>-11.3%</b>
<b>2012</b>	5.1%	2.2%	0.7%	-2.6%	-2.9%	3.6%	-2.0%	3.5%	-0.3%	0.1%	0.3%	0.3%	<b>7.7%</b>	<b>-4.4%</b>
<b>2013</b>	2.2%	2.5%	1.2%	0.9%	3.4%	2.4%	3.2%	0.8%	1.6%	1.4%	1.1%	2.7%	<b>26.0%</b>	<b>20.5%</b>
<b>2014</b>	2.0%	5.0%	1.7%	-1.4%	1.2%	2.3%	-2.0%	0.1%	-1.6%	0.5%	-2.6%	2.2%	<b>7.7%</b>	<b>29.8%</b>
<b>2015</b>	-5.3%	4.9%	1.1%	0.8%	1.4%	-1.8%							<b>0.9%</b>	<b>31.0%</b>

NOTE: The above returns are net of fees. Past performance is not a guarantee of future returns. Annual performance is thru December 31 of each year. Returns since inception represent the return since the Fund inception March 1, 2011.

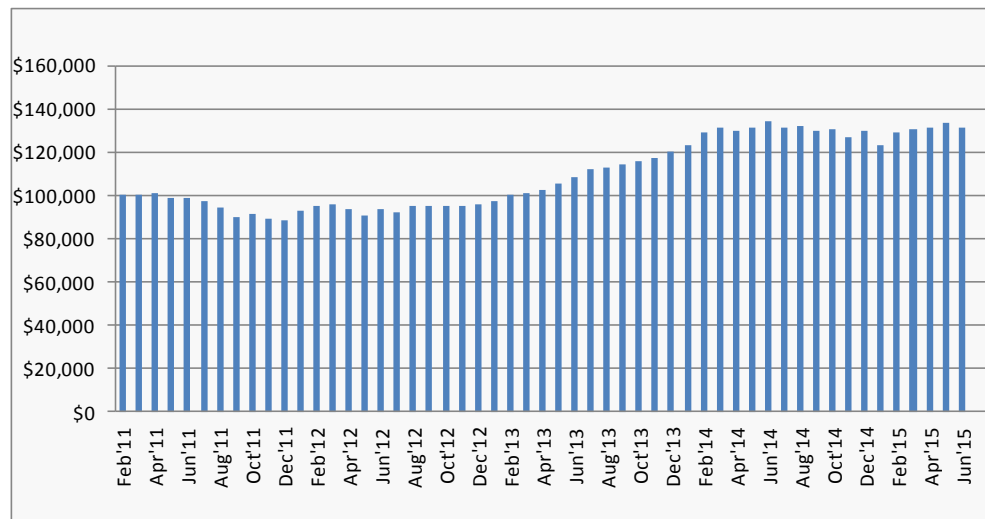
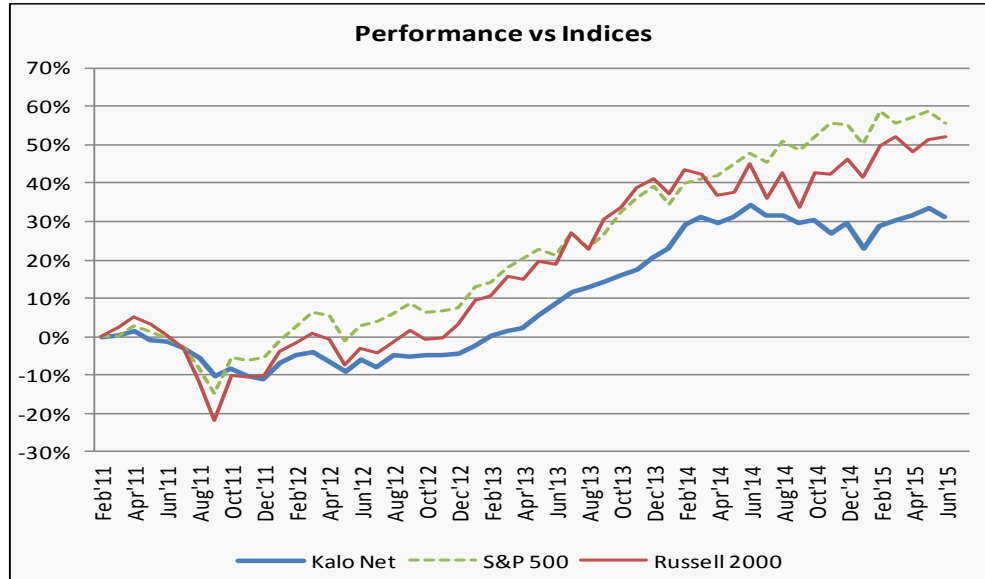
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## Assets Under Management - Emerging Growth with Reduced Volatility

Kalo Capital Management, LLC AUM (\$M)	
LP Fund (EGRV)	\$5.8
Separately Managed Accounts (EGRV)	\$5.0
Total AUM EGRV Strategy	\$10.8

Note: Kalo Capital Management, LLC also manages separately managed accounts using a Global Growth Strategy and a Trading Strategy. These strategies sometimes invest in the same positions as those held by EGRV strategy (Emerging Growth with Reduced Volatility) used by the Kalo Capital Management, LP fund. The Fund utilizes several methods to ensure all accounts are treated equally.

## Historical Performance - Emerging Growth with Reduced Volatility



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## OVERVIEW OF KALO CAPITAL MANAGEMENT

### Background

Steven Friedman is the founder and Chief Investment Officer of Kalo Capital Management, LLC ("Kalo"), and manages a long/short equity strategy focused on emerging growth opportunities. Kalo manages the Kalo Capital Management, LP fund ("The Fund"), as well as separately managed accounts.

### Strategy

The Fund utilizes an Emerging Growth with Reduced Volatility ("EGRV") strategy, developed by the Chief Investment Officer over the last decade. The EGRV strategy invests the bulk of capital in emerging growth equities with promising risk/reward characteristics based on fundamental analysis. These companies are often associated with large open-ended growth opportunities, disruptive technologies, disruptive business models, or changing industry dynamics along with powerful business models driven by significant operating leverage. Kalo looks to generate further alpha and hedge performance with company-specific and general market short positions. In addition, Kalo will execute short term trades in situations where we identify significant news/stock action that we expect to drive near term stock moves. This Trading Overlay is intended to further enhance alpha performance. The Fund reduces portfolio volatility through a variety of means including: i) adhering to many investment criteria for positions to limit downside risk on an investment-specific and portfolio basis; and ii) combining the emerging growth investments with other less correlated long and short positions.

The Fund believes there is more potential for consistent, outsized returns in long positions over time as companies grow. Thus, the Fund favors having a net long exposure. However, the Fund also looks to hedge these long positions with index and company-specific short exposed positions to create additional alpha, smooth returns and limit drawdowns. This risk control helps enable the Portfolio Manager to take advantage of market contractions.

The majority of the Fund's positions will be in equities. Derivatives are used opportunistically in order to: make an investment with extremely high volatility, create a hedge to a specific position or portion of the portfolio, or to gain additional exposure to an idea.

### Investment Philosophy

The Fund's objective is to produce relatively low volatility returns with consistent alpha primarily by identifying emerging growth opportunities that are fundamentally mispriced by the market. Throughout many industries, companies bring products/services to the market that have the opportunity for extremely fast-paced growth. Many of these opportunities are caused by the introduction of disruptive technologies, disruptive business models, and changing industry dynamics. When these transforming events occur, the Fund believes well managed companies positioned properly can achieve superior growth and offer the opportunity for attractive stock returns.

The Portfolio Manager believes that the market often misprices these emerging growth stories. This provides the Fund the opportunity to build positions when it believes that the general market is not appropriately valuing the stock. This opportunity is often caused by the following:

- **The market broadly values companies on near term results, disregarding longer term results.** The market focuses on valuation multiples looking out 1-2 years, initially disregarding the following years. However, many of these opportunities see accelerating EPS growth 2-4 years out, driven by operating leverage and economies of scale, which

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the market overlooks. By establishing an investment before the market focuses on these outer years, the Fund may earn consistent alpha.

- **The investor community often develops unrealistic financial expectations.** These inflated expectations can be caused by a lack of industry understanding, irrational exuberance, and management hype. This creates opportunities for short sale investments.
- **Sell-side analysts often don't recognize or acknowledge the sales growth and/or leverage impact that can occur during certain inflection points.** The Fund believes that sell-side analysts will generally only be comfortable forecasting a certain amount of fundamental growth, even when evidence points to more significant growth, in order to not be recognized as overly bullish. This situation often leads to companies significantly exceeding earnings expectations, despite the stock being known by the investment community.
- **The broader market often over-reacts to positive or negative events.** These over-reactions cause dramatic stock price movements, which may create opportunities with relatively low downside risk when a stock is overly depressed as well as short opportunities when a stock is inflated.
- **Many emerging growth companies are not well known by the broader market.** Many emerging growth companies are under followed by sell-side analysts, and thus are either unknown or not well understood by the investor community. Discovering these companies before the general market creates the opportunity to make an investment while it is undervalued.

The Fund believes that traditionally investments focused in this space have been characterized by attractive returns accompanied by very high volatility. The Portfolio Manager believes it is possible to capture most of these inherent returns with reduced volatility by using a balanced, diversified, and hedged portfolio approach, supported by rigorous fundamental and stock technical analysis. The Fund will also utilize options to control downside risk. The Fund targets absolute performance with low drawdowns, but expects better absolute performance in up or flat markets, than in down markets.

## Investments

### **Fundamental Longs and Calls: Emerging Growth Opportunities**

The Fund believes emerging companies with good business models create an excellent investment vehicle for outsized returns. The future earnings power of companies with certain key characteristics are often under-appreciated, creating the investment opportunity. The key characteristics the Fund looks for include:

- Large open-ended growth opportunity
- Markets with low, but growing penetration
- Demonstrated traction with their customer base
- Leading market share
- Significant barriers to entry
- Profitable business model with significant operating leverage
- Recurring revenues
- Sufficient capital
- Potential for above average returns based on future market multiples, combined with limited downside risk
- Good technical trading pattern

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## **Fundamental Shorts and Puts: Deteriorating or Flawed Fundamentals**

The Fund primarily looks for two types of fundamental bearish positions: i) emerging growth companies that the Portfolio Manager feels are fundamentally flawed and likely to decline; and ii) companies impacted by industry changes such as increasing competition or shifting demand. As industries change, many companies' products/services become inferior to ramping new technologies. When this momentum occurs, these companies often face significant challenges and suffer from dramatic reductions to their earnings power. The Fund looks to short these names when the investment community does not fully realize this market shift is occurring, or how significantly it may hurt the earnings power of the company.

## **Trading Opportunities**

The Fund identifies and invests in opportunistic trading opportunities. Positions are typically made in equities, where a positive catalyst is expected, or it can benefit from the following two philosophies: i) purchasing stocks that are in the early stages of a larger move upward, driven by fundamental good news; or ii) purchasing stocks that have been excessively sold off after disappointing or bad news where the Fund expects some of the losses to be recovered. This same strategy is used for shorting stocks, under the opposite circumstances. The Fund strongly considers the fundamental and technical downside risk to its positions, the liquidity, and sizes positions accordingly in order to limit potential losses. The Fund generally avoids holding positions entering a quarterly earnings report when significant bad news may hit the stock and not provide an opportunity to exit a position before the stock makes a significant move, unless the Fund believes that the stock is at strong support levels and large losses are highly unlikely. The Fund will also look to exit individual positions that are causing losses, in order to limit losses in any one name. These opportunistic investments tend to be of shorter duration than the fundamental emerging growth positions and occur on both the long and short side.

## **Hedges**

The Fund often hedges long positions with index and company specific short exposed positions, in order to limit drawdowns when the stock market contracts. A portion of these hedges typically consist of index ETFs.

## **Risk Management**

The Fund uses a variety of methods to better control portfolio risk. On an individual stock basis, the Fund sets a maximum position size, with lower limits for stocks that are more volatile and less liquid. The Fund will also utilize options to enter positions in cases of extreme short term volatility. The Fund utilizes soft stop loss controls in order to limit losses from money losing positions.

In addition to controlling risk on an individual stock basis, the Portfolio Manager further reduces volatility and downside risk through diversification and by running a balanced portfolio. The portfolio maintains a balance by spreading exposure across a wide breadth of geographies, industries, valuation levels, beta levels, and risk levels. The Portfolio Manager will also limit the Fund's aggregate exposure to investments that are more speculative and could have significant downside risks.

The Fund utilizes a variety of risk analyses and regularly monitors exposure levels in order to ensure portfolio downside risk stays at controlled levels.

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## **Investment Team**

### **Steven D. Friedman, CFA**

Steven D. Friedman is the founder and Chief Investment Officer of Kalo Capital Management, LLC and Kalo Capital Management, LP. Prior to founding Kalo in 2010, he spent ten years in the hedge fund industry as a Portfolio Manager and Senior Analyst, focused on the Emerging Growth space. Mr. Friedman was Portfolio Manager at Manalapan Oracle Advisers (2009-2010), a Proprietary Trader \* (Aug-Dec 2008), Portfolio Manager at Pequot Capital Management within the Emerging Manager program (2006-2008), senior analyst at Feirstein Capital Management (2001-2006), and financial analyst at Lazard Frères & Co. (1996-1998). Mr. Friedman earned a BBA from the University of Michigan (1996) and a MBA from Columbia Business School (2001). Steven has also been a CFA Charterholder since 2005 and is a Registered Investment Adviser in New Jersey.

\* The proprietary trading desk was part of the Market-Making business at Bernard L. Madoff Investment Securities LLC, separate from the fraudulent investment management business. Federal prosecutors have stated the proprietary trading arm of the firm was legitimate. (Reuters Article, "Market-Making Arm of Madoff's Firm to Be Sold Off", 3/27/09).

### **Tony Alaimo, CFA**

Tony Alaimo is an analyst at Kalo Capital Management. Prior to joining Kalo in 2014, he spent 7 years as an equity research analyst at Axiom International Investors, a \$12 billion dollar global equity manager. He has experience as a global equity generalist and financial services specialist. Tony graduated from Sacred Heart University (2006) with Bachelor of Arts degrees in Finance and Economics. He has been a CFA Charterholder since 2011.

## **LEGAL DISCLAIMER**

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Performance and other quantified metrics shown here are estimates. Actual investor returns will differ. Past performance is not necessarily indicative of future results.

Any Fund or investment involves risk. Potential investors must familiarize themselves with the offering materials related to such investment and must meet certain investment sophistication levels in order to make such investments and must be able to fully absorb the risk associated with such investments. The Offering Memorandum for the Fund and related Subscription Agreement and Limited Partnership Agreement will be made available to those who demonstrate the capacity to evaluate the risks and merits of this investment.

The past performance of any Fund or investment discussed herein is no indication of future results that may be achieved by an investment in the Fund. The Benchmark indices presented in these materials may or may not hold substantially similar securities to those held by the funds referred to herein, and thus, little correlation may exist between the Funds' historic return and those such indices and there is no guarantee that any correlation which may have existed will continue to do so in the future.