Quarterly Update
CWS Capital Partners LLC
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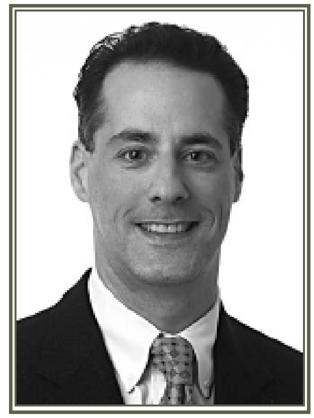
It's a Liquid World
by Gary Carmell



The world is awash in liquidity. I usually get nervous when I agree with the conventional wisdom, but in this case I must agree and get comfortable being in a crowd. Money is available for all types of investments as investors far and wide hunger for the same thing: yield. When something that most people want is in short supply, people will do some strange things to get it. They usually don't fully appreciate or are even aware of the risks they are taking to get what they desire. As very few things have gone wrong and many things have gone right for investors over the last three years, people are valuing all investments with relatively small premiums over risk-free assets. Right now there is much more greed than fear and when this is the case assets are priced aggressively. Why is this the case and what does it mean for real estate?

Global trade and capital flows have been extraordinary over the last few years. The pace of globalization has expanded at a phenomenal rate during this time. For example, between October 2003 and June 2006, the United States has run a trade deficit of $2.2 trillion according to the Bureau of Economic Analysis. That was trillion by the way. In a world of flexible exchange rates, there is always a balance between outflows and inflows with the trade deficit being offset by capital coming into the United States from foreign investors, especially from Asian central banks. These capital flows have been recycled into the United States and created an unprecedented supply of money for individuals, businesses, and speculators.

I won't get into the debate as to whether our capital surplus is driven by our trade deficit or the desire among global savers to put their excess capital into the deepest, most liquid, and safest market in the world, the United States. Suffice it to say that our consumer-oriented and finance-driven economy, through the ingenuity and avarice of Wall Street, has found numerous ways to attract this capital, aggregate it on a large scale, and get it to those individuals and businesses with the appetite to grow and to borrow money. It's a highly efficient manufacturing, sales, and distribution operation. In this case, the product is money and the users of it include individuals purchasing homes, venture capitalists funding emerging businesses, private equity

Continued on Page 2

Continued from Page 1

firms buying other companies, particularly large public ones using a large amount of borrowed money, hedge funds pursuing exotic investment strategies utilizing a lot of leverage, and real estate companies buying existing properties and developing new ones. There has been a particularly ferocious appetite for Real Estate Investment Trusts (REITs), as this asset class has been the third best performing one in the year ending 1/5/07 (27.89%), the third best one for the three years ending 1/5/07 (24.60% per year), and the third best performance for the five years ending 1/5/07 (20.54%) according to Morningstar.com. The principal reasons for its strong performance has been its relatively strong yield and the large number of public companies that have been taken private by firms willing to pay a premium for control of large real estate companies and to utilize widely available, low cost debt to fund most of the buyout price.

Despite real estate's terrific performance, there has been minimal growth in cash flow during this bull market. This is very well exemplified by one of the largest apartment REITs, Equity Residential Trust, created by legendary investor Sam Zell. The following table shows the dividends per share, stock price, dividend yield and corresponding yields on 3-month and 10-year Treasury securities at the end of 2001 and 2006.

Equity Residential Trust (EQR)

	12/31/01	12/29/06	% Change
Last 4 Quarters Dividend per Share	$1.73	$1.77	2.3%
Stock Price	$28.71	$50.75	76.8%
Dividend Yield	6.03%	3.49%	(42.1%)
3-Month T-Bill Yield	1.71%	5.02%	193.6%
10-Year T-Note Yield	5.07%	4.71%	(7.1%)
Dividend Yield/3-Month T-Bill Yield	353%	70%	(80.2%)
Dividend Yield/10-Yr. T-Note Yield	119%	74%	(37.8%)

The stock went from generating a fat dividend yield that produced a significant income premium over Treasury securities, particularly short-term instruments, to a substantial discount. With virtually no growth in dividends, the impressive return produced during the five-year period was almost entirely generated by stock price appreciation. In fact, EQR would have had to cut its dividend since it was paying out more than it was generating in cash flow had it not been for its property sales to help fund the dividend. Rather than reinvesting all of its sale proceeds into new investments, the company diverted some of this money to shareholders in order to avoid cutting its dividend.

With short-term interest rates significantly higher and now back to early 2001 levels and long-term rates slightly lower than they were five years ago, the logical expectation is for real estate yields to go back to where they were in 2001... Right? Not a chance, Dorothy. We are not in Kansas anymore. Many investors have expressed their desire for higher yields from our investments, but we are in a very different world. Yields have compressed dramatically and not even borrowing less money will produce the

Continued on Page 3

Continued from Page 2

yields we had in the past because even if we purchased properties with no debt, the cash flow would be approximately 4.50%. To paraphrase Jack Nicholson, "What if this is as good as it gets?" I'm afraid that this is indeed the case.

We are in the modern era of capital excess, low risk premiums, and a global hunger for yield. For example, in August 2000 we locked in 10-year fixed rate financing at 8.00%, which represented an approximately 2.00% premium over the risk-free 10-year Treasury note. Today, that premium would be approximately 1.00% and the rate would be 5.70%. This drop in interest rates combined with very strong performance of commercial real estate loans has dramatically reduced borrowing costs and allowed purchasers to pay much more for $1 dollar of Net Operating Income as compared to 2000 and earlier. Prior to 2002, real estate purchased without any debt usually generated yields of 7%-8%. Today, the range is 4%-5% with the estimated 3% drop being attributable to the cost of debt dropping nearly 2.50% and the required return for equity capital falling as well.

To put this compression in risk-premiums in more dramatic perspective, let's look at yields generated by low quality junk bonds. In March 2003, according to Standard & Poor, these investments averaged approximately 8.2% more than corresponding, risk-free Treasury securities. As a point of reference, higher quality, investment-grade bonds had an average spread of 2.1%. At the end of 2006, the junk bond spreads had compressed to 3.4% while investment grade spreads dropped to 1.3%. This dramatic drop in the cost of money for lower quality debt rippled through all asset classes, including real estate, as there was a significant narrowing of yields paid for high quality and low quality investments of all types, not just real estate. The lower cost of funds pushed down real estate yields and increased real estate values. Sharply escalating values led to very few non-performing loans and this great performance led to more demand among lenders to allocate capital to real estate.

Investors who have purchased Commercial Mortgage-Backed Securities (CMBS) over the last five years have been handsomely rewarded with attractive returns with virtually no credit problems. This has led to credit rating agencies upgrading much more real estate debt than they have downgraded. For example, Fitch Ratings announced in a press release on January 4, 2007 that "U.S. CMBS upgrades reached record highs in 2006. Fitch upgraded 1,781 tranches and downgraded 52 among approximately 500 CMBS deals (34:1 upgrade-to-downgrade ratio, compared to 11:1 in 2005)." This exceptionally strong performance has led CMBS investors to demand much more of these securities which has created a feeding frenzy for borrowers like CWS as Wall Street banks have become more aggressive in structuring new loans to satisfy the ferocious demand for CMBS paper. Ultimately, such "rear view mirror" investing sows the seeds

Continued on Page 4

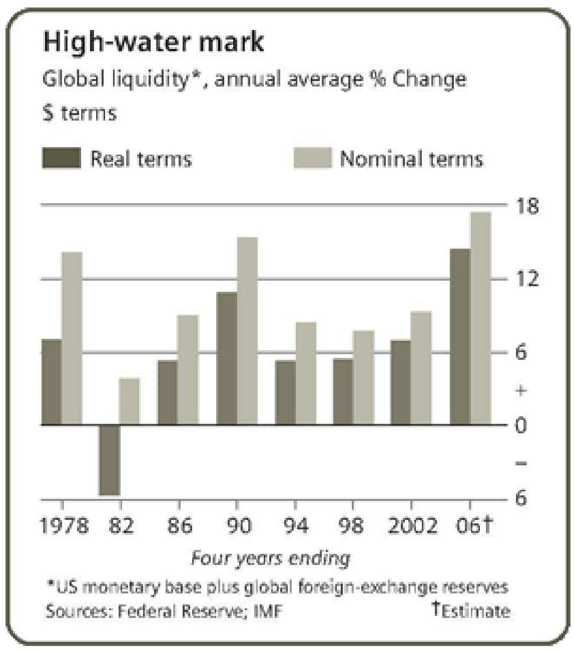
Continued from Page 3

of its own demise as more aggressive loan structures necessitate more optimistic assumptions about current and future performance in order to service these higher octane loans.

One of the most commonly used features to allow borrowers to access more loan proceeds is interest-only loans. These allow borrowers to defer repayment of principal for either a portion of the loan term or for the entire term until the loan matures. Debt service payments usually have an interest and principal component. By allowing for interest-only payments, the debt service burden is lessened thereby allowing borrowers to qualify for more loan dollars. In the Fitch press release, this tendency was cited as a cause for concern.

"While upgrades will continue to vastly outweigh downgrades for U.S. CMBS in 2007, the increased presence of interest-only (IO) loans likely means that the ratio of upgrades to downgrades will decline in the long-term, according to a report by Fitch Ratings. 'Deals issued last year averaged 70% of full or partial interest-only terms in a CMBS pool, compared with 60% in 2005,' said Senior Director Britt Johnson. 'As these deals will amortize more slowly than more seasoned transactions, the number of upgrades will drop unless the low interest rate environment lasts and there continues to be a significant amount of defeasance'."

Fitch is essentially saying that the best days are behind us for debt investors in this real estate cycle. Interest rates have fallen, property values have increased, there is tremendous global demand for U.S. real estate, the economy is strong, and investors have been handsomely rewarded. With conditions having been so favorable, it is inevitable that errors of optimism will be made by debt providers seeking to increase their allocation of capital to real estate. Because most real estate operators need and thrive on leverage, many of them will only be too happy to help them put their money to work in real estate by borrowing their money on favorable terms.



High-water mark What does all this mean? **Yields will remain low** as properties are being priced with the ability to access large amounts of creative and aggressive debt structures. This pushes returns down as there is much more buying power than

Continued on Page 5

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there otherwise would be in the absence of this capital. I don't see this changing for the foreseeable future as the global demand for yield is still ferocious and U.S. real estate is one of the few places in the world to obtain this on such a large scale for global investors. This table from The Economist attempts to quantify global liquidity and it shows that 2006 represented the highest rate of growth during the 28-year period covered by the table.

As I stated at the beginning, the world is awash in liquidity. Until this changes, then I would expect yields to be thin for all asset classes. The days of 6%-8% first year cash flows are over for a long time unless you are willing to take a large amount of risk. Meanwhile, CWS is very comfortable being exposed to the apartment industry as the demographics are favorable, construction costs have risen, making the economics of new development less favorable, the housing market has been weakening, and many of our markets are experiencing healthy economic growth without a corresponding increase in new supply of apartments. Overall, we are hard pressed to think of a better real estate category to be focused on over the next 3-5 years. Occupancies should continue to improve, rents should grow in strong markets and locations at rates greater than inflation, and we see excellent opportunities to reposition properties by upgrading them and increasing rents aggressively.

While we expect to continue to be swimming in this ocean of liquidity we will always make sure to avoid the inevitable sharks and the songs of the siren that may lure us onto those dangerous rocks. Like Odysseus, we will make sure to tie ourselves to the mast by trying to never lose sight of focusing on fundamentally strong real estate and adding value through our management, local knowledge, and construction capability.

Save The Date

Monday, March 26, 2007

The CWS Capital Partners 38th Annual Investor Meeting will be held on a ***Monday*** this year.

The meeting will take place at the Newport Beach Marriott Hotel in Newport Beach, CA.

Our speaker will be **Admiral B.R. Inman, USN (Ret.)**. Admiral Inman directed the National Security Agency including duty as deputy director of the Central Intelligence Agency. His decorations include the Defense Distinguished Service Medal, the Navy D.S.M. and the Legion of Merit. Admiral Inman's primary activity since 1990 has been investing in start-up technology companies, where he is a Managing Partner of Gefinor Ventures. He is a member of the Board of Directors of Massey Energy Company and of several privately held companies.

Formal invitations will be mailed out in February.

The annual meeting is a wonderful opportunity for you to hear firsthand about the past year, learn about future company plans, and to meet and ask questions of our onsite property personnel.

If you have any questions regarding the meeting or would like to get your RSVP in now, you may leave a message on the RSVP voice mailbox at **(800) 466-0020** ext. 391 or simply send an email to **sjuarez@cwscapital.com**. If you prefer to speak to a live person, you may call **(800) 466-0020**, during regular business hours and ask to speak with Sunnie Juarez-Mills at extension 291.