Volume 23, No. 3, October 30, 2009

QUARTERLY UPDATE

CWS CAPITAL PARTNERS LLC

CWS Capital Partners LLC

CWS

CALENDAR OF EVENTS

November 20, 2009
Semi-Annual Conference Call

November 26th and 27th
Thanksgiving Holiday – CWS Office Closed

Friday, December 25, 2009
Christmas Day, CWS Office Closed

January 1, 2010
New Years Day, Office Closed

January 15, 2010
4th Quarter 2009 Estimated Tax Payment Due

January 29, 2010
4th Quarter 2009 Quarterly Packages Mailed

April 6, 2010
CWS Annual Partners Meeting

April 15, 2010
2009 Tax Filing Deadline

April 15, 2010
1st Quarter 2010 Estimated Tax Payments Due

April 30, 2010
1st Quarter 2010 Quarterlies Mailed

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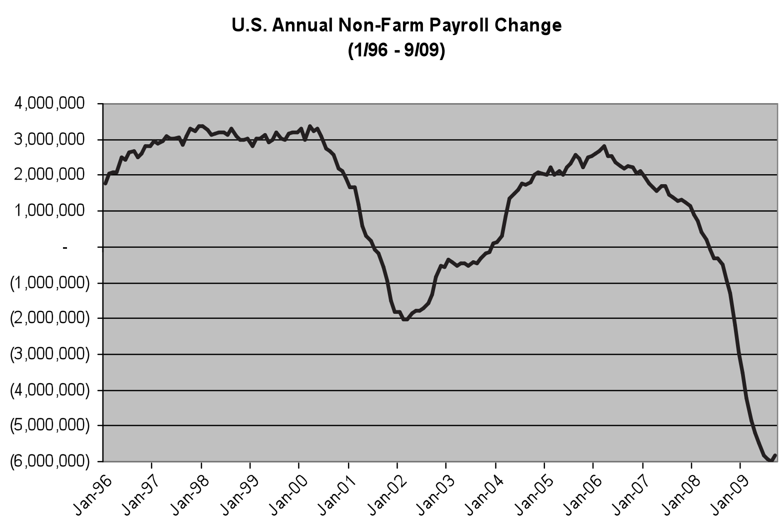
DOING MORE WITH LESS

By Gary Carmell

National job losses have been massive over the last year. We have now returned to a level of employment that we had in 2005. The following chart shows the annual change in non-farm employment in the United States going back to 1996.



Source: U.S. Bureau of Labor Statistics

One can see that the loss of jobs in this recession far exceeds that experienced in the 2002 downturn. When will jobs begin to turn around? It is very possible that we have seen the worst already. It is not unusual for the rate of job loss to hit bottom

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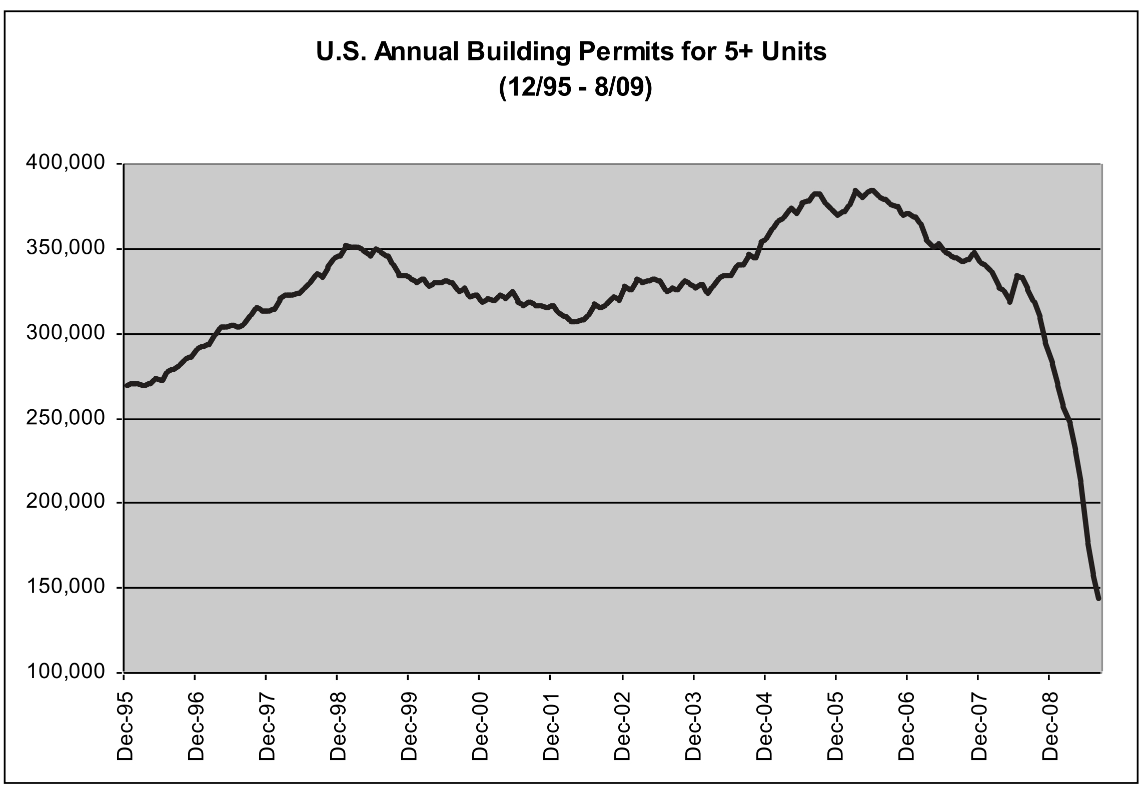
approximately six months after the stock market reaches its low. The market troughed in March and it looks like the rate of loss peaked in September. Although we will continue to see the unemployment rate increasing and job losses still with us for the next few months or so, the rate of employment reduction should begin to improve.

As a result of this tremendous job loss and the massive losses experienced by banks which have decimated the supply of construction capital, new apartment development is falling at a very dramatic rate as evidenced by the chart below.

Although this level of permitting is the lowest in 50 years, this reduced supply is necessary as national job losses have been so large over the last year as evidenced earlier.

In my past few articles my tone has been more upbeat with regard to my belief that we have most likely hit bottom economically and from a stock market perspective. I wanted to touch on this again this quarter from a slightly different perspective. It's easy to be influenced by all of the noise that we hear from the media and daily market fluctuations. Many people have very legitimate concerns that the recovery in the stock market is fleeting because it's based more on momentum and that any economic progress is being inflated by temporary federal spending like the stimulus program, cash for clunkers, and the home buyer tax credit.



Source: U.S. Census Bureau

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The labor market is still clearly shedding jobs, consumers are not spending, the banking system is very weak with banks going under daily, a powerful credit crunch is still upon us, and international trade tensions are escalating with China. Add to this the concerns about the federal deficit and the policies of the Federal Reserve (both addressed somewhat in last quarter's article), and there is a lot of understandable fear.

What positives can I possibly see in all of this? It is this set of conditions that sow the seeds of greater efficiency and profitability in the future. This is the case because these conditions lead to a much stingier capital environment and the silver lining is that with capital so much harder to access, businesses will have to do more with less. Actually, we all have to, but my focus is on businesses versus individuals and families.

Profit-requiring enterprises will have to make difficult decisions about what their most important priorities are and how they can create the greatest value. This will require focusing on what they do best and making sure they deliver their product or service at the best quality and at the most competitive price. This is painful for the economy in the short- to medium-term as businesses cut costs (primarily labor) and these ripple through the economy in the form of lower consumer spending. This is why the government is stepping in. There is a void that could negatively reinforce itself if not filled. Job losses lead to lower spending and investment which lead to more cost cuts which lead to less spending and investment, etc.

A perfect example of this shift in having to manage in a capital constrained environment is what is happening in Las Vegas. This is an excerpt of an article from the Wall Street Journal on October 4, 2009 about the sea of change that has taken place there:

> LAS VEGAS -- After a six-year building frenzy that transformed this city, casino companies are shifting strategies dramatically toward slower growth, paying down debt and cutting back on spending.
>
> Many casino executives don't expect to break ground on another major building project in Las Vegas for at least 10 years.
>
> "The old model has been thrown out the window," says MGM Mirage Chief Executive Jim Murren.
>
> For most of this decade, casinos embarked on a debt-fueled expansion, plowing more than $30 billion into casino and hotel projects around Las Vegas. When the economy collapsed, it left casino companies with dwindling revenues and mountains of debt. Several entered bankruptcy-court proceedings.
>
> Now, casino companies are eschewing capital-intensive projects to focus on increasing profit margins through branding, marketing and customer loyalty.
>
> MGM Mirage spent the past few years planning an $8.5 billion hotel and casino complex called City Center, slated to open later this year. But in the future, it will adopt a more conservative strategy of trying to lure more customers to its existing properties, "and it doesn't take a $3 billion building to do it," Mr. Murren says.
>
> "The industry is seeking a new equilibrium," says Gary Loveman, the chief executive of closely held Harrah's Entertainment Inc. ***"The last period was one where people were drunk on the use of capital and used it to solve every problem. Clearly that can't continue."***
> --Wall Street Journal 10/4/09

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The byproduct of being in an environment of extreme capital rationing and cost control is a dramatic reduction in the break even rates of firms. As companies adjust to a lower level of sales by reducing their fixed costs significantly, a slight, unforeseen increase in revenues can have a dramatic increase in profitability. Companies are trying to position themselves to have a very lean cost structure in order to absorb a higher level of sales before adding costs at a rate equal to sales growth. This is known as earnings leverage and can allow investors to prosper because operating results can exceed expectations with only moderately better than expected revenue generation.

With the Dow in the 10,000 range as of this writing, it's at levels that were attained in 1999. For all intents and purposes, the 10-year return, exclusive of dividends, has been zero. From an investor's perspective it is usually better to enter the market after a long period of very poor returns, when capital is hard to access, and firms are focused much more on efficiency than growth. Why is efficiency more beneficial than growth, all things being equal? Actually both are very favorable to investors, but numerous studies have shown that firms that grow their balance sheets the most rapidly through the issuance of equity and/or debt tend to dramatically underperform the market. In other words, the firms that consume the most capital produce the worst investment results. There are two exceptions to this rule. One group is those firms with proven track records of generating high returns on equity. The other group is those companies whose balance sheets grow by the organic generation of cash that is retained in order to improve their financial strength, either to protect themselves when times get tough or to take advantage of the opportunities that arise during periods of distress. All others underperform because they tend to be empire builders with poor corporate governance in which management teams benefit from growth as opposed to wise deployment of capital. (<u>Balance Sheet Growth and the Predictability of Stock Returns</u> by Louis K. C. Chan, Jason Karceski, Josef Lakonishok, and Theodore Sougiannis, May 2008).

The major Las Vegas casinos are perfect examples of the empire-building mentality. They went through a period of massive expansion and debt accumulation because no one thought the good times would end. The stock prices reflected this view that trees can grow to the sky before investors realized that this was indeed not possible. After stock drops of 98%+ and many companies either declaring bankruptcy or coming close to it, they have come to realize that they have no choice but to do more with less. With the right management focus, these companies are in a position to become attractive investments again as they improve operations and use their free cash flow

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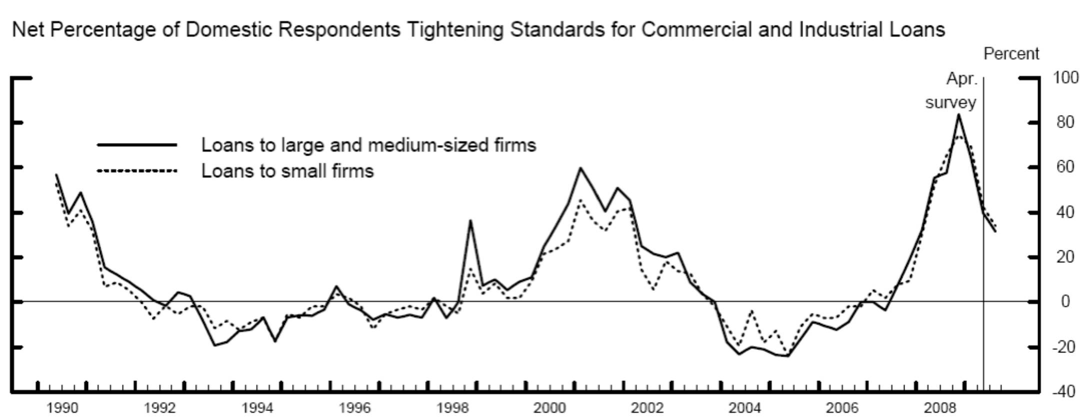
to reduce debt rather than spend it on wasteful projects. The Vegas casinos are a microcosm for the entire economy. Individuals, households, and businesses all have to restructure their balance sheets, shrink their expenditures, and batten down the hatches to work in a much leaner environment. CWS is no exception. We have made substantial reductions to our corporate overhead, reallocated talented resources to strengthen our operational capabilities, and are aggressively managing all of our expenditures, particularly our capital projects. We believe that we will be in a very competitive operating environment over the next couple of years and that the highest value can be created by positioning ourselves to attain and retract the best quality residents while making sure we intensely focus on maximizing the return on every dollar spent to operate and maintain the assets.

Although the best operational performance occurs when we are not in an environment in which capital is easy to access for mergers, acquisitions, and large capital expenditures, there is an optimal balance between tight and inaccessible capital. The former allows for much better rationing of capital to those management teams and businesses with the best prospects for adding value, while the latter can suffocate the economy and destroy even the best of businesses. The ideal set of conditions is when capital is being prudently allocated based on proven success, financial commitment, and thoroughly analyzed projections, and when, simultaneously the cost of capital, having been quite high, is coming down on a slow and steady trajectory over a long period of time. This creates a more favorable financing environment while still creating an incentive for management teams to conserve capital, aggressively manage spending, and maximize profit margins. Each quarter the Federal Reserve surveys bankers regarding whether they are tightening, loosening, or keeping lending standards the same. The following chart going back to 1990 shows that lending standards, the tightest in the short history of



Source: Federal Reserve

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the survey, while still tight, are beginning to loosen somewhat. Approximately 65% are still tightening while 35% are loosening or keeping them the same. This is down from 90% and 10% in the April 2009 survey.

I mentioned above that it's not only important to see capital becoming more accessible, but that the cost of capital should be dropping over time. I will also hope to prove that, for investors, deploying capital after a major spike in the cost of capital and when it is coming down has proven to be a fairly good entry point. One of my favorite indicators to measure the cost of capital and its directional trend is the spread between the cost of money for riskier businesses (Baa rated firms) and much less risky ones (AAA rated). This measures the willingness of investors to take risk between risky assets. For example, when the spread is low they don't see much distinction in the downside characteristics between riskier and less risky firms. Said differently, investors are more willing to ignore the downside in order to squeeze out a little extra yield. The opposite is true when spreads are high and investors are fleeing from risk and will pay large premiums to invest in the debt of safer companies and ignore the higher return offered by riskier ones. The chart on the next page shows this spread since 2004. Spreads reached the highest level since the Great Depression in December 2008 and after widening again in March they have fallen precipitously since that time.

Why is this important? Earlier I said that a slow and steady declining cost of capital is very favorable for investors because it allows the economy to grow without allocating capital to poor management teams and businesses. Why do I make this assertion? The table on the next page shows the biggest bull and bear markets since 1929 as measured by the Dow and what the Baa-AAA spread was at the beginning and end of the cycles.

In most of the bear markets, there was a material widening in spreads while the opposite was the case in the most powerful bull markets. We have just come down from having the widest spreads since the Great Depression, the stock market has made no progress in ten years, there is a tremendous amount of cash on the sidelines earning only slightly positive returns, and credit, while still tight, is loosening somewhat. These are all the hallmarks for improving financial markets and a stronger economy ahead. It will not happen overnight and it's possible that we can have more shocks to the system, but on the other hand, we have absorbed the blows of Bear Stearns, Lehman Brothers, AIG, Fannie Mae, Freddie Mac, Citigroup, and Bank of America. It is inconceivable to me that we will experience anything like that again in the next few years (hopefully never).

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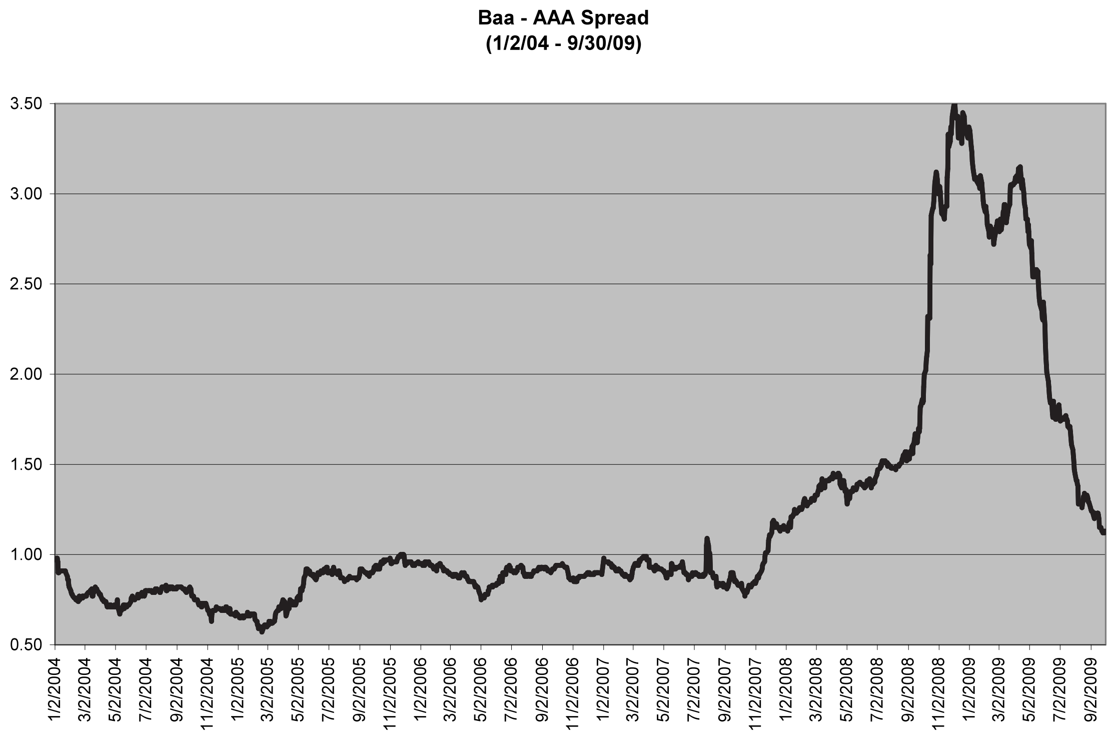

Peak Date	Value	Spread	Trough Date	Value	Spread	% Change in Dow
9/3/1929	378.23	**1.32**	7/8/1932	40.56	**5.59**	-89.3%
3/10/1937	192.77	**1.36**	3/31/1938	97.46	**3.08**	-49.4%
11/12/1938	157.72	**2.13**	6/10/1940	110.41	**2.15**	-30.0%
11/12/1940	136.56	**1.73**	4/28/1942	92.69	**1.43**	-32.1%
2/9/1966	987.63	**0.34**	5/26/1970	627.46	**0.87**	-36.5%
1/10/1973	1040.94	**0.75**	12/9/1974	570.01	**1.98**	-45.2%
4/27/1981	1013.87	**1.68**	8/9/1982	769.98	**2.61**	-24.1%
8/25/1987	2694.83	**1.13**	10/20/1987	1616.21	**1.10**	-40.0%
1/14/2000	11612.53	**0.58**	10/9/2002	7286.27	**1.40**	-37.3%
10/9/2007	14164.53	**0.79**	3/9/2009	6547.05	**2.87**	-53.8%

Trough Date	Value	Spread	Peak Date	Value	Spread	% Change in Dow
7/8/1932	40.56	**5.59**	3/10/1937	192.77	**1.36**	375.3%
3/31/1938	97.46	**3.08**	11/12/1938	157.72	**2.13**	61.8%
4/28/1942	92.69	**1.43**	2/9/1966	987.63	**0.34**	965.5%
5/26/1970	627.46	**0.87**	1/10/1973	1040.94	**0.75**	65.9%
12/9/1974	570.01	**1.98**	4/27/1981	1013.87	**1.68**	77.9%
8/9/1982	769.98	**2.61**	8/25/1987	2694.83	**1.13**	250.0%
10/20/1987	1616.21	**1.10**	1/14/2000	11612.53	**0.55**	618.5%
10/9/2002	7286.27	**1.40**	10/9/2007	14164.53	**0.82**	94.4%

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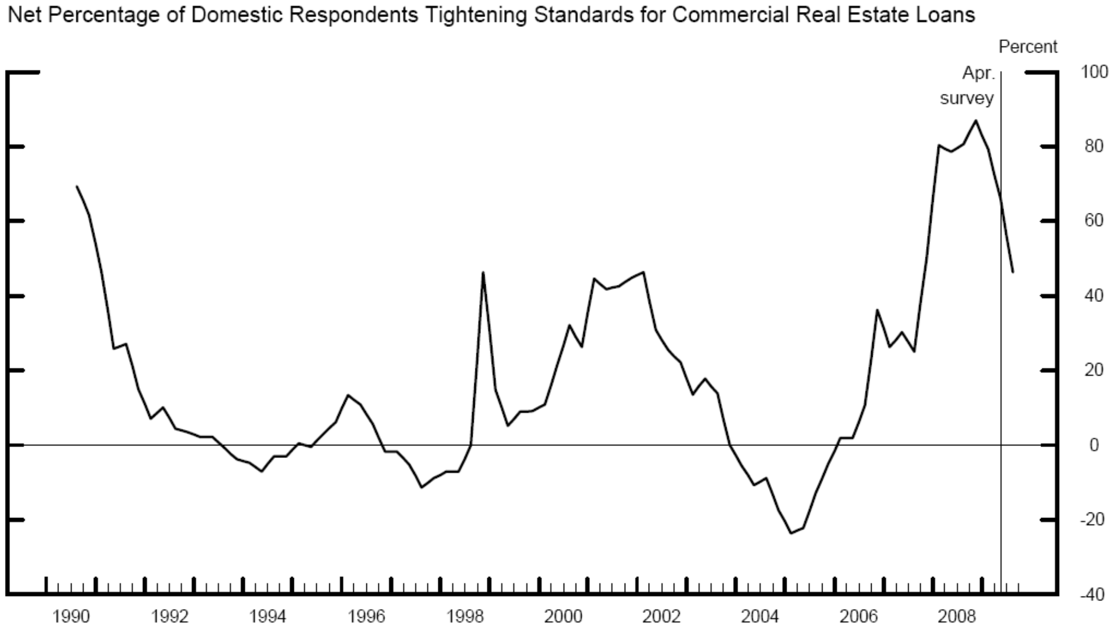

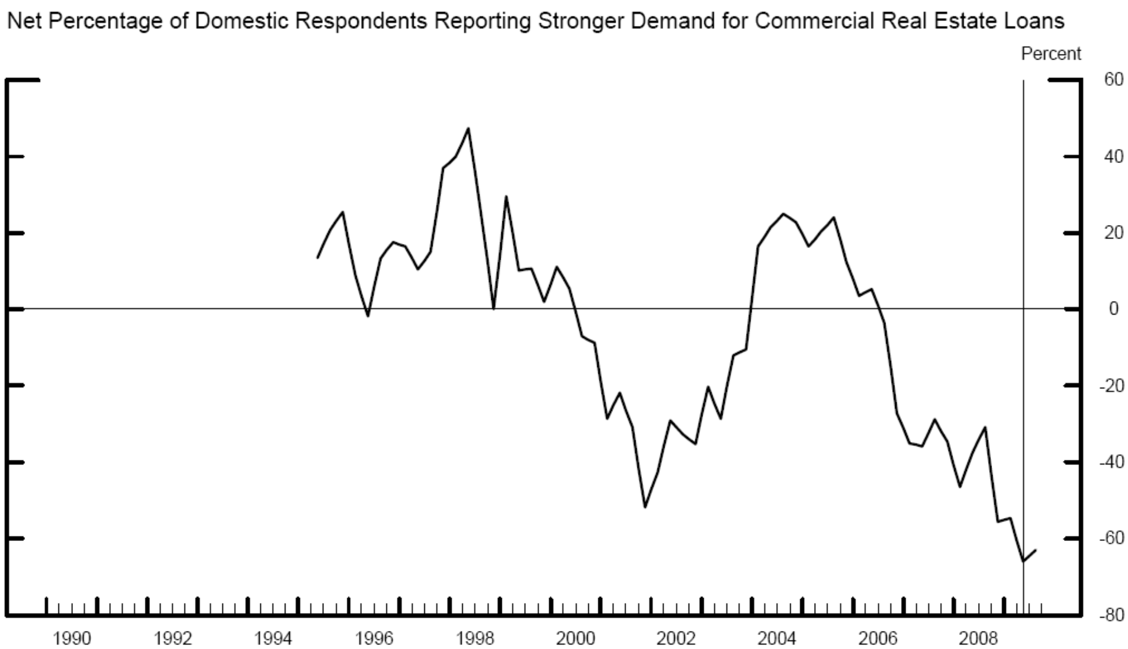

Source: Federal Reserve

What about real estate? The Federal Reserve carries out the same lending survey with regard to commercial real estate and it is following almost the precise trajectory as the survey for commercial and industrial loans.

At the same time, the Federal Reserve also does a similar survey assessing the demand for commercial real estate loans. Not surprisingly, it is at very low levels.

Approximately 80% of respondents are reporting less demand for loans with only 20% reporting similar or greater demand. From a real estate

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investor's standpoint this provides an interesting time to be looking at new opportunities. Capital is difficult to access, the economy and financial markets have probably bottomed, the cost of capital is coming down from extreme levels which created shocks to the system, and there will be owners who will be forced to sell, providing opportunities to those with the track record and capital access to take advantage of such situations. In addition, there is strong demand among investors for securities backed by apartment loans generated by Fannie Mae and Freddie Mac. With our very strong relationship with both companies and the yield on new investments higher than the cost of their debt, CWS believes that it is very well-positioned to prosper in this capital constrained, but hopefully opportunity-rich environment.