Market Update and Quarterly Manager Commentary

5 April 2018

Main Points

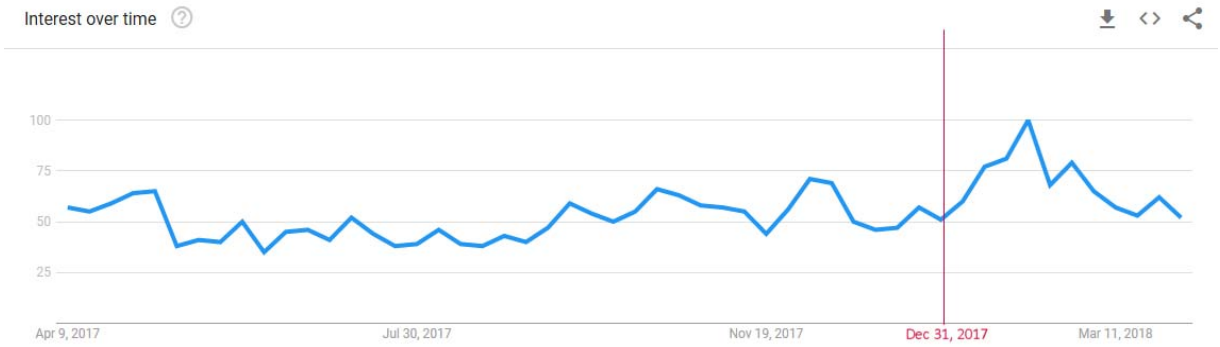
1. Inflation has become an economic concern to some.
2. Markets have returned to "normal," meaning they don't go up every week and when they do move it's a very crooked path.
3. 2018 and beyond will be a bumpy ride; investors should be patient.

Market Update

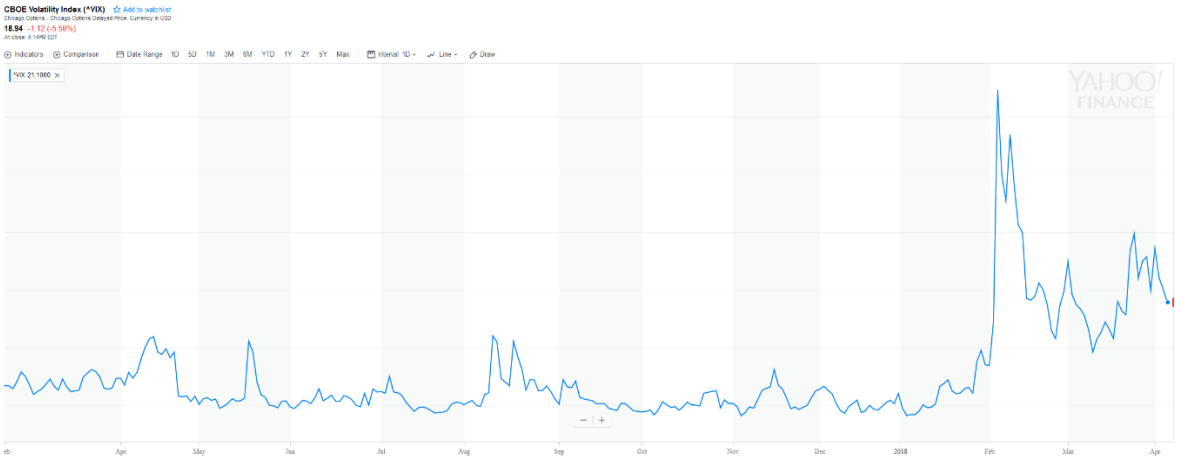
In our 4Q17 update, we stated

> "We expected to see inflation alongside the current global growth streak."

Shortly after we wrote that, google searches for "inflation" hit a 5-year high (not because of us).



This inflation fear sent the markets into a type of drama-queen panic, and volatility spiked. Usually, high volatility means stock prices fall sharply. The market had its first down quarter since 3rd quarter 2015.



However, if you look at where volatility has typically been, you'll see that all that has happened is that the market has returned to normal levels of volatility.

What does this mean? In 2017, you could buy stocks and make money, you could buy bonds and make money, you could buy bitcoin and make money, and you could hold cash and make money compared to some other currency. That's not the case anymore.

Cane Island Global Macro

Much of the market is sorting itself out. For now we have overweighted our holdings to capture dividend yield. This is called "being paid to wait," and it's an idea that Shark Tank investor Kevin O'Leary also espoused on CNBC just the other day (Apr 2) on "Fast Money Halftime Report." Now, we didn't do this because we saw it on CNBC, we were doing it anyway. Still, it's nice to hear someone famous confirm your investment strategy on TV.

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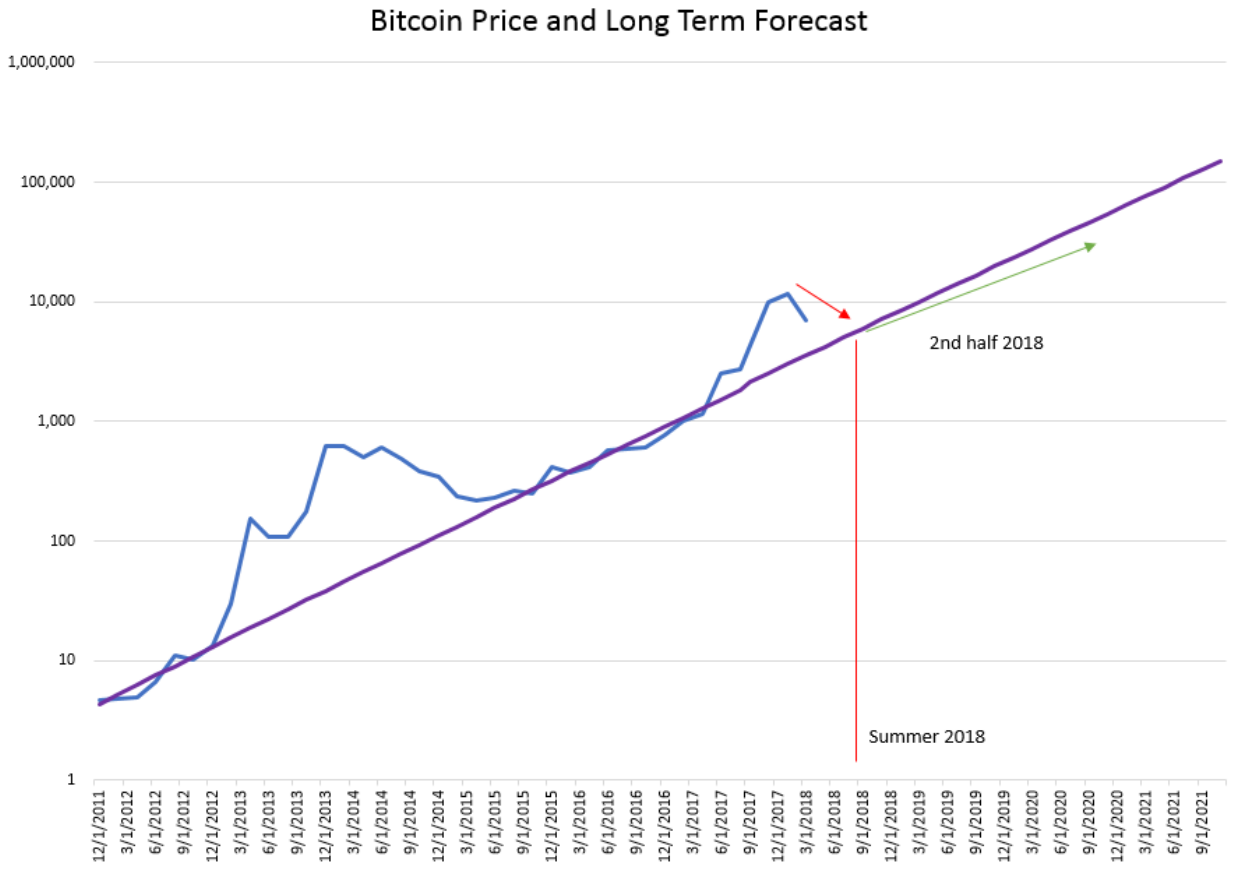
We spent considerable time developing a model for cryptocurrency values. The first part of that model will be published in CAIA's *Alternative Investment Analyst Review* later this year. The full paper can be found at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3078248. That paper has become quite popular, nearing 3,000 downloads (the top 5% of all papers posted) in just a few weeks, and has received some minor press.



We think bitcoin, and most other cryptocurrencies, will reach equilibrium value later this year. After that, it should resume a relatively steady upward trend as it has in past years, perhaps earning as much as 60% per year for the next couple of years. Once we confirm that bitcoin's price is resuming its Metcalfe Value growth rate, we will again consider an investment.

Timothy F. Peterson CFA, CAIA

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Market Update and Quarterly Manager Commentary

15 July 2018

Main Points

1. Inflation has become an economic concern to some.
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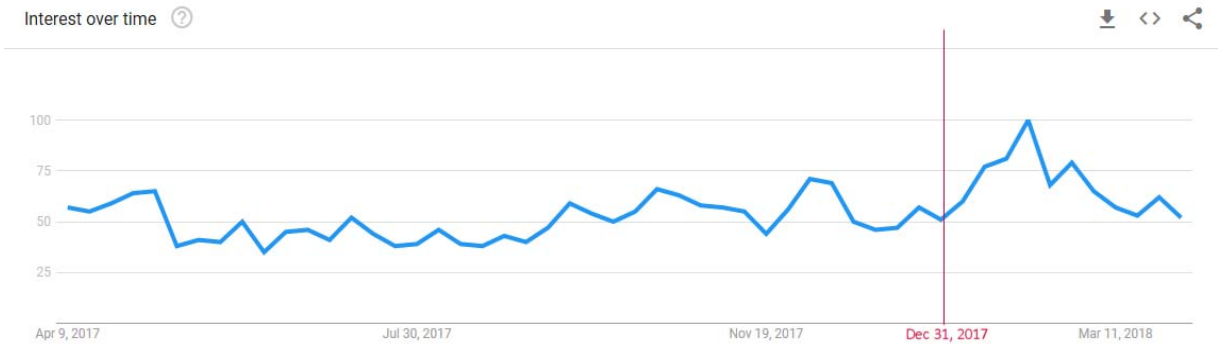

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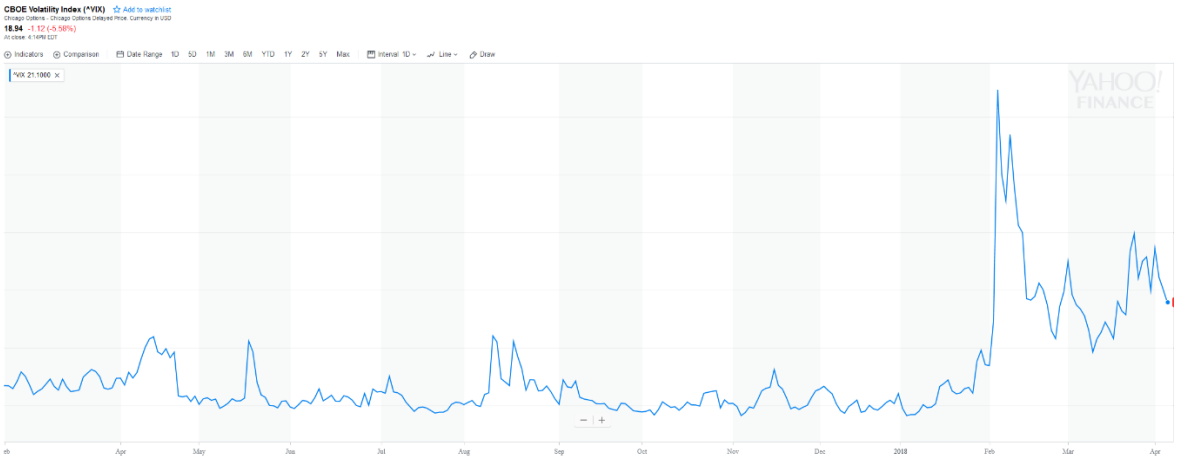

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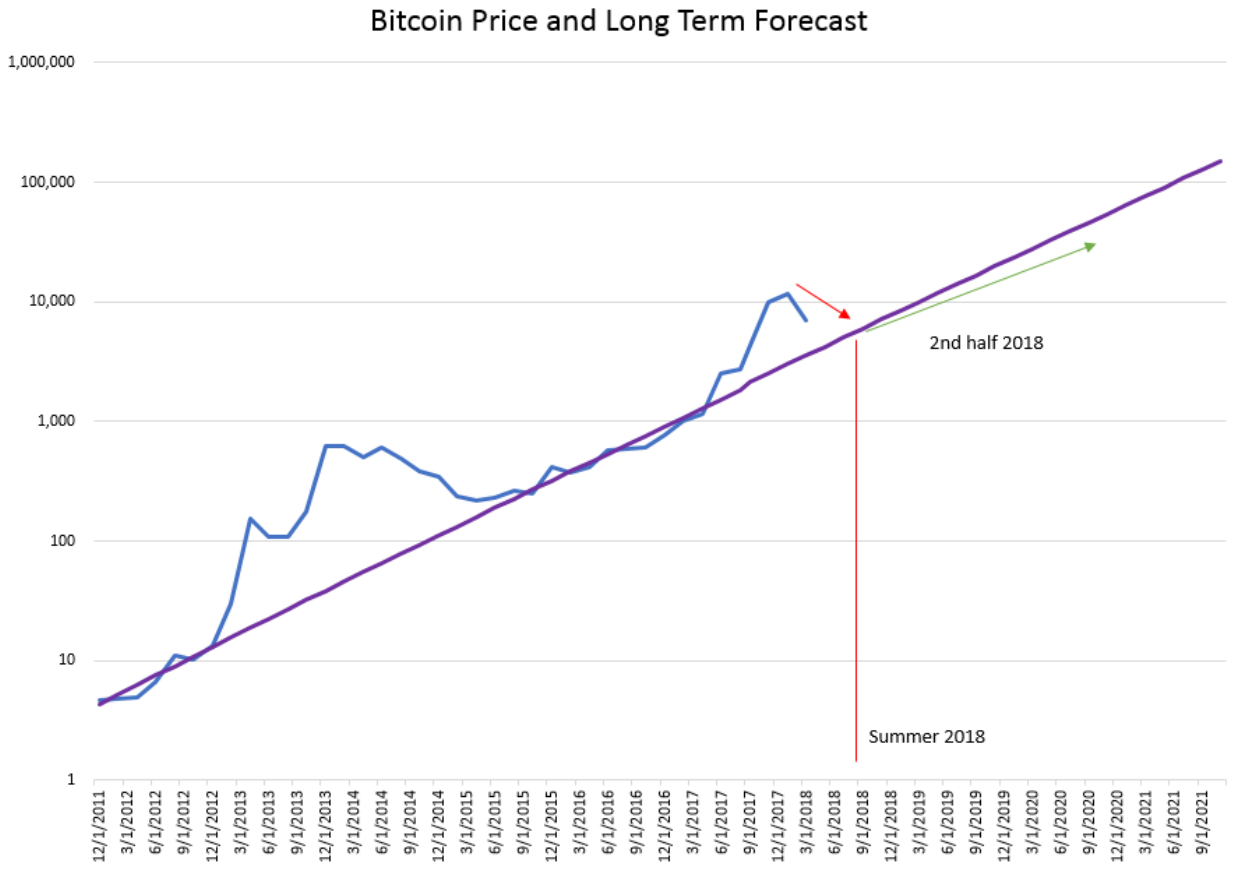

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CANE ISLAND
ALTERNATIVE ADVISORS

Market Update and Quarterly Manager Commentary 11 October 2018

Main Points

1. As of 2018, we are in a long-term prosperous economic cycle, a condition we expect to last for another 4-6 years. However, we think a chance of recession grows with each passing day.
2. We expect to grow our allocations to Bitcoin and Ethereum Classic over the next year.
3. In our last letter we indicated 2018 might be "bumpy." That has proven to be the case, but we are, as always, doing our best to manage risk.

Market Update

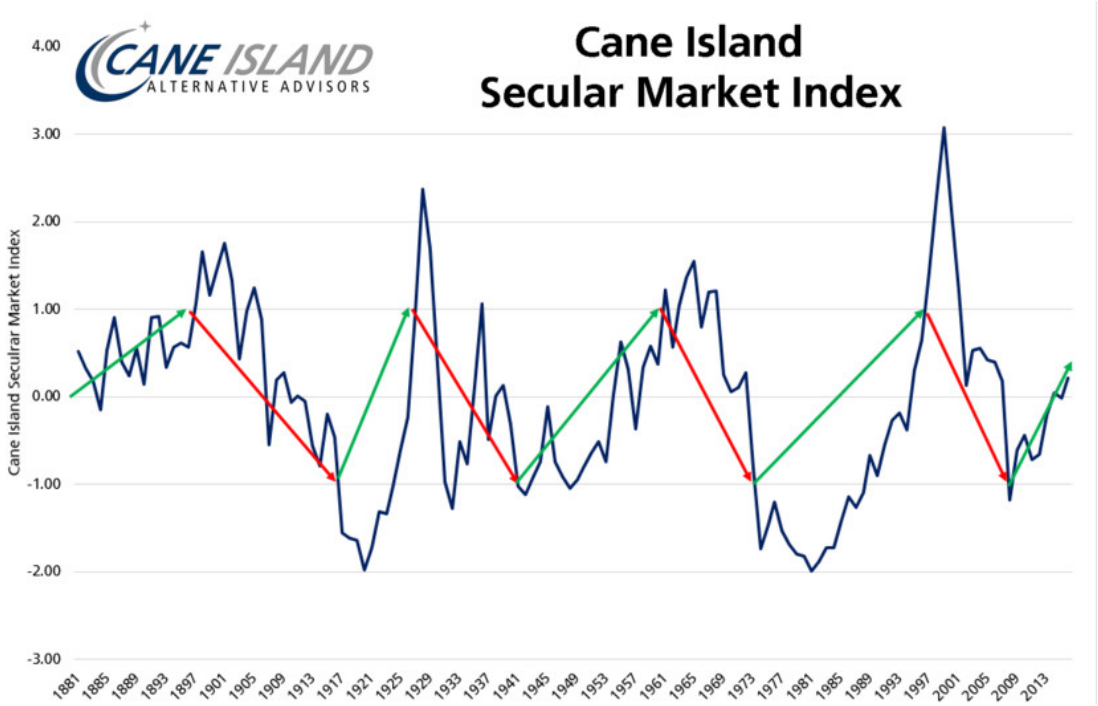
Last year, we conducted some research into how one can gain insight into whether the economy and markets will be positive in the future. We put some of our initial thoughts in a LinkedIn article here. One of the methods discussed was our own invention, the "Secular Market Index."

A secular market is a long-term macroeconomic cycle usually covering one or two decades. Within a secular market are the "normal" bull and bear markets, but the overall economic trend is either growing or depressed. The American economy has exhibited these repeating cycles since 1881. You can see a picture of secular markets here.

The Cane Island Secular Market Index is based on the Shiller Price-to-Earnings (CAPE) Ratio, adjusted for the price of gold. Robert Shiller is a well-known Yale professor who won a Nobel Prize for his work on the CAPE Ratio because, at the time, it seemed to do a good job of predicting economic performance ten years in advance. Right after he published his article, the measure stopped being predictive, which means that if you had done what the CAPE Ratio suggested you do, you would have lost money. They gave Shiller a Nobel Prize anyway.

We modified the CAPE Ratio to account for the price of gold. What we discovered is that our forecast model predicts the economy ten years in advance, just like Shiller's did, but unlike CAPE, has also worked for the past 30 years.

The index works like this: if the value goes above 1, long-term economic drudgery awaits. When it dips below -1, long term economic prosperity is on its way. As of 2018, we are in a long-term prosperous cycle, but we think a long-term bear market could happen in about 4-6 years. Mind you, we are not talking about a recession, which usually lasts 9 months. We are speaking of **10+ years** of economic stagnation. Right now, we don't see signs of either. That said, we expect a recession around 2020-2022, perhaps sooner.



We are pleased to announce that our findings will be published in "When to Own Stocks and When to Own Gold," in The Journal of Wealth Management, Winter 2018. The Journal of Wealth Management is a respected academic journal covering a range of wealth portfolio management issues that are relevant to high-net-worth investors. Articles offer practical investment strategies in private wealth management, commentary on estate and financial planning, and research on behavioral finance and family office management. We're excited that our work was noted for its relevance to such a broad category of investment portfolios.

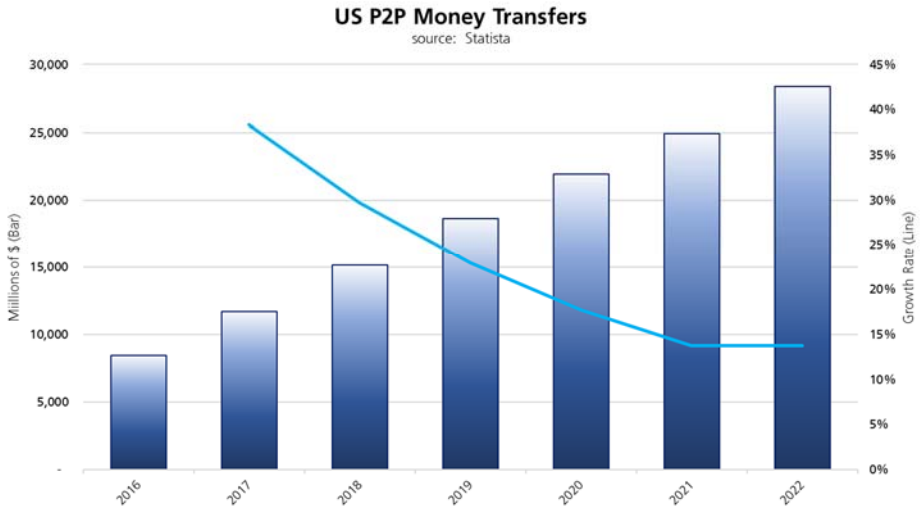
Cane Island Global Macro

Last quarter we mentioned that we had exited our cryptocurrency position, and that most other cryptocurrencies will reach equilibrium value later this year. We are watching this very closely and have taken a very small position in Ethereum Classic. We expect to grow our allocations to Bitcoin and Ethereum Classic over the next year.

Last quarter, CAIA's *Alternative Investment Analyst Review* published our paper on Bitcoin's Value. We were the first published paper showing how Metcalfe's Law applied to cryptocurrency. We were only the second published paper (ever!) to validate Metcalfe's law with empirical data.

We have recently developed a website (www.caneislandcrypto.com) where we explain cryptocurrency values and track the investment attractiveness of several cryptocurrencies. This initiative is designed to offer investment advisors, hedge funds, family office, and other professional investment managers access to valuable information regarding cryptocurrency investment.

Along with cryptocurrency, peer-to-peer payment systems have been growing very rapidly.



The blue line represents the growth in this industry (businesses like Paypal, Square, Venmo, Apple Pay) which is the return on investment we would expect to earn. However, if we are selective about which companies we invest in, we think we could do better than that.

Timothy F. Peterson CFA, CAIA

www.cane-island.com

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CANE ISLAND
ALTERNATIVE ADVISORS

2018 ANNUAL REPORT

January 18, 2019

Dear Investor Client,

We are entering our fourth year, and we are so grateful that you have been part of this journey. Each of us shares a goal – financial security not just for ourselves but for those we love and others in our community. For most, it extends to causes and concerns in each person's circle of appreciation and influence.

For our part, we have grown in number of investors, and new assets contributed, every single year. You are part of that group, and I thank you for your trust. Please let me know how I can continue to be a part of your financial growth and planning.

Best Regards,

Timothy F. Peterson, CFA, CAIA

Cane Island Alternative Advisors, LLC
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Katy, TX 77450
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The Economy

There are three economic battles underway.

Battle #1: US Oil vs. Legacy Oil

The US has become a net oil exporter, and is on its way to becoming the world's largest oil producer. The world's wealthiest country and most technologically advanced nation is now energy independent. This must be frightening to America's enemies, and with good reason. America wasted no time to use this new power to hurt its traditional adversaries: Russia, Iran, Venezuela, Libya, to lesser extent Saudi Arabia and OPEC. US oil production is used as an economic weapon to lower global oil prices and deny revenue to countries like Russia and Iran. To some degree, this benefits US consumers at the pump, and smaller emerging economies like China, India, and Brazil. It keeps inflation low. US consumers like it. But as net exporter, low oil has negative effect on the US economy as well. After all, the gulf states did not get rich by selling their oil for dirt cheap, and neither will the US.

Battle #2: The Federal Reserve vs. The President

The history of central banking is rather lackluster. Each solution to an economic crisis seems to help cause the next crisis years later. The Federal Reserve has been raising rates all year among questionable claims that the economy is at risk of "overheating." But with oil prices low, inflation has been kept in check. Banks drastically cut their lending, almost overnight. Despite this, the Federal Reserve reiterated its commitment to raise interest rates into 2019. This perplexed and angered many economists and financial experts as unnecessary and probably harmful. The Federal Reserve's goal is to hurt the economy just enough to ensure that Donald Trump is voted out of office in 2020. The consequence is worst market and economic outlook we've seen in 10 years.

Battle #3: US vs. China

This is the conflict that grabs the most headlines, but has the least impact on the US economy. China's economy is at risk at the moment. The US is using its economic strength against China's weakness to renegotiate trade agreements. China is upset about this. But the net effect of trade tariffs between the US and China is not very great, especially when compared against the 2018 tax cut. In the long run this will be good for the US, but in the short term it creates stress and uncertainty.

Despite an overall good economy with strong growth and low unemployment, the consensus is that this latest 10-year boom cycle is ending and the economy will trend flat to downward for years to come.

The Markets

After performing well for most of the year, global markets dropped dramatically in 4th quarter 2018. Given the speed, magnitude, and breadth of the decline, it can best be described as a global crash.

In the past 100 years, there have been 400 calendar quarters. 4Q18 ranked 386th out of 400, the bottom 4th percentile. Statistically, an event like this happens once every 28 years, which is just about once in an investor's lifetime.

The economy has cooled and markets reflect that. 82% of CFO's believe a recession will occur by 2020 (Duke University/CFO Global Business Outlook).

Here is a summary of major asset class returns (in %), as published by Callan Associates:

	2017	2018
Cash	0.86	1.87
US Fixed Income	3.54	0.01
High Yield	7.50	-2.08
Non-US Fixed Income	10.51	-2.15
Large Cap Equity	21.83	-4.38
Real Estate	10.36	-5.63
Small Cap Equity	14.65	-11.01
Non-US Equity	24.21	-14.09
Emerging Market Equity	37.28	-14.58

2018 was the year that every major asset class went down. Stocks went down. Bonds went down. Gold went down. Real estate went down. Oil went down. Bitcoin went down. For the first time in a lifetime, cash was the best performing major asset class, gaining about 1.9% for the year, the same as inflation. Globally, the average investor got nothing or lost money, no matter what they were invested in.

Cane Island Global Macro

In our quarterly updates over the past year we warned that 2018 would be volatile. That has proven to be the case. But volatility is necessary if one expects to achieve good results. From 2000-2010, Warren Buffett's portfolio underwent a 50% drawdown not once but twice. It's a great example of how pushing ahead over the long term is very important for superb investment outcomes.

Another consideration is that when we build our portfolios, we do not always buy something because we think it will go up. Instead, we buy it because we think it may go up in a crisis. Oil is a great example. Every nation in the world needs oil Oil does not go to zero. When Russia puts 80,000 troops on the border of Ukraine, we need to be prepared for how an outbreak of war will affect markets. Oil is one such insurance policy. However, if oil declines 40% in 90 days, it takes a toll. As another example, we also bought gold. Our position in gold is the highest it has ever been, but it has not been enough to offset recent declines in other areas.

We are going to have losses but those losses usually come from serving an important purpose to protect the portfolio in times of crisis.

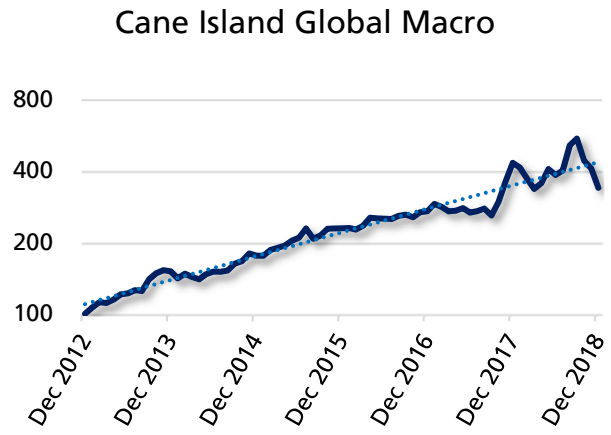
2018 Performance

If we measured our performance from March 31st to December 31st, we would have beat the S&P 500, even including the worst quarter in our history. But we had such great performance last year, we were not surprised to see it decline in 2018. That is partly the reason we like to measure performance over 2-year periods. Over any 24-month period in our history, we have never lost money. Hopefully, we can keep that trend going.

2018 is best marked by what we *didn't* own. We didn't own Facebook (-19%). We didn't own Goldman Sachs (-32%). We not only sold our bitcoin (-75%) at prices above $10,000, we correctly forecast its decline to $3,500 by December.

Still, our gains through September were gone, and then some, by the end of the year. As a rule of thumb, it takes twice as long to make money back as it does to lose it. The good news is that in 6-9 months, circumstances could be completely different. That's not a very long time to wait for an improvement.

Despite the year's disappointment, we think we are still on track. 2018 was a volatile year and that is evident in our recent performance. However, the long-term trend is virtually unchanged.



2019

We are skeptical of the financial markets going in to 2019, not because of the recent crash, but because of what those declines portend. We expect higher volatility, mixed earnings, flip-flop interest rate policy, surprises to the upside and downside, and a general slowing of the economic engine. 2019 will not be a kind year, even if it turns out to be a positive one.

Here are some themes we are looking at:

Certain medical device companies: there are two companies that have done well even through the crash, and we believe they will continue to do well. After all, people don't stop getting sick or needing medical treatments just because the economy is bad.

Some energy: we have been in-and-out of lithium this year with mixed results. The long-term prospects are good, but a global economic downturn would hurt. Higher oil would help, and we are looking at oil possibly moving up significantly over the next 18 months.

Bitcoin: we were the first to get published on how to value bitcoin using economic principles and methods. Our expertise here is superb, and we expect to hold some bitcoin throughout the year regardless of what happens to the price. There is a better than 50/50 chance that bitcoin will grow by 50% or more during 2019. We are not as confident with other digital assets at the moment.

Gold: based on research we had published in 2018, we believe that gold will outperform stocks, on average, ***for the next ten years.***

Market downturns provide opportunities for future investment gains with lower downside risk. In years like this, the following year was up 70% of the time.

Some equities, mostly outside the US: Emerging markets (India, Brazil, etc.) offer some decent risk-adjusted opportunities.

This is a much different portfolio look than we have had for the past several years, and is more defensive. But it is entirely consistent with our expectations for US equity and bond markets, which will be far more unpredictable in 2019 than they have been in the past 10 years.

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DAVID W. STERN

GLOBAL MACRO STRATEGY

CONSOLIDATED PERFORMANCE AND DISCLOSURE PRESENTATION

As of December 31, 2018

Performance

Portfolio returns are of three accounts combined into a single portfolio. Results are shown in USD.

Results portray total time-weighted rates of returns that include reinvestment of dividends, investment and other earned income, and realized and unrealized gains and losses. Results were achieved primarily in tax-exempt retirement plans and the strategy assumes no taxes are incurred through the management of the accounts. Past performance is not necessarily indicative of future performance.

Fees & Expenses

The figures shown are calculated assuming no management fees charged. Cane Island does not charge management fees, and no management fees were incurred on managed accounts. New investors are subject to a 24-month lock-up period.

Index Performance

An index does not represent the performance of any specific investment product or portfolio. An investment cannot be made directly into an index. There is no passively managed benchmark which adequately reflects the strategy shown. The manager's return objective is 25% over any consecutive 2-year period, on a net of fee basis.

Certain data was obtained from third party sources and is believed to be reliable, but Cane Island cannot verify the accuracy of such data.

"Market" is the S&P 500 Growth Total Return Index. This index is shown for comparison purposes as a market indicator only. Cane Island's portfolio is not managed against this index.

"Peers" is the BarclayHedge Global Macro Index. Performance shown is an average of managers that choose to submit their performance to BarclayHedge. It is not reflective of the performance of any single manager. This index is shown for comparison purposes as a peer group indicator only. Cane Island's portfolio is not managed against this index.

Risk

"Current Portfolio Themes" represents categories developed by the manager, showing the intended allocation of each category of investment based on from a hypothetical portfolio constructed by the manager. It is the approximate allocation of the model portfolio as of the report date. Your portfolio's actual allocation may differ from that of this portfolio. However, the manager strives to align your portfolio with tis model to the extent suitable.

The strategy may at times and with some frequency use covered call options to hedge positions. Writing a covered call option is considerably less risky than writing a naked call option but it is not entirely risk-free. The principle risk is the loss of participation in stock appreciation above the strike price. As the stock price increases in market value, the market value of the written call option declines.

The strategy may at times and with some frequency use leveraged and unleveraged exchange traded products (ETPs, aka ETFs and ETNs, etc.) to hedge or replicate exposure to certain markets, securities, or assets. The purpose of a leveraged ETP is to increase the exposure to and impact from the underlying index or investments in the ETP. A primary risk is that the performance of an ETP over a period longer than one day can differ significantly from their stated daily performance objectives.

The portfolio strategy is highly concentrated, sometimes holding a single security. With a concentrated portfolio there is the risk that a material event, which negatively impacts one or more of the securities, could have a meaningful negative impact on portfolio performance. However, diversification does not assure a profit or protect against loss. Further, this strategy actively hedges downside risk.

Other

Cane Island Alternative Advisors, LLC is a Wyoming LLC that provides marketing and other services. Portfolios are managed through an affiliated company, RStat, LLC, (dba Cane Island Investment Management, LLC) a Texas limited liability company.