Volume 23, No. 4, January 29, 2010

Quarterly Update

CWS Capital Partners LLC

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CWS

CALENDAR OF EVENTS

Prior to March 1, 2010
K-1's Mailed

April 2, 2010
Good Friday, CWS Office Closed

April 6, 2010
CWS Annual Partners Meeting

April 15, 2010
2009 Tax Filing Deadline

April 15, 2010
1st Quarter 2010 Estimated Tax Payments Due

April 30, 2010
1st Quarter 2010 Quarterlies Mailed

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A Year of Hope and Transition

By Gary Carmell

"Well now, everything dies, baby,
that's a fact
But maybe everything that dies
someday comes back"
Bruce Springsteen, "Atlantic City"

This article continues in the mode of the relatively optimistic ones I have been writing for a little over a year. The one difference, however, is my New Year's resolution of greater brevity (is that an oxymoron? I probably shouldn't have written that because it will make this article longer than it needs to be). Like virtually every business in this economy, except for perhaps pawn shops, CWS has accomplished significant belt tightening. With the latest round of cost reductions we anticipate that our 2010 corporate expenses will be approximately 22% less than they were two years ago. Fortunately, however, we have been able to redeploy resources to supplement our talented property management team with an equally capable asset management team (we call them Investment Managers). We will provide much more of the nuts and bolts of these changes in our Annual Investor Report. Since we have all been asked to make some sacrifices to the greater good, I am no exception. While we are very proud of our Quarterly Update, I was told that if my articles could be more concise, then I would be doing my part to help the cause. As a result, this is lucky for you, too bad for me.

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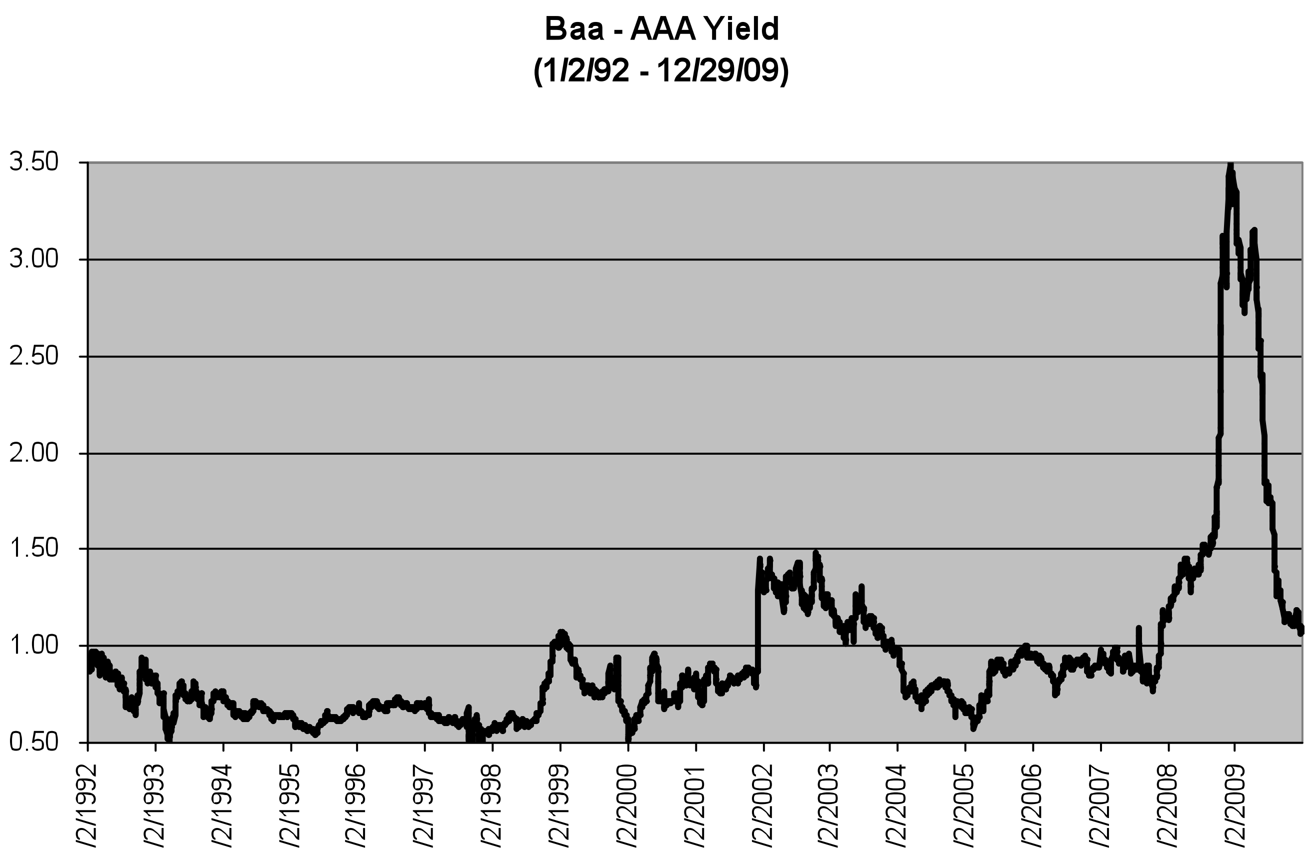
So why did I include the Bruce Springsteen lyrics at the beginning of this article? Nothing is permanent, good or bad. What is good today may sow the seeds of what is bad tomorrow and vice versa. We have been through extraordinary events in the past two years with Bear Stearns, AIG, Lehman Brothers, Citigroup and Bank of America bailouts, and the effective nationalizations of Fannie Mae and Freddie Mac, just to name the most monumental of the problems. And Ben Bernanke thought the subprime problem would be "contained." We have had our financial crash. This is now dead. The operative word is "now" because someday we will forget the lessons we learned and we'll make the same mistakes again. We are in the recovery mode. Clearly the stock market believes this as it is up 60% from its March lows. I use two indicators to help me assess whether I should be concerned or optimistic. Admittedly they're blunt instruments but they help me cut through the clutter. One I've used before in my writings while the second one is new. The first one is more real time and volatile while the second is more directional and long-term in nature.

The first chart is the yield differential between two types of corporate bonds, Baa rated bonds and AAA rated bonds. When the spread is low then investors do not perceive much risk between riskier companies (Baa rated) and far less risky ones (AAA rated). This implies risk seeking behavior and tends to sow the seeds of a future downturn as capital becomes too easy to access and poor lending decisions are made based on projections that are too rosy. When the spread is high the opposite situation prevails. Investors are fleeing risk and capital is hard to access. This tends to plant the seeds of a future recovery as rationed capital requires companies to become more efficient and profitable. Once the market believes the recovery is taking hold as firms produce more profits, then capital begins to loosen up which allows for future expansion and hiring. So what is the chart showing?



Source: http://research.stlouisfed.org/fred2/

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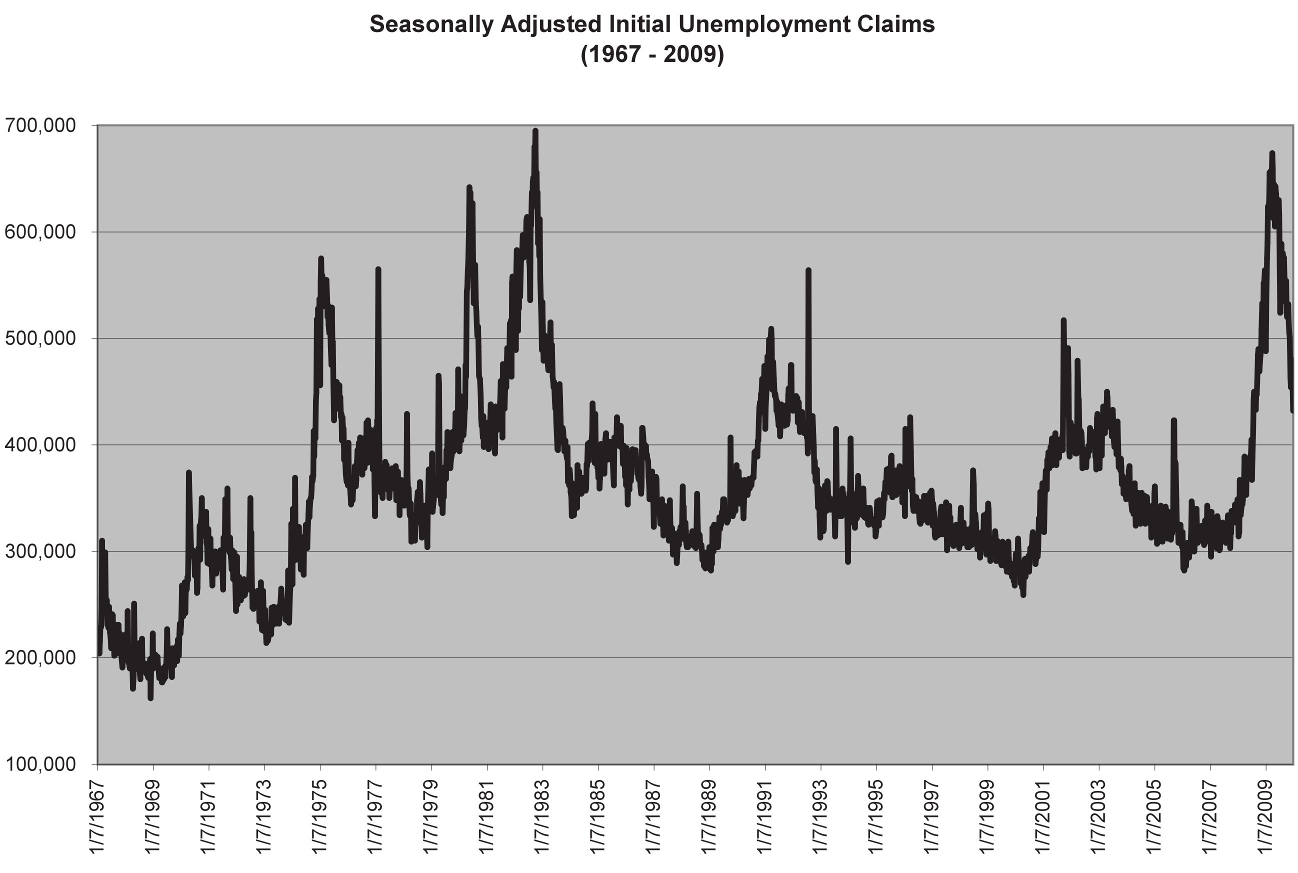
After an unprecedented spike in the yield spread only paralleled by what happened in the Great Depression, we have seen a remarkable contraction that has fueled one of the greatest junk bond rallies in history. This has enabled lower rated companies to issue new debt and avoid what was projected to be imminent default and/or bankruptcy. Despite the incredible drop from a 3.50% spread in early December 2008 (interestingly we made only one acquisition in 2008 and that was in December) to 1.07% as of December 29, 2009, the current spread is still higher than the 0.50% to 1.00% typical average. It is conceivable that it could continue to drop. Because this indicator changes daily it can obviously be quite volatile and subject to directional changes without any kind of warning. Nevertheless, this indicator is still positive from my perspective.

The second indicator I use is the level of initial unemployment claims (seasonally adjusted). The government tracks the number of people who file for unemployment for the first time. It turns out that this is a very good indicator of turns in the economy and, correspondingly, market inflection points as well. It's less accurate from a market perspective than an economic one which is because it is a very good directional gauge of where things are headed since it doesn't fluctuate that much from a trend perspective. Here is the chart:



Source: http://research.stlouisfed.org/fred2/

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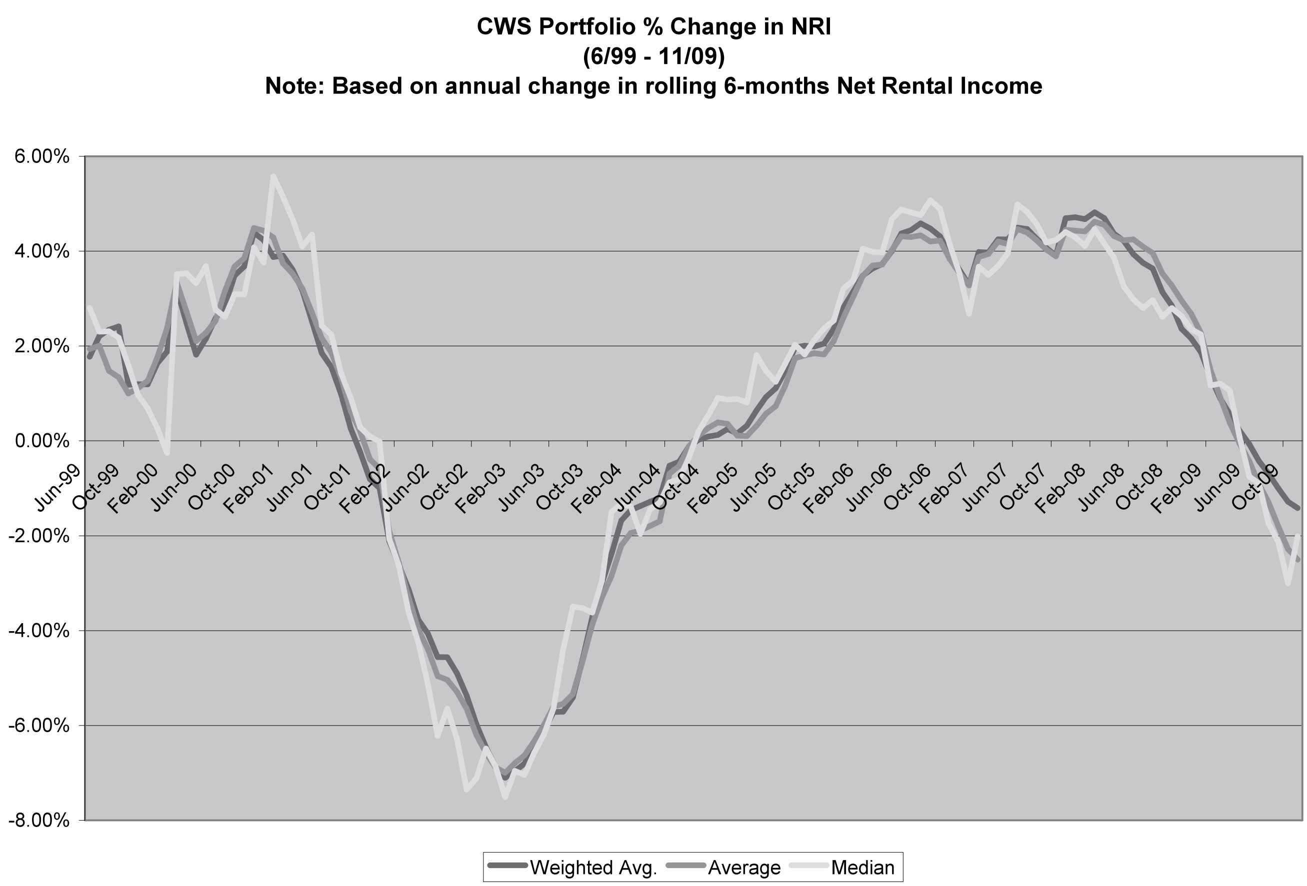
I have a very simple way of using this information. When the level of initial unemployment claims drops to 300,000 or less then I get very nervous and think seriously about becoming more defensive from an investment standpoint. At this time the economy is growing consistently, optimism is high, assets are priced for perfection, and very few people can see clouds on the horizon. We sold a large number of assets in 2007 and this turned out to be good timing. Conversely, when claims approach or exceed 500,000 the opposite conditions tend to prevail: pessimism, cheap asset prices, weak economy and scarce capital. These are all conditions that tend to make the risk-reward ratio much more favorable for investors.

The worst bear markets and best bull markets all followed this trend of reaching a peak when the claims were in the 300,000 range and bottoming out when they approached or exceeded 500,000. These include the bear markets of 1973-4, 1981-2, 1990, 2000-2, and 2007-9. Even the October 1987 crash occurred after claims dropped to less than 300,000. On the other hand, the major bull markets began after claims breached 500,000. Interestingly, the peak claims in this latest cycle occurred on March 28, 2009, within weeks of the bear market bottom of March 9. With claims of 432,000 as of December 26, 2009, they are still elevated from a historical standpoint but far below the peak and clearly on a downtrend.

Economically we should continue to see growth in 2010 with job losses turning to growth in the first quarter. The headwinds from stimulus withdrawal for housing and the Fed's purchase of mortgage-backed securities stopping in March 2010 should make this recovery anything but robust. From a CWS standpoint we anticipate 2010 to be a bottoming process for us from a rent collection standpoint. The chart below shows the



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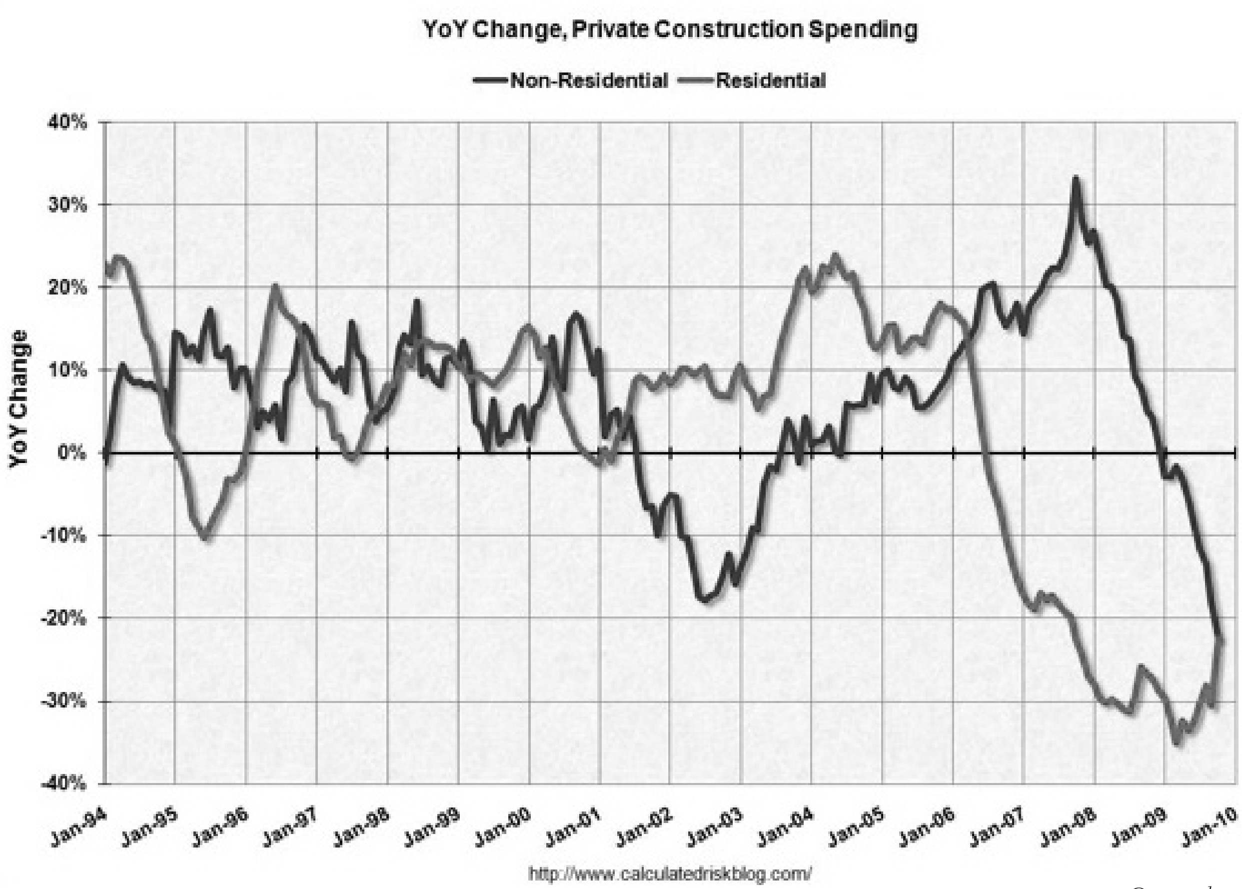
annual percentage change in our portfolio net rental income for the last ten years. It shows three different measurements: average (simple average of all the properties' performances), weighted average (average adjusted for larger properties having more weight than smaller ones), and median (the percentage in which 50% of the properties are above and 50% are below).

Although we have been experiencing a contraction in our rental income since June 2009, the deceleration is far less extreme at this point than it was in the last downturn in 2001-4. We do think that 2010 will continue to see pressure on rents because the economy is still weak with high levels of unemployment and the completion of the last wave of development in some of our markets. We have also been experiencing a large gap between the rents we are able to attain from new residents filling vacant units and those we can obtain from current residents renewing their leases. In some cases the differential can exceed 10%. Our goal is to do all we can to renew our current residents and lower our turnover rate in this economy. People looking for new apartments are very savvy and do a great job of negotiating and holding out for the best deal while current residents tend to value their living experience with us and do not want to incur the expense and hassle of moving. On the other hand, development is coming to a screeching halt (see the chart below which is for all non-housing related construction, but inclusive of apartments), the homebuyer tax credit goes away in April, and the Fed's announcement that it will stop purchasing mortgage-backed securities should result in higher mortgage rates (rates are already up approximately 0.50% from their low). Once jobs start growing more rapidly, then apartment owners should be faced with a much greater wave of demand in the face of relatively no new supply. Similar to the discussion about the structural changes we have made at CWS, we



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will discuss our operational strategy and performance in greater detail in our Annual Investor Report due out in April 2010.

In summary, my two key indicators continue to show growth ahead in 2010. The apartment market will probably lag the recovery somewhat since we tend to go down later. Our leases average approximately 11 months, so re-pricing of rents is somewhat delayed and, correspondingly, we don't immediately capture the upside when the economy does turn. 2010 should be a transition to a much more improved outlook in 2011 through 2013.

How is that for brevity?