Volume 30, No. 2, July 29, 2016

Quarterly Update

CWS Capital Partners LLC

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CWS

CALENDAR OF EVENTS

September 5, 2016
Labor Day
CWS Offices Closed

September 15, 2016
3rd Quarter 2016
Est. Tax Payments Due

October 17, 2016
2015 Personal Income Tax Return
Extensions Due

October 28, 2016
3rd Quarter 2016
Quarterly Packages Mailed

November 2016
CWS Capital Partners
Semi-Annual Conference Call

November 24, 2016
Thanksgiving Day
CWS Offices Closed

November 25, 2016
Day-after Thanksgiving
CWS Offices Closed

December 26, 2016
Christmas (observed)
CWS Offices Closed

www.cwscapital.com

$50 Million and Counting

By Gary Carmell

Since late 2011 I have been tracking how the cost of our variable-rate loans have compared to the fixed-rate options we could have chosen at the time of origination. The results have been very favorable. As of July 1st we have saved over $50 million dollars in interest for those loans in which we had the option of choosing a fixed or variable interest rate structure. This actually understates the savings because, for example, when we completed our 18 property refinance in 2015, most of the loans we refinanced were already variable-rate loans. Had they been fixed-rate loans we could not have included them in the refinance unless they were close to maturity since the pre-payment penalties would have been too high. As a result, the most accurate comparison would have been to compare the new variable-rate loan with the original, hypothetical fixed-rate loan since those still would have been in place. I chose not to do this and instead updated the fixed-rate loans to the lower-cost ones that were available at the time of refinance. This would have added over $5 million more in savings in my estimation.

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Despite the tremendous benefit to date in terms of higher cash flow as a result of the lower interest rates from having variable-rate loans, an even greater benefit has come from much lower pre-payment penalties that allow us to refinance or sell with very little cost when we believe the timing for either action is optimal. This is not just a theoretical point as we have sold a number of properties over the last couple of years with variable-rate loans which allowed us to earn a much higher return for our investors since we did not have to divert a meaningful amount of sale proceeds to paying a pre-payment penalty or having to reduce our price to compensate buyers for assuming our less than ideal fixed-rate loans.

I wanted to take this opportunity to quantify the impact of our financing decisions on two sales we recently consummated: Marquis of North Druid Hills in Atlanta and Marquis Shoreline in Austin. I am going to compare the total return for our investors in each scenario. The first scenario, however, which is the fixed-rate, hypothetical one, goes back and quantifies what our investors would have received had these fixed-rate loans been in place. This is applied to cash distributed during the holding period and what the sale proceeds would have been had a pre-payment penalty been paid. I only show the total proceeds distributed, rather than breaking them out by operational distributions, refinance proceeds, and sale proceeds. Some might argue that this scenario is a bit harsh in terms of factoring in a price discount since we would have required buyers to assume our loans and that the price discount would not have been as great as the pre-payment penalty. Rather than theorize as to what price we would have received, I have chosen to use these two scenarios so that readers can get a feel for the magnitude of the financial costs of having debt that creates great inflexibility.

I will start off with North Druid Hills since this is more straightforward in that we purchased the property, made distributions, and sold it at the end of May 2016. Shoreline is more complicated since it involved a refinance with a large return of capital mid-stream.

North Druid Hills

	Hypothetical Fixed-Rate Loan	Actual Variable-Rate Loan
Investment Base	$7,552,708	$7,552,708
Cumulative L.P. Proceeds	$11,105,363	$13,236,952
% of Investment	148%	176%
Internal Rate of Return	13.78%	21.15%

From the table above, one can see that there was a very meaningful difference in the total return to our investors by having the variable-rate loan in place versus a fixed-rate one. It resulted in total proceeds being approximately 28% higher relative to one's original investment and increased the annual return from 13.78% to 21.15% for the holding period that was slightly more than three years. This is a very significant return enhancement.

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Shoreline

	Hypothetical Fixed-Rate Loan	Actual Variable-Rate Loan
Investment Base	$7,484,205	$7,484,205
Cumulative L.P. Proceeds	$16,626,186	$18,426,829
% of Investment	222%	246%
Internal Rate of Return	23.91%	32.63%

Shoreline also produced a meaningful difference in the return. The variable-rate loan allowed us to generate total proceeds to our investors which were 24% higher relative to one's original investment than the fixed-rate alternative during the four-year ownership period. The IRR differential was larger here than at North Druid Hills because the refinance we carried out in 2015 allowed us to make a very large distribution which increases the IRR since it is a time-based return calculation such that dollars received earlier are more valuable than those distributed later. The fixed-rate loan would not have allowed us to carry out a refinance without incurring a large pre-payment penalty whereas we could with the variable-rate loan. This resulted in an IRR of 32.63% versus 23.91%, a differential of approximately 9% per year.

I am often asked when I would select a fixed-rate loan. Setting aside some of the benefits of HUD's 35-year fixed-rate loans with relatively manageable pre-payment penalties which I think have some strong appeal, from a purely financial standpoint I find myself hemming and hawing when asked this question. Absent some material increase in the interest rate spread we have to pay over Libor, which has happened from the absolute lows we were able to attain in March and April 2016, and can lessen the differential between fixed and variable rates, I am still variable biased because I think the conditions have not changed such that inflation and higher interest rates are a concern.

I have been saying for many years that apartments prosper from what I have called "Insecure Growth." This is the set of circumstances where the economy continues to grow, households are being formed, and yet insecurity is highly prevalent such that people are hesitant to make long-term commitments to home ownership. It also keeps interest rates at historically low levels. All of these combine to add up to a wonderful set of circumstances for apartment owners.

As I have been waiting for my 15 minutes of fame for coining such a cool phrase as "Insecure Growth," what happens? PIMCO, the investment colossus just down the street from us, came out with its new secular outlook and changed its theme from the "New Normal" to what they are now saying is the new regime of "Insecure Stability"! That sounds a little like what CWS has been saying for a few years now. We'll let them take credit while we have been profiting from it for the last few years.

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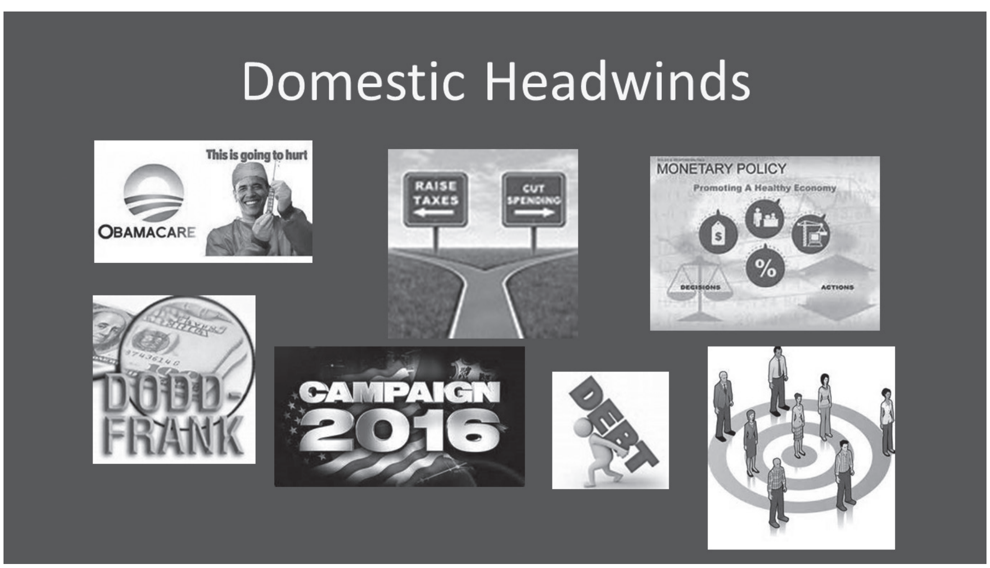
In all seriousness though, PIMCO's theme does reinforce my belief that rates should continue to stay low for many years to come. Its premise is that loose monetary policy around the world has kept economies from stalling and yet there are not enough evident sources of productivity or organic demand to support a more robust expansion. With monetary policy losing its efficacy and sustainable demand called into question, financial markets and economies are at constant risk of tipping over. It is this delicate balance that should keep rates low, particularly in the United States as it still has some of the highest interest rates in the developed world.

One of the great analogies I recently read came from investment manager Laslo Birinyi. What he described was in the context of the 2008 Lehman Brothers crisis, but it has tremendous applicability to today and is one of the reasons why I remain variable-rate centric. During the Lehman crisis everyone was waiting for the other shoe to drop and Birinyi said the following:

> *"This is a centipede. We keep waiting for the other shoe to drop and it drops and then it drops and then there's another shoe and another and another."*

This is exactly how I see the world and what it results in is risk aversion, gravitation towards the ultimate safe haven asset, U.S. Treasuries, and insecurity among business leaders, governments, central bankers, and consumers. This should continue to keep us in an environment of "Insecure Growth" which should benefit apartment owners for the foreseeable future.

To amplify this, at our annual investor meeting in April I highlighted the following domestic and international headwinds that I thought would keep interest rates low and insecurity high.



The last image is meant to convey changing demographics, particularly with the slower growing population and aging society which should lead to less consumption growth and more demand for savings.

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The second image relates to challenges within the E.U. and Germany's dominance. The fifth one relates to refugee crises around the world. The seventh one attempts to convey the perilous state of the Italian banking system while the eighth one relates to the political paralysis in Spain. The ninth shows the terrorism threat around the world, particularly in Europe.

The Matrix: A Race to Negative Bond Yields

Country	1-Year	2-Year	3-Year	4-Year	5-Year	6-Year	7-Year	8-Year	9-Year	10-Year	15-Year	20-Year	30-Year
Switzerland	-1.00	-1.04	-1.08	-1.04	-1.01	-0.92	-0.87	-0.75	-0.66	-0.61	-0.36	-0.23	-0.10
Japan	-0.34	-0.33	-0.32	-0.33	-0.35	-0.35	-0.35	-0.33	-0.30	-0.25	-0.12	0.03	0.06
Germany	-0.62	-0.67	-0.68	-0.66	-0.59	-0.56	-0.48	-0.42	-0.29	-0.16	-0.09	0.11	0.37
Netherlands		-0.61	-0.61	-0.59	-0.46	-0.43	-0.32	-0.19	-0.07	0.05			0.50
Finland	-0.63	-0.62	-0.61	-0.51	-0.46	-0.34	-0.27	-0.14	-0.05	0.10	0.35		0.52
Austria	-0.56	-0.56	-0.54	-0.52	-0.43	-0.39	-0.36	-0.30	-0.01	0.15	0.12	0.59	0.83
France	-0.57	-0.59	-0.56	-0.49	-0.39	-0.33	-0.23	-0.13	0.02	0.15	0.49	0.74	0.92
Belgium	-0.58	-0.61	-0.57	-0.55	-0.46	-0.37	-0.26	-0.11	0.05	0.19	0.53	0.60	1.03
Sweden	-0.50	-0.64		-0.53	-0.36		-0.23			0.11		1.00	
Denmark		-0.57			-0.35					0.06			0.46
Ireland	-0.39		-0.31	-0.26		-0.12	0.05	0.21	0.38	0.44	0.74		1.19
Spain	-0.27	-0.14	-0.06	0.06	0.23	0.31	0.53	0.89	1.02	1.19	1.53		2.26
Italy	-0.26	-0.08	-0.01	0.10	0.31	0.51	0.69	0.90	1.09	1.27	1.57	1.93	2.29
United States	0.43	0.57	0.67		0.95		1.21			1.39			2.16

Pension Partners
THE ATAC ROTATION MANAGER

Source: Marketwatch

Does this chart reflect a world where inflation is a concern and the U.S. will have materially higher interest rates? The dark gray boxes reflect negative interest rates by country and maturity whereas the light gray are positive rates. The United States is the only major country with positive rates throughout all maturities. As previously mentioned, with the possible exceptions of occasionally locking in 35-year fixed rates via HUD loans which admittedly look very attractive because of the long maturities and declining pre-payment penalties each year, I continue to believe that the strategy we are pursuing of focusing on variable-rate loans will continue to literally pay dividends for our investors. I am hoping that three or four years from now I will be able to say we broke through the $100 million mark in cumulative savings. Until then, let's continue to enjoy the ride on this occasionally bumpy road of "Insecure Growth."