QUARTERLY UPDATE
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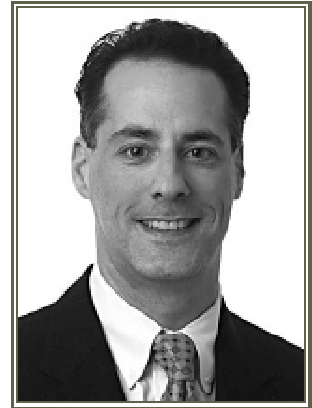
GO ASK ALICE
by Gary Carmell

> *"If I had a world of my own, everything would be nonsense. Nothing would be what it is, because everything would be what it isn't. And contrary wise, what is, it wouldn't be. And what it wouldn't be, it would. You see?"*
>
> -From Alice in Wonderland by Lewis Carroll



I have been racking my brain to write about topics other than housing and the sub-prime mortgage meltdown. It also applies to what I talk about as well. It was great to speak about this at our annual investor meeting in March because my wife doesn't find the topic particularly stimulating. When I bring it up with my kids, they somehow find a way to leave the room rather quickly. Yet, I can't shake it. I think the curtailment of credit to a fairly large segment of current and future borrowers will have enormous consequences for our society, economy, and the apartment market. Just when I was going to embark upon writing about another topic, I read something of such significance that it wouldn't allow me to leave the subject. I can now relate somewhat to the mafia.

Once you join it, you can never really extricate yourself from it. Every morning I visit Bloomberg.com to catch up on important financial stories and to check interest rates. I saw two articles on April 10, 2007 that really caught my eye, one in particular. The first one cited comments from the chairman of the nation's second largest home-builder, D.R. Horton, which said "the spring selling season has not gotten off to its usual strong start." Orders for homes they build dropped by 37% for the first three months of 2007 compared to the same period in 2006. The dollar value of their orders dropped by 41% while 32% of their sales were cancelled during the quarter. Most significantly, Housing optimists will say that it's always darkest before the dawn and that conditions can't get much worse. Yet, this is not your father's housing cycle and I think that is what people are missing. In the past, loans were usually generated by local banks and savings and loans to borrowers and mortgage brokers they tended to have some relationship with for properties in their markets. When the economy got too hot and inflation became a threat, the Federal Reserve always had the blunt instrument of raising interest rates by slowing down one of the economy's biggest engines, housing. Ultimately, when housing slowed down too much and the Fed wanted to help make housing more affordable, it could lower interest rates.

Today, we live in a technology-driven, impersonal, algorithmic, global, securitized world of finance in which all roads lead

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through Wall Street. Loans are originated by banks and private mortgage bankers backed by Wall Street capital, sold to Wall Street, aggregated into enormous multi-billion dollar pools and sliced and diced into an alphabet soup of various grades of securities to be sold to investors around the world. A South Korean bank may be risk-averse and only want to purchase securities rated AAA. No problem, they can create this out of these pools of mortgages. They will collect all the payments from the homeowners and the first dollars received will go to the AAA owners because they want the smallest amount of risk and are willing to accept the least amount of reward in return. A Dutch pension fund, however, may want a higher return and is willing to buy a lesser rated security from this smorgasbord of loans. No problem again, as Wall Street can create a security rated BBB which will pay a much higher yield than the AAA securities but will absorb some of the first losses associated with borrowers defaulting. There's something for everybody. This is actually a wonderful thing for the global economy. It allocates risk and reward to those investors who theoretically can bear it most...
Until it doesn't.

The system works well as long as buyers of this paper from Wall Street do not collectively lose their minds (more on this shortly). It also effectively takes the Fed's power away because Wall Street's ingenuity has created increasingly larger quantities of exotic mortgages designed to enable borrowers, in the very short term, to afford the increasingly expensive homes that traditional repayment terms would not enable them to own given their incomes. The blunt instrument of interest rate changes has been nullified by Wall Street's craftiness. Even if the Fed decided to alter rates, they are still currently at fairly attractive levels from a historical perspective and housing is still in the tank. Because most homeowners have loans at lower interest rates than the rates available for new loans, except for those with very expensive adjustable rate loans used to finance overvalued real estate that can no longer be refinanced, a reduction in interest rates will not have nearly the same effect as it did in past cycles unless they drop significantly. The most effective antidote to the affordability problem is lower prices. Obviously every market is different and this is a very general comment.

> *"Growing foreclosure rates among borrowers with poor or limited credit histories is also adding to the number of homes for sale.* ***Tighter lending standards because of problems in the subprime mortgage market are also reducing demand.***
>
> ***Stricter lending practices and the overhang of existing and new homes for sale will make it difficult for the new-home market to recover this year."*** *(Emphasis mine)*

A Mad Hatters Tea Party

As long as collective insanity is the prevailing state of mind and in full force, nutty things can happen that are reinforced by Wall Street's securitization machine,

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rather than serving as a countervailing force until it's too late and then only shock therapy and lobotomies are the solutions. The democratization of credit from securitization invites everyone to the party, particularly those for whom the door was never opened before and never even knew such parties existed. Unfortunately, it turned out that the gathering was more like the Mad Hatter's Tea Party in Alice in Wonderland and many of the invitees never belonged in such company. Here's a glimpse into that world.

The table was a large one, but the three were all crowded together at one corner of it: 'No room! No room!' they cried out when they saw Alice coming. 'There's plenty of room!' said Alice indignantly, and she sat down in a large arm-chair at one end of the table.

'Have some wine,' the March Hare said in an encouraging tone.

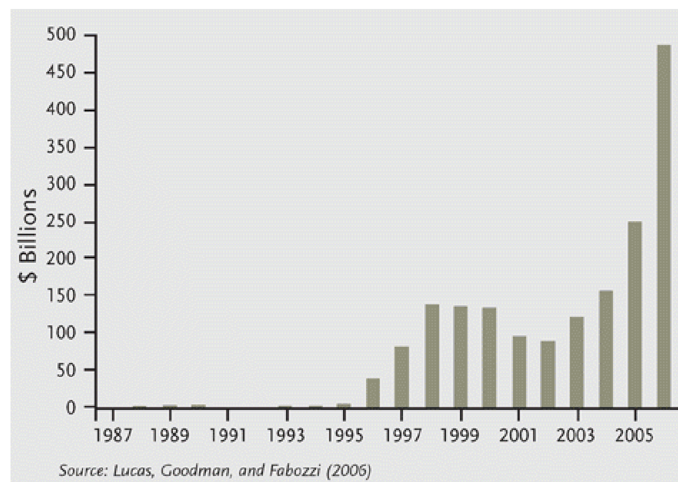
Alice looked all round the table, but there was nothing on it but tea. 'I don't see any wine,' she remarked. 'There isn't any,' said the March Hare.

'Then it wasn't very civil of you to offer it,' said Alice angrily.

'It wasn't very civil of you to sit down without being invited,' said the March Hare. 'I didn't know it was your table,' said Alice; 'it's laid for a great many more than three.'

How has the insanity manifested itself? CDOs. Collateralized Debt Obligations. These highly complex instruments have been the rocket fuel for home lending over the past three years. These beasts buy some of the riskiest pieces of mortgage securitizations (pools of thousands of mortgages) and repackage these securities into additional securities. All you need to know is this: Often times, not one of the securities in the portfolio of CDOs is AAA rated (the highest debt rating), yet when these CDOs repackage their securities into new securities they are able to sell off AAA pieces to buyers around the world. It's akin to financial alchemy. It's like taking millions of pieces of the most unhealthy, disease-prone pieces of a cow and pig and reselling some of these and convincing buyers that they are filet mignon. In the words of Alice, "If it had grown up, it would have made a dreadfully ugly child; but it makes rather a handsome pig, I think."

I've talked to people on Wall Street about this and how insane this is but they basically say that I don't get it. Maybe I don't but it's clear that risk has been badly



Source: Lucas, Goodman, and Fabozzi (2006)

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mis-priced and these CDO owners are going to be suffering large losses. The following chart shows how significant the growth has been in CDO issuance.

It's important to remember that as long as CDOs were being manufactured, underlying mortgages had to be created to populate these CDOs. Now that sub-prime loans are going bad as their default rate exceeds 13%, these CDOs are getting crushed and now no one can sell sub-prime loans without incurring substantial losses. Once the high octane fuel is gone because it is ruining engines in vast numbers, then demand among buyers disappears and sellers of the fuel go out of business. Hence, we have seen 50 sub-prime lenders go out of business over the last six months. Credit is tightening, American families are losing their homes, jobs are being lost, and Congress is upset.

This now brings me to the second article that I read on Bloomberg which led me to believe that things are going to get a whole lot nastier for housing. Apparently, Congress now believes that what's been going on in the sub-prime world has been like the Mad Hatter's Tea Party. Poor, unsuspecting, salt of the earth individuals were invited to a party they weren't really welcome at but had to be accepted to without garnering any respect from its hosts. As a result, the hosts, Wall Street investment banks, have drawn the Queen's (Congress) wrath as depicted in Alice in Wonderland:

There is no way that the sub-prime mortgage implosion and the lives it's going to impact is going to go down without somebody taking the fall. In the Bloomberg article entitled, "Mortgage Bondholders May Bear Subprime Loan Risk" from Bloomberg. com on April 10, 2007, some of the details of prospective new legislation regulating the origination of new sub-prime loans are revealed. I can't overstate how signifi cant this is if it is enacted. In the wake of the Great Depression, bank and investor regulation came about, the Civil Rights Act resulted from the discrimination present in American society, campaign fi nance reform from Water- gate, The Patriot Act as a result of 9/11, and Sarbanes-Oxley from the terrible corporate fraud of the late 1990s and early 2000s. And now sub-prime mortgage regulation. Each of these has served important purposes and has been beneficial to our society in many ways. Nevertheless, they have important ramifications and tend to alter and disrupt what had been the normal course of action and interaction. It appears that access to home mortgages for lower quality borrowers is going to be tightened dramatically which will make homeownership harder to attain and should increase the market share of renter households. Of course, Congress and federal regulators are always late to the party. As the Mad Hatter says, "No wonder you're late. Why, this watch is exactly two days slow." They should have been sounding the alarm three years ago.

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Allow Me To Quote Liberally From The Article

The Queen: Now, I give you fair warning, either you or your head must be off, and that in about half no time! Take your choice!

April 10 (Bloomberg) -- The top Democrat and Republican on the House Financial Services Committee said investors in mortgage bonds should be liable for deceptive loans made by banks.

Democratic Chairman Barney Frank of Massachusetts and Spencer Bachus of Alabama, the committee's highest-ranking Republican, said such legislation would discourage lenders from extending loans to people with poor credit histories ***by making it more difficult and expensive for the banks to sell the mortgages.****(Emphasis mine)*

"More money was being lent than should have been lent," Frank said in an interview from Washington. Frank, who last month predicted that the House would approve such a bill this year, said growth in the market for mortgage bonds "provided liquidity without responsibility."

An agreement by the two lawmakers may increase the likelihood legislation will be passed this year. ***The cost of borrowing would rise and curb financing for some lenders and subprime homebuyers****, said David Brownlee, who oversees $14 billion as head of fixed income at Sentinel Asset Management in Montpelier, Vermont.* ***It would also reduce opportunities for the Wall Street firms that pool the home loans as securities.*** *(Emphasis mine)*

A total of $2.12 trillion of mortgage-backed bonds were sold last year, according to the Securities Industry and Financial Markets Association, a New York-based trade group. ***About $540 billion of the bonds are backed by sub-prime mortgages, or loans to people with poor credit, up threefold since 2001****, data compiled by New York-based Bear Stearns Cos. Show. (Emphasis mine)*

Bachus said he favors legislation similar to a law enacted in New Jersey in 2003 enabling homeowners whose loans are the result of predatory lending to gain compensation from lenders and investors who purchased the mortgages. The indemnity includes attorneys' fees, the borrower's total loan payments and the cost of terminating the borrower's remaining liability. *(Emphasis mine)*

New Jersey's Safeguards

The New Jersey law erected safeguards against predatory lending, including ***a requirement that lenders certify that borrowers can repay the loan. The borrower must receive fi nancial counseling when financing mortgage points and fees, which may not exceed 2 percent of the total loan amount.***

Reckless investors shouldn't receive any sympathy, Frank said.

"Our job is to continue to have money available for people to continue to buy homes with minimal chance of these kind of disasters," Frank said. "The effect this has on the ability of people in the bond market to make money is simply not a factor." *(Emphasis mine)*

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This is a tectonic shift in mortgage finance. Homeownership will be out of the reach of millions of people. Assuming the carnage is not too great on the American public and doesn't signifi cantly impact job creation and household formation, then the next decade should be very favorable for multifamily rental property owners such as CWS. "Curiouser and curiouser!"

Join Us on May 14, 2007 For Our CWS Semi-Annual Conference Call

The CWS Capital Partner's Semi-Annual Conference really is for you. It's your opportunity to have all of your questions answered on one call. It's the perfect forum to hear about your investments and how they're performing.

The details of the call are:
Date: Monday, May 14, 2007
Time: 12:00 PM Pacific Time
Dial-In #: (866) 409-1555
Conf. #: 4064662

If you are unable to make the live call, you can access the previously recorded call from Tuesday, May 15, 2007 through Thursday, June 14, 2007. Here are the details for the live replay:
Dial-In #: (888) 203-1112
Replay passcode: 4064662

We hope you will join us.