Volume 23, No. 2, July 31, 2009

Quarterly Update

CWS Capital Partners LLC

CWS Capital Partners LLC

CWS

Calendar of Events

September 1, 2009

Change of Ownership Requests for Year 2009 Due

September 15, 2009

3rd Quarter 2009 Estimated Tax Payment Due

October 30, 2009

3rd Quarter 2009 Quarterly Packages Mailed

November 2009

Semi-Annual Conference Call

November 26th and 27th

Thanksgiving Holiday – CWS Office Closed

Friday, December 25, 2009

Christmas Day, CWS Office Closed

January 15, 2010

4th Quarter 2009 Estimated Tax Payment Due

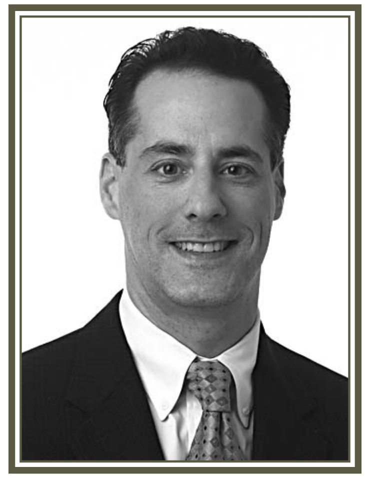
January 29, 2010

4th Quarter 2009 Quarterly Packages Mailed

www.cwscapital.com

Finding Wisdom

By Gary Carmell



"The wonder on this side of the Atlantic deepens, in view of these circumstances, that Chamberlain remains in office. In the five years previous to the outbreak of war, he led the British people from one diplomatic disaster to another. He was firm when he should have been conciliatory and palsied when action was demanded. Manchuria, Ethiopia, Munich—these stand as bleak monuments to his incapacity and shortsightedness. Can the mere fact of war transform proved talent for doing the wrong thing into ability to do the right thing?"

-Editorial from the Modesto Bee on March 23, 1940 about British Prime Minister Neville Chamberlain

Wisdom is one of those qualities that is exceedingly rare in fallible human beings. It is something for which I have a great fascination and is a subject I have written about before (2007 Annual Investor Report). My assertion is that, over a long period of time, wise people and organizations will produce better outcomes and are more prepared to avoid catastrophic failure. The consequences for societies and individuals for

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electing and investing with unwise people can be disastrous. Neville Chamberlain clearly had very little wisdom and Great Britain and the world suffered terribly for it. Thus, when assessing leaders in business and government it is critical to determine whether they possess or lack wisdom. Do they float with the wind by being overly influenced by public opinion or peer pressure, or do they have a capacity for independent thought bolstered by the possession of a bedrock of principles and core values, both from a moral standpoint and a business one as well for those who are making investment decisions? When individuals and a nation can recognize wisdom in others, it is often in their best interest to support them through their political or financial capital.

Wisdom has been discussed and debated for more than two millennia and was a great focus of the major Greek philosophers, particularly Socrates. There are many erudite definitions of wisdom that are often times quite complex. While simplicity is not always one of my hallmarks, in this case I do prefer to keep it uncomplicated. I have come to believe that wise people have the uncanny ability to consistently make correct decisions. Of course we can only know this in hindsight and it is important to understand the context in which decisions are made. And often times we may not know whether our decisions, recommendations, or prognostications will be accurate for many years.

To be an effective decision maker requires independent thinking, foresight, the ability to separate the signal from the noise when gathering information, to be open to diverse points of view, and to know our own limitations and blind spots. There is a line in the movie *The International* in which the antagonist states, "Act like a man of thought and think like a man of action." Chamberlain clearly did not as the quotation at the beginning shows. I think this is good advice for someone seeking to train himself to become a better decision maker.

At CWS we have tried to stay true to our values and business cardinals developed over 40 years. While we think our track record is an enviable one and we are proud of what we have accomplished, like any individual or business that has been around for a long time and has a bias towards action, self-improvement, and progress, we have had our share of disappointments and regrets. Failures are inevitable, but catastrophic ones are not. We have always tried to manage our business and investments by avoiding catastrophe and making prudent bets when we think the odds are in our favor. We believe that we are approaching the time where many factors are coming together to offer as compelling a risk-reward relationship for

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apartment investing as we have seen since the early 1990s. It is for this reason that we have embarked upon the creation of a CWS apartment fund that is designed to allow us to have a loaded gun of capital in order to move quickly to seize opportunities that may be fleeting. Socrates stated that "if you let the right moment for a task pass by, the task suffers." We do not intend to miss this opportunity. The fund will be targeted at investors that meet certain financial requirements in terms of net worth, income, and liquid assets. For those of you who meet these criteria, you either will or already have received the materials which should thoroughly lay out our case for the compelling reasons to be investing in apartments over the next couple of years.

Naturally, there is still a lot of fear and uncertainty among investors which makes it difficult to have confidence investing. Jobs are still being lost, homes continue to lose value, government spending and borrowing are at unprecedented levels, gas prices are rising again, and the banking system is still riddled with problem loans. Other than the stock market having rallied approximately 30% from its lows and junk bonds having experienced its most powerful rally ever, there is very little to cheer about. Yet, a funny thing happened on the way to the Second Great Depression. Perhaps the financial markets believe the worst is behind us and maybe they know something we do not. Since the theme of this article is wisdom and how it's incumbent upon us to find it wherever it may reside, then to what wise source do I turn in order to help me separate the signal from the noise regarding the economy? I have found wisdom at the Economic Cycle Research Institute which is affiliated with Columbia University. Its entire focus is studying business cycles and identifying the best leading indicators for predicting turning points and they have proven to have an uncanny track record in successfully predicting them. This is what they said on March 19, 2009 (www.businesscycle.com):

The "giant error of pessimism" is now rampant. This is why many will be blind to the light at the end of the tunnel that marks the exit from this recession. But to ECRI's array of objective leading indexes, designed specifically to spot recessions and recoveries, the end of the recession is now in clear sight.

In fact, the annual growth rate of its leading index is now decidedly positive after being in the red for 22 months and is unambiguously pointing to U.S. economic growth, perhaps as early as this summer. At almost every bottom it feels like things are either getting worse or, at best, not getting better and it is hard to find a catalyst for recovery. This time is no different. Yet, with financial markets stabilizing, the cost and availability of credit having improved

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for corporations, and the ECRI definitively calling for a recovery to take hold imminently, we believe that we will be entering the sweet spot for apartment investing.

We see a combination of dramatically reduced supply, soon to be improving demand fundamentals, positive demographics, banks that have no interest or capacity to make construction loans, and rents far too low to justify building new apartments, all coalescing in a very favorable way for apartment owners. These only have value when this set of conditions intersect with favorable pricing and this is something we are already beginning to see. Financing has become much more conservative and Freddie Mac and Fannie Mae are the only viable lenders. In addition, they are increasingly focused on lending to only substantial firms with strong track records, which is a positive for CWS. Therefore, we expect to see a number of pressured sellers who will not be able to raise the capital to pay down their over-leveraged loans when they come due and they cannot be refinanced for an equal or greater amount. This will most likely necessitate these sellers to unload assets at favorable prices. Buyers will benefit from this, especially those who can display the ability to close (e.g. having a fund like CWS') and access financing because of their track record.

Investors around the world are understandably concerned about the state of U.S. government spending and the resulting explosion in federal debt. Will this result in the crash of the U.S. dollar as we potentially inflate our way out of the problem? And will our largest foreign creditors, China, Japan, Russia, and India, lose confidence in the U.S. dollar and sell their Treasury holdings and drive interest rates through the roof? Many citizens are also fearful of a much more intrusive role for government in business through the prospect of more regulation and higher taxes.

Because there is very little new under the sun, we can obviously learn a lot from history, especially from people who demonstrated great judgment and foresight. One of my personal historical mentors in this regard is Walter Lippmann, one of our country's great journalists. He died in 1974 and was a prominent writer during World War I, The Great Depression, World War II, and the post-war Cold War world. He was very astute when it came to economic issues as well. He was an extraordinarily thoughtful person whose writings were clearly devoid of emotion, a welcome attribute given that he rarely shied away from controversial topics. Is there anything we can learn from Lippmann about the United States' increasing reliance on foreign funding, the dollar, and much greater government involvement in the

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economy? I would assert that there is. Although the U.S. economy does appear to have hit bottom, I still think the best economic model is the Great Depression and New Deal so I will quote liberally from Lippmann articles written between 1932 and 1935.

There is a lot of concern being expressed by economists, politicians, investors, and most importantly, the Chinese and Russians about the viability of the dollar as the world's reserve currency in light of unprecedented federal government deficits and borrowing. Many argue that we are at great risk having to rely on foreigners, particularly foreign governments, to fund our deficits and that when they lose confidence in the dollar and the security of U.S. Treasury instruments, they will sell or stop buying our debt and interest rates will increase dramatically. Lippmann wrote about this in 1934 and I think what he had to say is very interesting in light of today's situation. Think China when you read creditor and the United States for debtor.

Creditor Country Faces Difficulties

The very fact that a country is a creditor, is owed more money than it owes, makes it very difficult for it to receive payments from foreigners. The only way around the difficulty is to reinvest the payments abroad, to lend back to the foreign debtor what he pays. That is what England did in the nineteenth century. It is what we did in the post-war years when the debts were being paid. But if you are a creditor country and won't lend back what you receive, then your choice is between not being paid on the one hand and doing less export business on the other.

If we accept rubber and tin and whiskey as payments in kind we shall sell less cotton, wheat, tobacco, or automobiles. For only foreigners can buy from us only as much as they have dollars, plus whatever gold they have and whatever silver we will accept. And the amount of dollars they have with which to buy goods will depend upon how many dollars they receive when we buy goods and services from them, plus what we lend them.

--Walter Lippman, June 14, 1934

China and Russia (and now India as well) can talk about alternatives to the U.S. dollar or not buying U.S. Treasuries or selling U.S. Treasuries but I don't see this happening unless they want to significantly cut back on their exports to us and they are willing to buy a lot more goods and services from the United States. I do not think either country would like to see this happen, particularly China, because of the social unrest that would ensue from the massive layoffs. China is already contending with a significant reduction in its exports and increase in unemployment and I do not think it wants to see much more. My point is that it is

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in the world's best interest to manage an orderly rebalancing of the value of the dollar and global trade so that there is more consumption in China and less in the United States. A disorderly adjustment is in no one's interest and I think that the major economic players will make decisions from what is in their interest and not based on what people think should happen or is inevitable in their opinion. I think Walter Lippmann has it right and he is the wise horse I am betting on as opposed to dollar bears that see the United States devolving into currency debasement and hyperinflation.

Lippmann wrote an article that was published on December 30, 1934 just prior to President Roosevelt submitting his 1935 budget to Congress. In the article, Lippmann laid out the very real and legitimate debate going on in the country between businessmen who were worried about perpetual deficits and how that would lead to future inflation and a dollar collapse and others who were more concerned about the here and now and believed that those out of work should be taken care of. Allow me to quote liberally as I think the debate that took place then is very relevant to today.

The question which will be before the country next week when the President submits his budget to Congress is a hard question. It involves the inter-related problems of relief, unemployment and "business confidence", which means the willingness of business executives to spend money and of bankers and investors to lend money for capital goods. On this question there has been raging a passionate conflict of opinion between those who fear inflation in the future and those who are horrified by the misery of the unemployed in the present

The test of Mr. Roosevelt's statesmanship will be whether he can formulate and make intelligible to the public a program that gives confidence equally to business executives and to the unemployed. There will be some who say that it is impossible to do this. But to say that is to declare that there is an irreconcilable antagonism within the existing social order and in a spirit of defeatism to accept the premises of the doctrines of class war.

The case of the realists is that a series of large government deficits which have no visible end must lead to the destruction of the currency. As that would mean the destruction of savings, middle class incomes and real wages, it would be social catastrophe of the first order. It is no answer to this argument to show that our nation's debt, per capita or in terms of national income, is very much smaller than that of Great Britain. For the argument of the realists is that if business men and investors see no end to the deficits, their willingness to invest will be paralyzed; if they do not invest, the unemployed will not be re-employed; if unemployment continues, relief continues, 'deficits will continue. Thus a vicious circle will be set up from which they see no escape except through a destruction of the currency and a general collapse.

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No realistic estimate of the possibilities of recovery in the near future can promise that more than half the unemployed will find jobs in private industry. For given a great revival of confidence in America there will still remain a large residue of unemployment due to the less of foreign trade and unless miracles happen all over the world, that foreign trade will not quickly be restored.

It is only prudent, therefore, to assume that there will be an abnormally large number of unemployed for some time to come. The realists say that the best policy is to feed them as cheaply as possible and then to let them wait for full recovery. Is this a truly realistic policy? Let us pass over the social dangers, the deterioration of men in idleness, the effect on their children or being brought up in a household supported by a dole, the recruiting of these men for lawless or revolutionary movements. Let us ignore the lessons of experience, past and contemporary, as to the peril to a state when it has within it a large mass of able-bodied, disinherited men.

Lippmann ends up siding with the camp that the deficit is a long-term issue but far superseded by the problems of the day. He asks,

What good will it do us to balance the Federal budget if that involves a policy which keeps the national economy unbalanced? Balanced budgets are highly desirable. But they existed in the pre-depression years. And they did not save us. Why? Because the economic system was out of balance at several different points and this imbalance finally destroyed the budgetary balance in all the leading countries.

In an even more fascinating article published on January 9, 1935 after Roosevelt's budget was submitted to Congress, Lippmann summarizes the key principles that he believed were underlying the expenditure decisions. What comes through loud and clear is that the way out of the deficit is through economic growth and that this is no time to stop federal spending because there are far too many unemployed Americans. Once again, I think this has tremendous relevance to today. I have not studied the Obama admistration's policies with the degree of depth that would allow me to assess what its core principles are. On the other hand, I have felt that President Obama has been taking a page out of the FDR playbook after entering office so I am willing to give him the benefit of the doubt that he subscribes to the principles laid out by Lippmann when I drill down more deeply into his speeches and policies. Lippmann writes,

The heart of the matter is to be found in a passage in the budget message where the President says:

> *I am . . . submitting to the congress a budget . . . which balances except for expenditures to give work to the unemployed . . . such deficit as occurs will be due solely to this cause, and it may be expected to decline as rapidly as private industry is able to reemploy those who are now out of work.*

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Underlying this statement, which must be read, of course, in conjunction with the message, are certain implied basic principles which it may be useful to list:

1. It is the duty of the government to provide the unemployed with the opportunity to work. That is to say, there is a right to work.

2. This right is not a substitute for private employment. It is a supplement to it when private employment is lacking. Therefore, the public work should be non-competitive with private enterprise; the wages paid on it should be fixed at a point which is above what men must have to live but below the ordinary wages of private employment.

3. The supplementary public work should be paid for not out of taxes but out of borrowing. For when private industry is not employing the unemployed and is not drawing upon idle capital, the government can safely and should, as a matter of policy, use capital that would otherwise be idle.

4. As private industry absorbs the unemployed, public work should diminish. As private industry draws upon the capital market, government borrowing should diminish. Thus the budget should come into balance when private industry is in balance.

5. Since the balancing of the budget is made dependent upon the revival of business, it becomes the duty of the government to reject policies which obstruct revival and to adopt policies which promote it. This involves a refusal to raise the costs of production before profits are earned, and therefore a refusal to encourage monopolistic prices, monopolistic wages, and the monopolistic restriction of output. That means drastic revision of NRA and serious reconsideration of many aspects of the AAA. It involves an administration and interpretation of the securities act which will not merely stop abuses but will positively promote refunding and new financing. It involves the abandonment of merely punitive and terroristic attacks on private business and banking in favor of direct regulation of specific evils.

6. Since the policy calls for a deliberate use of government expenditure to put unemployed labor and capital to work, its execution requires unified executive initiative and control in the whole realm of expenditure, taxation, and borrowing. Therefore, it is necessary to resist all proposals to disorganize the policy by prepayment of the bonus, the Townsend plan, printing of greenbacks, and the like.

Hindsight proved that devaluing the dollar and large government involvement in getting people back to work, although not as successful as the Roosevelt administration would have liked, did generate extraordinary economic growth between 1933 and 1937. It was only when the Federal Reserve got very nervous about all the excess reserves in the banking system (something that is present today) and began tightening credit, that the economic recovery was stopped in its tracks. I do not see the Fed repeating the same mistake and,

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therefore, we will see continued Federal Reserve involvement in the financial markets and short-term interest rates remaining low for the foreseeable future. I am also in the Walter Lippmann camp that the best cure for our deficit is greater economic growth and I do not see this occurring without government involvement in getting more people back to work. Therefore, we will continue to see large deficits and an orderly decline of the U.S. dollar because this will help our export sectors, although it will be accompanied by periodic, nervous statements about the U.S. embarking on a reckless path of dollar devaluation, socialism, and hyperinflation by investors and foreign governments.

Whether these beliefs will turn out to be wise or not, only time will tell. One can never know if economic growth would have been stronger and more durable without such large deficits and government spending. On the other hand, we should have objective evidence as to whether our country will have suffered from painful bouts of inflation and whether the dollar depreciated in a way that caused us long-term economic harm. Although inflation is beneficial for real estate, I believe we will all be more prosperous if it is held in check in a way that results in more people being employed and greater economic growth. This too, is good for real estate, and is the scenario that I am betting on, despite being in the distinct minority.