

QUARTERLY UPDATE

CWS CAPITAL PARTNERS LLC

CWS Capital Partners LLC

CWS

CALENDAR OF EVENTS

September 5, 2011

Labor Day
CWS Office Closed

October 15, 2011

3rd Quarter 2011 Estimated Tax Payment Due

October 28, 2011

3rd Quarter 2011 Quarterly Packages Mailed

November 2011

Semi-Annual Conference Call

November 24th and 25th

Thanksgiving Holiday
CWS Office Closed

Monday, December 26, 2011

Christmas Day (Observed), CWS Office Closed

Monday, January 2, 2012

New Year's Day (Observed), CWS Office Closed

January 15, 2012

4th Quarter 2011 Estimated Tax Payment Due

January 27, 2012

4th Quarter 2011 Quarterly Packages Mailed



www.cwscapital.com

ENHANCING LIVES THE CWS WAY

By Gary Carmell



For a long time I have felt that to be successful in business, and in life for that matter, one of the necessary traits is to be an effective hypothesis tester. Most people don't do it consciously but they have an awareness and finely tuned antennae to pick up when something goes differently than expected or a particular pattern is evolving. It may be a parent vis-à-vis their children, medical researcher, coach, etc. Issac Asimov said that the two most important words in science are "That's funny." It's what we don't expect that often catches our eye and can lead us in a different, more beneficial direction. I have used this hypothesis testing approach to life for a number of years now and I have found that it makes it much more interesting and engaging. For example, after 22 years of marriage I test how well I know my wife by constantly saying things that I hypothesize will get a rise out of her. Sure enough, she falls for it almost every time like Charlie Brown believing each time that Lucy won't pull the football away when he tries to kick it. A hypothesis can never truly be proved, only falsified, because we can never say with 100% confidence that we have tested every possibility. However, I must say with confidence that my wife constantly taking my needling seriously suggests some dominant personality traits that could be exploited and constructed into profitable bets. (I know it sounds romantic. I'm that type of guy.) In fact, I could virtually guarantee that if she reads this she will not be happy with me

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which makes this even more interesting because it could serve as another test of my hypothesis. On the other hand, I've already shown my cards as to my intentions so I will probably bias her. Nonetheless, she'll be upset but these are the sacrifices we researchers need to make for science and progress. It's almost as risky as Marie Curie's work with radioactivity and the consequences could be just as dire. I will acknowledge that the benefits to society will not be as far reaching, however.

With that very self-serving and wordy introduction, I must say I was delighted to see the following quotes when I read the July 4 and July 5 entries in The Daily Drucker by Peter Drucker, considered to be history's greatest management consultant/philosopher (I took liberties to combine two of them):

"The theory of business has to be tested constantly. It is not graven on tablets of stone. It is a hypothesis. And it is a hypothesis about things that are in constant flux – society, markets, customers, technology. And so, built into the theory of the business must be the ability to change itself. Some theories are so powerful that they last for a long time. Eventually every theory becomes obsolete and then invalid. . . [A] theory's obsolescence is a degenerative and, indeed, life-threatening disease. [Leaders] know and accept the surgeon's time-tested principle, the oldest principle of effective decision-making. A degenerative disease will not be cured by procrastination. It requires decisive action."

To generate competitive rates of return in the world of investing, managers typically need some sort of information advantage, a portfolio allocation that is sufficiently constructed and concentrated such that this advantage can translate into meaningful results, and a very independent thought process and disposition that allows one to feel secure being apart from the

crowd and not falling prey to one's emotions when fear and greed begin to manifest themselves. Well designed hypothesis testing can go a long way to enabling managers to make little bets before taking on more meaningful exposure to a particular thesis. For example, in the 1980s and 1990s, CWS was one of the larger owner-operators of manufactured housing communities in the United States. By the middle 1990s we were seeing some disturbing lending and business practices in the industry that gave us pause with regard to whether easy money was creating excessive demand for manufactured homes. In fact everything that happened in subprime lending took place in manufactured home finance close to a decade before. For various other reasons we felt that a much larger, fully integrated, well capitalized company that could apply its financial muscle towards purchasing homes, lending on them, and building new communities was more suited to where the industry was headed¹. In short, we came to the conclusion that CWS could add more value focusing and growing our emerging apartment business which we believed had a better future relative to our capabilities.

In 1998 we entered into an agreement to sell our manufactured housing management company and almost all of our properties to a newly formed Real Estate Investment Trust (REIT) focused on manufactured housing. With 20-20 hindsight our timing was spot on. The following chart shows annual shipments of new manufactured homes in the United States from 1994-2010.

¹As an aside, the company that purchased the manufactured housing REIT that bought our portfolio has had to invest well over \$100 million that it never expected to have to put into the business to buy homes and to provide mortgages for buyers since virtually all forms of commercial lending exited the industry.

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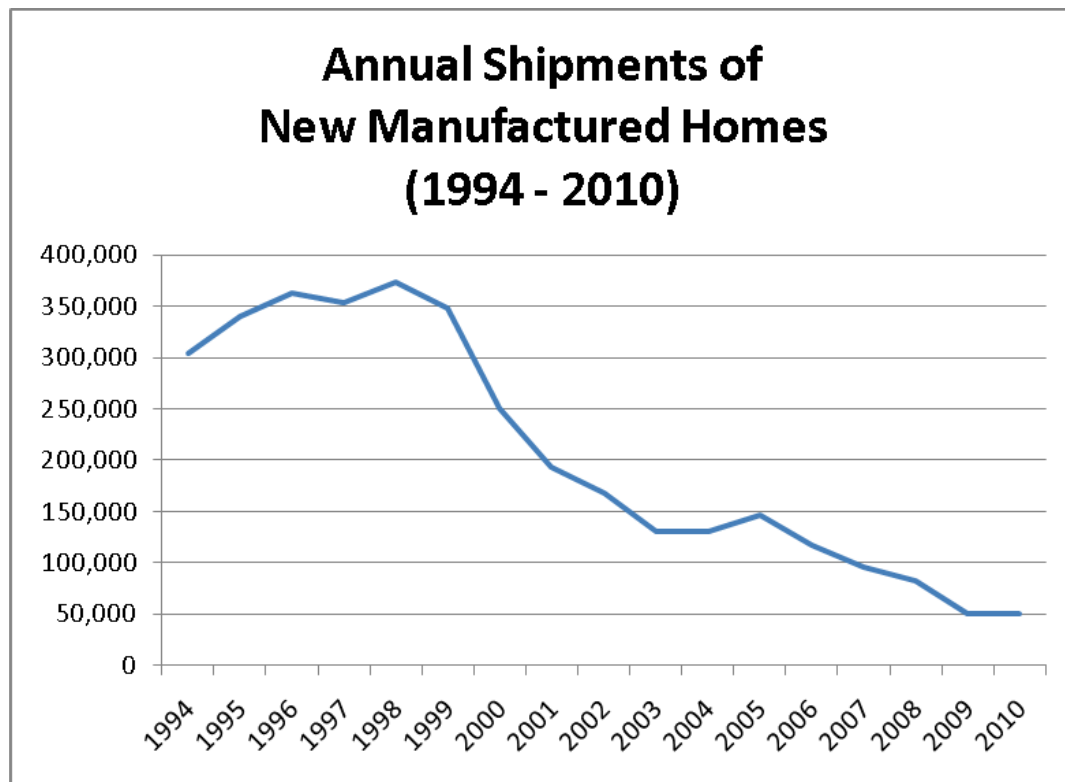
As the chart below shows, shipments of manufactured homes reached a cyclical peak in 1998, the year we entered into the agreement to divest ourselves of the business. The future for the business is also very tenuous as well. IBISWorld Inc. is a market research firm and in late 2009 it came out with a study identifying the ten most doomed industries in the United States. One of the ten on the list, along with video rentals, the local photo shop, and newspaper publishing, was manufactured housing. Here is what IBISWorld Inc. had to say²:

Why the decline: The industry has been squeezed between more innovative competitors and a drop in the price of traditional homes. Attempts to cut costs meant a less appealing product but prices not low enough to lure customers. The result: 'Some of the steepest declines in revenue and establishments over the past decade,' IBISWorld says.

- Decline in revenue in last decade: -73.7%
- Forecasted decline in revenue in the next decade: -62.0%
- Forecasted decline in the number of establishments next decade: -56.7%

It is clear that we made the right decision to exit the manufactured housing business. Our thesis regarding the challenging future turned out to be proven correct by the near collapse of the industry. Although our redeployment of the capital into the apartment business was not without its challenges during the first five to seven years due to the bursting of the tech bubble and the inflation of the housing bubble which decimated demand for apartments, we are very pleased that we made the transition. As investment managers we believe our first mission is to protect capital and then grow wealth. Our decision to exit the manufactured

²<http://finance.yahoo.com/career-work/article/112946/doomed-industries-bnet>



Source: U.S. Census Bureau

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housing business helped to protect capital, while turning our focus almost exclusively to apartments, has enabled us to grow wealth for our investors.

As an example, we just sold a property for which we purchased the land in 2002 and constructed an apartment community (Marquison McKinney). Although the investment had some bumps in the road, when all was said and done it produced an annual rate of return of approximately 10%, producing \$2.19 of cash flow and sale proceeds for every \$1.00 invested. Contrast this with a few manufactured housing communities we sold between 1998 and 2000 as part of our portfolio and management company sale. These communities became available to us to repurchase within the last twelve months. If we wanted to make an offer, which was a big if because of the deteriorating fundamentals of the industry, we would have offered to pay prices far less than we sold them for.

We truly believe that we are invested in an industry (professionally-managed apartments) with one of the brightest futures over the next decade. One of the ways we believe we can do a better job of protecting capital and increasing our odds of producing competitive rates of return is to keep control of the management of the assets in which we are invested. We are fanatical about this as well as not diluting our organization by doing management for other owners unless there is a very strategic reason to do so. By keeping control of management it allows us to access tremendous amounts of valuable information for which we can gain an actionable edge. With over 15,000 units in our portfolio and our real-time pricing system, we have access to an extraordinary amount of information from which we can generate testable hypotheses regarding the credit quality of our residents, value of upgraded units, strongest markets, etc.

Another vital byproduct of having such a well-trained, competent, and long-tenured employee base is the high degree of trust that exists among one another. This serves to minimize friction of information flow that may result when less secure people are fearful of divulging bad news ("shooting the messenger"), admitting mistakes, or political posturing. This allows us to course correct quickly if necessary. In the words of Eddie Vedder, we are "turning our mistakes into gold" or at least we strive to do so as much as we can.

It is also inevitable that people will leave or need to be replaced. By having a concentration of assets in our markets this enables us to have a bench we can turn to in times of transition. Although most management companies like to think they can consistently outperform their competitors, we have found that outperformance often results from not going backwards and having to dig yourself out of a hole as opposed to doing better in a steady state environment. This can occur when an underperformer is left in his or her position for too long either because the systems did not uncover the issues quickly enough or action wasn't taken soon enough despite awareness of the problem. Controlling the management from top to bottom better positions us for identifying red flags early in the process while having a highly committed, performance-oriented team gives our experienced leaders a bias towards action in terms of making personnel moves when they are required. The converse is also true. A very people-centric, long-term oriented company like CWS affords tremendous opportunities for personal growth and career enhancement for those who are energetic, competent, fully engaged, and adhere to our values.

Having survived and prospered for over 40 years is definitely unusual in the world of business. A group of CWS company leaders recently got together with a facilitator in an off-site meeting to explore what has

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made CWS such a special organization and articulate this in a concise sentence via a purpose statement. After some very personal and honest conversation that got a little spirited at times, we crafted the following:

Enhancing Lives The CWS Way

We thought the word “enhancing” was a great descriptor of what we seek to accomplish. The definition is:

Intensify, increase, or further improve the quality, value, or extent of; make better or more attractive

From an investor, resident, employee, and community standpoint, if we can seek to accomplish this every day, then we believe we have the opportunity to make a significant difference in the lives of those we serve.

A great leader stands on a bedrock of principles, can build consensus, and provides a moral compass to others. We believe our purpose provides the very same attributes to CWS employees. Every day we come to work and have the opportunity to enhance the lives of those we serve. What’s even more powerful is that we engage with people on a very deep and personal level. We are involved with their money and where they live, two of the most important and personal parts of their lives. Given the responsibility of relating to people in these spheres, we believe that it is vital for everyone to be treated with compassion, respect, and integrity.

What is inspiring about our purpose is that it means something different for everybody, yet everybody knows what it means as well. It is somewhat analogous to the American Dream. It’s been said that the conversation is the relationship and at CWS we are so deeply committed to forging meaningful relationships with each other and with those we serve and when someone asks what is the CWS Way, it gives us an opportunity to speak from the heart and our very personal experiences. It allows us to engage in a meaningful conversation that can further the relationship with those whom it matters to and to whom we matter. As the facilitator of the process we went through to craft our company purpose said, “Companies spend millions of dollars to try to develop what you already have and they rarely succeed. What you have is very special.” We agree and that is one hypothesis I see confirmed each and every day, yet never to be taken for granted.

Gary’s Reading List

Nature’s New Deal: The Civilian Conservation Corps and the Roots of the American Environmental Movement
By Neil M. Maher

Little Bets: How Breakthrough Ideas Emerge from Small Discoveries
by Peter Sims

The Complete Works of Ralph Waldo Emerson
by Ralph Waldo Emerson

Zen in the Art of Archery
by Eugen Herrigel and Daisetz T. Suzuki

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