January 14, 2022

Quarterly Report - Kalo Capital Management, LP

Net Performance	Oct'21	Nov'21	Dec'21	Q4'21	YTD 2021		Trailing 2 Year (Jan'20-Dec'21)
Kalo Capital Management, LP	7.0%	(5.8%)	(2.7%)	**(1.9%)**	**(10.4%)**		**23.8%**
Russell 2000 (IWM)	4.3%	(4.3%)	2.3%	2.0%	14.5%		37.5%
S&P 500 (SPY)	7.0%	(0.8%)	4.6%	11.1%	28.7%		52.3%
Small Cap Momentum ETF (DWAS)	7.0%	(5.3%)	1.1%	2.6%	19.7%		58.5%
Gross Alpha Performance	5.6%	(4.0%)	(3.1%)	(1.5%)	(14.1%)		27.4%
Gross Beta Performance	1.5%	(1.9%)	0.5%	0.0%	6.6%		9.2%

Performance

In the fourth quarter, Kalo lost 1.9% net versus a 2.0% gain for the Russell 2000, bringing our full year performance to -10.4% vs. +14.5% for the Russell 2000. Microcap stocks continued to languish in Q4, suffering from continued dried up liquidity and diminished investor appetite. Meanwhile, the S&P 500 continued to march higher, as did the top favorite growth stocks.

Outlook

After a strong stretch in the prior two years, microcap stocks suffered a material pullback in the second half of 2021. It is common for pullbacks like this to occur periodically after strong performance and they are generally fueled by diminished investor appetite and investment fund flows, as opposed to actual company fundamentals. The sell-off in microcap stocks has been significant… stocks are on average 42% off their one-year highs (analysis across over 1,100 stocks in the sectors we follow: technology, communication services, industrials, and consumer discretionary - with market caps $70-$700 million). We have used this valuation reset as an opportunity to increase our holdings in certain stock as well as enter new positions where we see an excellent risk/reward potential. We are excited by the potential upside power in our existing portfolio.

I strongly believe that interest in underfollowed/smaller companies will return in 2022. We focus on stocks with fundamental growing businesses and cash flow generating ability. As the fundamentals of a business become further misaligned with stock valuation, I expect to see insider buying and/or companies getting acquired. In fact, we have already seen insider buying across several stocks in our portfolio over the past couple of months. Further, these microcap stocks have become extremely out-of-favor, leaving a much smaller pool of shareholders ready to sell stock. As the tide shifts, we expect significant stock price appreciation in these microcap names. Most "weak-handed" stockholders have already sold their stock in these companies and valuations have significant upside potential. It is worth remembering that when a stock gets cut in half, it's a 100% move up to just get back to where it started (weighted by position size, our current long positions are 55% off their one-year highs and 28% off June 30, 2021 levels).

While microcaps broadly fell in the second half of 2021, the larger and more followed small-cap stocks were generally stable throughout the second half of 2021. This is despite the extreme valuations across many growth stocks which had a significant run-up in 2020 and early 2021. These stocks finally showed some weakness in November/December 2021 and this weakness has continued in early 2022. However, valuations are still high across many of these names, and we expect more downside.

Meanwhile the large-cap stocks that dominate index performance ramped higher throughout 2020 and most of 2021, driven by exuberant fund flows and loose Fed monetary policy. Valuations are beyond excessive. At the same time, we are quickly approaching a shift in Fed policy where Fed bond purchases will be slowing and interest rates will be rising in 2022. We expect this will lead to a major rotation in the market, where funds will stop flowing into these well-known high growth and high valuation stocks. In short, the significant pullback that started in microcaps, and just recently started moving upstream to small-cap stocks, we believe will continue and make its way to large cap stocks in 2022.

Currently, there exists a major dichotomy in the market where less followed microcap stocks are extremely beaten down with many sporting extremely low valuations. Meanwhile, well followed small-cap and especially large-cap stocks have extremely high valuations. We believe this is an excellent set up for significant alpha performance for Kalo. As the broad sell-offs continue to move upstream to the large cap stocks, investors will seek out other sectors/areas that have been out-of-favor, which we believe will benefit our portfolio. We are already seeing the start of this shift.

In tune with our market view, we have been building our individual stock short exposure, as we expect many of the extreme high valuations in these stocks will be curtailed. Our exposure is currently 98% long / 60% short, for 38% net exposure.

Investment Spotlight: Intellicheck (IDN)

Intellicheck is a leading provider of on-demand digital identity validation, used to instantly authenticate consumer ID's and prevent fraud. This is commonly used by banks, credit card companies, and retailers. Last year the company validated over 100 million physical and digital identities across North America. What differentiates Intellicheck from competitors is their unique access to DMV barcode information stemming from their long-term relationship with key government motor vehicle administrations. This allows their fraud identification to have much higher accuracy than their competitors, and their product is also offered at lower prices.

The stock has been hit hard (down 60% in 2021) despite growing sales, by virtue of being an illiquid microcap and concern around the pandemic's negative impact on in-person retail scans. Growth is expected to accelerate in the coming years with the ramp up of their sales force and the release of their new Platform 2.0 which will expand the use cases for their solution.

While Intellicheck is a smaller market cap than we typically invest (currently $75 million), we see a beaten down stock with strong competitive advantages, recurring revenue growth, significant incremental operating leverage, little to no cash burn, minimal downside from the current price, and significant upside potential. Management seems to agree, as we have seen some recent insider buying at prices ranging 5-50% higher than the current stock price. Based on a 7-10x gross-profit-taxed multiple looking out 1-2 years, we believe the stock should trade around $8-12 in our base model, with significant opportunity to surpass this estimate (current price of $4.85).

Conclusion

With the broad market seemingly beginning to finally stall, and the microcap space being significantly out-of-favor with depressed valuations, we feel it is a perfect combination to generate strong alpha in 2022 for the Kalo strategy. We are disappointed in last year's performance, but look forward to brighter returns going forward. We appreciate your confidence in us. Wishing you, your family, and your business health and happiness in 2022.

Sincerely,

Steven D. Friedman, CFA
Founder and Portfolio Manager

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

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