

QUARTERLY UPDATE

CWS CAPITAL PARTNERS LLC

CWS Capital Partners LLC

CWS

CALENDAR OF EVENTS

September 6, 2010

CWS Office Closed for Labor Day

September 15, 2010

3rd Quarter 2010 Estimated Tax Payment Due

October 29, 2010

3rd Quarter 2010 Quarterly Packages Mailed

November 2010

Semi-Annual Conference Call

November 25th and 26th

CWS Office Closed for Thanksgiving Holiday

Friday, December 24, 2010

Christmas (Observed), CWS Office Closed

January 15, 2011

4th Quarter 2010 Estimated Tax Payment Due

January 28, 2011

4th Quarter 2010 Quarterly Packages Mailed



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FALLING INTO PLACE IN A KEYNESIAN WAY

By Gary Carmell

“The importance of money flows from it being a link between the present and the future.”

John Maynard Keynes



John Maynard Keynes gets a bit of a bum rap from a number of modern, free market ideologues as the father of Keynesian economics.

Those who take the time to learn more about him, however, will come to realize that he was a brilliant individual who had remarkable foresight, a keen understanding of human nature, and was a very successful investor despite being an economist. He was also an extraordinarily gifted writer with the ability to communicate very complex topics into intelligible and entertaining language. For this I will always have the utmost respect for him, knowing how difficult this can be. I digress, although Mr. Keynes will reappear periodically in this article.

If investors could answer two questions accurately, then the probability of their success would increase significantly. The first is what will the future profits of the business I am investing in be during my time horizon and the second is what will be the cost of capital

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during this same period of time? All investments are based on the cost of capital, adjusted for risk, applied to an income stream. Because it is assumed that the U.S. Treasury will always pay what it owes on time, there is no risk assigned to the U.S. Treasury defaulting. Virtually all of the risk applied to U.S. Treasury securities is related to the currency depreciating in value due to inflation and the taxes applied to those dollars received. Although Treasury securities are debt instruments, investors do not have to worry about the underlying cash flows of the U.S. government and only need to concern themselves with the future purchasing power of the dollars they receive.

All other investment vehicles, bonds, stocks, preferred stocks, real estate, venture capital, etc., do not have the same luxury. Purchasers of these investments must feel reasonably confident that the underlying businesses will have sufficient cash flow to repay its debt providers and offer its owners a compelling risk-adjusted rate of return. To have such confidence requires some understanding of the future income stream of the business. Under most circumstances this is enough information. On the other hand, if investors believe that markets are irrationally priced for whatever reason, then they may believe that they need to be compensated for the risk that the future cost of capital will be higher such that much of the gains generated by the business performance will be offset by a higher cost of money. As Keynes said, "Successful investing is anticipating the anticipations of others."

For example, in 2000, Microsoft produced close to \$12 billion in pre-tax owners' earnings (pre-tax income + depreciation – capital expenditures) and its market value was approximately \$570 billion at the peak, offering an earnings yield of approximately 2%. Today, Microsoft's owners' earnings has grown to close to \$23 billion, almost a 100% increase, while its market capitalization has dropped to approximately \$180 billion, adjusted for cash on hand, representing close to a 13% earnings yield. This is quite a change and is strong evidence that a growing, profitable business still may not be a profitable investment if the cost of capital applied to that business increases at a greater rate than the growth in its cash flow. In Microsoft's case, the multiple applied to its owners earnings dropped by approximately 86% (50x to 7x) while its owners earnings increased by approximately 90%. An investor who purchased the stock in March 2000 at the peak would have lost money over ten years later despite very healthy growth in company profitability because Microsoft continuously repurchased billions of dollars in stock that dropped in value rather than paying it out in the form of dividends.

As owners of apartments we have continuously expressed our belief that our product type is extremely well-positioned

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to produce higher rents and improved cash flows in the years ahead. Construction has slowed dramatically, demographics are very favorable as the number of people in their prime renting years will be growing, large numbers of people have moved home or doubled up, offering latent demand for when the economy recovers, mortgage financing is harder to come by, and the expiration of the homebuyer tax credit has shown that with the collapse in home buying that all it did was accelerate weak demand. Finally, with our concentration in Texas we feel particularly well-positioned for an economic recovery since Texas should grow more rapidly than the rest of the country. Since I have been writing about this for awhile I feel like a broken record and I have been waiting for some independent confirmation of this materializing. For if it didn't arrive, then I would have to re-think my hypothesis. As Keynes said to someone who pointed out that he had been wrong about an economic prediction, "When the facts change, I change my mind. What do you do, sir?" In this case, I don't believe there is a current need to change our positive outlook for apartments, particularly high quality ones in Texas as a recent article in the Dallas Morning News (7/2/10) attests. I will quote liberally from it.

Dallas-Fort Worth apartments seeing boom in leasing

08:37 AM CDT on Friday, July 2, 2010

By STEVE BROWN / The Dallas Morning News
stevebrown@dallasnews.com

Net apartment leasing in Dallas-Fort Worth topped 9,400 units in the second quarter, according to the latest estimate by analysts at MPF Research.

So far in 2010, apartment occupancy in the D-FW area has jumped by more than 15,000 units, the best performance in five years.

The jump is indisputable evidence of a comeback in North Texas' economy, analysts say.

"I don't think you can get this demand unless you are creating significant jobs," said Greg Willett, MPF Research vice president. "New households are being created at a pretty rapid pace, so apartment demand is gaining considerable momentum."

"Some of the people who had taken roommates are moving out on their own," he said, "and some people who had been renting single-family homes and condos are coming back to apartments."

Also, young renters who had moved in with their parents when the economy tanked may

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now be leaving again, he said. Some renters have sold homes and are waiting to buy.

Overall area apartment vacancy has fallen to close to 9 percent.

"Everything in the apartment market is looking significantly better," Willett said.

'Right direction'

Economists are taking notice of the strong rental market numbers.

D'Ann Petersen, a business economist at the Federal Reserve Bank of Dallas, said the latest apartment data shows that "the local economy is heading in the right direction at pretty good pace."

At the end of May, employment in the D-FW area gained 3,400 jobs from a year earlier – the first such increase since the economic crash.

The local job base may be growing even faster than that.

Employment analysts are "notorious for having to make dramatic changes in their numbers," said James Gaines, an economist with the Real Estate Center at Texas A&M University. "The

economy might be recovering more quickly and quantitatively better than the current statistics are showing."

Gaines agrees that North Texas could face an apartment shortage in some markets if current demand continues and construction remains low.

"The inventory of new apartments is going to be held down for two or three years," he said. "A year or two from now, the lack of building will make a good market for apartment owners."

Willett doesn't expect apartment construction to rebound quickly, even if the market gets tight.

"You could see development start to trickle back in late next year," he said. "Our starts in 2012 probably will be huge."

Money worries persist

Apartment builders are dusting off plans but say it's still tough to find the money to begin projects.

"We are out looking for funding on some deals now that we are trying to start" in Uptown and Las Colinas, said Tom Bakewell of Gables Residential. "The question is when will construction financing be available?"

Bakewell agrees that the apartment market has turned the corner.

"Back in January, we were still dropping our rents on lease renewals," he said. "In May, we were giving rent increases, and people were staying and taking it."

Finally, things are starting to fall into place as we're beginning to see increasing demand in the face of modest supply. Despite worries about a double dip recession (more on this later) the demand for apartments would suggest otherwise and we have found this to be one of the best real time indicators of the economy. Our hypothesis also contends that it will be difficult for developers to get money to build because it doesn't make sense to construct new apartments until rents rise materially. On average we believe that rents are still at least 20% too low to justify building. This is an educated guess and as Keynes said, "It is better to be roughly right than precisely wrong."

With accelerating demand and muted competition from new construction and home buying, the stage is set for a positive outlook for future cash flows. Now the question is what about the cost of capital? Can we be going into a situation where the positive growth that we expect to occur in our cash flow will be consumed by future purchasers of apartments paying less for a dollar of cash flow than they are paying today a la Microsoft?

Our cost of capital is largely driven by our borrowing costs which are a function of the interest rate and how much lenders will extend credit for a

dollar of cash flow. With lenders having returned to a more traditional lending standard of ensuring that borrowers have a minimum of \$1.25 to \$1.30 of Net Operating Income for every dollar of debt service (including principal and interest) and not lending more than 75% to 80% of a property's value, I don't expect these standards to get more conservative. The remaining variable is interest rates and this is a function of two main factors. The first is what will happen to Fannie Mae and Freddie Mac since they now provide approximately 80% to 90% of apartment loan dollars and their interest rates are significantly lower than those offered by Wall Street and life insurance companies, their major competitors. The second is what will happen to the cost of risk-free money (10-year U.S. Treasuries) in the face of continued massive deficits that need to be financed?

Fannie and Freddie's apartment lending, unlike their single-family business, has been stellar from a performance standpoint. They have been very knowledgeable and prudent lenders and their much lower levels of default rates are a testament to this. When this is combined with the unmistakable conclusion that our society and economy were harmed terribly by an overemphasis on home ownership and the corresponding misallocation of capital, apartments are clearly a critical component of our economy. After all, one of the hallmarks of our economy has been a flexible labor force that has mobility to go to where the jobs are. To do this requires not being tied down by an illiquid asset like a home that needs to be sold in order to move.

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Today, millions of people are unable to go to where the opportunities are and employers are unwilling to pay for their expensive moves because they have negative equity in their homes. Right now, the U.S. Treasury is "all in" with regard to Fannie and Freddie and I don't see them cutting the cord for a long time. While it is conceivable that they could spin off their apartment lending arms into private companies, I don't think this is very likely given how important their cost of capital has been to the apartment industry and the social benefits rental housing provides.

From an investor perspective there appears to be no indication that the U.S. Treasury will abandon Fannie and Freddie. For example, on June 28, 2010, Freddie Mac auctioned 6-month securities at a yield of 0.25% while yields on 6-month Treasury bills were 0.22%, representing a very slim premium of 3 basis points. Commercial paper of corporations of a similar maturity had a yield premium of approximately 31 basis points, much higher than Freddie Mac's. Recently, mortgage-backed securities issued by Fannie and Freddie traded at 15-year highs in terms of their prices which shows investor confidence in their guarantees. As an aside, we have some loans tied to the 27-day Freddie Mac reference notes. These traded at approximately 0.05% on June 27. Based on this rate, our lowest cost of debt is 1.45%.

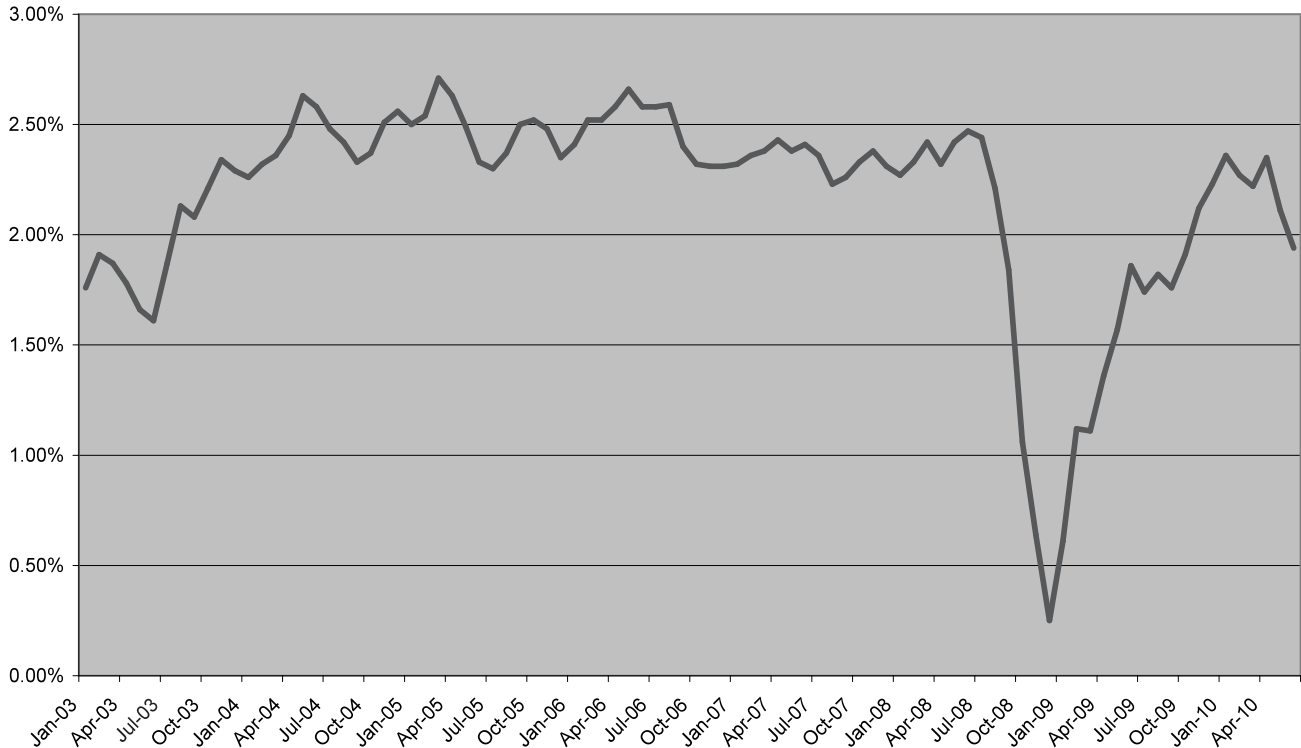
If one accepts the premise that Fannie and Freddie will still be lending on apartments based on their

current underwriting parameters and that real estate is not revalued as an asset class to offer more competitive returns to better compete with other investment opportunities, then interest rates will have the most important impact in determining whether the prices paid for a dollar of apartment cash flow will change materially.

With ten-year Treasury yields at approximately 3% as of this writing, there is skepticism that rates will stay this low given the large government deficits and the concern about future inflation. Yet, the break even inflation rate for Treasury Inflation Protected Securities (TIPs) is approximately 1.75%. If inflation turns out to be less than 1.75%, then investors who purchased Treasury securities without inflation protection would have been better off than those who did and the opposite is the case if inflation exceeds 1.75%. The chart on page 7 shows the 10-year break-even inflation rate since TIPs were introduced in 2003.

Except for the deflation/economic collapse scare in late 2008 to early 2009 with the bankruptcy of Lehman Brothers and its aftermath, the average has hovered in the 1.75% to 2.50% range with today's being at the low end of the range. Although the market turned out to underestimate inflation by approximately 0.4% per year (2.2% average break even inflation rate estimate compared to an actual average of 2.6% for the next twelve months), on average it's been a pretty good barometer of inflation trends. During this time we had a

TIPs 10-Year Break-Even Inflation Rate (1/03 - 6/10)



Source: Federal Reserve Bank of St. Louis

housing bubble, commodity price explosion, commercial real estate bull market, financial markets implosion, large deficits, manageable deficits, wars, Republicans in power, Democrats in power, etc., and yet the break even and actual inflation rates never changed that significantly except during the panic. Despite this incredible volatility, we have been able to borrow consistently on a fixed rate basis typically between 5.50% and 6.00%, although rates are lower today.

If one accepts the premise that inflation is not a major concern, then changes in yields are probably more a function of investors' beliefs about the economy's growth rate as opposed to inflation. Given all of the events we've gone through during

this 7-year period, our borrowing rate has remained in a remarkably tight range. I would assert that this will continue to be the case. Hopefully I will avoid Keynes' concern about unchanging, conservative people when he says, "I do not know which makes a man more conservative - to know nothing but the present, or nothing but the past." Clearly I'm expecting past trends to continue into the future which can be a dangerous assumption. Hopefully this conclusion will be drawn from intellectual honesty and continuous questioning of assumptions versus inertia born of laziness.

The natural concern about the viewpoint I have offered up regarding the future cost of capital relates to the enormous deficits we have been incurring.

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How can we repay all of this debt? Rather than provide a mathematical road map to emancipation from deficits and debt accumulation, I am going to take financial markets at face value and try to define what they are saying. The Treasury market is the deepest, most liquid market in the world with daily trading volume of over \$600 billion in May according to the Securities Industry and Financial Markets Association. As a result, I'm skeptical that it is prone to bubbles. I believe the market is saying that too many governments around the world, particularly in Europe, are focused incorrectly on austerity as opposed to growth. Households must deleverage and corporations are stockpiling cash due to economic and political uncertainty. Deleveraging implies a lack of demand for capital at a time when interest rates suggest there is a surplus of capital available. Commercial and industrial loans are contracting (from a peak of \$828 billion in October 2008 they have shrunk to \$599 billion in mid-June 2010), transactional money supply (MZM) has been shrinking for the last nine months, households are walking away from or restructuring mortgage debt, housing activity has virtually collapsed, and businesses do not have a need or desire to take on new debt in this environment. Market signals suggest more of a concern about very slow growth than an economy that should be worried about inflation (contrary to what apartment leasing activity would suggest). These include widening credit spreads, continuously elevated unemployment claims, a significant contraction in the growth rate of the Economic Cycle Research Institute's (ECRI) leading index, and real yields on

TIPs (less than 1.30%). Added together, the picture suggests slowing growth, a weak labor market, and investors gravitating to safety and moving away from risk.

Whether we like it or not, I believe markets are saying that this leaves governments as the best source of growth through a combination of tax cuts and/or increased spending. Investors are almost begging large sovereigns like the United States, Japan, and Germany to borrow their money to generate the growth that is necessary to repay the debt that will be accumulated during this cyclical downturn as opposed to cutting back spending and running the risk that the economic pie shrinks. Boy, do I sound like a Keynesian! Yet, I believe the facts bear this out and we have evidence from countries that have embarked on aggressive austerity programs that the markets are not rewarding their thrift. Ireland has seen its GDP contract by 8%, Estonia 14%, and Latvia by 18% since their bubbles have burst and they have cut back government spending. Rather than these actions improving investor confidence, the opposite appears to be the case as spreads on credit default swaps have widened for these countries, which suggests that investors believe the risk of default has gone up with government cutbacks. This makes sense as too much austerity has shrunk these economies. This has lowered tax receipts as unemployment has escalated and profitability diminished which has created a larger deficit despite cutbacks in spending. It can become a vicious cycle unless it is arrested. To many people this is heresy, having to rely on the government

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to get us out of this tough spot we're in. Rather than getting into a philosophical debate about the efficacy of government spending and tax cuts, my job is to view the world as dispassionately as possible and to attempt to interpret what various markets are saying to better guide our investment decisions. I try to keep an open mind because if I don't then I can make costly mistakes. Keynes said, "The biggest problem is not to let people accept new ideas, but to let them forget the old ones."

What does this all mean in general and to CWS investors in particular? I would assert that apartments are well-positioned to grow their revenues materially over the next five years and that the cost of capital will not change in a manner that would significantly revalue how much investors will pay for a dollar of cash flow. This should offer apartment owners and

investors compelling returns in the years ahead through improved cash flows and appreciation as the pieces start to fall into place for apartment owners. From a CWS perspective we hope this will translate into improved distributions, better positioning from a refinance standpoint with regard to those properties with loans coming due in 2011 (six properties, although we still expect challenges given more conservative lending standards), and a healthier transaction market in which to buy and sell properties. Despite the pieces falling into place in what I would characterize as in a logical manner, I'm also aware of Keynes' warning when he said, "There is nothing so disastrous as a rational investment policy in an irrational world".



**CWS Apartment Portfolio
PERFORMANCE SUMMARY
1/1/2010 - 6/30/2010**

<i>Number of Properties:</i> 59	<u>Actual</u>	<u>Budget</u>	<u>Variance</u>	<u>%</u>
Total Revenue	\$89,166,467	\$86,510,323	\$2,656,144	3.07%
Total Operating Expenses	<u>\$41,295,764</u>	<u>\$43,365,122</u>	<u>\$2,069,358</u>	<u>4.77%</u>
Net Operating Income/(Loss)	<u>\$47,870,703</u>	<u>\$43,145,201</u>	<u>\$4,725,502</u>	<u>10.95%</u>

Revenue - when actual is greater than budget result is positive variance

Operating Exp. - when actual is greater than budget result is negative

NOI - when actual is greater than budget result is positive

INVESTOR
WEB PORTAL NEWS
2Q10 QUARTERLY UPDATE

WWW.CWSCAPITAL.COM

CWS has been busy this quarter enhancing your investor experience by introducing a full line of electronic communication options to allow you to access your CWS Capital Partners account information quickly, securely, and at your convenience. Log onto www.cwscapital.com and go to My Account to see all the new features including:

- Opt-in to Go Paperless
- Access Documents from the CWS Investor Web Portal
- Allow Additional Authorized Users to Access Your Account
- View Multiple Accounts from a Single Login

The Electronic Communications packet mailed to you earlier this month described each of these features in more detail. It also provided step-by-step instructions on how to activate your account if you have never visited the portal or last accessed it prior to August 2009.

Look out for the **Going Green Go Paperless** icon on your "My Account" home page when you log onto the CWS Investor Web Portal.



If you have additional questions, please do not hesitate to contact Investor Relations at 800-466-0020 or 949-640-4200 or via e-mail at investorrelations@cwscapital.com.

INVESTOR RELATIONS RECAP

For more information on CWS investment opportunities, contact Marcus Lam at (800) 466-0020 ext. 1011.

REFINANCES and/or LENDER GROUPS

The Marquis at Town Centre – The refinance of The Marquis at Town Centre is set to close at the end of this month. Per the communication dated June 30, 2010, this refinance will be a move in a positive direction for the property as the interest rate will decrease from 8.05% to a projected 5.56%. We will notify you when this refinance has closed.

The Marquis at Barton Creek – The refinance of Marquis at Barton Creek is set to close at the end of this month. The projected refinance will lower the interest rate from 8% to an estimated 4.17% (variable-rate, subject to change), which will reduce debt service costs. In order to close this refinance, the General Partner is proposing to expand the existing lender group by \$500,000. To the extent that original Barton Creek investors decline to participate, the lender group will be open to Barton Creek lender group investors. To the extent that Barton Creek lender group investors decline to participate, the lender group will be open to all CWS investors.

The Marquis on Briar Forest - We are in the process of expanding the lender group at The Marquis on Briar Forest located in Houston, Texas by \$500,000. The maximum amount of the lender group expansion is \$900,000. Therefore, if the property needs additional capital, we will call for a phase 2 funding of approximately \$400,000. To the extent that original Briar Forest investors decline to participate, the lender group will be open to original Briar Forest lender group investors. To the extent that Briar Forest lender group investors decline to participate, the lender group will be open to all CWS investors.

The Marquis at Briarcliff – We have reached an agreement with the lender to allow for two years of interest-only financing on the loan at the property. A communication will be sent to the investors.

OFFERINGS

CWS Strategic Apartment Fund - CWS is actively looking for properties to acquire for the "CWS Strategic Apartment Fund". The Fund will target under-capitalized apartment assets across the nation. The Fund may also acquire private real estate secured debt instruments with the goal of ultimately acquiring the underlying real estate. Please contact Marcus Lam if you are interested in investing in the Fund.

CWS INVESTMENTS PRIVACY NOTICE

We provide this notice to our individual investors as required by regulations adopted under the federal Gramm-Leach-Bliley Act in order to inform you about our policies with respect to the non-public personal information we maintain about you. We have been sensitive about the personal information we have received regarding our investors and plan to continue that tradition.

In connection with our private investment activities, we collect and maintain non-public personal information from the following sources:

- Information we receive from you in subscription agreements, investor questionnaires, applications or other forms or in other communications; and
- Information about your transactions with us, any of our affiliates or others.

We do not disclose any non-public personal information about you to anyone, except as may be permitted by law or regulation, such as to our auditors, attorneys, other advisors or regulators, or to certain service providers but in all such cases, only as necessary to facilitate the acceptance, management and disposition of your investment.

We intend to maintain non-public personal information of our former investors and apply the same policies to that information that apply to current investors. We employ physical, electronic and procedural safeguards to protect your non-public personal information in our possession or under our control.

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Please contact Investor Relations at (949) 640-4200 or investorrelations@cwscapital.com if you have any questions.

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CWS
CAPITAL
PARTNERS
LLC

AN INVESTMENT MANAGEMENT COMPANY

VISION:

BACKING PEOPLE, IDEAS AND VALUES:

BUILDING GREAT COMPANIES

VALUES:

A DEMAND FOR EXCELLENCE WITH
A SENSE OF URGENCY

A RESPECT FOR PEOPLE

REQUIREMENT FOR PROFITABILITY

HONORING OUR WORD

ETHICAL DEALINGS ARE PARAMOUNT

CWS QUARTERLY UPDATE

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