Volume 27, No. 2, July 26, 2013

QUARTERLY UPDATE
CWS CAPITAL PARTNERS LLC

CWS Capital Partners LLC

CWS

CALENDAR OF EVENTS

Monday, September 2, 2013
Labor Day
CWS Offices Closed

October 15, 2013
3rd Quarter 2013 Estimated Tax Payment Due

Friday, October 25, 2013
3rd Quarter 2013 Quarterly Packages Mailed

November 2013
CWS Capital Partners
Semi-Annual Conference Call

Thursday, November 28, 2013
Thanksgiving Day
CWS Offices Closed

Friday, November 29, 2013
Day after Thanksgiving
CWS Offices Closed

Tuesday, December 24, 2013
Christmas Eve
CWS Offices Closed

Wednesday, December 25, 2013
Christmas Day
CWS Offices Closed

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Shoot First, Ask Questions Later or Read my Lips: Stay the Course

By Gary Carmell

We had people over recently and I was distressed to pull a bottle of wine out of the wine cooler to find that it was not very cool. I impatiently tried to fix the problem by putting it in the freezer on top of the ice bucket to expedite the cooling. It was a brilliantly executed plan until it turned out we didn't need to serve that bottle of wine, and I forgot it was in the freezer. The next day I opened the freezer to discover the cork had blown off and the wine had frozen. I was much more surprised and intrigued by the events that resulted in the cork blowing off on its own accord then I was about a good bottle of wine going to waste because of my absent-mindedness. This incident is a good metaphor for what has happened in the financial markets since May 22, 2013 when Ben Bernanke testified in front of Congress and mentioned a possible timeline for tapering the Federal Reserve's $85 billion per month bond purchases. I was stunned by how aggressively the markets reacted, leaving virtually no asset class unscathed. It was the equivalent of investors complacently sitting back after making big bets on continued Federal Reserve accommodation only to open the freezer to see the cork had blown off the wine bottle. The inevitable expansion of the water molecules leading to a ruined bottle of wine had ensued.

From a CWS perspective, I try to keep it simple in terms of assessing the outlook for our investments by assessing the outlook for two variables:

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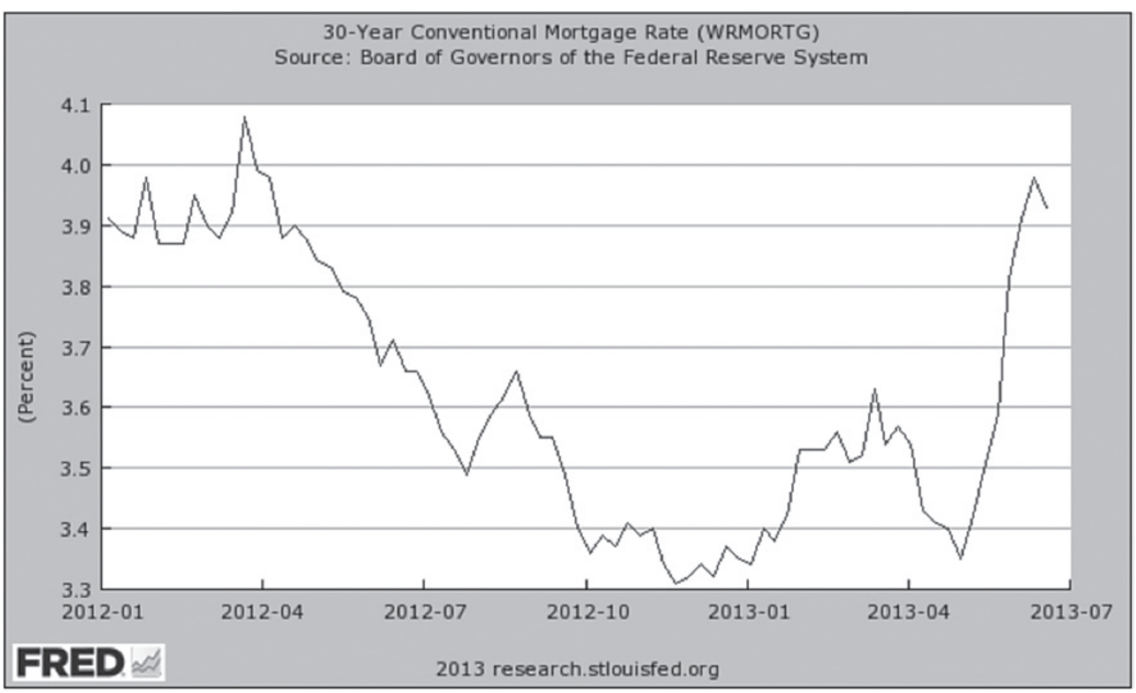
Net Operating Income (NOI) and cost of capital. Having perfect foresight for both can allow us to accurately assess our future cash flows and the multiple applied to those operating earnings to determine whether our property values will continue to grow or are at risk of shrinking. The multiple paid by investors is heavily influenced by borrowing costs which are a function of risk-free Treasury yields and the premium lenders require over those yields to compensate them for parting with their money for a defined period of time. The bulk of this article will focus on our cost of capital but I will quickly address our outlook for NOI.

We are still seeing healthy rent increases across the portfolio, particularly in Houston. This is offset somewhat by very aggressive initial assessments from the taxing authorities in the various counties in Texas that may result in significant increases in property taxes. We will fight these aggressively but this is our biggest risk to our 2013 budgets. Nevertheless, we are still pleased with the direction and strength of our markets. While the single-family market is improving, we believe this is a healthy development as it will produce more jobs yet not take away demand from apartments since we believe there are far too few homes and apartments being built for the demand. For example, demographic and economic factors lead analysts at PIMCO to believe that there should be annual household formations in the 1.5 million range[1] while we are producing less than one million new homes and apartments. We believe that apartments can co-exist and prosper with an improving single-family housing market that is currently under-supplied.

Let's turn to the cost of capital. Borrowing rates for fixed rate loans have gone up quite significantly in a very short period of time. This has impacted both home mortgage rates and the cost of debt for apartment borrowers. The graph below shows what has happened to home mortgage rates.

It's been estimated that over $1 trillion was lost globally after Ben Bernanke held his press conference on June 19, 2013. Virtually every asset class got clobbered, especially those that were benefiting from future inflation like gold, silver, and Treasury Inflation Protected Securities (TIPS). Here is what happened to gold prices.



1. Hold Your Houses: The Housing Recovery May Take Longer Than You Think to Reach Consumers, http://www.pimco.com/EN/Insights/Pages/Hold-Your-Houses-The-Housing-Recovery-May-Take-Longer-Than-You-Think-To-Reach-Consumers.aspx

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This is what we care about, short-term interest rates, as we have many loans that are tied to 30-day Libor and if Libor rises, then our payments increase as well. Although we have utilized variable rate debt since 2003, we have been much more aggressive borrowers of variable rate loans since 2011. This is what Libor has done since 2011:

It has fluctuated between approximately 0.18% and 0.30% over the last two and a half years and has even dropped a bit during the chaotic period starting on May 22 through the end of June.

So what happened? To me it is very simple. There were too many investors who were too leveraged and had no margin of safety to think carefully about what Bernanke said. They had to get to the exits before everyone

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else because someone yelled fire in a crowded theater. There had been Fed officials lamenting about there being too much loose credit and frothiness in the capital markets. I believe that it was Bernanke's goal to reintroduce some fear into the psyche of market participants so they know that the road to profits is not a one way, risk-free bet, riding on the coattails of an accommodating Federal Reserve that is trying to improve the lot of Main Street. It's OK if Wall Street makes some money in an effort to help Main Street, but it is not a license to print money.

Sometimes it's important to read carefully what people say and take them at their word. In extreme situations this can save a person's life as it probably did for management guru Peter Drucker who left Germany far earlier than most. This is from a Business Week article about Drucker:

> At the age of 18, Drucker trekked to Germany to become a journalist at a large Frankfurt daily. As a young journalist, he opposed the Nazis, understanding the threat that Hitler posed. "I can claim to have been one of the very first ones who saw Hitler as a real danger," Drucker tells Witty. "I was simply scared. I had read Mein Kampf, which no educated person was willing to read. I realized that Hitler meant every word of it."

Ben Bernanke held a press conference on June 19, 2013. That press conference expedited the avalanche that was beginning to formulate on May 22. It was here that Bernanke went into more detail about the conditions upon which the Fed would start slowing down its $85 billion per month purchases of Treasuries ($45 billion) and mortgage-backed securities ($40 billion). I went back and read the transcript. It's important to know that I am not reading it from the perspective of a highly leveraged hedge fund manager who has very little margin of safety to withstand a relatively small paper loss in the assets he has invested in with a large amount of borrowed dollars. Rather, it's from the context of an investor who has borrowed money based on 30-day Libor which generally moves up and down with changes in the federal funds rate. In addition, our loans are not subjected to margin calls and the money we borrowed was invested in assets with generally growing income streams. Thus, all I care about is the outlook for short-term interest rates: What will cause the Fed to increase them and when? What follows are very heavily excerpted portions of Bernanke's press conference. I am focused on what he is saying and taking him at his word. My conclusion remains the same: short-term interest rates will remain low for at least through 2015. I have added my interpretation and comments in bold underneath some of the paragraphs:

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Let me turn now to current policy issues. With unemployment still elevated and inflation below the Committee's longer-run objective, the Committee is continuing its highly accommodative policies. As you know, in normal times, the Committee eases monetary policy by lowering the target for the short-term policy interest rate, the federal funds rate. However, the target range for the federal funds rate, currently at 0 to ¼ percent, cannot meaningfully be reduced further. Thus, we are providing policy accommodation through two alternative methods: first, by communicating to the public the Committee's plans for setting the federal funds rate target over the medium term, and, second, by purchasing and holding Treasury securities and agency mortgage-backed securities.

It's important to make the distinction between what the Fed does with short-term interest rates via the federal funds rate and making its policy even more highly accommodative via its purchases of Treasuries and mortgage-backed securities. They are not one and the same.

Let me discuss a few key points regarding each of these two policy tools.

First, today the Committee reaffirmed its expectation that the current exceptionally low range for the funds rate will be appropriate at least as long as the unemployment rate remains above 6½ percent so long as inflation and inflation expectations remain well behaved in the senses described in the FOMC statement. As I have noted frequently, the phrase "at least as long" in the Committee's interest rate guidance is important. The economic conditions we have set out as preceding any future rate increase are thresholds, not triggers. For example, assuming that inflation is near our objective at that time, as expected, a decline in the unemployment rate to 6½ percent would not lead automatically to an increase in the federal funds rate target, but rather would indicate only that it was appropriate for the Committee to consider whether the broader economic outlook justified such an increase.

6.5% unemployment rate and 2.5% inflation are thresholds, not triggers. Even if these two criteria are met, this does not mean the Fed will raise its federal funds target. In fact, Bernanke is not even sure that 6.5% is a low enough unemployment rate as will be shown later.

All else equal, the more subdued the outlook for inflation at that time, the more patient the Committee would likely be in making that assessment.

In my opinion investors have underestimated the inflation component of the two thresholds. As the graph below shows, inflation is at a greater risk of falling far short of the 2.5% threshold than exceeding it. The Fed's preferred inflation indicator is the Personal Consumption Expenditures Index excluding food and energy. The graph, on page 6, shows how it is running not only less than the Fed's 2.0% minimum target and back to levels last seen in the 1960s, but less than the 2.5% threshold for it to begin considering raising short term interest rates.

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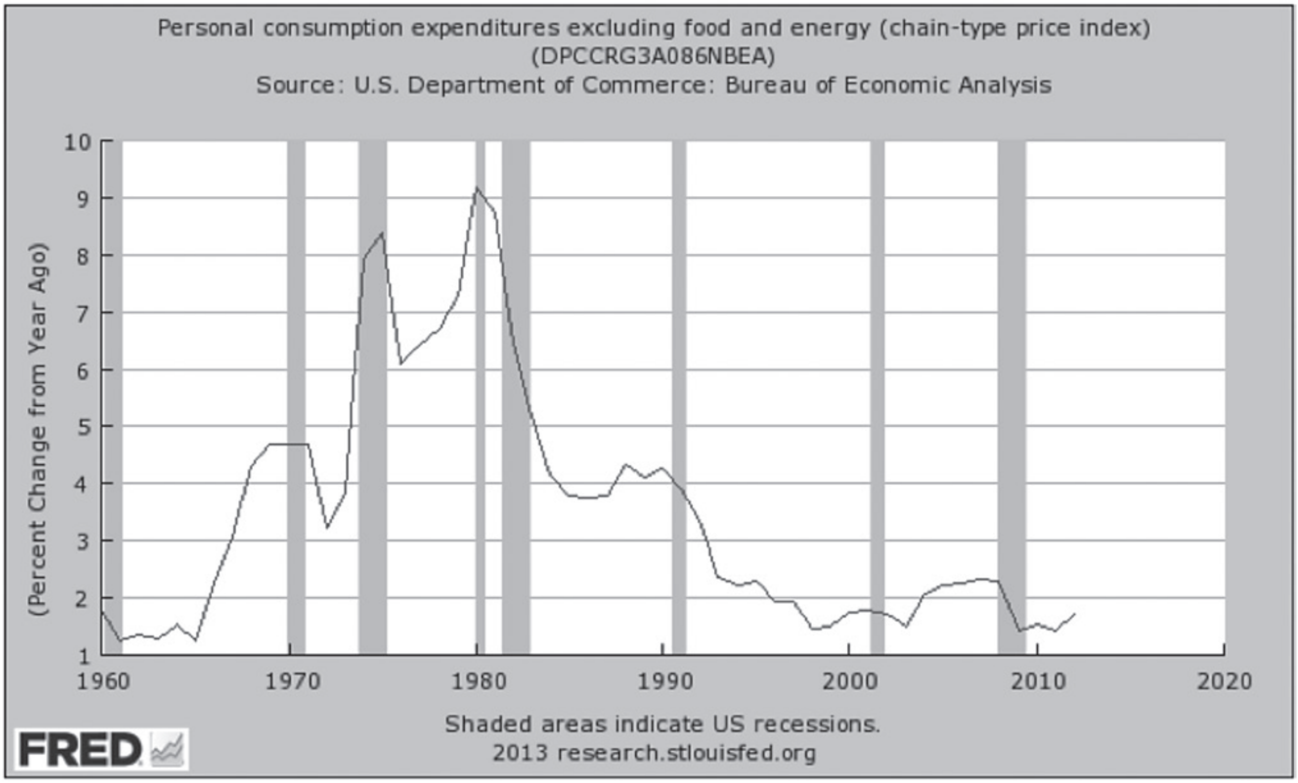

The purpose of this forward guidance about policy is to assure households and businesses that monetary policy will continue to support the recovery even as the pace of economic growth and job creation picks up. Importantly, as our statement notes, the Committee expects a considerable interval of time to pass between when the Committee will cease adding accommodation through asset purchases and the time when the Committee will begin to reduce accommodation by moving the federal funds rate target toward more normal levels.

This distinction is vitally important. The Fed expects a considerable amount of time to pass between when it stops adding to its balance sheet and when it raises short-term interest rates.

If the incoming data are broadly consistent with this forecast, the Committee currently anticipates that it would be appropriate to moderate the monthly pace of purchases later this year. And if the subsequent data remain broadly aligned with our current expectations for the economy, we would continue to reduce the pace of purchases in measured steps through the first half of next year, ending purchases around midyear. In this scenario, when asset purchases ultimately come to an end, the unemployment rate would likely be in the vicinity of 7 percent, with solid economic growth supporting further job gains, a substantial improvement from the 8.1 percent unemployment rate that prevailed when the Committee announced this program.

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The world is now on notice that it's not QE Forever. There is certain forward momentum with regard to improving unemployment that would lead the Fed to slow down its balance sheet growth and eventually stop it altogether. This is admittedly tricky since the Fed has been overoptimistic in its growth forecast and it will begin curtailing securities purchases based on an improving labor market that may not materialize in the way it is projecting. This does give the Fed latitude to adjust its purchases up or down based on the trajectory.

> I would like to emphasize once more the point that our policy is in no way predetermined and will depend on the incoming data and the evolution of the outlook as well as on the cumulative progress toward our objectives. If conditions improve faster than expected, the pace of asset purchases could be reduced somewhat more quickly. If the outlook becomes less favorable, on the other hand, or if financial conditions are judged to be inconsistent with further progress in the labor markets, reductions in the pace of purchases could be delayed. Indeed, should it be needed, the Committee would be prepared to employ all of its tools, including an increase in the pace of purchases for a time, to promote a return to maximum employment in a context of price stability.

This supports the point I just made that there is inherent flexibility in the Fed's approach to expanding its balance sheet.

> It's also worth noting here that, even if a modest reduction in the pace of asset purchases occurs, we would not be shrinking the Federal Reserve's portfolio of securities, but only slowing the pace at which we are adding to the portfolio while continuing to reinvest principal payments and proceeds from maturing holdings as well. These large and growing holdings will continue to put downward pressure on longer-term interest rates. To use the analogy of driving an automobile, any slowing in the pace of purchases will be akin to letting up a bit on the gas pedal as the car picks up speed, not to beginning to apply the brakes.

Take a chill pill everybody. I know people will freak out that we are going to tighten, but that interpretation is only for you highly leveraged, scared investors who have no margin of safety. For those of you who are healthier psychologically and financially, we are just slowing our growth a bit and not stopping it for at least another year.

> I will close by drawing again the important distinction between the Committee's decisions about adjusting the pace of asset purchases and its forward guidance regarding the target for the federal funds rate. As I mentioned, the current level of the federal funds rate target is likely to remain appropriate for a considerable period after asset purchases are concluded. To return to the driving analogy, if the incoming data support the view that the economy is able to sustain a

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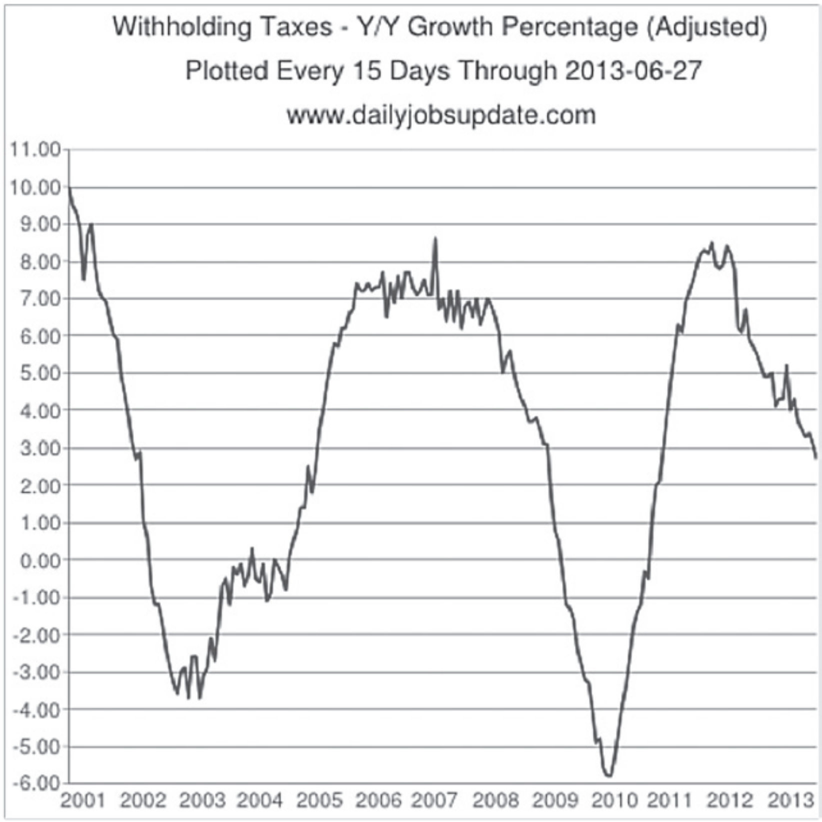
reasonable cruising speed, we will ease the pressure on the accelerator by gradually reducing the pace of purchases. However, any need to consider applying the brakes by raising short-term rates is still far in the future. In any case, no matter how conditions may evolve, the Federal Reserve remains committed to fostering substantial improvement in the outlook for the labor market in a context of price stability.



All I needed to read was "any need to consider applying the brakes by raising short-term rates is still far in the future." I'm still happy to be a variable rate borrower given this statement, especially given how much fixed interest rates have risen (approximately 1%) while our variable interest costs have even dropped ever so slightly with the modest drop in Libor.

Interestingly, it looks like we're seeing some decelerating momentum in the labor market if withholding taxes are any indication. The chart above plots the annual growth rate in withholding taxes adjusted for the one-time increase in census workers and the payroll tax cut and reinstatement. This seems more consistent with my more subdued unemployment forecast that I published in October 2012 versus the Fed's more optimistic outlook.

Finally, there were a couple of interesting responses by Mr. Bernanke during the Q&A session that I have reprinted below. The first one relates to whether the 6.5% unemployment threshold is too high.

CRAIG TORRES. The forecast and the mysterious dots kind of don't map into the unemployment forecast. We see more-gradual rate rise going out into time. People moving to the right, at least one

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person, on when they expect the rate to increase, and yet, unemployment's going to fall to 6.5 percent in 2014. I also note that labor force participation isn't in that great shape, and you, in fact, have been a big believer that a lot of the exit from the workforce is related to weak demand, not structural factors. So here is my question. Can you explain a little bit more—you know—maybe is the threshold too high? And I'll point out that the Vice Chair and two other people who used to work here have done significant research on, maybe you need to let the employment rate fall much lower to pull these people back into the labor force. So I'm wondering if you can expand on that.

CHAIRMAN BERNANKE. Well, it's a great question and—but the—what you pointed out, the difference between the little dots and the forecast actually illustrates the point, which is, remember, the 6½ percent is a threshold, not a trigger. In other words, when we get to that point, we will then at that point begin to, you know, look at whether an increase in rates is appropriate, and among the things we would take into account, first of all, is inflation, and inflation obviously is very low and expected to stay low. Secondly, we would be taking into account, does that unemployment rate fairly represent in some sense the state of the labor market? And, as you pointed out, we have underemployment, part-time work, people leaving the labor force, reduced participation, long-term unemployment, a number of factors which suggest that maybe the 6.5 percent is a little bit—not exactly representative of the state of the labor market at that point. So, first of all, since it is a threshold and not a trigger, we're entirely free to take all that into account before we begin the process of raising rates, and that's **what the diagram suggests. People are saying that unemployment will be at 6.5 in late 2014 or early 2015, but they're saying that increases in rates may not follow but several quarters after that. In terms of adjusting the threshold, I think that's something that might happen. If it did happen, it would be to lower it, I'm sure, not to raise it. (Emphasis mine)**

If anything the threshold unemployment rate to begin considering raising rates will be less than 6.5%, not higher.

Another reporter asked what "substantial" improvement in the labor market means. Here is Bernanke's response:

CHAIRMAN BERNANKE. Well, "substantial" is in the eye of the beholder. I think going from 8.1 percent and a stagnant rate of improvement to 7 percent and stronger economic growth is a substantial increase. I think it's important to explain that, you know, we view ourselves as having two tools. One of them is rate policy, and that includes both setting the rate and providing guidance about future rates. That's our basic tool, that's the one that the Federal Reserve and other central banks have used forever. Asset purchases are a different kind of thing. They're

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> unconventional policy, they come with certain risks and certain uncertainties that are not necessarily associated with rate policy. So our intent from the beginning, as I've been very clear, was to use asset purchases as a way of achieving some near-term momentum to get the economy moving forward into a sustainable recovery. And then, essentially, to allow the low interest rate policy which—to carry us through. So what I—so let me just make two, I think, very important points. The first is, our target is not 7, it's not 6½, our target is maximum employment, which, according to our projections, most people on the Committee think is somewhere between 5 and 6 percent unemployment, and that's where we're trying to get to. The 7, the 6½—these are guide posts that tell you how we're going to be shifting the mix of our tools as we try to land this ship on a, you know, on a—in a smooth way onto the aircraft carrier. (Emphasis mine) The—sorry. So, the other thing I wanted to say was that stopping asset purchases, when that happens, and I think we're still some distance from that happening, but when that happens, that won't involve ending the stimulus from asset purchases because we're going to hold on to that portfolio. And if the stock theory of the portfolio is correct, which we believe it is, holding all of those securities off of the market and reinvesting and still keeping the, you know, rolling-over maturing securities, will still continue to put downward pressure on interest rates. And so, between our commitments to a low federal funds rate and the large portfolio, we will still be producing a very large amount of stimulus—in our view, enough to bring the economy smoothly towards full employment without incurring unnecessary costs or risks.

I have nothing else to add when the chairman has said everything we need to know about when short-term interest rates are going to rise. Fortunately we are in a position to take the time to listen carefully to what he has to say and not be forced to act reflectively. We remain bullish on our apartments as they should continue to benefit from household formations in excess of new supply and short-term interest rates remaining low at least through 2015. Stay the course.