October 11, 2018

Dear Co-Investor,

The Cottonwood Diversified Program ended September with a return of 3.04% and a YTD return of 1.30%, net of fees.

The strategy was broadly positioned, ranging from feeder cattle and fed funds to the Nasdaq index and crude oil. A large portion of the portfolio is comprised of positions initiated during September with most of these new positions contributing to the month's positive performance. The only detractor was a short-lived position in natural gas.

Gold

Gold was a particularly compelling short opportunity from the start. From a price standpoint, this market simply went nowhere for two years, from the middle of 2016 to around June of this year. Even though prices remained unchanged, the gold cheerleaders seemed to be out in force; few markets see a level of enthusiasm similar to that of gold. This lofty level of enthusiasm coupled with a lack of price advance created an interesting divergence between perception and reality which would need to be reconciled. In addition to this divergence, the fundamentals surrounding gold were particularly worrisome. Without going in to too much detail, gold tends to thrive in times of uncertainty, volatility, geopolitical risk and/or inflation. According to my pricing models, nothing on this list seemed to be of much concern, suggesting that there was little to drive the price of gold higher. As prices broke down in June, I initiated a short position. My hope is to hold for a considerable period of time, but should the model or pricing profile change, I'll exit the position promptly.

Sugar

One of the most persistent and profitable trends among all global markets over the past year has been sugar. Most analysts would argue that the current downtrend is predominantly driven by oversupply, stemming from a strong decline in the Brazilian Real. Approximately 20% of the world supply of sugar is grown in Brazil and their currency plays a large part in the pace of their exports. With their currency, the real, dropping quickly, the incentive to sell quickly in order to lock in a higher exchange rate prompted a flood of supply. The result of this ongoing supply flood is lower prices on the global market.

The demand side is much more difficult to quantify, although I have a suspicion that there are long-term secular themes at play and although important, might not be as critical over the short- or medium-term as supply issues will be. In terms of demand, there seems to be an increasing number of research studies implicating sugar in a number of diseases and health issues, like heart disease and diabetes.

Known collectively as "metabolic syndrome", health and fitness circles seem to be increasingly focusing on the deleterious side effects of sugar consumption. Some medical professionals go so far as to implicate sugar in tumor growth and Alzheimer's. One could simply wrap this theme into broader "healthy eating" initiatives shared by various groups as well as restaurants and food companies. Most people are well aware of the trend to organic foods, non-gmo, raw foods or clean eating.

Dietary changes for a large demographic pool will certainly occur slowly and over time. This means, however, that any changes should be structural and not short-lived. I suspect the growth in sugar consumption will slow over the coming decades. Certainly, this alone isn't reason to short sugar or to not establish a long position in the future. However, when building a future fundamental model, it might be an important component to include when considering the demand side of the equation.

FX

In terms of currencies, I initiated a short position in the euro, favoring it over other major global currencies for a number of reasons. Whenever particular sectors looks primed for a move, one needs to select the particular market to trade. In currencies, the picture can be convoluted and murky with so many global variables. I try to make it as easy as possible: which market is moving decisively, where is sentiment, which countries should benefit economically going forward? The euro position was initiated earlier in the summer and in September I added a short position in the Japanese yen. The yen is unique in that it maintains a very low correlation to other major currencies. Conversely, the Australian dollar, euro, Canadian dollar and British pound will typically all move together on any given day. A position in the yen tends to be a helpful way to diversify.

In all, this was a productive quarter, gaining over 6% net of fees. With that said, there are reasons to believe that current trends will continue a bit longer before consolidating or retracing. This potential continuation should give new positions room to digest, before hopefully continuing further. The risk in trend following is to be stopped out from short-term market variations, preventing participation in the remaining portion of the trend. I believe the strength of the current market trends have provided breathing room so that this risk has been minimized.

Sincerely,

Andrew McCormick
West Seattle, 11 October 2018