Cottonwood Capital Management

2Q2026 Commentary

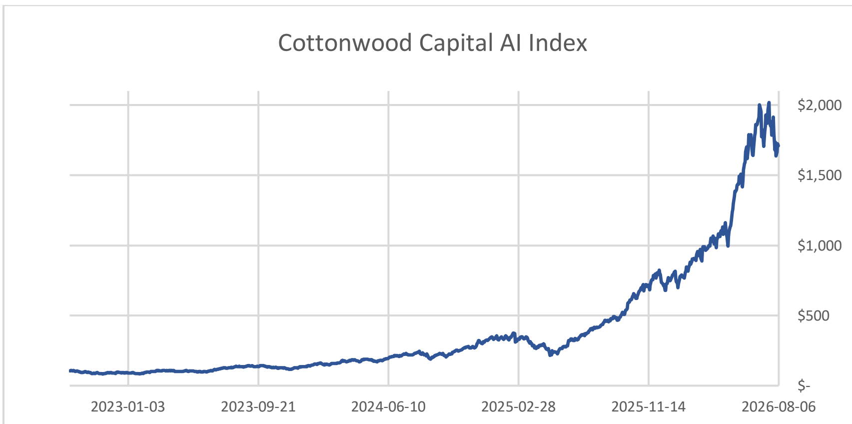
August 19, 2026

During the first half of 2026 our client portfolio returned approximately 9.5% on a net-of-advisory-fees basis versus a gain of approximately 5.9% for a traditional 60/40 portfolio comprised of the S&P 500 and U.S. treasury bonds. This outperformance occurred even while gold, a notable component of our portfolios, corrected off its early 2026 highs (2025 was an incredible year for precious metals). In all, it's been a volatile six months due to the Iran war, the resulting oil volatility, and a relatively euphoric second quarter for AI stocks. I'll talk about the latter in greater detail below.

In my view, 2026's signature issue continues to be the AI/datacenter frenzy that grips both Wall Street and Silicon Valley. Having now surpassed the late 1990's fiber optic buildout (in terms of overall capex spend relative to GDP) the only larger capex boom in U.S. history was the railroad buildout of the late 1800s. It seems unlikely, though, that the current data center buildout will reach that lofty level. Investment and construction of the rail system here in the United States reached 6% of GDP in a *single* year (cumulative AI spend is currently about half that) and continued at lesser levels for roughly 20 years before activity and funding collapsed near the turn of the century.

However, becoming the largest infrastructure boom ever isn't necessary for problems to result. After all, the unwind from the late 1990's tech bubble was plenty costly for U.S. investors and the fiber optic buildout only reached about 1% of GDP. History suggests that extreme technological buildouts, accompanied by massive investment and rich equity valuations have usually been followed by both product gluts and investment hangovers. Whether or not a contraction follows isn't much of a question, it's the timing of the downturn that is both highly impactful and, unfortunately, impossible to time. An infrastructure boom often coincides with easy financing, elevated capex spending, and strong sales growth for the picks and shovels companies related to the expanding industry. And as we saw in the 1990s and today, rising equity valuations. The eventual glut (of rail miles, fiber optic cabling, data center servers, Nvidia chip stockpiles, etc.) is the result of overbuilding and the malinvestment. Lower equity values eventually follow when investors adjust to the new supply and demand reality.

To help illustrate the current frenzy I've included below a homemade index of the 35 hottest AI/datacenter companies. In the first six months of 2026 this basket of companies rose 164%, in the past year it's up 407%, and since the market's low in 2023 it's up an eye watering 24x. Some of these are small-cap companies which partially explains the large price moves, but others, such as Corning, Broadcom, and GE Vernova, are rather large and don't typically exhibit such volatility.



In addition to these extreme gains, I've enjoyed watching some different events unfold this year. It's hard to know exactly what to do with these, each event is unique and together they are hard to code into a reproducible investment strategy. But for now, I'll simply file them under "things that don't happen at market lows". These include the much-anticipated SpaceX IPO which set the record for the largest ever (by over a factor of 2) even after adjusting for inflation. The initial offering was planned to raise $75b but, due to extreme investor demand, ended up generating just over $85b. That same week Google's parent company, Alphabet Inc., completed a secondary offering that also raised $85 billion. Alphabet explained that those funds would be used to fund AI infrastructure and compute capacity. Furthermore, SK Hynix, an established Korean semiconductor company, completed a secondary listing here in the United States simply to take advantage of insatiable U.S. investor demand for AI-related stocks. Their plan paid off and the offering raised $26 billion, ranking it among the largest US offerings ever.

Coupling these investment events with the performance of my hypothetical AI index paints a picture of financial perfection. Needless to say, conditions have been perfect for those involved in the AI and data center industries. I'm not saying this is a bubble that needs to pop imminently, I'm staying open minded about how long this party can continue. However, even within a bull market prices don't march along in a straight line, corrections occur from time to time. In fact, it's these declines that prevent the overall market from overheating too quickly. Declining prices and consolidations shake out the weak hands and give each stock a stable base from which to begin its next advance. I'm eagerly awaiting such a selloff to deploy idle cash (T-bills). Fortunately, we are entering a seasonally weak period for equity prices (August – October) as well as a mid-term election that historically generates some additional volatility.

Unfortunately, triangulating the current AI/data center growth to the boom/bust framework is impossible. As helpful as it would be to know when the boom ends and the bust begins, we need to be able to successfully operate without that knowledge. From my standpoint, this means investing in companies at a reasonable valuation in industries unrelated to AI. I believe that this boom will eventually end and share prices will decline, but I'm trying to keep an open mind as to the timing. History is littered with investors claiming a top several years before one ultimately arrives and the truth is that bull markets tend to go on longer than anyone expects. For example, back in the 1990s, Alan Greenspan, Jeremy Grantham, and James Grant warned investors of overheated conditions in 1996, four years before the stock market peaked. Recently, several prominent market commentators, investors, and CEOs have cautioned that this bull market may end soon. Similar to their 1996 analog I suspect they too may be early.

My investment approach isn't contingent upon knowing when the AI boom ends. However, for various reasons I suspect it can continue a while longer and that not participating in any additional broad stock market advance will be quite painful for investors who remain underinvested. One way to mitigate the impact of a pending AI hangover is to invest outside of technology. Fortunately, I focus on and primarily invest in non-tech companies for numerous reasons – all of which were well established before AI became a household concept.

In terms of avoiding technology companies, I try not to be too dogmatic, after all, client accounts held Alphabet (Google) shares for most of the last year. However, in my experience it's awfully difficult to have the confidence in a company when you don't have a deep understanding of what they do or why their technology should remain resilient to competition. To use Alphabet as an example, Google search was immune to disruption…until ChatGPT introduced a new way to find information in 2022. In fact, ChatGPT experienced the fastest adoption curve in consumer technology history by reaching 1 million users in its first 5 days of existence. Four years later it has 1 billion monthly active users and several other large competitors also have similarly large user bases. It turns out software isn't just eating the world as Marc Andreessen stated, it's eating software too. In response, Google was forced to adapt and now has a similar AI interface for users. Warren Buffet summarized the difficulty with technology investing: "I have avoided technology sectors as an investor because in general I don't have a solid grasp of what differentiates many technology companies. I don't know how to spot durable competitive advantage in technology."

Those are the difficulties as it relates to the competitive environment within the tech industry and my limits as an investor. In addition to those challenges, technology businesses can toil for years as they develop a product, roll it out to customers, then constantly update their technology to keep it competitive and compatible with everything else in their ecosystem. All of this work occurs while, simultaneously, a new startup receives VC funding to invent the next product that renders the competition obsolete. The tech industry's rate of change dwarfs all else, it's creative destruction's playground.

Furthermore, in recent years, in order to retain talent, many tech companies continuously dilute shareholders in order to pay their employees generous stock options. Until recently when showing a profit became more popular, many tech companies plowed all would-be profits back into R&D or sales and continuously operated at a loss. Furthermore, Wall Street accepted proportional losses – losses that grew in step with revenues. Magically, as the revenues grew so did the losses.

Ultimately, I'll invest in a technology company but it faces additional hurdles, above and beyond what a boring company in a boring industry would need to clear in order for me to have reasonable confidence to invest. For example, a particularly strong competitive position where competitors would need to spend astronomical sums to compete. Or, maybe it would be a niche company that was misunderstood and traded at an undeserved discount because investors weren't aware of small but impactful competitive element.

Portfolio

Activity in the second quarter of the year was quiet; I sold a few positions that, in my opinion, appreciated too much too quickly. The proceeds from those sales will be quite welcome if the market corrects and compelling companies can be purchased at lower prices.

Furthermore, gold continues to digest the gains from its historic advance which began in 2024. After advancing over 150% it makes sense that it'll move lower or sideways for a while. Should the stock market experience substantial volatility or if inflation moves higher then gold will likely be a helpful diversifying asset in client portfolios.

I looked at many, many companies this year and added a few to my primary watchlist, some will likely make their way into client portfolios before the end of the year. If that happens then I'll touch on them in my year-end letter.

Thank you for your business and confidence in the investing process.

Andy McCormick