April 2, 2020

Quarterly Report - Kalo Capital Management, LP

Net Performance	Jan'20	Feb'20	Mar'20	YTD 2020		Trailing 2 Year (Apr'18-Mar'20)
Kalo Capital Mangement, LP	**4.5%**	**0.6%**	**(16.1%)**	**(11.8%)**		**2.9%**
Russell 2000 (IWM)	(3.1%)	(8.8%)	(21.5%)	(30.6%)		(22.6%)
S&P 500 (SPY)	(0.0%)	(7.9%)	(12.5%)	(19.4%)		1.9%
Small Cap Momentum ETF (DWAS)	(2.8%)	(5.8%)	(22.1%)	(28.6%)		(17.7%)
Gross Alpha Performance	6.1%	5.4%	(6.7%)	5.0%		28.8%
Gross Beta Performance	(0.4%)	(4.3%)	(11.0%)	(15.2%)		(13.4%)

We hope you and your loved ones are healthy and safe dealing with Covid-19 and these uncertain times. The Kalo investment team is healthy and working from home remotely. Our continuity back up plans are working well. Research, trading, administration, and other processes continue to operate as normal.

Performance

In the first quarter, Kalo lost 11.8% net versus a loss of 30.6% for the Russell 2000. We are disappointed that we did not do a better job limiting the downside. A more detailed look at the drivers of Q1 performance and lessons learned can be found later in this letter. Our efforts and attention are focused ahead on continuing to generate alpha and generate absolute returns while limiting downside risk, regardless of the future market environment. While disappointed, we've invested in these types of markets in the past and are confident we will come out of this with stronger, alpha-driven performance.

What Happened?

We underestimated the severity of Covid-19 contagion, devastation and fatalities. In order to avoid overwhelming our healthcare system, extreme society life-changing rules have been put in place. Playgrounds roped off and vacant, schools suspended, stores and restaurants closed, life as we all know it at a standstill. While we were acutely concerned about the Coronavirus in February, this impact far surpassed our expectations. As a result of our earlier concern, we had ensured our gross long exposure was not at high levels. However, we were not as cautiously positioned as we could have been in retrospect. This was partly due to data coming out of China which had started to show signs of virus recovery and gave us a false sense of optimism.

In the first two weeks of March, stocks sold off in dramatic fashion, at a pace frequently eclipsing the 2008 financial crisis. Valuations did not seem to matter, only the supply and demand of stock, with much of the investment community over-extended and now being forced to sell. Any companies with debt seemed particularly at risk. Stocks across much of the market fell anywhere from 20-60+%, before stabilizing around March 18 and then slightly rebounding. As many stocks we know and like reached extreme lows, we added to positions to take advantage of the extreme selling pressure.

Current Thoughts

Our thoughts continue to waver between fear and hope about when societal normalcy will return. Ultimately, we do believe this normalcy will return. However, it is still quite unclear when that will be. Things have quickly escalated and it now seems that this "stay at home" way of life will certainly be here for a couple of months, and that it could extend much further (a view that we thought very unlikely just one month ago).

Much is still uncertain with Covid-19. Here's what we currently think:

- It appears that we are still 2-4 weeks away from cases peaking in the United States.
- We expect the economy to gradually open up in May and June, and more fully in July.
- Some parts of typical life may be different for much longer (attending sporting events, airline travel, etc. may not return to normalcy until a vaccine is commonly available, which may not be for 12-24 months).

It is quite scary to consider how dramatic an impact this may have on society. Of course, the timing of how this impacts stocks and the overall stock market can be quite different than our everyday experiences. Many stocks may have already borne the brunt of all these expected outcomes, while many haven't.

Valuations have been smashed broadly across the market. Stocks of good companies are down 30-60%, sometimes more. While painful now, this is creating fantastic investment opportunities once visibility and Covid-19 concerns are tempered. If you believe the world will return to normalcy (which we do), then we believe there are great opportunities to buy. While we do feel the market may fall further, there are significant opportunities that we are starting to pick away at now. To put in terms of a generic example, if a $10 stock falls down to $5, and then falls to $4, but will be back at $8-9 later this year…. is it a good buy at the $5 level on the way down? Or said another way, if a company generates $100 million in cash flows per year, but will have losses in the current environment before returning to $100 million cash flows next year…. How far down should the stock fall? On an individual stock basis, we believe there are many great investment opportunities right now with a 12 month time horizon. However it is unclear whether these stocks will reach new lows in the meantime.

Over my career I have created guideline rules that help me remember lessons learned (one of the benefits from having invested for almost 20 years). Over the last couple of weeks I have found myself revisiting my notes and guidelines from 2008. Having managed capital in 2008, I have seen this type of stock action before. However, this is not quite like 2008. In 2008 it felt like the entire monetary system might crumble. 2020 was something I thought would be a temporary alteration in life, but just that… "temporary". As the impact on life gets more severe (directions to stay at home, restaurants closing, etc.) and the timeline gets drawn out for how long this will last, I worry about the contagion effect. The government is clearly making a strong effort to support businesses and people to carry them over this temporary period. But the risk does exist for a contagion effect to become a greater risk to the financial system (however, this is not an outcome I expect to occur).

Again, we do believe societal normalcy will return. Fear in the stock market has surpassed the peak levels in 2008 (based on the VIX volatility index). If you do believe normalcy will return, as we do, then the worst of the market decline has likely passed. We expect the market to stay volatile. We plan to continue to opportunistically add to stocks we like at greatly reduced prices. For our shorts, we will continue to cover shorts opportunistically, and seek out new shorts in stocks

that haven't fully reacted to the downside risk. We plan to keep our gross exposure levels at low to typical levels, to protect against further market falls, as Covid-19 risks are certainly prevalent. We expect our gross longs to stay around the 60-75% levels, and our net exposure in the 25-50% level. Our current exposure is 70% long and 45% short, for 25% net exposure.

Reflection

Many of you may have heard me reference our trading rules guidelines which I mentioned earlier. Essentially, these are "rule of thumb" guidelines created from experience over my career. We have added some new guidelines as a result of the experience in 2020 so far. We also note that this is but one part of a long marathon. We are focused on managing the portfolio to control additional downside risk amidst the heightened volatility, which we expect to continue for quite some time. There are an abundance of great stock opportunities available now, in companies with solid balance sheets and great cashflow-generating abilities. In times of market stress like these, it is common for smaller market cap stocks to suffer exaggerated losses driven by investors desire to reduce leverage and build cash. While painful today, we expect to generate significant positive alpha performance from these opportunities in the coming months to years.

We constantly harp on our alpha generation (our performance from selecting stocks that outperform the broader market). Amidst the wild volatility we've had this year, it is easy to overlook this. Quarter to date in 2020, we have generated +5% of alpha, outweighed by -15% beta performance. Over the last five years, we have a CAGR of 6.8% net, in a period that the Russell 2000 CAGR is -0.3% (yes, the Russell 2000 is amazingly down 1.4% over the last five years, even including dividend reinvestments). We attribute this alpha performance to our process and systems. While we do not like the recent negative performance, we are confident we will more than make up for it in the months and years ahead, as we have in prior drawdowns.

As a reminder, we generally keep the portfolio within a band of 20-60% net exposure at all times. It is in this range we find we can appropriately limit downside risk, while maximizing our overall absolute performance, without the need for leverage.

Q1 2020 Review

In Q1 2020, we lost roughly 11.8% net. Our longs and shorts generally moved with the overall market on average, with both longs and shorts falling roughly 26%. Our overall net exposure averaged our typical 40%, resulting in beta losses from general market exposure. The outperformance from our longs relative to the Russell 2000 resulted in +5% alpha in the quarter.

Kalo Capital Management LP Net Performance			-11.8%
	Bps Gain/Loss	Avg Exposure	Average Performance
Longs	(2,284)	85%	-26.7%
Shorts/Hedges	1,230	-46%	-26.5%
Russell 2000 (IWM)			-30.6%

Alpha (Gross performance from stock selection)	5.0%
Beta (Gross performance from exposure)	-15.2%

Conclusion

Especially in light of the negative recent performance, we greatly appreciate each and every investor. The partnership holds the vast majority of my liquid net worth. We appreciate your confidence in us and will continue to strive to do our best protecting and growing your assets. If any like-minded investors are interested in investing, please contact us.

We will close with some positive thoughts: Hopefully a vaccine is coming, improved treatments methodologies for Covid-19 and other viral pathogens will continue to evolve, and the world will soon return to the new normal.

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.

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