Cottonwood Capital Management

4Q2025 Commentary

February 19, 2026

2025 proved to be a profitable year for the stock market, but more importantly, for gold. The S&P500 stumbled in the first quarter with a -20% correction but rebounded and finished the year with a return of +17.7%. Investors widely believed that early 2025's tariff-induced correction was The Big One. Fortunately, my models suggested that a major top, like 2000 or 2007, wasn't due yet and we continued to hold all positions through the correction. Gold had a stunning year and finished 2025 with a total gain of over 64%. It maintained its strength during the S&P's correction, contributed to strong gains for our portfolios and, due to its low correlation, resulted in less volatile performance as well.

I have stated in prior commentaries that I do believe that a major stock market top (like 2000 or 2007) is coming sometime in the next couple of years. At this stage, however, I still think the broad market will do quite well for the first few months of 2026 but I'm less confident for the back half of the year and 2027 makes me downright nervous. Broad economic fundamentals continue to deteriorate and stock market valuations continue to climb which increasingly make stocks vulnerable to a meaningful bear market. Given that deteriorating combination, however, investor sentiment remains neutral after cratering to extreme levels of investor fear in early 2025. This lack of exuberance is a helpful engine for the broad market as investors will likely continue to buy stocks until sentiment reaches levels associated with greed. As sentiment does become greedy though it will then transition to be a headwind acting along with fundamentals and valuation to increase the downside risk to the stock market. Recall how sentiment analysis works: if everyone has bought then who is left to do the buying?

Gold

Gold is the asset of last resort and it's difficult to always understand what drives its price at different times. Sometimes it's straightforward, like in the 1970s, when inflation ran hot and gold was a new asset class for investors. All commodities made huge moves higher in price during this time and the global investing industry allocated into gold for the first time from the very low level of ~0% exposure. Prior to the 1970s investors were restricted to buying gold bars or coins since there were no gold futures or ETFs. The opening of a new asset class, like gold (via the futures market) in the 1970s or Bitcoin after 2010, can be very lucrative. The result of extremely minimal ownership and the excitement of a new market is a nearly constant inflow of dollars which drives prices higher.

Currently, from my standpoint, gold benefits from a variety of rolling factors. Initially, back in 2023 when this current advance started, the precious metals benefitted from elevated inflation from Covid stimulus and it was also the beneficiary of the 2022 bear market in stocks and bonds (gold tends to benefit from financial volatility). As the bull market developed and geopolitical events unfolded, rumors of Russia using gold to circumvent the dollar system swirled. Following Russia's likely boost to the gold market, China's central bank seemed to find a genuine passion for accumulating the metal due to declining U.S. treasury bond prices and fears of being exposed to U.S. financial control. They likely saw the restrictions placed on Russia and wanted to ensure their independence within the global financial order. After all, gold has no counterparty. Lastly, at some point speculators likely joined the party and concerns over possible central bank-issued digital currencies both acted as tailwinds. In all, the party was multi-faceted and the run in gold and silver prices has been one for the history books.

As I finish editing this letter on February 19th gold prices sit at $4,987/oz and silver at $77/oz (after hitting a high of $120). It's quite impossible to know when these cyclical bull market will end and at what price, I'm already surprised each has appreciated so much so quickly. But, end they will. I have a rudimentary valuation model for gold that includes the impact of the monetary base, inflation, and the U.S. dollar. Currently it shows gold as somewhat overvalued, further upside may be capped until inflation or quantitative easing return, or a meaningful bear market in stocks occurs.

Portfolio

In November, Exact Sciences Corp., a company we've owned since late 2024, received a buyout offer from Abbott Laboratories for approximately a 50% premium to its prior week's average trading price. When a company receives a credible buyout offer the subject company's shares typically open for trading within a few percent of the offer price. The small residual gap tends to close as the odds of a successful buyout gradually becomes a certainty. This is the territory of merger arbitrage.

Due to the buyout offer being cash (instead of stock) it made little sense to hold on to the shares as any additional gain was unlikely and client portfolios already owned the position for over a year thereby qualifying for long-term capital gain treatment. Funds from this sale were used to purchase a small basket of companies that appear to be under-valued and positioned to move higher after a period of under-performance. This combination of high-quality business, low valuation, and signs of share price momentum tends to be fruitful and is one I search for regularly.

Toro

Two of these companies are The Toro Company and Thermo Fisher Scientific. Toro manufactures a diverse portfolio of equipment across sixteen different brands. These include mowers, ditch diggers, snow plows, augers, and irrigation products. Toro maintains a strong brand and they're positioned reasonably well to benefit from onshoring efforts and general economic growth. Historically, they've maintained a 35% return on invested capital (ROIC) although that has slipped since covid due to some slightly inferior acquisitions. Currently it's generating a (respectable) 20% ROIC which is still well-above average for the broad market. Historically, the company has been a buyer of its own shares thereby returning capital to shareholders in an efficient manner.

Decades ago, companies typically returned cash to shareholders in the form of dividends. Although this practice is still widely used, buying back shares has become more popular for its tax-efficiency. Instead of receiving a dividend check (and paying taxes on it), investors benefit from the decline in share count – they now own a larger percentage of the overall company. In addition, since they haven't directly received funds or transacted themselves, they have no new tax liability.

Although buybacks can be a fantastic way for management to reward shareholders they need to be done thoughtfully. Buying back shares when the stock is materially overvalued is a poor use of capital since the stock may very well decline in price for several years and capital will be destroyed. Buying back shares when the stock is undervalued is ideal since shareholders will increase their ownership percentage before the stock begins to appreciate. Toro's leadership has shown to be savvy allocators of capital since they've stepped up their buying of shares while the company's stock price has been under pressure and had declined to price levels not seen since 2021.

Overall, Toro appears well positioned to benefit from the broad onshoring activities that remain underway as some high-end manufacturing moves back to the United States. Furthermore, we're seeing a mid-west renaissance of sorts which will further benefit the company. Certain companies have voted with their feet and decided to move manufacturing away from more densely populated (and expensive) coastal states in favor of less expensive and more welcoming inland areas. For example, Anduril, the new and exciting defense startup, inked a deal with the state of Ohio to fast-track a large manufacturing operation for its drone wingman product. Furthermore, much of the new construction for large-scale datacenter construction is focused in Texas, Iowa, Nebraska, Indiana, Ohio, Geogia, and North Carolina. All of these will beneficially impact Toro's construction segments and the economic tailwind for these regions will eventually benefit Toro's maintenance products as well.

Thermo Fisher Scientific

Moving on to Thermo Fisher Scientific, this well-known company serves the scientific research and pharmaceutical industry with instruments (16% of revenue) as well as "services and consumables" (84% of revenue). The latter often receives a higher multiple from Wall Street due to its software-like recurring revenue traits. With only 52% of their revenue from U.S. customers they have meaningful international operations across Europe and Asia.

Thermo Fisher benefits from a number of global tailwinds, the largest being an increase in demand for healthcare services from an aging population. The "silver tsunami" is very real and has already inspired some of our other portfolio investments, like Ensign Healthcare.

Normally I'm not terribly interested in investing in a company with a $200B market cap. Instead, I prefer smaller companies which often have a higher likelihood of being overlooked, misunderstood, or generating higher possible revenue growth rates. Huge companies are often efficiently priced since Wall Street has analyzed them from every possible angle.

Biotechnology and pharmaceutical companies have underperformed the broad market since 2015 and ten years of investor neglect will convince me to spend more time on a sector. However, that being said, I often avoid small pharmaceutical and biotechnology companies because I don't have sufficient understanding of how drugs are developed, the science behind it, or any particular medical expertise. Thermo Fisher falls under the "picks and shovels" umbrella which enables us to benefit from biotech growth while (hopefully) avoiding the speculative pitfalls. When biotech benefits, they'll require more of what Thermo Fisher has to offer. Additional R&D and a robust product pipeline should directly drive Thermo Fisher's revenues.

While biotech remains speculative and dependent on the lottery aspect of new drug development and approvals, Thermo Fisher historically generates high-quality revenue and consistent performance. They have consistently increased per-share revenue by more than 7% while profit margins remain resilient and have increased to 17% from 11% in 2010. Their return on invested capital (ROIC) also continues to climb.

Like many companies related to healthcare their stock price rose aggressively in 2020 due to the flurry of additional Covid business and has since consolidated. The combination of a stock price moving sideways for five years while revenue continues to grow means their valuation has compressed thereby making it an appealing investment.

I appreciate your trust and look forward to 2026.

Sincerely,

Andrew McCormick
Managing Member

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